



The Governance
Institute

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Statutory audit market study
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1 November 2018

Dear Sirs

Statutory audit market - invitation to comment

We welcome the opportunity to contribute to your market study on the statutory audit market.

ICSA: The Governance Institute is the professional body for governance. We have members in all sectors and our Royal Charter purpose is to lead 'effective governance and efficient administration of commerce, industry and public affairs'. With more than 125 years' experience, we work with regulators and policy makers to champion high standards of governance and provide qualifications, training and guidance. ICSA is the professional body that qualifies Chartered Secretaries, which includes company secretaries. Company secretaries have a key role in companies' governance arrangements, including the development of governance policies, the application of and compliance with the UK Corporate Governance Code, supporting the board on all governance matters, and in companies' relationship with investors. Our members are therefore well placed to comment on the issues arising in the audit market and on the board's perception of issues such as auditor availability and independence.

In preparing our response we have consulted, amongst others, with a number of groups of our members, including the ICSA Company Secretaries Forum, a group of company secretaries from more than 30 large UK listed companies from the FTSE 100 and FTSE 250. However, the views expressed in this response are not necessarily those of any individual members of any of these groups, nor of the companies they represent.

We set out below some general comments, followed by our responses to specific questions set out in the call for evidence. As The Governance Institute, our focus is on the governance issues raised by recent audit failures rather than the impact of specific accounting decisions.



PART 1 – GENERAL OBSERVATIONS

We believe that a review of the audit market is important. In our view this should be focussed not only on what audit is supposed to achieve and how well it does so, but also on the difference between what audit is supposed to achieve and the press and public expectation of audit and of auditors.

In our response to Sir John Kingman's review of the Financial Reporting Council, we noted that he will "receive a number of responses to this call for evidence. Many will be sensible and well-considered, but there is a risk that some will be self-serving, advancing private interests or grinding axes over existing disputes with the FRC. We are pleased to see that the scope of the review specifically excludes some of these, but we would counsel caution over adopting some of the more radical options that will be put before you ... We will leave those with greater technical accounting expertise to comment on the culpability of regulation and accounting standards for those market failures, but there is a real risk that change for change sake may make things worse, rather than better. Whilst we agree that some change ... is necessary, this should not be allowed to adversely affect those areas ... which work most effectively." We would respectfully offer the Competition and Markets Authority the same warning.

PART 2 – RESPONSES TO SPECIFIC QUESTIONS

A) Issues

1. How well is the audit sector as a whole serving its stakeholders?

Theme 1: The audit framework

2. How well does the audit framework support the interests of both direct shareholders and also wider stakeholders in the economy?

The answer to both these questions depends very much on the far more difficult questions of who are the stakeholders of a statutory audit and what is its purpose. Paragraph 2.26 of the invitation to comment captures this issue quite well in its analysis of the 'expectation gap'. That is, that "Stakeholders' expectations of statutory audit may differ from what it is required to provide by law. Sources of this gap may include expectations some stakeholders have of auditors in providing assurance on the business's future viability."

As we noted in our response to Sir John Kingman's review, "There is an important education issue here – the political, press and public expectation of the role of audit is very different from what an auditor would perceive it to be. Whether this education should be undertaken by the FRC, perhaps through the Auditing Practices Board and funded by an increased levy on audit firms, which we believe to be the better solution or by the accountancy profession itself is a matter for them. Equally, whether the law or regulation should be changed to bring those two views into line is a matter for the government and/or the FRC."

As the invitation to comment notes in paragraph 2.25, International Financial Reporting Standards have developed "over time from an approach based on historic cost accounting to that based on fair value accounting. The key principle is that assets and liabilities should be valued on market prices, based on the idea this would make the financial statement more 'useful to users'. Some commentators have argued that fair value accounting has led to greater risk because of the difficulty, and subjective nature, of valuing and auditing certain assets and liabilities." We leave the debate over which approach to accounting standards is correct to those better qualified, but we do offer the observation that a number of the 'accounting scandals' that we have seen in recent years have at their heart questions of judgement. Whether particular value could, or should, be regarded as crystallised in the accounts should, in our view, be a question of fact rather than of opinion – either it is yours or it isn't. It should not

be possible for one accountant to draw up the books for a period and have them audited against current accounting standards and for another to perform the same exercise, for the same period, have it audited by a different auditor and find many millions of pounds difference. We cannot recall a single occasion when such a restatement has ensued to the benefit of shareholders. In our view, a detailed examination of the appropriateness of the use of fair value accounting would be an extremely useful first step in improving the quality of audit.

Theme 2: Incentives and governance

3. To what extent do the decisions made by audit committees support high-quality audits, whether through competition for audit engagements or otherwise?

We believe that the audit committees of the overwhelming majority of public companies do make decisions which support high-quality audits.

We were struck by the assertion in paragraph 3.19 of the invitation to comment that “Audit is a service for shareholders, but is commissioned by company management.” In our experience, this is not the case. The audit committee of most larger corporates consists of independent non-executive directors who have been appointed by shareholders to address the ‘principal-agent problem’. The Competition Commission’s strengthening of the powers of the audit committee in most cases simply reflected existing practice. There are, undoubtedly, cases where shareholders have not required companies to adopt the audit committee model, and this does risk management having undue influence on the appointment of the auditor, but that is their choice.

4. How has this changed following the Competition Commission’s intervention?

We are not aware of evidence that the Competition Commission’s intervention has affected the degree to which the decisions made by audit committees support high-quality audits or, indeed, of evidence that the audit market has been improved by more frequent tendering, although we believe that it probably has. Where the intervention has been useful is in creating a greater reliance on the audit committee in cases where this was previously lacking.

Theme 3: Choice and switching

5. Is competition in the audit market working well? If not, what are the key aspects hindering it?

6. In particular, how effective is competition between the Big Four and between other firms and the Big Four?

In paragraph 2.20(b) of the invitation to comment there is a reference to “the unwillingness of larger corporates to appoint the mid-tier auditors”. This argument is further developed in paragraph 3.26 where it is stated that “the majority of audit committee chairs for FTSE 350 companies would not consider a mid-tier firm to be a credible auditor for the scale and complexity of their businesses. In particular, for FTSE 350, or other large companies, with significant international operations, there is a perception that only the Big Four have sufficiently developed international networks to service such accounts.”

This is important, but is untrue insofar as it places responsibility on larger corporates alone. In our view, the chief weakness of the audit market is the lack of confidence, not just on the part of companies, but also on the part of investors and, we understand, some regulators, in the ability of auditors outside the Big Four to provide an audit of an adequate standard for large, particularly multi-national, companies. In some cases, this perception may be unfounded but in others, especially more complex international companies, there is some evidence to suggest that

only the very largest audit firms have the range to carry out an audit of an appropriate standard. We would suggest that the accuracy of this perception should be tested by an independent body and the CMA may be well placed to undertake this task. If it can be shown that mid-tier firms are up to auditing the very largest companies then we believe that companies, investors and regulators will welcome them with open arms. If, on the other hand, it is shown that they are not, alternative solutions will be necessary.

7. How has this changed following the Competition Commission's intervention?

Our understanding is that larger corporates have been more willing to consider a mid-tier firm as part of the audit tender process but, as Grant Thornton have publicly stated, no more willing to actually move to one. The attitudes of their shareholders and regulators inevitably play a part in this reluctance and there is much truth in the aphorism that "no-one was ever fired for hiring IBM."

8. What is the role for competition in the provision of audit services in delivering better outcomes (i.e. consistently higher quality audits)?

We are not persuaded that there is a role for competition in this regard. Certainly we believe that there is a much more significant role for audit standard setters and regulators.

9. In practice, how much choice do large companies and public interest entities have in the appointment of an external auditor?

10. What are the key factors limiting choice between auditors?

In theory they can choose any of the Big Four or any mid-tier firm that is up to the job. In practice, in some cases, we are told that there is little or no practical choice when those Big Four firms which are otherwise conflicted, whether through consultancy work or prior relationship with executive or non-executive directors, and those mid-tier firms that do not have the capability have been ruled out

This problem is exacerbated where a larger corporate with multi-national interests is concerned where even one of the Big Four may lack the necessary scope. We have been told of at least one case where two of the Big Four provided significant consultancy services for a FTSE company, leaving them with, potentially, a choice of one auditor other than the incumbent who they perceived able to do the work.

11. What are the main barriers to entry and expansion for non-Big Four audit firms?

We defer to the views of mid-tier audit firms on the issue of expansion. On barriers to entry we believe the principal one is as outlined above – the issue of confidence. We do not believe that there is evidence of the practice reported in paragraph 2.25 of the invitation to comment whereby Big Four firms make it difficult for mid-tier auditors to win audit contracts with FTSE 350 clients by pricing their statutory audit offer relatively low.

Similarly, we are not persuaded that there is significant evidence to support the assertion in paragraph 3.26b that the presence of alumni of the Big Four firms in audit committees and company management give those firms a competitive advantage. It seems to us that it is desirable that companies employ individuals who have expertise in accountancy and audit in their finance teams and on their audit committees. In our experience, and given the preponderance of the "big 4" firms in training the better accountants and auditors, it would be more surprising were their alumni not to be employed. We wondered whether there is a little 'conspiracy theory' in this debate. However,

we have been told that a study a few years ago of the firms with which FTSE CFOs trained, compared with where their team members trained and the company auditor, did show a stronger than expected correlation. This may be a piece of work for the CMA or one of the auditing professional bodies to revisit.

There is an underlying issue here, relating to the 'revolving door' between audit firms and their clients and we are aware that individual firms have their rules but even a period of, say, six months gardening leave is unlikely to deter an ambitious audit manager from moving in to a senior role in a client firm in the FTSE 350 as the Financial Controller or the Financial Accountant. In our view, this is an issue that needs to be addressed across the audit sector, probably by the APB or the professional membership bodies rather than by self-denying ordinances adopted by individual firms. We understand that at least one of the Big Four firms works to a rule of thumb that approximately 35% of each year's new intake of trainees will be expected to move out of their firms to other employment at the end of three years i.e. after qualifying. This is a feature that is not unique to this market and in our view it is up to the audit committee and the board to ensure that any conflicts of interest that do arise are properly managed and disclosed.

Theme 4: Resilience

12. Is there a significant risk that the audit market is not resilient? If so, why?

This is a question better directed at the Financial Reporting Council. We are not aware of any evidence of a specific risk, although intuitively there must be risks in a market so dominated by the Big Four. One of the questions posed by Sir John Kingman was whether the FRC "is too concerned with the risk of failure of one of the "big 4"" and our response was that, "Given the focus already on the dominance of the "big 4" it seems to us that any further contraction of the market would be detrimental and so the FRC is right to be concerned about "big 4" failure." In our view, the reason for any lack of resilience is likely to be the dominance of so few providers and the perceived gap between them and the next tier.

Theme 5: Regulation

13. What is the appropriate balance between regulation and competition in this market?

As in any other market, regulation should promote competition, but recognise the tendency of market forces to consolidation. It should regulate against anti-competitive practices but not interfere with the legitimate workings of the market.

B) Potential measures

14. Please comment on the costs and benefits of each of the measures in Section 4 and how each measure could be implemented.

See below.

15. Are there any other measures that we should consider that address the issues highlighted in section 3? If so, please describe the following: a) aim of the measure, b) how it could be designed and implemented, and c) the costs and benefits of each such measure.

As outlined below, in our view there are a number of actions that could be considered, but the fundamental requirement is to improve the quality of the work done by the appointed auditor. Part of this, in our view, is a training issue to foster a greater spirit of professional scepticism among auditors, moving beyond what Lord

Denning described as “an enquiring mind” but also revisiting accounting standards to give greater clarity on where judgement has been applied by both the preparer and auditor.

Restrictions on audit firms providing non-audit services

16. One way to create audit-only firms would be through separate ownership of the audit and non-audit services practices of the UK audit firms. Could this be effective, and what would be the relative scale of benefits and costs?

We cannot comment on the potential costs of this option. However, we are doubtful of its efficacy. There is a considerable body of evidence that in many cases non-audit services are more remunerative than audit services, particularly as we rightly see greater restrictions on the former (although we do believe that a review of non-audit services would be sensible, as there are some which it seems utterly logical and far more cost-effective for the auditor to carry out, that is something of a side-issue). The natural tendency within firms will, therefore, be for the ‘brightest and best’ to move towards the better remunerated consultancy roles and leave the basic audit work to others. We do not see how this will serve to improve the standards of auditing.

In terms of the perception that audit fees are too low and are being subsidised by non-audit work, we believe that the restrictions on non-audit work have largely mitigated this risk. We would not suggest that the CMA take any action to increase audit fees.

17. How do the international affiliations of member firms affect the creation of audit only firms? What is the extent of common ownership of audit firms at the international level?

In an increasingly global market, it will be difficult for an audit firm to offer the level of service required by larger corporates without appropriate international affiliations. One of the consistent issues that affect such firms is that of subsidiary governance, ensuring that local business units are complaint within the jurisdiction in which they are based. This includes the need to comply with local accounting practices and auditing standards as well as those applicable to the international parent, which takes local knowledge and, therefore, usually a local auditor.

18. What should be the scope of any measures restricting the provision of non-audit services? For example, applying to the Big Four only, the Big Four and the mid-tier audit firms, or any firm that tenders for the audits of large companies and PIEs?

We do not believe that there should be any such measures as we do not believe that they will be effective in improving the standard of audit. We have heard some anecdotal evidence that partners in other areas of practice within Big Four firms are becoming irked by damage to the brand associated with the exposure of deficient audits and the need for them to defend audit scandals when they are pitching for business. Internal pressure of this kind brings a commercial imperative for audit firms to improve their own quality and this will be lost if the businesses are separated.

Market share cap

19. How should the market shares be measured? - number of companies audited, or audit fees or some other measure?

20. Could the potential benefits (greater choice, and resilience) of a market share cap be realised?

21. What do you consider to be the relative scale of the costs of a market share cap, such as increased prices and potentially reduced competition, and potential benefits?

22. What should be the appropriate level of such a cap, collectively for the Big Four for the measure to achieve its objective? For example, 90%, 80%, 70%?

We see the concept of a market share cap for any individual firm as fundamentally anti-competitive and in any event do not believe that one will materially improve the quality of audit services. Were one to be introduced, we think this would need to be a numerical cap rather than a cap by value or some other model as it will be difficult for those outside the market to understand how other than a numerical cap is calculated and it will be subject to, or at least perceived as subject to, gaming.

Apart from the anti-competitive nature of a market share cap, we have concerns about whether the next tier of audit firms would be willing to make the necessary investment to encourage the development of the confidence in their ability to provide an effective audit for larger corporates that is so conspicuously lacking at present. Even if they were, would this be the perception?

23. Could a joint audit be an effective means of implementing a market share cap?

We have seen no independent evidence that joint audit is effective. Whilst it is advanced by some, it is our experience that this is generally by those who have a commercial interest in its introduction. We have concerns that a joint audit will inevitably increase costs for companies, both financially and in terms of management time, and create confusion. What will be the position if the joint-auditors disagree about a particular treatment?

Incentives and governance

24. Should the auditors and those that manage them (e.g. audit committees, or an independent body as described in section 4) be accountable to a wider range of stakeholders including shareholders, pension fund trustees, employees, and creditors, rather than the current focus on shareholders?

As we noted above, the questions of who are the stakeholders of a statutory audit and what is its purpose are fundamental to a review of the statutory audit market. The law is clear that directors owe duties primarily to shareholders, albeit with an obligation to 'have regard' to stakeholders amongst other factors. This suggests that the primary purpose of the statutory audit should be to give assurance to investors. However, as paragraph 2.26 of the invitation to comment notes, "Stakeholders' expectations of statutory audit may differ from what it is required to provide by law." It seems to us that there is an increasing focus on a company's obligations to its stakeholders and, to that extent, that auditors should have some accountability towards them. But is it reasonable to expect auditors to shoulder the burden of responsibility for the future performance of an audited organisation as the press, public and politicians sometimes seem to expect? Unless and until the directors' duties under the Companies Act are changed, we would suggest not.

25. If yes, should audit committees (in their current form) be replaced by an independent body that would have a 'public interest' duty, including for large privately-owned companies? Should this body be responsible for selecting the audit firm, managing the scope of the audit, setting the audit fees and managing the performance of the audit firms?

26. Please describe the benefits, risks and costs of such an independent body replacing audit committees.

We see no benefits from the creation of yet another regulatory body in this space and are not convinced that the evidence of poor quality audits is sufficient to justify further activity. It seems to us that the increased focus on the responsibility of the audit committee for ensuring the quality of the audit received and more proactive enforcement by the regulator in the event that audits are found to be sub-standard will be more effective.

27. Should companies be required to tender their audits and rotate their auditors with greater frequency than they currently are required to do? What would be the costs and benefits of this?

We do not believe that more frequent audit rotation will be helpful. It takes a period of time for an auditor to understand a client's business properly before the audit really adds value. We understand that in the first year of many new audit engagements much of the discussion revolves around financial practices within the business which, on examination, reflect the way in which they were recommended to perform that activity by the previous auditor.

We hope you find our comments helpful and would be happy to expand on any of these points should you wish to discuss them further.

Yours faithfully

A handwritten signature in black ink, appearing to read 'Peter Swabey', with a large, sweeping flourish above the name.

Peter Swabey

Policy & Research Director