March 18, 2013

By email to auditors@cc.gsi.gov.uk

Inquiry Manager
Statutory Audit Investigation
Competition Commission
Victoria House
Southampton Row
LONDON
WC1B 4AD

Dear Sirs:

Re: Statutory Audit Services Market Investigation

We are pleased to provide comments on the Issues for Comment in the Statutory Audit Services Market Investigation Notice of Possible Remedies Under Rule 11 of the Competition Commission Rules of Procedure (Notice) resulting from the Competition Commission (CC) provisional findings report (Report) issued in February 2013. The CC detailed investigation on audit market concentration in the United Kingdom is of great interest given the global reach of the companies and their external auditors under review.

Our response is based on an intensive initiative undertaken to consult with Canadian stakeholders on global proposals. The Canadian Institute of Chartered Accountants (CICA), which represents chartered accountants involved in large, medium and small accountancy practices, and in all sizes of corporations, and the Canadian Public Accountability Board (CPAB), which is the Canadian body charged to inspect auditors of public corporations, collaborated in the initiative, which focuses on three interrelated key areas in enhancing audit quality – the independence of external auditors, the role of audit committees, and auditor reporting. Discussion Papers were prepared by three working groups and coordinated by an independent steering group, which I chair. Global proposals in the three areas of focus were examined to determine their effect on audit quality. They considered several of the remedies on which input is being sought by the Competition Commission and these are the focus of our response. More information about the CICA/CPAB initiative can be found at www.cica.ca/enhancingauditquality. We commend these documents to the CC as they provide detailed information on the recommendations of the Canadian initiative.
Overall comments

We support the CC in recognizing the importance of high quality independent external audits to the financial reporting process and the credibility of financial reporting. We agree that it is important that there be a robust and thriving external audit marketplace with appropriate levels of competition. In this respect, we applaud the CC for having undertaken such a thorough and comprehensive review of competition issues in the UK audit marketplace. The CC’s findings will be an important reference as other jurisdictions, including Canada, consider competition issues.

We note that audit quality is only peripherally referenced as a factor in choosing the remedies to address perceived adverse effects on competition. Our response places significant emphasis on audit quality. This reflects our belief that any proposed changes should not negatively impact audit quality and should, preferably, increase audit quality because audit quality is a key factor in supporting credible, high-quality financial reporting.

The Notice also does not address how potential remedies might have global implications. Many large UK companies and their external auditors operate in a global environment. We therefore believe that competition remedies need to be considered in relation to the global context as UK-centric solutions could have unintended consequences. In particular, there are various other global bodies that are in the process of considering many of the potential remedies in the Notice. If different bodies were to arrive at different conclusions as to such remedies we believe that this may cause significant friction in the functioning of audits globally. We therefore encourage efforts to reach consistent solutions on a global basis.

Independence and professional conduct rules for external auditors address familiarity threats at the individual level between management and the external audit team through partner rotation rules. However, the financial environment is now identifying concerns about familiarity and self-interest threats between audit firms and the companies they audit at the institutional level resulting from long tenure of an audit firm. Such threats have become known as “institutional” familiarity threats. There is a perception that audit firms could develop an overly close relationship with clients over time, which may create a threat to independence that impedes the ability of the firm and, more specifically, members of the engagement team, from exercising an appropriate level of professional skepticism. In evaluating these threats we considered each of mandatory tendering, mandatory firm rotation and mandatory comprehensive audit firm review (MCAR) in the context of their effectiveness as a safeguard against the threats as well as their potential impact on transparency, audit quality, governance and the work effort/cost to implement. We strongly recommend that the CC consider MCAR as an alternative to mandatory firm rotation or mandatory tendering. This possible remedy is discussed in detail in the body of our response. In our view it is the only alternative that addresses institutional familiarity threats in a context that promotes audit quality.
Summary of our views on possible remedies being considered by the CC
The following are our views on remedies that were specifically considered as part of the CICA/CPAB initiative. Remedies 3, 4 and 6 are not addressed.

Remedy 1: Mandatory tendering: We do not support mandatory tendering because of the potential negative consequences to audit quality and associated corporate governance.

Remedy 2: Mandatory rotation of audit firm: We do not support mandatory rotation of the audit firm for the same reasons as mandatory tendering.

Remedy 5: Strengthened accountability of the External Auditor to the Audit Committee (AC): We support strengthened accountability of the external auditor to the AC.

Remedy 7: Extended reporting requirements: We support efforts by the International Auditing and Assurance Standards Board (IAASB) to develop standards for improving the auditor’s report.

Observations on some of the CC’s provisional views in the Report
In the Appendix, we include a number of observations on some of the CC’s provisional views in the Report.

Please contact me if you have any questions or require clarification on our response.

Sincerely,

David Brown, C.M., Q.C.
Chair
CICA/CPAB Enhancing Audit Quality Steering Group
**Mandatory comprehensive audit firm review**

MCAR puts an onus on the AC to consider, and report on, the external auditor’s independence in both mind and appearance, as well as the application of its professional judgment and external auditor skepticism. The disclosure requirements would improve transparency around the external auditor evaluation and reappointment process. The primary focus of this concept is on how audit quality can be enhanced. The CICA/CPAB Independence Working Group (IWG) recommended consideration of a comprehensive review led and driven by the AC at least every 5 years and the current practice of a yearly assessment of the external auditor would continue.

ACs are directly responsible for overseeing the work of the external auditor, including resolution of disagreements between management and the external auditor regarding financial reporting. The objective of the MCAR is to drive a behavioural change in the quality of the interaction between the ACs and the external auditors, and within the culture of the audit teams and audit firms. The resulting behavioural change should lead to improved audit quality and transparency for shareholders, as well as a better understanding of the external auditor’s independence, objectivity and demonstration of professional skepticism.

The key points raised during the discussion by the IWG are summarized below:

- A mandatory review process would promote the assessment of audit quality, independence and professional skepticism and would influence audit firms to enhance audit quality so that they will do well in the review assessments.
- As external auditors’ tenures increase, there is a greater risk of familiarity threats to independence.
- To ensure that MCARs are effective and avoid possible management bias, the AC needs to make the required assessments. Although this would increase the burden on the AC, the time required may well match up with what would be required under mandatory audit firm rotation and tendering.
- One of the components of the process will include information from audit regulator findings.
- The IWG also considered whether a multi-year fixed audit term (e.g., term of a minimum of 3 years or more) could enhance the culture of skepticism and objectivity because there would be diminished concern of the external auditor being terminated. The IWG did not support this proposal as it would constrain the AC’s accountability and responsibility for assessing and appointing the external auditor.
The CICA/CPAB Audit Committee Working Group (ACWG) supported the IWG’s recommendation that the AC should perform an MCAR every five years and suggested the MCAR and partner rotation not occur in the same year. An MCAR conducted every five years can focus on areas that the annual assessment cannot do, such as focusing on the audit firm and any institutional familiarity threats potentially created by increased audit tenure. It is a solution that better addresses the issues that the proposals of mandatory audit firm rotation or mandatory tendering of audits are intended to resolve by including an evaluation of audit quality. The ACWG considered that the comprehensive review should consider the following:

- Significant factors related to changes and trends in the audit firm’s performance and qualifications not evident from a year over year assessment would become clearer. For example, in assessing an audit firm’s expertise in a particular industry, departures of industry specialists or changes in the firm’s client base in the industry may not be material year over year but, over a five-year period, a significant change may be evident.
- Similarly, some aspects of an issuer’s business or its operating environment may change only marginally from year to year but, when considered over five years, it may become obvious that the external auditor’s expertise is not keeping up. For example, the issuer may do a small but increasing amount of business in a particular industry segment where the audit firm has no other clients; over a five-year period, this business may have increased to the point that another audit firm with expertise in that segment would better meet the issuer’s needs.
- The annual assessments of an audit firm may have been generally satisfactory but, when the AC reviews the findings over five years, it may find that the responsiveness to suggestions for improvement from regulators, the AC and/or management, has fallen short of expectations.
- When there has been some turnover in the membership of the AC, the committee may find it more difficult to assess or discern year-to-year changes in its external auditor’s performance, which may be more evident over a five-year period. This might be particularly true in subjective areas, such as the degree of skepticism exercised by external auditors when challenging key estimates made by management.
- Irrespective of the continuity in composition of the AC, it may be easier to identify changes in facts and circumstances over a five-year period that have created independence threats. Similarly, it may be easier to identify a lack of adequately challenging management’s assumptions or deterioration in the application of professional skepticism when reviewing an extended period.
- There may be assessment challenges when an issuer’s finance department personnel experiences significant turnover. The AC’s questions of the finance personnel on changes in the external auditor’s performance may elicit relevant information in these circumstances over a period of five years than a shorter period.
The scope of the MCAR should generally include reviewing and evaluating the following factors and how the audit firm has applied them to the audit:

- Safeguards against institutional independence familiarity threats.
- Quality of communications from the audit firm.
- Manner in which the audit firm ensures that the auditor has exercised professional skepticism.
- Results of the annual assessments (including communications received about CPAB inspections) since the previous comprehensive review and how the firm has responded to these assessments.
- Quality of the engagement team the firm has provided since the last comprehensive review, including technical and industry expertise.
- Quality and relevance of thought leadership shared by the auditor and any new accounting pronouncements or regulatory requirements.
- Transparency of communications from the auditor, particularly with respect to resolving any controversial accounting or audit issues.
- How the firm handled any partner rotations during the period.

The ACWG and IWG concurred that ACs should conduct an MCAR of the external audit firm at least once every five years. An MCAR would have a broader scope than merely addressing the institutional familiarity threat; it also offers ACs the significant benefits of augmenting their annual assessments and focusing on how their audit firm ensures that its audits are of high quality, including ensuring that the auditors have exercised appropriate professional skepticism, as well as permitting ACs to better evaluate the continuous improvement culture of the audit firm.

**Detailed comments on possible remedies**
The following are our detailed comments on possible remedies presented in the Notice.

**Remedy 1: Mandatory tendering**
The IWG noted that the arguments supporting mandatory tendering claim that it would:

- motivate audit firms to enhance its audit quality as reappointment can no longer be presumed;
- encourage ACs to assess auditor performance in greater detail;
- compared to mandatory audit firm rotation, increase transparency relating to AC decisions on audit appointments;
- provide an environment that reduces the institutional familiarity threat to auditor independence, thereby improving auditor skepticism and audit quality; and
- increase competition in the audit market and open up opportunities for smaller and mid-tier audit firms to grow.
The IWG also raised the following points in discussing mandatory tendering:

- The timing for tendering of the audit is best left to the judgment of the AC, not based on an arbitrary rule. Using an arbitrary time frame for a change could cause hardship for a company if it would occur at an inopportune time (e.g., when a major transaction is occurring) and would not then be in the best interests of the company’s shareholders.

- The tendering process may be focused on audit fees rather than audit quality. Competitive pressure on fees in the audit market over time can negatively impact audit quality.

- There may be an increased self-interest threat as an auditor may not challenge management as aggressively as before because of the fear of losing the audit of engagement as the firm approaches the tendering period.

- AC focus could be more on evaluating potential new audit firms and audit fees, rather than on the audit quality and independence of the incumbent firm.

- Mandatory audit firm tendering would add time and costs for both management and the external auditor – even though the same external auditor may well be appointed. The company would also incur costs for educating new external auditors (if a new auditor is appointed) on the company’s operations, systems, business practices, and financial reporting processes. Shareholders indirectly bear these costs.

- The choice in a successor external auditor could be limited because providers of certain non-audit services to the company would be ineligible to be appointed as the new external auditor. Companies in specialized industries (e.g., financial institutions) or with a global footprint could be particularly affected by such a limited choice.

The IWG did not support mandatory tendering because of the potential negative consequences to audit quality and associated corporate governance. The intrusion into the marketplace for audit services is disproportionate to the significance of the problem the concept is addressing (e.g., institutional familiarity risks given that other alternatives exist). Its preferred option is mandatory comprehensive audit review, discussed further above.

Other comment:

- Paragraph 22 of the Notice states that the CC proposes that tendering should be conducted on an “open book” basis. While it may be possible to change regulations in the UK to go beyond current regulations, this proposal could be difficult to implement for large public companies that have extensive global operations involving external auditors in different jurisdictions that are subject to different regulations in terms of communications between successor and predecessor external auditors.

**Remedy 2: Mandatory rotation of audit firm**

Mandatory audit firm rotation would prevent long tenures of audit firm appointments. Proponents of mandatory audit firm rotation suggest that it would enhance auditor independence and would increase audit quality by:
- preventing audit teams from building unduly familiar relationships with management of companies they audit;
- bringing the fresh and objective perspective of a new audit firm;
- encouraging increased audit quality because successor audit firms would review work of the incumbent audit firms; and
- reducing institutional familiarity threats.

The European Commission (EC) also argues that mandatory audit firm rotation would address market concentration by encouraging the appointment of smaller audit firms and make the market for audit services more dynamic.

The IWG raised the following points in discussing mandatory audit firm rotation:

- Mandatory rotation would result in a loss of cumulative audit knowledge gained over the years at arbitrary intervals, resulting in a higher risk of undetected financial statement misstatements.
- Under a mandatory audit firm rotation regime, disagreements between the external auditor and the company may become less transparent.
- Audit quality may suffer during the early years of a new appointment as the external auditor is still gaining sufficient knowledge of the company.
- Auditor rotation would increase the amount of time management spends during a transition on educating the new external auditors on the company’s operations, systems, business practices, and financial reporting processes. Shareholders indirectly bear these costs.
- An external auditor may be less likely to address longer-term issues that fall outside their term of service.
- Competitive pressure on fees during the tendering process may create long-term negative impacts on audit quality.
- Mandatory audit firm rotation would reduce the accountability and responsibility of the AC for periodically assessing the performance of the external auditor and, based on that assessment, for determining if and when to require a rotation or tendering of the audit.
- An arbitrary time frame for changing external auditors could cause hardship for a company if it were to occur at an inopportune time (e.g., when a major transaction is occurring) and would not then be in the best interests of the company’s shareholders.
- Mandatory rotation could be problematic in some smaller regions, particularly in specialized industries. The number of audit firms with the requisite qualifications and familiarity with reporting issuers and its accounting, auditing and reporting requirements, as well as having appropriate staffing levels and independence, may be limited in certain geographic areas. Even if audit firms that meet the general and technical requirements may be available in those regions, these audit firms may lack experience with respect to specialized industries.
The AC could be more focused near the end of the audit term on evaluating potential new audit firms and audit fees, rather than on audit quality and independence of the incumbent audit firm.

The choice in a successor external auditor could be drastically limited because providers of certain non-audit services to the company would be ineligible to be appointed as the new external auditor. Companies in specialized industries (e.g., financial institutions) or with a global footprint could be particularly affected by such a limited choice.

Most countries do not have mandatory audit firm rotation. Some have considered it but rejected it. Others have adopted it but later reversed it.

Extensive safeguards already exist to maintain auditor independence and objectivity including:

- mandatory audit partner rotation
- internal audit firm reviews of the audit partner and audit engagement
- external inspections by audit inspectors
- second partner quality review required on each engagement
- audit firm internal quality control procedures
- oversight by the AC of the independence of the external auditor.

The IWG did not support mandatory audit firm rotation because of the potential negative consequences to audit quality and associated corporate governance. The intrusion into the marketplace for audit services is disproportionate to the significance of the problem the concept is addressing (e.g., institutional familiarity risks given that other alternatives exist). Its preferred option is mandatory comprehensive audit review, discussed further above.

Other comment:

- As discussed above with respect to mandatory tendering, the proposal that tendering should be conducted on an “open book” basis could be difficult to implement for large public companies that have extensive global operations involving external auditors in different jurisdictions that are subject to different regulations in terms of communications between successor and predecessor external auditors.

Remedy 5: Strengthen accountability of the External Auditor to the AC

The ACWG believes that the role of the AC in fostering audit quality is to focus on independence and professional skepticism of the external auditor and to contribute to audit effectiveness in its oversight capacity. In this respect, the ACWG raised the following points in discussing the role of the AC and the external auditor that reflect the importance of strengthening the relationship between the external auditor and the AC:

- The AC has specific responsibilities for oversight of the work of the external auditor and that effective oversight of the work of the external auditor should help safeguard the auditor’s independence while contributing to the quality and effectiveness of the audit overall.
• There needs to be a mutually respectful working relationship between the external auditor and the AC and, in particular, between the lead audit partner and the audit committee chair (ACC).

• The AC should take action whenever it senses that communications between management and the external auditors are starting to deteriorate, or that there are increased risks to the organization’s culture of integrity in the financial reporting function.

• The absence of a respectful professional relationship between any combination of the AC, management and the external auditors would be detrimental to the independent audit process.

• The AC needs to consider the reasonableness of the audit fees and discuss with the engagement partner regarding the reasonableness of the fee in relation to the size, complexity and risk of the engagement compared to similar engagements; impact of changes on the organization’s risk profile, investment, or lack thereof, in control systems, IT, internal audit, etc.; discussion on how the engagement partner ensures both effectiveness and efficiency (such as external auditors’ use and leverage of IT, internal audit, etc.) in conducting the audit; impact of any changes in scope, any inefficiency such as delays in management’s delivery of audit support, multiple versions of key documents, etc.

• ACs should review the proposed audit fee in conjunction with the audit plan and assess whether the fee will adequately support the execution of the audit plan in full. In formulating their views on the appropriateness of the audit fee and plan, it may be helpful for ACs to hold discussions with management on the key risks facing the entity and changes in the business that may affect the audit fee and plan. Nevertheless, ACs remain responsible for recommending the audit fee for board approval; this decision cannot be delegated to management.

• Each year, ACs should assess the effectiveness of the external auditor in fulfilling their responsibility to make an informed recommendation to the Board on whether the external audit firm should be put forward for reappointment at the annual general meeting. This annual evaluation should, at a minimum, encompass an assessment of the qualifications and performance of the external auditor; the quality and candour of the external auditor’s communications with the AC and management; and the external auditor’s independence, objectivity and application of professional skepticism exhibited in conducting their work. The assessment should be reviewed with the external auditor to help the external auditor continually improve their effectiveness and performance. The AC should obtain management input to the assessment.

• The ACWG believes that the AC should conduct a comprehensive review of the audit firm every five years in addition to the annual assessment of the audit engagement, as discussed further above. This would be of greater depth and breadth than an annual assessment and would safeguard external auditors against institutional familiarity threats.
We believe that the role of the AC outlined by the ACWG serves to strengthen the accountability of the external auditor to the AC and increases the independence of the external auditor from management.

**Remedy 7: Extended reporting requirements—in either the AC’s or auditor’s report**

The Discussion Paper issued by the CICA/CPAB Auditor Reporting Working Group (ARWG) provides its views on auditor reporting proposals made by various international bodies.

- CICA/CPAB is supportive of the efforts being made by the IAASB to develop standards for an improved auditor’s report.
- We also support efforts to achieve consistency in auditor reporting globally so as to avoid confusion among stakeholders as to the audit process and audit quality.

**Remedies that the CC is not currently minded to consider further**

We make the following comments on remedies that CC is not minded to consider further:

- In Canada there are prohibitions on certain non-audit services where those services are perceived to conflict with the external auditor’s role or where safeguards have been determined to be inadequate. A review conducted by the IWG noted that the extent of non-audit services provided by external auditors today in Canada represented on average less than 20% of total fees billed to companies in Canada. The IWG did not support further significant prohibitions on non-audit services provided by external auditors.
- The IWG identified three differences between the Canadian and US Securities and Exchange Commission/Public Company Accounting Oversight Board prohibitions and recommended that those establishing independence rules in Canada assess these differences on a rule by rule basis. The three differences are personal tax services for individuals in a financial reporting oversight role, aggressive and confidential tax transactions and providing non-audit services on a contingency fee basis.
- The IWG discussed proposals relating to joint audits made by the EC. It noted that audit quality could be impaired due to:
  - lack of effective coordination of the audit between the two audit firms, with a potential for key issues to be overlooked since risks may be interrelated;
  - different audit technology platforms and audit methodologies between the two audit firms leading to a lack of effective sharing of audit work;
  - loss of clear accountabilities of each audit firm.
- The IWG believes that the cost of an audit conducted on a joint basis would increase due to duplication of effort and increased coordination costs. Working with two audit firms could increase the audit administration time requirement for management and the AC.
- The IWG recommended rejection of joint audits.
Appendix: Observations on some of the CC’s provisional views in the Report

The following observations are made from reviewing the Report:

7.149 The CC’s provisional view is that losses of auditor independence occur and that this would not be an outcome that the CC would observe if external auditors were responding only to the demand of shareholders. This provisional view appears to be based on concerns raised by the UK Financial Reporting Council (FRC) and other bodies regarding a loss of independence.

In the section of the Report dealing with independence (paragraphs 7.121-7.149), the CC makes reference to concerns about professional skepticism raised by the FRC and the US PCAOB. While we do not dispute these concerns, we are not convinced that a lack of professional skepticism is a direct result of a lack of independence or would be solved by the remedies proposed in the Notice. Professional skepticism can be influenced by many factors in addition to independence, including: auditor education, training, supervision of staff and knowledge of a company’s business, the culture of the audit firm, and the audit firm’s relationship with client management and the AC. We have noted that the PCAOB, CPAB and other audit inspectors are making efforts to identify root causes of audit deficiencies and we support these efforts because they may provide concrete evidence where specific changes to auditing standards might be made to address professional skepticism concerns if indeed this is actually part of the root causes.

11.55 The CC’s view is that there are limitations in the ability of the AC under the stewardship of the ACC, at least in its current incarnation, to ensure audit quality and independence of the external auditor.

As discussed in our detailed comments on remedy 5 (strengthened accountability of the external auditor to the AC), we consider that the AC plays a pivotal role in fostering audit quality through its focus on the independence and professional skepticism of the external auditor. We therefore believe that the CC should focus on remedies that enhance the role of the AC along the lines we suggest in our comments on remedy 5.

11.100 The CC’s provisional view is that as the AC relies on the auditor to bring matters to its attention it may not be in a position to identify judgments of the external auditor which have been taken to accommodate management’s aims.
We believe that as the AC has responsibility for oversight of the financial reporting process it must set the proper tone at the top by establishing an open, candid and direct communication among management, the external auditor and the AC so that the AC is fully informed about significant matters related to the audit and the financial statements, making sure the external auditors are aware of the AC’s insights and information about transactions and events, and ensuring the external auditor learns of any AC concerns about accounting or auditing matters. Such responsibility is complemented by performing an MCAR that focuses on the professional skepticism and objectivity of the external auditor.

11.104 The CC’s provisional finding is that the influence in practice of executive management on external auditors is a feature of the market that may prevent, restrict or distort competition and attributes this as causing failure by external auditors to demonstrate appropriate levels of professional skepticism. Further, the CC considers that this finding is consistent with the failure of external auditors to identify the impending financial collapse of some large companies.

As noted in our comments on paragraph 7.149 of the Report, professional skepticism can be affected by many factors. We do not believe that the CC has provided direct evidence of how competition in the marketplace is affecting external auditors’ professional skepticism. Further, there has been no evidence presented that external auditors failed to identify the impending financial collapse of some large companies.