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Invitation to Comment – Statutory Audit Market

We attach the responses of Moore Stephens LLP to the Invitation to Comment – Statutory Audit Market.

Yours faithfully

A large, stylized handwritten signature in black ink, appearing to read 'Moore Stephens LLP', is written over the typed name.

Moore Stephens LLP

A. Issues

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

We agree with the comment made in the paper that:

“Widespread public concerns indicate that the audit sector is not meeting expectations...” [2.23]

There has undoubtedly been a considerable amount of negative press coverage dealing with perceived audit quality. Reported issues related to the audits of companies such as Carillion, BHS, BT, and most recently Patisserie Valerie, have not shown the audit sector in a good light. Similarly, the reports issued on individual audit firms by the FRC at the end of their annual inspection visits received high levels of press coverage, much of which has concentrated on negative messages both in relation to the firms within the inspection scope as a whole and those firms where the reports indicated a decline in audit quality.

Whilst we have not undertaken any specific research into the views of stakeholders, our perception, consistent with the comment in the paper quoted above, is that many stakeholders have reduced confidence in the assurance provided by an audit report, when of course one of the key aims of an audit is to enhance the confidence of stakeholders in the financial information that has been presented to them.

However, as the paper acknowledges, there are two aspects to this issue. The first is the specific audit quality issue – the extent to which auditors are in fact providing the level of assurance that an audit is intended to provide. Any deficiency could be described as a performance gap. The second is referred to in paragraph 2.26 as the expectation gap – the difference between stakeholders’ expectations of statutory audit and what is actually required of an auditor. The expectation gap relates largely to the audit framework, as this term is used in the paper and which is addressed specifically in question 2.

The paper notes one part of the expectation gap, referring to the expectations some stakeholders may have with regard to the auditor’s assurance on the business’s future viability both in paragraph 2.26 and specifically in relation to Carillion in 3.15. Some stakeholders appear to hold the incorrect view that an unmodified audit report is akin to a guarantee that a business will continue. The auditor’s actual responsibility is much narrower than that, and is to obtain sufficient, appropriate audit evidence regarding and conclude on, the appropriateness of management’s use of the going concern basis in the preparation of the financial statements and whether a material uncertainty exists about the entity’s ability to continue as a going concern. The underlying assessment is that of management and the auditor does not, and cannot, provide any guarantee that the business will continue.

Other aspects include the scope of the audit and responsibilities in relation to fraud. The auditor is responsible for the audit of the financial statements. The auditor has certain responsibilities in relation to other material published with financial statements, which vary according to the nature of that other information, but (with some exceptions) does not audit them. Some stakeholders appear to believe that the audit covers the whole of the annual report. In relation to fraud, every audit report specifically states that auditors provide only reasonable assurance in relation to the financial statements being free of material misstatement due to fraud, and notes that reasonable assurance is a high level of assurance but is not a guarantee that an audit will detect a material misstatement. Despite this statement, it seems clear that whenever a material fraud (or indeed error) comes to light after an audit many stakeholders take the view that there must have been an audit failure. This is not supported by the actual current requirements, which indicate that this is just one possibility.

So whilst there are indeed widespread public concerns that the audit sector is failing to meet expectations it is important that the extent of that failure is addressed by considering, and clearly distinguishing between, actions that relate specifically to:

- Changes required to the audit market and the performance of audit firms to ensure that audit quality is high, and increasing, based on the requirements in place now and in the future;
- Changes that can be made to the audit framework such that auditors satisfy the expectations of the public, where those expectations are not covered by the current audit framework; and
- Ensuring that the public are aware of matters where it is not reasonable that auditors provide the level of assurance they might desire, even with changes to the audit framework.

These could be summarised as measures to improve audit quality, extend audit scope and educate users.

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

The issue of the audit framework has already been mentioned in our response to question 1.

In terms of current requirements, in our opinion the current audit framework is generally reasonable.

There are nonetheless issues concerning the requirements as set out in standards. The current auditing standards are intended to be principles based, focussed on ensuring appropriate outcomes rather than process. In practice, and over time, standards tend to diverge from this and become more rules based. Whilst each change may be well intentioned, and taken in isolation appear reasonable, eventually the audit standards will tend to look like a set of processes that need to be followed rather than a set of requirements that need to be met, but which can be met in different ways, in order to ensure that the audit opinion can be fully supported.

The position is sometimes made worse by regulators, who concentrate on detailed requirements of standards which are themselves overly prescriptive, rather than standing back and considering whether or not the work undertaken by auditors has ensured that sufficient appropriate audit evidence has been obtained. Monitoring compliance with detailed provisions of standards is clearly intended to assist in improving audit quality but this is not effective where those detailed provisions are perceived as taking precedence over what it was those provisions were intended to achieve.

The wider issue is that of how the scope of the current audit framework supports the interests of stakeholders. As noted above there are areas where the expectations of stakeholders are not being met, which then needs to be sub-divided into those matters where that framework should change to meet their expectations, and those where it would not be feasible to provide the level of assurance desired and the issue of stakeholder education arises. This is not a total divide, and there are areas, such as forward looking information, where it may be possible for auditors to provide more than they currently do, but the nature and extent of that assurance will differ from that possible in relation to historic financial information.

As noted in the paper, there are projects already started (or intended to start) which will look at some of these issues.

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

This is a difficult question since the quality of audit committees varies considerably. They have an important role to play both in relation to choice of auditors and through their own challenge of management.

Whilst audit committees are mostly associated with listed companies and other public interest entities we have seen an increasing number of private companies taking on good corporate governance and using non-executive directors to form an audit committee, albeit that its remit may not be quite the same as that envisaged in the UK Corporate Governance Code.

We have also seen indications that the objectives and motivations of audit committees for public interest entities have been re-focused with the introduction of the EU audit directive. The increased accountability of audit committees particularly for such entities is increasing the level of engagement between auditors and the non-executive directors on audit committees. We have particular experience in the insurance sector, where we have seen growing interest in the audit process, a desire to understand how auditors have gained sufficient assurance, and a wish to judge audit quality. The insurance sector is unusual, in that whilst all insurance companies are now treated as public interest entities most are private, some are mutual organisations, and many are relatively small.

Nonetheless, there are areas where beneficial changes could be made. For example:

- extending requirements to apply specifically to the audit committee chair, rather than just the committee as a whole;
- requiring a minimum number of meetings per annum with the auditors (particularly during the audit itself) to ensure that the audit committee fully understands the audit process and its members are able to challenge the direction and quality of the audit;
- extending the existing requirements for the audit committee to report as part of the annual report (per C.3.8 of the 2016 UKCGC and 26 of the 2018 version) to cover wider observations on the audit, the key findings of the auditors, and the scope and remit of the auditors; and
- annual re-election of the audit committee chair.

In relation to reappointment, a high proportion of audit committee chairs are alumni from big four firms. This is hardly surprising, given the dominance of the big four in the audit market for fully listed companies particularly at the larger end, but will tend to reinforce that dominance. It would therefore be beneficial to extend the pool of experienced individuals available to become audit committee chairs, and possibly even to have involvement of regulators in their appointment.

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

We have not been able to distinguish between the changes arising as a result of the intervention, and changes arising from other causes.

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

This depends on what is meant by the audit market.

The majority of audits undertaken in the UK remain those of smaller private entities. There are a wide range of audit firms providing services in this market and we are not aware of any major issues affecting competition.

Where the market is not working well is in relation to the largest companies, primarily the largest listed and some other public interest entities.

Within this market there is dominance from the big four firms. There is a large gap in size and global coverage between the big four and other firms, making it hard for larger companies to choose other firms. There has also not been a desire by companies to select non-big four firms, even when they are equally able and qualified to undertake some work. Audit committees will sometimes choose to select big four firms because they could not be blamed for choosing such a firm even were something to go wrong. This is a significant barrier to entry.

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

In general, we consider that there is effective competition between the big four. (There is the separate issue that where non-audit services are, or in some cases have been, provided by big four firms this may limit choice between these firms as a result of the prohibitions on the provision of some non-audit services by auditors.)

We do not consider that there is effective competition between the big four and other firms, in relation to the largest companies.

Among the factors that limit competition are:

- the ability to service assignments in some global jurisdictions where the big four may be dominant. For example in South America there are virtually no non-big four firms that are able to audit insurance companies;
- ensuring all relevant locations for an audit can be managed by the same firm, or ensuring there are adequate arrangements between firms. Whilst many firms are part of global networks, few of these have the depth of international coverage of the big four;
- the importance of the big four as brands, with a perception of higher quality;
- the depth of expertise in certain specialist areas within the big four firms;
- the required investment in audit and related technology; and
- the alumni effect, noted already in relation to audit committee chairs, whereby many of the finance staff in the largest companies have trained with a big four firm and will tend to be more familiar with dealing with these firms.

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

Mandatory rotation and tendering appears to have increased competition between the big four firms.

In relation to competition between the big four and other firms it has not, to date, increased competition and appears to be having the contrary effect. Whilst the rotation of audit firms could potentially lead to opportunities for other firms to develop a greater market share, we have seen little indication that this is happening in practice. Rather some firms with specialist expertise and a significant involvement in a

sub-sector of the market are being required to resign from audit clients over a relatively short period with limited opportunities to win additional work. In many cases such audits are moving to big four firms, since there are few other firms with the relevant experience. As noted in 3.30 of the report there have also been changes in sub-sectors of the market, such as Grant Thornton reaching the decision not to compete for FTSE 350 contracts where they perceive that the chances of obtaining clients in the current competitive environment are low whilst the costs of tendering are high.

Whilst not directly related to the intervention, increased regulation of the audit profession and the extension of the highest level of regulation to all PIEs has led to some firms leaving that market entirely, reducing competition and choice.

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

For competition to have a role there must be adequate transparency on quality and that must be acted on by audit committees.

Paragraph 3.4 of the report notes the existence of asymmetric information in relation to information about companies, but the same asymmetry applies to information about audit quality. The information about quality remains limited, notwithstanding changes to the UKCGC as noted above, and much of the information available relates to general information about firms rather than their quality in relation to particular audits.

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

As noted above the choice is, in practice, very limited.

There is a circularity in that, understandably, many such companies will appoint an audit firm only once they have demonstrable experience in the sector and with entities of similar scale. This means that firms without such experience will always find it difficult to obtain any such clients in order to build up their experience. This will limit their appetite to undertake such changes as expanding their international networks or make significant investments in specialist expertise.

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

We consider the main factors to be:

- the number of firms able to deal with clients' needs globally, whether generally or due to not having access to firms which are permitted to undertake certain types of work in particular jurisdictions;
- access to specialist skills and resources, which suffers particularly from the circularity point noted above; and
- the willingness of decision makers to accept firms other than the big four.

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

We consider the main factors to be:

- the willingness of some jurisdictions to accept other firms;
- the willingness of audit committees to accept other firms;
- limitations imposed by non big four networks often not having adequate sizes of firms in all key jurisdictions for the company's needs;
- lack of depth of expertise in some sectors, together with a lack of incentive to invest in building up such expertise due to the low likelihood of obtaining clients in the short term; and
- lack of connections since many listed company finance directors and audit committee chairs have previously worked in the big four.

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

We consider that there is a significant risk that the current position is not sustainable.

Particularly with the requirements around non-audit service restrictions and tendering audit services there are already issues where companies that have determined they need a big four firm, whatever the merits of that view, have extremely limited choice. In practice, one firm may be the resigning firm whilst two others may provide non-audit services that are not compatible with acting as auditor. This would leave one firm that could be appointed as auditor. Were one of the big four to fail, this problem would only get worse.

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

Competition is essential to any healthy market, but in one such as the audit market where there is an inevitable lack of transparency it is important that regulators are ensuring there is sufficient choice and competition within the audit market, and also ensuring quality is high.

Currently the competitive position is not ideal, and needs correction. However the regulators need to tread carefully. There is a risk of unintended consequences with decisions made in this area, particularly in relation to the smaller company market where there is no indication of absence of competition.

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.

Market Share Cap

The main benefit of this measure is that it will directly lead to the involvement of non-big four firms in more listed and PIE audits. However, it would be likely to be complex to implement and to monitor and would need to be defined clearly in advance to allow firms to fully understand and be able to tender for the audits that the big four would be unable to go for. In addition the approach would only be effective if there are sufficient non-big four firms who are willing to audit PIEs, given the additional costs and regulatory risks of auditing such companies.

Variant of Joint and Shared Audits

This model is applied in other global jurisdictions. It would be easiest to apply by other audit firms

auditing certain entities in a group, rather than parts of a particular entity. This should be explored further.

Support for Non Big Four Firms

This could be useful for resourcing and specialist skills, but would take absolute commitment on the part of all parties.

Reduced Barriers for Senior Staff

It is not clear that this would be effective, since the only mechanism that could be implemented simply is limitation on notice periods. It is not at all clear that financial barriers could be amended without effectively regulating salaries and profit shares.

Changes to Restrictions on Ownership of Audit Firms

It is unclear how this would meet the objectives since it would not change the regulatory barriers.

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.

We would suggest that consideration is given to a blended approach of the market share cap and joint or shared audits. For example, a market cap could be put in place to limit the amount of the audit market that the big four can audit solely and then a joint or shared approach would be required for any further involvement in the market above the cap. This might address any issues that could arise in the first few years post implementation if there are insufficient non-big four firms willing to tender for the audit or to be able to meet audit committee requirements.

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 do not support this measure.

Firms deliver high quality audits through the knowledge and expertise of their staff – if this were to be restricted to ‘audit only’ and ‘non audit only’ staff, then there would be issues in terms of staff retention and also limited wider experience and knowledge within the staff pool.

The benefits of reducing the risk of performing audit work when not independent would not outweigh the reduction in experience and expertise.

There would be an increase in costs, as support teams could no longer be ‘shared’ between audit and non audit service providers.

Taking our specific example, we have a reasonably large insurance team in London. This means we are able to compete with the big four firms when it comes to auditing most insurance companies. We are able to have a reasonably large insurance practice, which includes actuarial, IT, regulatory, and insurance tax professionals, because of the non-audit service that we provide. If non-audit services were to be split from audit services, we would not have the breadth and depth of specialists that we currently need to be able to audit this type of PIE effectively.

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?

This problem would make introducing audit only firms virtually impossible on a UK only basis. Ownership is only part of the issue, since there is also the problem associated with networks where there is not common ownership. For an international audit it is difficult to see how any solution which deals only with UK firms could work.

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?

The same restrictions should apply to all firms operating in this market. They should be based upon the position of the audited entity and not the auditor. Consideration should be given to the extension of restrictions in the case of PIEs eg. black listing any non-audit services to PIEs.

Market share cap

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

Were such a cap to be introduced it would be better if it were in terms of audit fees. This would allow flexibility between big four and other firms auditing parts of a group or whole groups.

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

Please see our response to questions 14 and 15.

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?

Please see our response to question 14.

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%?

Were such a measure to be introduced we would expect a progressive fee cap moving towards 70% with an appropriate transitional period, taking into account the issues noted in response to question 14.

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

It could be. Each of the models mentioned has its merits but shared or joint audits could increase the

relevant experience of non big four firms.

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?

There are merits in considering extending the responsibilities of auditors to wider groups. However, there are also various potential problems associated with this:

- current accounting frameworks concentrate on the needs of shareholders, whilst acknowledging that others may have an interest in financial statements. It would not make any sense to have auditors owing responsibilities to parties wider than those for whom financial statements are prepared in the framework that has been adopted for the financial statements that are subject to audit;
- widening auditors' responsibilities would also involve reconsideration of liability issues of auditors. Widening the pool of parties to whom auditors owe a duty of care will not increase the appetite of audit firms to deal with larger and more complex entities and would be extremely likely to have the opposite effect.

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?

We consider that audit committees perform a very important function and should retain the role of appointing auditors, setting audit fees and monitoring the performance of auditors. If an independent body is to be introduced we would suggest it takes more of an oversight role rather than direct involvement except in limited circumstances. Consideration could be given to the model used by the FCA and PRA with the Skilled Person panel. In most cases (ie. Non-directly appointed) the FCA and PRA take the role of oversight of the choice of Skilled Person but the regulated firm is the one that assesses and chooses the Skilled Person and sets the fees. We believe that the panel approach has successfully increased competition and expanded the involvement of non-big four firms in this area of professional services over the last few years.

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

Please see our comments in answer to question 25. In addition, if the independent body replaces this aspect of the role of an audit committee, there would be a risk of duplication of effort between the audit committee and the independent body. It is also useful to have internal audit and external audit reporting to the same body to ensure appropriate oversight.

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 this would address the competition concerns in the longer term. In the shorter term there may possibly be temporary benefits that could be achieved, particularly if run along-side a market cap approach, which could deliver increased opportunity for interested challenger firms and therefore improve market competition. Increasing the frequency of rotation would lead to greater tendering costs for companies and audit firms and could actually result in less competition in the longer term, given these costs would tend to impact non-big four firms disproportionately.

