



Competition & Markets Authority - Statutory audit market

Our response to your invitation

October 2018



A) Issues

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

Our view is that the question itself reflects a misunderstanding of the audit sector. It is not a homogenous marketplace. Considerable attention has been focussed in recent months on high profile failures in the PIE audit market and on the Regulator's perception of poor performance by the Big 4 firms. Our view is that any analysis needs to recognise that the PIE audit market and the non-PIE audit market are structurally and operationally different and present different pictures in the light of competition, choice, resilience and incentives.

Our view is that the current evidence demonstrates that the PIE audit sector is not servicing its stakeholders at a sufficient level. That evidence has not been presented in the context of the non-PIE audit market.

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 audit framework has its roots and underpinning in the Companies Act and International Auditing Standards. To the extent that stakeholders in the PIE market have wider expectations, there will inevitably be the wider accepted expectation gap that is now commonly recognised. In the non-PIE market, our perception is that both shareholders and wider stakeholders better understand and accept the nature and context of audit reports on historical statutory accounts.

Theme 2 - Incentives and governance

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

It is difficult to discern the ambition and criteria used by audit committees in audit selection and in agreeing scope of work to be undertaken. However there seems to be a consistent pattern of Audit Committees opting for a Big Four alternative in the PIE market which is part of the cause for concern in the PIE market place generally.

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

In our view it is difficult to perceive any change.

Theme 3 - Choice and switching

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

In the PIE market, the general opinion is that competition is not working well, notwithstanding statements to the contrary by the Big Four audit firms. The key factors hindering competition are the lack of choice and the inevitable but understandable constraints placed on firms by professional ethics and the necessity to avoid conflicts of interest.

However in the non-PIE audit market there is strong and effective competition with a realistic range of credible alternatives to finance directors and audit committees as they make their selection.

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

In the PIE market there is little effective competition, witness the withdrawal of GT from the FTSE350 market.

In the non-PIE market there is effective competition, which includes the Big Four. They do not have a dominant position and companies therefore have a better range of choice.

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

Very little.

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

Theoretically, competition should provide the incentive for higher quality audits. Competition can be seen to have such a benefit in the number of other markets. However in the context of audit the impact of competition seems more to drive down price with a potentially adverse impact on quality.

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

With the apparent preference of audit committees and finance directors to select audit firms from within the Big Four, there will inevitably be little choice in this regard.

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

In the PIE market, limiting factors are the number of audit firms available and the impact on competition of ethical guidelines and the need to avoid conflicts of interest which will rule some firms out of competitive tendering situations.

In the non-PIE market there is a wider range of audit firms available from whom companies can choose.

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

The incentives for new firms to enter the large company audit market are outweighed by the risks for many mid-sized audit firms. These risks include costs of additional resources (both volume and technical ability), cost of tendering, cost of regulation, increasing size of fines, potential reputational damage.

Theme 4 : Resilience

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

There is a concern, which we would support, that the PIE audit market lacks resilience. There are already only 4-6 credible players. The combination of the level of fines, public criticism by regulators and agenda setting headlines from the House of Commons, increases the likelihood that one or more of the existing Big Four firms could decide to withdraw from the market or indeed fail under the weight of fines being imposed and litigation brought against them.

The non-PIE market is more resilient given the great number of players already present and the comparatively lower barriers to entry for new players to aspire.

Theme 5: Regulation

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

Competition has been and must continue to be a key part in the evolution dynamic of the audit market in both the PIE and non-PIE sectors.

Regulation has increasingly become process rather than outcome focussed with an apparent emphasis on high profile fines and penalties. A positive move would be to emphasise outcome focussed priorities and a stronger balance of regulators working with firms to achieve combined and agreed goals in the enhancement of audit quality and its delivery.

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

This addresses the risk of conflicts of interest but in our view does not significantly enhance choice in the PIE market. However our preference is that there should be no further restrictions on audit firms providing non audit services in either the PIE or the non-PIE markets.

In the PIE market, firms should continue to be self-policing and companies should be required to set up procedures whereby their service purchase system identifies and precludes possible conflicts. Where such conflicts do occur, we would concur with the current policy of fines as an effective penalty.

In the non-PIE market, most companies would not have large and sophisticated finance departments able to manage the sourcing of professional services from a wide range of different suppliers. In that context the ability for one firm to offer a range of different services is beneficial to the client company as well as being most efficient in terms of delivering commercially important and valuable advice.

Increased competition from non-Big Four firms

15. Are there any other measures that we should consider that address the issues highlighted in Section 3?

The agenda set is an effective basis for reform of the audit market.

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 would not support a move to the creation of audit-only firms. In our view that would weaken the quality of audit services going forward as audit-only firms would be less attractive to quality entrants and would have limited career opportunities. In the provision of non-audit services, our view is that this leads to greater business awareness and ultimately better quality auditors. We are also of the view that in the non-PIE audit market, the provision of other services alongside audit is in fact beneficial to companies in the UK economy and that benefit would be seriously harmed were solely audit-only firms allowed to practice.

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?

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There is no common ownership of audit firms at the international level within the Nexia network. Were audit-only firms allowed to practice in the UK, this would lead to significant problems in the international networks of which those firms form an important part.

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 existing restrictions are in our view adequate providing companies are themselves made partly responsible for ensuring that their purchasing policies do not allow conflicts.

Market Share Cap

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

Imposition of a market share cap is going to be highly contentious and difficult to operate. A simplistic model will be the most easily agreed, and most readily understood and applied and our preference would be for the number of companies audited as a starting base.

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

Opening up the PIE market in this way would create opportunities for challenger firms. However there would have to be a good balance between market opportunity and incentive to participate for such challenger firms to embark seriously into the PIE market.

A potential solution would be to link a reducing market share with a positive incentive to move to joint audits.

Thus the market cap could start at 90%, and reduce by, say 5% per annum over 5 years. The market share thus released would be open to challenger firms acting in sole capacity or to a joint audit arrangement involving no more than one of the big four firms.

The gradual reduction in the cap would mitigate the negative short term impact on the Big 4, and the opportunity to participate in the market share released would incentivise the Big 4 to enter into Joint Audit arrangements with challenger firms, allowing the latter to build experience, capacity and reputation.

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?

There will inevitably be costs in the securing of necessary changes in the PIE audit market. One of these will be the impact the Big Four of losing a segment of their existing market following the introduction of a market share cap, but there will be others and these in aggregate will need to be weighed against the benefits being sought by the CMA review.

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%?

A sliding scale cap as described above would be optimal.

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

In our view, the introduction of joint audits would be one of the most significant new measures which could come out of the CMA review and which would be effective in encouraging competition and participation in the PIE audit market. A brief examination of the French market where a similar model is adopted shows a contribution is now being made by challenger firms through their participation as joint auditors in PIE audits.

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 while the current focus on shareholders?

There is already a fundamental break in the relationship between the auditor and the shareholder where the auditor is responsible and to whom the audit report is presented. Choice of audit firm is made by an audit committee which may or may not invite or consider the needs and preferences of the shareholders to whom they are accountable.

This relationship needs to be strengthened before accountability is extended to a wider range of stakeholders.

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 audit fees and managing performance of the audit firms?

It is difficult to envisage how this would work without more detail.

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

No comment.

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?

In the PIE audit market, the latest requirements to tender audits and rotate audit firms do not seem to have generated material benefit. Further acceleration of the process is unlikely to improve this situation.

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