Section B

Statutory audit market – invitation to comment responses

A) **Issues**

(1) **How well is the audit sector as a whole serving its stakeholders**

Auditors currently report to the members of companies i.e. to a company's shareholders. Additionally, on occasions auditors separately report to regulators, notably in the financial sector. Unlike directors, auditors do not normally have obligations to wider stakeholders.

There is increasingly a view that auditors have obligations to wider stakeholders, notably employees but also customers and suppliers. There is an expectation gap.

To address the expectation gap, it would desirable that auditors' responsibilities encompass similar obligations to those of directors under S172 of the Companies Act.

Themes

1 The audit framework: (2) how well does the audit framework support the interests of both shareholders and also the wider stakeholders in the economy.

The audit framework is based on the adoption of accounting standards (generally IFRS) under the going concern principle. The adoption of IFRS shifted emphasis to fair value accounting whilst putting less emphasis on prudence in reporting. Financial management and auditing have not developed with commensurate sophistication. There is an expectation gap.

It is unrealistic to presume that the principles of IFRS will change (because they have been internationally agreed). However, it would be appropriate for financial management to report explicitly on the sufficiency of capital and cash resources to meet the going concern principle i.e. there is a reasonable expectation that the entity would continue to be able to operate for 12 months after the date of the audit report. The risks and dependencies would need to be articulated.

Auditors should similarly be required to report on management's statement of capital and cash resources and draw attention to shortcomings, material caveats and key judgements applied in the statement.

This dual reporting approach would serve to warn shareholders and other stakeholders of vulnerabilities allowing them to determine their behaviours accordingly.

In our opinion, greater reporting on the going concern principle, i.e. reporting on near term vulnerabilities, is much more relevant to users of accounts than increased reporting on viability, i.e. the medium term future. There is no medium term future if there is no short term future!

However, we recognise that the viability statement has its part to play in addressing longer term issues.

2 Incentives and governance: (3) To what extent do decisions made by audit committees support high quality audits, whether through competition for audit engagements or otherwise? (4) How has this changed following the Competition Commission's intervention.

Auditors are now chosen by audit committees which are normally made up of non-executive directors. Their choice may or may not accord with the wishes of executive directors. Audit committees are highly focussed on high quality audits. Compulsory rotation of auditors has resulted in audit committees being more interested in new ways of auditing, the scope of audits and skill sets of auditors than previously. Audit committees challenge the auditors on the work planned to be performed and undertaken. In our capacity as a major investor in UK companies, our discussions with the Chairs of Audit Committees have often highlighted new innovative audit methods that are implemented by new auditors following a tender.

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? (7) How has this changed following the Competition Commission's intervention? (8) What is the role for competition in the provision of audit services in delivering better outcomes (ie consistently higher quality audits? (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? (11) What are the main barriers to entry and expansion for non-Big Four audit firms?**

The Big 4 firms are fiercely competitive as amongst each other. They can each deliver a first class global service for all industries. They differentiate themselves on the skill sets and resources they can bring to particular companies. The competition serves to raise the quality of auditing as this is a key determinant in audit retention and rotation decisions by audit committees.

Other firms are not competitive vs the big 4 due to limited expertise and resources in international coverage and depth of knowledge of particular industries. They can on occasions differentiate themselves with particular skill sets but it is relatively uncommon.

In practice the choice of auditors for companies is constrained below the expected level of say, four firms on an annual basis and three firms when there is compulsory rotation. As a practical matters, auditors are unlikely to be changed other than every five years when rotation is mandatorily reviewed by audit committees. For there to be sufficient competition, it is highly desirable that there are always three firms that compete for an audit. More than three is unnecessary because three gives sufficient choice to audit committees (if there were more than three, it is unlikely that a shortlist would contain more than three firms).

Companies, particularly financial services companies, are frequently constrained from allowing all three of the big 4 to tender for an audit (assuming the incumbent is not permitted to retender) due to independence constraints. Auditors need to be independent of their clients but we have gravitated to allowing minor independence issues to reduce competition to the detriment of shareholders.

It is unrealistic to believe that non-big 4 firms can or want to take on complex audits (whether financial services or otherwise). However, I do believe such firms could serve to increase audit competition. In particular, when there is an independence issue, a non-big 4 firm could be mandated either to undertake the related audit that causes the independence issue (e.g. a pension fund) or undertake that part of the audit causing the independence issue (e.g. modest IT support). In the former situation, the non-big 4 auditors would be engaged directly in the normal way. In the latter situation, they could be engaged jointly by the company and the auditor that signs the overall opinion. The audit committee would oversee that the independence issue is properly handled and the both the audit committee and the overall auditor would oversee the quality of the supporting firm's opinion. The supporting firm would have a duty of care to the company and the overall auditor. We anticipate that competition would be increased by around one-third.

As a consequence of this approach, the aggregate audit fees will extend to the non-big 4 and, in time, the work will increase the skill set of the non-big 4 firms so further increasing competition. We would expect big 4 firms always to bid on such a basis. Audit committees should determine whether the conflict of interest is or is not too great to be solved in the proposed manner.

You might consider obliging boards to ensure they do not engage big 4 firms for non-audit work that cannot be resolved for audit purposes in the manner outlined.

4 Resilience: (12) Is there a significant risk that the audit market is not resilient? If so, why?

Whilst there is some chance that legal claims could cause a lack of resilience, this risk appears to be well managed by the firms. The greater risk is that the scale of auditing becomes too small to warrant it continuing as a service with the conglomeration of services provided by the Big 4 and there is a market withdrawal. The splitting up of the Big 4 or other measures to reduce the workload would exacerbate this risk.

5 Regulation: (13) What is the appropriate balance between regulation and competition in the market?

The greater importance is quality of auditing which is enhanced by competent regulation. Competition may enhance quality but is less important that the public interest requirement of high auditing standards.

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. (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. (16)-(18) Restrictions on audit firms providing non-audit services. (19-23) Market share cap.

Audit firms need not be restricted from providing non-audit services to audit clients if the services provided do not inhibit the ability to compete for an audit due to independence considerations (see A3 above). Prohibitions or separating audit from non-audit services will reduce specialised resources available to audits (at least at a reasonable price). This is likely to reduce audit quality.

It is a fundamental tenet of English corporate law and governance that companies are managed by their Board of directors. Restricting the ability of a Board (represented by its audit committee and approved by shareholders) to choose an audit firm would diminish the Board's responsibility for high quality corporate governance and in particular auditing. Consequently, market share and similar limits are not supported.

Shared audits (as opposed to joint where two firms take equal responsibility) has merit in overcoming conflicts of interest which would improve competition (see A3 above). Joint audits would significantly increase costs and most likely slow down financial reporting for companies. One method of encouraging shared audits would be to set annual targets for the Big 4. The targets could increase over time and ultimately be abolished as unnecessary.

Wider ownership structures will not necessarily reduce quality. Quality depends on the governing body of the auditing entity. Whether there is outside equity or not, there would be merit in auditing firms adopting normal corporate governance standards and having their businesses governed by a Board comprising a majority of non-executive directors with relevant commercial experience. The Senior Partner should be the Chief Executive and the Chairman should be independent on appointment. The partners, as owners, would be able to vote on the reappointment of all directors. As most firms operate as LLPs, this may require legislation to give effect to a suitable body corporate.

The splitting of the big 4 to create eight firms is undesirable for the reasons set out in the invitation to comment.

Incentives and governance. (24) Should auditors and those that manage them be accountable to a wider range of stakeholders rather than just the current focus on shareholders. (25) If yes, should audit committees be replaced by an independent body that would have a public interest duty, including for large privately owner companies?(26) Please describe the benefits, risks and costs of such an independent body replacing audit committees. (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?

See A(1) above. There should be a duty of care to wider stakeholders in line with S172 Companies Act but extending accountability to more stakeholders will make the audit considerably more complicated which will probably create a new expectation gap undermining credibility and the practical completion of work.

Audit committees comprise independent non-executive directors. They have to comply with existing directors' duties which include duties to wider stakeholders. There is no need for another body.

Audit tenders are a complicated and time consuming process – typically taking 3-6 months to complete and a year thereafter to prepare. An increase in frequency would be a major burden on companies and auditors and is not supported.