CMA Statutory audit market – Invitation to comment

Consultation questions

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Consultation Questions

A) Issues

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

R1: The answer to this question depends on the size and complexity of the audited entity. For example, given the recent failures of large public entities such as Carillion it could be argued that the audit sector is failing certain stakeholders, namely employees and suppliers of large / PIEs.

However, for owner-managed SMEs it could be argued that the audit sector is serving them well. They often present a relatively simple business model / financial reporting challenges and an audit can provide assurance to stakeholders that they are presenting true and fair financial information.

This split could be indicative of the need for a two-tier system, with auditing standards (framework) and liability exposure reflecting different requirements for PIEs and the rest.

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?

R2: The audit framework is clear and requires a high level of assurance for a clean audit opinion to be issued.

When applied correctly, the audit framework supports the interests of both direct and wider stakeholders.

However, there is still a clear 'expectations-gap' (the gap between the public expectations of what an audit delivers and what the requirements of auditing standards are) for audits of large complex entities / PIEs. Perhaps this gap is indicative of the requirement for enhanced auditing standards for these larger, more complex entities.

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?

R3: One role of an audit committee is to ensure that appropriate auditors are appointed. The auditors appointed should be able to perform a high-quality audit. Decisions should not be based purely on price and certainly not on a perceived 'easy-option' basis, for example an auditor the committee feels is not as thorough as they could be. Decisions made for reasons other than to ensure that a high-quality audit is performed could be due to the audit committee not acting in the interests of investors.

The audit committee should ensure that a rigorous, competitive tendering process is in place and the thought process associated with selecting the firms invited to tender should be on record.

The majority of clients our firm deal with are owner managed and therefore often do not have audit committees. The beneficial owners of these entities are typically the same individuals as those purchasing audit services.

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

R4: The rules governing rotation and the tendering process would surely have assisted with this, although given our client base this is not something that has been regularly observed.

Theme 3: Choice and switching

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

R5: Given the recent decision taken by Grant Thornton and the small number of firms performing the audits on FTSE 350 companies it must be argued that competition is not working well. Four choices is not perceived to be sufficient for a competitive market.

Key aspects firstly include the sheer size that an audit firm needs to be to successfully staff a large PIE audit. For example, even a [mid-tier] firm would struggle to staff an audit of a major bank (perhaps). This doesn't just relate to staff numbers, but also the expertise required. Fee dependency would be an issue for many smaller firms, if they were to look at PIE audits.

Secondly, the confidence of audit committees of PIEs to have appoint a none-Big-four auditor seems to be low. They do not have the confidence in smaller firms to perform the work they require.

Thirdly, many mid-tier firms simply do not want to compete for the larger audit clients. The risk / reward ratio is not acceptable in its current form. There needs to exist an audit framework and a proportionate regulatory environment to enable these firms to gain the required market experience.

There doesn't appear to be enough expertise outside of the Big-four to audit certain complex industries and there simply aren't enough qualified accountants expert in specialised areas to create further competition.

Significant time and financial investment would be required to compete and many firms do not believe that the benefits are great enough.

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

R6: **Between the Big-four** – The competition appears to be relatively healthy between the four firms. There appears to be consideration of all firms for larger audits. However, this may be limited where significant non-audit services are provided to entities.

Between the Big-four and other firms – given the low rate of audits of FTSE 350 audits performed by none-Big-four firms it is clear that competition in this area is poor. The decision of number five – Grant Thornton to pull out of tendering in this market is indicative of this area competition not working well. If number five cannot compete, how can smaller firms?

Competition for smaller audits, especially non-PIE audits appears to be far higher, although there still appears to be a leaning towards the Big-four where entities appear to have a continued impression that the Big-four produce higher quality work, where this may well not be the case, as exemplified by recent matters.

The audit market for the mid-tier appears to be functioning well.

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

R7: Given the increase in concentration of audits of FTSE being performed by the Big-four, little appears to have changed. If anything competition outside of the Big-four appears to have decreased.

However, competition within the Big-four could well have increased. Enforced, shorter rotation periods and other measures has increased the rate of auditor changes. However, it could be argued that rotation around four firms is not sufficient for an appropriate level of competition.

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

R8: This is difficult to say for sure. It could be argued that increased competition leads to a higher standard of audit (for example firms are further incentivised to perform a more thorough audit as there is increased competition), however, increased competition could lead to fee pressure and therefore a reduction of audit quality, due to time / cost pressures.

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

R9: Very little. In reality, in the current situation, for large companies and PIEs of a complex nature, no firm outside of the Big-four is likely to be able to perform the audit sufficiently.

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

R10: 1. Ability to appropriately staff assignments, 2. expertise, 3. International presence. For smaller assignments 3 has little relevance, but for the larger, international clients it is essential.

The reality is that the PIE / larger, listed entities require a highly specialised service, a service that can be provided by very few firms.

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

R11: As per 10 and cost. Ability to staff jobs, the expertise of staff available and an international presence.

The sheer scale of staff required to perform larger audits is out of the reach of many firms, as is the availability of staff that have the highly specialised skills to perform the work. It is not simply a matter of cost, but of availability of individuals. Non-Big-four firms that currently do not have any banking clients (for example) would not have the ability to train junior members of staff to be able to audit banking clients. They would be reliant on staff transferring from the Big-four and there would be very little motivation for them to make the transfer.

Theme 4: Resilience

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

R12: Yes. Having only four firms capable of performing audits of large / PIEs does mean that the existing four are becoming almost too big to fail. If one fails, competition drops and the reliance on those remaining three becomes even higher.

There are no obvious short-term solutions to this issue. As an estimate it would take a mid-tier firm at least a decade to up-scale to a level to be able to compete with the Big-Four.

Theme 5: Regulation

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

R13: There needs to be market conditions to encourage the desire by company directors and shareholders to obtain a high quality audit. Both through competition and enforcement of regulations.

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.

R14: **Increased competition between the Big-four**
It is thought that if given a choice, Big-four firms would choose non-audit work over audit work as it is often more profitable and carries a lower risk. Therefore prohibiting firms that perform audits from performing non-audit work would likely reduce competition and in the extreme would make it impossible (at least very difficult) for some entities to appoint a suitable auditor.

One option would be to separate the Big-four and create new audit firms. However, as the invitation to comment notes on pages 23 / 24 this would likely create its own issues.

The splitting of firms would also likely incur significant financial costs and could actually lead to reduced audit quality due to the restrictions on access to specialists.

The benefits would be increased independence.

Increased competition from non-Big-four firms

(a) Market Share cap

This would create significant issues in practice and potentially reduce competition. Auditors may focus on certain companies, ignoring perceived higher risks jobs. It is also debatable whether this would increase competition from mid-tier firms that still avoid tendering for certain entities given perceived risk.

In theory it could increase competition, but the reality may differ.

(b) Joint or shared audits, or peer review

It is believed that this could work most effectively considering a peer review. This would help mid-tier firms to generate more fees and would hopefully lead to Big-four firms ensure high file quality as they wouldn't want to present lower quality work to another firm. Yes, it is likely that this would increase fees, but audit fees are not currently perceived to be high, especially for larger entities / PIEs.

Two firms signing the report would surely lead to excessive duplication and a shared audit would give rise to issues of reliance of one auditor on another. This has been identified as an area of weakness in recent FRC audit reviews of group entity audits.

(c) Direct support

No motivation can be seen for a Big-four firm supporting a mid-tier firm and therefore this is not thought to be a likely option. Professional bodies may be able to provide some assistance, but again, the level of support required, for example to audit a highly specialised area is unlikely.

(d) Reducing movement barriers

As noted this is likely to only support a switch to another Big-four firm. Why would an experienced Big-four listed company specialist move to a mid-tier firm when that firm currently had very few listed clients, on the possibility that their appointment may attract some listed clients?

(e) Restrictions on ownership

There is the potential benefit here of increased investment, but as noted this would likely increase external pressures on auditors, potentially by individuals that did not understand or respect the ethical code under which audits are expected to be performed under.

(f) Break-up of the Big-four

4.28 of the invitation to comments sums up why this would likely not be realistic.

Measures to improve incentives

It is thought that transferring the power to appoint auditors directly to shareholders would eliminate the current issue and would focus the process on higher quality audits.

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.

R15: No further comment here.

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?

R16: No. A vital aspect of being able to audit larger, more complex entities is to have appropriate expertise in-house. This would not be the case in audit-only firms.

Further to this and given the international nature of many larger and PIE companies it would simply lead to audits being performed by firms outside of the UK.

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?

R17: See above.

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?

R18: If any restrictions are added they should focus on large companies and PIEs. Many smaller, owner-managed entities rely on the support given by their accountants and any restrictions in this market would hamper their development.

Market share cap

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

R19: Market share could be measured simply by the number of companies audited. There are numerous other possibilities but this measure needs to be kept simple and easy to measure. Perhaps the number could be weighted for companies in the FTSE 100 compared to the FTSE 350, but the overall aim should be for a simple measure.

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

R20: No. It would artificially alter the market.

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?

R21: It is considered that the costs far outweigh the benefits. Some entities would be left to be audited by firms they don't want to be audited by and perhaps the firms performing the audits would not really want to be acting as auditors.

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%?

R22: Looking at the French model this could be even lower. Perhaps 70%, although it is not believed that a market cap is appropriate in the UK market.

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

R23: Yes, joint audits could work and could provide the incentive for higher quality audits. They would present a more realistic option than simply limiting the share of audits a given firm could perform. Taking the form of a peer review this could work.

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?

R24: Auditors, no. Directors of the companies, yes.

The only potential expansion would be for the larger / PIEs where, as mentioned above there is some scope to introduce a different set of standards to reduce the 'expectations-gap'.

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?

R25: Potentially for the larger assignments, yes to all questions, other than potentially fees.

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

R26: Benefits – such a body would clearly be more independent / risks – limited. / costs - limited.

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?

R27: Yes, it could help. There would be financial costs relating to additional tendering / time costs. Benefits would include a fresh look at financial information by different auditors and greater independence from management.