

Statutory audit market study
Competition and Markets Authority
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31 October 2018

To the members of the Competition and Markets Authority.

I am writing in response to your 9 October 2018 invitation to comment on the review of the Statutory Audit Market.

My background and credentials to comment

I am a fellow of the Institute of Chartered Accountants in England and Wales. I spent 25 years with Price Waterhouse where I was a senior partner until 1998 and 4 years with Ernst & Young from 2001 to 2005.

In addition, I was finance director of Mirror Group plc from 1998 to the end of 1999 and COO and CFO of the Palladian group from 2005 to 2008.

I have since served in various non-executive roles as audit committee chairman, including Next plc from 2007 to 2017. I am currently the audit committee chairman at The AA plc, Domino's Pizza Group plc and Fenwick Limited.

In addition, I serve as a member of the steering group of ICAEW's Audit Quality Forum.

Having served as an auditor, CFO and audit committee chairman, I believe that I am well qualified to comment, particularly as I have been the audit committee chairman for several audit tenders. Also, I have worked extensively with the 3 firms just outside the big 4.

However, the views expressed in this letter are mine and not those of the companies I represent.

Timing and pre-conceptions

Your review and comment periods are exceptionally short and it is important to ensure that your review is given the proper consideration it warrants and is

not dominated or influenced by pre-conceptions of the audit market or comments by uninformed sources seeking publicity.

Your document states that “the audit sector is not meeting expectations”. Whilst this may be the case in a few high profile cases, it does not recognise that the vast majority of audits do meet expectations. This may be because of management quality, audit committee resilience or auditor quality but instances of audit failure are actually quite rare – possibly significantly less than 1%.

We live in the real world and audit failures will inevitably happen, almost always as a result of unwarranted optimism or deliberate misstatement by management or human failure - although this may change going in to the world of artificial intelligence when the quantum of failure could be dimensionally greater than previous instances.

It is also worth noting that in many cases of audit failure, it is not so much a matter of not having “ticked the boxes” as having made commercial judgements that, in hindsight, were flawed.

Competition, choice and quality in the audit market

It is my experience that competition in the audit market remains fierce. The issues to be addressed are of choice and quality.

Competition

Having chaired several audit tenders, I have viewed first hand just how competitive the firms are.

Although, some years ago, audit work may have been the source of other more profitable work, the world has changed and the cost of an audit stands very much on its own. As discussed later, there may be reasons for non audit services to be further restricted but a firm would be ill advised to lowball their audit fee – and audit committees do not want to accept the lowest fee quote.

In fact, on every audit committee I have served, the prime concern of the audit committee has been to ensure that the auditors perform a robust audit, unconstrained by fees. No audit committee wants to discover that the audit has been inadequate as a result of low fees.

Choice

So far as choice is concerned, the route causes of the perceived lack of choice can be directly traced back to two events.

Firstly, the failure to prevent the merger of PW with C&L and secondly the demise of Andersen. In the case of the latter, the highly talented team at Andersen joined Deloitte, another move that could have been prevented.

We are now faced with four big firms and two or three smaller firms where, regrettably, the overall strength and reach in audit is often not good enough.

When the Competition Commission reported their findings on the audit market, I made a submission to say that the proposals with regard to non big four firms tendering for major audits was a recipe for them to lose money as a result of the costs of tendering (which the CC dramatically underestimated). Recent events show that this is the case.

When performing an audit tender, choice is fundamental and it is inevitable that some of the big firms may be conflicted in the short term. However, a properly planned audit tender will allow for a proper handover period which would enable any firm to become "clean". Consideration of conflicts are paramount but not insurmountable. The reality is that the firms have to make a choice as to whether they want to tender for an audit if they perform other work for a business. A company cannot insist on a firm tendering but my experience is that firms will tender unless their non audit services are long term and of significant size.

At the end of the day, there should usually be a choice of 3 large firms but various factors, such as concerns over market concentration and competitor issues, may reduce the choice to two. Not exactly desirable and more would be desirable but there is at least some choice. However, increased competition in the market is most unlikely to attract new firms.

Quality

As already noted, the key issue is not competition or choice. It is simply audit quality – or in some instances the lack of it.

Audit committees want their audits to be robust and high quality. Who wouldn't?

I always question our auditors as to whether they are in any way constrained by fees when performing their work. If the answer were to be yes, then we would increase the fee.

I do feel that auditors are given sufficient scope to increase fees with the audit committee if they have concerns. It is hard to believe that any audit committee would decline a request to extend scope if there were concerns and I cannot believe that any audit firm would fail to address issues of concern even if fees were an issue. The penalties for failure are significant and increasingly so, to the extent that the firms would happily lose money on an audit to prevent a problem.

The fact that the CC mandated that audit committees agree fees with the auditors rather than management was a massive step forward. It changed the "incentive" dynamics but, in my view, it will take time to demonstrate the impact.

Assessing audit quality is ferociously difficult and invariably only looked at with hindsight when there has been a failure. An audit committee will know if the group has been robustly audited but this is not a matter of ticking boxes. It encompasses so many more factors.

Although the requirement to rotate audits and put them out for tender may lead to an increase in audit quality over time, the short term consequences may often be negative. A more powerful alternative, which has now been in place for a number of years, is the requirement for audit partners to rotate after a number of years. I wholeheartedly support audit partner rotation but would not want to see the partner's maximum tenure shortened; if anything, it could be extended by a year or two.

It is not a lack of choice or competition that compromises audit quality. It is more likely to be incompetence of or fraud by management (allegedly at Patisserie Valerie and Conviviality), over optimism on behalf of management (perhaps Carillion and Quindell) or a potentially dominant chief executive or shareholder (perhaps BHS).

The expectation gap

As a member of the steering group of the Audit Quality Forum, I have seen how the expectation gap for audit has been a key issue and we are trying to address that. However, people who "rely" on audited accounts need to understand the limitations of an audit, especially materiality.

The "man in the street" may believe that £1 million or £10 million is material but in the world of finance in a major multinational, £100 million could easily be immaterial. An audit "failure" may be viewed in many different ways and, in my opinion, the extended audit reports now being applied actually serve to confuse rather than assist the reader. Who wants to or will plough through many pages of accountancy speak rather than see an opinion that simply says that the accounts are true and fair?

Role of the audit committee

In the vast majority of cases, audit committees are formed from highly experienced professionals with good reputations. They represent the shareholders and have no desire to damage their reputations by doing a poor job.

The committee relies on the integrity of management and the robustness of the internal and external auditors. It is of note that in very few cases of "audit failure" have the executive directors been prosecuted or fined whereas the auditors have been, regardless of who created the problem.

It is the audit committee's responsibility to approve any non audit services to be provided by the external auditors and the current restrictions on such services could be strengthened so as to restrict them solely to audit related matters, albeit broadly defined. Although this may not affect the auditor's judgement, it should improve perceptions. In any event, there are now a number of sizeable alternative providers of non audit services outside the top ten accounting firms, such as FTI and Alvarez and Marsal.

Your statement in 3.18 that audit "is commissioned by company management" is wrong. The audit committee appoints the auditor and agrees the audit fee – as per the CC recommendations which have, in my opinion, strengthened the role of the audit committee. The board only ratifies the audit committee's recommendations and, under the Code, the board should comprise a majority of independent directors.

Perhaps the CMA review should look at whether "audit failures" could or should be attributed to poor governance or non-compliance with the Code?

Remedies discussed in the CMA paper

Market share cap and joint audits

I believe that imposing caps on market share would actually reduce competition and choice and increase prices. It is arbitrary and unnecessary. Also, joint audits are inefficient both from a cost and quality perspective as well as reducing choice.

Too big to fail

The fear of a reduction in the number of firms from 4 to 3 is unrealistic. If one of the big four failed or declined to perform audits then the team of auditors from that firm would no doubt join another firm or set up on their own. This would be the ideal moment for one of the firms from outside the big four to get the critical mass and quality they need. Unfortunately, when Andersen collapsed, the audit team was allowed to join Deloitte. The failure of a big four firm should not reduce competition and they are not too big to fail.

Break up of the big four

A break-up of the big four, unless somehow achieved on an international scale including the USA, is unrealistic. If the UK acted alone the vital

international links, as noted in your paper, would be broken and it is likely that audit quality would suffer as a result.

One has to question why increased competition would lead to new entrants to the market. Similarly, the suggestion that large firms have incentives to take greater risks or reduce quality strikes me as wrong.

Audit only firms and/or greater restrictions on the provision of non audit services

As mentioned earlier, the restrictions on auditors performing non audit services should be strengthened but to make firms audit only would be a massive mistake with unintended consequences. The attractiveness of accounting as a profession would be irreparably damaged and recruitment of the best talent would be impossible; it is questionable whether the firms would then have the expertise to audit specialist areas.. The expertise of the UK's accounting profession is a national asset and should not be destroyed.

The idea of introducing insurers as the substitute for audits may be intriguing but the fact is that insurers already underwrite the solvency (to some extent) of the audit firms. Changing to an insured basis would lead to a host of other issues where the insurers would simply not have the expertise – and at greater cost with increased litigation.

Responsibility for appointing auditors and frequency of tenders

Appointing a third party body to select auditors is, to my mind, ridiculous. It smacks of bureaucracy and fundamentally misunderstands the needs of companies. Expertise and chemistry are fundamental to the proper working of an audit and these would be lost. It takes some years for an audit committee member to get fully up to speed with a business and a central appointing body would lack this knowledge. The same applies to blind tenders. In addition, the role of the audit committee would be diminished to an extent that it may be difficult to find people willing to serve.

Taking audits into a government controlled body would be a massive retrograde step. It would certainly not improve audit quality.

I believe that the recently introduced existing frequency of audit tenders is the right balance. Quality would fall if changes occurred more frequently.

Regulators

Much blame has been attributed to the audit profession for companies failing but an element of blame lies with the standard setters who, in my opinion, have over complicated accounting standards and were the people who introduced the flawed (and now repealed) standard on financial instruments,

soon to be followed by leasing. Nowadays, management need to spend as much time explaining the accounting as the results themselves. If anything, certain accounting standards are hindering outcomes by over complicating financial statements.

The thought of an AGM deciding between two firms of auditors detracts from the audit committee's responsibilities and would lead, inter alia, to lobbying by the firms. There is already a requirement for shareholders to approve the appointment of the auditors each year at the AGM and shareholders can make their views known at any time.

There is a body of opinion that wants auditors to widen their remit so as to report on matters such as long term viability and cyber risks. In an ideal world, this could happen for significantly higher fees but I doubt whether any firm would report definitively or usefully on such matters.

Summary

It is my view that non audit services for audit clients should be further restricted but the prime concern is one of quality not competition or choice.

To break up the big four from the UK is not a realistic option. To have audit only firms would reduce quality and diminish a profession that is so highly regarded across the globe.

Yours faithfully

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