

Our ref PRM/AFE/00100000

30 October 2018

Statutory audit market study
Competition and markets Authority
7th Floor,
Victoria House
37 Southampton Row
London
WC1B 4AD

Dear Sirs

Statutory audit market

Kreston Reeves LLP appreciates the opportunity to respond to the Invitation to Comment as part of your study of the statutory audit market.

Kreston Reeves LLP is a firm of Chartered Accountants that is amongst the top 25 largest firms in the United Kingdom. Based in London and the South East, we predominantly operate in the SME market providing audit and other accountancy services. Our client portfolio does though extend to include AIM-listed companies. We are a member firm of Kreston International, a global network of independent accounting firms. We are also a member of the Association of Practising Accountants and the Forum of Firms.

As a member firm of the Association of Practising Accountants we have been consulted on the response being made separately by the Association to your invitation to comment. We would like to endorse the comments made in the Association's response which broadly echo our own views.

By virtue of our size and client base, as a firm we do not have experience of all the matters being considered by the invitation to comment. We consider it vital however that the study takes into account the views of mid-tier firms such as ourselves, thus we have provided responses to those questions in the invitation to comment where we feel that our opinion has sufficient merit to be considered as part of the study. These detailed responses to the questions raised in the invitation to comment are contained in Appendix 1.

Key points

Whilst we accept the need for reform of the audit profession as there are clear problems arising from the lack of competition in the market as far as the audit of larger companies and public interest entities are concerned, care should be taken not to overburden the remainder of the audit profession and SMEs where these problems do not exist.

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Although there are considerable barriers to achieving greater competition where it is most greatly needed, we do see merit in taking steps to increase the involvement that non-Big Four firms have in providing services to public interest entities, whether this is in the form of audit services or in other areas such as tax and consultancy.

If you have any questions on the contents of this letter then please contact Peter Manser at the address shown.

Yours faithfully

Appendix 1

Statutory audit market Invitation to comment

Responses to specific questions

Question 1

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

There have been several high-profile business failures in recent months, where it is possible that the actions of the auditors involved may have contributed to a reduction in the level of trust the public places on the work of the audit profession. We do not believe though that this should be taken to suggest that the audit market as a whole is failing its stakeholders. Beyond the headlines it should be remembered that the incidences of fundamental audit failures are few and far between, certainly where a lack of competition in the audit market could be seen to be a factor.

We are of the opinion that where auditors apply the provisions of the current regulatory framework in which we operate, high quality audit work will be performed. This will be true for the majority of the audit work currently being undertaken in the UK, and should be remembered before any changes are made to address a problem that only exists in the market for audit services to larger companies and public interest entities.

Question 2

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

We believe that the current framework generally supports well the interests of direct shareholders. The increasing importance of fair value accounting presents challenges to auditors where techniques and guidance needs to continue to develop to match the pace of developments in accounting. Failure to do so will only widen the current expectation gap.

Wider stakeholders in the economy are less well served by the current framework as their needs have not played a significant role in the historical development of company law and associated regulation. More work could be done to identify groups that have a legitimate role as stakeholders and their needs that can reasonably be met by auditors. Security of employment, credit risk of suppliers, and impact on local economies are all linked by the risk of business failure. Further development on going concern reporting by larger entities would address common needs of wider stakeholders.

Question 3

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

A majority of our clients are in the SME sector and are owner managed and therefore typically do not have Audit Committees.

Where we do experience Audit Committees amongst our commercial clients our experience has been polarised between those that rate quality of service and those that are risk adverse. Audit Committees concerned with audit quality often have wide experience of auditors across the size range recognising there is a role for mid tier firms and valuing their audit work. Audit Committees that are risk adverse often have a more narrow experience consisting of alumni of the Big Four where the safe option is seen to be to appoint a larger firm.

Increasingly we are experiencing Audit Committees in the not for profit sector. These are a significant factor for driving competition and ensuring auditor independence from executive management. Inexperienced Audit Committees find it difficult to judge audit quality but we anticipate this will improve as this sector of the market matures.

Question 5

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

For the purposes of your study, which is clearly centred upon the audit market at the top end of the economy, it would seem clear that there is a lack of competition which may be hindering audit quality. The dominance of the Big Four firms has only increased in recent years, and the barriers to entry appear insurmountable to a firm of our size, and indeed to firms much larger than ourselves.

From our perspective there appears to be a reluctance on the part of audit committees to look beyond the Big Four when making auditor appointments. Whilst there may be concerns over audit quality, it remains the case that when faced by pressure from stakeholders, appointing a well-established Big Four firm remains the safe option for audit committees for which they are unlikely to be criticised. This in turn does not enable other firms to gain the experience and expertise necessary to be able to mount any significant challenge to the Big Four, leaving the audit market uncompetitive.

This is thought to be true also for the provision of non-audit services, where the appointment of a large firm to provide tax and consultancy services is also the norm. This too hinders competition, as firms providing such services will often be prevented from being considered for the appointment as auditor due to the requirements of the FRC Ethical Standard. Often larger companies and public interest entities may find that realistically they only have a choice between 1 or 2 firms when making an auditor appointment decision.

The situation is quite different elsewhere in the audit market. There is little evidence to suggest that the SME market in which we predominantly operate is being adversely impacted as a result of a lack of competition between audit firms. In deed it is our experience that there is a healthy level of competition between firms in this important sector of the economy. Although there continues to be consolidation in our market place, reducing the number of audit firms that operate at our level, we still see there being considerable choice available when making decisions over auditor appointments.

Question 6

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

As a mid-tier firm it is difficult for us to comment on the level of competition between the Big Four firms. We would imagine that there is intense competition between the Big Four firms for market dominance, and if audit quality is used as a means to achieve this then this should in turn benefit the wider audit market.

As referenced in your invitation to comment, at the highest level of the audit market, namely the audits of FTSE350 companies, the level of competition between the Big Four and other firms is practically non-existent. At other levels of the audit market the situation differs, particularly in respect of the market for audit services to privately owned companies, and to a lesser extent companies listed on the Alternative Investments Market. Our experience shows that firms of our size are able to compete against the Big Four at this level, where we are able to match or better them in areas such as price, service levels and importantly audit quality. Indeed, firms such as ours often relish the opportunity to demonstrate our ability to do so and are capable of winning clients from Big Four firms. However, even at this level many companies will feel pressured to appoint a Big Four firm as an auditor when they are planning an event such as a listing or business sale, when this is seen as a safe option that would better facilitate such events.

Question 8

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

Effective competition and proportionate regulation combined are key to delivering better audit outcomes. Our perception of the market we operate in as a mid tier firm is that price competition is fierce. This is balanced by the serious nature of regulation that operates in our sector of the market.

Our concern for the audits of PIES and complex organisations is the perception that the large audit firms are too large to regulate. For example, the latest AQR reports a decline in audit quality for all the Big Four and an unacceptable deterioration at KPMG. Yes business continues as usual with all Big Four allowed to accept new appointments before demonstrating sustainable improvement.

Question 9

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

With a growing reluctance on the part of the larger non-Big Four firms to operate in the market for audit services to large companies and public interest entities, as shown by Grant Thornton's announcement in March 2018 referred to in your invitation to comment, it would seem that the choice for companies in this sector is limited.

As already indicated in our response to Question 5, when coupled with the market for non-audit services and the need for auditors to be able to demonstrate independence and objectivity, realistically the choice available to large companies and public interest entities may not even extend to all of the Big Four firms when selecting their auditor.

We do not see how this situation can be sustainable over the longer term.

Question 10

What are the key factors limiting choice between auditors?

With regards to audit services provided to larger companies and public interest entities relevant specialist expertise, international presence, and staffing capacity are key limiting factors.

Question 11

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

The principal barrier that we perceive to exist when attempting to penetrate the market for audit services to larger companies and public interest entities is an inability to adequately resource such an assignment, particularly when there are large and complex group structures in place that would require an international approach.

The inability of non-Big Four firms to be able to demonstrate the expertise necessary to provide an audit service of sufficient quality will inevitably result in such firms removing themselves from this sector of the audit market, as Grant Thornton have effectively done.

Our own view, and we imagine that of most other firms our size, is that the cost of 'scaling up' to be able to compete against the Big Four at the top end of the audit market is one that we are not willing to invest, particularly if there can be no guarantee that our efforts would be rewarded. Where we do envisage being able to compete with the Big Four is in the audit market for smaller, privately owned companies and in the provision for non-audit services, and this is where we are likely to focus our attentions.

Question 12

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

We believe that there is indeed a significant risk that the audit market is not resilient. With the overwhelming majority of public interest audits only being carried out by four firms leaves the market seriously at risk should one of them fail or choose to leave the market for other reasons. It is difficult to envisage how the remaining firms would be able to continue to serve the market on their own.

Question 13

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

The expectations placed upon the audit profession requires there to be an effective regulatory framework, but these should not act as barriers to competition. We are of the opinion that legislators and regulators should keep the need to maintain and develop a healthy marketplace for audit services as one of their key desired outcomes when developing the regulatory framework.

Question 14

Please comment on the costs and benefits of each of the measures in Section Four and how each measure could be implemented.

Increase competition between the Big Four

In respect of the audit of public interest entities we believe that it is time to consider a complete prohibition on the provision of non-audit services by their auditor. Such a move we hope would put to rest the continuing notion that auditors are not independent of the clients, an accusation that is commonly made in the media whenever there is a significant business failure. We see no need to extend this to prohibiting the provision of non-audit services to entities that are not their audit clients.

There is a risk that the potential fall in income that would be experienced by the Big Four firms from such a measure could see them reluctant to take on audit work over more lucrative tax and consultancy services. We see though the potential for them to gain work from the audit clients of other Big Four firms, so overall there should be minimal impact although we would hope that there would be some leakage with non-Big Four firms providing non-audit services to entities that were previously provided by their auditors.

We foresee considerable difficulty in splitting the major accounting firms into separate audit and non-audit practices. As well as the cost that would be involved, which would inevitably drive up prices for audit and accountancy services, we fear that this move would actually reduce audit quality by reducing their ability to draw on the expertise of non-audit specialists within the firm.

Increase competition from non-Big Four firms

a) Market share cap on the Big Four

At first glance this would appear to be an attractive option, but as you will note from our response to Question 20 we have doubts as to whether such a move will be able to achieve the benefits that it seeks.

b) Variations of joint and shared audits

We believe that there is some merit in this proposal, providing that the firms involved are willing to enter into such arrangements. Of the options provided the introduction of a peer review would appear to be the most workable solution. Clearly to be effective the peer review would need to be undertaken by a firm with sufficient expertise and experience of large company audit, which may restrict the firms that are able to provide such a service. Over time, with movements of personnel between firms such that a suitable level of expertise can be obtained, we can see such a solution working in practice to drive up audit quality.

Alternatively the idea of shared audits also has some merit. We foresee this working by having non-Big Four firms acting as component auditors for entities within the group being audited.

c) Direct support to the mid-tiers by the Big Four and professional bodies

We do not see how such a proposal would work in practice. All firms are protective of their practices, which can be costly to establish for example in the development of new technologies used in audit work. Forcing them to share this knowledge with other firms seems unrealistic.

Similarly we doubt whether the professional bodies have the resources to be able to provide the support that is being suggested.

d) Reducing the barriers for senior staff to switch between audit firms

We would be supportive of any such changes, particularly as this would help enable non-Big Four firms to gain the skills necessary to be able to compete. Whether this would have any significant impact in practice would be dependent on their being sufficient incentive for people to change firms, and at present it is unclear as to whether this would be the case.

e) Changes to the restrictions on the ownership of audit firms.

There would be some merit across the entire profession for such a move, particularly at smaller firms where audit is not always a major component of the services they provide. Whether this would generate sufficient investment to enable mid-tier firms to grow and compete with the Big Four is debatable given the sums that would be needed.

Break up of the Big Four into smaller audit firms

We would agree with the comments included in section 4.28 of the invitation to comment, which would suggest that this proposal is not viable.

Measures to improve incentives

We are generally supportive of the moves being suggested, with the exception of increasing the frequency of mandatory auditor rotation as you will see from our response to Question 27. Of the suggestions raised we would give greatest support to moves that enable greater involvement of shareholders and other stakeholders being involved in the selection of the auditor. Such a move we feel would be fundamental in maintaining the transparency of the auditor appointment process.

Question 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 feel that there needs to be greater appreciation of the fact that audit does not provide an absolute guarantee against business failure and the poor corporate behaviour of company management. Addressing this expectation gap should also be seen as an outcome of this review of the regulatory framework for audit services. We feel that one way this could be achieved is by increasing the accountability of management through the inclusion of all directors to the FRC's disciplinary process, not just those that are qualified accountants.

Question 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?

No. The unilateral implementation of such a proposal would damage the UK auditing profession in isolation. The effective auditing of multinational entities requires a wide multi-country professional network. Multi-disciplinary firms can draw upon in-house expertise for specialist audits which would be problematic for audit-only firms.

Question 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?

The increasingly complex structure of the large firm, including their affiliation to international networks, acts as a significant barrier to making the suggestions to break up the Big Four firms workable in practice.

Question 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?

Any restriction on the ability of firms to provide non-audit services to their audit clients should have as their focus the need to demonstrate effective independence and objectivity in respect of that engagement. Thus it would not be appropriate to base any restriction on the size of the firm, as we see no reason to restrict larger firms from providing non-audit services to their audit clients when appropriate safeguards can be implemented to the engagement in question.

Thus we are of the opinion that any such measures to restrict the provision of non-audit services should apply in respect of the audit of public interest entities. We see no need to amend the existing regulations in place for the audit of other entities where there is no public interest.

Question 19

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

For simplicity and transparency we would propose that the number of companies audited would be the most appropriate means of measuring market share.

Question 20

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

Any move to introduce a market share cap would require the support of the companies concerned, and it is unclear to us whether at present there is any willingness on the part of larger companies and public interest entities to appoint a non-Big Four firm as their auditor.

Similarly such a move would also require the support of non-Big Four firms who are willing to enter the audit market for larger companies and public interest entities. Your study may reveal firms that are willing to do so, but as outlined in our response to Question 11 we are not aware of any such firms with the ambition to enter that market.

Thus we are of the opinion that it will prove difficult to realise the potential benefits of a market share cap.

Question 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?

As you will note from our response to Question 20 we do not support the proposal to introduce a market cap. Such an intervention could have unintended consequences in actually reducing competition, choice and increasing costs.

Question 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%?

Although we do not support this approach, if a market cap were to be introduced it would seem practicable to set the level high at first, at say 90%, with a view to reducing the cap over a period of time to say 70%. However, we are generally of the view that the introduction of a market share cap is not a desirable approach.

Question 23

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

Yes subject to overcoming issues on staffing capacity and liability.

Shared audits provide the possible opportunity for mid tier firms to build experience, credibility and staffing capacity whilst diluting the dominance of the Big Four in certain sectors of the audit market.

Peer review would be an innovative way of firms working together and should be explored further as a way of improving audit quality. Issues of experience and specialist skills could be a barrier subject to the parameters of the peer review.

Such an approach may be attractive to the larger non-Big Four audit firms, but for a firm such as ourselves we feel that the disparity in size when compared to the Big Four firms and our limited experience of larger companies and public interest entities would often make such an approach unworkable except where the nature of the client concerned was similar to those we currently act for, such as those listed on the Alternative Investment Market.

Where we do perceive an ability to become more significantly involved in this sector of the audit market is through the provision of services as a component auditor of group member companies, where the size and nature of such companies is comparable to those entities for whom we already act as auditor.

Question 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?

Such an extension to the scope of an external audit would require a fundamental change to company law, and as interesting as this question is, as clearly there is a far larger group of stakeholders with a potential interest in the audit process than just the shareholders, it is one that we consider is beyond the remit of this study.

Question 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?

See response to Question 24.

Question 26

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

See response to Question 24.

Question 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 there is any merit in amending the regulations as they currently stand. There are considerable costs involved in both the audit tender process and the actual rotation of the auditor that we believe would outweigh any benefits obtained from increasing the frequency.