

BY EMAIL: statutorvauditmarket@cma.gov.uk

Statutory audit market study
Competition and Markets Authority
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Victoria House
37 Southampton Row
LONDON
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Monday 29th October 2018

Dear Sir/Madam,

Statutory audit market - Invitation to comment

I am writing in my personal capacity, drawing on my experiences as the FD of Lovells, CFO of Telecom New Zealand Limited, CFO of United Utilities Group PLC, Chair of the Audit Committee of Orange Polska SA and Chair of the Financial Reporting Committee of the 100 Group. The views expressed in this letter are my personal views and should not be construed as the views of any of these organisations.

I do not consider any of the material contained in this letter to be confidential and confirm that I am content for this letter to be attributed to me by name and be published as part of your due process.

I am fully supportive of the need for the Competition and Markets Authority (**CMA**) to give detailed consideration to the supply of statutory audit services in the United Kingdom and very much welcome the opportunity to comment on the CMA review. The general themes you raise, the detailed points therein, and the potential outcomes suggested, are all immediately recognisable and represent a comprehensive summary of the current issues and the associated challenges with the potential solutions.

The points I raise in this response are very much outcomes focused, and as such I do not express a view on whether or not the CMA should make a market investigation reference under section 131 of the Act. This matter is best considered by CMA when assessing how best to implement what are considered to be the necessary changes in the way the current market operates.

I have also not sought to address the detail of each of the individual questions raised but instead have clearly identified what I believe are the three broad issues that need to be the focus of further consideration by the CMA. These are summarised below.

1. Theme 3: Choice and switching – sufficient choice of auditor (questions 5-11)

The current choice of four major audit firms is the minimum for an effective market for the audit of large companies – ideally there would be more. However the choice of four firms is undermined by the fact that higher value consultancy services offered by these firms often means they are conflicted, and ultimately would prefer not to perform the statutory audit, rendering the market potentially impotent.

I believe it is therefore essential that the statutory auditor should be limited to performing statutory audit work together with closely related activities such as regulatory compliance work, creating a market within the UK with a genuine choice of four major audit firms.

Your invitation to comment identifies 5 areas of challenge with such a proposal. While each of these may be valid concerns they are neither individually nor collectively an insurmountable challenge .

Considering each of these in turn:

- **International nature:** I recognise that a UK firm will need to be connected to an international network to service global clients and that these international audit practices may provide non-audit services. However, I do not consider this to present an insurmountable challenge in itself, so long as the UK firm that is accountable for the audit has no financial benefit from the international practice and that the relationship remains on arm's length commercial terms.
- **Access to specialist resource:** Although the UK firm will need access to specialist resource to support aspects of audit work (e.g. pension specialists), I can see no reason why such access would be more problematic if the firm was limited to audit only activity. They would either have sufficient demand to maintain a core specialist team themselves or could easily procure third party specialist support as necessary.
- **High quality staff:** I believe the concern that it would be significantly harder to recruit high quality staff into audit firms is overstated. Those individuals that join as audit trainees today and move across into consultancy roles post qualification would likely continue to do so, just with a different employer offering the consultancy services. The people today in the key audit review and decision making roles, comprising senior managers, directors and partners, have made a career choice to specialise in statutory audit work and I see no reason why that would change.
- **Impact on mid-tier firms:** This point is a duplication of the concern about access to specialist resource but specifically in relation to mid-tier firms. As already noted, the firm will either have sufficient demand to maintain a core specialist team themselves or could easily procure third party specialist support as necessary.
- **Financial dependency:** I doubt that audit only firms would be significantly more financially dependent on large audit clients than those with consultancy services. As such I do not believe this would lead to increased concern about their independence. However, my third point below in relation to a more meaningful penalty regime would in any event further mitigate this concern.

Lastly, and in addition, I also think it is worth emphasising that were there to be less than four major audit firms, I believe the CMA would need to consider the broader implications for the market and take far more radical action to restore effective competition.

2 Theme 2: Incentives –transparency and oversight of audit committees (questions 24-26)

Greater transparency and public oversight of audit committees is to be welcomed in enhancing their legitimacy from a broader stewardship perspective. While Audit Committees comprise independent non-executive directors and as such are "independent" from the company executive there is a broader board relationship between the parties to be considered that extends beyond the scope of the Audit Committee and from an external stakeholder perspective may be seen to undermine overall governance.

An approach which could improve trust and transparency without cutting across corporate governance considerations would be to require attendance of an observer with participation rights but no voting rights in the Audit Committee meetings. This observer could be appointed from a public body such as the National Audit Office with the remit to scrutinise and provide further challenge in areas of significant audit focus where there are often highly judgemental decisions to be made.

Such a role could provide valuable challenge and scrutiny, particularly if the individuals held a portfolio of appointments across companies where they could promote best practice and consistent application, unfettered by the responsibility of ultimate decision making. These appointments *could* rotate with reasonable frequency, say every three years, ensuring the relationship with the Audit Committee remained fresh and invigorated.

Transparency could be further enhanced by making the formal minutes of these meetings either publicly available or available to the Financial Reporting Council (**FRC**) Audit Quality Review (**AQR**) team and Corporate Reporting Review (**CRR**) team as part of their due process in reviewing the quality of audit process and compliance with corporate reporting requirements.

3. Theme 5: Regulation -penalties for audit firms and the statutory auditor (question 13)

Robust and independent enforcement is essential to instil appropriate behaviours and I believe it is therefore necessary that enforcement against audit firms, and the individual statutory auditor, results in penalties that are sufficient to act as a proportionate counter balance to the principal-agent dynamic that exists between the company and the auditor .

I strongly believe that a more meaningful penalty regime, where the scope and scale of fines were increased and linked to AQR findings, would change behaviours and lead to more robust challenge and in turn a higher quality audit.

Should you wish to discuss my comments please contact me.

Yours sincerely

Russ Houlden
