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Statutory audit market study
Competition and Markets Authority
7th Floor
Victoria House
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London
WC1B 4AD

30 October 2018

Dear Sir

Statutory audit market – invitation to comment

I write on behalf of Nationwide Building Society's Audit Committee in response to your invitation to comment on your market study of the statutory audit market. As a large financial services institution, market and consumer confidence, and the role of an effective statutory audit in this, is a key concern for Nationwide's board and management.

We should not lose sight of the fact that primary responsibility for effective governance and business management, and for the preparation of statutory financial statements, including critical judgements on matters including the viability of the business, clearly rests with executive management with oversight from the audit committee. In instances where there has been an audit failure, the first failure tends to be of management and governance and in some instances culture is at the root of the problems. In organisations where there is a culture of transparency and integrity, it is more likely that governance is effective, and the board, audit committee and executives will value the role of an audit in providing robust challenge to management. Conversely, where governance is weak and management and/or the board do not seek an appropriately independent and robust relationship with their auditors, issues are more likely to arise.

The large accounting firms are generally well respected for their professional skills and expertise and they make a significant contribution to the development of talent within the UK. In most cases audit quality is high – good audits tend to go unnoticed, whilst relatively few high profile corporate failures attract strong criticism, in some cases justifiably, but sometimes even where the primary accountability lies elsewhere. It is therefore important to view the need for change in its proper context and to avoid proposing solutions which will undermine the effectiveness of audits or blur accountabilities.

Our responses regarding the themes and potential remedies in your invitation to comment are set out below. Our overall observations are:

1. It is apparent from recent well-publicised audit failures and the public reaction to these failures that there is a significant gap between the construct and scope of a statutory audit and stakeholder expectations, particularly in respect of broader business risks and forward-looking financial information. Resolving this requires an extensive re-think of the purpose of an audit and how audit work is reported;

2. While there is a high level of competition between the Big 4 firms, based significantly on skills and audit quality, it is very difficult for other audit firms to build the depth and breadth of expertise needed to audit large organisations and there is therefore limited choice. It is unlikely that a single measure will resolve this, but we believe that a combination of measures may over time enable such firms to build the required capability. We comment below on specific potential measures. We would welcome the expansion of the number of firms able to conduct audits of large organisations through developing capability in this way but not by breaking up the Big Four firms.
3. We believe that accountability for governance must remain firmly with the board and audit committee, which includes selection and oversight of the audit firm. While certain measures may improve how governing bodies are held to account for exercising oversight, measures which dilute such accountability would be counterproductive and may well reduce audit effectiveness.

We have in the last year completed an audit tender, experience from which has informed some of the responses set out below.

Theme 1: The scope and purpose of audit

As referred to above the “expectation gap” is real and growing as a result of increasing regulation and business complexity. The existing framework is essentially focused on validation of a historic position with limited emphasis on future prospects or existential risks. Corporate failures typically arise from ineffective management of material risks or failure to address clear business model/viability challenges. Auditors already have unparalleled access to information which would reveal these problems where they exist and they have the skills to evaluate the issues, but in many cases it is not within their remit to consider them (other than indirectly) or to report on them. Unless the scope of audits is redefined it is reasonable to assume that corporate failures where (from a public perception) the auditors appeared to be absent will continue to arise, and may indeed become more frequent.

Stakeholders are typically more interested in the future than the past and audits are relevant to this, but only up to a point. The problem is compounded by the scope of reporting as well as the scope of work; reporting is still essentially based on providing a binary conclusion as to whether financial statements present a true and fair view; as a consequence adverse going concern conclusions are challenging to report due to the risk that they become self-fulfilling.

Some enhancements to reporting would however be beneficial. It would be appropriate for management to report explicitly on the sufficiency of capital and cash resources to meet the going concern principle (that 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). This should include explanation of the risks and dependencies. Auditors should similarly be **required to report on management’s statement of capital and cash resources** and draw attention to shortcomings and emphasise material caveats to the statement.

This dual reporting approach would serve to inform shareholders (or members in the case of a mutual) and other stakeholders of vulnerabilities. Greater reporting of near term vulnerabilities on the going concern principle is much more relevant to users of accounts than increased reporting on viability ie the medium term future. However, it is recognised that reporting on viability is also relevant to longer term risks.

Auditors are also well placed to identify concerns about the culture of the organisation but public reporting does not lend itself to commentary on such matters; potential requirements for private reporting to regulatory bodies (in the way auditors report privately to regulators in respect of financial services firms) may be worthy of consideration. Furthermore, the expert judgements and insight based on independence and objectivity (which lie at the heart of a good audit) are hidden behind the audit report template. Recent developments to include key risks within audit reports and enhanced governance reporting by audit committees are helpful in this regard, but they are not sufficient to fully address the problem; in particular they tend to explicitly consider “audit risks” relevant to historic reporting, not business risks relevant to the future. The debate about the scope of the audit should thus consider risks such as cyber security, beyond the impact on the financial statements.

An important aspect of the audit framework is the independence rules. No reasonable person would argue that independence is not a fundamental pre-requisite of the auditor's role. However, the requirements need to be fit for purpose based around principles, judgement, materiality and practical safeguards. Instead they are rules-based and tend to disregard the materiality or significance of threats; as a result typically there is no practical solution to an independence conflict even where its link to audit quality feels tenuous at best. In a world where many large/complex organisations are effectively restricted to a choice of four audit firms at the outset, inflexible independence rules, with no opportunity to exercise judgement or take practical mitigating steps, are increasingly problematic in restricting choice. One potential and practical solution could be to appoint other firms to carry out specific audit work, either of an entity which causes an independence issue or of that part of the audit causing the independence issue.

Theme 2: Incentives

Decisions made by audit committees are critical to audit quality – they can be, indeed should be, a significant determinant of the effectiveness of the audit process. They select, monitor, challenge and guide auditors, and where necessary they can remove them. A well constituted audit committee with the right composition of skills and the right mindset will go a long way towards ensuring that audits are effective. By the same token an audit committee that lacks relevant expertise or commitment to a rigorous audit will likely create the conditions for a problem to emerge. Audit committee accountabilities are clear in this regard and it would not be helpful to dilute or blur those accountabilities; rather they should continue to be reinforced and extended where relevant as the scope of the audit framework evolves.

Theme 3: Choice and switching

Competition does operate effectively amongst the Big Four. The problem is choice; for larger organisations, and particularly ones with diverse international networks, one or even two firms will frequently be conflicted as a result of existing service relationships or local regulation. A rotation requirement can therefore become a choice of “one from two”, or even “one from one” in practical terms. As referred to above, avoiding exclusion due to immaterial conflicts should be part of the answer.

Increasing choice is not easy as the gap between the Big Four and the rest is substantial. It is most in evidence in large international companies and/or those which operate in very specialised industries or who are heavily influenced by complex regulation. The depth of the resource pool and breadth of expertise required to audit such clients effectively is very substantial, and for most a consistent standard across a wide ranging international network is also essential. Significant investment in training, methodology development and technology is required and represents a real barrier to entry at the top end of the market. Staff rotation rules are healthy and appropriate, but they compound the problem; in many specialised industries it is simply not credible to manage audit partner and staff succession and rotation for a small number of clients, which inevitably drives a focus on scale. One avenue to explore in reducing barriers is giving challenger firms access to the Big Four firms' technology solutions in a way which increases capability without creating dependencies.

Theme 4: The resilience of the audit market

Concentration amongst the Big Four is a potential vulnerability for the reasons outlined in the Invitation to comment document. Mandatory rotation is helping to some degree, for example by increasing the efficiency and timeliness with which firms can switch in and out of audit engagements. Increasing choice within the market would in part address resilience issues.

In practice, whilst there is a risk 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 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.

Theme 5: Regulation of audit in the UK

The audit service is complex and critical to the effective function of markets and the economy. It is therefore appropriate for it to be subject to strong regulation. Steps taken in recent years to promote audit regulation are therefore welcome and I have already provided input to the Kingman Review. Our overall impression is that, notwithstanding recent progress, audit regulation has some way to go to be viewed as truly effective. In particular it needs access to increased resources (probably both quality and quantity) and to become more responsive to risks, whether thematic emerging risks, sectoral risks or individual high risk public interest entities. A focus on material audit shortcomings rather than a pre-occupation with rules-based compliance will also be critical.

Potential measures: Increase competition between the Big Four

We would not support splitting UK firms to create audit only practices or prohibiting audit firms from providing non-audit services to any large organisation. It is not clear to us that this would significantly increase competition in a way that would enhance audit quality. We accept that it could, and probably would, enhance the perception of independence, but it would come at a significant cost in diminishing the breadth of expertise available to audit firms and could damage the profession more broadly by reducing the ability of audit firms to recruit and retain talent. In summary we would endorse the reservations covered in 4.10 of the Invitation to comment and believe these considerations would significantly outweigh any additional clarity on independence.

However we do believe that the option of greater restrictions over the *purchase* of non-audit services by audit clients is worthy of consideration. In particular, audit clients should not purchase services that will impair independence and the ability of any of the Big 4 to tender for audits. This should secure most of the independence benefits without threatening the depth and breadth of expertise available to support audits. If pursued it would be important to carve out services which can only practically be provided by auditors and which realistically pose no threat to independence. Relevant to our business under this category would be comfort letters and related assurance to support routine capital markets activity which can only realistically be provided by the auditors. Notwithstanding any changes to independence requirements, the audit committee should be responsible for overseeing auditor independence and the resolution of any potential conflicts, including by the engagement of alternative firms for certain audit work as suggested under Theme 1 above.

Potential measures: Increased competition from non- Big Four firms

We would not support a market share cap for Big Four firms because it would undermine the accountability and control audit committees can exercise in pursuit of their responsibilities. This proposal could on the face of it compel audit committees to appoint an audit firm even though they may have concerns over its ability to fulfil the role effectively, blurring responsibilities and accountabilities in the process. The repercussions in the event of a subsequent audit failure could be catastrophic for the audit firm involved and would be difficult to manage from a reputational perspective for all concerned. At its worst a cap could (arguably, inevitably would) severely reduce audit quality in relation to some of the largest and most complex UK companies. In our view this proposal is wholly impractical.

The notion of shared audits using combinations of Big Four firms and smaller partners is in our view a better way to seek to build capability across a broader front. It would not be without cost and inconvenience given the limited use of such a model in the UK. At least in theory, such arrangement could be undertaken without damaging audit quality. It also offers a potential mitigant to relatively minor independence issues (an issue raised under Theme 1 above) as the second firm could audit a statutory entity or specific area (for example IT systems) creating the conflict. There are many practical questions which immediately arise in relation matters such as whether shared audit appointments would be made mandatory or merely encouraged, and how smaller firms would gear up to make the meaningful contribution to overall audit effort which would be necessary for the proposal to yield benefit in terms of increased choice over time. Nevertheless we believe this is the most practical of the suggestions for increasing competition between Big Four firms and other firms over a period of time. It may be appropriate to consider how it could work alongside proposals for direct support from Big Four firms as part of the joint venturing arrangement. We would not support joint audits (where two firms take equal responsibility) as this would significantly increase costs and would be likely to delay financial reporting.

We do not believe the suggestions for reducing barriers to switching staff between firms or for changing ownership restrictions would yield significant benefits. They are either unlikely to make a significant difference or carry different risks which are likely to make them problematic in practice.

We would not support the so called “Break-up” of the Big Four. This feels very difficult, if not impossible, to achieve given the need for international consensus and orchestration as referenced at 4.29 in the Invitation to comment document. It also runs the risk of damaging audit quality due to reduced resource pools, enforced staffing changes on existing audit assignments and general disruption. The question-mark over sustainability of the imposed solution raised in the document is also a key concern.

Potential measures: Measures to Improve Incentives

The Invitation to comment contemplates a number of other measures aimed at changing the incentives and governance around appointment of, and relationship with, auditors. In particular these include increasing the frequency of mandatory tendering/rotation, greater involvement of members/shareholders and the possibility of transferring responsibilities (for appointment/management of auditors) to external bodies. In general we believe these suggestions would convey limited benefits and be difficult or impractical to deliver, including potentially for reasons of confidentiality. Hence whilst we would support the philosophy of steps which promote shareholder understanding of the role of auditors (including its limitations), and of course involvement in proposals for change where relevant, we are firmly of the view that proposals which dilute the role of audit committees and boards in managing auditor relationships would be a retrograde step. It is integral to their primary governance responsibility and by virtue of knowledge of their company and their expertise they should be in the best position to make good decisions – if this is not the case then there is a different problem.

We look forward to receiving the consultation on your provisional views in due course and would be very happy to discuss any of the matters raised in this letter.

Yours faithfully

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Audit Committee Chairman, Nationwide Building Society