

Statutory audit market study
Competition and Markets Authority
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Dear Sir/Madam

Consultation: Statutory audit market study

We welcome this opportunity to engage with the CMA's market study for the statutory audit market.

We recognise that this is a matter of public interest and the document sets out a number of matters of importance to RBS both as a preparer and user of accounts. RBS undertook an audit selection process in 2014, resulting in a 2016 change of auditor, which provides it with insight on the challenges of undergoing auditor change.

As an issue of some complexity, we have concerns about introducing changes that may have the opposite effect to those intended. We are happy to share our experience of auditor selection as well as how it affects us in our role as banker to both large and small companies when they change their auditor.

Lack of choice

As a large bank, with international operations, we do believe choice is problematic. Outside the Big 4, most accounting firms do not have the spread or depth of global coverage to act as our auditor. We have to ensure that our auditor has presence in the countries where we operate and has adequate quality in each of those countries.

Further, if we are looking to rotate our auditor, then our past (incumbent) firm is unavailable as a potential option, regardless of the quality on offer. If we find another firm is conflicted then we may only face a choice of two firms. As a bank, this potential conflict includes the accounting firm having a banking relationship with us – in such cases it may be an onerous option for the firm to change its banking arrangement.

Key issues

Making an auditor selection that properly focuses on the quality of the audit procedures is a process that requires a level of examination and testing of the approach of each firm, often with practical tests. It also requires engagement with the individuals who will deliver the audit to evaluate their personal attributes. This is a costly exercise, both for the firm tendering and for us as an organisation.

Undertaking a change of auditor is especially complex since we are a large bank, with an international presence and a US listing. We gave ourselves 15 months to make this change, and in hindsight we would allow a longer timeframe. This was to address the many potential conflicts that would prevent the appointment.

Challenges and limitations

Long term advisory and non-audit engagements represent a particular challenge in promoting competition. Such long-term contracts create a real impediment to the appointment of that provider as the statutory auditor. We consider that engagements that last longer than 18 months are likely to impair potential rotation.

Audit quality

Companies may apply different criteria in establishing what is most important in achieving audit quality. These choices reflect the specific circumstances and environment of each company. It is this consideration that is most important in being able to identify the accounting firm that is likely to provide the best audit. It will reflect the firm that best understands the position and direction of the company and offers most flexibility in designing an audit that addresses the relevant issues.

The role of the audit committee

Individuals on audit committees include those with specialist skills and experience relevant to that entity. It is, therefore, best placed to consider the appointment and subsequent performance of the auditor.

Non-audit services

As a provider of finance to many smaller organisations we note that it is often harder for these organisations to obtain quality advice, and the auditor is often uniquely placed to supply this. Therefore, restrictions on non-audit services can often be harmful to smaller companies and caution is needed in extending restrictions.

For larger organisations there are significant restrictions already in place, and in many cases, auditors are limited in their involvement beyond work that is directly or closely related to the audit, and generally assurance in nature.

Remedies

We are concerned about the potential consequences (whether intended or unintended) of the proposals set out in the invitation to comment. In particular:

- Actions affecting the UK market in isolation from other jurisdictions. Proposals to separate audit from other services within the Big 4 would isolate the UK firm, and create a serious impediment to the audit of international concerns.
- Market share caps, or other limits or quotas, restrict companies from appointments based on audit quality. As a measure, this is unpredictable and harmful to the companies affected as well as the accounting firms at whom it is directed.
- Audit committees are best-placed to make decisions on the appointment, management and removal of auditors.
- An audit takes a risk-based approach. The judgment of the senior auditor is critical to a high quality outcome. A “blind” process would inhibit the assessment of this and other leadership qualities.

Alternative options

We do believe options exist that would promote competition and choice, and which do not have the detriments associated with those set out in the invitation to comment. These include:

- Compensating small firms for the costs of tendering.
- Encouraging greater use of small firms for assurance engagements.
- Permitting the use of skills and expertise from the Big 4 by smaller firms, especially with regard to access to subject matter experts and specialists.

We would be happy to meet to discuss our comments in more detail if this would be helpful.

Yours faithfully

Matthew Waymark
Interim Director of Finance

Responses to questions

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

Question 2 *How well does the audit framework support the interests of both direct stakeholders and also wider stakeholders in the economy?*

The value of audit

The delivery of audit, and related assurance services, is something that brings considerable value. The activities of the auditor:

- provide assurance to our shareholders;
- support the oversight of our senior management by the company directors; and
- help raise awareness of issues across the organisation, including the linkage of issues and risks across the organisation that might otherwise be missed.

As a provider of finance, we also take comfort from the work of the auditors of our customers, both through their statutory role, and supplemental assurance work on the ability of those companies to service lending.

Public concern

The association of accounting firms with high profile failures creates significant public concern about the effectiveness of audits, and this represents a real threat. This reflects the expectation gap noted in the invitation to comment, but also reflects a broader issue as to whether there has been a decrease in the quality of audit services.

The UK market place

The UK financial sector attracts many international companies, making the delivery of the audit an international not a UK-only activity, and this makes global service provision a critical component of a successful audit firm.

Developments in reporting

We also see the development of corporate reporting extending beyond its traditional financial measures, with non-financial measures and metrics taking increasing prominence in the measurement and evaluation of company performance. The audit framework primarily focuses on financial aspects, while wider reporting is often provided through broader assurance engagements, often delivered by the incumbent auditor. The reduced focus on the financial statements and the demands for faster reporting may be unhelpful in maintaining audit quality.

Question 3 *To what extent do the decisions made by audit committees support high-quality audits, whether through competition for audit engagements or otherwise?*

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

Role of the audit committee

Individuals on audit committees include those with specialist skills and experience relevant to that entity. This committee is, therefore, best placed to consider detailed decisions regarding the auditor.

We believe that the decisions on the appointment of a statutory auditor, their work, performance and fees should be the responsibility of the audit committee. Unlike other areas of company activity, management has a limited role to enable the committee to make these decisions. In other areas, management carries delegated responsibility.

Audit committees actively wish to see robust challenge to the judgments of management and the processes established by management. We therefore see the audit committee as a critical driver in promoting audit quality because the greater level of challenge is likely to enhance and improve management decision making.

Our experience

We considered which attributes were most important in determining audit quality, and were most influential to our choice of auditor. Our Audit Committee established the parameters of our search, and company management provided data back to the committee to allow it to reach a decision. The factors that were most important in our decision were:

- The ability to establish a "bespoke" audit that properly reflected the shape and challenges faced by the organisation rather than the application of a 'generic' audit template

- The ability and willingness to provide an effective challenge to management from an external perspective and the inclusion of subject matter experts to support the audit team
- The overall breadth and quality of the senior partner team offered

Key considerations that influenced these factors were:

- The ability to cover all areas of the organisation and to use the knowledge to spot trends and issues that might have eluded management
- Coverage across key international locations where RBS conducted business and/or operations and to bring experience from similar scale banking organisations into the audit team
- [§<]

Changes over the last ten years

The previous intervention from the Competition Commission has already led to greater independent scrutiny of the methodologies of audit firms. This is a helpful development, since audit committees did not have visibility of the internal processes of the auditor – and this also provides an additional line of defence, in much the same way as internal audit functions do within the company.

Corporate governance already promoted the idea of periodic tendering, so the introduction of mandatory rotation continued a theme already in place. However, as we have seen with our recent change of auditor, we believe there is value from the fresh perspective that a new audit team brings to an organisation.

CHOICE AND SWITCHING

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

Question 6 *In particular, how effective is competition between the Big Four and between other firms and the Big Four?*

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

Question 8 *What is the role for competition in the provision of audit services in delivering better outcomes?*

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

Question 10 *What are the key factors limiting choice between auditors?*

Question 11 *What are the main barriers to entry and expansion for non-Big Four audit firms?*

Lack of choice

As a large bank, with international operations, we do believe choice is problematic. Outside the Big 4, most accounting firms do not have the scale of global coverage to act as our auditor. We have to ensure that our auditor has presence in the countries we operate in and have adequate quality in each of those countries.

Further, if we must rotate our auditor, then our past (incumbent) firm is unavailable as a potential option, regardless of the quality on offer. If we find another firm is conflicted then we may only face a choice of two firms. As a bank this conflict also includes the possibility of the accounting firm having a banking relationship with us – in such cases it may be onerous for the firm to change its banking arrangement.

Impact of mandatory rotation

The introduction of mandatory tendering has highlighted this issue of choice. Previously, a key tool for directors and management was the threat of a tender to spur improved quality. In this situation all four firms would appear to be viable alternatives. The reality now that re-tendering and change is frequent is that the choice is not as wide as thought.

Contracts with accounting firms

Increasingly accounting firms are entering long-term contracts with companies to provide services. These services often involve technology or areas of consultancy, management support or advocacy. The provision of these services is inconsistent with an appointment as auditor.

A company that chooses to undertake an audit tender would face particular issues in appointing a firm that is part way through a long-term contract. As a result, we believe this is a significant impediment to choice. We would consider contracts that exceed, say, 18 months are particularly likely to cause a problem.

Barriers to entry (bank auditors)

As a heavily regulated business sector, there are not, at this time, realistic alternatives outside the Big 4. We need an auditor that is seen as credible to our regulators, as well as one who is equipped to challenge management across the organisation. This typically requires significant specialist input.

The combination of international coverage, coupled with high quality individuals, plus the availability and credibility of subject matter experts and specialists creates a significant barrier to entry for smaller firms. At times even one of the Big 4 will not be an option if they do not have credible presence in countries that a company would consider to be critical.

The invitation to comment notes that the change in rotation led to the increase from three to four of the number of accounting firms auditing banks in the FTSE-350. This points to the decision to appoint our current auditor. While not undertaking any UK bank audits at the time of the tender, the firm had taken the commercial decision to significantly grow its UK financial services practice on the premise that it would be successful in a tender at some point. It was also able to point to its considerable international experience and to bring into the UK experienced individuals from its overseas offices.

RESILIENCE

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

We do believe that UK resilience is an issue affecting a Big 4 firm. Failure of one firm can impair choice and therefore competition. Even if a Big 4 firm does not fail but faces local sanctions in a single location, this is likely to create problems for any company that has significant operations in that location. A current example is the restrictions placed on KPMG in South Africa preventing their work on audits in that country.

REGULATION

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

Since regulation can create unintended consequences, we prefer outcomes delivered through competition. Regulation is less flexible, and less reactive to changes in environment and circumstance. Intervention should therefore focus on characteristics to support competitiveness in the market rather than seeking to restrict the practices of participants.

POTENTIAL MEASURES

Question 14 *Please comment on the costs and benefits of each of the measures in Section 4 and how each measure could be implemented?*

In the timeframe available, it is not possible to offer a detailed evaluation of each of the measures proposed. However, we provide broad comments on the key issues we perceive from the options set out. These are set out under questions 16 to 27 below.

Question 15 *Are there any other measures that we consider that addresses the issues highlighted in Section 3?*

1. Tenders are costly for companies to run and for the firms that participate. A robust process requires investment from both the company and the potential accounting firms. Competitors may be discouraged from bidding because of these high costs where they believe there is a low chance of success. We therefore believe options that enable smaller firms to recover some/all of their bidding costs would encourage greater competition.
 - a. The costs of doing so would need to be met, probably by the companies themselves. This would be challenging for smaller organisations.
 - b. Such an approach could risk the creation of making tender a profit activity which is not the desired effect. It would therefore need to be addressed so as to mitigate but not remove the commercial risk of tendering for winners and losers.
2. 'Fee blind' processes encourage a focus on audit quality. However, any organisation would be reluctant to commit to a supplier without understanding the costs of doing so. [3<]
 - a. Increasingly we see fee blind processes being recommended by those who advise on tenders. [3<]
 - b. Any fee-blind process arguably favours bigger firms that would typically require a higher fee than a smaller firm.

3. We would be supportive of mechanisms that encourage greater involvement from smaller firms. We believe one option might be to give greater encouragement to companies to use a wider range of suppliers for “assurance” activities. In doing so, companies would observe a greater number of potential auditors in operation and be able to see the potential audit qualities available. Restricting the statutory auditor to financial audit matters may encourage this approach. Requiring companies to disclose their policies on assurance provision could supplement this approach.
4. Allowing the Big 4 firms to offer advisory support to smaller firms and to provide access to subject matter experts or specialists may also help smaller firms access the wide range of skills they need to undertake an audit.
 - a. The key risk with this option is that the Big 4 and their staff may not have the correct incentives to make this expertise available. In doing so, they potentially harm their wider audit practice. Equally, they may not prioritise the third party provision over their own audit activities.

RESTRICTIONS ON AUDIT FIRMS PROVIDING NON-AUDIT SERVICES

Question 16 *Create audit only firms. Could this be effective, and what would be relative scale of benefits and costs?*

Question 17 *How do the international affiliations of member firms affect the creation of audit only firms?*

Question 18 *What should be the scope of any measures restricting the provision of non-audit services?*

International presence in the UK

The UK financial sector has built its success on the ability to attract international companies to list on UK markets. This means that the UK audit sector is especially dependent on its ability to harness a global network of audit providers. The consequence of this success is that measures that affect the audit firms in the UK only but are not applied equally at the international level will be ineffective and may even be harmful.

Non-audit services

There are already significant restrictions on the non-audit services that a statutory auditor may provide to the company and those services that the company can provide to the auditor. For a bank, these restrictions can cover banking relationships of individuals within the audit firm.

RBS's practice regarding non-audit services is restrictive. The bank procures few services other than activities where the involvement of the auditor is most relevant (notably private reporting on quarterly reporting, debt issuance reporting accountant work and regulatory reporting including s166 work). This is generally assurance in nature rather than advisory.

Effect on smaller companies

As a banking provider, RBS makes significant use of accounting firms to support restructuring activities with customers. We are concerned about the consequences of limiting the choice of firm selection and the risk of creating sub-optimal outcomes for customers where a bank is prevented in appointing the accounting provider with the best skillset and experience. Indeed for syndicated lending arrangements, it is possible that all of the major accounting firms could act as auditors for the lenders.

As a provider of finance, RBS is also a key user of the reports of auditors from its clients, and sees how smaller businesses utilise auditors in their wider business. While larger organisations typically have wide access to multiple accounting firms, making their engagement more straightforward, this is not true for smaller entities. We do not consider it appropriate to require the same restrictions on non-audit services for such smaller or less regulated entities. We do recognise that rotation is relevant for smaller entities given the possibility of this greater reliance.

MARKET SHARE CAP

Question 19 *How should the market shares be measured?*

Question 20 *Could the potential benefits of a market share cap be realised?*

Question 21 *What do you consider to be the relative scale of the costs of a market share cap and potential benefits?*

Question 22 *What should be the appropriate level of such a cap?*

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

Market share caps exist in some countries already. Our experience of these is that while such measures induce alternative appointments, companies are forced to compromise on audit quality. Market share caps create an artificial restriction on the company seeking an audit appointment, reducing the options available.

As such the remedy may mean companies are left facing a situation, at short notice, where they have to accept an appointment offering lower audit quality than they would have obtained from a wider field of candidates.

As a short term measure market share caps may provide smaller firms the option to take on some audit appointments and “prove” themselves. In the long run it detracts from competition and this may reduce the drive from firms seeking appointment.

Joint audits

While joint audits are used widely in some jurisdictions, they are not favoured in many. They are not prohibited in the UK, and historically there have been examples. However, they are no longer present in the UK market, which points to issues with their success.

We consider one of the primary benefits of an auditor is their ability to observe activities across the entire organisation and to draw linkages that management may not identify. Joint audits require the accounting firms to split up the organisation, which means that holistic oversight is no longer present. This is an impediment to understanding the organisation and being able to challenge practices within the organisation.

Question 24 *Should the auditors and those that manage them be accountable to a wider range of stakeholders including shareholders, pension fund trustees, employees, and creditors, rather than the current focus on shareholders?*

Question 25 *If yes, should audit committees be replaced by an independent body that would have a ‘public interest’ duty, including for large privately-owned companies?*

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

Role of the audit committee

We comment in question 4 above on the role of the audit committee. The audit committee is best placed to oversee the appointment, work and quality of the auditor.

Extension of participating stakeholders

Since auditors report to shareholders, the audit committee is relevant as a conduit, since the non-executive directors have direct accountability to shareholders for their actions. If the audit appointment took input from other stakeholder groups then it would be appropriate for this to affect how the audit committee undertook this responsibility.

The Companies Act is changing to require directors to more formally consider the interests of wider stakeholders in their decision making. From 2019 reporting on this will be included within the Annual Report.

Independent body

It is very difficult to see how an independent body can offer the same specialist skill sets and experiences that are available a company’s audit committee. An audit committee already has accountability to shareholders. With changes in corporate reporting and the Companies Act, directors need to articulate how they include wider stakeholder concerns and input into their decision making. From 2019, large companies will need to include information on this engagement within their annual reporting. We do not believe an independent body will enhance this.

Question 27 *Should companies be required to tender their audits and rotate their auditors with greater frequency than they are currently required to do? What would be the costs and benefits of this?*

Current law requires companies to tender every ten years and rotate auditors every 20 years. We commented above on the high costs of effective tendering, and we observe the undue affect this cost has on smaller firms that are successful on fewer occasions than larger firms.

Increasing the need for tenders and rotation will add bring additional benefit. It is notable that the mandatory rotation has brought about wholesale change in the delivery of audit. Further change does not seem to be warranted at this time.

Instead, the study should consider how to improve choice and quality.