The Association of Practising Accountants

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Project Director
Statutory Audit Market Study
Competition and Markets Authority
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London WC1B 4AD

Via email: statutoryauditmarket@cma.gov.uk

Dear Mr Hayter,

On behalf of the Association of Practicing Accountants (APA) I am pleased to enclose a written submission to your current Market Study.

APA firms collectively audit a significant proportion of the real economy from SMEs to the AIM market. We also bring sector expertise in areas such as the media, education and charities where a number of our firms undertake PIE audits.

Collectively we help drive employment and growth across the mid-market while at the same time ensuring that this vital sector of the economy is well managed and kept on a sustainable footing.

While our clients do not pose the same systemic risk as the top end of the market, in aggregate they represent a significant proportion of GDP – some 14,000 entities with turnover ranging from millions to hundreds of millions.

We also differ as a sector in that those who buy our audit services are typically owner-managed businesses where the purchaser is also the primary shareholder of the entity. As a result, there is generally an alignment of incentive in terms of the assurance we provide. Our clients also rely on us for a range of advisory services where it is more cost efficient for them to purchase compliance support and business counsel from the same firm.

As a sector we have two principle concerns:

1) That regulatory and market interventions imposed on the largest companies and their auditors do not disproportionately impeded audits of the mid-market where there is everything to suggest our firms provide a valuable service which is working well.

2) That any meaningful long-term solution to the current concentration at the top end of the market creates a context where medium-size firms can scale up over time to take on more of this work.

On this second point it is worth noting that a key conclusion of the last Competition Commission enquiry in 2013 was that *"Mid Tier audit firms face barriers to entry, expansion and selection in the FTSE 350 statutory audit market".* There is little to suggest much has changed in the intervening five years despite the new audit-tendering regime.

Recent qualitative research we have undertaken among our managing partners suggests that a significant minority would want to step up if the regulatory and market barriers to entry were less acute.

Our research also suggests that compliance costs, coupled with increased liability exposure, were the biggest disincentives for APA firms to enter this market. While scale and expertise were also identified as challenges there was nothing to suggest longer term these could not be overcome.

If the overarching objective is to encourage a more competitive audit market with multiple players helping drive quality and choice, a key consideration should be how to encourage smaller firms to skill up to take on this kind of work. As you will see from our comments below we believe shared audit is, on balance, the best way forward here. This is not a short-term fix but it is one that could ensure the long-term sustainability of the sector.

Yours sincerely,

Clive Stevens
Chairman
Association of Practicing Accountants

CMA Statutory audit market – Invitation to comment

Consultation Questions

A) Issues

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

There is every indication to suggest that audit across the mid-market, which includes a significant proportion of the real economy, is currently providing a valuable service to its stakeholders who rely on the assurance we provide in order, among other things, to secure funding for growth.

While there are legitimate questions to be asked of the audit profession when there is market failure it is worth remembering that there are many examples of high quality audit that go unremarked because the profession has done a good job.

At the top end of the market more needs to be done to bridge the expectation gap between what an audit provides and what stakeholders might legitimately expect it to provide. If this requires that the profession work with wider market participants to rethink the current audit model would be supportive of this move provided it does not disproportionately impact the mid-market whose stakeholders are different and value the service we provide.

Theme 1: The audit framework

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

When the current framework is applied correctly it supports both the interests of direct and wider stakeholders requiring a high level of assurance before a clean audit opinion can be issued. As noted above however, at the top end of the market the gap between public expectations of what an audit delivers and what is required under current auditing standards may indicate a need for enhanced auditing standards for the largest, most complex entities.

Theme 2: Incentives and governance

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

Across the mid-market the majority of entities are owner-managed businesses where there is not the same need for an audit committees to represent the interests of beneficial owners. Where our member firms do undertake PIE audits – in specialist areas such as academy trusts and the charitable sector – we are clear that the role of the audit committee should be to ensure that auditors are appointed to undertake high quality work where the driver is not just cost but value. In practical terms that means ensuring that there is a robust and competitive tendering process where firms are invited to compete on the basis of their expertise in a given sector.

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

While the new tendering regime that was introduced has undoubtedly put the role of audit committees into the public eye there is little evidence to suggest that it has fundamentally changed the composition of the current audit market. To the extent that greater competition drives higher quality audit, more needs to be done to incentivise smaller players to step up including the need to challenge the 'Big 4 only' bias that is still prevalent the top end of the market. High quality audit is not just about scale, as the PIE clients that APA firms currently audit will testify.

Theme 3: Choice and switching

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

While there is clearly intense competition for the FTSE 350 between the largest firms the failure of smaller firms to get any meaningful purchase on this market over recent years suggests that competition in the audit market is not currently working well. There are a variety of barriers here:

- The scale of the largest firms is of a quantum that makes it hugely difficult for the next tier down to bridge the gap.

- As noted above, an inherent bias among audit committees to appoint the largest firms makes it difficult for new entrants to get purchase at the top end of the market.

- The sector expertise it would require for smaller firms to skill-up to take on this work is not something that could be achieved overnight.

- Moreover the risk appetite among mid-tier firms to take on this work, in the main, does not exist at the moment. For that to change there would need to be a more proportionate regulatory framework where the risk/reward balance was realigned to enable smaller firms to gain the experience to take on these kinds of audits.

6. In particular, how effective is competition between the Big-four and between other firms and the Big-four?

In terms of the listed company market competition between the Big 4 appears to be robust. Competition between the Big 4 and smaller network firms is more or less non-existent as evidenced by the very small number of FTSE 350 audits undertaken by smaller players.

In terms of competition for smaller, non-PIE audits across the AIM market and owner-managed sector competition is generally strong as evidenced by the 15 APA firms who regularly compete with each other for this share of the market.

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

A key conclusion of the last Competition Commission enquiry was that "*Mid Tier audit firms face barriers to entry, expansion and selection in the FTSE 350 statutory audit market"*. There is little to suggest much has changed in the intervening five years despite the new audit-tendering regime.

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

As a general rule competition should drive high quality audit forcing firms to compete with one another on value as well as price.

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

For the largest, most complex entities, conflicts of interest between the Big 4 mean that the choice is often not just between four firms but in reality between three or even two. Over the long-term this is not sustainable.

10. What are the key factors limiting choice between auditors?

At the top end of the market where there is often a need to audit highly complex entities over multiple jurisdictions scale, international presence and specialist expertise are all factors.

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

Recent qualitative research we have undertaken among our managing partners suggests that, while a majority do not currently have the risk appetite to enter the PIE market, a number of our member firms are doing PIE audits while a significant minority would want to step up if the regulatory and market barriers to entry were less acute.

Our research also suggests that compliance costs, coupled with increased liability exposure, are the biggest disincentives for APA firms to enter this market. While scale and expertise were also identified as challenges there was nothing to suggest longer term these could not be overcome.

If the overarching objective is to encourage a more competitive audit market with multiple players helping drive quality and choice, a key consideration should be how to encourage smaller firms to skill up to take on this kind of work over the longer-term. APA firms would be happy to help research and identify practical solutions to these barriers including shared audit, which would enable our member firms to gain the expertise and client exposure to take on this work in their own right.

Theme 4: Resilience

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

Yes. As noted above for the largest entities choice is often not just between four but three or even two. For these reasons, in the event that reputational damage brought about the collapse of one of the existing Big 4, it would difficult for the remaining three to step in.

Theme 5: Regulation

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

A number of APA firms come under the direct jurisdiction of the FRC in virtue of the size of their audit clients. At the moment our sense is that the regulator takes a one size fits all approach where a more proportionate regime would help encourage more firms to compete here.

While we understand that the regulator needs to ensure there is robust oversight at the top end of the market it often feels like there is little understanding of the distinct challenges faced by the mid-tier firms or the risk profile of our sector.

We do think the FRC has a potential role to play in terms of promoting competition here and have responded separately to the Kingman review on these issues.

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

Increased competition between the Big-four

We do not think it would be either viable or desirable to split the audit and non-audit arms of the Big-4, which as your analysis notes, creates its own issues. Such a split would also be likely to drive up cost and reduce audit quality because of the restrictions it would place on access to specialists across these firms.

Increased competition from non-Big-four firms

(a) Market Share cap
From a mid-tier perspective there may be some merit in market caps but there is also a danger that the larger players would use this to jettison higher risk clients which would be unlikely to find homes with mid-tier firms because of the perceived risk / liability exposure here.

(b) Joint or shared audits, or peer review

In principle both approaches have merit. In practice our preference would be for shared audits where there is likely to be less duplication of work and where it is easier to limit our liability exposure. While there is risk that such an approach could drive up costs, if over time this allowed smaller firms to get a foothold into the market the public value would be worth the pain.

(c) Direct support

We can see little market incentive why the Big 4 would want to provide such support and in practice the level that would be required in relation to highly technical audits would probably be unpractical to deliver. However, we could see merit in for example the sharing of audit methodologies and IT systems provided this were done through an independent third party such as the ICAEW.

(d) Reducing movement barriers

Until the scale difference between firms can be addressed through industry consolidation and growth across the mid-tier it is difficult to see this leading to anything other than a move to another Big 4 firm.

(e) Restrictions on ownership

There could be potential benefit here in terms of increased investment.

(f) Break-up of the Big-four

As your own analysis makes clear there are too many possible unintended consequences to make this a viable option.

Measures to improve incentives

Transferring power directly to shareholders would help tackle some of the disincentives identified by the CMA but such an approach would need to be capable of being implemented at a practical level and it is unclear how this would be achieved.

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.

While it is right that auditors should face increased scrutiny when there is a major company collapse such as Carillion the role of Directors also needs to be considered as part of any rounded set of market or regulatory solutions.

When things go wrong it is understandable that auditors are called to account but it is often the case that a failure of company stewardship or governance are actually to blame. Taking Carillion as a case in point the company was highly exposed to the public sector at a point in time when this sector was reducing its expenditure significantly. Arguably this risk should have been identified and managed better earlier.

Restrictions on audit firms providing non-audit services

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. As noted, to audit complex multifaceted entities requires a breadth and depth of expertise which would be compromised under such a model. Moreover such an approach would be likely to result in these types of audits being done by firms outside the UK which would risk undermining a hugely important sector of the economy.

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?

See 16 above.

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 measures need to be proportionate to the problem we are trying to fix and should not adversely impact the mid-market where there is simply not the same level of systemic risk.

Market share cap

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

The easiest and simplest way to measure market share is by number of entities audited. This figure could be weighted for FTSE 100 but overall needs to be transparent and easy to assess.

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

On balance we think not. It would also risk artificially altering the market for audit services.

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?

This figure is difficult to quantify but merits further analysis.

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%?

See 21 above.

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

Potentially in that it provides a less blunt instrument than simply limiting the share of audits a given firm can perform but again such an approach raises issues around liability exposure which would need to be addressed in tandem.

Incentives and governance

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?

As previously mentioned there are subtly different lines of accountability for mid-market auditors and there is nothing to suggest these lines of accountability are not working at present. At the larger end of the market this is an issue that could be explored as part of review of the current expectation gap for larger, more complex PIEs.

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?

In principle this could merit further examination but any moves to introduce such an approach would need careful cost benefit analysis as well as a through examination of potential unintended consequences. Otherwise the introduction of yet another moving component simply introduces additional complexity.

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

This would depend on the terms on which such a body was created but the obvious benefits would be greater independence from management versus the risk that this distance impedes fully formed decision making as to which auditor is best placed to undertake the work.

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?

The experience of the last few years has been that increased audit tendering alone is not enough to drive a significant difference in market behaviour. While there is merit in regular tendering as a driver of audit quality unless a set of underlying issues to do with scale and risk appetite can be addresses through a more proportionate regulatory regime it is difficult to see that increased tendering alone making a significant difference here.