

Appendix: CMA Review of the Statutory Audit Market

Consultation questions

A) Issues

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

In general stakeholders are not being well served. The key stakeholders (the shareholders) have little or no input to the procurement and management of the external audit service. There are concerns that:

- Professional audit practices are conflicted by the fact that they also provide non-audit (consultancy) services. The audit is a route to winning additional lucrative consultancy business.
- Competitive tendering is being used to reduce the cost of the audit rather than achieve best value for money.
- Audits are often 'skimped'. They are seen as a formality and are 'done to a price'. Shareholders can no longer rely on the audit and it is a matter of sheer luck that there have not been more major audit failures recently.
- There is a suspicion that in most cases the service provided by the external auditor is no longer fit for purpose. Audits are based on ticking boxes and monitoring adherence to rules rather than principles.

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?*

At present it is, to varying degrees, failing all of them. For example, the bankruptcy of Carillion did not merely impact retail shareholders. It also caused serious damage to:

- The many suppliers and subcontractors who have lost money; some of these business will fail as result with the owners facing bankruptcy and their employees losing their jobs;
- Some 43,000 Carillion employees who have lost their jobs, including 19,000 in the UK;
- The financial prospects of the many thousands of members of Carillion's pension fund;
- Carillion's customers (not least one of which is the UK government) in terms of losses, dislocation to services, delays in completing works contracts and the costs of finding new suppliers and re-letting contracts.

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?*

This is very unclear. We believe that there are serious deficiencies in the procurement process for audit services. These are discussed in our covering letter. We also suggest possible solutions.

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

We have no feedback to give about this.

Theme 3: Choice and switching

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

There is competition but it does not work well. As outlined in our covering letter the (sensible and well-intentioned) constraints on firms doing non-audit work for clients are having the perverse effect of limiting competition.

FTSE 100 companies have been lazy and remiss in failing to encourage a healthy supply market for audit services that can meet their needs. They claim that only the Big Four practices have the scale and reach to provide the service they require. This sounds like the argument that 'nobody ever got fired for hiring IBM'. They have done little to try to encourage the smaller suppliers and, if anything have tended to shut them out.

There is nothing in the public domain to reassure investors that when companies run a competition for audit services it is open, fair and based on achieving best value.

Although, t strictly speaking, there are four large players in the audit market, at the point at which the audit has to be rotated there are actually only three.

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

It appears not to be effective as evidenced by Grant Thornton's decision to withdraw from bidding for FTSE 350 audit contracts because they consistently failed to win them on the grounds that they were not competitive with the Big Four.

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

We are unable to comment.

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

See our covering letter. Competition alone will not guarantee high quality audit services with the desired outcomes for stakeholders. The wider procurement process is flawed.

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

As indicated in our response to Q.5 they could have more choice. It is up to them as the buyers of these services to ensure that they have sufficient choice to meet their needs and those of their stakeholders. Over the last twenty years or so they have failed to do this. They have sat back and watched as the supply market has consolidated to become an oligopoly. They seem to have taken the view that the statutory audit is a formality; the only real requirement for selection is that they get on well with the audit partner/s. It is only recently that they have been forced to retender the audit contract every ten years and rotate it at least every twenty years. Prior to this some audits had remained with the same firm for over a hundred years. There is no other area of procurement in which this would have been tolerated.

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

There are a number of factors, some real, some perceived. The main ones are:

- The perception that only a Big Four auditor has the global reach, resources and depth of expertise to handle the audit for a FTSE 100 company. We suspect that this perception is unjustified and that there are audit firms other than the Big Four which could audit many FTSE 100 companies.
- The desire on the part of companies to 'play for safety' when choosing an auditor. This is the 'nobody-got-fired-for-hiring-IBM' syndrome. It may look harmless but it is corrosive because it results in a supplier being chosen for all the wrong reasons.
- The fact that many smaller audit firms really are too small to take on the audit of a large company.
- Potential reputational risk; there were a number of scandals some years ago where companies got into financial trouble and it subsequently turned out that the auditor was a small company whose senior partner played golf with the chairman of the client company.
- Concerns about impartiality and favouritism – particularly following the Enron scandal. If the FD is a former employee of, say, [], will suspicions of favouritism be raised if [] is awarded the audit contract? This issue can cut both ways. At some companies there may be a predisposition towards hiring an audit firm where you know many of the people, the culture and style of the organisation.
- The restrictions on the amount of non-audit work that a company's auditor can take on with their client. This has a potentially limiting effect when the time comes to re-tender the audit – and particularly when the time comes for the audit to be rotated. At this point these can only possibly be three contenders from the Big Four. If one of the three is already doing significant consultancy work or providing, say, internal audit services then there are in effect only two bidders.

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

The main barrier seems to be the perception on the part of many large public companies that anyone other than a Big Four firm is simply not capable of handling their audit. This perception is almost certainly unjustified.

The cost of bidding for major audit contracts is significant. It is not surprising that a firm like Grant Thornton has decided to pull out of the market altogether if they are incurring high bidding costs and not winning any work.

Theme 4: Resilience

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

We are unable to comment on this

Theme 5: Regulation

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

This is a false dichotomy. Regulation in the audit market is not inhibiting competition. There is a problem with quality in the audit market. This, however, is not related to an intrinsic lack of competition.

Audits are not fit for purpose, as discussed in our covering letter. This is neither a competition nor a regulation issue – although the current regulatory regime has contributed to it. Auditing has become highly formulaic. It has increasingly become focused on identifying whether certain rules have been followed and on putting ticks in boxes. This is reinforced by the fact that the existing regulatory environment is primarily based on the observance of rules. The problem with this is that:

- Rules cannot cover every eventuality. It is too easy for companies to 'game' a rules-based system by adhering to the rules while adopting approaches to financial reporting which are legal and comply with the letter of the rules but which fail to reflect the standards of reporting that investors and other stakeholders expect. Carillion's approach to its financial reporting was a case in point. Quindell was another.
- Under a rules-based system the regulatory environment becomes one in which the regulator tends to refer to the rule book when deciding whether standards are compliant. This is not a sound basis for ensuring 'true and fair reporting' – which is one of the FRC's key priorities. It is worth noting that 'true and fair reporting' implies a judgment from the regulator. It is crucial that the FRC should be able to exercise this sort of judgment and that those they regulate understand this. A rules-based approach frustrates this requirement.

The FRC has a strong case to answer in this respect – a point that we have made strongly to Sir John Kingman in [?] his review of the FRC.

B) Potential measures

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

Please see the comments and suggestions in our covering letter. Our preferred courses of action are to:

- Improve the professionalism and transparency of the procurement process (not just the tendering process).

- Strengthen the links between audit committees and their key stakeholders – the primary stakeholder being the shareholders.

In addition to this there are sound arguments for:

- Reducing the maximum period of any audit contract. A maximum period of seven or eight years might be more appropriate. The longer the period of tenure, the less scope there is for competition. It is unusual in the public sector (which is obliged to follow good-practice purchasing principles) for contracts to be let for more than five years. Only the largest and most complex contracts involving significant investment by the supplier run for longer.
- Stopping audit firms from offering consultancy services. The current system of allowing audit firms to offer consultancy services creates many actual and potential conflicts of interest. Audit work should command fees which enable audit to be a profitable activity in its own right. It should not have to depend on consultancy revenue to support it or to provide attractive career opportunities to employees. However, we acknowledge that achieving this split outside the UK could be difficult. Nevertheless, the UK should be leading the world in this respect.

We are not in favour of:

- breaking up the Big Four to create, for example, the ‘Slightly Smaller Eight’. We believe that this would be difficult. Even if it were done in the UK it would not be possible in all other countries. More crucially, it would not directly address the overriding problem of audit quality.
- creating an NAO-style auditor. The NAO does not do audits as the private sector would understand them. It does value-for money audits for public sector organisations. It is not concerned with issues such as revenue recognition, distributability of dividends and how to value goodwill. It would have to acquire this knowledge and skills from somewhere – probably the Big Four auditors. It would be prone to the same sort of ‘capture’ that has constrained the regulators such as the FRC and the FCA.

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.

Please see the covering letter.

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?

As mentioned in our response to Q14, we believe that this would be appropriate. We have concerns about the conflicts of interest that the current system of combined audit and consultancy practices creates. However, we acknowledge that, even in the UK, a split in which all ties and alliances between the two parts were severed could be difficult to achieve. In some

part of the world it would almost certainly be impossible. We are not able to comment on the likely costs of doing this but strongly believe that the benefits of avoiding another Enron and avoiding the conflicts that arose at Carillion would be huge and could easily outweigh the costs.

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?

We are not able to comment on this. However, the key requirement is to have an audit-only firm responsible for the auditing of the UK parent company.

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?

The restrictions should apply to all audit firms that tender for the audits of large companies and PIEs. We suspect that it would be unhelpful to the owners of small businesses if their accountants and auditors were banned from providing services such as tax advice.

Market share cap

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

We have no particular view on this.

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

We are unable to comment on this.

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?

We are unable to comment on this.

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%?

We have no views on this.

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

We have no particular views on whether joint audits would be an effective means of implementing a market share cap. However, we do believe that joint audits would be a potentially interesting way of enabling mid-tier audit firms to work for some of the UK's largest companies thereby helping them to gain a foothold in this sector of the audit market.

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?

In principle, yes. The shareholders are a key stakeholder as the ultimate owners of the company and are Primary under CA2006, S172. However, they are by no means the only stakeholder. Suppliers, customers, employees and pension fund trustees all have a legitimate interest in the ongoing viability and success of the company.

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?

We are doubtful about this idea. We would prefer to see a system of stakeholder groups working closely with audit committees as outlined in our covering letter.

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

The main risk is that it removes both control and responsibility from those who should be exercising their stewardship responsibilities. Many of the large shareholders (fund managers) fail to take any active involvement in the businesses in which they invest other people's money. As Lord Myners has said, shareholders all too often act like absentee landlords. Shareholders need to be encouraged to become more involved in the companies they own, not provided with a system that absolves them of any requirement to become involved.

We would prefer to see a system of stakeholder groups. Fund managers and other institutional investors have argued that they could not possibly provide representation on all the stakeholder groups of the companies in which they are invested. This is another lame excuse. They are handsomely paid by their clients and customers and it should be well within their capabilities to ensure that they do have the resources to play an active role on any stakeholder group. This should be a key element of their stewardship responsibilities.

The areas in which an independent body would be helpful are those of:

- assisting with setting up and facilitating stakeholder groups;
- assisting with the provision of guidance and training for stakeholder groups;
- carrying out a review of a sample of audit procurements each year to ensure that the bidding, evaluation and selection process was open, fair and professional in all cases;
- Intervening, if necessary, to ensure that stakeholder groups did not become prey to capture or disruption from single-issue, special interest organisations with extreme views.

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?

See our response under Q14 (Reducing the maximum period of any audit contract)