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Statutory audit market study
Competition and Markets Authority ("CMA")
7th floor, Victoria House
37 Southampton Row London WC1B 4AD
**email:** statutoryauditmarket@cma.gov.uk

**Re: Market Study Notice - Supply of Statutory Audit Services in the United Kingdom ("the matter")**

Dear Sir/Madam

As an interested party who has worked in both the Big Four and mid-tier audit firms in UK I take the opportunity to make representations on the matter. I believe that CMA should make a market investigation of the matter. I do not object my response to be attributed to me by name.

**Comment on "Scope of the market study"**

CMA has outlined that "The scope of the market study will be the supply of statutory audit services in the UK to large companies, both listed and private, and public interest entities (PIEs)". The inclusion of private large companies significantly widens the scope of the market study. Currently the focus of FRC audit quality reviews is on PIEs audits. The annual FRC publication "Key facts and trends in the accounting profession" compiles data only from audit firms who provide audit services to PIEs. It is suggested CMA defines the term "large private companies" in the market study and obtains data on audit concentration from the recognised supervisory bodies (ICAEW, ACCA and ICAS).

The consultation questions have been answered in detail in the appended Questions box. Below is a summary of the measures that are regarded as most effective under each theme. It is my firm belief that only a combination of these measures can lead to radical change in the audit market.

**Theme "Choice and switching"**
Measure 1 - Restrict audit firms from providing non-audit services to PIEs audit clients
Measure 2 - Split the UK arms of major accounting firms into audit-only and non-audit services practices.

**Theme "The long-term resilience of the sector"**
Measure 1 - Market share cap
Measure 2 - Joint audits
Measure 3 - Changes to restrictions on ownership of audit firms

**Theme "The incentives between audited companies, audit firms and investors"**
Measure 1 - Break the link between company management and auditors

Yours faithfully

X

Filip Lyapov

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# Appendix - Consultation questions

**A) Issues**

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

*The audit sector fulfils its main purpose to provide attest service to its stakeholders. Its quality is comparable to other professional services markets; however, it sells a high risky, litigation-prone, low margin service and is often exposed to not always warranted negative criticism. The "expectation gap" still exists and more must be done to educate the public. The extended audit report was a step in the right direction.*

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?

*The audit framework is based on well-established International Standards on Auditing ("ISAs") which are regularly revised/improved and customised for UK specific company law. The interests of all stakeholders are well protected.*

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?

   *Audit committees have strengthened their role and their decisions support audit quality as a buffer between auditors and management in fee negotiations and mediator in disagreements over accounting issues.*

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

   *The role of the Audit Committees has changed for the better after the intervention.*

Theme 3: Choice and switching

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

   *The competition in the FT 350 market is not working well. The size, complexity and risks associated with there large listed companies make it very difficult for audit firms outside the Big Four to compete with the Big Four. The profit margins are not very high compared to private company audits, there are higher risk management costs which these firms are struggling to absorb. The mid-tier audit firms are better off with provision of more profitable non-audit services to FT 350 clients.*

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

*For the reasons above the competition is not effective and there is little choice in the market.*

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

   *The intervention did not lead to significant change in the status quo.*

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

   *I do not believe competition can affect significantly the quality of the audit which tenet is high quality. However, competition is very important for fair audit fees for all stakeholders.*

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

   *The choice is very limited between the Big Four and the next 5 mid-tier firms.*

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

    - *Limited technical capability and investment capacity of non-Big Four firms to audit PIEs*
    - *Conflict of interest when many of the Big Four and mid-tier audit firms provide non-audit services to PIEs. The conflict of interest problem covers the entire international networks of these firms.*
    - *Market perception among the key stakeholders that only the Big Four audit firms can conduct big and complex audits*
    - *Some mid-tier audit firms they have decided to abandon the FT 350 market – this further limits the choice between auditors*

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

    - *Capital, staff, technical, marketing and IT resources needed to audit PIEs*
    - *Public trust in mid-tier audit firms to be increased and promoted*
    - *There is a concentration of Big Four alumni acting as Audit Committee chairs*

Theme 4: Resilience

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

    *I do not see such significant risk; the audit market is resilient and was tested with the collapse of Arthur Anderson in 2002 and it survived. If a Big Four firm fails, its audit staff and partners will join the mid-tier firms. Compared to other EU countries UK has the largest number of registered audit firms, its audit firms are bigger in size than its EU competitors and the number of statutory auditors (physical persons) is only second to Italy.*

Theme 5: Regulation

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

*Audit has become highly regulated and litigation-prone profession which hinders investments and competition. Non-Big Four audit firms must invest in deploying senior legal and technical resources to deal with ongoing inspections and investigations.*

**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.

<u>Measure - Restrict audit firms from providing non-audit services to PIEs audit clients</u>

*This has been almost implemented with the Ethical standard. With no cost the complete ban can be extended to all non-audit services provided by audit firms to PIEs audit clients. This measure will benefit the creation of audit-only firms in the mid-term.*

<u>Measure - Split the UK arms of major accounting firms into audit-only and non-audit services practices.</u>

*Over the past 20 years the proportion of audit fees total fee income in the Big Four has fallen from 40% to 20% (mid-tiers: 27%). The concept of audit-only firms has been discussed after the credit crisis and still has considerable costs and benefits attached to it.*

*<u>Costs:</u>*

- *PIEs may need to change their non-audit service providers who will choose to be audit-only;*
- *UK audit-only firms would likely need to remain connected to the international network in order to service global clients, leaving questions whether both the audit-only and the non-audit services businesses can remain part of the network (the practice of having more than one member firm in one country is existing);*
- *Audit-only firms must hire or use external experts skilled in advising the audit teams on complex areas – tax, valuation, actuarial, IT, IFRS*;

*<u>Benefits:</u>*

- *increased actual and perceived independence of auditors;*
- *increased choice of auditor, by removing the possibility that major firms could be conflicted out of bidding for audit work because of their non-audit practices;*

- *it could benefit retention of top talent in the audit-only firms because currently many senior auditors move into consultancy or industry*

*Implementation*

*This will require change in legislation and could prove to be a costly and time-consuming exercise due to the complex LLP agreements between the audit and non-audit partners in terms of separation. It should go with a suite of other complementary measures – modification of ownership rules and giving audit firms more access to capital.*

Measures to reduce the barriers for non-Big Four firms to build their capacity

Market share cap

*Benefits;*

- *increase of the number of audit firms in the market and the choice of auditors;*
- *non-Big Four firms would gain experience on complex audits and build their capacity*

*Costs:*

*The costs will be associated with switching of auditors for some companies*.

Joint or shared audits, or peer review

*Out of these measures joint audits appear to be an effective measure with proven results in France and other EU countries. This will lead to greater competition and resilience in the market, more scrutiny over the accounts and smooth rotation process. A disadvantage for the measure will be the increased cost of audit fees, professional indemnity insurance, engagement quality reviews and more time for the joint auditors to agree on the final audit report. The implementation would require change in legislation and expected resistance from the market.*

Measure - Direct support by the Big Four and/or professional bodies to the mid-tiers

Measure - Reducing the barriers for senior staff to switch between audit firms

*These measures seem to be not very practicable.*

Measure - Changes to restrictions on ownership of audit firms

*This is a critical measure in case the CMA recommends the introduction of audit-only firms. Audit-only firms would need capital to build the capacity to be better placed to take on audits of larger listed companies. The Boards of* *these firms must be controlled by statutory auditors who should implement safeguards for maintaining independence and objectivity.*

Measure - Break-up of the Big Four into smaller audit firms

*Costs:*

- *complex and unprecedented legislation to be introduced;*
- *challenges with the ownership structures due to the international network and loss of access to the global reach*
- *duplication of many non-productive activities that must be replicated for many smaller audit firms;*
- *redundancies and staff retention issues would undermine the sustainability of the smaller audit firms*
- *smaller audit firms would be disadvantaged in winning audit tenders for big global companies*

*Benefits;*

- *increased choice and competition in the audit market*
- *decrease of concentration and risk of "too big to fail"*

Measure - Break the link between company management and auditors

*The costs and benefits of setting up an independent body to select, appoint and pay fees to the auditors are discussed in Question 25.*

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.

    *No other measures.*

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?

    *This could be effective if the audit-only firms are supported in providing a wider range of ISA assurance services related to non-financial information for the private and public sector – e.g. effectiveness review of NHS, attestation of subscription, membership, environmental metrics, contract covenants etc. The costs and benefits were discussed in Question 14.*

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?

    *The Big-Four audit firms have become very much global corporations and they will oppose the creation of audit-only firms as this will diminish their global financial powers and coverage. In many cases the ownership of local member firm is controlled by international structures based in foreign jurisdictions.*

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 firm that tenders for the audit of PIEs and large private companies must be restricted from provision of non-audit services to its audit clients at minimum.*

Market share cap

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

*The market share cap should be measured in relation to the following benchmarks depending on the type of sector:*

- *Large commercial public and private companies – revenue*
- *Banks, other credit institutions and pension funds – gross assets*
- *Investment trusts and venture capital trusts – net assets*
- *Insurance undertakings – gross written premium*

*If there is a significant deviation between the market share calculated against the benchmark (e.g. 20% of insurers) and the market share of audit fees for this sector (e.g. 40%) the market share cap could be adjusted to reduce the discrepancy.*

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

*Yes, this measure would be effective and will provide incentive to mid-tier audit firms to invest.*

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?

*The benefits of increased competition between the audit firms and the greater choice will outweigh the costs of introducing a market share cap.*

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%?

*The cap must be introduced in a phased approach but on individual firm level to avoid any collective schemes by the Big Four. Below is an example:*

*By 2022 – no audit firm should have more than 20% of any separate industry or total audit market of PIEs and large companies*

*By 2026 – not more than 15%*

*By 2030 – not more than 10%*

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

*Yes, joint audits will be in a proportion 50% to 50% or at least 60% to 40% of audit involvement by the joint auditor. This will reduce the market share of the Big Four.*

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?

*No, the auditors have duty of care only to the shareholders to whom they report. Auditors should not be blamed for failure of companies with poor governance. The scope and responsibilities of the auditors are often misunderstood by the general public and the expectation gap did not narrow over the years. The public still expects a protection against fraud and confirmation of the financial health of the entity being audited. However, if we look at the audit as a business who produces half a million audit reports in the UK (its product) then the faulty products (wrong audit reports) is a very small fraction. In many cases these failures are due to professional judgment and interpretation of complex accounting matters and significant matters.*

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?

*The audit committee have important role to monitor internal and external audit and they should continue its function.*

*However, the idea of creating an independent body to select and appoint the audit firm on behalf of the shareholders has its supporters and has been* *applied in certain countries where the auditing experts have been appointed by the court. The independent body will be funded by fees from all audited PIEs and large private companies and its staff will be made of various representatives – shareholders and investors, the accounting bodies and various industry professional organisations. In this way the auditors will be independent from management and will be paid by the independent body.*

*The Audit Committees will continue to manage the scope of the audit and will manage and evaluate the performance of the audit firms by giving feedback to the audit firm and the independent body.*

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

*The independent body will not replace the audit committees but will appoint the auditor through a selection process and will determine the audit fee. The costs for audit tenders will be significantly reduced which will benefit the audited company and the auditor. Auditors will be fully independent from management and could apply strong professional scepticism and challenge any controversial accounting practices. Being appointed by management auditors are conflicted and even if they provide robust challenge on controversial practices they may lose out by either resigning or not being retained if they qualify their opinion.*

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?

*No, the current rotation rules are appropriate.*