Competition and Markets Authority Response

This representation is made on behalf of John Rishton, Chair of the Audit Committee, and Angus Cockburn, Group Chief Financial Officer, of Serco PLC.

1. **There is currently sufficient choice of auditors for companies**

The demise of Arthur Andersen in 2002 combined with the approval of the Coopers and Lybrand/Price Waterhouse merger in 1998 meant that the audit market for complex, international companies contracted in terms of auditor choice. However, companies, like Serco, have adapted to this market dynamic and have enough auditor choice with four big international audit players. Given the level of scale and investment required to be an "integrated" global player in the audit market, it is perhaps not surprising nor inappropriate that there are only four such firms. Intense competition among the so called "Big 4" firms has meant that the market has operated without the pricing characteristics of an oligopoly. It would be better to have more competition, but the current situation works well despite the potential conflicts caused by non-audit work and there is sufficient choice for companies when appointing auditors.

2. **An additional global audit firm of sufficient quality cannot be created in the UK alone**

It is no accident that the market share of the Big 4 FTSE 350 is so high. It reflects their international connectivity, scale and the ability to invest in the infrastructure and capability required to execute large, complex audits. Complex, internationally diverse companies like Serco require these capabilities in their auditor. Creating additional auditor competition is very difficult given the international nature of many companies and the need for audit firms to operate globally. An additional global player cannot be created through actions taken in the UK alone but would need a coordinated global approach. Breaking up the Big 4 is an unwelcome and unrealistic prospect. Doing so would destroy the fabric of the international networks of these firms which is vital to the audit of complex international companies like Serco.

3. **Market share caps will increase risk**

Artificial market share caps would be wholly inappropriate and counter-productive as the mid-tier firms do not possess the capability nor experience to undertake complex, international audits. These global associations of the mid-tier firms have proven not to provide a consistent and unified approach to a global audit leaving the company to manage the audit in each country adding additional time and cost for the company. They have not made the necessary investment to build credible global networks to undertake audits for international companies. Forcing artificial market share creation for mid-tier firms will create significantly greater audit risk for companies, particularly international companies. There is an important role for mid-tier firms to play but it is not the audit of complex, international companies.

4. **Increased regulation is unnecessary and would increase audit risk**

Over-regulation in isolation in the UK would damage our overall reputation for high quality professional services and undermine the UK's leading global position in the accounting profession at a time when the UK is preparing for Brexit and depends more and more on being a fully joined up member of the international community. Mandating any requirement for joint auditors, for example, would create increased audit risk, cost and complexity.

5. **Measures that could improve audit quality**

We do not see the issues around audit quality as being related to a lack of competition. Instead, there are in our view several other issues that need to be considered and, in places, addressed. The first relates to non-audit work. The reality is that the limitation on non-audit fees works well, and for Serco tight restrictions exist on non-audit work. To address external perception and create more public trust in the audit profession, a ban on all non-audit work, properly defined, could be introduced. This would be eminently preferable to breaking up these firms and creating audit only firms. It is likely that the creation of audit only firms in the UK would reduce audit quality given the single country remit of this review and, further, the required expertise for audits, for example, pensions, treasury and valuation expertise could not be called on as part of an audit. It would also make it harder to recruit high quality employees, particularly graduates and school leavers, which over time would erode audit quality.

A challenge for both preparers and auditors has been the complexity of recent accounting standards. This may well have had an impact on audit quality given the complexity and judgements required. It has also confused the purpose of a set of accounts, added pages of indecipherable disclosure read only by Regulatory bodies and made auditing certain standards well-nigh impossible. It has also added cost and time to the year-end process whilst adding little value. This is beyond the remit of this Market Study, but is an important consideration for the accounting profession.

The appointment of the auditor does not appear to be a major concern. The Audit Committee is made up of directors who are appointed each year by the owners of the company and should continue to be empowered by them to undertake their stewardship role. It should be made clear that the decision as to the audit firm and the audit partner should lie exclusively with the Audit Committee and not executive management. This will counteract the perceived conflict between audit quality and price. It is the job of the Audit Committee/Board to hire and fire auditors and assess the quality of the audit work. To have this role performed by an external body would undermine the whole system of governance in the UK which has to date proven to be largely very successful.

The role of external audit needs to be set in the context of the total assurance programme. Audit failure does not always just lie at the door of the auditor. Audit is only a third line of defence and it can be argued that investment in the first and second lines of defence may result in a more optimal allocation of the assurance budget. The fact that audit is post the event and not real time reduces its value as an assurance tool for management and shareholders alike. There may be real assurance value in moving from once a year sampling activity to “real-time” audit of all transactions with the advent of robotics, advanced analytics and artificial intelligence. In this case, the auditors would be conducting their audit procedures through the year thereby identifying issues early and removing some of the time and resource pressure on audits post year end. This should have a significantly positive impact on audit quality.

Audit is a critical element of the effective operation of the capital markets and audit quality is therefore key. However, we have lost sight of the fact that Accounts are signed by the Chief Executive and Chief Financial Officer who work and are remunerated for working in the business full-time and who are responsible for making appropriate judgements. Responsibility should not just lie with the auditors but should start with executive management. To this end, an intelligent form of Sarbanes Oxley which forces companies and their management to document and review the operation of the company’s internal control system may reduce the risk of material mis-statement in the Accounts. Having a strong internal control environment is critical and may discourage unethical management behaviour. This will also allow the auditors to perform their duty in a better controlled environment and allow them to focus their work on the key judgements which have the biggest impact on financial reporting, for example, having the time to spend understanding the actual operation of material contracts. If this process was introduced, the risk of audit failure could be reduced significantly, and more onus would be placed on the preparers of the Accounts.

Finally, the expectation gap which has existed since Noah's first audit has gone from being a gap to a chasm. This needs to be tackled in terms of who an audit is for and what can be expected from an audit. One aspect is the perception that an audit should bring wider stakeholders into the equation, but that would be a mistake and would render auditing almost impossible. It needs to remain focused on the owners of the business. Turning the role of audit into one where it is expected to report on the quality and likelihood of success of a company's strategy is to miss the point. Predicting the future is hard enough for experts and company directors but to expect auditors to be able use a crystal ball and predict whether a firm is viable or not is not what audit is configured to deliver and arguably can never deliver. There is a real danger with this that auditors are forced to become shadow directors and held accountable for a company's future performance.