Nexia Smith & Williamson

Competition & Markets Authority - Statutory audit market

Our response to the Statutory Audit Services Market Study of 18 December 2018

January 2019

1. Do you agree with our analysis in section two of the concerns about audit quality?

Audit quality has become an acceptable term but has no definition. Until it can be defined, we run the risk of reform with an ill-defined goal.

2. Do you agree with our analysis of the issues that are driving quality concerns, as set out in section three? In particular:

a. Issues relating to the role of Audit Committees and investors in the process of appointing and monitoring auditors;

We would agree that ACs should be more accountable for the decisions they make to counter the apparent inherent bias to Big Four firms.

That accountability should also extend to shareholders with ACs having a duty to report to shareholders on the basis of the audit appointment decisions they have made.

In our view the oversight body should be required to positively affirm the choice made by the AC, probably in the form of a negative confirmation along the lines “there is nothing in the decision made which causes us to have reservations…”.

Whatever new requirements are introduced however, the oversight body should not be a source or cause of delay in the auditor appointment process.

Companies which do not heed any recommendation by the oversight body to change the selection should face the possibility of both reprimand and fine.

There is a further matter we consider important relating to membership of ACs. Our recommendation is that there should be a limit on the number and proportion of former Big 4 partners allowed to be members of an AC for any given FTSE 350 company and/or a cooling off period where the former Big 4 partner’s firm cannot be appointed until at least 5 years after the partner has left.

b. Limitations on choice leading to weaker competition;

Agreed.

c. Barriers to challenger firms for FTSE 350 audits;

There are significant entry barriers.

d. Resilience concerns; and

This identifies a significant market and sectoral risk with which we concur.

e. Wider incentive issues raised by the multi-disciplinary nature of the large audit firms.

We are not convinced by the CMA logic on this point. Devising a reward structure and quality focused culture for audit partners is possible and can be done. Formal regulation is not required or desirable.

B) Remedies

For all remedies:

3. What should the scope of each remedy be? Please explain your reasoning. For example, should each remedy apply to all FTSE 350 companies, or be expanded to include PIEs or large privately-owned companies that could be deemed to be in the public interest?

Remedy 1: Regulatory scrutiny of Audit Committees

4. How could the regulatory scrutiny remedy be best designed to ensure that the requirements placed on Audit Committees by a regulator are concrete, measurable and able to hold Audit Committees to account? Please respond in relation to requirements both during the tender selection process and during the audit engagement.

Our preferred remedy would be the second option in the CMA report, namely a requirement for ACs of all FTSE 350 companies to be accountable to an external body for the decisions they make. A challenge to the near-automatic appointment of Big 4 firms would serve to redress the current bias in appointments.

However, if the move is made to require joint audits for all FTSE350 companies, the impact of the current bias by ACs is reduced at a stroke without a further structure being introduced.

We suggest the introduction of a framework within which ACs are expected to operate. This could be along the same lines as ISAs and would clarify and standardise the obligations and expectations of ACs. This could also build on the FRC’s existing guidance on ACs and audit tendering.

Remedy 2: Mandatory joint audit

5. What should the scope of this remedy be? Please explain your reasoning.

Our view is that this should be first introduced in the FTSE350 market to see the outcomes and benefits which arise and then reassess after, say, 5 years, to establish whether the reforms are generating the improvements required. If so, the changes could be extended to all PIEs.

a) Should the requirement to have a joint audit apply to all FTSE 350 companies or potentially go wider by including large private companies?

To extend to all PIEs in the short term could generate a resource constraint and reduce quality in the short term due to skills shortage.

b) What types of companies (if any) should be excluded from a requirement for joint audit?

We believe that competition is effective in the audit market below the FTSE350/PIE markets and therefore do not believe there is need for intervention at this level.

6. Should one of the joint auditors be required to be a challenger firm? If so, should this be required for all companies subject to joint audit? Are there any categories of companies to which this requirement should not apply? Please explain your reasoning for each of the answers.

Yes, one of the joint auditors should be required to be a challenger firm, unless none responds positively to an invitation to tender.

There will be some (few) sectors where the challengers do not yet have the required expertise.

However, this latter point should be left to market forces rather than regulation. If, in a particular sector, a challenger firm does not respond to the ITT, a FTSE 350 company would be free to appoint two Big 4 firms as joint auditors. In such a situation, the AC should be required to provide an explanation for choosing two Big 4 audit firms to shareholders.

7. Should a minimum amount of work (and fee) allocated to each joint auditor be set by a regulator? If so, should the same splits apply across the FTSE 350? (please comment on the illustrative examples in section four). Please explain your reasoning.

The setting of a minimum percentage is desirable as part of re-balancing the market. However, we do not favour a complex regime in this regard.

We would suggest a minimum of 20% for FTSE 100 companies and 30% for the remaining FTSE 350 companies. The actual splits would be determined by individual ACs.

Both these minimum limits could be increased over time to ensure challenger firms are not restricted in the return and growth they are able to achieve for the investment made.

8. Our provisional view is that there would be merit in the joint auditors being appointed at different times. Should this be mandated, or left to the choice of individual companies? How should companies manage (or be mandated to manage) the transition from a single auditor to joint auditors?

We agree that appointment dates should not be identical.

Companies should be required to appoint a joint auditor two years before the next scheduled audit rotation. This would accelerate the process and avoid delay in a structural change which has significant potential benefits on a number of fronts.

Where the existing time frame for an audit tender is shorter than two years, the appointment of a challenger as joint auditor would need to be as soon as possible.

The only constraint here would be the number and capacity of firms willing to participate as challenger firms. The initial rate of introduction of the new regime would need to be calibrated to reflect this.

9. Should a joint liability framework be introduced to encourage active participation in the market by the Big Four and challenger firms? Please explain your reasoning. In the context of joint audits, what are the advantages or disadvantages of auditor liability being proportionate to the audit fee of the joint auditors, compared to the auditors being jointly and severally liable?

PI costs can be significant and we would favour a new regime of proportionate liability based on the balance of fees earned.

Whilst some larger firms could argue that they will be more at risk working alongside challenger firms, our view is that the review of the other's files by the joint auditors will provide sufficient checks and is more than likely to increase the rigour, scepticism and quality of documentation on both sets of files.

Remedy 2A: Market share cap

10. How could the risks associated with a market share cap, such as cherry-picking, be addressed?

Our clear preference is for the joint audit approach and we see the market cap alternative as overly intrusive in an open market with the risk of significant restriction of choice.

11. Would it need to apply only to FTSE 350 companies, or also to other large companies, and if so, which?

Remedy 3: Additional measures to reduce barriers for challenger firms

12. We welcome evidence from stakeholders on the existence of barriers to senior staff (including partners) switching quickly and smoothly between firms. We also welcome views on how justified such barriers are, bearing in mind commercial considerations that audit firms have.

A reduction in the period of restrictive covenants for partners and senior staff would be desirable, to say 6 months.

13. We welcome estimates on the costs of setting up and running a tendering fund or equivalent subsidy scheme, and views as to how this should be designed.

The costs of investment to increase capacity for challenger firms in the FTSE 350 markets together with regular costs of tenders will be significant. A fund would be one way to provide incentivising compensation.

Another mechanism would be an increase in the reward level for audit delivery through the fee level mechanism.

14. We welcome comments as to whether the Big Four should be compelled to license their technology platforms at a reasonable cost to the challenger firms, and/or contribute resources (financial, technical, algorithms and data to enable machine learning) towards developing an open-source platform. In the first scenario, we also welcome comments on how such a 'reasonable cost' might be determined in such a way that it is affordable for challenger firms but does not disincentivise Big Four firms from innovating and developing new platforms.

We agree that the technology platforms should be made available under license. Such license fees should include the cost of staff training and update.

To encourage continued innovation and investment, we suggest that the version available for license could be up to 12m from the current date allowing the developing firm to have a competitive edge consequent on their ongoing development.

However we also see a risk if challenger firms move to using Big 4 Technology platforms, as the independence of such firms may fall into question and there may be a tendency for ACs to select a challenger firm which uses the same technology platform as the Big 4 audit firm appointed.

Remedy 4: Market resilience

15. How could a resilience system be designed to prevent the Big Four becoming the Big Three, not just in the case of a sudden event, but also in the case of a gradual decline? Please also comment on our initial views to disincentivise and/or prohibit the movement of audit clients (and staff) to another Big Four firm.

There is an element of timing here. If the demise/decline of a Big 4 firm happened once several challenger firms had had time to build capacity, the risk to the market would be reduced.

In the short term, it is hard to see how a Big 4 could be offered a support lifeline.

We would therefore agree with a proposal for a lifeboat type rescue lead by one of the challenger firms. This may require central Government funding support to encourage a challenger firm to take on the management and risk load this would generate.

16. How could such a system prevent moral hazard? Please comment on our initial view.

Regulators should not be required to have in mind the financial or operational resilience of a Big 4 firm, when considering the outcomes of specific enquiries.

17. What powers would a regulator and a special administrator require, and how would their roles be divided? At what point should a regulator or a special administrator be able to exercise executive control over a distressed firm? Please comment on our initial view.

A special administrator should have the authority to run a distressed firm for a relatively short term only with a view to finding a rescue firm able and willing to absorb the audit obligations and resources.

18. What could be done regarding the challenges relating to the fact that an audit firm's value lies in its people and clients – which would be complicated to restrict? Please comment on our initial view.

Preventing partners and staff from leaving a firm in distress would require complex regulation. The reality of the market is that any such distress should require expeditious action by whichever body is given responsibility.

The value of a firm will also, and increasingly, rest in the Technology Platform it has developed. Any solution will need to bear this in mind.

Remedy 5: Full structural or operational split

19. Do you agree with the view that the challenges to implement a full structural split are surmountable (especially relating to the international networks)? If not, please explain why it would be unachievable, i.e. that the barriers to implement this remedy could never be overcome, including through a legislative process.

We would not agree with the contention that either structural or operational splits are required.

The evidence presented is inconclusive and selective and lacks the rigour and evidence to suggest or require such a fundamental realignment of firms.

The very significant investment being made by all firms in IT to deliver the next generation of audit platforms is clear evidence that investment decisions are not driven in favour of non-audit services to the detriment of audit and that audit firm activities continue to attract the necessary investment within their firms.

20. How could an operational split be designed so that it would be as effective as the full structural split in achieving its aims, without imposing the costs of a full structural split? In your responses, please also compare and contrast the full structural split to the operational split.

21. With regards to the operational split, please provide comments on:

a) implementation risks and whether they are surmountable: e.g. how any defined benefit pension schemes could be separated between audit and non-audit services;

b) risks of circumvention and how they could be addressed e.g. how audit firms could circumvent the remedy through non-arm's-length transfer pricing and cost allocations;

c) implementation timescales to separate the audit firms and how soon the remedy could be brought into effect;

d) ongoing monitoring costs for the audit firms and a regulator;

e) role and competencies of a regulator in overseeing ongoing adherence to the operational split.

22. Under an operational split, how far, it at all, should it be possible to relax the current restrictions on non-audit services to audit clients? For example through changes to the blacklist or to the current 70% limit.

23. Should challenger firms be included within the scope of the structural and operational split remedies?

If the CMA proceeds with recommending either form of split, our view is that this should only apply to the Big 4 firms and should be an operational split only. To extend further would potentially create smaller and less financially stable entities, which is the reverse of the intention.

24. Which non-audit services (services other than statutory audits) should the audit practices be permitted to provide under a full structural split and operational split? Please explain your reasoning.

If a split is required, services currently barred for PIEs would be appropriate.

Remedy 6: Peer review

25. What should be the scope (ie which companies) and frequency of peer reviews, if used as a regulatory tool?

We would not support this proposal.

The introduction of joint audits for FTSE 350 companies will generate an automatic review of the joint auditors' files by the other party and further overlays are not therefore required.

However if a peer review system were to be introduced, firms not considered as challengers should be allowed to participate to start generating the next rank of challengers.

26. How could peer reviews be designed to best incentivise auditors to retain a high level of scepticism, and thus improve audit quality?

Next steps

27. What are your views, if any, on our proposal not to make a market investigation reference?

Given the number of reviews of the audit market currently under way, we agree that a coordinated response to the issues identified would be desirable.