

Statutory Audit Market Study
Competition and Markets Authority (CMA)
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21 January 2019

Dear Sirs

RESPONSE ON UPDATE PAPER

Johnston Carmichael fully supports this CMA study, recognising the importance of a competitive and high quality audit market in which users of financial statements have trust and confidence. We therefore welcome the opportunity to comment on the Update Paper issued on 18 December 2018 and hope that our views will be of some assistance to the CMA in continuing its progress with this study.

Introduction

Johnston Carmichael LLP is Scotland's largest independent firm of Chartered Accountants and Business Advisers, and a UK top-20 firm.

We are also a member of PKF International, a global family of legally independent firms bound together by a shared commitment to quality, integrity and the creation of clarity in a complex regulatory environment. Our PKF network consists of over 400 offices, operating in 150 countries across five regions.

Johnston Carmichael LLP acts as statutory auditor to around 900 entities. Our audit client base is predominantly private businesses many of whom are large entities as defined by the Companies Act 2006. Our client base also includes a small number of Public Interest Entity (PIE) audits, debt listed on the London Stock Exchange or listed entity (non-PIE) audits, including entities listed on the Alternative Investment Market (AIM) and on international markets including the The International Stock Exchange.

We have restricted our response on the Update Paper to two matters that we believe to be central to the study, namely mandatory joint audit and full structural or operational split of audit and non-audit firms.

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Mandatory joint audit

We support the introduction of joint audits. Our submission to the initial market study highlighted that this would only work if one audit firm did not dominate the other. A regulatory regime will ensure that the cultural change which investors, audit committees and audit firms require would occur. We support the proposition that joint audits should apply to FTSE 350 companies. We would also support the extension of the requirement to all companies with equity, as opposed to debt, traded on London stock exchange main market.

There is no simple remedy to ensure that there is an equitable split of responsibilities and audit fees between the joint audit firms. The suggestion that a joint auditor of FTSE 100 companies earn at least 10% of the total audit fee may result in an unintended consequence. The challenger firm may audit a large number of small components of the group which, when combined, may not be of significance to the consolidated audit report. For instance, ISA 600 *Special Considerations – Audit of Group Financial Statements (including the Work of Component Auditors)* provides an example of 15% of a chosen benchmark, such as turnover, to determine when a component is significant. If the requirement does not also ensure that each firm must also audit at least one significant component of the assignment, there are limited incentives for challenger firms to move into this market. They would be required to adopt the stricter, ethical requirements of auditing a public interest entity without a compensating financial reward (the stricter ethical and independence requirements do not apply to non-significant components of public interest or listed entities).

The proposal to increase the minimum fee for the joint audit firm to 40% or 50% for FTSE 350 companies, whilst promoting opportunities for challenger audit firms, fails to take into the business structure of the company. A FTSE 300 company could have 3 divisions, accounting for 30%, 35% and 35% of group turnover. The mandatory requirement would increase costs and inefficiencies as both auditor firms will be required to audit at least one of the components. An alternative split, explained by the audit committee in its report to investors, which takes into account its own organisational structure would be supported by all parties. Tendering undertaken using entity specific organisational structures will ensure the best fit for all parties.

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The CMA review should ensure that audit committees are required to apply as wide a definition of challenger firms as they can for their business. We would recommend that challenger firms should not be limited to mid-tier firms (top 20 audit firms). The forthcoming merger of Moore Stephens and BDO could be misinterpreted by some audit committees as reducing the acceptable number of challenger firms. If the number of challenger firms is pre-defined and some firms choose not to participate in listed company audits, there may in effect be a continuation of the current status-quo with limited actual choice in the audit market.

Full structural or operational split of audit and non-audit firms

In balance we accept the viewpoint that the barriers to a full structural split of audit and non-audit firms are, in essence, currently insurmountable. However, we believe that a full operational split, whilst not without challenges, could be achieved.

Whilst the concept of a full operational split appears laudable we believe that it may have unintended consequences that would actually have the effect of reducing competition in the audit market. Therefore we would have significant concerns about whether an operational split would achieve the desired objectives of the study.

The Update Paper does not define the criteria for determining which firms would be subject to a full operational split. One option mentioned is to apply it to "at least the Big Four". There is also mention of it being applied to all audit firms of a certain size. An alternative might be to apply it to all firms performing audit services to certain types of audit clients (e.g. FTSE 350 companies).

Regardless of the criteria actually used, this remedy is likely to result in a two-tier audit market of firms that are subject to operational split and firms that are not.

If a simple size-based measure is used, regardless of where the line is drawn, by definition this is likely to limit the number of firms competing in the listed company audit market. This seems contradictory to the above measure of mandatory joint audit which, if experience from other countries applying this measure is to be believed, would appear to be at its most effective where it invites widespread participation in the market.

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Furthermore, firms falling below the size threshold are likely to find their opportunity to participate in the listed market restricted, either because they are not eligible to participate or they are excluded in practice courtesy because they are perceived to be less independent. In such a scenario firms may have to consider voluntarily splitting off their audit practice but with significant cost/benefit challenges. Without the operational split measure, such firms may well have been incentivised to participate in an enhanced marketplace brought about by mandatory joint audit.

If a client-based measure is used such as firms providing audit services to FTSE 350 clients, then firms currently largely or wholly outwith this market, including some considered to be challenger firms by the CMA, may well prefer to exclude themselves from that market, avoiding the significant complications of an operational split, again limiting the size of the market for audit services to these listed companies.

Consideration is also needed of the effect of an operational split of certain firms on the "smaller companies" audit market. Such audits represent a significant part of the total UK audit market. Given that the Big Four and other firms who may be subject to an operational split operate in this market, companies may be faced with a choice of appointing an auditor that is operationally split (with potential perceived independence benefits that will be marketed by the split firms) or to choose a firm that is not split that can potentially meet more of their total needs through a single provider. In either case, choice is going to be more limited for such companies which is unlikely to be in the interests of shareholders. In addition, if smaller firms need to split to be competitive in the audit market, they may well elect to withdraw entirely from the market, further accelerating the pattern of declining audit firms that has been seen in recent years.

Therefore, for the reasons above, we do not believe that a structural or operational split will, in practice, result in achieving greater competition.

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Conclusion

We hope that the above considerations are of assistance and would welcome the opportunity to continue our participation in this study.

Yours faithfully

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