Statutory audit services market study

Response from Aberdeen Standard Investments

Executive summary

As a global investment manager Aberdeen Standard Investments uses a range of tools to evaluate the quality of assets in which we invest on behalf of clients and customers. It is essential we are able to rely on company audit reports as a source of accurate, considered and impartial information.

Audit cannot prevent corporate failure and should not be expected to do so – this is not its purpose – but as shown by recent events the current system cannot always be relied upon to identify serious failings within a particular company before they become apparent through total corporate collapse.

The key objective of any reforms must be a significant increase in audit quality so investors and other stakeholders can have confidence in the audit process and the content of company reports. Increasing competition in the audit market will help to increase choice but will not in itself lead to an increase in the quality of audit: other measures will be required such as widening the scope of audit to include independent experts who can assist with complex judgements.

It is in this context we welcome the analysis and recommendations proposed through the Statutory Audit Services Market Study. We are generally supportive of these recommendations and would like to offer the following comments.

Consultation questions

A) Issues

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

Yes, we agree with the CMA's analysis in that recent corporate failures have highlighted weaknesses in the audit market, the appointment and oversight of auditors and the audit process itself.

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As an investor we rely heavily on the work of auditors to help us make the right decisions on behalf of our clients and customers. It is therefore a cause of long-standing concern for us that almost every company in the FTSE 350 is audited by one of the Big Four. This degree of concentration is not characteristic of a competitive and well-functioning market. It is an oligopoly which has arguably led to a misalignment between commercial and public interests.

We are therefore generally supportive of the recommendations set out in the CMA update paper. In summary:

- It is not sustainable for so much of the audit market to be concentrated on the Big Four. We would be supportive of the introduction of joint audits on a gradual and selective basis to bring 'challenger' firms into the market. We would also be supportive of the progressive introduction of caps on market share (over a period of time) to ensure audit work is shared out equitably.

- We do not accept many of the arguments made against the structural separation of audit functions from advisory businesses but neither are we entirely persuaded it would lead to an increase in audit quality. We are therefore more supportive of operational separation (i.e. ring fencing) of audit functions to ensure they have greater autonomy and independence.

An area for reform which did not come out strongly in the update paper is widening the scope of audit to involve non-accountants. Audit committees could consider whether the scope of audits should bring in independent experts to assist with complex judgments in specialist areas. There also needs to be greater transparency around identifiable financial risks (e.g. outstanding debts, fraud, fluctuating residual asset values, etc.) along with explanations of judgements or assumptions made in quantifying such risks and their materiality.

Further enhancements to auditor reporting could substantially improve the usefulness of the audit process. For example, a requirement to comment on specific financial risk factors such as debt levels may prove useful. Audits should also take into account non-financial issues such as culture, diversity and inclusion. As an investor we have been encouraging the chairs of audit committees to expand the scope of audit to perhaps include formal consideration of the viability statement and other aspects of the front section of an annual report. Unfortunately the response thus far has been disappointing and we are coming to the view that regulation may be required.

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;
b. Limitations on choice leading to weaker competition;
c. Barriers to challenger firms for FTSE 350 audits;
d. Resilience concerns; and
e. Wider incentive issues raised by the multi-disciplinary nature of the large audit firms.

(a) As an investor we are we are very aware that audit committees fulfil their responsibilities to different degrees: some are highly engaged but others are less so. Increased regulatory oversight of tendering and monitoring processes followed by audit committees will help to achieve higher and more consistent standards of diligence.
(b) As mentioned above, we do not believe it is sustainable to have so much of the audit market concentrated on such a small number of providers: the level of participation by smaller firms needs to be improved to create more choice and competition. However, increased competition will not in itself lead to an increase in the quality: other measures will be required such as widening the scope of audit to include independent experts who can assist with complex judgements.
(c) Joint audit is likely to lead to higher fees. We believe this would be justifiable if it leads to an improvement in audit quality. The opportunity to earn higher audit fees may also

help to attract new entrants into the market which is widely acknowledged as having high barriers to entry (it is said the cost of tendering for an audit contract is around £300,000 and up to £1 million in some cases).

(d) We agree that market resilience is a cause for concern: the loss of one of the Big Four from the audit market would impose yet further constraints on choice. This underlines the need for more competition.

(e) We believe that the multi-disciplinary nature of the Big Four in itself creates a barrier to entry for smaller firms hence we are supportive of measures to encourage the participation of smaller firms through measures such as joint audits and operational separation of audit functions.

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?

We are generally supportive of all of the proposed remedies as a means of improving audit quality but we are not convinced they need to be applied in all instances. It may be more pragmatic to adopt a selective approach to their application (see below) but the key test in every instance should be: will it improve audit quality?

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.

The expectations of audit committees will need to be clearly set out in terms of the processes they are expected to follow and the required outputs. These will need to relate directly to the quality and transparency of the audit. This should include areas in which the auditor has found the need to challenge the company and the outcome to such interactions, particularly if the auditor has unresolved concerns.

Remedy 2: Mandatory joint audit

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

a) Should the requirement to have a joint audit apply to all FTSE 350 companies or potentially go wider by including large private companies?
b) What types of companies (if any) should be excluded from a requirement for joint audit?

(a) We see significant merit in mandatory joint audits as a means of increasing competition and audit quality. We would certainly support joint audits for the majority of FTSE 350 companies and PIEs (allowing for some exceptional cases where such an approach may not be beneficial but these are likely to be few and far between). We are not convinced joint audits are needed for all large private companies where the governance structure

is likely to be very different to publicly listed companies and the division between control and ownership is much clearer. In many cases the directors of a private firm will be its owners and can therefore be expected have a far stronger interest and much better understanding of what is happening 'under the bonnet'. However, we can still see a case for joint audit where corporate failure could have significant social and/or economic costs. The final judgement on whether a private company should be subject to joint audit is ultimately one for the regulator.

(b) We suggest that joint audits are introduced gradually and selectively, possibly by focussing on companies whose accounts require the application of significant levels of judgement (such as longer-term contracting businesses). It may also be preferable to avoid joint audits where significant levels of specialist external skills (such as the valuation of complex financial instruments) are required.

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.

In our view joint audits should ideally be undertaken by one of the Big Four and one of the smaller 'challenger' firms. We can see a number of immediate benefits:

- Improvements in audit quality as a result of increased of oversight (i.e. audit firms cross-checking and verifying each other's work).
- Encouraging new entrants into the market, particularly in areas of specialism, by reducing barriers to entry.
- Increase competition among the Big Four by eliminating any potential conflicts of interest.

While we are supportive of joint audits as a means of bringing more participants into the audit market our concern is that smaller firms do not currently have the necessary capacity or expertise to support joint audits across the entire FTSE 350. We would therefore suggest that joint audits are introduced gradually and selectively.

As mentioned above, joint audits could focus initially on companies whose accounts require the application of significant levels of judgement (such as longer-term contracting businesses). We also agree with the point that in some instances it may be preferable for a joint audit to be undertaken by two of the Big Four but we would see such instances as being exceptional. If an audit committee was to engage two of the Big Four it must be prepared to explain its reasoning and the process it had gone through to arrive at the decision. The regulator would have to be satisfied the rationale was sufficiently robust to make it an exceptional case and audit quality would not be adversely compromised.

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.

We believe there should be a minimum amount of work for a joint auditor. We would suggest a minimum split of 80/20 with a view to achieving a more equal balance over time.

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 believe it would be preferable for the joint auditors to be appointed at different times as this would help to provide continuity and a smoother transition. As mentioned above, we believe the transition from single to joint auditors should be a progressive process.

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?

Yes, a joint liability framework is required. This will be essential to encouraging challenger firms to enter the market. In general we would see liabilities being apportioned according to the audit fee.

Remedy 2A: Market share cap

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

Similar to the CMA, we believe joint audit would be more effective in breaking down barriers to audit than market share caps but we see no reason why the two could not work in tandem. As regards the risks of cherry-picking, this is clearly an area for oversight by the regulator. The proposal for imposing multiple market share caps over subsets of the FTSE 350 may be an option but we have some concerns it would be quite complex and difficult to enforce. We would like to see further analysis and proposals on how market caps would operate in practice.

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

FTSE 350 only.

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.

We agree with the CMA recommendation on prohibiting or imposing reasonable time limits on contractual non-compete clauses for audit partners.

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.

We are not convinced a tendering fund or other subsidy scheme is either necessary or workable due to the challenges of administration. It should ideally be left to individual firms to bear the cost of tendering. The other remedies set out the CMA paper – such as joint audit - should help to ensure that tendering for such contracts results in a higher chance of success, hence defraying the costs. This should encourage challenger firms to tender for audit business. However, this should be monitored and if it fails to achieve the desired outcome the proposal for a tender fund should be looked at again.

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 would be supportive of the Big Four being required to share technology under licence as a means of increasing market participation by challenger firms.

<u>Remedy 4: Market resilience</u>

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.

This is not an issue we have considered in depth but we would agree the 'living will' approach referenced in the paper is an option worthy of further consideration.

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

It is always very difficult to fully mitigate the risks of moral hazard but increased regulatory oversight would be a key mechanism for identifying major risks. We would also agree that ring-fencing of partner equity may help to discourage excessive risk taking.

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.

This is an issue which requires further consideration but in our view any change in executive control would take place at the point at which the regulator was of the opinion the firm in question was unlikely to be viable in the short to medium term.

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.

We agree that the value of an audit firm lies its people and clients (as it often the case in most areas of the service sector) but preventing staff from transferring to another Big Four firm is likely to be difficult in practice. While such transfers could be subject to regulatory approval this is likely to lead to frustration and resentment among staff which would not be conducive to

audit quality. Providing financial incentives to staff to remain in situ is a potentially feasible option but likely to create significant additional costs for the firm.

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 think it is feasible to create 'audit only' firms. We do not support many of the arguments put forward by those who oppose structural separation of audit functions, some of which are spurious and lacking in evidence. However, neither are we convinced the inevitable disruption it could cause would lead to an improvement in audit quality. For this reason we are more supportive of operational separation (i.e. ring fencing) which would give audit functions a far greater degree of independence and autonomy. It will also help to allay fears that the impartiality of audits can be tainted by conflicts of interest or other commercial considerations.

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.

Many of the benefits of structural separation could be achieved through operational separation by adopting the same key features e.g. separate governance structures, profit pools, remuneration arrangements, etc.

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.

(a) We believe any risks arising from operational separation are likely to be surmountable.
(b) No comment to make.
(c) We think a period of one to two years would be a reasonable timeframe.
(d) No comment to make.
(e) No comment to make.

22. Under an operational split, how far, if 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.

Our preference is a clean split between audit and non-audit services with firms providing one or the other (but not both). In our contact with the Big Four we detect a growing acceptance this is inevitable to remove any potential conflicts of interest.

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

Yes.

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.

As stated above, our preference is that audit firms do not provide non-audit services.

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 believe the introduction of joint audits would reduce the need for peer review but it should be an option where the regulator believes it is warranted.

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

The potential for peer review should help to raise audit quality. Peer review should focus on areas where the firm has not been subjected to challenge or the auditor has not shown the degree of professional scepticism that would normally have been expected e.g. areas where a high level of judgement has been used.

C) Next steps

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

We support this decision as we do not believe a market investigation reference is required at this time.

Aberdeen Standard Investments – further background

Aberdeen Standard Investments is the investment arm of Standard Life Aberdeen plc and manages £557.1bn* of assets, making it the largest active manager in the UK and one of the largest in Europe. It has a significant global presence and the scale and expertise to help clients meet their investment goals. *as at 30 Jun 2018

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