

**Statutory Audit Services Market Study**

**Update paper of 18 December 2018**

**BT Group plc (“BT”) response**

**Introduction**

BT agrees with the Competition & Market Authority’s overall aim to encourage competition to drive more choice and better audit quality.

BT further agrees that in order to achieve this objective several areas need to be addressed including:

- **Increasing the supply of credible audit firms** beyond the “Big 4” by lowering barriers to entry such as:
  - capacity
  - technology access
  - access to deep technical expertise
  - international coverage
  - access to audit tenders
  
- **Ensuring the tender process is fair and objective.**

BT believes any action taken needs to be clear as to the specific aim it is trying to achieve.

BT has set out on the following pages its comments on each of the remedies suggested in the Update Paper.

*Regulatory scrutiny of Audit Committees*

*Audit Committees should be subject to specific regulatory requirements and obligations. Our current view is that this regulation should include:*

- A requirement that Audit Committees report directly to the regulator before, during and after a tender selection process. The regulator would also have the ability to include an observer on all or a sample of Audit Committees.*
- A requirement that Audit Committees report directly to the regulator throughout the audit engagement.*
- The ability for the regulator to issue public reprimands or direct statements to shareholders.*

*The remedy should apply to at least all FTSE 350 Audit Committees but we would welcome views on whether this remedy should be extended to cover a wider group of companies, such as all PIEs.*

**BT believes that the transparency of tender selection processes should be high. Current guidance and regulation provide clear frameworks in which an Audit Committee should operate, allowing an Audit Committee to discharge their responsibilities diligently and to a high standard. BT considers these frameworks are sufficient and is unclear as to the evidence that suggests they are currently ineffective.**

Further, companies are currently required to provide detailed descriptions of how an Audit Committee discharged its duties in the Annual Report. This reporting is required under provisions of the Corporate Governance Code on a 'comply or explain' basis.

**BT believes there might be further opportunity to:**

- be more prescriptive in what should be covered in Audit Committee reporting in Annual Reports**, for example by requiring reporting on matters such as whether an audit has been challenging, the granularity of key accounting issues and how the auditor challenged management's judgement and assertions and exercised professional scepticism.
- require more detailed reporting on the selection process** the Audit Committee undertook in appointing a new auditor, or for the company to set out the details of Audit Quality Review findings from the inspection of the auditor's work on the company.
- increase reporting by regulators to companies on their inspections of audit firms**, including the power to recommend to an Audit Committee that the company's auditor be changed where it can be demonstrated through the inspection and enforcement process that there have been repeated instances of failures of professional judgment or scepticism in the auditor's audit of the

company. However, this would need to be balanced with the speed at which a company is able to initiate an audit change, as it can take time to ensure other tendering firms, both big four and challenger firms, are independent of the company.

**BT does not believe that either additional direct Audit Committee reporting to a regulator, or attendance of a regulatory observer at Committee meetings are necessary, either during or after a tender or throughout an audit engagement.** BT is concerned that the regulatory observer would need to have detailed practical experience and understanding of the role and operation of an Audit Committee and of the specific circumstances of the company the regulator is attending. This would require significant experienced resource which BT does not believe would be available in the short to medium term.

*Joint audit*

*Our provisional view is that joint audit would increase competition without risking audit quality. Our initial views on design are:*

- The main aim of this remedy is to reduce the barriers facing challenger firms. Our preferred way of achieving this would be by mandating that at least one of the audit pair is a challenger firm. We would welcome views on any alternative ways of delivering this outcome and ensuring that the remedy is effective in reducing concentration.*
- This remedy should at least apply to FTSE 350 companies – perhaps with some limited exceptions where the nature of the company would not sensibly justify a joint audit. We seek views on whether this remedy should apply to other large companies or whether specific types of company should be excluded.*
- Each joint auditor should have to be granted a significant proportion of the audit work. The minimum proportion to be assigned to any joint auditor might vary across the FTSE 350 companies and over time to allow challenger firms to build their capacity.*

**BT is supportive of measures to increase competition in the audit market.** However, BT's concern is that the challenger firms do not currently have the capacity, access to technology, geographic reach and level of subject matter expertise to immediately perform large, international, complex audits.

**BT strongly opposes the view that joint audits would achieve an increase in competition. Instead, we consider this remedy could present a significant risk to audit quality. With responsibility for the audit opinion, and audit liability, resting with both auditors there could be serious practical implementation and quality issues.**

In addition to the concerns that the challenger firms are not currently able to operate as effective joint auditors BT sees the following risks (which would also apply to joint big four audits):

- **risk in coverage and quality from each joint auditor only having partial oversight, including complications in how ultimate holistic financial statement sign off is achieved.**
- **risk of less accountability and 'finger pointing'.**
- **risk of reliance on the other firm's review and increased possibility that issues may 'fall through the gaps', equally there could be issues of duplication and even disagreement between the firms. As well as impacting quality these could lead to higher audit fees and delays.**

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- **issues around auditing international groups**, particularly where there are a significant number of local statutory requirements and where UK legislation is unable to mandate a joint audit. Simply splitting local audits between the joint auditors may be contradictory to the auditors dividing significant risk areas for their attention. This could result in duplication, disagreement and practical complications for statutory audits.
  - risk that this remedy could **reduce choice in the tender process** with more firms being precluded from tendering for an audit when they are subject to mandatory rotation. Appointing one of the joint auditors at different times would increase tendering costs and disruption which can be experienced when changing auditors.
  - joint audits would also **increase independence issues** and reduce the choice in providers of the non-audit services that auditors are not allowed to supply to their clients.

*Market share cap*

- *Our provisional view is that a market share cap would deliver a substantial increase in the number of challenger firms auditing the largest companies in a relatively short period of time.*
- *However we prefer mandatory joint audit to a market share cap as a means of breaking down barriers to non-Big Four firms competing successfully for larger audits. Both remedies would provide good market access, but joint audit would do so without the risks to short-term quality and competition presented by a market share cap.*
- *This remedy would initially apply at least to FTSE 350 companies. We seek views on whether it should apply to other large companies that could be in the public interest.*

From an audit quality perspective, BT believes market share caps would be preferable to joint audits as they avoid the risks set out above (i.e. holistic view, accountability, reliance, duplication, disagreement and delay risks). **However, BT has serious concerns over how market share caps can be practically implemented. BT has concerns that a share cap could limit the Audit Committee's ability to select an appropriate audit firm to deliver the audit, therefore impacting competition.** BT is also concerned that the challenger firms are not currently able to deliver large complex international audits as set out above.

*Additional measures to reduce barriers to challenger firms*

*We favour the prohibition or limits on the length of non-compete clauses as these make it harder for audit partners and staff to switch firms. Partner switching is necessary for challenger firms to build their capacity.*

*A number of other measures such as technology sharing warrant further consideration.*

**BT would favour the prohibition of unreasonable non-compete clauses that go beyond the objectives of avoiding business disruption.** However, BT has seen little evidence that these clauses are a significant factor in limiting competition.

**BT would support licensing and sharing options that allow firms access to the best technology which could serve to improve audit quality.**

**Resilience regime**

*This remedy warrants further consideration and we welcome parties' views on how an effective resilience regime could be designed to avoid going from the Big Four to the Big Three.*

*This remedy should apply to at least the Big Four. It may also be appropriate for some large challenger firms to come within scope as they grow in relative size.*

**In a market with already limited audit quality BT would support a resilience regime to avoid going from the Big Four to a Big Three.** However, BT notes that this is likely to be an international issue rather than solely a UK matter. BT considers the most viable solution to be the use of a Special Administrator to support the running of the firm during its period of distress or voluntary withdrawal. BT agrees this should focus on the Big Four in the immediate term, but may need to expand as challenger firms grow.

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*Full structural or operational split between audit and non-audit services*

*Full separation would be an effective remedy. Nevertheless, we seek responses from parties on whether and how an operational split could be equally effective in addressing our objectives.*

*Either form of separation – full structural or an operational split – should apply to at least the Big Four. We seek views as to whether this remedy should also apply to challenger firm, as well.*

**BT is not clear how this remedy would increase either competition or audit quality. BT believes it will reduce audit quality and reduce auditor independence as well as audit firm resilience for the following reasons:**

- **in-house non-audit expertise increases audit quality** as there is significant use of non-audit experts on audits, particularly large and complex audits.
- a sole reliance on audits would **increase the auditor's dependence on audit fees** and management thereof and **decrease resilience** and independence.
- **this remedy would present challenges to the ability of audit firms to recruit and retain the best available auditors.** Currently audit firms offer opportunities for their auditors to gain experience in other non-audit areas to increase their experience of wider business markets and the issues they face. Experience which these auditors can subsequently apply in better quality audits. This would not be available in audit only firms.
- BT is also **concerned how this would apply to audit related services.** BT's audit of regulated financial statements is classified as non-audit in accordance with legislation, as are transaction related assurance activities, which the auditor is best placed to deliver. There would be significant operational and practical issues if BT's auditor were prevented from performing such non-audit work if a full structural split were implemented.

**BT believes the rules that have been introduced to restrict significantly the provision of non-audit services to audit clients are becoming increasingly effective in serving to focus auditor incentives on high quality audits.** BT has seen and continues to see a significant reduction in the level of non-audit services and non-audit fees BT pays to its statutory auditor with these becoming limited to those audit related services where it is efficient for the auditor to perform the work. Measures such as [ ]'s voluntary restriction to prohibit the provision of a wider range of non-audit services to audit clients would seek further to reinforce this.

BT does recognise that operational splits could serve to reduce matters such as profit pooling across audit and non-audit services within firms. However, BT believes these conflicts can be equally effectively managed by continuing to restrict the level of non-audit services that can be provided to an audit client.

*Peer review*

*Our provisional view is that peer review would be a useful remedy as part of the regulator's toolkit.*

*The regulator should have the ability to determine the scope of the peer review function, perhaps initially targeting this at companies that it considers high risk or which require additional scrutiny.*

**In principle BT would support the addition of a peer review to the regulator's toolkit. If performed after the completion of an audit to complement the AQR process, this could help improve audit quality.** However, BT does not think this would be effective in enhancing competition from challenger firms, as these reviews would not give challenger firms sufficient additional bandwidth and experience to make them more competitive in tendering for larger audits.

If the objective is to improve audit quality, BT believes it is important that the review is performed after the completion of an audit. This would mitigate risks of delay, disagreement and opinion shopping impacting the quality of the opinion of the primary auditor. The targeted areas of peer review should also be sufficiently limited so that they are not considered to impact the independence of the peer reviewing audit firm and thus not impacting choice at a future tender.