ABI

ABI response to CMA Statutory audit services market study, Update paper

The ABI

The Association of British Insurers (ABI) is the leading trade association for insurers and providers of long-term savings. Our 250 members include most household names and specialist providers who contribute £12bn in taxes and manage investments of £1.6 trillion.

ABI comments

1. We welcome the opportunity to comment on the Competition & Markets Authority's (CMA's) *Statutory audit services market study, Update paper.*

2. We do so in relation to our members' roles as preparers of accounts on which suppliers of capital to our members rely. High quality audit is essential to this reliance by capital providers and accordingly it is given priority by our members in their selection and ongoing monitoring of auditors.

3. We acknowledge that the CMA has identified evidence supporting concerns about audit quality which require remedies. However, we are not convinced that there is clear enough evidence about the issues driving these concerns on which to base substantial structural changes to the market. In particular, we would not support any structural remedies whose ability to deliver the benefits intended is unclear and yet which impose significantly higher costs or may have adverse unintended consequences.

4. On that basis, we therefore do not support two of the market solutions proposed in the following remedies: mandatory joint audit, and subsidies for challenger audit firms (remedies 2 and 3).

5. We regard the imposition of a market share cap (remedy 2A) as having in principle the potential to be the least intrusive in the operation in the market. Much will however depend on how it is implemented, and we stress the need for maximum flexibility on the part of both companies and audit firms to operate within the caps.

6. For the splitting audit and non-audit services remedy (remedy 5), we note that significant new measures to safeguard audit quality have been in operation for a relatively short time. We suggest that a further review is carried out by the audit regulator in due course before making additional changes.

7. Notwithstanding our tentative support in principle for a market share cap, we favour regulatory changes which aim to improve audit quality but do not entail changes in the operation of the market. We recognise that this is the central focus of the parallel Kingman review. The CMA's remedies 1 and 6 fall into this category. We think that remedies of this type, including those in the Kingman report, are more likely to be effective and not have such significant unintended consequences.

8. We are unclear that regulatory scrutiny of audit committees (remedy 1) would achieve the results intended and we suggest that more detailed analysis be taken before this remedy is implemented.

9. For peer reviews (remedy 6), however, we think there should be scope for targeted peer review to be used as part of an audit regulator's toolkit, and we strongly support such a form of remedy 5 as offering a direct and effective way to increase the quality of audits, at a proportionate cost and with less risk of unintended consequences. We see this as complementary to the thrust of the Kingman review recommendations to strengthen the powers of the audit regulator.

10. We add one further general comment on the scope of any remedies, which is to suggest strongly that there should not be an assumption that all public interest entities are the same. The degree of reliance that can reasonably be assumed to be placed on audited accounts varies considerably, and any remedy needs to be focussed accordingly.

11. We set out our detailed responses to the CMA's consultation questions in the appendix to this letter.

Association of British Insurers
January 2019

Consultation questions

A) Issues

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

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.

ABI response

1. The CMA reports substantial direct evidence supporting concerns about audit quality per se - in particular, as identified by the FRC, both in relation to corporate failures and through the FRC's audit quality reviews (AQRs). We agree there is scope for improvement in audit quality.

2. However, the evidence supporting the CMA's identification of the issues driving quality concerns seems much less strong. There appears to be little evidence supporting direct linkage between the corporate failures or poor AQR results cited with:

   a) Audit Committees appointing auditors, or monitoring their work, without due regard for audit quality – which, as the CMA appears to accept, is anyway difficult for an Audit Committee to observe or to judge, especially in key respects such as professional scepticism;
   b) Companies being particularly restricted in their choice of auditor firms – even though there is variability in the degree of effective choice within the FTSE 350, as well for companies which are not in the FTSE 350. Furthermore, the evidence seems to be that the Big 4's audit approaches do not differ substantially, even though their application in individual audits has been found to vary. This suggests that it is not the choice of audit firms but rather of audit teams which is significant in practice;
   c) Audits being of FTSE 350 companies rather than of other companies – indeed, rather more striking is the CMA's evidence that challenger audit firms have scored worse than the Big Four in AQR reports for FTSE 350 audits. This may be significant, given that the CMA's evidence is that Audit Committees aim to select on the basis of quality rather than of price.

3. This lack of clear evidence makes it difficult to identify specific remedies, especially those which do not impose disproportionate costs on companies, nor present risks of significant unintended consequences.

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.

ABI response

4. Given the difficulty which audit committees generally have in observing or judging audit quality, it is not clear that a regulator would be better at doing this by acting eg as an observer on audit committees - whether for a tender selection process or during an audit engagement. It is therefore generally questionable what extra value would be derived from such a measure. We also question whether it is appropriate generally for audit committees to have any responsibility for competition in the audit market and whether any regulatory involvement might risk undermining the audit committee's independent role. We suggest that further analysis be undertaken both of how in practice improvements in audit quality are to be derived from this remedy and of how the function of audit committees to provide an independent function representing the interests of shareholders is preserved.

5. As to the scope of any such measure, we suggest that this be determined by considering further the degree to which reliance is placed on audited accounts, in particular by external suppliers of capital who do not have access to more detailed financial information. Accordingly, we accept that all FTSE 350 companies could be assumed to be within scope. However, the case for any extension beyond that needs to be considered separately by category. In particular, we would not agree with a blanket use of the existing Public Interest Entity categorisation as that includes all insurers, including very many that are small enough to be quite unlike the corporate failures cited by the CMA.

6. Further, all insurers are heavily regulated by the Prudential Regulation Authority (PRA). The PRA's safety and soundness and policyholder protection objectives are served by a supervisory approach which includes reliance in audited financial information. Supporting this reliance is the open, co-operative and constructive relationship between the supervisor and the auditor in the context of a particular regulated firm that is promoted by in the PRA's Supervisory Statement LSS7/13, *The relationship between the external auditor and the supervisor: a code of practice*.

7. The PRA's Code of Practice differentiates between different categories of insurers. For category 1 insurers, which pose the most risk to the PRA's objectives, the code of

practice requirements are the most exacting – eg trilateral meetings are also held are held to include the company as well as the auditor and the supervisor. However, no requirements are included for most insurers, being those in the PRA's categories 3, 4 & 5, as these offer much less risk to the PRA's objectives.

8. More generally, insurers already benefit from a 'second pair' of eyes in the form of close scrutiny through the PRA's supervision which manifests itself in measures ranging from approval of senior appointments including the chair of the audit committee, the submission of much detailed financial information, and the commissioning of skilled person reviews (FSMA s.166).

9. Further, because all insurers are PIEs, insurers which do not have any significant reliance on external suppliers of capital, such as those which are 100% subsidiaries and those which are mutuals, would be within scope. The cost/benefit balance for these is quite different from that for insurers which are listed companies.

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?

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.

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.

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?

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?

10. As the CMA acknowledges, the extra cost of joint audit is significant. We do not consider that the evidence is clear enough that audit quality would generally be enhanced substantially to make this extra cost worthwhile. We would also place more weight than the CMA on the increased risks both of lower audit quality – eg because neither firm may have a complete view and gaps or weaknesses in coverage, communication and accountability may arise, and of inefficiency because of duplication in coverage. Lastly, we think that there may be other unintended consequences such as a reduction in choice for non-audit services.

11. The case is particularly weak for requiring challenger audit firms in the joint audit of larger insurers. The expertise required is highly specialised, and the resources are largely concentrated in the Big 4. In practice, these larger insurers would be more likely to need two Big 4 firms. This of course would practically eliminate choice for audit services (with consequential risk to audit quality, in so far as that is driven by any reduction in choice and competition) and it would also severely restrict choice for non-audit services.

12. Accordingly, we do not support the joint audit remedy.

13. If this remedy were nevertheless pursued, please see paragraphs 5 to 9 above as to its scope. We have no comments on the allocation of the work/fee, nor of liability. However, we do not support any restriction on how joint audits are arranged, eg requiring audit appointments at different times, as that would surely serve to reduce both audit and non-audit service choice still further.

Remedy 2A: Market share cap

> 10. How could the risks associated with a market share cap, such as cherry-picking, be addressed?
>
> 11. Would it need to apply only to FTSE 350 companies, or also to other large companies, and if so, which?

14. A market share cap would not necessarily impose extra costs on companies, nor increased operational burdens. It does restrict competition and choice, but the risks to audit quality from a reduction in choice as between the Big 4 themselves are not so different from those arising from the joint audit option. There might potentially be a risk to audit quality arising initially from greater participation of challenger firms, reflecting their poorer AQR scores and current relative lack of resource. However, this risk can be mitigated to some extent by enhanced scrutiny on the part of both the Audit Committee and, if this option is pursued, action by the audit regulator.

15. We therefore are not opposed in principle to a market share cap approach, although we note its implementation would be challenging operationally. However, we stress the need for maximum flexibility on the part of both companies and audit firms to operate within the caps, without the regulator second-guessing what it thinks works best. We accept that this means that there will be unevenness in the distribution of audits as between the Big 4 and challenger audit firms. However, we think it inevitable that eg international companies are likely to choose auditors with networks which match, and this of course will favour the Big 4 until challenger audit firms place themselves on an equal footing.

16. We also emphasise that the cap should be high enough not to constrain the choice of auditor unduly, at least initially and perhaps with tapering over an interim period with a post-implementation review to see what should be done next. Lastly, we are not convinced that the evidence on pricing supports fears that the Big 4 will cherry-pick purely on profitability grounds.

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.

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.

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.

ABI response

17. We have no specific comments on barriers to staff switching between audit firms, although generally we oppose unfair restrictions in employment contracts.

18. We are very wary of introducing market distortions in the form of subsidies, whether for tenders or for technology platforms. Further, the links between the subsidies and the benefits to audit quality seem unlikely to be sufficiently close to provide a basis for appropriate criteria be identified to determine how the subsidies should be awarded and then monitored as providing value for money. Unless these concerns can be met, we do not support either of these Remedy 3 subsidies.

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.

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

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.

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.

ABI response

19. We have no comments on market resilience.

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.

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?

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.

ABI response

20. Measures have already been put in place relatively recently to safeguard audit quality from risks arising from the provision of non-audit services. The non-audit services which can be provided by audit firms to their audit clients are now subject to significant prohibitions and other limits. We consider that additional measures should only be undertaken if there is new evidence of tainting.

21. In relation to the possibility of a split in audit/non-audit service provision, we do not have views on whether this should be structural or an operational. However, we think it would be detrimental to audit quality if any new measures were to result in audit staff not being able to provide any non-audit services or non-audit staff not being engaged in any audits, as that would be likely to reduce the level of expertise that is needed to deliver high quality audits. That's particularly true in specialised sectors such as insurance, for which eg highly skilled actuarial input is essential.

22. We consider that any new measures should apply to challenger audit firms as well as to the Big 4. We see no reason why either should be put at a competitive disadvantage.

23. We do not consider that any changes are needed to the list of current restrictions on non-audit services being provided by auditors. Further, we think that in any case our members have strong policies in place to avoid conflicts of interest.

Remedy 6: Peer review

> 25. What should be the scope (ie which companies) and frequency of peer reviews, if used as a regulatory tool?
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> 26. How could peer reviews be designed to best incentivise auditors to retain a high level of scepticism, and thus improve audit quality?

ABI response

24. We consider that, in principle, peer review is greatly preferable to joint audit. The potential benefits are clearer. Operationally it will be easier to apply, as there is greater clarity regarding the respective responsibilities. Further, it would cost much less.

25. We do not think that it should be applied across the board, as we doubt that in many cases it would be justified on cost/benefit grounds. However, a highly risk-based approach could be taken by the regulator to require peer reviews in some circumstances, to add to its capability to raise audit quality.

C) Next steps

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

26. We agree with this proposal. We are not convinced that the problems identified in the CMA's review relate to competition issues in a way which require such a reference.