

Statutory Audit Services Market Study

Comments by Peter A Smith

Introduction

I am a Chartered Accountant. My professional career of over thirty years was spent with PwC and its predecessor firms, principally as an auditor in the financial services sector. I was UK Senior Partner of Coopers & Lybrand and PwC and Chairman of Coopers & Lybrand International. Since 2000, I have held a portfolio of non-executive directorships including the chairmanship of three FTSE250 companies and the ACC role at a FTSE100 company. I am currently the ACC at a French listed SBF120 company. I write in a personal capacity.

My comments on the Study derive from my recent non-executive experience.

The Study deals with two themes – the quality of the audit and competition in the audit market. My comments are directed particularly at audit quality and I test the proposed remedies in terms of the potential improvements to quality. I think it is a pity that a further review of competition is being conducted before the effects of the CC's 2013 initiatives have had time to settle down. I do not believe that the case has been made in the Study for further structural adjustments but do consider that there are useful opportunities for process improvements to improve audit quality.

Audit quality

I agree with the Study's comments about audit quality in section 2.39. If I have a single concern as an audit committee member, it is to establish that the auditor is able and willing to take the tough judgements.

I believe it is worth considering whether there are common themes within the list of cases in section 2.42 where prima facie there are doubts as to the quality of the audit. Leaving aside the small number of fraud related cases and those where non-compliance with required process is the issue, it appears to me that there is a significant number of cases that raise questions as to the challenge of and judgements on forward projections – the carrying value of receivables and bad debt provisions, the impairment of goodwill, revenue recognition and the allocation of project costs to different accounting periods – and the viability of the company. These are all areas where management prepares projections, the directors consider them and the auditors opine on them; they are all prone to optimism and a deficit of scepticism.

These are also understandably matters of concern to investors. But they are also areas where there is unlikely to be a "right" answer and ranges and probabilities are the norm. Where the year's cash flow does not broadly match the year's profit, it is important the business model is fully explained and adequate disclosure is made of the risks and assumptions. I believe that effort in this area to enhance the transparency of reporting and the competencies of both auditors and audit committees is likely to have a fuller and faster beneficial impact on audit quality than the remedies proposed by the study.

A start has been made with the strategic review, expanded audit report and the viability statement, but there is further to go.

Market analysis

Section 3 of the study contains some data but also many assertions, opinions, judgements and hearsay not adequately supported by the evidence. Rather than argue the issues line by line, it is more appropriate to examine the proposed remedies in Section 4.

What I see from this section is that, given the scale of some of the recent structural changes, in the space of four years considerable progress has been made. I do not believe that a case has been made for re-opening some of the proposals rejected by the CC just a relatively short while ago

Proposed remedies

Regulatory scrutiny

I have significant concerns about this remedy and, indeed, the need for it.

There is already a defined process for auditor selection. The intention to tender is pre-announced, the process is subject to public report by the AC and shareholders are invited to approve the recommendation. It is a requirement of company law that the directors (the AC) should act in the interests of the company having regard also to the interests of other stakeholders. It is their duty to make the right recommendation having audit quality front of mind. Inserting the regulator into this process by way of observer or reportee confuses the legal responsibilities. It is for the regulator to comment, but I cannot understand why, when the new system seems to be developing appropriately, the regulator would want to be engaged in a matter that is the legal responsibility of shareholders and directors.

There is some discussion in the Study about chemistry between the auditor and the company. In my experience the members of ACs are fully mindful of their personal responsibilities and ACs tend to be respectful, not cosy. For an audit to work, there needs to be mutual trust between the auditor and the committee members and that starts with an understanding of their respective responsibilities. Owning the responsibility means owning the selection process.

If it is helpful, I have no problem with the AC being required to explain further the processes it has adopted and the basis of the decision it has reached. I would add that in the nine years I chaired a FTSE100 AC I only ever had one enquiry from an investor and that was on a matter outside and unrelated to the terms of reference of the committee.

Mandatory joint audit

Over the last thirty years the world has moved away from joint audits, preferring the clarity of responsibilities and efficiencies of a sole auditor worldwide.

I have personal experience, albeit limited, of joint audit in France. It works adequately and seems to suit the French culture and its rules based approach to regulation; but it is considerably more expensive. It supports a larger population of small or medium size audit firms but whether it would be invented if it did not already exist must remain a question. It may provide some form of peer review, but not obviously greater than the large firm's internal quality control functions.

In my opinion, a challenger firm appointed as a joint auditor would need to consider very hard whether the rewards and the risks were in balance. Some might wish to take the

appointment in sectors where they had the necessary experience, but to mandate it across the FTSE350 market seems particularly ambitious.

It is not clear to me why business should bear the cost of a regulator-imposed inefficiency.

If mandatory joint audits are required as a means of building audit capability, then it is sensible that the second firm should be a challenger firm. I would need to be convinced that there is adequate capacity in the challengers for such a policy to be mandated.

It is acknowledged that this remedy would be part of a long term solution. I would prefer to see a greater commitment of the challenger firms to taking the sub FTSE350 segment of the listed company market, including a re-enforcement of their international networks, to move over time into the FTSE250 market from a position of accomplishment.

As with Remedy 1, I believe that this proposal cuts across the legal responsibilities of directors to act in the best interest of the company by putting in place what they consider to be the most appropriate audit arrangements.

Market share cap

For many of the reasons summarised in section 4.78 I am not supportive of a market cap. In particular, such a policy also trespasses on the ability of the AC to appoint a firm that in their opinion is best placed to do the job and therefore increases the risks and potential costs of a loss of audit quality.

Again, as with Remedy 1, this cuts across the legal responsibilities of directors to act in the best interest of the company by putting in place what they consider to be the most appropriate audit arrangements.

Additional measures

I agree that artificial restrictions on the movement of people should be prevented wherever possible.

Market resilience

I agree that further work would be beneficial. The normal conversation has it that there would be an event that imperilled one of the Big 4. My view is that it is more likely that progressive deterioration of the performance of a firm over time is a more likely concern. A perception of loss of quality, an inability to recruit the best, pressures on costs (technology investment and remuneration) causing people to leave will lead to a reluctance to consider the firm at tender.

Structural or operational split

In my opinion, few ACs would object to a prohibition on the supply of non-audit services by the auditors a means of eliminating a perceived challenge to audit independence.

For many of the reasons set out in sections 4.122 and 4.128 I am opposed to the creation of audit-only or ring-fenced audit firms. The ability to leverage knowledge across the firm and provide staff with development opportunities would be severely reduced.

I am not as relaxed as the Study about the ability of an audit-only firm to succeed. People businesses are fragile and very vulnerable to sentiment. My experience is that in order to be

successful and recruit and retain people, a firm has to be seen to be growing so as to create the new opportunities and vacancies that attract recruits and offer promotion to existing staff. Taken together with technology developments and AI, I really do not see the growth rates in the UK audit market that will sustain the levels of long term growth that are the ingredient for a successful enterprise. Such firms will continue to exist but their ability to invest in technology and people may be too low to ensure that audit quality is maintained.

I am supportive of the further development of a public oversight regime within the firms to enhance the safeguarding of audit independence. My understanding is that the large firms have established such arrangements yet the Study appears silent on their performance. Further evaluation and potential enhancement of these governance arrangements would be appropriate as an alternative to separation or ring-fencing.

Peer review

In principle I am supportive of peer review in some format. The simplest approach is an extension of the AQR regime. More complex and expensive is regulator-directed review by other firms.

Before going down this path, I would like to know more about why the firms' own internal quality control processes failed in those examples in section 2.42. In other sectors such as aviation or pharmaceuticals where failure could threaten life, the QA processes tend to be internal rather than external or outsourced. Why are the Big 4 seemingly not able to manage their reputation through an internally managed assurance process? As an ACC I am buying the firm not just the nominated engagement partner.

If further external reviews are considered appropriate, I recommend that in the absence of other problems they are targeted specifically towards the auditor's performance in the risk areas identified in the extended audit report

Conclusion

If there is any further information I can provide, please let me know.

Peter A Smith

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