

RK Perkin MA (Cantab), FCA

Statutory Audit Market Study  
Competition and Markets Authority  
7<sup>th</sup> floor  
Victoria House  
37 Southampton Row  
London WC1B 4AD

To the Members of the Competition and Markets Authority

This response is written entirely in a personal capacity.

**Background experience:**

I joined Arthur Young (now EY) in 1969, became an audit partner in 1979 and retired as a senior partner in 2009.

Until 'Big Bang' I worked with clients, of widely varying size, across many industries, but with a significant focus on oil and gas. Following the rapid expansion of financial services in the UK in the late 1980s, I worked almost exclusively with financial services (FS) clients, including retail and investment banking, asset management, private equity and insurance. This work took me to over 40 countries, including seven years as the 'signing partner' for the largest Swiss bank.

Since 2009, I have served on the boards (and, with one exception, been ACC) of seven FS companies and four charities. Among the FS companies have been two FTSE 100, the UK's largest mutual, three FTSE 250 and one PIE. In these roles I have had significant exposure to all the Big Four and five 'other' firms.

I confirm that I am entirely independent of the Big Four.

In this response I use the word 'he' to cover 'he/she'.

**Concerns about audit quality:**

You highlight that perceived audit quality issues are a global phenomenon (Fig 2.19). In Fig 2.16 you set out a schematic of FRC enforcement actions against the Big Four and Grant Thornton over an extended period of time, and in para 2.41, you indicate the basis on which you have concluded that 'several indicators suggest a persistent problem of variable and sometimes poor audit quality'.

It is impossible, therefore, to disagree with your conclusion that there are concerns. However, before pushing through some of your radical structural proposals, which will undoubtedly be costly to business and with unproven benefit to audit quality, further significant investigation should take place with a view to seeing if there are alternative, less disruptive measures that can be taken to achieve the same goal.

In particular, it is unarguable that the 'concerns' form part of a wider, and vitally important, 'trust in business' issue. Therefore, logic dictates that the issue of perceived audit quality should only be dealt with in the context of the wider corporate governance and financial reporting

framework. I would propose that during the time that the Kingman proposals are introduced, and the Brydon review takes place, proper and full investigation should be conducted into the desirability of introducing a UK version of the Sarbanes Oxley regime with a view to ensuring enhanced senior management accountability for financial reporting and thus clearer framework around the gathering of audit evidence.

At the same time, while evidence such as your Fig 2.16 is seductive, further work is necessary to ensure that it is not taken out of context of the overall audit market for PLCs and other PIEs. In other words, as evidence, is it proportionate?

### **Audit Committee's role in the appointment and monitoring of the auditors:**

Your analysis places significant emphasis on the fact that, from your review of tender documents, there is an excessive focus on 'cultural fit' and that management plays too great a role in the process. I am sure that in a number of cases words and emphasis could have been better expressed. However, the reality is that, to a massive degree, business is about people, human interaction and culture. The lead audit partner is absolutely pivotal; he and his team can only work fully effectively if they establish an efficient, mutually respectful relationship with management and the audit committee. If the 'fit' isn't there, then this will not happen.

An expression used repeatedly and rightly in the literature is 'professional scepticism'. In practice, this translates into two key questions in the auditor's mind: am I being told the (whole) truth; and does the person telling me command all the relevant and verifiable information to support what he is telling me. And the ACC has (or should have) exactly the same questions. So, in appointing (and retaining following ongoing evaluation) the auditor, he needs to be satisfied that he has the combination of professional skill and experience and the ability to work alongside and challenge management so that it is overwhelmingly more likely than not that the right questions will be asked, the right evidence obtained, and the right conclusions reached.

In my experience the ACC values his reputation above all else and, of course, it is that reputation which has underpinned his appointment. It would defy normal logic to conclude that the ACC would be prepared to compromise that and make inappropriate audit choices. Therefore, in the present environment and for the reasons outlined, I believe you have been led inadvertently to the wrong conclusion with regards to appointment and retention of auditors by audit committees.

Nonetheless, in the context of your and the Kingman reviews, and the need to address the vital public perception issues, I would propose that the new regulator inter alia addresses:

- The experience, time commitment and motivations of ACCs
- The circumstances in which regulator intervention is necessary in the auditor appointment/retention process with a view to avoiding unnecessary intrusion into the operation of the unitary board.

Additionally, I am sure all contributors to this process would welcome an independent analysis of the impact on audit quality of the appointment of new auditors. First, there was a long-standing, though (probably) not particularly well-founded, view that appointing new auditors heightened 'audit risk'. And secondly, it would be very instructive to hear evidence as to whether audit quality (and more importantly, the level of audit challenge) had been compromised in those appointments where 'fit' and 'management engagement' had been emphasized.

### **Limitations on choice leading to weaker competition:**

That having four very dominant firms in the global auditor market is sub-optimal is unarguable. But the train left the station when Price Waterhouse was allowed to merge with Coopers in the late 1990s and Arthur Andersen was effectively killed off when indicted by the DoJ. We have a global audit market operating in a global economy. A UK centric 'solution', while seductive, cannot be in our long-term interests.

All my experience, reinforced by most of the initial responses to the CMA consultations from those who have practised on 'both sides of the fence' (i.e. audit partner and ACC), is that competition between the Big Four is fierce. It is instructive that 46 % of auditor changes resulted in an increased audit fee (para 3.21). So, if price is not the main determinant and ACCs have the motivation I described earlier, then the conclusion must be that, in general, audit quality has not been diluted by a lack of competition.

Like many, I was surprised by the most recent AQR findings. Given the environment and the 'heat', the Big Four must have been feeling they were to say the least counter-intuitive, and so warrant further consideration/explanation.

However, wherever possible, it is generally accepted that an open competition of (at least) three firms is likely to deliver the best outcome. In para 3.79 you confirm that in the 30% of cases you looked at, less than three firms pitched and in para 3.97 that in 57% of cases the reason not to pitch was non-audit services.

A major cause of this limitation is the frequently trivial and historical involvement of the advisory arms of the firms. Therefore, there should be a thorough investigation into non-audit services with a view to ensuring that those which are trivial and/or pose no realistic threat to proper audit independence are grandfathered. At the same time, there should be a process designed to ensure that those services which the auditor is uniquely or overwhelmingly best able to provide are no longer defined as 'non-audit'.

### **Barriers to challenger firms for FTSE 250 audit:**

Given the virtually total market dominance of the Big Four, that there are massive barriers to the challenger firms is self-evident. What is not self-evident is that using the (other than in France) largely anachronistic mechanism of the joint audit to lower those barriers is either likely to improve audit quality or be in the public interest. I will leave the firms (Big Four and challengers) to address the many practical and legal issues. There do, however, seem to be a number of contextual matters worthy of further consideration.

First, in Remedy 3, you suggest that the barriers to movement from the Big Four to the challengers through non-compete clauses should be lowered. But if the perceived quality problem is within the Big Four, how can it possibly be a solution to facilitate personnel movement from the Big Four to challengers?

Secondly, going back in time, the driving force behind the contraction of the original Big Eight to the Big Four was (except for the Arthur Andersen accident) the economies of scale necessary to support the substantial investment required to match up to increasing complexity and demands of larger more complex clients. And don't forget, in simple terms, the risk capital base to support this comes from the partners alone. That none of the challengers have remotely been able to

stay in or join the market is not an accident driven by monopolistic practices. Rather, it is a consequence of basic economics.

Thirdly, at least based on your sample in figure 2.16, the only challenger highlighted is not immune from the issues related to the Big Four on which you focus.

Much better, at this stage, would be to do the following:

- Charge the new regulator with focusing on how the Big Four ensure uniform standards of quality. For example, at least in the FS space, a disproportionate number of 'audit failures' seem to have been at offices other than London. What means do the firms use to ensure such audits are properly staffed, supervised and reviewed?
- At least one of the firms has an internal peer review process. How well does it work and can it be recommended more widely? And, for that matter, what should be reported to ACs of its workings.

#### **Resilience concerns:**

Here, I will leave it to the experts. One thought - since the financial crash there has been huge effort in this area in the banking industry. Are there lessons from that area which are applicable to the audit profession?

#### **Wider incentive issues raised by the multi-disciplinary nature of the large audit firms:**

No doubt the Big Four will provide their considered response(s) to the proposed organisational separation.

As an ACC my fundamental objective is to have an auditor who can tell me if the numbers are right, and in the areas of judgment, where the company sits on the curve of the range of acceptable outcomes (and that the underlying assumptions and calculations are well founded). In many respects this satisfies the definition of a good quality audit. However, the ACC and the rest of the board require a lot more - recommendations on internal controls; insight into the company's people and culture; benchmarking with best practice in comparator organisations; etc - before they are satisfied that they do indeed have a good quality auditor.

With the above in mind, I focus on a number of paragraphs in your document.

3.25 'Interpersonal skills and an understanding of the organisation, its culture and ambitions may be relevant to an auditor's ability to effectively (sic) question and challenge management'.

3.185 'Based on current trends, audit practices are likely to continue to decline in relative significance in the Big Four'.

3.189 '...underlying tension created by the different objectives of audit and non-audit work... we would expect those tensions to increase, undermining the incentives to focus on independent, high quality audit'.

I have three observations:

First, if, as you state, the relative size of the audit business within the Big Four firms is likely to decline further and so reduce their influence, then I see no rational argument to support

accelerating and increasing that dilution by shifting work from the Big Four to the challenger firms.

Secondly, as discussed earlier, interpersonal skills are not a 'nice to have' - they are a vital ingredient in performing good quality audits. The more the Big Four is forced into a separation of audit from other services the narrower the auditor will, by definition, become. This trend is already happening and may, indeed, be a contributory factor to some of the audit failures.

My own experience while a Big Four audit partner included forensic investigations; litigation support and expert witness; administrations; operational control reviews; reviews on behalf of the regulator; due diligence; reporting accountant; etc. All of my experience convinces me that having a wide range of professional experience (including that gained while working collaboratively with clients) must enhance the auditor's ability to ask the right questions and not rest until he has the supporting evidence. I hope the Brydon review includes this aspect in its work.

Thirdly, while the overwhelming majority of the work I performed described in the previous paragraph was at 'board level', it is my experience that unlike the external audit, the vast majority of the 'non-audit' services provided by the Big Four are commissioned below board level; indeed, they are mostly invisible to the board. However, the symbiotic relationship between the Big Four brand, driven by the audit practice, massively increases the ability of the Big Four to recruit the best across a wide range of disciplines and then to deliver the services in a highly professional way. And it is precisely those high-quality specialists - actuaries, valuers, insolvency experts, IT security experts, etc - who are so important to the audit as you have recognised.

## **CONCLUSION:**

### **Mandatory joint audits:**

The imposition of mandatory joint audits would inevitably lead to increased cost and disruption to business. For all the reasons discussed in this response, I see no compelling argument in favour of shifting work away from the Big Four to the challenger firms either on competition or quality grounds.

In para 4.55 you concede:

'While several empirical studies have been conducted on the impact of joint audit on audit quality, the conclusions are mixed. In particular, the literature has not established a clear link between mandatory joint audit and audit quality. Conversely, there is no clear evidence that audit quality is lower in a joint audit regime.'

Therefore, to impose joint audit for no apparent reason or benefit, and thereby making us a global outlier in the major capital markets, is an unnecessary, disruptive and potentially damaging remedy. I propose a time out while the new regulator is established, the Brydon review completes its work and the further work I have proposed in this response is undertaken.

### **Market share cap:**

Again, for the reasons set out in the first paragraph of this conclusion, I see no merit in this backstop proposal. Furthermore, I cannot see how it can be other than anticompetitive assuming that, on competence, professional skill and global reach grounds, a substantial portion of the FTSE 100 and specialist industries in the FTSE 350 would need to remain with the Big Four, so the choice left for the remainder would inevitably be significantly narrowed.

**Timetable:**

While the urgency with which you have gone about your task was understandable, particularly in the context of the Kingman review, now is the time to pause (particularly in the light of the ongoing Brydon review). As it is, the timeframe for response to your proposals is unrealistic and not conducive to getting the widest possible inputs and so achieving the best outcome for stakeholders. Indeed, my professional scepticism leads me to conclude it was a cynical attempt to minimise such input.

**Global Issue:**

The Big Four oligopoly is a global issue; tinkering (albeit in a highly disruptive way) in the UK market alone cannot begin to address that global issue.

**Central basis for your remedies:**

I have not seen a persuasive case in your review either:

- That somehow moving audits from the Big Four to challengers will improve audit quality.
- That structural changes to the Big Four themselves will improve the quality of auditors, indeed, the opposite may be the case.

**A strong regulator:**

As an ACC operating in the highly regulated FS market, I can only endorse the results of the Kingman review. I hope that (successful) lessons from the FS market can be used to inform the operation of the new regulator, albeit in an appropriately proportionate way.

**Applicability of (eventual) remedies:**

The FTSE 100/350 are constantly evolving. Equally, a number of the 'audit failures' referenced by you occurred in the PIE or large private space. It therefore seems self-evident that any eventual remedies should cover PIEs and large private companies.

**The Future:**

The majority of your analysis is locked in the past. While I discussed earlier some of the attributes of a good auditor historically, it is certain that they will evolve significantly over the next few years. The role of the financial modellers, data security and data mining experts, for example, will undoubtedly become essentials. Again, hopefully these needs and how best to satisfy them will be addressed by Brydon.

**Below the parapet:**

I pondered long and hard as to whether I should write this response. To a great degree, the auditor and ACC operates quietly and effectively, 'below the parapet'. But the issues you are seeking to address, and to which I have devoted 50 years of my life, are just too important to let go. No doubt it will be an easy shot for critics of the Big Four to dismiss my views as being from someone who has been 'captured'. I can only respond that they have been formed with the aim of ensuring the best possible outcome for all stakeholders with regards to external audit. No more, no less.

Yours faithfully

Roger Perkin