



## **Statutory audit services market study Update paper December 2018 – Wellcome Trust response**

### **Applicability to Wellcome**

Wellcome Trust is an independent global charitable foundation. We benefit people around the world by improving health through complementary approaches across science, research and engagement with society. We achieve this by advancing ideas, seizing opportunities and driving reform and are supported by an investment portfolio which was £25.9 billion at 30 September 2018. We do not raise funds from the public.

We tendered for the Wellcome Trust audit in 2015 and we are not proposing to tender again until 2025 so will not be evaluating the firms in any depth until that date. The audit partner is rotated every five years.

Wellcome is a PIE with a large investment portfolio and consequently:

- requires an audit firm with adequate resources to support the external audit process and challenge and provide comfort to management as appropriate
- requires access to firms with expertise to provide non-audit services to support the internal audit and complex investment and charitable activities as they arise

### **A) Issues**

We do feel that it is appropriate that this survey has been done alongside the Kingman review of the role of the FRC and the need to enhance its regulatory powers and structure.

We also feel that there is an expectation gap between the scope and responsibility of the auditors and the expectations of the public and also that financial statements themselves cause an expectation gap as they have become too complex (for example, the treatment of intangibles and the application of certain fair value rules).

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.

## **B) Remedies**

We have suggested the scope in the responses below where appropriate.

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.

We are pleased that the CMA has recognised the general opposition to the use of an independent appointment and monitoring body. We believe that the regulator should have the ability to issue public reprimands to a wider group than the FTSE 350 (all PIEs and larger entities) where it is not satisfied that Audit Committees have followed proper procedures. It is not appropriate for the regulator to be directly involved in the tender selection process and the audit process itself as this would add to the costs of what is already an expensive process and requires a level of knowledge of the organisation that a regulator would not have. There is clear FRC guidance on the role of Audit Committees and the disclosure within the Annual Report and Financial Statements provides a good indicator of the operation of the Audit Committee (for example, does the Report give a clear indication of the timings and procedures for the audit tenders; does it address the work the Audit Committee has done to ensure an adequate evaluation of key risks, estimates, judgement areas and the strength of the

viability statement; are the messages consistent with that within the Report of the Independent auditor).

## Remedy 2: Mandatory joint audit

We do not support the use of joint auditors as this can increase complexity and result in duplication of work and a longer time to get agreement relating to key accounting matters without a noticeable increase in quality or competition. There could be some merit in a second audit firm reviewing the audit of all larger entities and PIEs as a “second partner review” but we note that there are challenges with this approach as well (such as costs and timing).

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?

## Remedy 2A: Market share cap

We do not support the implementation of a market share cap and this might have

the unintended consequence of hindering competition and choice if firms are unable to participate in tenders. It would also be complex to implement and expensive to monitor. The implementation of a market cap does not address the issue of the non-Big Four firms choosing not to participate in tenders due to resource or other constraints – and it could actually add to this.

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?

### Remedy 3: Additional measures to reduce barriers for challenger firms

We believe that the professional firms are best placed to respond to these proposals in detail. However, senior staff should not be faced with unreasonable barriers to movement and this should be encouraged although it could be complex to implement for example, the need to ensure that audit partners or other senior staff do not “take” clients with them. All firms are in business to be profitable and there need to be a balance between not imposing onerous restrictions on staff being able to move to other firms and obtaining benefit from the costs that have been incurred (e.g. the investment in training staff; the costs of recruitment; the need to have notice periods).

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.

#### Remedy 4: Market resilience

We believe that the professional firms are best placed to respond to these proposals in detail however, we are fully supportive of non-Big Four firms increasing their participation, which would increase competition and choice, and increase audit 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.

#### Remedy 5: Full structural or operational split

We believe that the professional firms are best placed to respond to these proposals in detail.

Whilst there are clear benefits to full structural separation we have concerns about how a separation could impact the quality of delivering an audit, as audit-only firms may not have sufficient access to the technical specialists required for a high-quality audit and the firms would need to source advisors and specialists externally with increased costs and reduced control over quality. The skilled and senior members of the profession could be incentivised to join the non-audit service firms that are generally more lucrative and provide a broader range of opportunities. This could also remove the potential opportunities for the challenger firms to develop their expertise in specific areas over time enabling them to attract new audit and non-audit clients.

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, 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.

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.

There are certain services that the auditors may be best placed to provide in view of the knowledge that they have of the organisation and/or elements of the service that might already have been covered by the audit work. These include reviews of half-yearly financial statements, the provision of certain comfort letters and other legal and contractual requirements, an accountant's report in relation to the sale of a business or undertaking financial due diligence.

## 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 support the use of peer review as a mechanism for improving audit quality for all larger entities and PIEs possibly once every two years for PIEs and FTSE 350 with a slightly extended period for other large entities. We recognise that there are several issues that need to be addressed (including how any conflicts would be resolved).

The scope should be similar to the current “second partner” review process with a focus on areas of risk, key judgements and estimates and the viability statement.

We do have concerns with the proposal that the Regulator’s report be made available to the Audit Committee before the accounts are approved as the financial year end process for many entities is generally extremely tight in its current form without this additional burden. It could also be expensive, and the costs of mandatory audits are already considerable. If the audit firm are aware that a peer review was to take place shortly after the audit, it is likely that they would take this in to consideration whilst conducting the audit as it would do considerable reputational damage if they were to be challenged as a result of the Regulator’s Report.

We also have concerns about the role the Regulator would play when there are any significant changes to accounting standards. Our experience has shown that when a new standard is implemented, there are often several “grey” areas where the audit firms place different interpretations and it takes a few reporting cycles for best practice to be agreed upon and consistently applied.

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

The scope should be similar to the current “second partner” review process with a focus on areas of key judgements and estimates and risks together with evidence of management challenge and consistency within the financial statements.

### **C) Next steps**

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

We support this proposal and think that recommendations to the government and a considered and staged route to implementation is more appropriate and will result in better cooperation from all parties involved.