Response to statutory audit services market study

This response has been submitted by John Rishton, Audit Committee Chairman, and Angus Cockburn, Chief Financial Officer.

Regular scrutiny of Audit Committees

The recommended remedy proposed for Audit Committees does not recognise the fact that shareholders approve auditor appointment for the following year and the associated audit fee, not the company. It also appears to ignore the wishes of the body to whom the audit opinion is addressed, namely the shareholders. The non-Executive Directors, appointed annually by shareholders, are the shareholders legally elected representatives and part of their role is to ensure the audit is effective. Adding a third party to the process undermines the whole concept of UK governance and it is not clear how the appointment of a third party would help with quality, effectiveness and accountability. The proposed regulatory oversight or additional bureaucracy during the audit process will add confusion, time and cost. The concept of a non-Executive Director is such that they are neither executive management nor an auditor and having them report regularly to a Regulator seems inappropriate and undermines the entire concept of the role a non-Executive Director. Again, it is not clear what value will be added by the additional bureaucracy proposed around auditor appointments given the fact that the Audit Committee is composed of the appointed representatives of the shareholders and are already empowered to run the process to select new auditors with shareholders subsequently approving the appointment.

Increasing the pressure on Audit Committees completely misses the point that the responsibility and accountability for the integrity of financial reporting should rest on the executive management who are in the business 365 days a year and are responsible for making judgements as well as preparing and signing the Accounts. The report seems to miss this point completely. In many respects, a focus on this area would improve audit quality significantly more than many of the suggested remedies.

Mandatory joint audit

There is no evidence that joint audits improve audit quality and, in cases such as Parmalat, may have contributed to audit failure. From a company's perspective, joint audits add risk, cost and complexity and on the face of it reduced audit quality. Having to manage two firms means that multi-jurisdictional audit issues may be missed and audit quality will be reduced in a haze of joint audit planning, "who does what" execution and reporting confusion. A key benefit of having a "joined up" global audit firm is its ability to plan, coordinate and execute audits seamlessly. It also allows the Group team to look for systemic issues and be able to pick up emerging themes/issues and have additional test work performed in other locations. Joint audits will likely add cost, duplication, delay and increase risk and are therefore unlikely to address the concerns of the company's owners, namely the shareholders. It will also reduce the number of firms who are not precluded from tendering due to conflicts which will therefore reduce competition further. Mandatory joint audit is undertaken in France and there is no evidence of any benefit from a competitive perspective because the audit is largely executed by the large firm with the small firm contributing very little.

Market share cap

This is anti-competitive and is likely to undermine the reputation of the UK as a financial centre. By restricting choice further, particularly for smaller international companies, the risk of audit failure is increased significantly given the geographic network, as distinct from informal alliances, required to audit any global company which only the four largest firms can currently provide. The smaller firms are unlikely to have the capacity, integrated global network and experience required to take on global audits. Additionally, there is a danger that an artificial construct that reduces competition will lead to cherry picking by firms and the very companies that, from their owners perspective, require the expertise and rigour of a Big 4 audit will be deprived of that. At a time when the UK needs, more than ever, to maintain its reputation as an attractive place to do business, this artificial constraint of restricting auditor choice will potentially reduce the UK's competitiveness if companies are unable to access the full range of international audit firms. In this case, they may go elsewhere to a location where they have access to the full suite of audit firms rather than being forced to select a firm from the second tier.

Splitting audit and non-audit services

We have stated before that the current four large firm model, whilst not ideal, works and artificially creating competition is very difficult given the international nature of auditing and the costs to compete, for example, technologically. Splitting out consulting and auditing seems on the face to add nothing in pursuit of audit quality given the clear rules on auditor independence rules. There is already very a clear process that management can follow to limit conflicts when it comes to auditor selection. The inability of an auditor to call on specialist advice from its consulting business in areas such as Pensions, Treasury and Tax is likely to damage audit quality, in fact the engagement of non-audit functions during the planning process of an audit would be beneficial to ensure the audit plan is designed address non-financial risks associated with the company, for example its business model, the use of systems, and the geographies and sectors in which it operates.. Additionally, having audit only firms will likely significantly increase the complexity and risk of audit as the audit firms will need to source this information elsewhere. It will also likely make the accounting profession a less attractive career for graduates and school leavers and will in the long-term lead to retention challenges and a risk in terms of the quality of audit personnel. Given the preponderance of December year ends, the audit firms will be faced with a feast/famine staffing model with the resulting inefficiency being passed onto companies by way of higher fees, again making the UK a less attractive and uncompetitive place to do business.

Peer Review

Peer review is an innovative idea but the responsibilities of a peer reviewer would have to be very clear together with their potential liability. This will again add cost and slow down the audit process leading to delays in company reporting which will be detrimental to shareholders. The process to resolve differences of opinion during the peer review and how to deal with disagreements whose materiality is such as to be market sensitive will also have to be addressed. The nature of the work the peer reviewer will be required to perform will also need careful consideration to ensure that there is not in effect two separate audits. A peer review performed outside the reporting window would have attractions in terms of "sharing best practice" which may help the smaller firms build up expertise in terms of auditing large, global businesses, however this may deliver another expectation gap in respect of what value the peer review is providing to the shareholder.

Our comments on other areas of the CMA's initial report are set out below.

Management responsibility

The paper misses the point that Accounts are prepared and approved by Executive management who are in the business full time and responsible for all aspects of managing the company. It is ultimately their responsibility to make the appropriate accounting judgement. Their responsibility goes further in that they prepare the majority of papers reviewed by an Audit Committee and also have to explain their positions to the external auditor. It feels like this report is scapegoating the auditors and Audit Committees rather than dealing with the root cause of poor quality reporting and auditing, namely executive management. Management responsibility should not be ignored in terms of this report.

The complex nature of multinational organisations is such that executive management must rely on controls and systems being effective in managing risk and operating as designed. It would naturally follow that the auditor assess the effectiveness and operation of these controls and report on them as part of the annual audit opinion. This assessment should be robust for areas of significant risk and any deficiencies reported within the audit opinion.

Implementing a stronger internal control framework along the lines of Sarbanes Oxley and making management more accountable will go a long way towards preventing future accounting and audit failures.

Audit Committees

The Audit Committee has a key role to play in terms of appointing auditors and agreeing audit fees, independent of management. The Audit Committee also has an important role in ensuring that the financial control framework is in place and that there is a robust process around the publication of external reports. However, Audit Committees generally meet 4-6 times a year for a few hours and to expect the Audit Committee to regularly update a Regulator on audit progress is contrary to the role Audit Committees are set up to play. If this becomes a requirement, then Audit Committees will need additional support, probably in the form of another auditor, to give them advice. It also blurs the line of the role of a non-executive vis a vis an executive thereby potentially undermining the whole basis of a UK corporate governance framework that is widely regarded as being world leading.

The art of finding the right balance between regulation and self-regulation is challenging, particularly in the aftermath of Carillion, but adding complexity and cost whilst reducing audit quality does not feel appropriate. The question that needs to be addressed most urgently is the role of executive management rather than placing all the onus on reforming external audit and the role of the Audit committee. Leaving the Big 4 intact and not breaking them up will help ensure a higher level of audit quality going forward given the need for high quality people, global reach and technological investment. Increasing the onus on executive management from a reporting perspective and introducing a Sarbanes Oxley type regime will achieve a lot more from an audit quality perspective. A complete ban on non-audit fees will remove any last vestige of questioning auditor independence. An over-reaction in terms of regulatory intervention will not solve the bad behaviour of certain company managements.

Given the expectation gap that exists between the accounting profession and the public as to the scope and purpose of an audit, the Bryden Review is clearly very important. It would seem presumptuous for the CMA to make decisions about the future of Audit before the Bryden Report is presented.

Audit focus

The report sets out that auditors must be robust in reporting when companies do not clearly report on the underlying business, financial risks and significant estimates and judgements made in preparing the financial results.

The reporting of such risks is limited to financial accounting and more recently the application of complex accounting standards, where different conclusions can be reached by different parties with the same facts presented. In addition, the accounting standards have moved away from cash flows and therefore the ability to navigate through a set of financial statements is complex.

The make-up of audit teams tends to be of qualified chartered accountants who are comfortable in assessing these complex rules, however this does not always extend to the shareholders of a company where returns on investment, viability and management incentives are the key focus. Assessing these risks requires a broader understanding of the business operating model and risks faced within the industry in which the entity operates. Whist the auditor will review these as part of the audit process, the experience of the average auditor does not lend itself to a credible assessment of these.

Therefore, whilst the focus of finance within a large organisation is changing to be one of business partnering with systems and processes being delivered centrally, it would be appropriate for auditors to ensure that the audit mirrors this structure. Therefore, more audit time can be spent on assessing how management are reviewing the critical risks and judgements which are important to the shareholders of the company.

Concluding remarks

The appointment of auditors is managed by representatives of shareholders through the Audit Committee, but the subsequent approval by the shareholders can be seen as an administrative exercise. However, it is these stakeholders who are most impacted by any bias in reporting by executive management or an audit which does not focus on key risks relevant to their investment.

Notwithstanding the need to hold executive management to account in relation to the quality of financial reporting and forecasting, there is a potential need to improve shareholder engagement in respect of the audit process and findings. This may help bridge the expectation gap in respect of the audit services, or help the audit focus on key risks relevant to an entity's shareholders as outlined above, however this will require a significant change in the audit approach and the skills of individuals who form the audit team.