



Statutory audit market study
Competition and Markets Authority
7th floor
Victoria House
37 Southampton Row
London
WC1B 4AD

21 January 2019

By email: statutoryauditmarket@cma.gov.uk

Dear Sirs,

Leathers LLP

Response to the Statutory audit services market study

Leathers LLP (“Leathers”) would like to thank the Competition and Markets Authority (“CMA”) for the opportunity to comment on the market study into the current audit services market.

We believe that audit plays a crucial role in the ability to train the highest calibre accountants and financial advisors. As a firm that prides itself on the quality of work and service that it provides to its clients, we have a strong belief that this has been facilitated by the training our staff have undergone. This would not be possible without a well functioning audit division that serves to provide a well rounded introduction to the financial and business world.

We share the CMAs concerns over the current issues with audit quality seen in recent regulatory reviews, and the public’s perception of audit quality due to high profile company failures, and agree that action is needed. Furthermore, the domination of the big four accounting firms is limiting choice in the market which we see as a barrier to improving quality, particularly in the case of the FTSE 350 and larger private groups. We therefore specifically address the suggested remedies in the report of joint or shared audits, peer reviews and full structural or operational split.

Newcastle

First Floor 2 Collingwood Street Newcastle upon Tyne NE1 1JF
0191 224 6760

weareleathers.com

Remedy 2: Mandatory joint audits

We welcome the CMA's proposal and aims of the concept of joint audits. The ability of challenger firms to win audit tenders from the big four is very limited. We agree that a restructure of the audit market in this way would help to reduce at least some of the barriers faced.

Additionally, we have concerns that the increased pressure on fees and efficiency has led to falling audit quality in the case of subsidiary companies in group audits. This is supported by 3 out of the 4 big four having group audits identified as an issue in the latest FRC AQR reports, and in particular the area of component auditors. Too often the subsidiary is seen as a component of the larger group, rather than a stand alone entity with its own risks and issues in its own right. We see the introduction of joint audits as a potential remedy to this issue.

We have reviewed the proposed approach to joint audits put forward by the CMA and believe that a structure which would break up large group audits and allow smaller, independent firms to carry out the audit of the simpler trading subsidiaries would be a sensible first step. We commonly find these subsidiaries are regional operations, that on a daily basis operate largely autonomously from the wider group and as a result have the most adaptable structure to facilitate this reform at this time. We would consider any FTSE 350 group and any private group with turnover in excess of £100m to fall into this classification. Additionally, the market is already aware of this principle of separate firms completing components of group audits due to international networks operating on a similar basis already. Working on an established mechanism will allow for faster and smoother reform in the domestic market.

Allowing challenger firms to audit these subsidiaries would allow for greater scrutiny and challenge as they would not carry the pressures of the more complex group issues which often require significant time and resource. We concur with Deloitte's views that sharing audits would enable audit firms outside the big four to develop skills and increase capacity, which would be of benefit to the entire audit market. We believe that shared audits would be the most appropriate path in the early years of reform, eventually leading to a more formalised approach of structured joint audits.

Leathers propose the following approach to the sharing of group audits:

- No less than 25% of the groups revenue or legal entities should be audited by a separate audit firm to that which audits the wider group
- Responsibility of the group statutory audit opinion to remain with the group auditor
- Independent firms auditing the subsidiary businesses provide a partner report to be distributed to the group board of directors in advance of the audit opinion sign off

At this point in time we would not propose that any entities other than groups are included in the requirement for shared audits and so do not propose to break up a single entity audit at this time. Once the market has evidence of its effectiveness, the remedy could then be rolled out in other forms.

Leathers also understand the CMAs additional proposal to rotate work allocation within the shared audit. A mechanism to continually refresh the review process can only serve to improve audit quality and this will be key in the sharing of single entity audits. The introduction of this allocation proposal will go hand in hand with the expansion of shared audits to the wider entity structures.

We believe that staggering the roll out of shared audits in this way will give challenger firms time to build capacity to service the breadth of audit work required through both ground level recruitment and internal training.

Remedy 6: Peer review

We also acknowledge the CMAs proposal of peer reviews and believe this goes hand in hand with the idea of a shared/joint audit. Leathers view is in line with the CMA; that there should be a function in the market that requires all audits to be peer reviewed on a periodic basis prior to the release of the audit report. Leathers believe that this review should be performed by independent firms, under the supervision of the regulatory body. It is Leathers belief that by removing the burden of these reviews from a regulatory body, this function would operate in a more efficient manner. We believe that this would also result in better quality work due to competition in the market place.

Leathers propose the following approach to peer reviews:

- FTSE 350 companies to be peer reviewed every 3 years by an independent firm
- Large private companies to be peer reviewed every 5 years by an independent firm
- The company completing the peer review must have no association to the company being reviewed and would be restricted from tendering for the audit for 2 years following the review
- The results of the review should be presented to the audit committee and/or those charged with governance after consultation with the incumbent auditor for factual accuracy
- A clear pricing policy for the reviews, with defined fee brackets linked to size and complexity of entities, should be agreed by the regulator to mitigate appointments based on cost rather than quality of expertise

Leathers do not believe that an incentive system should operate to reward firms that find issues in the incumbent auditors' work. Implementing a system such as this

carries the risk that the firms review would be disproportionately focussed on finding issues and errors rather than review of the overall quality of the work completed.

Remedy 5: Full structural or operational split

There is an ongoing conflict in accounting firms between the fees earned for the statutory audit and those earned for non-audit services. We agree with the CMA that this can lead to conflict in the auditor's interests as the majority of the business is derived from those non-audit services.

We understand the need for a separation between the audit service line and the rest of the business, however we do not believe a blanket implementation of legal separation of firms is the most appropriate approach. We agree with the concerns raised that this would lead to a restriction of access to non-audit experts in other areas of the firm. We also have concerns that this would inadvertently restrict the experience gained by audit staff, especially in smaller firms. Audit service lines offer a valuable training route into the accountancy profession and narrowing the entry point to a specialist firm may be detrimental to recruitment.

The concept of an operational split would alleviate some of these issues, whilst still being able to address the issue of reliance on non-audit fees. However, we would recommend that this is implemented at big four level only in the interim. Smaller firms will face issues surrounding single individuals being both an RI and key member of the overall firm, which will take time to remedy.

Whilst we have reviewed the other remedies proposed by the CMA, we have focussed our response on the areas we believe are key to an immediate and visible improvement in the audit market. Our belief is that by opening the audit market to greater competition and greater scrutiny, the quality of audit will improve.

This is a crucial time in the industry and there is a chance to make positive reforms and reaffirm the public's faith in audit. It is vital that audit is retained as the premium entry point for individuals into the wider financial services sector to ensure that the best talent is attracted for the future of the profession. Quality will then inevitably follow. We would welcome any further opportunity to comment or participate in this process, and should you wish to discuss any of the points we have raised please do not hesitate to contact us.

Yours sincerely


Leathers LLP 