

Statutory Audit Market Study
Competition and Markets Authority
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21 January 2019

To the members of the Competition and Markets Authority.

I am writing subsequent to my letter to you of 31 October 2018 and in response to your 18 December 2018 Update Paper on the Statutory Audit Services Market Study .

My background and credentials to comment

I will not repeat my credentials to comment, since they are set out in my previous letter, other than to reiterate that I have served as an audit partner, a CFO and an audit committee chairman.

In my role on the steering group of the Audit Quality Forum, we are delighted that the Expectations Gap is to be reviewed by Sir Donald Brydon. Over the past year we have endeavoured to find a person to review this vital area.

The views expressed in this letter are mine and not those of the companies I represent.

Unintended consequences and contradictions

As I mentioned previously, the time scale for the preparation of your report was extremely short, as is the period for comment. Given the importance of the matters under consideration, I believe that no decisions or final proposals should be made until the Kingman and Brydon reports have been finalised and agreed as the way forward.

The UK audit profession is not perfect but it is a world leader and the training ground for a large number of people in business. I believe that it is the number one employer of graduates in the UK and attracts many of the very best graduates. Unfortunately, some of the proposed "remedies" could have unintended consequences that damage the accounting profession and I urge caution in this respect.

I continue to believe that in the vast majority of cases, audits do meet expectations. The update quotes several instances of "failure" (such as Ted Baker) which were not audit failings as such.

Unfortunately, the Update continues to work on the basis that the model is broken and requires draconian change when, in my view, some relatively minor changes to the current regime could be more effective than the proposed remedies.

There is an inherent contradiction in the Update which assumes that audit quality – the key issue at stake – will be increased with greater competition. My view is that increased competition (if it could be achieved) leads to lower prices and by implication lower quality.

In any event, who would want to enter or expand in an audit market which would be more regulated and less profitable?

I would also note that the scaremongering about the big 4 becoming a big 3 is unrealistic. If one of the big 4 were to fail or (as they may well do) withdraw from the audit market then the pool of highly talented partners and staff would join another firm. In this event, it would be for the CMA and others to ensure that they had to join a challenger firm rather than one of the big 3, thereby maintaining choice.

Quality and the proposed remedies

The Update rightly focuses on quality. However, I do not believe that the proposed remedies will achieve increased quality. Quite the reverse.

Taken in turn:

1 Joint audit

There is no evidence to support the contention that joint audits enhance audit quality.

From my experience, joint audits are less efficient and significantly more expensive.

They have been mandated in France as a counter to the dominance of the Anglo Saxon dominance of the audit profession.

Importantly, it is barely conceivable that the challenger firms would want to take on the responsibilities or challenges entailed in regulated industries such as financial services. Staffing and IT issues would be a further constraint.

Also, the concept of joint audits would not increase competition – it may even reduce it.

2 Market share cap

This proposed remedy would not improve quality either.

Although the update says that firms would not be allowed to cherry pick the audits to be given up, it is inevitable that the big 4 would let their highest risk and lowest profitability clients go. Would the challenger firms want such clients or be able to audit them to a sufficient standard?

A proposed cap would increase audit fees and reduce choice – and perhaps quality too.

In addition, such a cap (or joint audits) might be detrimental to the UK as a financial centre and is not mindful of the international implications.

3 Full structural split

I believe that the challenges to a full structural split are insurmountable and would be detrimental to the UK.

4 Operational split

It is my view that, although feasible, this could be cosmetic, have numerous unintended consequences and be detrimental to recruitment and, eventually, quality. It would not increase choice.

The assumption is that profits from non-audit services will always be higher than audit but my experience is that this is not always the case. It is, however, likely that an operational split would increase the cost of an audit.

Regardless of an internal split, the restrictions on a firm providing non-audit services to an audit client should remain in force. Otherwise the perceptions of bias would remain.

5 Peer review

I am opposed to this. It would be unworkable within audit deadlines and would significantly delay reporting as well as reduce choice.

Also, if the ARGA is to review audits post the event, peer reviews would simply increase the level of duplication.

Kingman proposals

I support the majority of the proposals put forward although I believe that a lighter touch than the SEC model is best and a full Sarbanes Oxley approach would be disproportionately expensive.

Of particular note in the proposals is the interaction with audit committees which should provide a communication channel that does not exist at present.

However, there is a large element of overkill in suggestions that that a body other than the audit committee should appoint auditors or attend audit committee meetings. The ARGA should have the right to attend audit committee meetings and have some oversight of the appointment of auditors but the current suggestions go too far. If these recommendations were introduced then the question would be whether it was worth having an audit committee at all?

As I said in my previous letter, appointing a third party body to select auditors – even the ARGA - is, to my mind, ridiculous. It smacks of bureaucracy and fundamentally misunderstands the needs of companies. Expertise and chemistry are fundamental to the proper working of an audit and these would be lost. It takes some years for an audit committee member to get fully up to speed with a business and a central appointing body would lack this knowledge. In addition, the role of the audit committee would be diminished to an extent that it may be difficult to find people willing to serve.

The Update gives much weight to the appointment process focusing on chemistry and cultural fit but underlying every aspect of every tender that I have been involved in is the requirement for a robust and challenging audit. That is what audit committees want.

Taking audits into a government controlled body would be a massive retrograde step. It would certainly not improve audit quality.

I believe that the recently introduced requirement for audit tenders to be performed on a regular basis is the right balance. Quality would fall if changes occurred more frequently.

The Update again makes the statement that the company appoints the auditors. In reality, following the CCs recommendations, this is now carried out by the audit committee. The board only ratifies the audit committee's recommendations and, under the Code, the board should comprise a majority of independent directors.

Alternative remedies

I believe that the following remedies would enhance audit quality and market perceptions:

1 Further restrict the provision of non-audit services to audit clients

Although it may only impact perceptions, I believe that audit firms should not be allowed to provide any services to their audit clients other than audit and (broadly defined) audit services.

The EU cap of 70% and proscribed services only partially addresses this.

This proposal would eliminate the perception or reality that the auditor was influenced by non-audit work.

2 Penalties for failure

The recent penalties for failure have increased considerably and have been significant; they will have focused minds in the big 4 on audit quality.

The costs of failure – both financial for the firm and personal for the partner – are enormous and the fear of failure will lead to better quality audits. Although not seen, the legal costs arising from a failure are vast. The reputational ones are possibly even greater. What better incentive to do a quality audit?

Of course, care needs to be taken not to drive a firm to give up on auditing because the punishments are so draconian as to make the risk reward ratio unacceptable.

3 Increased penalties for executive management

There have been very few instances of executive management being punished for issuing accounts which were misleading or for misleading auditors.

With the Kingman recommendations, this should change and focus executives.

Put simply, the first line of failure usually lies with management and audit quality would be improved if management know that they are fully in the firing line.

4 Access for the auditor and audit committee to the regulator

Audit committees have not previously had formal support or an effective channel for expressing concerns but the Kingman proposals should address this.

For a variety of good reasons, many of the issues raised by auditors and audit committees do not get communicated to shareholders. Having a regulator with whom these issues can be discussed or even pre-cleared should enhance the role of audit committees.

Again, it should lead to better quality.

Summary

It is my view that non audit services for audit clients should be further restricted; the prime concern remains one of quality not competition or choice.

To break up the big four from the UK is not a realistic option. To have audit only firms, joint audits or a market share cap would reduce quality and diminish a profession that is so highly regarded across the globe.

Yours faithfully

SD Barber