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Statutory Auditor  
[ ]

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Statutory audit market study  
Competition and Markets Authority (“CMA”)  
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**Re: Market Study Notice - Supply of Statutory Audit Services in the United Kingdom (“the matter”)**

Dear Sir/Madam

I take the opportunity to provide my responses to the updated audit paper. I do not object my responses to be attributed to me by name.

Below is a summary of my responses on each remedy. The analysis and reasoning is provided in the appended Consultation box.

**Remedy 1: Regulatory scrutiny of Audit Committees** – supported

**Remedy 2: Mandatory joint audit** – supported

**Remedy 2A: Market share cap** - supported

**Remedy 3: Additional measures to reduce barriers for challenger firms** - supported

**Remedy 4: Market resilience** – not supported

**Remedy 5: Full structural or operational split** – strongly supported

**Remedy 6: Peer review** – not supported

Yours faithfully

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**Box 6.1: Consultation questions**

**A) Issues**

1. Do you agree with our analysis in section two of the concerns about audit quality? *Yes*
2. Do you agree with our analysis of the issues that are driving quality concerns, as set out in section three? *Yes* 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**

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?

*A cost-benefit analysis has to be performed and the scope of each remedy has to be proportionate to the size and nature of the audited business, the risk to the public and the cost, nature and complexity of the audit assignment. Typical examples of PIEs with less public exposure and audit fees below £100,000 (therefore uneconomical for joint audit) are:*

- 1) *Small listed Investment trusts and VCTs*
- 2) *Small mutual insurers and insurers in run-off*
- 3) *Small branches and subsidiaries of private foreign banks*

*For these entities it would be uneconomical to have mandatory joint audits unless the two audit firms are both challenger firms to increase their exposure to such audits.*

**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.

*The Audit Committees can have dual mission and reporting responsibilities both to the audited company and to the regulator. However, it is important that the members of the Audit Committees increase their involvement with the audit firms and ensure audit quality and no unreasonable pressure from management is exercised over the auditors. I believe there is scope for a fully independent body to assign and pay the auditors which will break the management influence over the auditors. This practice existed in the 30s and 40s in Bulgaria when auditors were appointed via the court system. Factual and perceived independence is paramount not only for the public but for protection of the auditors. After the Enron scandal one of the best writers on professional firms David Meister raised this matter in his 2002 article “The Auditing Debate” which could be found at <https://davidmaister.com/articles/the-auditing-debate/>.*

## Remedy 2: Mandatory joint audit

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?

*It should cover large private companies because they employ many people and provide wider services to the public.*

b) What types of companies (if any) should be excluded from a requirement for joint audit?

*See explanation under point 3.*

Should one of the joint auditors be required to be a challenger firm? *Yes. The audit will be robust and gradually the challenger firm will enhance its capability and reputation.* If so, should this be required for all companies subject to joint audit? *Yes. In the first year of joint audits for very large specialized audited entities (high-street banks, life insurers, Lloyd's syndicates and big investment companies the challenger will deal with less complex aspects of the audit.* Are there any categories of companies to which this requirement should not apply? Please explain your reasoning for each of the answers. *See explanation under point 3.*

6. 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.

*I agree with the examples set in section four. The minimum amount of work and fees allocated by the regulator to the joint auditor should be 40% and would apply to all PIEs and large private companies unless exemption applies – please refer to point 3.*

7. 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?

*I agree with different time appointments. This should be mandated as is the case in countries with joint audits. The transition period should be mandated as well but for the largest and most complex FT100 companies the process should take longer and would require preparation work and consensus between all parties for the implementation in the first year – the audited company, the Audit Committee, the Regulator, the incumbent audit firm and the joint auditor (challenger) have to be comfortable with the start of the joint audit process without compromising on audit quality, deadlines, risk management, audit costs, effectiveness and efficiency.*

8. 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?

*I am in favour of joint liability framework – it will be easy to implement by the insurers, easy to understand by the public and will drive full cooperation and interaction between the joint auditors. The challenger firm might feel unprotected in the absence of joint liability.*

## Remedy 2A: Market share cap

9. How could the risks associated with a market share cap, such as cherry-picking, be addressed?

*This risk has to be managed by the regulator who will monitor periodically the market share cap and the portfolio of clients by the Big 4. There is no proof that large audits are more profitable than small audits. The audit pricing is based on the quantum of the audit risks rather than simply size of the audited entity.*

10. Would it need to apply only to FTSE 350 companies, or also to other large companies, and if so, which?

*It should also apply to large private companies who provide services to the public on a wider scale – airlines, food and clothes retailers, water and energy utility providers, telecoms, construction.*

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

11. 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.

*Such economic and legal barriers inevitably exist in Big 4 firms for audit partners. These senior partners have been invested in for a long period, their earnings are considerably higher than audit partners in challenger firms, they also enjoy high reputation and legal protection amongst other benefits. This makes it commercially justifiable that they have more restrictions to join other Big 4/Top 10 audit firms.*

*The challenger firms have to aim at recruiting young and talented audit managers and directors from Big 4 who will bring practical client and industry knowledge in return for a fast track partner career. Another source of finding talent for the challenger firms would be to seduce back in the profession auditors who work in industry but would prefer to re-join for new roles in the audit. I believe these barriers can be overcome by the market itself and should not be directed.*

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.

*Tendering is imposed by law and the costs should be split between the independent regulatory body and the entities subject to audit tendering. It is a big burden for challenger firm in terms of efforts, time spent and resources engaged. To be on level terms the funding provided to the Big 4 and challenging firms should be the same. This funding will definitely bring down the audit fees because these enormous tendering costs are inevitably factored in the pricing.*

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.

*This process should be left to the joint auditors to agree the most efficient use of technology and other resources. If a Big 4 offers unreasonable fees which hinder joint audit contribution the challenger can refer the matter to the Audit Committee or the independent regulator.*

#### Remedy 4: 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.

*I believe the success of the other remedies would create more major audit firms capable of auditing PIEs and larger private companies and this should be the focus of the government and regulator intervention. The audit market managed to adjust itself after the collapse of Arthur Andersen. The proposed remedy is very administrative, and companies should have the choice to select their auditors. Audit staff and partners should not be forced to follow their audit client in the new firm. Yes, audit is important for the economy but there could be a short-term solution for the affected clients to have exemption from audit for one year if the Big Four firm collapses and the provision of audit services is disrupted. This would be a force majeure and with UK's strong governance system the lack of temporary audit should not affect significantly the capital markets. Challenger firms can step in and perform limited review of financial statement, agreed-upon-procedures or other assurance engagement to mitigate the absence of full scope audits. The annual financial statements can include more detailed information and disclosures on management judgments, complex accounting estimates and fair values. The Annual report can incorporate short statements from independent providers of pension liabilities valuations, insurance liabilities, property valuations, fair value valuations which will contribute to the credibility of the financial statements. In conclusion, I do not see the resilience of the audit market as a significant and systemic risk for the economy. At the time of writing UK has [ ] registered statutory audit firms which is one of the highest audit service penetration in the world. The market will adjust by allocation of less complex and risky audit work to smaller audit firms.*

16. How could such a system prevent moral hazard? Please comment on our initial view.

*No comments.*

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.

*No comments.*

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.

*No comments.*

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

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.

*Yes, full structural split will be more effective and can be achieved to fulfil the objective of the remedy – increase independence, reduce conflicts, give chances to audit-only firms to tender for clients without being stopped by partners from non-audit side of the firm who compete to sell highly priced advisory work.*

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.

*To a bigger extent such operational split already exists in Big 4 and some challenger firms and this would facilitate and decrease the cost of the full structural cost which I support as a right and long-term solution. The operational split in Big 4 has created "mini" sectoral audit firms – financial services audit; public sector and not-for-profit audit; media, entertainment and telecommunications; retail and manufacturing, etc etc. Each of these departments has its own professional staff, administration, marketing team, finance team, recruitment team, technical team, all managed on its separate income statement.*

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.

*No comments.*

22. Under an operational split, how far, it 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.

*No comments.*

23. Should challenger firms be included within the scope of the structural and operational split remedies?

*Yes.*

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.

*Only the services defined under ISA – audit, review, agreed upon procedures and other assurance services.*

#### **Remedy 6: Peer review**

25. What should be the scope (ie which companies) and frequency of peer reviews, if used as a regulatory tool?

*I do not support this remedy for the reasons given by the parties. Currently all of these PIE audits are subject to a vigorous review process. Here are some of the reviews on such complex audits that happen at Big 4 and challenger firms:*

- a) *The team itself - senior, manager, senior manager, director and partner all of them reviewing in detail or as second reviewer the audit working papers;*
- b) *An "audit quality" support team is reviewing the audit file and provides challenges to the audit team who have to respond and make revisions – there could be several rounds of comments;*
- c) *The work of the specialists (IT, tax, actuary, valuer) is reviewed by the respective departmental partner.*
- d) *A technical team reviews the quality of the Annual Report and the financial statements and provides observation to the audit team before clearing the document*
- e) *The audit file and all deliverables that go to the Audit Committees are then presented to a second independent partner called engagement quality control reviewer. His review usually challenges the audit team conclusions on the most complex and technical accounting areas. The second partner is involved in planning and completion but does not meet the client and is ordinarily from an office different to the engagement partner, whenever possible.*

*In addition to this process on sample of audits there are internal annual quality reviews within the member network and the external FRC inspection by their audit review team which is robust and allegedly takes more time than the audit itself.*

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

*I do not believe this will be an effective remedy. Auditors are already kept on their fees and the reasons for failures are unlikely to be due to insufficient reviews.*

#### **C) Next steps**

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

*I agree with your reasoning not to make a market investigation reference.*