Statutory audit market study

Competition and Markets Authority
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Dear Sir/Madam,

Statutory audit market study update paper - invitation to comment

BP is an integrated Oil and Gas company headquartered in the UK with operations in 70 countries. We have a primary listing on the London Stock Exchange and a secondary listing in the US.

The CMA paper notes that there are a number of other reviews being undertaken concurrently, and that "the Government has an opportunity to consider all the market features and potential reforms in parallel". The Kingman Review has proposed the establishment of a new regulator with powers of investigation and enforcement. We support this proposal, and believe a strong regulator is the best way to directly impact audit quality in the UK, potentially reducing the need to implement other remedies.

The proposed remedies of a mandatory joint audit and market share cap would both present significant challenges for large international companies, and may reduce competition for the audit of those companies. The aim of the remedies is to increase participation of UK challenger firms auditing FTSE 350 companies. However, in our case, the majority of our operations (including finance processes) are conducted in global teams outside the UK. A quality audit requires a wide international network, which the challenger firms do not possess.

The CMA highlights an "expectations gap" around the purpose and scope of an audit. We agree with this assessment. By its nature, an audit is primarily backward-looking. It is an essential building block in the process of assessing the financial health of a company, but on its own is not capable of preventing a corporate failure. Investors and other stakeholders still need to assess the

company's strategy and ability to execute in the context of prevailing market conditions. A corporate failure is not necessarily an indicator of a low quality audit. A high quality audit that lays out financial weakness and risk of failure still needs to be acted upon by management, investors, customers and creditors.

Our response is set out below against the consultation questions provided in section 6.

A) Issues

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.

Response:

- We believe the Audit Committee plays an effective role in the appointment and monitoring of the auditor.
- In our experience the auditor is able to provide an effective challenge and we have no concerns around audit quality.
- The international scope and complexity of our business are a barrier to challenger firms performing the role of auditor to the required level of quality. The challenger firms do not have the international coverage to provide an effective audit.
- The controls around independence and the limitations on non-audit work are effective.
- We agree with the observation of an "expectations gap" around the purpose and scope of an audit.

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?

   We have limited our response to our experience as a large corporate, so have not commented specifically to this question of scope.

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 believe the Audit Committee plays an effective role in the appointment and management of the auditor, and consistent with other stakeholders, we are opposed to the creation of an independent appointment and monitoring body.

   New regulatory reporting obligations for the Audit Committee should be implemented alongside the recommendations of other reviews in this area such as the Kingman Review.

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?

      We have limited our response to our experience as a large corporate, so have not commented specifically to this question of scope.

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

We do not believe that a mandatory joint audit is the right remedy to increase audit quality for our audit. It would present significant implementation challenges, additional expense and reduce competition:

- The integrated nature of our business and global finance processes makes it difficult to unbundle the audit, which means a joint audit would be highly duplicative and potentially unworkable.
- The scope and scale of our audit means there are limited options outside the big four. A joint audit would reduce competition as only two of the big four firms would be able to bid on rotation.
- The range of the estimated increase in fees is quoted as 20% to 50%, which represents a significant additional expense.
- The assessment of the impact on audit quality in paragraphs 4.52 to 4.56 is inconclusive, meaning the case for improved quality resulting from a joint audit is unproven.
- We would caution against adopting an approach that is inconsistent with most other markets around the world.

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.

Given the scope and scale of our audit, we do not support the proposal to require one of the joint auditors to be a challenger firm. We believe that the selection of an auditor should be made with reference to the

skills and capability of the firm. The challenger firms do not have the international coverage to be the lead auditor, and the integrated nature of our business and global finance processes makes it difficult to unbundle the audit to provide a junior auditor a meaningful role.

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.

   See our comments above on 5(b).

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?

   See our comments above on 5(b).

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?

   See our comments above on 5(b).

Remedy 2A: Market share cap

We do not support the proposal to introduce a market share cap. As noted in paragraph 4.87, the positive effects of the introduction of a market share cap would be felt more quickly towards the bottom of the FTSE 350 than towards the top. The CMA acknowledges in paragraphs 4.76, 4.83 and 4.84 that investors are not supportive of this proposal and there will likely be short term compromises to both quality and competition.

The scale and complexity of our audit would make it extremely challenging for any audit firm that is not part of one of the large global audit networks to acquire sufficient expertise and reputation to be appointed as sole auditor. As such, a market share cap is unlikely to lead to an increase in choice for our audit. In fact, if the large audit firms have reached their cap, this may reduce or eliminate competition when the audit is re-tendered on rotation.

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

See our comments above on Remedy 2A.

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

See our comments above on Remedy 2A.

Remedy 3: Additional measures to reduce barriers for challenger firms

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.

We believe it is primarily for audit firms to respond to this but see also comments below on Remedy 5.

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.

We believe it is primarily for audit firms to respond to this but see also comments below on Remedy 5.

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.

We believe it is primarily for audit firms to respond to this but see also comments below on Remedy 5.

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.

We believe it is primarily for audit firms to respond to this but see also comments below on Remedy 5.

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

We believe it is primarily for audit firms to respond to this but see also comments below on Remedy 5.

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.

We believe it is primarily for audit firms to respond to this but see also comments below on Remedy 5.

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.

We believe it is primarily for audit firms to respond to this but see also comments below on Remedy 5.

Remedy 5: Full structural or operational split

We believe it is primarily for large audit firms to respond to this proposed remedy. However, we would note:

- Change in this area needs to leave audit firms with a sustainable business model, including the ability to attract and retain the required talent.
- The audit team needs access to the wider expertise of the firm to preserve the right level of business understanding, and therefore audit quality.
- Our audit relies on the global network of our auditor, so a UK-only split may present a challenge.
- Existing measures to manage the conflict between audit and non-audit work are working effectvely.
- In the case of any split, the definition of permissible "audit related services" needs careful consideration. Such services are more extensive than quarterly or half yearly reviews (paragraph 4.119), and should at a minimum include all capital market activity (such as class transaction circulars and bond issuances).

Paragraph 4.116(b) states that restriction of the provision of non-audit services by audit firms can address the lack of choice that can arise as a result of audit firms being conflicted from taking part in the audit tender. We believe that a tender undertaken with sufficient time between selection and the commencement of the audit tenure can ensure that there is no limitation on participants. Paragraph 4.113(d) states that the "selection process is not truly non-discriminatory" due to the closeness of the audit firm with the company. This implies that it is management who select the audit firm, when in reality it is the Audit Committee, who are suitably independent.

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.

See our comments above on Remedy 5.

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.

See our comments above on Remedy 5.

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.

See our comments above on Remedy 5.

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.

See our comments above on Remedy 5.

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

See our comments above on Remedy 5.

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.

See our comments above on Remedy 5.

Remedy 6: Peer review

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

- We note the statement "We do not…consider peer review [to be] an effective way to improve choice and resilience" (paragraph 4.155).
- We believe the most effective use of peer reviews would be to supplement existing regulatory review processes in cases where audit quality was already in question.
- Changes in this area should be implemented together with the recommendations from other reviews such as the Kingman Review.

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

See our comments above on 25.

Part C: Next steps

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

The proposal not to make a market investigation reference is pragmatic in light of the reasons outlined in paragraph 5.3(c) (Government has an opportunity to consider all market features and potential reforms in parallel).

We agree that this consultation, the Kingman Review and the government's review into the scope of audits need to be implemented together. The outcomes of the latter two studies are likely to lead to broader changes to the regulatory framework.

Yours faithfully,

David Bucknall, Group Controller, BP p.l.c.