**Response to the CMA: Statutory Audit Services Market Study: Update Paper 18th December 2018**

**Responder:** Paul Waterhouse trading as The Analytical Cooperative

**Confidentiality:** None of the material, comments, opinions or views in this document are regarded as confidential.

**Attribution of Response:** The response can be attributed by name (as above)

**Summary of Interests in Responding:**

- Many of my direct clients (and the ultimate clients of other firms that I work with in providing services) need to rely upon (or at least form an opinion about) audited accounts. Those clients would be much be better served (as would the market as a whole) if auditing quality (and transparency) are improved.

- As a services provider I have encountered instances of behaviour (and heard second-hand from other parties of similar instances) from the non-audit practices of audit firms that seem anti-competitive in nature and raise questions (in my mind at least) about the independence and quality of audit. While such instances are hopefully the exception rather than the rule, I believe there is a strong case for changes that reinforce both the actuality and the perception of independence and quality.

- Finally, as a shareholder (and potential shareholder) of audited firms I regard the goals and quality of the audit itself as being disadvantaged by the presence of non-audit activities within the audit firm.

**Structure of Response**

I would first like to make some general comments arising from consideration of the issues raised and commented upon in the review document and then respond (where appropriate) to the specific questions posed in section 6 of the review document.

**GENERAL COMMENTS**

**Introduction**

I welcome the recommendations made by the CMA and recognise that a strong case for more far-reaching changes also potentially exists. I hope that the spirit of the nature of those concerns is fully embraced by the audit industry and that both incumbent and challenger firms will proactively take further steps that go well beyond the CMA recommendations.

**Summary (General Comments)**

In my opinion:

- The co-existence of audit and non-audit services is a significant problem that represents a major impediment to both competition and audit quality. This should be addressed

without delay by a full migration to an "audit only" business model. (An operational split would not address this problem)

- There is a need for the derivation of (and adoption of) comprehensive, best-practice guidance for auditor-selection that is aligned with critical value-added attributes of an audit.
- "Cultural fit / chemistry" as a criterion for auditor-selection (other than as potential rare over-ride) should be eliminated.
- The Statutory audit should be expanded (in remit and objective) to encompass and consider (in its undertaking and conclusions) the interests not only of existing shareholders but also those of all stakeholders. This is particularly important for larger firms, those that are publicly quoted, and companies of public interest.
- Irrespective of the current legal role of the Statutory audit, CMA recommendations for change should nevertheless take into consideration the interests of all other stakeholders
- Audit reports should be made much more transparent. In particular audit reports should fully disclose: key assumptions made, the rationale for those assumptions, the sensitivity of results / audit opinion to variations in those assumptions, benchmarks employed, and an objective rationale for why a particular benchmark is deemed appropriate. Moreover, transparency of this nature should (as a minimum) be of an extent that shareholders (the intended beneficiaries of the audit) or other stakeholders would be able to formulate their own independent view of the validity and conservatism (or optimism) of any audit opinion.

**Co-Existence of Audit and Non-Audit Businesses**

The co-existence of audit and non-audit services is a significant problem that represents a major impediment to both competition and audit quality. This impediment can only be effectively removed by prohibiting audit firms from engaging in any non-audit business. An "operational" split (bolstered by strong firewalls, processes and surveillance) of these distinct businesses within the same legal entity (or group) would not be effective.

Although section 3 of the CMA Report details some of these concerns (about the co-existence of audit and non-audit businesses) and investigations conducted, a number of issues that directly undermine audit quality have been omitted.

<u>Presence of Non-Audit Activities Undermines Audit Quality</u>
Audit firms are also potential (or actual) competitors (as a result of their non-audit activities) to third-parties providing services to audited firms. Therefore, there is a constraint on how much information can be shared with auditors during an audit exercise and the manner in which information can be shared.

Even if the audit firm conducting the audit does not provide non-audit services to a particular company, the concern remains that it's non-audit practice will acquire information or knowledge that the non-audit practice will then commercialise and use with other companies (to the commercial detriment of the third-party provider). Indeed, if the audit practice is reliant (as will often be the case) upon input or expertise from the in-house non-audit practice then it is inevitable that the non-audit practice gains such exposure.

Processes and procedures do exist to overcome this obstacle so as enable the audit exercise to be carried out while seeking to protect third-party interests. However, by necessity (as a result

of the non-audit activities of the audit firm) these processes and procedures add to both the time required for the audit exercise and the cost of the audit exercise. Moreover, the inability of third-parties to fully engage with the auditor (an obstacle that would not exist for audit-only firms) risks that part of the audit exercise not being as comprehensive as needed – thereby undermining audit quality.

Additionally, some audited companies may inadvertently breach their agreements with third-parties by providing audit firms (and by extension their non-audit practices) with access to third-party proprietary IP and information. This confers on the audited company significant potential liability for damages. This issue would not exist at all if audit firms did not possess competing non-audit practices.

Conflicts of Interest in Providing Audit and Non-Audit Services

While audit firms often avoid providing both audit and non-audit services to the same company at the same time, this does not appear to be global practice. When the same party is providing to the same company a non-audit product or service, then validating the performance and application of that product or service, and finally auditing a company whose operations are in part dependent on the performance of said non-audit product or service questions about the independence and quality of the audit exercise must inevitably arise.

Even if the audit firm is rigorous in seeking to manage the conflicts of interest arising, the perception, suspicion and risk of lack of audit quality and independence remains. The only rational way to combat such risks is to prevent audit firms from conducting any non-audit business whatsoever.

(In-House) Non-Audit Services Reduces the Expertise Available to the Audit Function and Consequently Undermines Audit Quality and Competition

It is acknowledged that auditors within the audit function often need access to additional expertise and support in order to conduct a thorough, comprehensive audit exercise. However, in practice, the audit function is poorly served and disadvantaged by its reliance on knowledge and expertise from in-house, non-audit business operations.

In-house expertise rapidly becomes aligned with the commercial goals of the non-audit practices as opposed to best practice. Even when “fresh blood” is regularly brought into the organisation through hiring, the benefits are swiftly diluted over time as those new hires become incorporated into the culture and goals of the non-audit operations.

Additionally, as non-audit activities actively compete with third-party providers (and the non-audit businesses of competing audit firms), third-parties are rarely willingly to engage with (or cultivate interaction with) audit practices in providing expertise, knowledge, thought leadership or services that are (in fact) critical and integral to audit quality.

The expertise available to the audit function is therefore insular, unnecessarily restricted (due to the presence of in-house, competing non-audit businesses) and risks being below par (or behind the curve) in some areas. Effectively, the “benefits” of margins earned on non-audit services come at cost of potentially reduced audit quality for the audit business.

An additional consequent concern arises from the existing concentration within the audit market. In the event that an audit exercise led to reservations arising about aspects of the suitability of products or services provided (to the firm being audited) by the non-audit businesses of competing "Big 4" (or challenger) audit firms, how comfortable would the auditing firm be about raising and addressing those reservations? Would its view be tempered in anyway by concerns about retaliation (when the competing audit firm then audits other companies that are users of its own non-audit services)?

While such considerations are commercial considerations (and not audit considerations), the risk of direct or indirect influence (or pressure on the audit function) can only be really eliminated by audit firms ceasing to offer non-audit services.

Individuals Conducting the Audit are Human

Those individuals involved in (or overseeing) an audit exercise are expected to conduct themselves professionally, ethically, and with integrity; and undoubtedly strive to do so. However, we should remember that these individuals are also human like ourselves: they have families to support, mortgages to pay and other commitments.

Consequently, given the importance of the Statutory Audit (and the reliance of many stakeholders on its outcome), it is wholly unreasonable (and unnecessary) for us to place those individuals in positions that could give rise to conflicts of interest and place undue (and unnecessary) pressures on their integrity, ethics, compensation or professionalism.

It is unfair to the professionals concerned and should be remedied by migrating to "audit only" business models (and the spinning off of non-audit activities).

Challenger Firms More at Risk Than Incumbents

The issues arising from the co-existence of audit and non-audit services within the same firm (or group) are not confined to the Big4 but also apply to challengers.

Arguably, challengers seeking to acquire larger size and breadth of activities (subject to less scrutiny or sanction in the interests of fostering increased competition) are more at risk in this respect.

Furthermore, the belief (identified within analysis of the auditor selection process) that challenger firms lack experience, geographical breadth or resources to undertake specific audits (that has hindered increased competition in the audit market) are accentuated by the prevalent business model (of audit and non-audit services co-existing).

This impediment to increased competition would be partially addressed by full migration to audit-only firms.

Concerns About "Audit Only" Business Models are Exaggerated

Fears have been expressed about migration to "audit-only" business models.

However, all the concerns (stated) in practice apply equally (if not more so) to the current reliance on internal departments and functions of large organisations that often have divergent operational goals.

An operational split that seeks to address existing conflicts (as well as impediments to audit quality) will in fact exasperate all the issues of a structural split but with the added disadvantage that the access to non-audit expertise would not only remains confined to internal, insular, non-audit departments and functions BUT the relationship with those departments and functions will have been diluted and undermined through organisational segregation.

Client concentration risk management is an issue for any business and an audit-only firm would be no exception albeit offset by other favourable attributes of participating in the audit sector.

The introduction of joint-audit clearly provides an additional mechanism not only for improved audit quality but also to mitigate this risk through a number of smaller audit-only firms forming a consortium to bid for the audit business of a larger, complex corporation.

While fears about the impact of a full split should not be discarded, the concerns raised about auditing in the UK are in no means unique to the UK. Consequently, other countries will rapidly follow the UK lead and UK audit-only firms could find themselves with a short-term competitive advantage.

**Role of "Cultural Fit / Chemistry" in the Selection of Auditors**

I was pleased to note that analysis has concluded that "price was not the major determinant" in selection of an auditor.

However, the described role of "cultural fit / chemistry" in selecting an auditor raises concerns.

While the usual expectation of all stakeholders may well be that an audit will result in a "clean bill of health", the critical added-value of the audit process for shareholders (and other stakeholders) is when that proves not to be the case (and / or when tangible areas for improvement are identified). That critical added-value is not in any way compatible with a criterion of "cultural fit / chemistry".

A strong "cultural fit / chemistry" risks inadvertent negative consequences for audit quality as it will reflect an initial positive disposition towards the activities of and the running of the company being audited. This is accentuated if the auditors involved (or audit partner overseeing the audit) have previously worked with or for firms operating in similar sectors or firms managing their operations in similar ways. The benefits of "poachers turned gamekeepers" only manifest themselves if the [now] "gamekeepers" recognise that their previous activities actually involved some element of "poaching"!

The inclusion (and current use) of this type of criterion for auditor selection clearly stems from this prior "expectation" (of a clean bill of health) and therefore risks undermining the quality of the audit.

We believe that criteria related to "cultural fit / chemistry" should have a zero "weight" in terms of evaluating an auditor appointment but could continue to be deployed (on very rare occasions) as a secondary over-ride.

In other words, an otherwise "winning appointment" from evaluation of other criteria (excluding any consideration whatsoever of "cultural fit / chemistry") could be over-ridden but only in very rare cases where "cultural fit / chemistry" were considered to be so negative as to raise material concerns about how an audit could be effectively carried out. In such rare circumstances, the use of the over-ride would need to be fully disclosed together with a clear and well-articulated rationale for its deployment

The current use of "cultural fit /chemistry" naturally also raises questions about: the suitability of other criteria used in auditor selection process; how criteria are scored or evaluated; and how those evaluations are aggregated to determine which auditor is selected.

The selection process (and consequent audit quality) would greatly benefit from the derivation of new best-practice guidance on auditor-selection with companies proactively encouraged to adopt those best practices. Furthermore, best-practice guidance should incorporate: criteria to be used for selection; how those criteria should be evaluated; how those evaluations should be aggregated into a final result; the use of over-rides; and minimum requirements for transparency and communication to shareholders of the same.

I recommend:

- Derivation of (and adoption of) comprehensive, best-practice guidance for auditor-selection that is aligned with critical value-added attributes of an audit.
- The elimination of "cultural fit / chemistry" as a criterion for auditor-selection (other than as potential rare over-ride)

**Shareholder Perspectives and Role of the Statutory Audit**

A potential issue with the reliance on shareholder vote and scrutiny of both the audit itself and recommendations (for change) in the CMA document is the fact that many shares are held by institutions that are themselves subject to audit. In examining recommendations for change it may therefore be challenging for those institutions to consider the recommendations solely from the perspective of wearing the "hat" of a shareholder.

Additionally, the shareholders of widely traded companies will include long-term investors, short-term speculators and a mix of other profiles. Inevitably, some shareholder profiles will have different concerns and ambitions to other stakeholders such as employees, pension fund trustees, consumers, suppliers and governmental bodies.

I recognise that the purpose of the statutory audit is to provide: an independent opinion to shareholders on the truth and fairness of the financial statements; whether those statements have been properly prepared (as per statutory requirements); and to report (by exception to the shareholders) on the other requirements of company law (such as proper accounting records not having not been kept.

However, it is widely acknowledged and recognised that other stakeholders (including potential future shareholders, customers, suppliers, employees, governmental bodies and

organisations and the general public interest) are forced to rely on the soundness and quality of reporting.

While confidence in the outcome of a comprehensive, high-quality audit should conceptually be sufficient for all, past experience (and the other concerns that have been identified by the CMA review) demonstrate that this is not the case.

I therefore recommend:

- The Statutory audit be expanded (in remit and objective) to encompass and consider (in its undertaking and conclusions) the interests not only of existing shareholders but also those of all stakeholders. This is particularly important for larger firms, those that are publicly quoted, and companies of public interest.
- Irrespective of the current legal role of the Statutory audit, CMA recommendations for change should nevertheless take into equal consideration the interests of all other stakeholders.

**Audit Confidentiality and Lack of Transparency**

Paragraphs 3.50 and 3.51 of the CMA Report reference the lack of transparency (and confidentiality) of key management and auditor assumptions and benchmarks.

I recognise that companies wish to avoid competitors becoming prematurely aware of strategies, initiatives, products or services under development and other items on the grounds that this may undermine the company's perceived competitive (or short-term comparative) advantages.

However, the shareholders own the company and the audit is being carried out for the shareholders with the express intent of providing an independent opinion to the shareholders on the truth and fairness of the financial statements. Key assumptions made and benchmarks employed are fundamental and intrinsic to that audit opinion. Absent such transparency, shareholders are unable to form their own judgement (or in cases of concern or doubt about specific assumptions instruct a further party to investigate).

I cannot envisage any evident or unreconcilable conflict between providing shareholders with a full and comprehensive audit report that in particular includes: key assumptions made, the rationale for those assumptions, the sensitivity of results / audit opinion to variations in those assumptions, benchmarks employed, and an objective rationale for why a particular benchmark is deemed appropriate.

Moreover, for publicly traded companies and companies of public interest, such a report should be in the public domain.

Transparency of this nature should (as a minimum) be of an extent that shareholders (the intended beneficiaries of the audit) or other stakeholders would be able to formulate their own independent view of the validity and conservatism (or optimism) of any audit opinion.

If "confidentiality" relates to the auditors themselves wishing to keep the assumptions and benchmarks they have used (in a particular audit exercise) confidential then I would submit

that such a position is wholly contrary to the goal of audit and the interests of those for which the audit report is intended (i.e. the shareholders – owners – of the company being unaudited)

I therefore recommend:

- Audit reports are made much more transparent. In particular audit reports should fully disclose: key assumptions made, the rationale for those assumptions, the sensitivity of results / audit opinion to variations in those assumptions, benchmarks employed, and an objective rationale for why a particular benchmark is deemed appropriate. Moreover, transparency of this nature should (as a minimum) be of an extent that shareholders (the intended beneficiaries of the audit) or other stakeholders would be able to formulate their own independent view of the validity and conservatism (or optimism) of any audit opinion.

**Progress Made in Addressing Audit Concerns**

I note from the Report that total audit fees for FTSE-350 companies have increased by 25% over the period 2012-17. This is roughly twice the increase in consumer price inflation for the same period.

However, over this same period, there have been: substantive and ongoing regulatory changes to the financial services' sectors with a knock-on effect for reporting and auditing (which represents the bulk of audit fees), and numerous accounting standards changes that go across all sectors.

While audit firms may have implemented measures resulting in some cost savings, an increase of (only) 25% during this period (of substantive accounting and reporting changes) raises questions as to how much investment has genuinely been made in improving audit quality.

## SPECIFIC RESPONSES TO CMA 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? 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.

While in broad terms I agree with the analysis set out in section 3 of the report, the co-existence of audit and non-audit businesses within the same firm (or group) represents the most significant impediment to audit quality and increased competition. This can only be remedied by mandating migration of all incumbents and challengers (including new challengers) to a structural “audit-only” business model. (An operational split would yield no benefits whatsoever).

The auditor selection process is flawed by criteria being established with an expectation of a “clean bill of health” being achieved (which while desirable is not the valued-added benefit of the audit). Formulation of new, comprehensive, best practice guidelines for auditor selection is essential. Additionally, the role of “cultural fit / chemistry” is incompatible with the audit goal and should be relegated to rare usage as an over-ride in exceptional circumstances.

The lack of transparency surrounding the audit outcome with respect to key assumptions and bench marks is neither defendable nor appropriate. Much increased disclosure and transparency would bolster efforts to improve audit quality.

### 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?

Unless otherwise stated:

Remedies should apply equally to all FTSE 350 companies AS WELL AS PIEs and privately-owned companies deemed to be in the public interest in view of their overall importance to a range of stakeholders.

Remedies imposed upon audit firms should apply equally to both the “Big4” and challenger firms.

## 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.

As stated in general comments (above) initial steps I would recommend are:

- Development of (and adoption of) new comprehensive, best-practice guidance for auditor-selection that is aligned with critical value-added attributes of an audit.
- The elimination of “cultural fit / chemistry” as a criterion for auditor-selection (other than as potential rare over-ride)

Best-practice guidance should incorporate: criteria to be used for selection; how those criteria should be evaluated; how those evaluations should be aggregated into a final result; the use of over-rides; and minimum requirements for transparency and communication to shareholders of the same.

Criteria related to “cultural fit / chemistry” should have a zero “weight” in terms of evaluating an auditor appointment but could continue to be deployed (on very rare occasions) as a secondary over-ride.

In other words, an otherwise “winning appointment” from evaluation of other criteria (excluding any consideration whatsoever of “cultural fit / chemistry”) could be over-ridden but only in very rare cases where “cultural fit / chemistry” were considered to be so negative as to raise material concerns about how an audit could be effectively carried out. In such rare circumstances, the use of the over-ride would need to be fully disclosed together with a clear and well-articulated rationale for its deployment

Audit Committees would be required to confirm to the Regulator full compliance with best-practice guidelines. In the case of departures from that guidance or deployment of over-rides, the Audit Committee would be required to seek approval from the Regulator prior to Auditor appointment being confirmed.

Similarly, during the Audit engagement, the Audit Committee would be required to report to the Regulator on compliance with best practice guidance at each pre-specified milestone (and require approval for any departures from that guidance)

We concur with the other attributes of this remedy (as specified in section 4.25 of the CMA Report) and believe it should apply equally to all FTSE 350 companies AS WELL AS PIEs and privately-owned companies deemed to be in the public interest in view of their overall importance to a range of stakeholders

## 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 apply equally to all FTSE 350 companies AS WELL AS PIEs and privately-owned companies deemed to be in the public interest in view of their overall importance to a range of stakeholders

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

No exclusions. The expressed concern regarding the ability of challenger firms to have sufficient expertise or resources for the audit of more complex companies is exaggerated and can be addressed by audit-only firms leveraging third-party expertise (to the benefit of audit quality relative to the disadvantages of the current model that relies predominantly upon in-house non-audit expertise.

The concern about reducing candidate auditors on rotation is temporarily valid but will cease to be a concern under an “audit-only” business model as competition and audit quality increase.

### 6. Should one of the joint auditors be required to be a challenger firm?

Yes, to foster increased competition and to bridge the perception of an “experience / resource gap”. However, the definition of “challenger firm” should be broad in nature so as to incorporate new entrant firms.

The requirement to incorporate a “challenger firm” should also be periodically reviewed (perhaps every 3 to 5 years) as a function of how competition in the market increases.

#### If so, should this be required for all companies subject to joint audit?

Yes, the “experience / resource gap” concern is exaggerated (and there are no other grounds for considering a different treatment for some companies)

#### Are there any categories of companies to which this requirement should not apply? Please explain your reasoning for each of the answers.

No, the “experience / resource gap” concern is exaggerated (and there are no other grounds for considering a different treatment for some companies)

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.

No major comments.

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?

No major comments – though I have sympathy with the CMA view.

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?

I would recommend that the insurance industry be asked for its view on this topic with particular comments on: (a) the relative costs of professional indemnity insurance for auditors under each option and (b) the cost for an audit firm of protecting itself under each option in the event that their fellow auditing firm became insolvent prior to a liability claim being made.

Remedy 2A: Market share cap

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

I am not in support of this remedy and believe “cherry picking” could only practically be avoided by the Regulator selecting the auditor for each company

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

If applied then market share caps should also apply to PIEs and privately-owned companies deemed to be in the public interest in view of their overall importance to a range of stakeholders

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.

Common barriers include: deferred bonus options, long-term incentive plans, the obligation to exercise options on exit, the lost of non-vested options on exit, clauses

prohibiting such staff from working for competitors for a minimum period of time following exit, loss of other forms of compensation on exit.

While there are arguments in favour of such barriers in any commercial organisation those arguments would be significantly diluted in the event that all firms were required to migrate to an “audit-only” business model. In those circumstances specific consideration could be given to precluding such barriers from the compensation packages of audit-only firms.

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.

No comments.

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.

I would recommend that technology platforms and certain other resources be spun-off as part of a migration to an “audit-only” business model with the resultant independent technology / resources company being obliged to license its services and products to all “audit-only” firms.

Similarly, given the objectives of auditing, the “audit-only” firms should be required to pool data and other information to a non-profit, independent, entity designed to service the audit needs of the market as a whole.

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.

No comments

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 comment

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 comment

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, the challenges to implementing a full structural split are wholly surmountable

The co-existence of audit and non-audit services is a significant problem that represents the major impediment to both increased competition and improved audit quality.

Indeed, it is critical that this should be addressed without delay by a full migration to an "audit only" business model.

(An operational split would not address this problem)

Please also refer to the general comments that include additional concerns about the adverse consequences and disadvantages of the current mixed business model from the perspective of the audit function.

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.

An organisational split, if properly implemented, has no advantages for either the audit business or the non-audit business. It not only retains all the problems associated with the current business model but further accentuates them to the detriment of both audit and non-audit businesses.

Transposing my own experience of working for an organisation with a highly robust and effective operational split to that needed for the Statutory Audit function, it is evident that such approach would (in the audit market context): hamstring both businesses; be next to impossible to implement effectively; would require substantial cost to establish, monitor and maintain; be more costly than a full structural split; lead to a deterioration in audit quality; will require greater regulatory scrutiny; and offers no commercial benefits whatsoever.

By contrast, a full structural split potentially increases audit quality and provides the separated non-audited businesses with the potential for greater commercial success.

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.

I do not regard an operational split (as opposed to a full structural split) as: desirable; feasible in practice; or of commercial benefit to the firms concerned

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.

In the unhappy event of a purely operational (rather than structural) split occurring, I would be against any relaxation of current restrictions on non-audit services to audit clients.

Indeed, a purely operational split is likely to undermine audit quality while maintaining all of the current problems associated with the mixed business

model. Consequently, there is an argument (should operational splits occur) to tighten further restrictions on non-audit services to audit clients.

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

Yes, the issues arising from the co-existence of audit and non-audit services within the same firm (or group) are not confined to the Big4 but also apply to challengers.

Arguably, challengers seeking to acquire larger size and breadth of activities (subject to less scrutiny or sanction in the interests of fostering increased competition) are more at risk in this respect than the Big4.

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.

None. In order to protect the integrity of the statutory audit process no other commercial services should be offered. Arguably, speaking at seminars, non-fee workshops and training could be feasible.

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?

I would suggest at least triennial for all FTSE 350 firms, PIEs and other firms of public interest with more frequent or accelerated review when: (a) previous triennial reviews have found short-comings, or (b) the firm is audited by auditors associated with a recent high-profile failure, or (c) concerns about audit quality have been raised in the market, or (d) other flags have been breached.

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

Public disclosure of: the depth of peer review undertaken; the results of the peer review (and the materiality of any short-comings identified).

C) Next steps

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

I concur with the proposal on the grounds that the Report has already identified many of the issues and is already well-placed to make proactive recommendations that should assist in improving matters.