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10 September 2019

Dear Sirs

ICSA response to the Department for Business, Energy and Industrial Strategy (BEIS) Market Study on Statutory Audit Services – Initial consultation on recommendations by the Competition and Markets Authority

We welcome the opportunity to comment on the BEIS Market Study on Statutory Audit Services – Initial consultation on recommendations by the Competition and Markets Authority (CMA).

ICSA: The Governance Institute is the professional body for governance. We have members in all sectors and our Royal Charter purpose is to lead 'effective governance and efficient administration of commerce, industry and public affairs'. With more than 125 years' experience, we work with regulators and policy makers to champion high standards of governance and provide qualifications, training and guidance. ICSA is the professional body that qualifies Chartered Secretaries, which includes company secretaries. Company secretaries have a key role in companies' governance arrangements, including the statutory audit process. Our members are therefore well placed to understand the questions and proposals raised by the recommendations of the Competition and Markets Authority in relation to audit.

In preparing our response we have consulted, amongst others, with members of the ICSA Company Secretaries Forum, a group of company secretaries from more than 30 large UK listed companies from the FTSE 100 and FTSE 250. However, the views expressed in this response are not necessarily those of any individual members of this group, nor of the companies they represent.

We set out below some general comments, followed by our responses to the specific questions set out in the consultation document.



GENERAL OBSERVATIONS

Whilst we welcome the CMA Market Study into Statutory Audit Services, we believe the recommendations should be viewed in the context of the findings of the other work currently being undertaken in the audit arena, and so this is not the appropriate time to implement the CMA proposals.

The recommendations in the report of the Kingman review of the Financial Reporting Council propose substantial changes to the operations of the regulator and this will impact the statutory audit market. In addition, Sir Donald Brydon has been tasked with carrying out an independent review of the quality and effectiveness of audit. The Brydon review is wide-ranging and its recommendations may cover much of the same ground as the CMA Market Study. We therefore believe that the implementation of proposals resulting from the CMA Market Study should only be considered after the Brydon review has reported and its recommendations can be assessed together with those of the Kingman review and the CMA proposals to develop a joined up response to issues in the audit market.

Implementation of the CMA proposals in isolation risks a need to revisit some of the changes made in the light of the other reviews. In particular, we are concerned that the CMA has, not surprisingly, looked at the audit market through the lens of competition and their proposals risk allowing legitimate concerns about the concentration of the audit market to become conflated with the central issue of audit quality. Many of the CMA proposals will tend to increase competition in that market. However, they will not all necessarily improve the quality of audit which is, we believe, the more urgent task facing Government. In some cases, the recommendations risk reducing the quality of audit in the short term.

Our prescription for improvements in the audit market remains, as we have said in all our consultation responses on this subject, to focus on three principal issues:

- Firstly, there must be clarification of the role of audit in order to reduce the huge perception gap that exists. The political, press and public expectation of the role of audit is very different from what an auditor would perceive it to be. The average man in the street might believe that the purpose of audit is to stop companies from going bust whereas auditors themselves might believe that their role is simply to check the accuracy of the historical information provided to them.

Accounting and auditing legislation, regulation and standards are very important here. The invitation to comment for the CMA review noted (paragraph 2.25) that International Financial Reporting Standards have developed “over time from an approach based on historic cost accounting to that based on fair value accounting. The key principle is that assets and liabilities should be valued on market prices, based on the idea this would make the financial statement more ‘useful to users’. Some commentators have argued that fair value accounting has led to greater risk because of the difficulty, and subjective nature, of valuing and auditing certain assets and liabilities.”

As we said in our response to that invitation to comment, “We leave the debate over which approach to accounting standards is correct to those better qualified, but we do offer the observation that a number of the ‘accounting scandals’ that we have seen in recent years have at their heart questions of judgement. Whether particular value could, or should, be regarded as crystallised in the accounts should, in our view, be a question of fact rather than of opinion – either it is yours or it isn’t. It should not be possible for one accountant to draw up the books for a period and have them audited against current accounting standards and for another to perform the same exercise, for the same period, have it audited by a different auditor and find many millions of pounds difference. We cannot recall a single occasion when such a restatement has ensued to the benefit of shareholders. In our view, a detailed examination of the appropriateness of the use of fair value accounting would be an extremely useful first step in improving the quality of audit and accounting standards revised as necessary to give greater clarity on where judgement has been applied by either the preparer or auditor. This is a subject on which we trust that the Brydon review will provide helpful clarity.

- Secondly, much more training is required to foster a greater spirit of professional scepticism among auditors. Not only does the audit process not do what many in our society believe it should, it fails to do properly the bare minimum of what it is actually supposed to do. Politicians and other stakeholders question why the quality of accounting and auditing is not of the standard they expect. This is the delivery gap, rightly identified by the BEIS Committee, who argued that “the expectation gap must not be allowed to mask the serious failure of audit to deliver on its own current terms”. We do not agree, however, that the Committee is right to add that “the delivery gap is far wider than the expectation gap”. Both are significant and equally important issues and neither should be overlooked. To what extent do audit standards, regulation and legislation meet legitimate societal expectations and to what extent does auditor performance deliver high quality audits against existing requirements? This is a matter for the regulator and we believe that implementation of the Kingman review and the establishment of the Audit, Reporting and Governance Authority (ARGA) with enhanced powers to penalise poor performance will address this issue.
- Thirdly, there is the issue of a lack trust in the ability of auditors outside the Big Four. The lack of confidence on the part of companies, investors and some regulators in the ability of smaller auditors to perform to the same standard is an issue of trust and without the accuracy or inaccuracy of this perception being tested by an independent body, any potential misconceptions will continue to abound. It is essential that the validity of any gaps in auditing ability is investigated as the inclusion of challenger firms in the audit market will not serve to improve that market if those firms genuinely are performing at a lower standard. This will not be addressed by simply requiring companies to employ such firms – if there is a proper independent assessment that confirms that the challenger firms are operating at the required level, we have no doubt that companies will increasingly use them.

Responses to specific questions

Q1 Do you agree that the new regulator should be given broad powers to mandate standards for the appointment and oversight of auditors, to monitor compliance and take remedial action? What should those powers look like and how do you think those powers would sit with the proposals in Sir John Kingman's review of the Financial Reporting Council?

Yes, but only in the most exceptional circumstances. Both the original CMA market study and the current proposals appear to misunderstand the roles of the Audit Committee and management in the selection and oversight of the auditor. The Audit Committee comprises independent non-executive directors and is independent of management. Whilst the Audit Committee would take management views into account, the Audit Committee alone recommends the appointment of the auditor to the Board which, in turn, recommends the appointment to shareholders. Management does not have the power to appoint or recommend the auditor. Our members have been consistent in telling us that the audit committees with which they are familiar take their work, especially insofar as it relates to challenging management and ensuring the independence of the external auditor, exceptionally seriously and profoundly disagree with those who assert otherwise. They have cited examples where an auditor has been appointed despite management opposition.

The Audit Committee has an understanding of the business and the needs of the statutory audit in a way that the regulator does not. It is solely responsible to the owners of the company for the selection and oversight of the auditor, and has a key responsibility for ensuring the independence of the auditor. Audit quality is the most important element of overall value that is taken into account by the Audit Committee when an auditor is selected. The independent non-executive directors that comprise the Audit Committee are well aware of their legal duties to the company as directors, and the Audit Committee and each individual member of that Committee are already externally accountable. They are held to account by shareholders, who will not hesitate to oppose their re-election as directors and replace them if they feel the Audit Committee, or any individual appointed to it, has not acted properly in fulfilling its responsibilities.

We do not believe increased regulatory scrutiny would generally have a positive impact on the performance of Audit Committees or create a greater focus on quality. It will not increase accountability to shareholders and is likely to have the opposite effect. The Audit Committee reports to shareholders through the company's annual report and is available to answer questions at the company's AGM. Under the CMA proposals, the regulator would supplant the role of shareholders in scrutinising the activities of the Audit Committee whose members are elected by shareholders to act on their behalf.

That said, we could contemplate a role for the regulator to challenge an Audit Committee in exceptional circumstances but any such powers would need to be tightly circumscribed to prevent the regulator

second-guessing the Audit Committee from a position of less knowledge or taking action for purely political reasons or with benefit of hindsight. Guidance on audit tenders would always be welcome, but should not be developed into mandatory standards as there is no one-size fits all approach to the selection of an auditor and each Audit Committee will know the needs of its company better than a regulator.

Q2 What comments do you have on the ways the regulator should exercise these new powers?

As explained in our answer to question 1 above, we do not see benefits from the regulatory scrutiny remedy. The responsibilities of the Audit Committee are clear and the Committee's focus is on delivering a quality audit that provides value. The role of the regulator should be primarily confined to the regulation of audit firms and their activities. Involvement by the regulator in company matters and in the work of the Audit Committee should be by exception, and only in circumstances where a failure to the existing process has been identified, for example when a company's auditor has resigned and no other audit firm is willing or able to undertake the statutory audit, a poor audit quality review where the regulator should be supporting the Audit Committee in its challenge (or dismissal) of the failing auditor, or where a company's accounts require material restatement.

Q3 How should the regulator engage shareholders in monitoring compliance and taking remedial action?

As explained in our response to question 1, we do not believe the regulator should normally be involved in the shareholders' role of monitoring the activities of the company's Audit Committee. The Audit Committee is accountable to shareholders on matters relating to the audit, the appointment of the auditor and all other work of the Audit Committee. The Audit Committee and each of the independent non-executive directors that comprise that Committee are already subject to external accountability to shareholders, who will not hesitate to oppose their re-election as directors and replace them if they feel the Audit Committee, or any individual appointed to it, has not acted properly in fulfilling its responsibilities. The regulator should not be involved in this engagement between shareholders and the company's Audit Committee unless, exceptionally, it has reason to believe that shareholders are unaware of material failings on the part of the Audit Committee.

Q4 What would be the most cost-effective option for enabling greater regulatory oversight of audit committees? Please provide evidence where possible.

For the reasons discussed in our response to question 3 above, we do not believe regulatory oversight of Audit Committees is generally appropriate. We believe it would be unhelpful as it would disturb the shareholders' role in oversight of Audit Committees and it would incur costs for no benefit.

Q5 Do you agree with the CMA's joint audit proposal as developed since its interim study in December?

We do not support mandatory joint audits. We note the changes to the proposed design of the remedy and, whilst the limited exemptions are welcome, the changes do not address our original concerns. Mandatory joint audits would increase the cost of the statutory audit considerably, yet there is no evidence that the quality of the audit will be improved. We have noted the new proposal that the two audit firms would divide the necessary fieldwork between them, with both firms auditing areas that are highly material and/or involve a high level of judgement, and that the audit opinion and audit liability would rest with both auditors. However, we do not believe this proposal is workable and it does not address our concerns. This is clearly duplication of work and we believe duplication will not be confined to the areas set out, as one audit firm will feel unable to rely on work carried out by another audit firm. The proposal that auditors be jointly and severally liable would increase the reluctance of an audit firm to rely on the work of another.

We do not believe it is necessary to mandate joint audits using one 'Big Four' firm and one challenger firm to provide exposure of challenger audit firms to larger companies. This is already being achieved by challenger firms providing non-audit services to such companies, as a result of the restrictions placed on the audit firm providing non-audit services. As noted in our general comments above, if challenger audit firms can demonstrate the ability to deliver quality services to companies or, better still, be independently proven to be able to do so, we believe they will be invited to tender for the statutory audit. Companies would much rather have a better pool of auditors from which to choose – the issue is one of perceived capability. Recent enforcement sanctions applied by the FRC have not been limited to 'Big Four' firms and so it does not seem reasonable to argue that obliging companies to use challenger firms will necessarily improve audit quality.

Q6 Do you agree with the CMA's proposed exemptions to the joint audit proposals?

Yes. We agree with the CMA's proposed exemptions to the joint audit proposals but these exemptions do not address all our concerns about joint audits. The increased costs associated with joint audit need to be justified by improved audit quality and would disproportionately impact smaller companies. Although the proposed exemption to mandatory joint audits for the largest and most complex companies is important, and reflects the reality of challenger firms' ability to carry out this work, this exacerbates the problem of the increased costs disproportionately impacting smaller companies. The objective should surely be to increase the capability of challenger firms.

Q7 Do you agree that challenger firms currently have capacity to provide joint audit services to the FTSE350? If a staged approach were needed, how should the regulator make it work most effectively? If not immediately, how quickly could challenger firms build sufficient capacity for joint audit to be practised across the whole of the FTSE350?

We do not believe challenger firms generally have capacity to provide joint audit services to the FTSE350. This is demonstrated partly by the need for the exemption to joint audits for large and complex companies set out in the revised proposals. As discussed in our response to question 5 above, challenger firms already achieve exposure to FTSE350 companies by providing non-audit services to such companies, due to the restrictions placed on the audit firm providing these non-audit services. If challenger audit firms can demonstrate the capacity and expertise to deliver quality services to companies we believe they will be invited to tender for the statutory audit at an appropriate time. How quickly challenger firms can build up sufficient capacity to be invited to tender for the statutory audit by a FTSE350 will be reflected in their capacity to deliver quality non-audit services.

As we commented in our response to the original CMA invitation to comment on their market study on the statutory audit market, “In our view, the chief weakness of the audit market is the lack of confidence, not just on the part of companies, but also on the part of investors and, we understand, some regulators, in the ability of auditors outside the Big Four to provide an audit of an adequate standard for large, particularly multi-national, companies. In some cases, this perception may be unfounded but in others, especially more complex international companies, there is some evidence to suggest that only the very largest audit firms have the range to carry out an audit of an appropriate standard. We would suggest that the accuracy of this perception should be tested by an independent body and the CMA may be well placed to undertake this task. If it can be shown that mid-tier firms are up to auditing the very largest companies then we believe that companies, investors and regulators will welcome them with open arms. If, on the other hand, it is shown that they are not, alternative solutions will be necessary.” It is a pity that the CMA did not take the opportunity to test the quality of service offered by challenger firms. Had it done so, this further work may well have been proved unnecessary.

Q8 Do you agree with the CMA’s recommendation that the liability regime would not need to be amended if the joint audit proposal were implemented?

No. We do not believe joint and several liability for the auditors of joint audits is workable for a number of reasons. As discussed above, it will result in duplication of work and a substantial increase in costs. We also have concerns that, in practice, joint and several liability for joint audits between ‘Big Four’ and challenger firms will result in the ‘Big Four’ firm being held solely (severally) liable. In the event an audit failure resulted in loss to a company, the company would need to protect itself by ensuring the audit firm with the ‘deepest pockets’ was held liable.

Q9 Do you have any suggestions for how a joint audit could be carried out most efficiently?

We do not support joint audits and do not believe there is any efficient way they can be carried out in the UK, notwithstanding the firmly expressed views of some of the firms who anticipate benefitting from such a change. However joint audits were carried out they would result in duplication of work and a substantial increase in costs with no evidence of improved audit quality.

Q10 The academic literature cited in the CMA's report suggests the joint audit proposal would lead to an increased cost of 25-50%? Do you agree with this estimate?

We have no figures for the increased costs of the joint audit proposals but believe this estimate of increased cost is far too low. In view of the fact we do not believe the statutory audit work could be shared in the way envisaged by the proposal, we believe the duplication of work would result in the cost of the statutory audit increasing to a level closer to 100%.

Q11 Do you agree with the CMA's assessment of the alternatives to joint audit?

Yes. Whilst we do not agree that mandatory joint audits will result in providing greater opportunity for challenger firms to participate in the market, and believe that they will increase costs for no benefit, we do agree with the CMA's assessment of the suggested alternatives. We agree with the view that shared audits may cement preconceptions that challenger firms are less capable, and that market share caps could lead to companies finding their choice of auditor constrained.

Q12 How strongly will the CMA's proposals improve competition in the wider audit market, and are there any additional measures needed to ensure that those impacts are maximised?

We do not believe the CMA's proposals will improve competition in the wider audit market. As discussed in our response to questions 5 and 7 above, we believe this is best achieved by challenger firms demonstrating their capacity and expertise through the provision of non-audit services to FTSE350 companies. If challenger audit firms can demonstrate their ability to deliver quality non-audit services to companies we believe they will be invited to tender for the statutory audit.

Q13 Do you agree with the CMA's proposals for peer review? How should the regulator select which companies to review?

No. We do not see the need for peer review, except in circumstances where concerns have been identified by the regulator. In particular we do not believe that subjecting companies that are exempt from joint audits to peer review would be helpful. Large and complex companies are exempt due to

insufficient capacity from challenger firms, so it is difficult to see how a challenger firm could carry out a peer review, or improve quality through an independent quality check. Where companies are exempt because they do not produce consolidated accounts or because they have already appointed a challenger firm as sole auditor, it is hard to see what value would be added by a challenger firm carrying out a review.

Q14 Are any further measures needed to ensure that the statutory audit market remains open to wider competition in the long term?

We have no suggestions for further measures.

Q15 What factors do you think the regulator should take into account when considering action in the case of a distressed statutory audit practice?

Q16 What powers of intervention do you think the regulator should have in those circumstances, and what should be their duties in exercising them?

We believe that, in general, these questions are better directed to the FRC and the audit firms. However, one proposed power to be given to the regulator appears to be an anomaly. This section of the consultation is focussed entirely on measures to mitigate the effects of distress or failure of a Big Four firm, and all the recommended regulatory powers set out in sections 3.5 – 3.8 relate to the operations and activities of audit firms, with the exception of this second bullet point under 3.5. This bullet point recommends that the regulator should be given powers to *'require audit committees to inform it of upcoming tenders and any other information that the regulator considers necessary'*.

Companies' Audit Committees will have no insights into whether or not an audit firm is likely to become distressed or fail, and will have no control over such a situation. We cannot see how this regulatory power could have any bearing on the regulator's ability to pre-empt and intervene where an audit firm is likely to fail.

Q17 Do you agree with the CMA's analysis of the impacts on audit quality that arise from the tensions it identifies between audit and non-audit services?

No. We believe changes in recent years limiting the amount of non-audit work that may be carried out by the auditor have had a substantial impact on the level of non-audit work carried out by auditors. We are aware that companies tend to keep all non-audit work to a minimum, well below the level permitted. Appointing the auditor to carry out such work is now done only in exceptional circumstances.

Q18 What are your views on the manner and design of the operational split recommended by the CMA? What are your views on the overall market impact of such measures?

We do not support a full operational split of audit and non-audit work being proposed initially for the Big Four firms and extending to challenger firms at a later date.

We believe that changes in recent years limiting the amount of non-audit work that may be carried out by the auditor have had a substantial impact on the level of non-audit work carried out by auditors. We are aware that companies tend to keep all non-audit work to a minimum, and only in exceptional circumstances.

If the overall level of non-audit work carried out by auditors remains a concern, we would support further restrictions, however we do not believe a full operational split is appropriate or helpful. There are occasions when the auditor's knowledge and understanding of the company are essential to the carrying out of quality non-audit work and the costs may be increased substantially when appointing another audit firm.

Q19 Are there alternative or additional measures which would meet these concerns more effectively or produce a better market outcome?

We believe the restrictions already in place on non-audit services that may be provided by the auditor, combined with the growing market practice of the Big Four firms deciding not to provide any non-essential non-audit services to audit clients, are sufficient to address the concerns over risks to audit quality. As discussed in our response to question 18 above, if the level of non-audit work carried out by auditors remains a concern, we would support further restrictions, but believe the flexibility of allowing the auditor to carry out such work in exceptional circumstances is important.

Q20 Do you agree with the CMA's proposal to keep a full structural separation in reserve as a future measure?

No. We believe that a full structural split would be particularly onerous, and do not believe it is necessary. We are concerned that separating the firms will lead to the better employees gravitating towards the more highly remunerated consultancy roles and leaving the basic audit work to others. We do not see how this will serve to improve the standards of auditing. There is already some concern amongst Audit Committees that, unless kept firmly in check, auditors are too willing to entrust audit work to trainees.

We believe the changes to the limits on the amount of non-audit work that the company may engage with its audit firm has reduced the risks to independence such that it is no longer a concern. Many

companies no longer engage the audit firm for any non-audit work unconnected with the audit, except in exceptional circumstances, and many audit firms have taken similar action.

Q21 What implementation considerations should Government take into account when considering the operational split recommendations? Please provide reasoning and evidence where possible.

We believe that this question is better directed to the FRC and the audit firms.

Q22 Do you agree with the CMA's other possible measures? How would these suggestions interact with the main recommendations? How would these additional proposals impact on the market?

As discussed in our General Comments above, we do not believe the CMA's recommendations should be progressed until after the implementation of the recommendations of the Kingman Review of the FRC and the Brydon Review of the quality and effectiveness of audit. The implementation of the Kingman recommendations will result in a new regulator for the audit, with a new approach to regulation of the industry. It is also likely that the wide-ranging Brydon Review will cover many of matters highlighted in the CMA proposals. We therefore believe the other measures proposed by the CMA should also not be considered until after the implementation of the Kingman and Brydon recommendations.

**Q23 Do you agree with the CMA's suggestions regarding remuneration deferral and clawback?
Q24 How would a deferral and clawback mechanism work under a Limited Liability Partnership structure?**

We believe that these questions are better directed to the audit firms.

Q25 Do you agree that liberalising the ownership rules for audit firms would reduce barriers for challengers and entrants to the market?

Again, we believe that this question is better directed to the audit firms.

Q26 Do you agree with the CMA's suggestions regarding technology licensing?

We believe the audit firms are best placed to answer this question. However, it seems anti-competitive to oblige some firms to subsidise the business models of others and it is difficult to see why a Big Four firm would invest in audit technology if they were required to share it with challenger firms.

Q27 Do you agree with the CMA’s suggestions to provide additional information for shareholders? Do you have any observations on the impact of the Public Company Accounting Oversight Board’s database on the US audit market?

We believe the Audit Committee’s activities, including in relation to the statutory audit, are already reported fully to shareholders. It is difficult to see what additional information would be useful. The remit of the statutory audit and fees paid for the work are the responsibility of the Audit Committee of independent non-executive directors. The Audit Committee understands the business of the company and what is needed from the statutory audit. Shareholders elect the independent non-executive directors comprising the Audit Committee to select and recommend the auditor and scrutinise the audit work on their behalf. If the work of the audit is subsequently found wanting, the shareholders will hold the Audit Committee to account.

Q28 Do you agree with the CMA’s suggestions regarding notice periods and non-compete clauses? Do you agree that the regulator should consider whether Big Four firms should be required to limit notice periods to 6 months?

We have no experience of unreasonable barriers to senior staff switching between audit firms. There are perfectly reasonable justifications for firms having some restrictions, for example notice periods and non-compete clauses in place but, if notice periods in excess of 6 months are considered an unjustified barriers exist, we would support measures to address this.

Q29 Do you agree with the CMA’s suggestions regarding tendering and rotation periods?

No. We do not support the proposal to move to a fixed term of seven years for the appointment as the auditor of Public Interest Entities.

A fixed seven-year period of appointment is too short. Not only are audit tenders an expensive process, it can take a number of years before a new audit firm will function at its optimum level in auditing a company and audit quality can be reduced during this time. In the case of a PIE the time period can be much longer due to the size and complexity of the business. The current time periods of tendering every 10 years with a total maximum time of auditor engagement of 20 years is appropriate. The perceived problem of ‘familiarity’ is mitigated by the more frequent change of audit partners assigned to the company by the audit firm, with the maximum time periods being five or seven years.

Q30 Do you have other proposals or measures to increase competition and choice in the audit market that the CMA has not considered? Please specify whether these would be alternatives or additional to some or all of the CMA's proposals, and whether these could be taken forward prior to primary legislation.

We have no further suggestions.

Q31 What actions could audit firms take on a voluntary basis to address some or all of the CMA's concerns?

We believe audit firms are already taking a number of measures voluntarily to increase confidence in the statutory audit market and address the concerns identified by the CMA. This includes initiatives such as the decision by three of the Big Four audit firms not to undertake any non-essential non-audit work for any firm where it is engaged to carry out the statutory audit.

Q32 Is there anything else the Government should consider in deciding how to take forward the CMA's findings and recommendations?

We have no other comments.

We hope you find our comments helpful and would be happy to expand on any of these points should you wish to discuss them further.

Yours faithfully

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