Audit Reform and Regulation Team
Department for Business, Energy and Industrial Strategy
1st Floor, Victoria 1
1 Victoria Street
London
SW1H 0ET

19 September 2019

By email: auditmarketconsultation@beis.gov.uk

Dear Sir or Madam

Market Study on Statutory Audit Services – Initial consultation on recommendations by the CMA

Introduction

The Board of the Audit Committee Chairs' Independent Forum is pleased to respond to the initial consultation on recommendations by the CMA. We are not providing responses to each of the consultation questions but rather providing a note of our meeting with Claire Hardgrave and other members of the Audit Reform and Regulation Team on 3rd September 2019. This is included as an Appendix to this letter.

ACCIF key discussion points

We thoroughly enjoyed the meeting with you and the constructive discussion. We are keen to see a solution to choice but not at any cost. We want to work with change that is measured and will not put quality at risk. There are three aspects of our discussion that we would welcome further dialogue around. These are:

Big 4 v non-Big 4 auditor selection - there is a perception that there is an unfounded bias against the selection of non-Big 4 auditors; the audit committee chairs, not surprisingly, don't subscribe to this, however are interested in how to address this through enhanced communication around selection and other means.

Capacity in the market - as discussed in our meeting, Audit Committee Chairs support increased choice; they are however, very concerned that a path to change is selected that is out of step with the market that we have to select from. There needs to be confidence for stakeholders that change has a high chance of success and has the support of those taking responsibility for its operation.

Understanding the market – linked to the point above, the Audit Committee Chairs feel strongly that there has yet to be a detailed analysis of the characteristics of the FTSE 350 such that an informed decision can be made in relation to where the complexity lies and, therefore, where more specialist and experienced audit provision will be required. We feel it is too simplistic to work on the assumption that FTSE 100 is complex and the lower end of the FTSE 350 is more straightforward. There needs to be consideration of factors such as geographical locations, regulation, industry specialisms, use of shared service centres etc.

Background on the ACCIF

Launched in October 2015, the ACCIF is an independent forum focused on FTSE 350 company audit committees. Its overall objective is to promote good governance by enhancing the leadership by audit committee chairs through the sharing of experiences and the establishment of best practice.

We would welcome the opportunity for a further discussion of these views with you. Please contact me (jocklennox@gmail.com) if you have any questions in relation to the comments made in this letter.

Yours sincerely

Jock Lennox

Jock Lennox
On behalf of the ACCIF board

Appendix

Market Study on Statutory Audit Services – Initial consultation on recommendations by the CMA

Note of BEIS roundtable on CMA proposals – Tuesday 3rd September 2019

Attendees

ACCIF	**BEIS**
Jock Lennox	Claire Hardgrave
Mike McKeon	Liza Ennals
David Lindsell	Agni Singh
Alison Baker	Rob Cottam
Alan Ferguson	
Lucinda Bell	
Jim Coyle	

1. Audit committee scrutiny

1.1 Audit committee chairs agreed that a strong, high quality regulator is good for companies and for audit firms.

1.2 The Kingman proposals are sensible and give reasonable powers to the regulator but the devil will be in the detail. However, care needs to be taken not to undermine the unitary board by focusing too heavily on what the audit committee is doing. It is the board as a whole that is responsible for ensuring that risk management and internal control systems are effective and that annual reports are fair, balanced and understandable, and it is long overdue that all directors should be held to account rather than just the accountants.

1.3 In terms of audit regulation and scrutiny, the current regulator focuses heavily on the detailed audit processes – we need to avoid such an approach to the oversight of audit committees. Audit committees rely on the effectiveness of the audit process but must apply their own experience and their knowledge of the business and its audit risks in order to assess whether they can rely on the work and conclusions of the auditors. Judgement is therefore key and it is therefore essential to get the right people on the audit committee in the first place.

1.4 Recommending the appointment of the auditor is an essential part of the role of the audit committee and it would disenfranchise the audit committee if that responsibility were to be taken away and assumed or even influenced by the regulator. And how could a regulator have sufficient knowledge of a company and its areas of audit risk, and of potential audit teams, to take on this responsibility? It would be a great concern if the regulator started to influence the biggest decision we make and could well cause high quality audit committee chairs and members to resign. [It is recognised that it would be appropriate for a regulator to investigate the workings of the audit committee, including the appointment of the auditors, in clearly defined circumstances. These should be exceptional.]

1.5 BEIS stated that there would probably be only one opportunity to introduce Companies Act changes and asked for views on how it should approach this.

1.6 The powers of the new regulator are being defined before any detailed, objective analysis has been published of what went wrong in the companies that triggered the CMA review of the audit market. Introducing significant regulatory oversight of boards is, furthermore, a step change. The range of size and complexity of listed companies is huge and proportionality is required in the regulatory mechanisms. It would therefore be appropriate for any changes to the Companies Act to put in place a framework rather than a detailed rule-book for the new regulator, allowing the regulator to decide how to apply the law. For example, the power of the regulator to apply sanctions against all directors should be given in the Companies Act but the regulator should determine the actual sanctions to be applied. Furthermore, consideration needs to be given to whether large private companies should fall within the remit of the regulator (indeed, those that do not have an audit committee of independent directors to challenge management and the auditors may be more exposed than listed companies of similar size or complexity). This could be specified in the Companies Act but it might be better if the regulator were to define the private companies within its remit.

1.7 There is also a danger that the introduction and monitoring of audit committee standards by the regulator could undermine the UK Corporate Governance Code and the "comply or explain" approach on which it is based, which is generally seen as working well.

1.8 Any new regulatory oversight mechanisms must align with the financial services regulatory regime, or the financial services regulatory regime must be amended, so as to avoid financial services companies having to deal with two different sets of regulatory obligations.

1.9 There is a need to think about how audit committee chairs and members can share best practice. For example, on how to assess audit quality – understanding the different lenses you can use to build the assessment could be very helpful. The FRC Financial Reporting Lab is a good model of how best practices can be shared but the FRC has never actively encouraged best practice sharing by audit committees. Consideration should be given to a framework for transferring knowledge. This could also consider a model where funding comes from corporates and/or investors.

1.10 BEIS asked if the CMA was right to be concerned about the focus on "fit" with an audit firm, or is this actually about establishing a positive and constructive relationship. This could be made clearer through a slight change in the wording within the audit committee report and the tender documents.

1.11 The skills and experience of the senior audit team are the primary selection criteria: audit committee chairs are uncompromising on audit quality - this is a critical issue for the audit committee and particularly the audit committee chair, as his/her reputation is on the line. However, audit committees are rightly concerned to ensure that there is an open, constructive and cooperative working relationship between auditor and management. High quality auditing requires the exercise of professional scepticism but an adversarial relationship between auditor and management would be a major barrier to communication and so would negatively affect the quality of the audit.

2. **Shareholder engagement**

2.1 Institutional shareholders (aside from their corporate governance managers who have no responsibility for the investments and usually no commercial management experience) continue to show little interest in company annual reports, despite the introduction of the audit committee report, the strategic report and the extended audit report, all of which provide significant insights into areas of risk in the financial statements. They spend a good deal of time on management remuneration issues but very little time on - and generally do not seem to have the resources necessary to review – annual reports. Shareholder engagement might increase if a shareholder vote on the audit committee report was required, with a significant vote against triggering regulatory intervention.

3. **Audit quality**

3.1 BEIS noted that one reason for the current inquiries is that there is a perception that there is a persistent problem with audit quality that no-one is taking action to self-correct. BEIS believes that it will only be allowed to open the Companies Act once and so is considering what mechanisms to activate to drive the required changes and to determine what type of regime they are aiming for.

3.2 The audit regulator reviews only a very small number of audits each year, which are selected based on perceived audit risk and other criteria. The audits chosen are therefore not a representative sample of the total audit population. The regulator highlights the number of audits that it classifies as “improvements required” and “significant improvements required” but even in the latter case it says that this does not necessarily mean that the audit opinion was at risk. However, by emphasising this data, the regulator effectively encourages the media and other interested parties to focus on minor changes in the data from year to year and to claim that poor quality auditing is widespread. In the absence of a change of approach by the regulator, this will continue to be the case. The UK regulator’s approach contrasts starkly with that of the US PCAOB, which reports publicly only any very significant shortcomings in the audits it reviews, explaining the specific issue and its significance in relation to the specific audit. The PCAOB does not attempt to classify and present the results of all its reviews in simplistic statistical terms.

3.3 The CMA cites a (marginal) fall in audit partner hours as being consistent with the variable and sometimes poor audit quality identified by the FRC's reviews. However, far more important than the number of hours is how the audit partner is spending their time.

3.4 BEIS asked if it is possible to assess audit quality objectively over time and between audits?

3.5 As noted above, the regulator reviews only an extremely small proportion of audits each year. The companies concerned differ enormously in size, complexity and business activity and also in their areas and degree of audit risk. Further, the number of audits by the Big Four firms that the regulator classifies as "significant improvements required" in each of the last five years can be counted on the fingers of one hand. It is therefore not possible to draw any reliable conclusions about audit quality over time based on the regulators' findings.

3.6 The CMA also failed to consider such aspects as discussions held by audit teams with their firms' internal technical teams – a process which audit committee chairs would like to understand more about and also the issues discussed.

3.7 BEIS articulated three perceived problems within the FTSE 350:

Bottom section of FTSE 350 – there is a demand side issue in that the challenger firms are capable but are not being selected.

Middle section – there is a combination of a demand and supply-side failure

Top section – there is constrained supply and resilience could be a real problem

3.8 Audit committee chairs feel that they cannot take the risk of appointing GT or BDO to audit a global business. As well as having significantly less international strength than the Big 4 in terms of people, they have only a fraction of the financial resources that the Big 4 can invest in developing their audit services and techniques. Audit Committee Chairs look objectively for an appropriate level of skill and experience in their auditors. Challenger firms are being included in audit tenders and the results reflect capabilities.

3.9 It was acknowledged that no-one would start from the basis of having just four global audit firms but that the gap between the Big 4 and the challenger firms is huge. If the Challenger Firms want to be competitive against the Big 4 then they will need to invest heavily in the development of the capability/expertise of their people, their technology and quality oversight. There has to be a minimum standard to be an effective market participant.

3.10 At the same time, the increasing use by companies of non-Big 4 firms to provide non-audit services provides a platform for them to develop their capabilities and their relationships with listed companies. In particular, internal audit services enable them to obtain experience in and knowledge of large, complex companies.

3.11 Although there are many audits of smaller FTSE 350 companies that could be carried out perfectly well by non-Big 4 firms, the issue is very often not the size of the company concerned but its complexity. It is often the case that a high quality audit requires knowledge and audit experience of the industry sector in which the company operates and this will be among the most important factors considered by the audit committee in assessing the ability of an audit team and selecting an audit firm.

3.12 With regard to the resilience of the Big 4, they are all global organisations and if the viability of the UK arm of a Big 4 firm were to be under threat, the global firm would in all likelihood provide the finance – and would very likely second staff – to the UK arm in order to overcome the problem. It is really only if the US arm of a Big 4 firm ceased to be viable (such as occurred with Arthur Andersen) that a Big 4 firm would break up, resulting in a Big 3. There does not seem to be any realistic effective step that the UK government or regulator could take that would prevent such an outcome.

3.13 BEIS asked whether the AC chairs felt that they get a range of quality of teams from the Big 4 depending on whether it is a pitch for a large company or one at the smaller end?

3.14 It was felt that the firms were good at assessing the quality and capability of their people and that whilst you might get someone with less experience on a smaller or less complex company audit their capability would still be high as they would have built experience under the supervision of very experienced and able senior partners and managers. More junior partners are often leveraged in the very largest audit teams, particularly in the more specialised industries such as energy and financial services, thereby giving them the industry knowledge they need to apply on the audit of a smaller company in the industry concerned.

3.15 BEIS asked about the risk of the Big 4 choosing to walk away from high risk clients.

3.16 The AC chairs noted that the firms have to consider the risk-reward relationship: reputation risk, the increased level of fines and the potential associated costs have undoubtedly caused the large firms to avoid companies perceived to present very high audit risk.

3.17 The Big 4 response is a rational business response to the current risks. Perhaps the concept of an auditor of last resort, appointed by the regulator, needs to be introduced where no appropriate auditor is willing to tender for the audit. There is also a question for shareholders to answer in this situation – what are they doing about it? This risk issue is only going to get more challenging. There is a real possibility now of having an inexperienced auditor on a high risk client.

4. Joint audit

4.1 Audit committee chairs are strongly opposed to joint audit, and especially to joint audit where one firm would not qualify for appointment as the sole auditor. There is no evidence that joint audit improves audit quality and it is a matter of simple logic that if one of the joint auditors does not have relevant experience or expertise, the quality of the audit as a whole would be lower than that of an audit carried out by a single firm/audit team that does have relevant experience and expertise. It is difficult to see how it would be in the public interest in the face of concerns about audit quality and alleged audit failures to introduce a regime that would be likely to affect audit quality adversely.

4.2 From a practical standpoint, joint audits tend to extend financial reporting timetables, require significantly greater time from management, and also from audit committees, and would definitely result in a significant increase in the cost of the audit. This could only be justified if it could be demonstrated clearly that the quality of joint audits would be higher than that of sole audits.

4.3 BEIS said that the authorities in France supported their joint audit regime. However, the audit committee chairs pointed out that joint audit had not had a positive impact on choice in the French listed company market and that it was a much smaller market than the UK market: the vast majority of CAC 30 joint auditors are Big 4 firms and only one non-Big 4 firm remains as a joint auditor of a CAC 30 company (others having been eliminated over the years, often by merging into a Big 4 firm), and none of the non-French companies in the CAC 30 have opted to have joint auditors. It was noted that Denmark had used joint audit but then gave it up after ten years.

4.4 The audit committee chairs suggested that shared audits might be a way forward to enable non-Big 4 firms to build their capacity, expertise and experience to enable them to compete with the Big 4. Before such a regime could be introduced, however, it would be necessary to develop guidelines on how it would be expected to work, perhaps including definition of the firms that would qualify and the (minimum) share of the audit to be conducted by the firm that was not the group auditor.

5. Non-audit services/split between audit and non-audit services

5.1 The auditors' ethical standard, together with legally imposed fee restrictions, has resulted in significant reductions in the volume of non-audit services provided by audit firms to their audit clients. Audit committees are now planning and thinking much more about who is delivering non-audit services and for tender situations, with sufficient notice, it is possible to ensure that the prospective auditors are not prevented by their non-audit services from tendering for the audit. And if a firm appears reluctant to tender in the expectation of providing non-audit services, there is the option for the audit committee to make it clear that no further non-audit services will be awarded to that firm.

5.2 In relation to splitting audit from non-audit services, one question which needs to be answered is "Are audit practices sufficiently profitable to maintain an appropriate investment in audit quality and how do we make that more visible?" Audit committee chairs are not aware that information about the profitability of the firms' audit practices is published (as opposed to the profitability of the firm as a whole).

5.3 There is a case for requiring the Big 4 to demonstrate more clearly that they have meaningful arrangements in place to exercise independent oversight of the audit business. There is a real issue to be acknowledged in terms of how to define "independence" in terms of this oversight function as finding appropriately independent individuals with the necessary skills and experience can be extremely challenging. In addition, the authority of the head of the audit practice in the firms needs to be significantly strengthened, particularly as the UK arms of most of the Big 4 firms are now headed by non-auditors.

5.4 In terms of resilience, it may be the case that the firms' audit businesses are not entirely self-financing. In any event, separation would make them less-resilient. The multi-disciplinary model is an integral part of the firms' business model and there would undoubtedly be some negative impacts on the audit practices if the audit practices were formally separated from the rest of the organisation. For example, separation would make it challenging to ensure that specialists participating in the audit were made available as required, and held to account sufficiently for the advice they provide. In some sectors access to the wider specialist skills are essential to delivering audit quality. It may well also be the case that the Brydon Review results in widening the scope of the audit, for example by requiring some form of review of viability statements by the auditors, thereby increasing the need to involve such specialists. It is also highly likely that by separating the audit practice it will reduce significantly the career attractiveness of audit, thereby reducing the talent pool available and thereby damaging audit quality.

5.5 The CMA's consideration of whether audit practices should be split from non-audit practices appears to be framed around the Big 4 firms. However, any such split would clearly need to apply to all firms that conduct audits.