ACCIF
AUDIT COMMITTEE CHAIRS' INDEPENDENT FORUM

Attached is a note of a meeting on 19 November 2018 in connection with the CMA review of the Statutory Audit Market between representatives of the CMA and a number of Audit Committee Chairs brought together by the Audit Committee Chairs' Independent Forum. The views expressed by the Audit Committee Chairs were those of the individuals concerned.

The key points raised were:

- the CMA recommendations in its Invitation to comment are focused on competition but the key issue is audit quality

- the audit expectation gap needs to be addressed based on a clear definition of the audit framework: the current framework should be reviewed and, if necessary and practicable, revised to meet legitimate expectations

- the directors have fiduciary duties to investors and this is given insufficient consideration in the CMA's Invitation to comment

- audit quality inspections by the FRC should be focused on the quality of key judgements and estimates rather than on discrete process or documentation lapses

- audit committee members must have sufficient knowledge of the business and its performance to enable them to assess the effectiveness of the audit

- the key to assessing the effectiveness of the audit is the quality of the face-to-face interaction by the ACC and the AC with the lead audit partner and (depending on the size of the company) other senior members of the audit team

- it is for consideration whether more specific obligations should be placed on directors to maintain adequate capital and liquidity as part of the UK Corporate Governance Code

- having the FCA responsible for monitoring preliminary announcements (through the Listing Rules) while the FRC is responsible for monitoring annual reports seems illogical

- institutional investors show no interest in having any interaction with ACCs with regard to the work of the AC

- the perceived limited international reach and expertise of mid-tier firms, particularly in emerging economies, and lack of industry experience or other required specialist expertise in particular sectors are considered to be key factors in companies' decisions not to invite them to tender for FTSE 350 audits, although in a number of cases mid-tier firms had declined to tender as they did not believe that there was sufficient likelihood of their being selected

- in many if not most FTSE 350 audit tenders one or more of the Big Four firms have been unable to tender due to conflicts. A choice of three firms might be regarded as sufficient but it is not satisfactory when only two of the Big Four, one of which is the incumbent, are able to tender.

- the conflict rules prohibit the appointment as auditor of firms that provide relatively small amounts of prohibited non-audit services to a company or services that in practice would have no impact on the objectivity of the firm were it to be appointed as auditor. Changing the conflicts of interest rules would be a more practical way of increasing competition for audits than trying to bring smaller firms into the market

- reviews of interim financial information and reporting accountants work on a prospectus by a company's auditor should not be included in non-audit services for the purpose of the capping of non-audit services at 70% of the audit fee

- joint audits are inefficient and give rise to a significant risk of conflict rather than collaboration between joint auditors

- capping the market share of the Big Four would be likely to have a negative effect on audit quality and there would also be practical problems in designing and operating such a quota system. Where the cap came into play it could prevent audit committees from selecting the best qualified firm as their company's auditor

- ring fencing of the audit practices of the major accounting firms from the rest of the firm, with separate governance arrangements, might be an appropriate step at this stage to increase public confidence in audit, although it might increase the cost of audit

- the increasing burden of regulation and other environmental factors are making it more difficult for audit firms to recruit and retain high quality people who are able to perform high quality audits. There is a need to make auditing attractive to potential recruits

Notes from the CMA roundtable meeting

Date: 19 November 2018

Location: Victoria House, 37 Southampton Row, London, WC1B 4AD

Feedback by Audit Committee Chairs to CMA representatives on the review of the Statutory Audit Market. The ACCs were invited by the Audit Committee Chairs' Independent Forum ("ACCIF") and the notes below summarise the main points made in the meeting by individual ACCs and do not necessarily reflect the views of all the ACCs present.

Attendees:

CMA

Will Hayter (Project Director)

Laura Warren

Marie Clark (Economist)

Victoria Kent (Paralegal)

ACCs

Carl Hughes

Shonaid Jemmett-Page

Jock Lennox

David Lindsell

Mike McKeon

Brendan Nelson

Kevin Parry

Other

Laurie Hannant (ACCIF)

The headings in bold below reflect the principal topics or questions put to the ACCs in the meeting by the CMA Project Director.

Background views on the study/current view of the audit market

The ACCs pointed out that the issue underlying the CMA's Audit Market Study seems to be audit quality but the remedies that the CMA has proposed relate largely to competition. There seemed to be an implicit assumption behind the CMA Invitation to Comment that greater competition in the audit market is needed to improve audit quality. However, a good deal more research would need to be conducted in order to assess the extent to which there is a direct relationship between competition and quality. Any remedies put forward by the CMA should be designed primarily to maintain and enhance audit quality and quality must not be put at risk by any measures designed to improve competition.

The CMA officials agreed that increased competition only makes sense if it incentivises increased audit quality, and indicated that any remedies it recommended should not exacerbate the expectation gap.

ACCs also emphasised that much of the criticism of audit quality in fact arises from an expectation gap between what the public and financial statement users (including many investors) believe auditors are responsible for and what auditors themselves believe their responsibilities to be, as reflected in the audit framework of standards and guidance. An audit can therefore be of high quality under the audit framework but not meet the expectations of stakeholders and in the absence of agreement on the audit framework, increased competition in the audit market would not address this problem. This expectation gap has surfaced in all high-profile cases of fraud and corporate collapse for many years and is therefore not easy to bridge.

In this regard the ACCs felt that the “demand” side of the market for audit services, i.e. what stakeholders want from an audit, is not addressed sufficiently in the CMA Invitation to comment. It was in particular important to consider what investors want and the practical implications for the auditing profession.

The CMA stated that this is not their area of expertise and that their focus is how the market can best work with the audit framework as currently defined.

It was highlighted that audit committees (ACs) have fiduciary duties to investors and the UK Corporate Governance Code places significant responsibilities on ACs to oversee and assess the quality of the audit. It was felt that this was missing in the CMA’s Invitation to comment. However, despite the detailed information about the role of the AC that is included in the annual report and account, it is not well understood by stakeholders and investors and indeed investors appear to show little interest in the work of ACs.

Audit quality – aberrations or systemic failure?

ACCs did not have sufficient evidence to assess whether audit quality issues were exceptional, widespread, or universal and in the absence of sufficient evidence, it is impossible to identify remedy/remedies that would be both effective and efficient.

Based on the FRC’s audit inspection work, in 2017/18 there was an increase in the proportion of audits requiring more than limited improvements, although as regards the FTSE 350 this was the first decline (from 81% to 73%) since 2013. The issue is how to assess audit quality. ACs don’t have access to the audit files, so an ACC looks to the regulator and relies on the review and conclusions it reaches. The audit quality trend line might suggest that audit quality has deteriorated but the FRC tends to attach importance to process and documentation weaknesses, an example of which, highlighted by the FRC in its annual seminar for ACCs, was an error in an earnings per share calculation in a set of published accounts. Whilst this should not occur, such a shortcoming does not constitute “audit failure” and the regulator focuses too heavily on relatively minor issues and not on quality of key judgements and estimates, which usually relate to asset and liability valuation/measurement.

It was noted whilst the focus was currently on auditors and audit quality, responsibility for the accounts rests with the directors and ACs have an obligation to satisfy themselves about the integrity of the accounts and not merely to rely on the views of the auditors. Knowledge of the business and its performance on the part of the directors is also essential to enable them to assess properly the effectiveness of the audit.

How do you go about challenging the auditors?

The key to assessing the effectiveness of the audit is the quality of the face-to-face interaction by the ACC and the AC with the lead audit partner and (depending on the size of the company) other senior members of the audit team. ACCs typically meet the lead audit partner – independently of management - as part of the auditors' planning process, and again towards the end of the audit, to discuss the key audit risk areas (usually complex transactions and/or significant judgements), how they were addressed and the auditors' conclusions. The relationship between the ACC and the lead audit partner is of critical importance if there is a difference of view on an accounting or reporting matter between the auditors and management. Where a good ACC and the audit partner are in agreement, management will realise that must acquiesce. The audit plan and audit results respectively are then discussed by the AC with the senior audit team members, with management in attendance. However, at the end of the AC meeting, or sometimes before the meeting, the AC meets privately with the audit team to ensure that the audit team is able to raise any sensitive matters and to enable the AC to satisfy itself about such matters as the auditors' relationship with management. The ACC should already be aware of such matters through his/her contact with the lead audit partner.

It is also common practice for companies to obtain feedback from their finance team members on the effectiveness of the audit, including whether it was sufficiently probing and how well the audit team understood the critical issues. The feedback is then provided to the AC in connection its review of the effectiveness of the audit.

Differences between regulated and non-regulated businesses

There is a significant difference between regulated (financial services) and non-regulated businesses. In a regulated business, the auditors are approved by the PRA and the FCA, as are ACCs. There is a requirement for separate reports on certain areas to ensure that the auditors have covered the areas satisfactorily and the ACCs can be challenged on these areas. Sometimes a tripartite meeting is held between the regulator, auditor and ACC to further discuss and challenge the key judgements.

The financial services sector is much more interventionist and demanding for the regulator and accordingly its regulatory structure and approach requires a vastly greater budget than the FRC, which is a relatively low cost regulator, but the result is greater transparency and a higher likelihood of greater rigour by the AC/board in its monitoring of the integrity of reported company performance. In addition, outside of the regulated sector there are no requirements for 'sufficient capital'. However, there are a limited number of business models in the financial services sector, there are direct regulatory requirements regarding capital and liquidity which could not easily be applied for example to capital intensive businesses, and the rationale for much of the regulation of financial services is based on protecting customer deposits and minimising systemic risk, neither of which is relevant to other industry sectors. However, the structure of regulation for commercial business as a whole should be reviewed since the current structure lacks overall coherence. For example, in the financial services sector, audit quality and the quality of ACs is essentially policed by the PRA, not the FRC.

There was a suggestion that more specific obligations could be placed on directors to maintain adequate capital and liquidity as part of the UK Corporate Governance Code.

(Lack of) stakeholder engagement

The ACCs noted that they had never been asked a question by a shareholder at the AGM or any other time. In addition, in relation to audit tenders, major investors had been contacted in order to engage with them on the process, in accordance with The Investment Association's Guidelines on Audit Tenders, but there had been no response. There was a view that shareholders are too concerned about the remuneration committee and that errors in remuneration tend to be immaterial in the context of the company as a whole, whereas a poor audit is a major issue as it could result in the accounts being materially incorrect. Attempts have been made by some companies to create a level of engagement but it is a challenge and shareholders tend to engage only when they think there is a problem.

There was a recognition that investment managers are often running so many stocks in their funds that they do not review annual reports which have anyway become so voluminous as to be almost impenetrable. An AC who is a former CFO commented that in meetings with investors, all the questions asked were about the future, not about the accounts included in the preliminary announcement. Annual reports tend to be reviewed only by corporate governance specialists who are interested only in compliance with the UK Corporate Governance Code and generally have very little if any knowledge of the business concerned or its performance or state of affairs.

Although auditors are required by the FRC to review preliminary announcements, they are not required to review any presentation to analysts, which is the principal means for communicating company results and performance to the investment community. It is also illogical that enforcement of compliance with requirements relating to the annual report and accounts is in the hands of the FRC but the FRC does not review preliminary announcements, which are within the purview of the FCA,

Tenders for FTSE 350 audits – why do mid-tier firms not tender?

The perceived limited international reach and expertise of mid-tier firms, particularly in emerging economies, is a significant factor in decisions by FTSE 350 companies not to invite them to tender for the audit.

Lack of industry experience or other required specialist expertise is also considered to be a key factor in a number of sectors. It is difficult to see how to get the industry experience if a firm does not have any significant clients in the industry concerned (it was remarked that it was a like trying to join a golf club without a handicap) and in several cases mid-tier firms had declined to tender because the high risk of not winning the tender did not justify the significant investment required in order to put together a good proposal.

There was an expectation that mid-tier firms would have more success in tenders for audits of smaller companies in the FTSE 350 but this has not been the case. This is most likely because previously the mid-tier firms would have audited the companies concerned from their early days but the requirement to put the audit out to tender inevitably introduced the Big Four and with the Big Four you can be more sure of what you are getting than is the case with the mid-tier firms. The increasing regulatory burden, including the level of possible fines, might also be a contributory factor in discouraging the mid-tier firms from actively pursuing FTSE 350 audits.

Level of choice in the market given conflicts that may arise

ACCs had experienced reductions in the number of Big Four firms able to tender due to conflicts in virtually every tender. A choice of three firms might be regarded as sufficient but it is not satisfactory when only two of the Big Four, one of which is the incumbent, are able to tender.

There was a view that the conflict rules have gone too far by prohibiting the appointment as auditor of firms that provide relatively small amounts of prohibited non-audit services to a company or services that in practice (as opposed to conceptually) would have no impact on the objectivity of the firm were it to be appointed as auditor. Changing the conflicts of interest rules would be a more practical way of increasing competition for audits than trying to bring smaller firms into the market.

It was also suggested that more onus should be placed on company directors and ACs to check conflicts and where possible to avoid awarding contracts for prohibited non-audit services to an audit firm that could otherwise tender for the audit at least a year before an audit tender.

In view of the restriction of total non-audit services to 70% of the statutory audit fee, ACCs felt strongly that reviews of interim financial information and reporting accountants work on a prospectus should not be included in non-audit services for the purpose of the fee cap,

Tendering assessment decisions

The CMA has received feedback that terms such as ‘cultural fit’ or value alignment’ are commonly included by companies in the selection criteria for auditors. ACCs pointed out that the audit cannot be seen as an adversarial process as auditors are ultimately reliant on explanations as well as data they obtain and review, and this requires open and trustful working relationships between the auditor and management. Auditors need not only to ask the right questions but to ask them in the right way so as to elicit the most truthful, comprehensive and balanced response. Ultimately, an effective audit depends on how well the lead partner and the senior members of the audit team work with company executives. Industry experience may underpin the team but teams on the ground with the right relationships, asking the right people the right questions in the right way are essential.

Comments on possible remedies

Joint audit: the ACCs were strongly opposed to a joint audit regime. Joint audits are inefficient and give rise to a significant risk of conflict rather than collaboration between joint auditors. The joint and several liability regime would be a barrier, particularly for smaller firms. The joint audit regime has not prevented audit concentration in France and historically where a smaller firm was one of the joint auditors, the lion's share of the audit work was usually performed by the larger joint auditor.

Restrictions on audit firms providing non-audit services (NAS): the current NAS fee ceiling and auditors' ethical standards are highly restrictive and in fact act to reduce competition unnecessarily by ruling out from audit tenders firms that have provided services of a type or monetary value that are most unlikely to affect their audit objectivity.

Market share cap: ACCs pointed to the likely negative effect on audit quality and also the practical issues that would be involved in designing such a quota system. Where the cap came into play it could prevent audit committees from selecting the best qualified firm as their company's auditor.

Ring fencing: ACCs thought that ring fencing, with appropriate separate governance arrangements, might be an appropriate step at this stage, although it might increase the cost of audit, whereas forcing a break-up of the Big Four in the UK would create major problems for the resulting UK audit firms in managing and ensuring high quality audits of international groups, as well as making it more difficult for auditors to draw on specialist skills such as actuaries and valuation experts to assist them in the audit.

Final comments

There is evidence that the increasing burden of regulation and other environmental factors are making it more difficult for audit firms to recruit and retain high quality people who are able to perform high quality audits. There is a need to make auditing attractive to potential recruits. As the ability of auditors to provide advisory services has been reduced by rotation requirements and increasingly restrictive rules on NAS, auditors tend to obtain recognition only by uncovering problems and errors – or more likely by failing to do so - which is not attractive for individuals who are seeking a rewarding career. It is important that any remedies proposed by the CMA do not make it even more difficult for audit firms to recruit and retain high quality people.