Thursday 10th January 2019

Rachel Reeves MP
Chair
Business, Energy and Industrial Strategy Select Committee
House of Commons
London SW1A 0AA

Dear Ms Reeves,

BEIS Select Committee enquiry into the future of audit: A written submission on behalf of the Association of Practising Accountants

1. As Chairman of the Association of Practising Accountants I am pleased to provide a short written submission to this important enquiry.

2. The Association of Practising Accountants (APA) is a network of 15 leading business advisory firms meeting the needs of the mid-market. APA members collectively audit a significant proportion of the real economy from SMEs to AIM companies. We also bring specialist expertise in almost every sector of the economy, including areas such as the media, education and charities.

3. While individually our audit clients do not pose the same systemic risk as the larger end of the listed company sector in aggregate they represent a significant proportion of GDP – some 14,000 businesses with turnover up to the hundreds of millions. They are also significant employers and drivers of growth.

4. Your enquiry into the future of audit is timely, coming as it does around the recent publication of the CMA Market Study and Kingman Report as well as the Government announcement of the Brydon Review.

5. Paragraphs 6 – 11 set out some general observations on the current audit debate. Paragraphs 12 – 34 address your specific terms of reference.

6. In summary we think that:

   - The current spotlight on audit presents a real opportunity to put in place regulatory and market reforms that will ensure the long-term sustainability of the UK audit profession.

   - While the non-listed and smaller capped sector of the market is well served concentration across the FTSE 350 needs tackling. Moreover we think there is a significant risk that unless policy makers put in place steps to encourage a robust pipeline of new market entrants to compete for this work under a revised definition of PIE, concentration could worsen over the next decade through further industry consolidation at the larger end of the market, including among the larger challenger firms.

- There are a number of practical steps that could be taken now to mitigate this risk including reform of the current liability regime around joint appointment; the introduction of shared as well as joint audit; and a more proportionate approach to audit oversight from the proposed new regulator.

- In particular the introduction of shared audits, where there would still only be one signatory and the overall liability would lie with a single firm would further increase the likelihood of new entrants acting to support the firm signing the report, given the reduced risk they would face. The new entrant would gain experience dealing with larger entities and build their reputation and skills to allow a move towards joint audits.

- Policy makers also need to recognise that attracting smaller challenger firms to enter the market maybe a decade long project given the scale difference between the largest firms and these potential challengers. For example the turnover of KMPG, the smallest of the big 4, is £2,200 million. In comparison the typical APA firm has a turnover in the tens of millions. Meaningful reform has to make it attractive for mid-tier firms to commit the necessary investment in people and technology to scale up.

- Identifying the right combination of measures will require a spirit of openness and collaboration - the prize for getting this right is too important to squander on political point scoring or the defence of entrenched positions.

- With no fewer than four major reviews of audit in train at the moment it will be critical to ensure the conclusions and reforms arising from these reviews, are aligned.

7. We would dispute remarks that ‘the audit market is broken’. While there are a number of challenges that need addressing at the larger end of this market, we would observe that there is a vibrant and healthy middle-market between the statutory audit threshold and the FTSE 350, which tends to get overlooked in the rush to apportion blame for recent large scale corporate failures on the audit profession as a whole.

8. The audits that are carried out across the mid-market help ensure that this vital sector of the economy is well managed and kept on a sustainable footing, ultimately driving jobs and growth. There is a risk that a ‘one size fits all’ view of audit reform could impede a section of the market that is working well.

9. In a recent letter to the Financial Times[1] I cited qualitative research undertaken among APA member firms which suggested that “a significant minority would be willing to tender for more of the PIE / listed company sector if the regulatory and market barriers to entry were less acute. In particular our research suggested that compliance costs and increased liability exposure were the biggest disincentives for firms to enter this market. While scale and expertise were also identified as challenges, there was nothing to suggest longer term these could not be overcome”.

[1] https://www.ft.com/content/28a9a9a4-054a-11e9-9d01-cd4d49afbbe3

10. Reputational risk is also a significant concern for mid tier firms who cannot absorb the same level of fines, or bad publicity, that a big four firm can in the event of an investigation with or without an adverse finding.

11. Finally it is worth noting that the audit sector tends only to be in the spotlight when things go wrong. While reform at the larger end of the market is needed this should not detract from the many instances of high quality auditing at all levels where the robust challenge auditors provide management helps mitigate the risk of company failures that might otherwise occur, encourages investment and employment and greatly benefits the UK economy.

What is the relationship between competition and quality in the audit market? How should reforms in one area complement the other?

12. All things being equal increased competition should help drive audit quality and innovation, as it requires firms to have to work harder to differentiate themselves from their competitors.

13. While there is competition for the FTSE 350 between the big four firms, which appears to have increased in recent years, the real issue is that there remains a lack of choice outside the Big four resulting in periodic churn between these firms where the decisions of audit committees to appoint, as the recent CMA study suggests, can be driven as much by 'cultural fit' as innovation or quality of service.

14. Any meaningful long-term solution here has to create a context where medium-size firms can invest to achieve scale over time to take on more of this work. In 2013 the then Competition Commission reported that 'mid tier audit firms face barriers to entry, expansion and selection in the FTSE 350 statutory audit market'. There is little to suggest that change has occurred in the last five years despite the new audit-tendering regime introduced to encourage greater competition and choice in the wake of the financial crisis.

15. In our view, the aspiration should be to create a market where there is a choice of at least twelve firms at any one time who can deliver worldwide consistency to enable them to adequately audit international PIEs, together with a pipeline of potential market entrants with the scale and expertise to mitigate against the risk of future market concentration. Shared audit would enable firms to scale up for such work by increasing their exposure to international groups over time allowing them to progress to being sole or joint auditors.

16. Realistically this is a ten-year project, which will require regulatory and liability reform to tackle the increased risks and compliance costs that act as a disincentive for smaller firms to step up. Meaningful reform that eases the regulatory barriers on smaller firms here will create a more heteronomous market that should drive audit quality and innovation. As regards liability, a review of auditor liability would be beneficial to ensure that a workable limitation of liability mechanism, proportionate to the degree of fault, is introduced rather than the auditor simply being viewed as having the 'deepest pockets'. The current liability

regime simply does not achieve this and acts as a further disincentive to gearing up to take on larger listed audit work.

Do you agree with the CMA proposals? Will the remedies proposed be likely to increase quality and trust in audits? Are there any potential unintended consequences?

17. Trust in audit is the outcome of a range of factors including public and investor recognition that audits are carried out to a high standard.

18. While we are still digesting the CMA and Kingman proposals our initial view is that there is much to commend here. In particular their recognition that the listed company sector needs more choice is something that we support albeit that we were disappointed to see that joint rather than shared audit was the proposed remedy. In our view this is not an either or. Enabling listed companies to have the option of either joint or shared audits (but mandating the choice of one or the other) would address the immediate market concentration point by enabling the next tier of audit firms to gain valuable market experience. In our opinion shared audit works particularly well in this regard, because it would also ensure that a wider range of mid-tier firms, not simply the largest of the ‘challenger firms’ were able to take on subsidiary audits of larger entities so that they too could begin to gain the experience needed to compete effectively at this level.

19. We are concerned that joint audit alone, even if the inclusion of a non Big 4 firm as one of the joint auditors is mandated, will not reduce current market concentration not least because it will be all too easy for investors or audit committees simply to opt for the very largest of the non Big Four firms, resulting in the remainder of the mid tier still being effectively excluded from participating in this market or having the ability to become a challenger over time.

20. A further concern regarding joint audit is that by definition more time will need to be spent, as a whole, by the two joint auditors in performing the work which will require non big four firms participating in such audits to significantly increase resources, including at senior levels. Logically they will only be able to recruit such resources from the current mid tier firms which will in turn reduces the ability of these firms to compete or to upscale.

21. We were pleased to see that the CMA did not recommend the creation of audit only firms (although remain concerned this remains a potential remedy, further down the line). While this might appear superficially attractive it would limit the breadth and depth of resource firms can bring to an audit, resulting in a potential loss of quality. It would also limit the ability of the UK audit profession to compete globally.

22. Increased scrutiny of the appointment of auditors should help underpin confidence in the audit process. Again however, we would caution against a ‘one size fits all’ approach here. In our written submission to the CMA’s Market Study we suggested that ‘across the mid-market the majority of entities are owner-managed businesses where there is not the same need for an audit committee to

represent the interests of beneficial owners'. The needs of wider stakeholders also need to be considered.

23. A number of our firms do undertake audits where there is an audit committee or similar body, for instance AIM companies, certain charities or academy trusts, where there is therefore already an enhanced degree of scrutiny. The role of the audit committee, where there is one, should be required by legislation to ensure that auditors are appointed to undertake high quality work where the driver is not just cost but value, which includes an appropriate degree of robust challenge of management.

24. It is worth noting that at the top end of the market the gap between public expectations of what an audit delivers and what is required under current international auditing standards may indicate a need for enhanced standards for the largest, most complex entities. Until this gap is bridged either through better education by the sector or a repurposing of the audit model, trust in audit will continue to be an issue.

Do you agree with the Kingman proposals regarding the FRC?

25. The Financial Reporting Council is in a difficult position. Its desire to be an 'improvement regulator' tackling causes not symptoms is admirable but this has inevitably meant a degree of proximity to those it regulates which has contributed to a loss of public confidence that it can be truly independent.

26. Our sense is that it is has also struggled for scale and resource over the years, something that the decision by Government to remove the tripartite funding system has not helped.

27. Nonetheless a perceived failure to be tough enough in relation to a number of recent high profile cases has clearly also dented public confidence in the current structure and we think on balance that the Kingman recommendations will help restore this confidence.

28. From the point of view of encouraging new entrants into the FTSE 350 audit market we would like to see the proposed new regulator work closely with the Recognised Supervisory Bodies to ensure a genuinely proportionate regulatory regime. In practice this would mean the risks and costs associated with taking on a first larger listed entity – for a typical mid-market firm - no longer being completely disproportionate to the commercial benefits which might accrue.

29. Ensuring that the regime is genuinely proportionate would encourage more mid-market firms to enter this market and ensure that meaningful competition can be achieved over time. This could include delegation of some functions of the new regulator to the RSBs where appropriate, for instance in relation to reviews of small PIEs where the systemic risk is relatively low.

To what extent do conflicts of interest undermine trust in audit? How best can they be removed or mitigated?

30. At the top end of the market perceived conflicts of interest may well undermine trust in audit and it is beholden on the largest network firms to demonstrate why this is not the case. In terms of the mid-market there are robust rules that limit the type of non-audit services we can provide and we carefully safeguard against threats to our independence.

31. Moreover the typical purchaser of an audit from an APA firm is an owner-managed business where the purchaser is also the primary shareholder of the entity. As a result, there is generally an alignment of incentive in terms of the assurance we provide, although we accept that the needs of wider stakeholders need to be considered, not just those of the shareholders.

32. Our clients also rely on us for a range of advisory services where it is more efficient for them to purchase compliance support and business counsel from the same firm. As such we would urge any reform in this area is proportionate to the risk posed and does not impact on the ability of UK Ltd. to be able to rely on a one-stop shop for business and professional services. We do not believe that there are significant independence risks in providing non-audit services, as well as audit, to an owner-managed business that cannot be mitigated by appropriate safeguards.

How important to the quality of audit is the relationship between auditor and audited company? How can we ensure that there is the right level of challenge? What role should shareholders have in ensuring high quality audits?

33. Across the mid-market trust between auditor and client is critical and underpins the whole commercial relationship. This trust is at least in part an outcome of the audit work that we undertake where it is in the interests of the typical owner managed business to get independent challenge on their numbers as well as the robustness of their business model. There is nothing to suggest this relationship is not currently working.

34. Across the larger listed company audit market there may well be a need for greater challenge from audit committees, institutional investors and ultimate beneficial owners, as well as other stakeholders. Part of the challenge here is trying to get institutional investors engaged in a debate, which they often see as peripheral to their investment decisions. Any steps that require institutional investors to play a more active part in the stewardship of the companies they own on our behalf is to be welcomed. Greater diversity in the composition of audit committees would also encourage greater challenge in our view.

Are the proposed reforms of audit consistent with other recent reforms of corporate governance? Are there any other consequential reforms required?

35. Given the critical importance of good corporate governance to the effective operation of capital markets there may be scope to place a duty on auditors of

larger listed companies to report concerns around compliance to the proposed new Regulator as part of the broader corporate reporting cycle.

36. In conclusion we would reiterate that we think there is a real opportunity to put in place regulatory and market reforms that will ensure the long-term sustainability of the UK audit profession but that unless policy makers put in place steps to encourage a robust pipeline of new-market entrants, concentration could intensify over the next decade through further industry consolidation at the top end of the market.

Clive Stevens
Chairman
Association of Practicing Accountants
Ground Floor
4 Victoria Square
St Albans
Herts AL1 3TF

clive.stevens@krestonreeves.com

+44 (0) 1727 896087