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## **Market Study on Statutory Audit Services – Initial consultation on recommendations by the Competition and Markets Authority**

### **Introduction**

Members of the Association of Practicing Accountants (APA) collectively audit a significant proportion of the real economy from SMEs to the AIM market. We also bring sector expertise in areas such as the media, education and charities where a number of our firms undertake public interest audits.

Collectively we help drive employment and growth across the mid-market while at the same time ensuring that this vital sector of the economy is well managed and kept on a sustainable footing. In aggregate our clients represent a significant proportion of GDP – some 14,000 entities with turnover ranging from millions to hundreds of millions.

We also differ as a sector in that the entities that we audit are typically owner-managed businesses where the management of the entity are also its primary shareholders. As a result, there is generally an alignment of incentive in terms of the assurance we provide.

As mid-tier professional service firms we have two principle concerns:

- 1) That regulatory and market interventions imposed on the largest companies and their auditors do not disproportionately impede audits of the mid-market where there is everything to suggest our firms provide a valuable service which is working well.
- 2) That any meaningful long-term solution to the current concentration at the top end of the market creates a context where medium-size firms can take on more of this work over time. If the overarching objective is to encourage a more competitive audit market with multiple players helping drive quality and choice this should be key consideration.

We would be happy to brief you in more detail on the points raised in this submission.

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**1. 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. The new regulator needs to be given the tools as well as the authority to undertake its statutory responsibilities effectively if it is going to command public confidence. In practice we would hope this would entail a 'prevention is better than cure' approach where the regulator sets clear expectations of what good looks like and works with the profession to ensure the dissemination of best practice. While we agreed with many of the Kingman recommendations we were also supportive of the 'improvement regulator' approach the FRC tried to adopt and would hope the new regulator would be given the resource to do so properly.

**2. What comments do you have on the ways the regulator should exercise these new powers?**

We would advocate that the new regulator adopt a proportionate approach, which reflects the significant scale difference that currently exists between the largest firms and their smaller counterparts. If more firms are going to be encouraged to take on listed entities the additional risk this entails should not be a barrier to entry.

On the specific point on trigger warnings we agree that the sudden resignation of an auditor or a significant restatement of company accounts should both signal the need for potential intervention.

**3. How should the regulator engage shareholders in monitoring compliance and taking remedial action?**

The investor community need to be encouraged to take on a more active stewardship role on behalf of the beneficial owners they represent. For example, they could be encouraged to feedback the degree to which they felt audit committees were actively representing their interests with management. For such an approach to work there would need to be greater transparency of the audit committee process, which we would encourage. The regulator could then take remedial action where needed.

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

The audit committee could be mandated to submit a short, clearly prescribed report to the regulator each year who could then test it as part of its regular file reviews.

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

No. Our concern is that there are currently very few if any firms below the Big 4 with the expertise, capacity or the risk appetite to take on joint liability for a typical FTSE company. In a best case scenario joint audit addresses the immediate concentration issue by allowing a very limited number of next tier firms to take on some of the less complex entities. However, this alone does not alone create the conditions that will allow a pipeline of challenger firms to be developed over time that could realistically take on this sector of the market. Shared audit has to be the write solution in this context.

**6. Do you agree with the CMA's proposed exemptions to the joint audit proposals? How should the regulator decide whether a company should qualify for the proposed exemption for complex companies?**

Yes. At this point in time it is unrealistic to think that any other than the largest global network firms could (for example) take on responsibility for a global energy company or complex financial services institution. This decision should be based on an open exchange of views with the firms on what should be out of scope.

**7. 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?**

With the exception of perhaps the 3-4 firms immediately below the Big 4 no. However shared audit could provide this staged approach. This model - where one firm is designated as the statutory auditor of the parent group with the other firm supporting this process through, for example, the auditing of group subsidiaries – already exists. With the right regulatory and political

frameworks in place, shared audit could help open up the market to a

significantly larger proportion of challenger firms, enabling them to build up expertise and capacity. Over time we believe that this is the best means of increasing market choice.

**8. 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. Without liability reform it will be difficult to convince challenger firms to take on board the additional risks associated with these kinds of audits given the significant scale difference between the largest firms and their competitors. Shared audit could be one mechanism for reducing this risk.

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

Through a scaled approach where challenger firms can build up the necessary expertise through a shared audit model which would then enable them to take on joint audits overtime. Corporates would be free to determine which approach (joint or shared) they adopted, based on a cost benefit analysis of need.

**10. 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 seen nothing to indicate these estimates are inaccurate. We would see this increase in cost as something the market should be willing to bear if this leads to greater choice over time.

**11. Do you agree with the CMA's assessment of the alternatives to joint audit, including shared audit?**

No. For reasons set out above we believe shared audits should also be part of the list of remedies where there is likely to be less duplication of work and where it is easier to limit liability exposure to the smaller firm. While there is risk that such an approach could drive up costs, if this allows smaller firms to get a foothold into the market the public value would be worth the pain.

**12. 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 believe they should help open up the market. In our response to the Kingman Review we argued strongly for the need for the regulator to take a more proportionate approach to audit regulation. Taken together we believe shared audit and a more proportionate approach to regulation could bring about the step change that is needed.

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

We think this is an interesting idea which would be worth exploring further / piloting in consultation with wider market participants provided conflict issues can be addressed.

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

As noted above, given the scale differences between Big 4 and challenger firms, we see any meaningful reform being a 5 – 8 year project, which regulators and policy makers will need to accept as the price of bringing about change. This is as much about mind-set as measures.

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

We were supportive of the agree CMA recommendations here.

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

Again, we were supportive of the CMA recommendations.

**17. 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?**

From a mid-market perspective, where the managers of the entity are often also the beneficial owners of that entity, there is greater alignment of incentive here meaning these tensions are less likely to arise. At the top end of the market we can see how non-audit service provision can create these tensions which clearly need managing with effective regulatory oversight.

**18. 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 are supportive of the proposed operational split for the largest firms, which sends a message to market that active steps are being taken to manage perceived conflicts here. Under this approach auditors will be focussed on audit while still allowing for essential services, linked to audit to be carried out. We were also supportive of the CMA recommendation to limit this split to the Big 4 (or firms that scaled up to equivalent size).

**19. Are there alternative or additional measures, which would meet these concerns more effectively or produce a better market outcome?**

We were supportive of the CMA's proposed approach here.

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

No. A full structural split of the Big 4, even if this is held back as a reserved measure, will do little to help provide the largest entities with the strategic advice and support they need from their advisors to help drive jobs and growth.

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

While the largest firms will be better placed to answer this question it will be important to ensure that any operational split that is introduced does not impact negatively on the ability of the profession to attract the brightest and the best talent.

**22. 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?**

When things go wrong it is understandable that auditors are called to account but it is often the case that a failure of company stewardship or governance are actually to blame. Taking Carillion as a case in point the company was highly exposed to the public sector at a point in time when this sector was reducing its expenditure significantly. Arguably this risk should have been identified and managed better earlier. Any fully rounded package of remedies will recognise this balance of responsibility between market participants.

**23. Do you agree with the CMA's suggestions regarding remuneration deferral and claw-back?**

Any such proposals will need to be carefully thought through to avoid unintended consequences. For example, we could well see such an approach having a negative impact on the ability of the firms to attract new auditors into the profession. More broadly this proposal should not impact on the ability of firms to invest in measures that will improve audit quality.

**24. How would a deferral and clawback mechanism work under a Limited Liability Partnership structure?**

This is something that would need to be fully explored as part of any risk assessment of these policy proposals.

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

We can see real merit in such an approach not least because attracting new forms of capital could enable challenger firms to scale up more quickly.

**26. Do you agree with the CMA's suggestions regarding technology licensing?**

Yes. Smaller firms simply do not have the economies of scale that the Big 4 have to invest in new technologies that can help drive audit quality. Such an approach would benefit the market as a whole and ensure greater uniformity of approach.

**27. 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?**

Yes. We are also supportive of a UK equivalent of a PCAOB if this increases company accountability.

**28. 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?**

These proposed remedies could help increase competition provided they do not compromise continuity in circumstances where a company decides to switch its auditors.

**29. Do you agree with the CMA's suggestions regarding tendering and rotation periods?**

We think that the current tendering regime is still bedding in and should be given time to work before the existing tendering and rotation periods are changed.

**30. Do you have other proposals for 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.**

While the CMA were lukewarm on shared audit, we think that its introduction could really help open up the market. A number of APA firms already undertake audit work for subsidiaries of listed companies under a shared audit approach so we know this model can work. Other member firms would like the opportunity to take on more listed company audits but currently lack the scale and sector experience to be able to do so. As noted above we believe that with the right regulatory and political frameworks in place, shared audit could help open up the market to a significantly larger proportion of challenger firms.

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

We are aware that this is something that the Big 4 have been considering in detail. Overall we would favour a voluntary, market led approach where this

can realistically be shown to being about the change that is needed but recognise that market and regulatory intervention are also needed here.

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

Audit is integral to the effective operation of capital markets as well the sustainable growth of many of the owner managed businesses which help drive employment and prosperity across the UK. Research we have undertaken suggests that our clients value audit for a variety of reasons from better access to capital through to the challenge we provide management.

There is every indication to suggest that audit across the mid-market, which includes a significant proportion of the real economy, is currently providing a valuable service to its stakeholders who rely on the assurance we provide in order, among other things, to secure funding for growth.

While there are legitimate questions to be asked of the audit profession when there is corporate failure it is worth remembering that there are many examples of high quality audit that go unremarked because the profession has done a good job.

At the top end of the market more needs to be done to bridge the expectation gap between what an audit provides and what stakeholders might legitimately expect it to provide. If this requires that the profession work with wider market participants to rethink the current audit model we would be supportive of this move provided it does not disproportionately impact the mid-market whose stakeholders are different and value the service we provide.