Statutory Audit Services Market Investigation

Notice of possible remedies under Rule 11

I should like to respond to your invitation to comment on proposed remedies.

My response is purely in a personal capacity. However, as background, I have extensive experience at board level and on Audit Committees over the last 19 years. I am currently chairman of a listed UK company and chairman of the audit committee for two UK listed companies. Previously I was CFO of a FTSE 100 company and have previously served as audit committee chairman on two other significant listed companies. However, whilst being a qualified accountant, I have never worked for any audit firm.

General Comment

1. The major competitive issue in audit services would seem to be the dominance of the big 4 audit firms. It is therefore a little surprising that none of the proposed remedies attempt to address this directly.
2. In this regard, the Competition Commission (CC) appears not to have understood nor investigated deeply why so many companies overwhelmingly choose to appoint big 4 firms in the current market.
3. The CC has developed a simplistic market model in which executive management seeks to pressurise audit firms to be amenable to management, audit firms give in to this pressure to retain their position and non-executive directors are largely irrelevant. It is not clear where the CC gets sufficient evidence to support this view, which would be a surprise to most company directors.
4. The CC appears to pay insufficient regard to the purpose of statutory audits beyond the signing off of judgemental numbers, for example in providing control reviews. The value of these can only be judged by directors who spend significant time reviewing such matters directly with the auditors.
5. The CC does not make a persuasive case that more frequent tendering or rotation would increase competition, and especially that this would result in more non-big 4 appointments.
6. The CC argues that the statutory audit is performed for the benefit of shareholders. However, this excludes other stakeholders who rely on accounts, notably providers of debt to the company.
7. The CC reflects current institutional shareholder pressure for more engagement in the audit process. However, it fails to take due account of the considerable opportunities that already exist for such engagement, and does not succeed in making the case that its proposed remedies are both necessary and proportionate in providing opportunities to engage beyond those already available.
8. Having participated in some of the CC-commissioned market research for this inquiry, I would express some reservations in the CC relying too much on the reported results due to the quality and scope of the questioning that I observed.

Issues for comment 1

26.Views are invited on the specification, effectiveness and proportionality of this remedy and, in particular, on the following:
(a)What an appropriate time frame for requiring mandatory tendering might be, given the bounds suggested above?

The case that mandatory tendering will improve the alleged 'adverse effect on competition' (AEC) of auditor concentration seems to be insufficiently convincing. The CC argues that a 'settled period of auditor appointment' would reduce 'incentives of auditors to compete to satisfy management', yet this is exactly the current situation of auditor longevity that the CC regards as giving rise to a possible AEC. The evidence of the CC's own research does not support the assertion that more tendering will reduce Big 4 dominance.

Mandatory (as opposed to 'comply or explain') tendering would potentially cause adverse effects in forcing companies to tender for an audit at times that management efforts need to be focussed on more pressing or urgent matters, for example when under an Offer or when trying to reschedule debts or when key personnel are changing. More frequent tendering is already being introduced as a governance requirement. The evidence is that companies' compliance with corporate governance 'comply or explain' requirements is very high, so further compulsion is neither necessary nor proportionate.

I believe that it is a matter of good practice that every supplier has to retender from time to time. In this respect a 7 to 10 year best practice ('comply or explain') benchmark is appropriate.

(b) Whether and for what reason the measure may be subject to 'comply or explain' implementation?

As discussed above, companies should always be allowed to defer tendering provided that they explain their reasons. If shareholders are unhappy with such action, they have the opportunity to vote against the board at each AGM.

(c) How a valid 'tender' and its constituents should be defined, including whether and how best to provide access to relevant information on an 'open book' basis?

A valid tender would be one where more than one audit firm is invited to bid for the company audit.

(d) What costs and benefits would arise as a result of this remedy?

The costs would be significant to both audit firms and tendering companies. Presently significant cost reductions are generally available to companies that tender. However, when tendering becomes more common, that competitive edge is likely to disappear in order to preserve audit firms' margins.

(e) What should be the requirements for phasing in this remedy? For example, those companies with the longest period since last tender may be required to tender first within a specified period.

The CC need do nothing as the 10 year benchmark and its implementation is already in hand.

Issues for comment 2

34. Views are invited on the specification, effectiveness and proportionality of this remedy and, in particular, on the following:
(a) What an appropriate time frame for requiring mandatory rotation might be, given the bounds suggested above and how this might relate to mandatory tendering periods if this were also to be pursued?

Mandatory rotation would seem unnecessarily intrusive if retendering were already prescribed.

Given that for many companies, a big 4 firm is the only practical choice, mandatory rotation would rule out the incumbent, reducing effective choice to three. Furthermore, it is quite likely that two of the big 4 are already providing transaction and tax advice, so mandatory rotation would in many cases force a change to a predetermined firm. Mandatory rotation will, by definition, reduce choice for boards, which would seem a counterintuitive remedy for a competition authority to argue.

The CC argues that audit firms work ultimately for shareholders. If shareholders wished mandatory rotation, they have it easily in their powers to mandate their boards to do this. The case that the CC should substitute its judgement for that of shareholders seems not to be justified.

(b) Should any such measure be subject to a waiver from the regulator (FRC) if a company's choice of auditor was substantially constrained and how would such a waiver operate?

The ultimate decision on issues such as this should always rest with boards that are directly responsible to and elected by shareholders.

(c) How a valid 'tender' and its constituents should be defined as a prelude to rotation, including whether and how best to provide access to relevant information on an 'open book' basis?

Mandatory rotation is neither an appropriate nor a proportionate remedy.

(d) What costs and benefits would arise as a result of this remedy?

As above.

(e) What should be the requirements for phasing in this remedy? For example; those companies with the longest period since last rotation may be required to rotate first within a specified period.

As above.

(f) Whether there are any other relevant considerations to be taken into account in evaluating and implementing this remedy?

As above.

Issues for comment 3

41. Views are invited on the specification, effectiveness and proportionality of this remedy and, in particular, on the following:
(a) How the AQRT's remit should be designed in terms of enhanced scope and frequency. For example;
(i) How frequently should FTSE 350 company audits be reviewed (and whether this should differ between FTSE 100 and FTSE 250 companies)?
(ii) Should the AQRT be required to published FTSE 350 results separately from other Public Interest Entity results?
(iii) Should the AQRT be required to change the scope of its review and if so, how? For example; should the AQRT be required to revisit key audit judgements based on the information then available?
(iv) How could AQRT reporting be expanded to allow better comparison of Big 4 and non-Big 4 firms?

The AQRT reports are currently of limited value to Audit Committees, tending to be an audit of an audit. This is not the same as a review of how effective an audit is for the customer, the audit committee (nor in fact how effective for shareholders either). The AQRT could start, for example, by asking company management and audit committees what they think of the quality of their individual audit. The CC, like the FRC, undervalue the possibility that management and audit committees understand what their auditors are doing. Regulators seem curiously keen to dismiss customers' view of their own suppliers.

Issues for comment 4

45. Views are invited on the specification, effectiveness and proportionality of this remedy and, in particular, on the following:
(a)The range of documents to which this prohibition should be imposed and how the prohibition could be best implemented. For example: are there documents in addition to Loan Management Association lending agreements that this prohibition should cover?
(b) What costs and benefits would arise as a result of this remedy?
(c) Whether there are any other relevant considerations to be taken into account in evaluating and implementing this remedy?

There is no justification for lenders, or any other third party, to specify which audit firms may or may not be used by a company.

Issues for comment 5

52. Views are invited on the specification, effectiveness and proportionality of this remedy and, in particular, on the following:
(a) How this remedy could be practically specified and implemented? For example, what change to ACC availability and remuneration would be necessary for ACCs to take on an enhanced role effectively? How should this measure be specified to avoid circumvention?

(b) Whether this remedy could be implemented as an extension to the current guidance on the role of the AC? How this could be implemented without affecting the current collective legal obligations of the directors of a company?
(c) What costs and benefits would arise as a result of this remedy?
(d) Whether there are any other relevant considerations to be taken into account in evaluating and implementing this remedy?

All of these proposals are in line with best practice now. There is no need for compulsion, being neither appropriate nor proportional, as some minor reinforcing of the Corporate Governance Code would achieve the desired effect with high levels of compliance.

Issues for comment 6

57. Views are invited on the specification, effectiveness and proportionality of this remedy and, in particular, on the following:
(a) What are considered to be the most effective means of enhancing shareholder engagement on audit and financial reporting issues?
(b) Suggestions as to how such means could be achieved.
(c) What costs and benefits would arise as a result of this remedy?
(d) Whether there are any other relevant considerations to be taken into account in evaluating and implementing this remedy?

Shareholders already have adequate opportunities to engage further in the audit process. Institutional shareholders speak directly to executives, to chairmen and can speak to non-executives if they wish. Individual shareholders can attend AGM's and ask questions or engage with any director. The fact is that these opportunities are very rarely taken up. That however is shareholders' prerogative.

AEP's usually attend AGM's. It would be a relatively harmless remedy to require that an AEP say a few words about the audit at the AGM, but it is not clear what the CC thinks they would say that would be helpful to shareholders.

A dedicated ACC Q&A session is superfluous, since most AGM's already invite questions from shareholders. When a shareholder has an issue or question about the accounts, they are free to – and do - raise this now. I have indeed been asked once at an AGM why we didn't tender the audit and I replied to the satisfaction of the shareholder. Further regulation is unnecessary, being also intrusive and disproportionate.

Issues for comment 7

64. Views are invited on the specification, effectiveness and proportionality of this remedy and, in particular, on the following:
(a) How the CC may best support the FRC in establishing enhanced reporting and whether there are other avenues, including direct measures by the CC, that should also be pursued?
(b) What should be the scope and form of enhanced reporting proposals? For example:
(i) whether further disclosure should be made via the AC's report or the auditor's report;

(ii) what the content of the additional disclosure should be. For example, should this be some form of commentary as to how the company's interpretation of the accounting standards compares with the norm; or commentary on the main topics of debate between auditor and management; or something else; and
(iii) what guidance as to the form of the disclosure should be required.
(c) What costs and benefits would arise as a result of this remedy?
(d) Whether there are any other relevant considerations to be taken into account in evaluating and implementing this remedy?

Considerable progress has been made in recent years in the quality of audit committee reporting. The FRC is working further on this topic. It is not clear why the CC needs to intervene to prefer its judgement over that of the nominated specialist regulator.

Simon Laffin