



Statutory Audit Market Study
Competition and Markets Authority
7th Floor, Victoria House
37 Southampton Row
London
WC1B 4AD

30th October 2018

Dear Sirs,

We are writing to you on behalf of the UK Shareholders' Association (UKSA) and the UK Individual Shareholders' Society (ShareSoc). Although both organisations are independent, we work closely together to represent the interests of private shareholders.

Responses to a number of the specific questions you ask are contained in the appendix to this covering letter. None of the information contained in the letter or the appendix is confidential. We would also be pleased to discuss any of our comments and suggestions with you in more detail if this would be helpful.

1. Summary of Recommendations

We believe that there is competition in the market for audit services, although in the case of FTSE 100 companies, market competition is limited. Wider choice and more competition would be beneficial. Nonetheless, competition does not necessarily lead to improved quality which is the main concern about audit at present. We believe that the main problem lies in the way in which audit services are procured. We recommend that:

- The regulator (the FRC) should work with preparers and users of financial reports to develop a specification for audit services which is fit for purpose in relation to current accounting standards.
- There should be a stakeholder group within each company which should be involved with the audit committee in the procurement of the audit contract. Both the audit committee and the stakeholder group should receive appropriate training as and when required.
- Training should be provided either by the appropriate regulator or accredited training providers. Accreditation should be by the government or regulator working in conjunction with the Chartered Institute of Purchasing and Supply (CIPS).
- The regulator or a similar body should carry out a review of a sample of audit procurements each year to ensure that the process is rigorous and is performed in a spirit of open and fair competition and with a view to the achievement best value for money rather than lowest cost.

- The members of the stakeholder group should meet formally on at least a six-monthly basis with the audit committee and informally as required to allow stakeholder oversight of the work of the external auditor.
- Stakeholder groups should have the opportunity to review and comment on the work of the internal audit team.
- FTSE 100 companies should be given positive encouragement to implement 'reverse marketing' programmes to encourage mid-tier audit practices to acquire the necessary breadth of resource and experience to carry out audits for them. This could include approaches such as splitting the audit between two firms.
- Firms providing audit services to large companies and PIEs should not be allowed to sell consultancy services.
- The regulator (currently the FRC) should use the teeth it already has to apply strong sanctions against individuals within the audit and accounting industry who fail to carry out appropriately high standards of work. This is likely to mean disqualification from practicing in the same way that doctors can be disqualified in cases of professional negligence.

Our recommendations are discussed in more detail in Section 2 below.

2. The procurement background

Audit services for FTSE 100 and FTSE 250 companies are not a trivial purchase. They cost many millions of pounds and are of vital importance to investors and often to other stakeholders such as customers and suppliers. It is well worth ensuring that the procurement process for external audit services follows best practice in procurement.

Current approaches to the procurement of audit services are often deficient in a number of areas. We have identified below the key steps in the procurement process in which we believe there are deficiencies. We have also suggested how these might be overcome.

2.1 Setting the specification

The specification for any product or service should be based on a full assessment of stakeholder needs. In the case of external audit, stakeholders are likely to include:

- investors (institutional and private)
- customers (who want to be sure that key suppliers will be able to deliver on contractual commitments)
- suppliers (who want to be sure they will get paid)
- employees (who want to be sure that their jobs are not at risk due to the financial mismanagement of the company or deceit)
- the company's directors (who want an independent check that, for example, fraud is not taking place).

There may be others, depending on the company and its activities.

Some of these stakeholders are more important than others. The shareholders are a key stakeholder group and the primacy of shareholders is recognised in CA2006, S172. The audit is primarily for their benefit and they are ultimately the ones who pay for the audit. It is vital

that their needs and expectations are met. The directors of the company are relatively minor stakeholders. They act as the buyers of the audit on behalf of the other stakeholders.

The problem with the audit specification process

The problems with the system at present are that:

- The key stakeholders, particularly the investors, make almost no input to the specification for audit services. It is not clear to most investors whether a satisfactory specification is issued to bidders for audit services. It is likely that very few investors have ever seen a specification for audit services and that even fewer have been asked to comment on it or to agree whether it meets their needs. This is a crucial issue. If the specification is wrong (or deficient in any way) the service purchased will not meet the needs and expectations of the key users. Money will be wasted buying a service that is not fit for purpose. In the worst cases it will positively unhelpful.
- Senior management have a much more limited role to play as stakeholders. They have (or should have) an interest in the audit as an external check on the company's own financial control and management systems. However, they are also potentially conflicted. Both management and auditors are incentivised. Under *current* accounting rules there are often incentives for directors to influence valuations and judgements by the auditor which will affect management bonuses. Incentives to audit partners to retain audit business may make them inclined to acquiesce.

The solution

There has to be an effective system for allowing key stakeholders to make their input to the audit specification. One way of doing this would be to create stakeholder groups. Each company would appoint a stakeholder group which would work with the members of the audit committee to agree the audit specification. This need not be particularly onerous. It is likely that a standard, outline specification for audit services can be developed which individual companies and their stakeholders can adapt for their own specific needs.

It is likely that, initially, this process would benefit from specialist external advice and guidance, possibly from the Regulator (currently the FRC), to ensure that:

- Members of the stakeholder groups were appropriately briefed on their responsibilities and given whatever training was necessary (as for, for example pension fund trustees).
- Measures were implemented to ensure that the stakeholder group could not be 'captured' or disrupted by extremist single-issue or special interest groups.

Expert procurement advice from The Chartered Institute of Purchasing and Supply (CIPS) might also be beneficial. This should be accessed via the Regulator.

2.2 Ensuring a competitive market

Use of competitive tendering does not guarantee the quality of a product or service. However, it is helpful if buyers have a choice. The spur of competition and the ability of customers to switch suppliers if they are dissatisfied with the service they are receiving are important in ensuring that value for money is achieved. In the case of the market for audit services, there is competition but it is not working as well as it could.

The problems surrounding competition

There are a number of concerns about the way in which competition works in the audit market:

- There is a perception that the audit for FTSE 100 companies can only be handled by one of the Big Four audit practices.
- The Big Four all have consultancy practices; rules designed to limit conflicts of interest by limiting the amount of non-audit work they can do for a client have the perverse effect of limiting competition. If the external audit is tendered and the consultancy arm of one of the Big Four auditors is carrying out a large IT project for the company it may mean that it is excluded from bidding for the audit contract. If another firm is providing internal audit services (as with Deloitte at Carillion) it may be that there are really only two potential bidders, one of whom is the incumbent.
- Where an audit firm also has a large consultancy business, there are perceptions that the audit practice acts as a source of 'leads' for the consultancy business. Despite the limitations on the amount of consultancy that the auditor can carry out, the consultancy work can still be financially attractive. This can create conflicts of interest. It has the potential to distort good judgement and business culture.
- There is an incentive for audit partners to want to retain audit contracts; no one likes to lose business and audit partners may be under pressure from their own side to go along with the blandishments of senior client-side management - particularly when the issue at stake is likely to affect bonuses on both sides.

The solution

The claim that only a Big Four auditor can realistically handle the external audit for a FTSE 100 company looks lame. It smacks of the 'nobody-got-fired-for-hiring-IBM' argument. Furthermore, if the market for audit service was working properly FTSE 100 companies would not have allowed themselves to get into a position in which they were dependent on just four suppliers.

One possible response to an uncompetitive supply market is for buyers to adopt a policy of 'reverse marketing'. This involves encouraging other, possibly smaller, suppliers to invest so that they can become an effective competitor. It usually requires help and commitment from the buying organisation but over the long term it pays off. It is hard to believe that action of this sort cannot be taken to help some of the mid-tier audit firms to increase their audit capabilities so that they can compete in providing excellent audit services for FTSE 100 companies.

It would be better if audit firms did not provide consultancy services to large companies and PIEs. As indicated above there are serious potential conflicts of interest if audit partners are seen as a source of leads for the consultancy practice. For small accounting and audit firms servicing small, often local, businesses this is not an issue.

The Financial Reporting Council (FRC), as the regulator overseeing the accounting and audit industry, needs to take a much tougher line with both the preparers of accounts and the auditors in all cases in which it is clear that the principles (not just the rules) of financial reporting and auditing practice have been abused. Heavy fines levied on companies have little impact. The fine of £10m (reduced to £6.5m) levied on PWC over audit failures at BHS can be seen as little more than a cost of doing business for a practice with worldwide turnover of £3.7bn. However, the fifteen-year ban on Steve Dennison from practicing as an auditor sends a much more significant message to senior practitioners that they need to take their responsibilities very seriously. The FRC, therefore, should be ready to make full use of the powers that it already has to penalise poor audit quality. This is vital in the current business environment in which fair-value accounting principles can be 'gamed' to ensure that bonus targets (and hence payments worth millions of pounds) are achieved by senior management.

2.3 The tendering and evaluation process for audit services

The problem

The way in which the tendering and evaluation process works for audit services appears in most cases to be opaque. It is usually carried out by members of the audit committee. It is also usually unclear:

- How the evaluation criteria were set and agreed, how they were 'weighted';
- Whether they reflected the true needs and expectations of the key stakeholders;
- Whether the whole evaluation process was as thorough as it could be, was properly documented and open to scrutiny.

The solution

Good practice procedures for the procurement of audit services should be prescribed by, probably, the regulator acting as an agent of the government on behalf of the stakeholders. The regulator should carry out its own review of a sample of tenders and the evaluation and selection process on a regular basis to ensure that they have met required standards.

In addition to this, when the audit is put out to tender, the bid-evaluation panel should include at least two or three members of the stakeholder group. There should be a report on the process in the annual report and accounts which should go well beyond the current sketchy summary contained in the report of the audit committee. The process should also be reported on at the AGM. As retendering is only likely to happen once every five to ten years this should not be onerous.

2.4 Contract management and supplier relationship management

The problem

Currently the audit committee appears to have responsibility for the management of the external audit contract. We say 'appears' because in most annual reports the commentary on the work of the external auditor is contained within the audit committee report. However, there is no statement of what constitutes best practice in this area and there are concerns about the scope for senior executive managers to apply undue influence to the deliberations of and any recommendations by the auditor.

In most cases the report on the external audit and the specific issues addressed is superficial and vague. Shareholders are told that the auditors identified key risks for audit consideration. However, they are not told why these were considered to be key risks. Nor are shareholders told what the outcome of the auditor's work was – apart from reassurances that everything was alright. All too often it appears that the so-called audit plan was devised so as to put a tick in series of check-list boxes by the auditor regardless of whether they were really relevant to recent developments within the business. In the case of Persimmon PLC, the audit committee report states:

'The Committee ensures that the auditor has exercised due professional scepticism. The Committee has reviewed and is satisfied with the performance of Ernst and Young plc'.

Nothing could be less enlightening for shareholders – and this in relation to a critical service for which shareholders paid £169,000 plus a further £46,000 for non-audit work. The exact nature of the non audit work is not specified.

A further area of opacity involves the early termination of an audit contract by either side. Currently there is no requirement to for the company or the auditor to say why the contract has been terminated. If an auditor resigns the audit or is dismissed by the company the shareholders must be told why.

The solution

It is appropriate that the audit committee should maintain daily and weekly contact with the auditor. It is also appropriate that the audit committee should be directly involved in shaping and agreeing the auditor's plan of work. However, there also needs to be a system which allows the stakeholder group to have clearer oversight of the plan of work developed by the auditors and to monitor the progress and performance of the external audit team. This should include being able to ask the auditors questions about their work and what they have found. If necessary members of the stakeholder group should be able to meet with the auditor on their own and without directors or non-executive directors present. Formal reviews at end of one year / beginning of the next and in the middle of each year should be sufficient as a minimum

Too often it seems that the work of the internal audit function bears little relation to the issues addressed by the external auditor. The activities of the external auditor receive superficial mention in most annual reports. However, the activities of the internal audit team receive even less coverage – despite the fact that this is a critical function within the

business. The stakeholder group, therefore, should also have a degree of oversight over the work of the internal audit team.

This is an area which should be of significant interest to shareholders. However, it is also an area in which input from employee representatives on the stakeholder group would be extremely valuable.

Clear guidance from the FRC or the appropriate regulator should be provided to help the members of the stakeholder group in performing this task. Appropriate training should be provided. At the AGM a member of the stakeholder group should be required to report to the meeting on the management of the external audit contract and key elements of the work of the internal audit team.

It has to be assumed that an auditor will only resign the audit contract or be dismissed by the company if serious disagreements have emerged and the working relationship has broken down. In this situation it is vital that shareholders are told exactly what has gone wrong. There are strong arguments for suggestion that the company should be forced to call an EGM so that both parties can be questioned by shareholders.

2.5 End of contract review prior to audit retender

Investors have to assume that companies carry out some sort of review of the audit contract when it comes up for retender. However, it is rarely clear what this involves. How rigorous is this process, what worked well, what didn't work so well and how should the specification for audit services be amended to take account of future and / or changing requirements when the contract is retendered? Shareholders are never told this.

This is another area in which stakeholder groups should be involved and in which they could make useful input.

3. Conclusions

The issue of audit quality is subject of great interest to private investors. Private investors are investing their own money (not somebody else's) and they want to be sure that:

- They have a clear understanding of the scope and purpose of the audit i.e. that there is a no mismatch between their expectations of the reassurance that the audit is providing and the levels of reassurance that the auditor believes he / she is reasonable able to provide.
- The information and opinions provided by the auditor are reliable as an aid to making investment decisions and performing their stewardship obligations satisfactorily, taking into account any agreed limitations and constraints. Investors want audits that are fit for purpose.

There have been a number of well-publicised cases recently which have caused investors to question whether audits have been carried out to a sufficiently high standard. Tesco, Carillion and Patisserie Holdings are just three of the most prominent recent cases. However, this is not just an issue of whether quality could be better. In a number of cases there appear to have been fundamental audit failings which call into question the whole value of the audit process. Competitive tendering may have helped to control audit costs but

low cost does not necessarily equate to value for money. If the external audit is deficient it is a complete waste of money. In fact, if it provides false assurance to investors, it is misleading and is worse than useless.

The external audit is a service that is so important that it is worth expending more resource and paying more to ensure that the service purchased is fit for purpose. The vast majority of shareholders would subscribe to this principle.

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