ICAEW
REPRESENTATION 127/18

REVIEW OF THE FINANCIAL REPORTING COUNCIL BY SIR JOHN KINGMAN: ARRANGEMENTS FOR AUDITOR PROCUREMENT AND REMUNERATION

Issued 9 November 2018

ICAEW welcomes the opportunity to respond to the invitation from Sir John Kingman to submit views regarding the arrangements for auditor procurement and remuneration. This extension to the remit of the Review Sir John is leading of the operation of the Financial Reporting Council (FRC) was requested by the Secretary of State for Business, Energy and Industrial Strategy on 8 October 2018, available from this link. This response follows our previous evidence to the Review (available here) and our recent submission to the Competition & Markets Authority's (CMA) market study into the supply of statutory audit services in the United Kingdom (available here).

ICAEW is a world-leading professional body established under a Royal Charter to serve the public interest. In pursuit of its vision of a world of strong economies, ICAEW works with governments, regulators and businesses and it leads, connects, supports and regulates more than 150,000 chartered accountant members in over 160 countries. ICAEW members work in all types of private and public organisations, including public practice firms, and are trained to provide clarity and rigour and apply the highest professional, technical and ethical standards.

We believe that the key focus of both the Kingman Review and the CMA's market study should be audit quality: ensuring that it continues to improve and continues to meet the existing and evolving expectations of customers and other stakeholders. We are sceptical about whether the number of firms active in the market for large corporate and Public Interest Entity audits has a direct causal link to auditor performance as the specialised nature of audit means that quality is driven by internal quality control, external monitoring and ethical standards. Reviews of the causes of several high-profile corporate collapses and audit failures in recent years have not also indicated any clear connection between competition and quality. However, ICAEW is confident that a consensus now exists across the accountancy profession that increased choice in this market is both necessary and desirable. This will require a basket of measures which address three interconnected aspects of the current situation: implementing changes to how the Big Four operate, reducing the obstacles which currently deter their potential mid-tier challengers from entering that market and, finally, and most relevantly for this Review, supporting audit customers to exercise their extended freedom of choice.

ICAEW would be concerned if any changes to audit procurement undermined the authority or effectiveness of the audit committee and its role within the wider system of corporate governance. In particular, we do not support the establishment of an alternate external body with exclusive responsibility to appoint auditors. We believe that audit committees generally perform well in terms of assuring audit quality, but that this success could be further reinforced by significant alterations to composition and procedure which would strengthen their technical expertise, independence and accountability to shareholders. An independent body could perhaps promote this objective through support, oversight and challenge.

ICAEW feels strongly that early and urgent action to address public concerns regarding concentration in the audit market is vital to maintaining the confidence of investors and wider stakeholders. If the Kingman Review can present recommendations in the same time frame as the output from the CMA's market study, then this will constitute a coherent programme to tackle underlying issues of regulation, quality and competition. Chartered accountants accept the need for change, and regulators and government can expect the profession to cooperate fully with the implementation of further market reforms.

ICAEW believes the natural follow-on to the work of the Kingman Review and the CMA should be a fundamental and independent examination of the role of audit itself. The expectations of investors and wider society have quite rightly increased in recent years, and we need to ensure that audit keeps pace. If that means extending assurance and embracing new tools and new technology, then the profession must embrace that.

MAJOR POINTS

1. Without detracting from the importance and impact of a series of high-profile corporate failures in recent years, ICAEW notes that as a whole the audit sector in the UK is working well and its customers are satisfied. It operates to rigorous professional and technical standards, and is recognised internationally as high calibre. Outside the FTSE 350, medium-sized companies and small businesses across the UK economy are served by thousands of audit-registered firms: competition is strong and quality is high. For large corporate clients and Public Interest Entities (PIEs) choice is much more restricted, because relatively few firms other than the Big Four are currently perceived to possess the scale and capacity to conduct audits at this level. Even this choice is further limited by independence considerations.
2. ICAEW is confident that a consensus now exists across the accountancy profession that increased choice in the market for large corporate and PIE audits is necessary and desirable. The largest audit firms and their potential challengers are willing to cooperate, and to work with government and regulators, to bring this about. There is also a collective readiness to see a fundamental and independent examination of the role of audit itself. The expectations of customers – and, other stakeholders, including investors, employees, pension-holders, customers, suppliers and wider society – have quite rightly increased in recent years, and audit must keep pace, which may mean extending assurance and embracing new tools and new technology.
3. ICAEW believes that the audit sector plays a key role in creating and sustaining domestic and international investor confidence in the UK business sector and wider economy. Possible measures to increase competition in the market for large corporate and PIE audits must be seen in the context of the need for the UK after its exit from the European Union to be perceived positively as a global trading partner and as a place where the business and investment environment is both attractive and well regulated.
4. ICAEW believes that the key issue is audit quality: ensuring that it continues to improve and continues to meet the existing and evolving expectations of customers and other stakeholders. The actual number of competitors operating at any time is an important but secondary aspect, and not necessarily directly connected to audit quality. It would not be a positive outcome if regulatory or legislative interventions brought more firms into the market for large corporate and PIE audits, but jeopardised quality and increased costs for customers.
5. ICAEW believes that achieving increased choice in the market for large corporate and PIE audits will require a balanced and integrated package of measures, rather than any single major regulatory or legislative intervention. These measures will need to address the three main aspects of the issue: implementing changes to how the largest audit firms, specifically the Big Four, operate; reducing the obstacles which currently deter their potential challengers from entering that market; and finally, supporting audit customers to exercise their extended freedom of choice.
6. ICAEW counsels against any expectation that major changes will happen quickly. For example, it will take time – perhaps a few years – for potential challengers to gain the experience and capacity to be regarded by customers as viable competitors to the Big Four in the market for large corporate and public interest entity audits. A graduated approach to implementation will also mitigate the possibility of causing one or more of the Big Four to withdraw from the market or significantly reduce their commitment to it.
7. ICAEW believes a market share cap – either collectively on the Big Four, or individually on all firms operating in the FTSE 350 audit market – would be difficult to implement and manage,

but should be examined further. We also strongly recommend that any capping mechanism is subject to a regular review of its impact, initially after three-to-five years. For several reasons, we do not see that breaking up the Big Four would be helpful, although we believe that ring-fencing within the largest firms to separate audit and non-audit service is an option worth investigating.

8. With regard to encouraging entry to the market for large corporate and PIE audits by mid-tier firms, ICAEW believes there may be a role for joint and shared audits: they would certainly help challenger firms acquire experience and credibility, but to date these have not been popular in the UK market. There is a readiness in the profession to consider initiatives which would facilitate the transfer of skills, technology and even staff between firms. However many of the possible entrants to this market are wary of the regulatory burden and financial liability, both for firms and on individuals.

9. ICAEW regards the idea of an independent public body to appoint auditors in the market for large corporates and PIEs as problematic, and recommends instead practical measures to strengthen the audit committee and its ability to monitor and challenge auditors.

10. ICAEW is encouraged by the evidence that the scope, conduct and timing of Sir John Kingman's Review interlock and align with the market study recently launched by the Competition & Markets Authority of the supply of statutory audit services in the UK. Between them, these two investigations are examining underlying issues of regulation, quality and competition in the audit market. We believe the natural follow-on to their work should be a fundamental and independent examination of the role of audit itself.

ANSWERS TO SPECIFIC QUESTIONS

Question 1: Notwithstanding the important role played by audit committees, as well as the formal requirement for shareholder approval, can present arrangements risk auditors being too close to company management, and insufficiently incentivised to pose suitable scepticism, objectivity and challenge?

Question 2: Notwithstanding the FRC's guidance which states that audit committees must be satisfied that the level of fee payable in respect of the audit services provided is appropriate and that an effective, high quality audit can be conducted for such a fee, could present arrangements in practice contribute to a situation where audit work is under-resourced or cross-subsidised from other work?

11. Threats to ethical behaviour vary from case to case. In some circumstances, the answer to both questions is 'yes'. Action is needed to promote and ensure continuous improvement in audit quality and to ensure audit committees are equipped and incentivised for optimal effectiveness. Both areas are within the remit of this Review and we hope to see them addressed in its recommendations. ICAEW has its own programme of activities to further these objectives and we would welcome further dialogue on how we might support the Review in its objectives.

12. Both the risks described above are controlled by the body of law, standards and practice that has grown up to protect auditor independence. These independence rules were enhanced and strengthened significantly by the actions of a variety of bodies including the FRC and ICAEW to implement the revised audit directive in the UK in 2015. It is too early to make informed comment on the effectiveness of these enhancements. However, we welcome the Review's questioning of whether it is now beneficial to go beyond this regime and look at new solutions to enhance independence.

13. We think there are actions to take now both in relation to audit committees and audit quality.

a. Audit committee

(1) We remain strongly in favour of the audit committee as a model for corporate governance. But, as we said in our recent response to the CMA market study of statutory audit markets (ICAEW representation 123/18), the model needs to be made more effective, and members of audit committees held to account for their decisions.

(2) We suspect that in some cases cost considerations may well be constraining the quality of audits even when the audit firm has the experience which is needed to be more thorough. Companies often seek to reduce their audit costs year-on-year. Part of the role of audit committees is to disrupt any narrow focus on costs by insisting on high quality. Some do this well, but the question is whether in general they are sufficiently empowered to do this. We believe this imbalance could be addressed by strengthening audit committees.

(3) As we have pointed out to the CMA, the FRC's recent review of the Corporate Governance Code did not focus on audit committees, and therefore resulted in very few changes in this area. The composition of audit committees remains unchanged (three independent non-executive directors), but there may be benefits to increasing their size and composition. The new Corporate Governance Code (issued in July 2018) still only requires one audit committee member with recent and relevant financial experience. While we support the need for a diversity of background and experience on audit committees, we note that the NYSE and Securities Exchange Commission (SEC) set a far higher standard for accounting and financial management expertise for US audit committee members.

(4) Individual members of audit committees are legally accountable as board directors. In theory at least, they may be subject to derivative actions for breaches of s.172. If steps were taken to make audit committee members more accountable, it should also be expected that there would be an increase in audit committee fees, commensurate with the risk-reward profile of the role.

(5) Making boards and directors accountable to stakeholders through engagement was considered in depth in the 2017 BEIS Green Paper on Corporate Reform. This consultation led to the Companies (Miscellaneous Reporting) Regulations 2018, which will require: a statement in strategic reports describing how directors have had regard to s.172, and statements in directors' reports about engagement with employees, suppliers, customers and others.

(6) ICAEW's original response (ICAEW representation 92/18) to the Review referred to the establishment of a 'Corporate Governance Office' (CGO) or similar, and described the functions of this new body as being: to monitor and improve technical, ethical and other standards in corporate governance; and to certify and monitor directors of listed and very large private companies so that all directors can be held to account. Such a body should have a public interest mandate and could be made legally accountable to stakeholders through the mechanism of judicial review.

(7) In summary, in theory at least, auditors and audit committee members are already directly and indirectly accountable to some stakeholders. Transparency for all stakeholders has also been improved. However, stakeholder interests should form a core part of the thinking and planning which goes into new methods of audit procurement.

b. Audit quality

(1) We believe that the audit firms, regulators and professional bodies have an important role in encouraging and demanding continual improvements in audit

quality. This is particularly important as regards those measures that act as a safeguard for auditor independence and therefore protect auditors from the pressures outlined in Sir John Kingman's letter to respondents dated 8 October; in particular it highlights the risk of 'being too close to management'. The role of the ethical independence framework is to guard against exactly this kind of risk, which manifests itself in a variety of ways.

(2) The ethical independence framework has been recently overhauled to enhance these safeguards and we believe it is too early to revisit it for further change. But there is much that could be done to continue to focus and enhance those aspects of the system identified as in need of strengthening. One key example is professional scepticism. We believe that auditors need to challenge themselves to find new and fresh ways of demonstrating scepticism and keeping it front of mind. This thinking is behind our recent publication 'Scepticism: the practitioner's take', which explores how scepticism might be enhanced.

c. PIE auditor independence

(1) The system of safeguards securing the independence of PIE auditors was significantly enhanced in 2015 and we believe operates effectively. Nevertheless, over and above this we are conscious of the importance of perceptions in public markets. Therefore, we feel that the Review could go further in introducing new measures to assure stakeholders of the independence of PIE auditors.

(2) To achieve this, we believe that one strand of the programme to enhance audit committee effectiveness could be to establish a presumption that they would choose a supplier other than their auditor for non-audit services. To avoid compromising the effectiveness of the audit it would be sensible to exclude any services closely related to the audit from such a presumption.

Question 3: If auditors of some or all major companies of public interest were to be appointed in a different way, by whom could this be done in practice?

Question 4: What capability would need to be built up to do this competently? How could this be properly governed?

Question 5: How could this be done in a way which commanded the confidence of users of accounts, such as investors? How could investors' rights of approval over auditor appointments be protected in any new arrangement?

Question 6: How would any alternative body take into account the views of Audit Committees?

Question 7: What companies should any new arrangement apply to? Is there a case for piloting an alternative approach, for instance in relation to cases where deficiencies in audit have been identified?

14. Regarding possible alternative arrangements for the procurement of audits, we believe that the role of audit committees needs to be strengthened and therefore, to that extent, believe that there are practical steps that could be taken to make the procurement process more robust. We recognise however that the Review may wish to consider more radical changes to the procurement process, perhaps along the lines of establishing an independent body for the appointment of auditors to PIEs – as the CMA is exploring in their market study.

15. As we said in our response to the CMA (ICAEW Representation 123/18) we do not believe that replacing audit committees with an independent body would have the desired outcomes. Any such body would need equivalent or greater experience than the collective knowledge of audit committees across a wide range of industries and accounting practices, which would be

very difficult to achieve. We would prefer any new body to oversee and even support audit committees, rather than replace them. Audit committees are best placed and most informed to choose an appropriate firm to audit the company.

16. ICAEW's recent work on audit committees includes responding to an International Organization of Securities Commissions (IOSCO) consultation on good practices for audit committees in supporting audit quality (ICAEW Representation 84/18), and our joint report with Deloitte, 'Making a difference', which covers the practical issues faced by audit committees across seven countries in Central and Eastern Europe. We concluded from this work that audit committees perform a vital role in corporate governance. Any new body should only make changes where necessary to address flaws, and tread carefully so as not to undo the achievements of audit committees to date.

17. Establishing and running an independent body is likely to be costly. Expertise in all UK sectors would be required, as well as individuals with sufficient audit experience in PIE, large companies and international businesses. The body would also need expertise in audit fee negotiation and an understanding of the drivers of costs for audit work.

18. The funding structure for any new body for auditor procurement would also need to be considered. Ideally, the shareholders would not bear the cost, but it is unclear how else such a body could be funded. There could be a perceived conflict of interest were it to be funded by those entities from which it is seeking independence.

19. An allegation sometimes made against audit committees is a compromised ability to monitor objectively their chosen auditor's work. There is a potential conflict of interest because any criticism of the auditor's work is an implied criticism of the audit committee's choice of auditor. A new external body with limited scope could work alongside audit committees to separate responsibility for the appointment and monitoring of auditors. For example, such a body could act as an Appointment Review Panel, able to review on a selective basis whether an audit committee has facilitated a competitive tender for audit services, as opposed to taking over the whole appointment process.

20. When considering the risks and costs of establishing an independent body to appoint auditors, it is important to consider the experiences of other bodies involved in the appointment and removal of auditors:

    a. Financial services regulators who can block the appointment of an auditor. For example, the Prudential Regulation Authority (PRA) can make reasonable requests for information about an auditor's qualifications, skills, experience and independence. The Financial Conduct Authority (FCA) must be notified of auditor vacancies and appointments and can appoint an auditor in some circumstances.

    b. The Audit Commission, which between 1983 and 2015 managed the market for local authority and NHS audits. The Commission's procurement function has in part been taken by Public Sector Audit Appointments (PSAA) Ltd. The Audit Commission's remit included appointing auditors to a range of local public bodies, setting the audit scope through a code of audit practice and monitoring the quality of audit work. The Audit Commission acted as a conduit between government departments and auditors on audit issues. It also set audit fee scales but took a percentage of the fees to support its own functions. The Commission maintained its own in-house practice. In this model, there was market concentration, with 70% of the work going to their in-house audit teams, and the rest split between seven private sector firms. Cost was one of the reasons given for the abolition of the Commission. As noted above, some of the Audit Commission's functions are now undertaken by PSAA Ltd, and public bodies are given a choice to opt-in to have their auditor appointed. Bodies not opting-in can appoint their own auditors.

21. Although it could be informative to draw on the experience of the public sector audit procurement bodies, it should be noted that a public sector audit has a different scope to a corporate audit. A public sector audit is a more commoditised product to commission with respect to the client base than an audit in the diverse private sector.