JOHNSTON CARMICHAEL

Johnston Carmichael LLP response to the Competition and Markets Authority invitation to comment on "Statutory Audit Market Review"

Background

Johnston Carmichael LLP are Scotland's largest independent firm of chartered accountants and a UK top-20 firm. We are also a member of PKF International, a global family of legally independent firms bound together by a shared commitment to quality, integrity and the creation of clarity in a complex regulatory environment.

Our PKF family consists of over 400 offices, operating in 150 countries across five regions.

Johnston Carmichael LLP acts as statutory auditor to around 900 entities. Our audit client base is predominantly private businesses many of whom are large entities as defined by the Companies Act 2006. Our client base also includes a small number of Public Interest Entity (PIE) audits, debt listed on the London Stock Exchange or listed entity (non-PIE) audits, including entities listed on the Alternative Investment Market (AIM) and on international markets including the Channel Islands' The International Stock Exchange.

Below, we have included responses to a number of the questions included in the Invitation to Comment. We have not responded to all questions, focussing instead on those where we are best placed to comment by virtue of our existing client base and market experience.

As a general observation, we feel it will be important for the CMA to consider whether its principle objective is to improve competition in the market or audit quality, as we feel that some of the measures set out in the ITC appear to be targeted more at the latter than the former. The two do not necessarily work in tandem.

A) Issues

Theme 3 – Choice and switching

Q.5 Is competition in the audit market working well? If not, what are the key aspects hindering it?

Competition is stronger within the private company audit market, principally because there are more firms operating in that market from which to select. However, some firms in the market choose to compete by using (low) cost as their primary selling point. If companies engaging in an audit tender process, prioritise cost over other factors, then the market may be competitive, but this does nothing to promote audit quality.

Cost aside, typically our clients advise us that the key factors they use when considering an auditor are range of services, perception of the quality/value of service and local availability of an adviser. Our large company clients like their auditor to offer a wide range of services, which will match those supporting their long-term growth and succession plans. They value only having to explain these plans once, allowing the implications across all aspects of the business to be considered rather than explaining these plans multiple times to different advisers. As different advisers ask questions pertinent to them, there is a risk that not all the company's advisers receive the same information, the advice they receive is based on sub-sets of information, with consequential implications for the business' long-term success.

High quality of service is also a critical factor in our clients switching between auditors, in addition to audit quality. An auditor offering a wide range of non-audit services is not enough, the auditor needs to be perceived as providing high quality services (both audit and non-audit).

The Big Four's offices are based in the UK's principal cities. With companies based throughout the UK, having a credible auditor based locally maximises benefits to stakeholders. The cost of an audit will increase, to cover hotel and other out-of-pocket expenses, with no increase in audit quality when a business believes it must appoint a Big Four auditor with no local presence.

In the listed audit market, we perceive competition as much weaker and often this takes place solely amongst Big Four firms. Whilst there are certainly barriers to entry for non-Big Four firms, the lack of attractiveness of the audit market to other firms, with high regulation, high risk and comparatively low reward, is also a key factor to the lack of participants.

We have commented, within question 11, on the main barriers to entry which limit choice and switching of auditors.

Q.6 In particular, how effective is competition between the Big Four and between other firms and the Big Four?

Almost every audit tender we participate in will include at least one Big Four firm. For the larger audit tenders, we are commonly the only non-Big Four participating in the tendering process. This can be a positive for our business but on occasions, whilst the feedback we receive on our tenders is invariably good, management and those charged with governance sometimes perceive that as a firm, we are "too big a risk" as we are less well known and prominent in their space.

With this mindset, we have a concern that there are very limited options for companies tendering, as it would not be unusual for some of the other Big Four firms to be providing non-audit services that prohibit their involvement in an audit tender and therefore rarely will there be a choice of all four Big Four firms from which to select.

Q.8 What is the role of competition in the provision of audit services in delivering better outcomes (e.g. consistently higher quality audits)?

We find that the link between competition and audit quality is strongest in listed entities and typically larger corporates, where there is stronger corporate governance and more qualified accountants in their leadership teams.

However, for private companies, tendering often appears to be a mechanism to reduce audit costs. The tender assessment criteria often applies a significant weighting to cost. A focus on cost is detrimental to delivering consistently higher quality audits.

The delivery of consistently higher quality audits requires investment by the firm, for example training and amending the firm's methodology. With regard to operating in the listed audit market, few firms outside of the mid-tier have the internal staff and capabilities to commit to this level of investment or the maintenance of it.

Effective tendering should gauge participants' understanding of the business and risks and the suitability of the audit approach. Often this means considering data analytics, especially if there is a Big Four firm involved in the tendering process. However, we believe that that tendering is often failing to deliver better audit quality as companies often highlight to us the gap between what an audit firm commits to undertake in the audit process as part of their tender and the reality of the audit process delivered. For example, extensive use of data analytics is promised but they see little application of it in practice. Or tenders promise a lot of access to senior time but ultimately more junior staff is allocated to the job in an effort to reduce cost.

Q.10 What are the factors limiting choice between auditors?

The key factors which we believe limit the choice between auditors include:

Company-related factors

- Perception of firms. Unfortunately, the barrier highlighted by the Competition Commission continues to exist. Rightly or wrongly, companies have a perception that non-Big Four firms have a lack of specialist sector experience or an inability to deal with entities of certain sizes and complexity.
- The number of Big Four trained staff on Audit Committees, large company Boards, acting as Chief Financial Officers or Chief Executive Officers. The unintentional bias favours Big Four appointments.
- Finance providers' (current and potential) expectations of auditors often favour Big Four firms. The removal of Big Four only clauses from finance agreements has done little to change expectations when significant levels of finance are being provided.
- The pre-selection process which a company adopts is non-systematic. Credible firms may be removed from the ability to participate in later stages of the process.

- Provision of non-audit services to Big Four firms leads to a lack of potential Big Four participants in an audit tender process (see 6. above).

Firm-related

- Firms strategically removing themselves from the market or sector.
- Some businesses prioritise cost over audit quality and some firms quote low to win tenders, thus limiting choice on more relevant qualitative factors.
- Firms preferring to engage on potentially more profitable non-audit services, thus avoiding taking on role of auditor which would preclude them from providing non-audit services.
- For some of the largest, most complex businesses (e.g. global banking institutions), at present only Big Four firms have the scale and attributes to take on the audit appointment.

Q.11 What are the main barriers of entry and expansion for the non-Big Four audit firms?

A lack of opportunity, by not being asked to participate in tenders, is one of the largest barriers of entry and expansion for non-Big Four audit firms. In order to make the necessary investment and related cost commitment, each firm would have to win a minimum number of PIE and listed entity assignments. If the mid-tier firms are not being asked to participate in tenders, and believe that they are unlikely to achieve this minimum number, they will turn down the few tendering opportunities they are offered for these clients.

The commitment required by these firms should not be underestimated. There are no commercially available PIE or listed audit methodologies. Each firm is "reinventing the wheel" by making and maintaining the necessary amendments to their own audit methodologies. Training will have to be provided to audit personnel, in addition to ethical training for those working in non-audit services.

The definition of PIEs includes companies with debt listed on London Stock Exchange's main market. The debt instrument may have never changed ownership in the post listing period. The business may not be complex, acting as a finance vehicle for other group or related entities. There are concerns that AQR have little experience of reviewing such simple businesses and would try to assess the audit methodology and approach adopted against those for far more complex PIE businesses. Firms are making a strategic decision to avoid situations that they consider could potentially result in inappropriate short-comings in an audit being identified by AQR.

There is an increased regulatory burden which applies to the entire firm when they enter the PIE and listed markets. The reputational and regulatory risk of being held publicly accountable against what the FRC deem to be best practice rather than against the standards and regulations is one reason for firms strategically removing themselves from this market.

B) Potential measures

Q.14 Please comment on the costs and benefits of each of the measures in Section 4 and how each measure could be implemented.

Section 4 includes a number of potential measures to improve competition in the audit market and we welcome the exploratory nature of this Section and the creative selection of ideas. Whilst we believe that a number of the measures will not achieve their objective for reasons given below, we also believe that there is merit in some of the proposals and we have commented on a number of them below.

Market share cap

We agree that the imposition of a market share cap is likely, by definition, to lead to increased competition and reduced concentration of the market and therefore merits further consideration and research.

We have some initial concerns around the effectiveness of a market share cap as a single measure to promote competition and therefore we believe its effectiveness is likely to be enhanced if introduced as part of a package of measures. Most specifically, we are concerned that if the Big Four have to reduce their presence in the large company audit market to within the cap levels, they will do so by seeking to retain the most prestigious and financially rewarding work. This might then leave other firms opportunities in the less commercially attractive or highest risk parts of the market. Given that entering the listed market imposes significantly regulatory burdens on firms, it is not clear that such a measure would provide a great incentive for firms to enter the market.

We note that a cap on market share might lead to greater availability of senior staff in the audit market but, as noted further below, we believe that the employment market is currently functioning without any further stimulus.

There is also the question of how this might limit choice for Audit Committees if, due to factors such as size or technical sector expertise, etc. the most suitable auditor is a Big Four firm which is prevented from participating due to the operation of the market cap.

Joint audit, shared audit or peer review

We have considered the respective merits of these measures and have highlighted our key thoughts under a number of headings in the table below:

<table>
<tr><th></th><th>Joint Audit</th><th>Shared Audit</th><th>Peer Reviews</th></tr>
<tr><td>Concentration of audit market</td><td colspan="3">All three of these measures are likely to lead to more participants in the audit market as demand for firms increases. Positively, as noted in your Invitation to Comment, this is evidenced by experience in France and also, we note, in India.</td></tr>
<tr><td>Credentials and skills of participating firms</td><td colspan="2">Recognising that a lack of existing credentials/skills can be a significant barrier to gaining appointment to FTSE audits, the ability to work alongside more established firms in the market offers the opportunity for firms to strengthen their skills and credentials and helps to bridge the gap between Big Four and non-Big Four in this regard.</td><td>As with joint and shared audit, there is some potential for firms to bridge the gap in existing credentials. However, as the scope of the secondary auditor's role is more limited in this scenario, it is unlikely to bridge the gap as quickly or perhaps be as successful in opening up opportunities to other firms to act as the "primary auditor".</td></tr>
<tr><td>Audit quality</td><td colspan="2">Should have a positive impact on audit quality as different firms will bring their own experiences and challenges to contentious or judgemental audit matters. The combination of two firms should also strengthen the auditors position in the event of client resistance to a particular course of action.</td><td>As with joint and shared audit, but there is perhaps less scope for influence of the secondary auditor given that the timing of their review is indicated as being prior to sign-off. In contrast, both joint and shared audits will necessitate greater dialogue amongst auditors in a timely manner.</td></tr>
<tr><td>Trust in audit report</td><td colspan="3">Each of these measures would, we believe, result in increased trust and confidence in the audit process although clearly this runs the risk of being undermined if cases come to light where the process has "failed". However, in principle, we believe that users of the</td></tr>
</table>

	Joint Audit	Shared Audit	Peer Reviews
	financial statements will take confidence from the involvement of a secondary party.		
Costs	Whilst research from other countries, including France, would suggest that joint audit in no way leads to a doubling of costs, it is inevitable that there will be some additional cost to this process.	As with joint audit but we would anticipate a lower incremental cost.	As with shared audits but we would anticipate that this option would have the lowest incremental cost of all three options.
Timings	We believe it is difficult to envisage how the application of joint or shared audit would not lead to significant challenges around adherence to audit timetables, which are typically long-established and highly linked to market announcements, the timing of which typically are consistent year on year. If joint or shared audit are to be effective and allow adequate time for cross-firm consultation then some market realignment of timetables will be required.		Whilst it may be possible for elements of this work to be undertaken as the audit progresses, the peer reviewer will be unable to draw conclusions until the primary auditor has completed their work. Accordingly, adequate time will need to be allowed for if the peer review is to be effective.
Methodology including software and training	Whilst audit firms are subject to common regulations including a single set of International Standards on Auditing (ISAs), each firm will have their own policies and methodology to implement the ISAs and software training will be	Challenges around working effectively in an environment of individual firm policies and methodologies are likely to be most significant in the area of shared audit.	Issues are likely to be more confined to the peer reviewer's need to familiarise themselves with the practices of the primary auditor. This is not considered to be a major barrier to its introduction.

	Joint Audit	Shared Audit	Peer Reviews
	designed accordingly. In such a context there will be practical and potentially significant challenges to ensure that firms can work together effectively in an environment where policies and methodologies are not shared. This runs the risk of impacting on audit quality.		
Regulation	At present there are no regulations in place, either through standard setters or Institutes, to address these forms of audit. These will need to be developed and time will be needed for firms to conduct the necessary training. There will also be matters to be addressed around AQR and other regulatory costs. In our view these would be increased if the regulator is visiting two firms to review one audit and clarity will be needed as to how will these costs be passed onto firms.		
Cultural challenges	We believe that the role of culture, led by the "tone from the top", is central to ensuring the right outcomes in audit. Even within a single organisation, achieving a consistent culture can be challenging and, given joint and shared audit will require audit firms to work closely together, there is a greater risk of different cultures leading to ineffective working relationships with a risk that this could impact on audit quality. Care also needs to be taken that the larger or primary audit firm does not dominate the outcome courtesy of their size.		Cultural barriers are less of an issue where only peer review is involved as both firms will largely work independently of each other.
Liability sharing and professional indemnity	There are likely to be significant challenges around where liability rests and how it is shared between firms and the interaction of this with professional insurers. This is perhaps likely to be most		

	Joint Audit	Shared Audit	Peer Reviews
	pronounced in the area of shared audit where, with only one firm reporting, but responsibilities being split between firms, it is likely to be challenging to agree liability between firms and clarity will be needed on where any liability to third parties rests.		
Relationships between firms	Both joint and shared audits will necessitate a close working relationship between audit firms. There is a balance to be had between the efficiency benefits of firms working together across several audits gaining a better understanding of each other and over-familiarity.		Our concern around over-familiarity between firms impacting on independence is less likely to be an issue for peer reviews, as demonstrating independence is likely to be a clear criteria for appointment of a peer reviewer.

In summary, in our opinion, the above analysis illustrates that there are significant challenges to be overcome if joint or shared audits or peer reviews are to be an effective and accepted measure, most notably in the area of cost and audit quality. However, some of our PKF network colleagues have experience of joint audit and report positively on that experience. We do believe that the concept of joint audit in particular has some merit in addressing the particular challenge of concentration in the audit market and may lead to an improvement in trust in the profession and would therefore merit further research and analysis.

We would note that in our view the introduction of joint audit would be a bold move within the UK, given that it is not a practice that exists worldwide on a major scale, with some limited exceptions.

Direct support by the Big Four and/or professional bodies to the mid-tiers

In our view this is unlikely to significantly impact competition in the audit market, as we do not see capability of non-Big Four firms as a key reason for the current concentration of the audit market. If this is to succeed, even in part, it would require a strong enforcement regime in order to overcome a number of important practical difficulties as summarised below:

- This industry will continue to see the audit market as Big Four led and it will be difficult to overcome the perception that other firms are not equal participants. The strong cultures of the Big Four could also dominate the process in practice.
- There are significant confidentiality issues to address and the Big Four will want to protect their own intellectual property.
- The timeliness of support is likely to be questionable, as the Big Four have their own clients commitments to fulfil and businesses to run. It is therefore difficult to foresee

in particular that their most capable staff will be given the capacity to support other firms.

- We are unconvinced that professional bodies would, at the outset, have the staff and experience to provide the required support to firms. Building this type of support would also take time. A strong enforcement regime would also be required.

Changes to restrictions on ownership of audit firms

As you will be aware, at the moment all registered audit firms must be controlled by a majority of individuals with an appropriate audit qualification (e.g. a subset of all CAs for an ICAS registered firm). To encourage more entrants into the FTSE 350 market, we believe that the CMA should at least explore whether allowing outside capital to invest in audit firms would help bridge the current large gap in size. This however would need to be controlled to ensure that short term commercial interests do not become more important than serving the public interest. We also believe that care needs to be taken to ensure that any entirely new entrants subject to wider ownership do not lead to a lessening of audit quality.

Turning to the other measures set out in Section 4, we do not see these as being likely to be effective in achieving their objectives for the primary reasons set out below:

- **Reducing the barriers for senior staff to switch between audit firms** - From our own experience we do not believe that any barriers for senior staff switching (such as long notice periods or the associated costs) are prohibitive. Whilst there are undoubtedly costs of recruiting senior staff and recruiting such staff is not instantaneous, our senior team has many ex Big Four auditors with significant skills in auditing in the large/listed market. We believe that such costs/time delays are normal in the industry and are not preventing us from acquiring the skills that we require. Therefore our limited involvement in the listed audit market is the result of other factors which will not be addressed by focusing on this particular measure.
- **Break-up of the Big Four into smaller audit firms** – Whilst we do not dispute the analysis provided in Section 4.28, nor indeed do we disagree with the conclusions, we believe that the CMA should give some consideration to the important question of whether the Big Four are too big to fail. If the answer is yes, this creates a huge vulnerability in the system.
- **Measures to improve the transparency around the tendering process** – We do not believe that there is a quality gap in tendering between Big Four and non-Big-Four firms. Indeed we typically receive very positive feedback on our tenders. Unfortunately, there are often cases when we are unsuccessful following submission of a tender as we are considered a higher risk option, due to having less experience in the listed market. This issue will not be addressed by opening-up the tender process.
- **Measures to reform mandatory tendering and auditor rotation –** In our opinion early experience with mandatory tendering/rotation requirements are that they have not impacted on the concentration of the audit market, with audit mandates typically just being rotated amongst the Big Four. We do not see increasing the frequency as having any tangible impact on this and indeed it runs the risk that

companies lose the benefits of an auditor’s knowledge built over time if switching of auditors becomes too frequent.

- **Break the link between company management and auditors** – we do not favour a change in practice here. In our view the Audit Committee is best placed to appoint auditors and this responsibility should remain there. Moving this responsibility is in our opinion unlikely in itself to lead to more firms competing in the market.

Q.15 Are there any other measures that we should consider that address the issues highlighted in section 3? If so, please describe the following: a) aim of the measure, b) how it could be designed and implemented, and c) the costs and benefits of each such measure.

We note that Section 4 of your Invitation to Comment includes a number of measures and, as noted in our response to question 14, whilst we do not believe that any in isolation provide a perfect answer to competition issues in the market, a number would merit further consideration. Most likely we believe that it may take a combination of measures to address the issues. In terms of the measures debated above, we do have a concern that none of these will ultimately address the attractiveness of the audit market to potential entrants. As long as audit is undervalued by stakeholders, it is likely to remain a low margin service. The high levels of expertise required and a high level of risk, means that firms are not incentivised to enter the market. Therefore we would suggest that the CMA does not look at measures in isolation, but carries out a more wholistic review and debate into the role of audit in corporate life and society, alongside the relevance of the associated financial reporting framework. Fundamentally, for a market to be effective there needs to be a regime that provides an adequate return for firms to participate in that market.

Q.16 One way to create audit-only firms would be through separate ownership of the audit and non-audit services practices of the UK audit firms. Could this be effective, and what would be the relative scale of benefits and costs?

For private entities, we feel this would be detrimental to them in meeting their needs and not reflect our experience of factors which are used when determining an auditor. We would expect that this would increase cost as entities would need to employ multiple firms without the benefit of a consistent and “joined up” service delivery. We would also have a concern, further to our response to question 15, that auditors would exit the market at this point due to the unattractiveness of audit as a separate service. This could therefore have a negative impact on competition.

If applied to all PIE audit firms, rather than PIE clients, we feel this is likely to result in a decrease in the number of firms willing to support smaller PIEs due to the effect this would have on their practices, also decreasing competition.

Q.17 How do the international affiliations of member firms affect the creation of audit only firms? What is the extent of common ownership of audit firms at the international level?

Mid-tier firms generally belong to an international network or association. Our network describes itself as a global family of legally independent firms bound together by a shared commitment to quality, integrity and the creation of clarity in a complex regulatory environment. There is no common ownership of member firms at an international level. The international affiliations of mid-tier firms would have little influence on the creation of audit only firms.

Q.18 What should be the scope of any measures restricting the provision of non-audit services? For example, applying to the Big Four only, the Big Four and the mid-tier audit firms, or any firm that tenders for the audit of large companies and PIEs?

We do not believe that restricting the provision of non-audit services beyond the scope included within the current regulations will benefit audit quality or competition within the audit market. Auditing is often perceived by clients as being a compliance activity, one which does not add to stakeholder or shareholder value. Without this view changing, companies would not accept higher audit fees which will enable audit-only clients to be profitable commensurate to the risks of providing an audit opinion in an ever increasingly regulated sector. Audit firms are likely to remove themselves from markets if additional restrictions are placed on the provision of non-audit services, decreasing choice and competition.

The question of which stakeholder group auditors should prioritise when undertaking an audit needs to be addressed. Many stakeholder groups have competing interests. For example, the payment of a dividend to shareholders decreases resources available for pay awards to employees. Stakeholder participation in the Review of the Audit Market process is required as their support will be needed for any solution that is adopted following completion of this process.

Where sharp minds meet

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