Written evidence submitted by ICAS (FOA0019)

Written Evidence from ICAS to BEIS Commons Select Committee Inquiry on Future of audit

1. Executive summary

We are pleased to submit our response to the BEIS Commons Select Committee Inquiry on the Future of Audit.

In summary, the key points in our submission are as follows:

- Increased choice should be encouraged but the primary overarching objective has to be to seek to ensure audit quality. There is no guarantee that increased choice in the audit market will increase audit quality.
- The introduction of joint audit could increase choice in the audit market but there is a lack of evidence as to its positive impact on audit quality.
- The introduction of a market share cap as an alternative to joint audit could create opportunities for challenger firms but this remedy also presents considerable obstacles when designing a fair and equitable quota system. There are also serious concerns that this remedy would reduce choice for many companies hindering their duties to find the highest quality auditor.
- We support a complete prohibition on audit firms providing properly defined non-audit services to their PIE audit clients (at least the FTSE 350) as a means of addressing and mitigating conflicts of interest.
- We welcome the announcement of the independent review to be chaired by Sir Donald Brydon and trust that this will encompass a holistic review of the purpose and role of the audit of PIE companies to ensure that the audit remains fit for purpose. Further consideration needs to be given to the adoption of an integrated audit approach, to ensure directors take responsibility for the control environment within their company.
- We also welcome the proposals for the reform of the FRC. We support the need for a more focused purpose and remit. We understand the need for a strong and robust regulator and will continue to encourage the new regulator to remain mindful of the benefits of developmental regulation, and the need to strike a balance of prevention, detection and deterrence.
- The optimum outcome is likely to be a combination of several themes (including the role and purpose of corporate reporting, a review of the scope of audit, improved audit regulation, enhanced corporate governance and increased choice and competition in the audit market).

2. Introduction

2.1 ICAS (The Institute of Chartered Accountants of Scotland) is a professional body for more than 21,000 world class business professionals who work in the UK and in more than 100 countries around the world. Our members have all achieved the internationally recognised and respected CA qualification (Chartered Accountant). We are an educator, examiner, regulator, and thought leader. We work primarily in the public interest.

3. Inquiry Questions on the future of audit

QUESTION 1: What is the relationship between competition and quality in the audit market? How should reforms in one area complement the other?

3.1 Following the introduction of mandatory tendering of audits there has undoubtedly been increased competition in the audit market. The issue is not so much the lack of competition, but rather the extent of choice available particularly in certain sectors.

3.2 The expectation is that increased choice in the audit market is the best way to improve audit quality, and that this would help safeguard against future corporate failures. That may not necessarily be the case and any expectation that audit alone could safeguard against future corporate failures is misplaced and not supported by the evidence. Competition and audit quality are both important, but one does not guarantee the other.
3.3 Increased choice should always be encouraged, but the primary overarching objective has to be to seek to ensure audit quality.

3.4 External audit forms part of the wider governance framework that oversees larger corporates, i.e. boards of directors, audit committees, investors and regulators. If audit quality is the prevailing issue, then the optimum outcome is likely to be a combination of several initiatives. In its response to the CMA Market Study, ICAS called for a Government supported multi-stakeholder review into the UK corporate governance and corporate reporting frameworks that would encompass a review of the role and purpose of audit and consider whether it needs to change to better meet current and evolving stakeholder expectations.

3.5 ICAS warmly welcomes the recent BEIS announcement of an independent review to be chaired by Sir Donald Brydon, which has been tasked with recommending what more can be done to ensure audits meet public, shareholder and investor expectations. We look forward to making a positive contribution to the work which BEIS has commissioned. This review is a key part of ensuring public trust in audit in the future.

3.6 We trust the Brydon review will take on board the comments made by the CMA. Part of the review ought to consider whether it is reasonable to rely on the current scope of audit to provide the assurance required by stakeholders for protection of their interests. Further consideration should also be given to the merits of adopting an integrated audit approach, which would ensure directors take responsibility for the control environment within their company.

QUESTION 2:
Do you agree with the CMA proposals? Will the remedies proposed be likely to increase quality and trust in audits? Are there any potential unintended consequences?

3.7 We will be responding in full to the CMA’s proposed remedies by 21 January 2019. We would be happy to send a copy of that response in due course. A copy of our original submission is available at https://assets.publishing.service.gov.uk/media/5bec32d240f0b667b363e281/icas.pdf.

We would however provide the following preliminary comments on certain of the CMA’s proposed remedies.

Joint Audit

3.8 Joint audit is only used in a few jurisdictions around the globe, most notably in France and for the audit of banks in South Africa. Some, but not all, of those that have carried out, or currently carry out, joint audits, support their operation as being effective, but there remain issues notably with accountability, liability, cost, ownership of risk and investor confidence. Furthermore, they may not have comparable legal and regulatory frameworks, and the UK may need to define its own approach.

3.9 In our response to the CMA Market Study, ICAS did not support joint audit. Nevertheless, we recognise that joint audit is one possible remedy to the current audit market concentration and could increase the number of audit firms involved in the audit of FTSE 350 entities, if implemented appropriately. Careful and detailed consideration needs to be given to the potential implications of the introduction of mandatory joint audit on costs, auditor accountability and liability and practical implementation issues.

3.10 Joint audit will require legislative change (particularly in relation to the implications for auditor liability). It will also require regulatory involvement, at a time when the regulator is itself undergoing a fundamental change. Furthermore, for effective implementation of a mandatory joint audit regime, it would need the full support of all key stakeholders including investors. It is unlikely to be a quick solution.

3.11 As far as the impact on audit quality is concerned, in 2012 ICAS commissioned a literature review of research which had been undertaken on joint audits. Entitled - What we know about joint audits? this research can be viewed at: https://www.icas.com/technicalresources/publication-what-do-we-know-about-joint-audit

3.12 The results reported by this literature review clearly indicate that various country-level characteristics are simultaneously at play. While joint audits can potentially enhance the
competition in the audit market by allowing challenger audit firms to maintain larger market shares, the impact of this lower market concentration on the quality of the audit has not been clearly demonstrated.

**Market share cap**

3.13 The CMA report highlighted that a potential alternative to mandatory joint audit could take the form of a market share cap. Again, if properly constituted this could create opportunities for mid-tier firms. However, considerable obstacles would need to be overcome in the design of any quota system to ensure that it is fair and equitable, not only to the firms but also having regard to the rights and responsibilities of the company. Any market cap is likely to leave some audit committees in the untenable position of a restriction in market choice when tendering, and, where appropriate, rotating their auditors. A market cap implies a restriction of market choice, could potentially negatively impact audit quality, and it is not something that investors in the company concerned would be likely to welcome.

**Peer review**

3.14 Peer review is ordinarily a regulatory condition imposed by a Recognised Supervisory Body (RSB) and only where there are concerns about audit quality. The definition of peer review presented by the CMA is very different and would have a very different purpose. It could present considerable obstacles to its introduction.

**QUESTION 3**

Do you agree with the Kingman proposals regarding the FRC?


3.16 We welcome many of the reforms set out in Sir John Kingman’s Report. We support the need for a more focused purpose and remit, stronger governance, and access to talent. We remain of the view that the new regulator will require a different funding model. We understand the need for a strong and robust regulator, and we will continue to encourage the new regulator to remain mindful of the benefits of developmental regulation, and the need to strike a balance of prevention, detection and deterrence. It is important that this new regulator can articulate where the audit quality bar is, and what is expected of its regulatory community.

3.17 Again, this report highlights the need for an independent review of the scope of audit, to explore (and in turn address) the issues arising from the audit expectation gap.

**QUESTION 4**

To what extent do conflicts of interest undermine trust in audit? How best can they be removed or mitigated?

3.18 There is undoubtedly a risk that conflicts of interest, whether perceived or actual, undermine trust in audit. Whilst we are of the opinion that many of these are perceived rather than actual, we believe the time has come to remove and mitigate any concerns that exist. In our response to the CMA we advised that we support a complete prohibition on audit firms providing properly defined non-audit services to their PIE audit clients (at least the FTSE 350), subject to a small agreed list of permitted assurance related services. The assurance and audit-related services that could be allowed to be provided to PIE audit clients should be reviewed and clarified, with a list of permitted services prepared accordingly.

**QUESTION 5**

How important to the quality of audit is the relationship between auditor and audited company? How can we ensure that there is the right level of challenge? What role should shareholders have in ensuring high quality audits?

3.19 The relationship between the auditor and the audited company is very important. We would note that collaboration and challenge are not incompatible in the professional world of accountants and auditors – indeed this is what they are trained to do. We do not believe that an adversarial relationship would be conducive to audit quality. Within that professional relationship it is critically important for the auditor to exercise professional scepticism and to challenge management as appropriate.
3.20 That audit committees take their role very seriously has been evidenced during our earlier research, by audit partners who highlighted to us they are challenged robustly by the audit committee. All of the audit committee chairs we have spoken to have indicated that the most important criterion when appointing an auditor is “audit quality”.

**Enhanced Investor Engagement**

3.21 Audit committees have a keen sense of acting in the interests of the company shareholders, and yet, those shareholders rarely, if ever, engage with the audit committee. Shareholders need to be more engaged with the audit committees of the companies that they invest in. We highlighted this in our response to the Kingman review. There is an apparent lack of willingness for investors to engage with audit committee chairs; this is in stark contrast to the engagement with remuneration committee chairs, yet the systemic risk impact is considerably higher in matters of audit. Ultimately it is the investors who will appoint the auditors of the company at the Annual General Meeting. ICAS has called for greater focus to be placed on the role of investors in promoting corporate governance (which we consider could be mandated if necessary).

3.22 In 2010, the ICAS Future of Assurance report proposed that investors should:

- Seek to satisfy themselves that the reporting of the company is sufficient for their needs as Investors;
- Where that reporting is not sufficient, seek to challenge the Board to improve its reporting; and
- Seek to engage with the audit committee on the sufficiency and quality of the assurance provided on the annual report, including the financial statements and any other assurance provided.

ICAS remains of the view that these initiatives remain relevant today. This Report can be downloaded at the following link: [https://www.icas.com/technical-resources/the-future-of-assurance-report](https://www.icas.com/technical-resources/the-future-of-assurance-report).

**QUESTION 6**

*Are the proposed reforms of audit consistent with other recent reforms of corporate governance? Are there any other consequential reforms required?*

3.23 Whilst none of the proposed reforms appear to be inconsistent with recent reforms of corporate governance there does appear to be a trend towards increased regulatory intervention in the running of companies. This requires a balance. It could undermine the UK’s unitary board model as certain assigned audit committee powers would be subject to greater oversight by a regulatory body e.g. selection of the auditor. This situation would obviously need to be kept under review as proposals develop.

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