

Statutory audit market study

Competition and Markets Authority
7th floor
Victoria House
37 Southampton Row
London WC1B 4AD

26 October 2018

Dear Sir/Madam,

Statutory audit market – invitation to comment

I am writing to you on behalf of The 100 Group to outline our views on the proposed reforms to the statutory audit market. The 100 Group undoubtedly supports measures to improve audit quality, which in our view is the most important factor for both investors and businesses, and competition within the audit market, as audit underpins effective capital markets and long-term company performance. We therefore welcome the opportunity to comment on the CMA review.

We have not responded to all of the individual questions raised in the consultation document as certain questions are best left to individual companies or other stakeholder groups.

Whilst we understand the rationale behind each of the themes and potential outcomes outlined in the consultation, our overarching concern is that further regulation in this area, without holistically addressing issues in the market place (such as non-participation), may have the unintended consequence of reducing audit quality without necessarily increasing competition. Furthermore, in our view, implementation of one measure in isolation will not have the desired goal of increasing competition or quality. Instead, there will need to be a combination of complementary initiatives to address multiple factors.

We believe that the ‘expectation gap’ is the fundamental cause of concern over the audit market and that it needs to be addressed. Until such steps are taken, the expectation gap will continue to undermine any benefits of other initiatives. In our view, it is vital that steps are taken to permanently close the expectation gap – for the benefit of companies, audit firms, investors and broader stakeholders, including the general public.

Additionally, consideration should be given to the benefits not only to investors but also to international businesses and/or those with extensive shared service activities, of having one global audit firm. These include but are not limited to, ensuring consistency in quality, approach, efficiency and in some instances avoidance of duplication of effort.

We acknowledge the significance of this review, as well as Sir John Kingman’s review of the FRC, in addressing the public concerns over the audit market. We encourage any audit market reforms as a result of these reviews, to be implemented concurrently. We fully support increasing audit transparency via publication of the FRC’s Audit Quality Review (AQR) reports on an individual company basis and ensuring that the FRC has appropriate powers to sanction audit firms for substandard audit quality, whether in relation to actual audit failings or AQR findings.

Effective corporate governance is another of the fundamental mechanisms underpinning the effective performance of global capital markets and long-term company performance. The inherent flexibility of the UK ‘comply or explain’ model allows for more demanding standards than those capable of being achieved through onerous legislative requirements. Recent changes to the Code have sought to ensure that the highest standards of corporate governance are maintained, as is the UK’s position as best in class. These enhancements have reinforced the role of the Audit Committee

and enhanced the reporting of its activities in the Annual Report and Accounts. We support such developments as an effective mechanism of providing additional information to investors and would support further review, if necessary, to ensure that Audit Committee reporting is addressing the needs of investors. We welcome the CMA's and government's determination to address public concerns over the audit market and the broader business landscape and support the consultation processes undertaken to develop effective and pragmatic solutions. Recognising this, it is, as yet, unclear whether the most recent corporate failings are a result of the lack of effective corporate governance or audit. Therefore, we would caution that the root cause of these failings should be identified before solutions are implemented to ensure that they address the underlying issues.

In our opinion, any proposal should ensure that competition across the market as a whole is enhanced and does not have a detrimental impact. We are concerned that the introduction of market caps may be detrimental and may not increase competition or quality and could possibly reduce competition. We do not have a definitive view on the other potential outcomes proposed. However, in our opinion, we believe that each, as outlined, carries a greater risk of negative impact to audit quality than effecting an increase to competition.

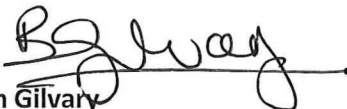
While not specifically mentioned in the consultation, in our opinion, technology developments will play an increasingly significant role in audit and therefore competition in the future. Technology will open up the audit market to non-Big Four firms and potentially also to new entrants, which will, ultimately, challenge the Big Four in the marketplace. As such, due consideration should be given to technological advances within audit when determining changes to the audit framework and audit market as a whole, to ensure that the solutions implemented are long term and sustainable.

Who we are

The 100 Group of Finance Directors represents the views of the finance directors of FTSE 100 and several large UK private companies. Our member companies represent almost 90% of the market capitalisation of the UK FTSE 100 Index. Our aim is to contribute positively to the development of UK and international policy and practice on matters that affect our businesses, including taxation, financial reporting, corporate governance and capital market regulation. Whilst this letter expresses the views of The 100 Group of Finance Directors as a whole, those views are not necessarily those of our individual members or their respective employers.

Please feel free to contact me at brian.gilvary@the100group.co.uk, should you wish to discuss our comments.

Yours sincerely,



Brian Gilvary
Chairman, The 100 Group

A) Issues

How audit serves its stakeholders (question 1)

Audit underpins effective capital markets and long-term company performance. Therefore, it is imperative that it is providing the users of financial statements with the necessary level of information and assurance.

We note that the benefit to users is not only the result of changes to the audit framework but is the product of a number of recent initiatives combined with changes to the audit framework, such as business model reporting, viability statements and the work of the FRC FR Lab. Whilst all have had a beneficial impact for users of financial statements, they have done little to address the expectation gap which in our opinion remains the biggest challenge for the audit profession to overcome. In our opinion, this is not limited to users of financial statements but to wider stakeholders including the general public.

In our view, there needs to be greater education of all stakeholders, to ensure that they fully understand the purpose of an audit and the benefits it provides to them. We appreciate that there have been steps to address this, such as long-form audit reports, but we do not feel the messages have landed as intended. For example there are misconceptions that auditors audit the entirety of the annual report including forecasts, that the auditor has validated every transaction recorded and is responsible for uncovering all fraudulent activity. In our view the expectation gap is an overriding issue that will dilute the impact of any other initiatives until tackled.

Theme 1: The audit framework (question 2)

As members of the 100 Group are responsible for the financial statements that are subject to audit under the audit framework, we recognise the potential for conflict in commenting on the adequacy of the framework, and believe that other stakeholders are better placed to comment on the effectiveness of it. However, we are fully supportive of a transparent and robust audit framework and welcome enhancements that better serve the needs of investors. We acknowledge that recent developments, such as long-form audit reports, have sought to close the expectation gap and ensure that users better understand the work of auditors.

As noted in paragraph 3.14 there has been a “*broad shift over time from an approach based on historic cost accounting to that based on fair value accounting*”. Whilst we acknowledge the challenges posed by this shift, in our opinion, it is right that auditing standards are effective in ensuring compliance with underlying accounting standards, and are not aware of any instances where the accounting framework adopted by a company has hindered competition.

Theme 2: Incentives and governance (questions 3 – 4)

In our experience, the Audit Committee’s focus is on the quality and challenge provided by the audit firm. The cost of delivery is a relatively minor consideration in selecting an audit firm, with a greater weighting typically being applied to other factors such as quality, innovation, sector expertise and efficiency.

We strongly believe that the right to appoint, evaluate, and determine the tenure of auditors should be retained by shareholders, as represented by the Audit Committee. In the experience of our members, the responsibility and ownership of the audit relationship firmly sits with the Audit Committee Chair and not with the Finance Director. In our opinion, this is not always fully understood by the public or investors. The introduction of mandatory firm rotation has made the role and responsibilities of the Audit Committee clearer but, as noted in our response to theme one, we still believe that there is a misunderstanding of this relationship resulting from the expectation gap.

Paragraph 3.8 states that management are looking to minimise costs of an audit through an audit tender – “*Company managers’ incentives may be for low prices*”; and paragraph 3.18 implies that management are the ultimate decision makers when selecting an auditor. We do not believe either assertion to be true for the reasons stated above.

Theme 3: Choice and switching (questions 5 – 11)

In our view, we would encourage non-Big Four firms to take a share in the larger end of the market if they have the ability and appetite to do so. Recognising that there is still a need for statutory audits in the market and any “opening up” at the top end, shouldn’t come at a cost in terms of suitability, quality and focus across the audit market as a whole (i.e. including non FTSE companies).

We note that there are a number of AIM-listed and large private companies which, if main listed, would be members of the FTSE 350, that are not audited by the Big Four firms (for example Fever Tree). Therefore it does appear to be possible for non-Big Four firms to compete more actively in the FTSE 100 audit market.

We are disappointed to note that our members have not had as much success in engaging non-Big Four firms in the audit tender process. Our members note that, whilst they do often invite non-Big Four firms to participate in the audit tender process, they often either choose to not take part or are excluded early in the process due to a lack of capability. Possible reasons why non-Big Four audit firms find it more difficult to participate in tenders are: smaller global footprint, lack of sector expertise and/or the need for the audit to have specialists, which the non-Big Four firms are not always able to provide.

We are supportive of mandatory audit firm rotation, as many of our members have seen first-hand the benefits that it brings – such as competition, quality, innovation and a fresh perspective, which outweigh the costs and arduous nature of changing audit firm. From the experience of our members who have gone through a tender, we have generally received good engagement and healthy competition from the Big Four firms. In our experience, in order to get the best engagement from audit firms, it is imperative that there is sufficient time between tender and appointment to allow for the incoming firm to become independent, as not doing so could restrict the number of participants. It is therefore, in our opinion, crucial that this is considered by the Audit Committee when planning a tender.

Theme 4: Resilience (question 12)

As noted elsewhere in our response, we are fully supportive of non-Big Four firms increasing their participation, where possible, in the larger end of the market. Whilst our primary motivation is to increase competition and Audit Committee choice, we note that this has the added benefit of increasing audit market resilience.

In our view, without changes to the current status quo, we do not believe the audit market would remain effective if one of the Big Four were to exit. Four active participants is the minimum number for a credible competitive market for the audit of large companies. We would be very concerned if one of the Big Four were to exit the market either by choice or through unexpected circumstances. If that were to happen, radical changes would be needed to restore an effective, competitive marketplace. This is based on the combined impacts of mandatory rotation requirements, independence requirements and, as noted previously, lack of participation in audit tenders by non-Big Four firms. If one of the Big Four were to exit the market, we believe there would be capacity issues in sharing the workload across the other firms, which would be to the detriment of audit quality. Therefore, at present, the exiting of a Big Four firm from the audit market would cause greater concerns to quality, efficiency, and cost of an audit, all of which are unfavourable to shareholders and companies.

However, considering the global nature of the Big Four, we think it unlikely that a Big Four audit firm would exit the UK market by choice.

Theme 5: Regulation (question 13)

As noted in our response to question one, audit underpins the effectiveness of the UK Capital Markets. As such, in our opinion, it is right that the audit market is subject to regulation. In our view regulation needs to be balanced to ensure that it does not preclude competition from audit firms in the marketplace, whilst also addressing the needs of users.

In paragraphs 3.40 to 3.42, various concerns in relation to the impact audit quality can have on capital markets, wider stakeholder confidence, and the effectiveness of enforcement are outlined, noting that these are being considered by Sir John Kingman's review of the FRC. In our opinion, publication of results of the FRC Audit Quality Reviews would have the benefit of not only increasing transparency but also addressing the credence good concern outlined in paragraph 3.40. Furthermore, we note that a similar process was implemented in the United States and, therefore implementation would not result in the UK becoming an outlier in global capital markets. We are also supportive of ensuring that the FRC has appropriate powers to sanction or penalise audit firms for substandard audit quality, noting this could be achieved in many ways such as increasing the scale and scope of fines or linking them to AQR findings.

B) Potential measures

Cost benefit analysis (question 14-15)

We note that the costs and benefits of each of the measures will vary depending on the extent to which they are implemented.

In our view, significant costs have been incurred as a result of audit tendering rules, borne both by companies (and therefore shareholders) and audit firms. However, we are supportive of these rules as the benefits to the shareholder clearly outweighed the costs incurred. We therefore strongly recommend that further cost benefit analysis is undertaken prior to putting any measures in place, to ensure that the benefits clearly outweigh the costs to the shareholder.

Restrictions on audit firms providing non-audit services (questions 16 -18)

In line with best practice, our members restrict their auditors from providing certain non-audit services. Often such restrictions go above and beyond the UK regulatory requirements, which are less stringent than the SEC requirements many of our members are also required to comply with.

In our opinion, it is appropriate to prohibit auditors from undertaking certain non-audit services, which could cause their independence to be impaired. We are supportive of further review into what services should be captured by the requirements. However, we do not support a complete prohibition of non-audit services being provided by audit firms. There are certain activities, classified as non-audit services that auditors are required to provide, such as reviews of half-yearly financial statements, the provision of comfort letters supporting bond issuances, regulatory returns (for example to the PRA), and other legal and contractual requirements. Furthermore, in our opinion, there are additional non-audit services that, with appropriate safeguards in place, the auditor may be best placed to undertake, such as an accountant's report in relation to the sale of a business, a carve out or a class 1 circular, or undertaking financial due diligence without any impact on independence.

For a number of our members, the audit team is supported by the knowledge and expertise of non-audit specialists, which is central to ensuring the provision of a high-quality audit. If audit firms were prohibited from providing non-audit services to their audit clients and any other large company or PIE (as per paragraph 4.8b), in our opinion, the quality of the audit would no doubt suffer.

The 100 group does not have a definitive view on whether there should be separate ownership of the audit and non-audit service practices of UK audit firms. Whilst we can see the benefits of separation, and how this would address the concerns that auditors are not willing or able to partake in audit tenders, due to non-audit services they provide, we have concerns about how a separation could impact the quality of delivering an audit, as audit-only firms would not have sufficient access to the technical specialists required to deliver a high-quality audit. In our opinion, splitting the firms would, more likely than not, increase the audit cost significantly, as the firms would need to source advisors and specialists from elsewhere. Any cost increase would ultimately be passed onto shareholders without any associated benefits such as improved audit quality or a greater level of assurance.

In our opinion, the international structure of the audit firms poses a significant barrier to creating audit-only firms and, in order to be effective at meeting the underlying aims, any such break-up may need to be done on a global scale.

Market share cap (questions 19-23)

In our opinion, implementing a market share cap would not solve the competition or quality issues identified. Furthermore, we believe that implementation of market caps, without broader market reform, may have the unintended consequence of hindering competition and choice if firms are unable to participate in tenders.

For example: Company A is required to rotate from its current auditor, PwC. It has invited KPMG, EY, and Deloitte along with a selection of smaller audit firms. In line with our response to theme three, the smaller firms have either declined to participate, or lack sufficient global footprint or sector skills. KPMG are conflicted, either from an independence perspective or there is a conflict of interest and are therefore unable to participate. If EY were restricted from participation due to a market cap requirement, Company A would have to appoint Deloitte.

Furthermore, the implementation of a market cap does not address the issue of non-Big Four firms choosing not to participate in tenders, as it does not help to address some of the obstacles that they may face in relation to geographical footprint and specialists required to deliver certain audits.

It is unclear from the consultation at which level the market cap will operate (e.g. across the FTSE 100, FTSE 350, the main market as a whole, or extended across AIM and/or the private sector). Furthermore, it is unclear whether the fees to be included are total global audit fees or the UK element only. As such, we are unable to provide meaningful commentary on the proposals in the consultation. However, given the number of AIM listed and large private companies that are of public interest, we would recommend that any market cap be considered across the audit sector as a whole. Additionally, we note that the majority of our members operate internationally and so a significant portion of the audit effort is undertaken by non-UK audit firms. Therefore the non-UK audit fees significantly outweigh the UK portion of the global audit fee.

Paragraph 4.13 refers to “*variations of joint audit and shared audits*”. From our experience joint audits increase complexity and do not lead to increases in quality or competition. They are more expensive and time-consuming with decisions relating to key accounting matters often taking longer to get agreement from the auditors. We understand that, despite a number of French companies appointing one Big Four firm and one smaller firm in a joint model, it is not clear that this has enabled the smaller firm to take on the larger audits themselves. We are, therefore, not supportive of a joint audit model as, currently, there are no benefits to shareholders.

Incentives and governance (questions 24-26)

In our experience Audit Committees do have due regard to a broader range of stakeholders, as the primary users defined by International Financial Reporting Standards (conceptual framework) are broader than just shareholders. Additionally, Audit Committees are cognisant of ensuring Annual Reports are prepared to a high standard, following best practice guidance which often makes reference to broader stakeholder groups.

In our opinion, it is important to recognise that audit is a well-defined global offering, and any changes should be mindful of the international market that audit opinions supporting UK PLCs' financial statements are considered in as well as the potential impact on UK investment going forward, if the UK moves away from this globally recognised model.

It is unclear what, if any, benefits will be generated for users of financial statements and wider stakeholders if Audit Committees were to be replaced with an "Independent Body" that has a public interest duty. The UK Corporate Governance requirements define the role and scope of the Audit Committee and states that the Audit Committee should be comprised of three independent directors with 'competence relevant to the sector' in which the company operates; and that the size, skills, experience and balance of the Audit Committee should be adequate to deal with the complexity and risk of the business and its industry. Therefore, Audit Committees are already independent from the companies that they oversee and are responsible for the selection of the audit firm, managing the scope of the audit, setting the audit fees and managing the performance of the audit firm.

It should also be noted that the remit of the Audit Committee extends further than the management and oversight of the external auditor, and includes reviewing the company's internal financial controls and internal control and risk management systems, as well as monitoring and reviewing the effectiveness of the company's internal audit function. It is unclear whether the intention of the proposal is that this "Independent Body" would assume the internal review aspects of the Audit Committee's remit.

In our opinion, the current role and remit of the Audit Committee is well defined and understood by investors. Splitting the remit such that an 'Independent Body' Audit Committee oversees external audit and a company Audit Committee oversees the internal aspects of the current remit, would cause unnecessary confusion to investors.

Furthermore, the appointment of Independent non-executive directors is subject to approval by shareholders at Annual General Meetings, as are appointments to chairs of committees. We fully support and encourage investors using their voice, via voting on such appointments, in holding the Audit Committee chair and members to account as their agents. Again, it is unclear from the proposal how, or if, investors will be able to hold members of an "Independent Body" to account, and what influence they will have over appointments.

As noted above, effective corporate governance is one of the fundamental mechanisms underpinning effective performance of global capital markets and long-term company performance. The inherent flexibility of the UK 'comply or explain' model allows for more demanding standards than those capable of being achieved through onerous legislative requirements. This has led to the UK having some of the highest standards of corporate governance in the world, which in turn makes the UK an attractive market for new investment. Recent changes to the Code have sought to ensure that the highest standards of corporate governance are maintained, as is the UK's position as best in class. These enhancements have reinforced the role of the Audit Committee and enhanced the reporting of its activities in the Annual Report and Accounts. We support such developments as an effective mechanism for providing additional information to investors, and would support further review, if necessary, to ensure that the Audit Committee reporting is addressing the needs of investors.

Additionally, we are supportive of the FRC's recent announcement to extend corporate governance to large private companies. In our opinion, this is an effective mechanism for addressing a further "expectation gap" – that all large companies are subject to the same corporate governance requirements. However we continue to believe that this should mirror the Code in full to avoid confusion and that large subsidiaries of companies applying the full code should be eligible for certain disclosure exemptions.

Whilst the consultation does not particularly seek views on the appointment of directors, both executive and independent non-executives, in our opinion, we would support a model, similar to that implemented by the FCA and PRA, whereby appointments to certain roles – such as Audit Committee Chair, are subject to approval by the regulator. In our opinion, this would be a pragmatic solution that is not overly burdensome to companies or the regulator.

We welcome the CMA's and government's determination to address the public concerns across the audit market as a whole; however, given that it is, as yet, unclear whether the most recent corporate failings are a result of the lack of effective corporate governance or audit failings, we would advise that the root cause of these failings is identified before proposals are implemented to ensure that they address the underlying issues.

In responding to this section of the consultation we have assumed that 'public interest' will be defined as per the 2016 EU Audit Regulation and Audit Directive, as noted in paragraph 3.46 and would therefore capture all main listed UK companies. We note that the consultation also uses the term "public interest" more generally to infer the general interests of a broader range of UK stakeholder, including the general public (as noted in paragraphs 3.19, 4.42, 4.44 and 4.50). If the CMA's intention is that the proposed "Independent Body's" public interest requirement would be the general interests of a broader range of UK stakeholder, including the general public, we would advise against the development of a "public interest duty" as, in our view, this could lead to confusion as to which companies are within scope of the "Independent Body" and which are able to maintain the current model, which could further undermine understanding of the market, and which appears at odds with the aims of the review.

Frequency of audit tender rotation (question 27)

As previously noted, we support the current audit rotation rules requiring a tender every 10 years and rotation every 20. Whilst we acknowledge the benefits that audit rotation can bring, it is a costly and arduous process for both companies and audit firms. In our opinion, the cost of increasing the frequency of tenders will outweigh any benefits to investors, which should be the primary concern of the Audit Committee when making the decision to initiate an audit tender.

In the experience of our members, incoming auditors are not able to reach optimal efficiency in their first year, as it takes them time to develop their understanding of the business and its risks. As such, more frequent audit tenders will increase the costs incurred in delivering an audit, which is ultimately passed onto shareholders.

Furthermore, the mandatory audit rotation requirements are relatively new and, to date, not all impacted companies have undertaken their first required tender (as at October 2018 approximately 75% of the FTSE 100 have undertaken an audit tender since the requirements were introduced). Therefore, we strongly recommend that, as a minimum, one complete cycle of the new requirements is completed before further changes are made, as it is not yet possible to ascertain whether the requirements have had a positive impact on the market.