THE 100 GROUP

*Main Committee*

Audit Reform and Regulation Team
Department for Business, Energy and Industrial Strategy
1 Victoria Street
London
SW1H 0ET

9 September 2019

Email: auditmarketconsultation@beis.gov.uk

Dear Secretary of State,

**Initial consultation on recommendations by the Competition and Markets Authority (CMA)**
Below is a summary of our views on the CMA's recommendations for the audit market. As this consultation builds on the CMA report we have also enclosed our responses submitted to the CMA.

In a time of significant change, it is critical that we protect UK competitiveness and for UK capital markets to remain attractive for investment, any recommendations made as a result of this consultation must keep this in mind.

Enhanced regulatory oversight of Audit Committees

- We support greater engagement between the regulator and Audit Committees (ACs).
- In our experience, the main priority in audit tenders is audit quality. However, we support the regulator subsequently reviewing the tender process as a method to address any concern.
- We are not supportive of having an observer on the AC or moving the selection of auditors to an independent body.
- We support the regulators Audit Quality Review (AQR) reports being published.

Mandatory joint audits of FTSE 350 companies and peer reviews for those not in scope

- We do not support mandatory joint audits or shared audits.
- We query how peer reviews would work and do not support the proposal that they take place during the year end audit. However, they may be useful in supporting the regulators AQR process.
- Market caps are likely to have a detrimental impact for audit quality however this may be to a lesser extent than mandatory joint audits. However, they may also have a detrimental impact on choice within the market.

Mitigate the effects of the distress or a failure of a 'Big Four' firm

- We agree there would be considerable concern if one of the Big Four were to exit the market, either voluntarily or due to distress and therefore support reviews over audit firm stability.

Mandate an operational split between audit and non-audit practices of 'Big Four' firms

- It is important that the logistics of any operational split has no impact on audit quality and that the audit practice is able to retain the relevant experts to ensure high quality audits. We believe the recommendation should be applicable to all audit firms and not just the Big Four.

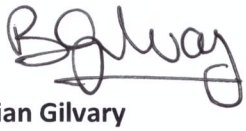
Other possible recommendations

- The corporate environment has benefitted from the introduction of long-term remuneration policies, as such there may be benefit to this being investigated for audit firms. However, it is for audit firms to comment on the practicalities of this for a partnership model.

- We would support technology licencing, if challenger firms feel it is helpful. If implemented, consideration would need to be given to product differentiation, or lack of it, in the market. Technology licencing should not inhibit challenger firms investing in their own technology.
- To date, not all companies have undertaken their first required tender. One complete cycle of the current requirement should be completed before further changes are considered, as it is not yet possible to ascertain whether the current regime has had the desired market impact.
- Whilst not specifically consulted on, we would support a model, similar to that implemented by the Prudential Regulation Authority and Financial Conduct Authority, whereby appointments to certain roles – such as the AC Chair, are subject to regulatory approval.
- We note the BEIS Select Committee proposed introducing cooling-off periods of three years. We would be concerned about cooling-off periods for outgoing auditors which risk limiting competition for both audit and non-audit services. However, we would be supportive of the introduction of one if a more appropriate period was considered, for example no more than 12 months.

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

Yours sincerely,



**Brian Gilvary**
*Chairman, The 100 Group*

**Enclosures: 100 Group responses to CMA Statutory audit market review**

1) Invitation to comment
2) Update paper - invitation to comment
3) Supplemental response

**Appendix 1**

**Audit Committee Scrutiny**

1) **Do you agree that the new regulator should be given broad powers to mandate standards for the appointment and oversight of auditors, to monitor compliance and take remedial action? What should those powers look like and how do you think those powers would sit with the proposals in Sir John Kingman's review of the Financial Reporting Council?**

   It is widely acknowledged that there is limited interaction between regulators and companies/Audit Committees (ACs) in relation to the appointment and oversight of auditors. We are supportive of the regulator having greater insight into the processes and procedures that companies and ACs implemented and followed for audit tenders, including those around the transition for both incoming and outgoing auditors.

   As a first step we would recommend greater engagement between the regulator and ACs. The regulator needs to better understand AC ways of working in order to determine whether any intervention is needed. Following this assessment, if deemed necessary, we would be supportive of the implementation of standards and compliance monitoring by the regulator.

   In our experience, the main priority for ACs during audit tenders is audit quality and this encompasses independence and sceptical challenge. Cultural fit is one of several elements considered by ACs when ensuring that a high quality audit will be provided by the external auditor. For the avoidance of doubt, cultural fit is not a synonym for cosiness but reflects the need for open, honest and productive relationships. This must be considered alongside the independence and sceptical challenge that an auditor brings. We would support adding a degree of regulatory oversight to this tender process. This could take the form of subsequent reviews of tender materials, (for example the request for proposal and score cards) as well as reviewing the quality of disclosure on tendering in company accounts. In our view, the regulator should consider such mechanisms before implementing regulatory oversight.

   Oversight of auditors is clearly defined in the UK Corporate Governance Code. In our experience this is well understood and ACs work effectively and to a high standard. The regulator should, as already permissible, engage on a more regular basis with the Audit Committee Chair (ACC). If there needs be greater emphasis placed on this engagement we would support this and suggest that consideration be given to how the Prudential Regulation Authority (PRA) and Financial Conduct Authority (FCA) approach AC engagement.

   As noted in recommendation 68 from the Kingman Review, in order for the regulator to be able to carry out such powers, the regulator will need to be staffed by highly experienced, senior people, including former or retired senior executives and experts. In our opinion this experience should be considered both in terms of necessary expertise (e.g. digital, sector knowledge) and 'on-the-job' experience (i.e. length of experience). This will be critical for the regulator to be able to effectively challenge ACs and will take time to recruit experts with the right range of experience to fulfil these roles.

   We are also supportive of the regulators Audit Quality Reviews (AQR) reports being published, as another mechanism by which to regulate the performance of both ACs and external auditors.

**2) What comments do you have on the ways the regulator should exercise these new powers?**

- **For instance, do you have any comments on the conditions that should be met for the regulator to exercise its powers to take remedial action?**
- **Are there particular events (such as a poor audit quality review, early departure of an auditor or a significant restatement of the company's accounts) which should trigger the regulator's involvement?**

How regulation should be exercised will be situation dependent. We propose the regulator performs an assessment of AC quality to identify areas of improvement, before determining what any powers or standards should be. No intervention should be undertaken without a detailed consultation with the company, AC and if necessary external auditor.

In relation to placing an observer on an AC or another part of the audit process, in order to oversee compliance with the standards, we query what value this will add. The observer will need to observe the AC for a long period of time and understand the business in great depth in order to properly assess whether the AC is operating effectively. At a time where the market is highly resource constrained, we question how the regulator would identify a sufficient number of people, with the relevant expertise and sector understanding to observe all FTSE 350 ACs. There may also be risk of market sensitive information being compromised through this process. Instead, placing greater responsibility on the AC to engage with the regulator may address this.

The regulator must ensure that they can exercise their powers in a timely manner. The current AQR process reports on reviews undertaken up to two years after the year reviewed, i.e. a December 2018 year-end AQR review will be externally published in June 2020, and therefore the regulator cannot act on a poor audit quality review until nearly two years after the audit has been completed.

We are not supportive of an independent body appointing the audit firm in the short or long term. We believe that an effective AC is best placed to make this appointment and can justify their rational to the regulator and investors.

**3) How should the regulator engage shareholders in monitoring compliance and taking remedial action?**

Shareholders already have the ability to engage with ACs, however in our experience this is rarely taken up. We do not think this engagement needs to be mandated as best practice standards already exist, for example the Stewardship Code. It is the joint responsibility of investors and the Board to engage with each other on any and all relevant topics including the external audit. We fully support there being greater engagement at all levels if it would be beneficial for investors.

**<u>Mandatory Joint Audit and Peer Review</u>**

**5) Do you agree with the CMA's joint audit proposal as developed since its interim study in December?**

No. We do not agree with any mandatory joint audit proposal (CMA or BEIS Select Committee).

**6) Do you agree with the CMA's proposed exemptions to the joint audit proposals? How should the regulator decide whether a company should qualify for the proposed exemption for complex companies?**

Our principle concern is that mandatory joint audits pose a greater risk to audit quality than the potential perceived benefits to competition and market resilience. The quality of a mandatory joint audit, even once successfully implemented, may not meet or exceed that provided by a single audit firm today.

Currently, the provision of audit services, the regulation applied and the framework adopted is the same across the audit services market, from the smallest statutory entity to the largest FTSE 100. This standardisation makes it easier for shareholders and the regulator to engage with the market. The introduction of mandatory joint audits would create significant complexity within this market, to the detriment of those whom it serves. Stratifying the companies in this way would cause ambiguity and complexity. For example there could potentially be four types of audit just within the FTSE 350:

i) Audits of 'complex companies' by a single Big Four auditor, which is peer reviewed by a challenger firm

ii) Audits of 'complex companies' by a single challenger auditor

iii) Audits of 'non-complex' companies through joint audit, by way of a Big Four and challenger firm

iv) Audits of 'non-complex' companies through a single challenger firm

The CMA proposes in its final report (paragraph 6.40.a) that companies must make the transition to joint audits no later than when they next re-tender. This implies that the tender date would be when the assessment is made as to what type of company it is, either 'complex' or 'non-complex'. Stratifying the companies like this would be extremely difficult for a number of reasons. Valuations of companies can change on a daily basis, one off events may move companies from being 'non-complex' to 'complex' and future plans to a business can quickly shift the risks a company faces. We therefore cannot see what mechanism would be adopted that the regulator could easily use to make this assessment. The burdens this process places on the regulator, companies and ACs could be highly significant and difficult to roll out, as well as create more complexity in the market.

Mandatory joint audits are more expensive and time-consuming, with decisions relating to key accounting matters often taking longer to get agreement from the auditors. They increase complexity with no demonstrable increases in quality or competition. Furthermore, mandatory joint audits may lead to delays in accounts being signed off, which could be detrimental to shareholders and potentially negatively impact the attractiveness of the UK listed market.

We strongly believe that ACs, as agents for investors, should be able to appoint the audit firm they consider will be best placed to provide a robust and challenging audit. In our view, mandatory joint audits may prevent this from happening. There is a risk that mandatory joint audit could add pressure to the external audit tender process. The tender decision may come down to a challenger firm, who may potentially be stretching themselves to deliver the audit, or a joint audit which poses different risks such as audit matters taking longer, issues potentially falling through gaps and higher costs. Neither of which is a good outcome for shareholders or audit quality, and should not be a trade-off AC's have to make.

**7) Do you agree that challenger firms currently have capacity to provide joint audit services to the FTSE350? If a staged approach were needed, how should the regulator make it work most effectively? If not immediately, how quickly could challenger firms build sufficient capacity for joint audit to be practised across the whole of the FTSE350?**

The most important consideration to any changes is the ability for the market as a whole to be serviced.

Consideration needs to be given to ensure that quality and competition in the market outside the FTSE 350 should not be degraded as challenger firms take on bigger and more complex audits. It is specifically for challenger firms to comment on whether they have the capacity to take on mandatory joint audits, as well as take on audits of 'non-complex' companies on top of their current audit portfolio.

We believe that challenger firms have the capability to deliver the audit of many companies in the FTSE 350 and note that a number of AIM-listed and large private companies of equivalent size to the FTSE 350 are audited by challenger firms. In our opinion, one of the risks of mandatory joint audits is challenger firms being responsible for less complex or low risk audit areas, which would not position them to take on more complex work in the future than they are able to today.

The FTSE 350 represents a small percentage of the companies that require an audit in the UK, as such consideration should be given to the audits outside of the FTSE 350 too. Enhancing their presence in growing markets, both private and listed, may provide a better way for non-Big Four firms to grow in size and compete more effectively, rather than inserting them into audits of companies which they may not yet be prepared for.

**8) Do you agree with the CMA's recommendation that the liability regime would not need to be amended if the joint audit proposal were implemented?**

As noted in paragraph 6.60 of the CMA's final paper, joint and several liability could be a potential additional cost that will impact those who want to enter the market in the short-term. It is the responsibility of the audit firms to determine whether or not they are willing to take on the associated risks of an audit.

**10) The academic literature cited in the CMA's report suggests the joint audit proposal would lead to an increased cost of 25-50%. Do you agree with this estimate?**

It would be reasonable to expect joint audits to result in an increase in costs, the size of this increase will differ for each company and may well cover the range suggested by the academic research. However, the financial cost is just one element to be considered. The most important is the impact on audit quality. The CMA reported in paragraph 4.55 of the update paper that "*conclusions are mixed as to the impact of joint audits on audit quality",* a potential 50% increase in costs for no demonstrable benefit in audit quality is not beneficial for shareholders, the AC or company. Additionally there may be an increase in time taken to deliver the audit, to which no financial cost can be attributed.

**11) Do you agree with the CMA's assessment of the alternatives to joint audit, including shared audit?**

We do not think there is a significant difference between shared audit and mandatory joint audits and therefore our comments expressed above, on mandatory joint audits, are applicable.

**12) How strongly will the CMA's proposals improve competition in the wider audit market, and are there any additional measures needed to ensure that those impacts are maximised?**

We welcome more competition in the market, but the primary question should be how quality can be maintained and improved across the entire audit market. In our view mandatory joint audits do not address this primary question and may not necessarily increase competition.

The CMA also considered market caps as a potential remedy. From an audit quality perspective, market caps may be less detrimental than joint audits, as they do not pose the same risks to quality, such as audit issues falling through the gaps or potential delays to audit delivery. However, we have concerns over how they could be practically implemented whilst still allowing ACs to select the audit firm best placed to deliver the audit.

**13) Do you agree with the CMA's proposals for peer review? How should the regulator select which companies to review?**

In our view, peer reviews are equivalent to being a joint audit 'light' approach, which we do not think will sufficiently address the concerns over audit quality.

Peer reviews conducted during the course of the audit would cause duplication of effort and could possibly detract the auditor, the AC and company by shifting their focus to process management (if the peer review is required to be performed before a company releases its results) rather than addressing audit issues. Furthermore, adding in an additional review of the external audit, on top of those that audit firms conduct internally themselves, could place auditors under undue pressure. This runs the risk of negatively impacting quality and could cause delays to the audit process, which would ultimately have a detrimental impact for shareholders.

Consideration must be given to how challenger firms will manage peer reviews alongside their audit work. For example, if a complex accounting issue arises in a company being peer reviewed, there should not be any resulting detrimental impacts to the audit quality of their audit clients, due to a diversion of resources or attention, and vice-versa.

As an alternative, the timing of these peer reviews could be pushed back so as not to take place during the audit process and instead form part of the regulator's Audit Quality Review. This has the added benefit of alleviating time and resource pressures on the regulator and/or enables them to expand the scope of their reviews. This would also give the challenger firm a better opportunity to enhance their knowledge and understanding of the requirements to perform complex audits. A peer review should not be a duplication of the audit itself but a review of the work and methodology performed.

**<u>Measures to Mitigate the Effects of the Distress or Failure of a Big Four firm</u>**

**15) What factors do you think the regulator should take into account when considering action in the case of a distressed statutory audit practice?**

The most immediate concern to the resilience of the audit market is that of an audit firm voluntarily choosing to exit, rather than exiting the market due to distress. The regulator needs to work alongside audit firms to determine how best to identify the causes and ways to prevent a voluntary exit, or further cases of non-participation in the market which we are increasingly seeing.

Audit firms are best placed to comment on the package of proposals outlined in the consultation. They appear to be appropriate and not overly burdensome and will enable the regulator to get near real-time information on market resilience, allowing them to determine what, if any, intervention is needed.

Any action taken by the regulator will be situation dependent. The regulator will need to establish a committee that includes audit firm representatives, who can appropriately interrogate the information submitted and act if necessary.

**16) What powers of intervention do you think the regulator should have in those circumstances, and what should be their duties in exercising them?**

As noted in our response to question 15, the action required will be situation dependent. As such, the regulator may need a range of powers enabling them to intervene in whichever form is most appropriate, taking into account the situation that has led to a firm becoming distressed. Regulators will need to work with audit firms, ACs and companies when intervening to best understand how audits and other services can be reallocated.

Consideration will also need to be given over the extent of the regulators powers to non-audit aspects of Big Four and challenger firms, which may be the cause of any potential distress.

**Operational Split between Audit and Non-Audit Practices**

**17) Do you agree with the CMA's analysis of the impacts on audit quality that arise from the tensions it identifies between audit and non-audit services?**

The CMA's conclusion that tensions can arise between a firm's non-audit activities and its audit function is, in our experience, not the case. In line with best practice, our members already restrict their auditors from providing non-audit services and often such restrictions go above and beyond the current UK regulatory requirements. As noted in our responses to the CMA, we welcome the regulator's current review of these permissible non-audit services. For certain specialist services there is benefit of those performing the work to also work in non-audit areas so they can keep in touch with live changes in markets. For example, for audits that require valuations expertise, those that perform the work cannot ordinarily gain valuation experience through an audit and therefore will need to work in a range of markets and services to develop their skills.

The recently introduced audit tendering requirements have already led to a change in market dynamics. ACs can ensure that all invited participants are able to deliver the audit (i.e. are not conflicted by independence rules) for example by maximising time between tender and appointment. Therefore audit firms, including challenger firms, can take advantage of the opportunities to enhance their understanding of a company in advance of the tender by providing non-audit work. We do not see this as being a conflict between the audit and non-audit services of firms.

We do not view the former external audit firm taking on non-audit work as a conflict, as the teams are distinctly different. However, if of benefit, we would support consideration being given to the introduction of a cooling-off period for the outgoing external auditor. We note the BEIS Select Committee proposed a cool-off period of three years, this in our opinion is too long and would risk limiting competition for both audit and non-audit services. If a cooling-off period were to be introduced, a more appropriate period needs to be considered, for example no more than 12 months. This would be subject to the implementation of other potential measures such as a split of audit and non-audit firms.

**18) What are your views on the manner and design of the operational split recommended by the CMA? What are your views on the overall market impact of such measures?**

As noted in our original submission to the CMA, we do not have a definitive view on whether there should be separate ownership or an operational split between the audit and non-audit service practices of UK audit firms.

It is the responsibility of the audit firms to ensure that any split does not negatively impact the quality of the work they deliver, across both audit and non-audit services. Our only comment on the design of the recommendation is that it should be applicable to all audit firms in the market and not just the Big Four.

**20) Do you agree with the CMA's proposal to keep a full structural separation in reserve as a future measure?**

It is right that the CMA undertake periodic reviews of the implementation of the final proposals from this consultation and continue to review any areas of market concern. Should further intervention be required, the proposals suggested from this consultation, as well as any new viable ideas, should be considered together and tested further before any additional changes are made.

**21) What implementation considerations should Government take into account when considering the operational split recommendations? Please provide reasoning and evidence where possible.**

As noted in our response to question 18, this remedy should apply across the audit market as a whole. Government also needs to work with audit firms to ensure that implementation of this remedy does not, even in the short-term, hinder audit firms ability to provide high quality audits with access to appropriate specialists or their ability to attract, retain and facilitate movement of staff across the business.

**Other Possible Measures**

**22) Do you agree with the CMA's other possible measures? How would these suggestions interact with the main recommendations? How would these additional proposals impact on the market?**

We fully support a review of the progress made post implementation. The timeframe of five years may need re-considering depending on what the changes are and how long they take to implement.

**23) Do you agree with the CMA's suggestions regarding remuneration deferral and clawback?**

Audit firms are best placed to comment on the practicality of this suggestion within the context of a partnership. There may be benefit in exploring this as the corporate environment has demonstrated the advantages that long-term remuneration structures can bring. If introduced for all partners, and not only audit partners, this may help to address the perceived tension between audit and non-audit partners being impacted by each other's performance.

**26) Do you agree with the CMA's suggestions regarding technology licensing?**

- **What changes would you like to see made to the current licensing framework?**

The introduction of licencing is a viable solution if lack of technology is a barrier to challenger firms competing. However, based on our discussions throughout this consultation and responses submitted to the CMA, we understand that challenger firms do not deem technology to be a significant factor that requires change in the market.

There is a risk that if introduced, this may lead to undifferentiated audit products in the market. Consideration needs to be given to the spirit of an audit as technology becomes an increasingly bigger part of an audit process. The benefits of changing audit firms may diminish if the same technology is used from one auditor to the next. This could be managed by the regulator ensuring that challenger firms continue to invest in and develop their own tools.

**28) Do you agree with the CMA's suggestions regarding notice periods and non-compete clauses? Do you agree that the regulator should consider whether Big Four firms should be required to limit notice periods to 6 months?**

If the current notice periods are restricting partners and senior staff from moving firms, and more specifically moving outside of Big Four firms, then we would be supportive of these periods being reviewed. It is for the audit firms to determine what an appropriate notice period would be whilst minimising disruption to the delivery of existing audit services.

**29) Do you agree with the CMA's suggestions regarding tendering and rotation periods?**

We acknowledge the benefits that audit rotation brings, despite it being a costly and arduous process for both companies and audit firms. The current mandatory audit rotation requirements are relatively new and, to date, not all companies have undertaken their first required tender.

Therefore, we strongly recommend that, as a minimum, one complete cycle of the current requirement 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.

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, increasing the frequency of tenders risks degrading the quality of assurance provided and will increase the costs incurred, which is ultimately passed onto shareholders.

**30) Do you have other proposals for measures to increase competition and choice in the audit market that the CMA has not considered? Please specify whether these would be alternatives or additional to some or all of the CMA's proposals, and whether these could be taken forward prior to primary legislation.**

As previously raised in our initial response to the CMA, we would support a model, similar to that implemented by the FCA and PRA, whereby appointments to certain roles – such as the Audit Committee Chair, are subject to regulatory approval. This would be a pragmatic solution that is not overly burdensome to companies or the regulator in ensuring that directors take their responsibilities seriously.

Secondly, we believe that BEIS should also consider how to enhance competition within other sectors of the market, not just focussing on the FTSE 350. For example companies with significant impact on the UK economy due to employment, pensions and/or services provided, or smaller companies which are growing at pace and likely to list in due course. As the requirements on Main Listed companies become more onerous and costly this may discourage companies from listing on the Main market. As such, there is an opportunity for challenger firms to take on a larger number of non-Main Listed companies and grow alongside them. This would be a more sustainable and achievable way to improve the market.

**32) Is there anything else the Government should consider in deciding how to take forward the CMA's findings and recommendations?**

In a time of significant change for the UK, it is critical that we protect UK competitiveness and for UK capital markets to remain attractive for investment. It is therefore crucial that any recommendations do not adversely affect this.

We would encourage the regulator to look at regulators across other jurisdictions and service lines to identify the teams they have in place to interrogate the quality of work provided and see how this can be mirrored for audit and company reporting. This should be applicable not only to FTSE 350 companies but those which have a material impact on the UK. The regulator can then identify early warning signals for distressed companies and take action as required.

**Appendix 2: Questions not answered**

4) What would be the most cost-effective option for enabling greater regulatory oversight of audit committees? Please provide evidence where possible.

9) Do you have any suggestions for how a joint audit could be carried out most efficiently?

14) Are any further measures needed to ensure that the statutory audit market remains open to wider competition in the long term?

19) Are there alternative or additional measures which would meet these concerns more effectively or produce a better market outcome?

24) How would a deferral and clawback mechanism work under a Limited Liability Partnership structure?

25) Do you agree that liberalising the ownership rules for audit firms would reduce barriers for challengers and entrants to the market?
    - What positive and negative impacts would this have?
    - Do you have any specific proposals for a reformed ownership regime?

31) What actions could audit firms take on a voluntary basis to address some or all of the CMA's concerns?