The Rt Hon Greg Clark MP
Secretary of State for Business, Energy and Industrial Strategy
Department for Business, Energy and Industrial Strategy
1 Victoria Street
London, SW1H 0ET

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Dear Secretary of State,

You have asked me to consider whether there is a case for a fundamental change in relation to who appoints company auditors, and how their fees are set. This letter sets out my thoughts on those questions.

This is a separate topic from my independent Review of the FRC, which is also published today. I have not conducted a full consultation on these additional questions, though I have sought and received helpful views from stakeholders on the questions you asked. This letter represents my personal views, not those of my Review's Advisory Group, nor those of L&G.

<u>A different model</u>

The model I have considered is one where:

- Instead of an auditor being proposed by the company's board and approved by shareholders, the appointment would be made by an independent body representing the public interest (as, for many years, local authority auditors were, by the Audit Commission). This body would also set the audit fee.
- This new arrangement would apply to so-called Public Interest Entities, ie larger companies.
- In my view the only workable candidate for the appointing body would be the new regulator, following implementation of the reforms proposed in my separate Review, published today. Some have suggested that the London Stock Exchange could perform the task, but I cannot see why the LSE, a commercial entity with other priorities, would willingly take it on. I also cannot easily see any workable way in which an investor group could be asked to do it.

- Clearly the new regulator would need to build an entirely new capability to undertake this work, with very different skills from those of the present FRC. This new unit within the regulator would need its own governance, with investors and users of accounts heavily represented.

- The regulator's decision on auditor appointment should be subject, as the board's is now, to shareholder approval. In practice this right of veto is only exercised exceptionally rarely, but it represents an important principle which in my view should not be changed.

The case for change

The change I have sketched out would be radical. No country in the world currently does anything like it. So why consider it? It is important to be precise about this.

Most respondents seem to assume that we would be trying to deal with a specific situation where a board deliberately goes out of its way to appoint an unusually weak and compliant auditor. Such situations may occur. But they are extreme, and probably fairly unusual.

To me the more important issue is subtler, less extreme - but also much more systemic.

It is widely acknowledged that, across the board, we do not see anything like enough scepticism and independent challenge from auditors. I suggest this is not surprising when auditors' incentives are, at best, blunted:

- The customers for their product are external users of accounts – a company's stakeholders, particularly investors – who clearly do want robust scepticism and challenge.

- But the customers are not buying the service. If auditors feel obligations to these external stakeholders, they are distant and rather theoretical.[1]

- With the company, by marked contrast, the auditor has a close and important commercial relationship.

- And yet the product we are talking about, being purchased on behalf of external stakeholders, is to mark, supposedly objectively and ruthlessly, the company's homework for them.

The underlying conflicts in this arrangement are clear.

[1] This is particularly true since, as a result of a 1990 House of Lords decision, auditors in the UK are – unlike those in the US – to all intents and purposes exempt from civil suit from investors.

In theory, of course, a well-functioning and independent audit committee perfectly solves this problem because the audit committee - which now appoints the auditor - can, and should, represent the interests of external stakeholders without fear or favour.

The great majority of respondents take the view that this is the right, and a satisfactory, answer.

I do agree that the strengthening of audit committees' role has been a very important step forward. But I still have to ask:

- If this arrangement is working as well as many believe, why then do we still not see more robust scepticism and independent challenge from auditors?
- It is inevitable that some audit committees will be more effective, independent and challenging than others. Is there not, unfortunately, likely to be a strong correlation between companies with weaker audit committees, and those where a challenging audit is most likely to be needed?
- In the real world, is there perhaps a certain naïveté in assuming that auditors truly owe their only commercial allegiance to audit committees, and not at all to corporate management? The reality is inevitably messier and more complex.

This therefore would be the principled case for radical change: switching the purchasing decision from the company to an independent regulator would make a shift in the commercial incentives on auditors, since as a purchaser the regulator's only interest would be to see challenging and high-quality audits.

There may also be – at least potentially – a second reason. This relates to audit fees. Opinion is divided as to whether or not audit firms are still using audit as a loss-leader, cross-subsidising from the rest of their business. I am not in a position to referee this argument and I have heard conflicting views as to whether audit is or is not under-priced. What is clear however is that a regulator, with duties to promote quality, would have clear incentives to ensure that fees are not cheese-pared and are set in a way that is consistent with audit quality being properly resourced.

The case against

Notwithstanding these considerations, almost all respondents (with the notable exception of one accounting firm, Grant Thornton) are currently opposed to change.

The main reasons given are, to summarise very broadly:

- Many believe very strongly that it is an inherent right of the board to appoint an auditor. (Typical comment, from one of the Big 4: "Any proposals which would result in the Board not being directly accountable for the appointment of

auditors would run the serious risk of 'moral hazard' and undermine the concept of the joint stock company governed by a unitary board").

- More practically, it is widely argued that appointing an auditor is a very complex job, requiring deep understanding of a company's business. There is no way, it is said, that a public body could do this as well as a board can.

These arguments are both debateable.

On the first point, the implicit assumption is that audit committees are currently doing their job so well, and already assuring that we are seeing such effective challenge and scepticism from auditors, that no alternative should be considered, as a matter of principle. As I say above, I am not sure the factual evidence is really consistent with this view. It is also not clear to me that companies, or audit committees, somehow have an inherent natural "right" to appoint auditors.

The second point is a much more substantive one and does need careful thought. It is absolutely clear that the FRC in its current form could not take this new role on, in a way which would command confidence. But it is not clear to me that such a capability could not be built, by a reformed regulator, in future. Investors would need to be heavily involved in the governance of such a new unit. It would need to start with, and prove itself, on a small number of audit appointments – there should be no question under any circumstances of risking any "Big Bang". But I am not sure it is true to say it could not be done, and done well.

The argument that appointing an auditor is a massive and complex task does seem to me somewhat overdone. The reality is that:

- Certainly, among the Big 4, audit services are frankly often much of a muchness;
- Companies often have limited choice anyway. An inevitable consequence of the UK's rules on auditor rotation and bans on non-audit work, however well-justified, is heavily to constrain companies' options;
- The argument, frequently put, that what really matters in choosing an auditor is extraordinary depth of experience in the specifics of the company's business, which only the company can judge, seems to me questionable. Of course, the regulator should naturally want to hear views from the audit committee on this point, and sector expertise is clearly essential. But just as important is, for instance, the strength of character, independence of mind and track record of the lead audit partner. These are not things that only an audit committee can judge. And "cultural fit" with management, as a criterion which some have suggested to me, seems actively suspect.

Nevertheless, there are some very important practical complications. These are not trivial:

- In practice, companies can quite easily now find themselves in situations where there is limited appetite from Big 4 firms to tender for audit work, because they prefer to stick to non-audit work, which pays better. This is of course a clear sign of a dysfunctional market, but it is the reality. In this situation companies need actively to "manage the market" – in effect, to threaten to withdraw non-audit work if a firm refuses to tender for the audit. This is something only the company can do; a regulator could not.

- The appointment of an auditor is only the beginning of a continuing process. The relationship with the auditor needs to be managed; there will be changes in real time in the nature of an audit mandate; the audit fee will need to be set in the light of actual work done; and ultimately, there may be situations where an auditor fails to perform and needs to be held to account. Again, I struggle to see how a regulator could do this without very significant engagement with the audit committee.

In short, I see no world in which audit committees could workably or sensibly be written out of the script. Even if the regulator were the decision-taker, audit committees and the regulator would need to work together.

I should also note that it has been questioned whether it would be feasible within the constraints of the EU Audit Directive to pass this responsibility to the regulator whilst preserving the ability of shareholders to vote on the appointment. I am confident on the basis of the advice I have seen that this would be possible, but clearly this would need to be confirmed and ensured.

Investors' perspectives

The purpose of the reform I have described would be to benefit users of accounts, through promoting better-resourced, more sceptical and challenging audits. This must mean that investors' views are particularly relevant.

The fact is that at present, investors (or at least their representatives, the fund management community) are very clearly opposed to radical change of the kind I have described.

I see this as quite a fundamental issue. You will want to judge very carefully whether it can be right to pursue a reform, one of whose central purposes is to benefit investors, in the absence (as yet) of really any support for that change from those it is supposed to help. My personal view, for what it is worth, is that - whatever the theoretical or principled arguments - it would not.

I would however make a number of points:

- The investment community appears to be assuming that change would involve depriving shareholders of their current right to approve the choice of auditor. As I say above, I do not believe this needs to be, or should be, the case. This approval right is, in my view, right in principle and - however rarely it is exercised in practice - should be protected.

- I note in my separate report on the FRC that the investment community is not currently as engaged in, or concerned about, audit weaknesses as they might be. When for instance the Investment Association asserts in its response that “IA members consider that historically the audit sector has served investors well in that instances of audit failure have been relatively isolated”, I do wonder whether there is not at least some potential danger of complacency or at least inattention.

- To be fair, the Investment Association goes on - quite rightly - to note in the body of its response that: “too often, audit firms consider the audited entity to be their clients”; that “the issues that investors consider impact audit quality arise due to… the incentives that operate”; and that “while the best audit committees are very good and genuinely independent, too many are not and do not necessarily use the relationship with the auditor to improve reporting and add challenge to the boardroom; some also believe that reducing the audit fee is in the interests of shareholders when the opposite is true”. I agree with all these statements. The question is what should be done about them. The IA suggests “that there should be a broader debate on how suitable scepticism, objectivity and challenge is ensured within an audit”. I agree – one might just question whether this debate should be quite as tightly constrained, in terms of ruling out upfront any meaningful change to the status quo, as the IA suggests.

My view is that the investment community’s very clear view must be respected and listened to. History does suggest though that it may be worth further, deeper continuing dialogue with investors to explore the case for change, and in particular how and whether change could be effected in a way which could carry their confidence and support, as well as being in the interests of beneficiaries.

A suggested way forward

My advice, overall, is that:

- There is a principled case for at least considering radical change, and not all the arguments for the status quo are fully persuasive.

- However I do not personally believe it would be right to contemplate a change as major as this, whose purpose is to benefit the users of accounts, when investors are currently so firmly opposed.

- I also think it is entirely understandable that there should be genuine doubts about the workability of transferring such a major systemic responsibility to the regulator, in what would be a world-first experiment, at a time when the credibility of the current regulator is legitimately in question for the reasons set out in my separate report.

However, I do think there are some more modest and focussed approaches you might nevertheless consider.

One possible approach for instance I know the CMA has considered is that there should be close scrutiny of auditor appointment and management by the regulator. This has pros and cons. The question to my mind is whether it solves the right problem – as I see it, the main purpose of change in this area is not (at least across the generality of firms) to prevent companies from picking the wrong auditor, but rather to change who auditors see as their client, which this approach would not do. And of course it would inevitably add considerable layers of process. So the costs and benefits need to be carefully weighed.

I would however strongly commend for your consideration two more focussed changes, for both of which in my view there is a compelling case –
and which would also go with the grain of the reforms proposed in my parallel Review of the FRC:

- First, I suggest you should give the new regulator the right to appoint an auditor, in the case of PIEs, in three very specific circumstances. One would be where quality issues (to a threshold to be defined) have been identified around the company's audit. The second would be where a company has parted company with its auditor, other than as part of the normal rotating cycle. The third would be where there has been a meaningful shareholder vote, even one well short of 50%, against an auditor appointment. In all these cases, I suggest it would be demonstrably in the interests of investors, other stakeholders and ultimately the company for the regulator to have the ability (not the obligation) to intervene. This would also usefully test whether the procurement task is really quite as complex and challenging as many respondents fear.

- Second, I suggest you should give the new regulator the right, again in the case of PIEs, to approve audit fees, where it sees a case for doing so in the interests of quality. This would ensure that the new regulator's market-based work on audit fees, and implications for quality, could be put to practical use.

Finally, many respondents have also made other specific suggestions relating to greater disclosure around audit committee decision-making, and/or tweaks to audit committee practice, in this area. You and the new regulator will want to consider these carefully. I would however urge caution against making changes, especially those which would give rise to potentially pointless boilerplate "disclosure", without fundamentally doing anything about the incentives in this market which are at the heart of the issue.

John Kingman