COMPETITION AND MARKETS AUTHORITY STATUTORY AUDIT MARKET

INVITATION TO COMMENT

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1 Introduction

ICAS is a professional body for more than 21,000 world class business men and women 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.

While ICAS has many members who work in both practice and across business and industry sectors, and who will be affected by any change to the accountancy, audit and PIE regulatory regimes, we work primarily in the public interest. It is this public interest that has driven our proposals. We welcome the opportunity to respond to the CMA Invitation to Comment.

The expectation is that increased choice in the audit market will improve audit quality, and that this would help safeguard against future corporate failures. That may not necessarily be the case. It is important to recognise that increased choice and quality will not eliminate the risk of future corporate failures – that is a part of corporate life as markets change and some companies fail to adapt, overstretch themselves or make poor decisions.

Increased choice should always be encouraged, and as part of this response we have sought to identify potential ways in which choice, within the audit market, could be improved. However, the primary overarching objective has to be to seek to ensure audit quality. Any measures which could impact negatively on audit quality will not be in the public interest.

If audit quality is the prevailing issue, then the optimum outcome is likely to be a combination of several initiatives, including a review of corporate reporting, scope of audit, enhanced corporate governance, and creating opportunities for increased choice. Therefore, the CMA needs to contribute to this wider programme of reform.

The escalated timescale of this market study is very tight, almost unreasonable, and stakeholders are unlikely to have had sufficient time to provide meaningful evidence to the CMA. Over the last few weeks, to shape and inform our response, ICAS has mobilised its resources and engaged with members and non-members, investors, directors of Public Interest Entities (PIEs) and large private companies (including audit committee chairs) and auditors (including beyond the Big Four) to seek out views on the CMA document and the questions posed.

External audit does not operate in a vacuum. It forms part of the wider governance framework that oversees larger corporates, i.e. boards of directors, audit committees, investors and regulators. ICAS members across the various stakeholder groups have highlighted to us that there is a willingness to identify and to embrace positive changes, for the benefit of the public and business. They have also shared their concerns over the unintended consequences of certain proposed reforms.

In the public interest, ICAS seeks to not only suggest a way forward, but also offer constructive challenge to some of the current CMA assumptions and proposals, all with a view to bringing clarity to the current debate.

Beyond the submission date, ICAS will look to see what further enquires and activities it may reasonably pursue to help inform the continuing debate on the future of assurance.

If you would like to discuss any of the matters in this response then please feel free to contact me.

Bruce Cartwright
Chief Executive
ICAS

2 Key Messages

We have identified the following areas for focus.

- A Government supported multi-stakeholder review into the UK corporate governance and corporate reporting frameworks including assurance should be instigated. This would encompass a review of the role and purpose of audit and consider whether it needs to evolve to better meet current and evolving stakeholder expectations. The objective of this review would be to address the core issues that we believe the public (and Government) want to see addressed. These are to improve the level of quality and trust in audit and its role in supporting the viability of Public Interest Entity (PIE) companies. It is however important to recognise that audit change alone will not eliminate the risk of future corporate failures. 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. This would include looking at whether non-GAAP measures should be brought into the scope of a more formal assurance process and also whether assurance is required on other corporate information that is reported by the company e.g. investor briefings. Consideration might also be given to the US requirements on the effectiveness of an entity's internal control over financial reporting (and the integrated audit approach). It will only be by giving due consideration to the role and purpose of statutory audit in the context of the broader corporate governance and corporate reporting environment that significant changes can be identified for consideration and, if supported, implemented.

- Any review of the market for audit in the UK should consider both the "demand" as well as the "supply" side. Looking alone at who is supplying audit services will not be sufficient to fully understand the market, and there are several potential demand-led initiatives which we believe could encourage increased competition within the audit market.

- It is incumbent upon shareholders to engage with audit committees of their investee companies. Many board directors have commented that while investors engage on matters relevant to the remuneration committee, there is little or no engagement on the matters addressed by the audit committee which arguably go to the heart of the quality of their investments. We have highlighted this point in our response to the Review of the FRC. Likewise, audit committees need to be mindful of their wider role and responsibilities.

- There should be increased transparency of the audit committee tender process and this should be communicated well in advance of the actual process commencing. In particular, this should include disclosure of the audit committee's key criteria for assessing the qualities they expect of their statutory auditors. This should be at a sufficiently detailed level to enable all firms including those outside of the Big Four to assess their own capabilities to audit a particular PIE company and if necessary to close any gaps in capability. Audit committees already publish their tender requirements (FRC Audit Tender Best Practice Notes, February 2017) but it is not being reported at a sufficiently detailed level to enable all firms including those outside of the Big Four to assess their own capabilities to audit a particular PIE company, or if necessary the level of investment required to close any gaps in capability. Any improvement in supply side choice will, we believe, require such investment (and we understand that firms are willing to invest).

- We would support a complete prohibition on audit firms providing 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, and a list of permitted services prepared accordingly.

- The current auditor liability regime concentrates the audit of the most complex PIE companies within a very small group of firms who have the capacity to invest in the training and technology required to manage this risk and who have the diversification and scale to absorb liability for failings should these arise. We believe the CMA will need to engage with the FRC to address this particular challenge. Consideration may need to be given to whether or not the existing auditor liability regime should be adapted.

- There is also a need for more constructive dialogue between the FRC and CMA to ensure the respective objectives of both bodies are aligned. The FRC has an established KPI that 90% of FTSE 350 audits should not require more than limited improvements; we support this. If this KPI is met through existing audit arrangements this acts as a constraint to making a change given that the risk of audit quality falling below the FRC threshold may be elevated in the period of transition from one auditor to another. The regulator would need to find ways to support the audit market through this process, if enhanced choice is to be a realised outcome.

- We note the CMA's proposed measure that the professional bodies, such as ICAS, could assist audit firms outside the Big Four to build capability and capacity, with a view to tendering for PIE audits in the future. ICAS is committed to working in the public interest and thus would look forward to exploring with the CMA what those initiatives might be, and the role we might play.

3 The purpose, scope and future of audit

Audit quality is receiving global attention, with public trust in business and the audit profession needing to be improved. However, the issues are broader than just audit and need to be considered in this wider context. At the heart of this debate is the overall corporate governance and corporate reporting arrangements for PIE companies.

Audit serves its many stakeholders well, and every year thousands of companies, both public and private, are audited without any material issues. This reflects generally high quality financial reporting, supported by the rigour of the accounts having to be independently audited. Our capital and financial systems depend upon reliable financial information and external confidence in our stock markets and financial system more generally, is evidence of broad-based trust in the information reported.

Whilst we do not believe that the current audit model is broken, we do accept that the public perception of audit has changed, and the time is ripe for a holistic review of the purpose and role of the audit of PIE companies to ensure that the audit remains fit for purpose. Against a background of changing public expectations, there still remains a level of confusion over the current role and purpose of audit, what it does and does not do.

In this section we reflect on the purpose and statutory scope of an audit, and the need for a review of the wider corporate governance and corporate reporting framework.

3.1 Purpose of Audit

Historically, the requirement for an audit of the financial accounts arose out of the increased separation of ownership from management following the industrial revolution in the 19th century, coupled with a series of corporate scandals in which the quality and sometimes the veracity of the documents provided by company directors were questionable. The response was to enshrine in law the need for external assurance of these financial statements – an audit – to be carried out by a suitably qualified professional – the auditor. This requirement has over the years gone through many and varied iterations in both law and regulation.

Ultimately, the purpose of the audit is to provide independent assurance that management has, in preparing the financial statements, presented a “true and fair” view of a company’s financial performance and position. Audit underpins the trust and obligation of stewardship between those who manage a company, its shareholders and wider stakeholder groups.

3.2 Audit Scope

The current statutory audit is governed by the requirements of UK primary legislation, International Standards on Auditing (ISAs) (UK) and Ethical Standards. While true that the ISAs (UK) set out the “way” the audit should be conducted, the fundamental objective of the audit is firmly grounded in Section 495 of the Companies Act 2006.

Audit Scope

The longer form of an audit report which requires the identification of key audit matters now provides considerably more information for investors and other stakeholders to assess the work of the auditors, but at its core, the work undertaken by the statutory auditor is restricted to an opinion on the financial statements (made up of GAAP defined measures), associated notes and parts of the remuneration report. Other parts of the company’s annual report, including the use of non-GAAP measures, are nonetheless reviewed for consistency and included within the auditor’s comments where there are “material” inconsistencies with the financial statements and/or conflict with the auditor’s knowledge gained during their audit work.

While the auditor does consider the future viability statements, they are not “audited” to the extent that the public might think; nor are they capable of being so without considerable further work, akin to that needed to report within a prospectus document. This is at the core of the now widely recognised “audit expectation gap”. It is in no one’s interest that this “gap” persists, alleviation of which can only be achieved through increased public awareness of the restricted scope of the audit, and/or some change to align the audit scope with society’s expectations. This task should be at the core of the proposed future multi stakeholder review into the UK corporate governance, corporate reporting and assurance framework.

Impact of increasing judgement
The CMA has made reference to the evolution towards "fair value accounting". By way of clarification, we would highlight that this relates to financial reporting standards, and not auditing standards. Fair value accounting has notably increased the level of complexity and judgement and the application of assumptions, in some cases without verifiable external inputs, both required for measurement and reporting of some material balance sheet and income statement accounts. These judgements and assumptions are the responsibility of directors, but are subject to audit. In particular, the measurement of the carrying value of goodwill, long term contracts, financial instruments and pensions involves complex accounting processes based on underlying assumptions.

Measurement outcomes naturally fall within acceptable but challengeable ranges rather than precise numbers. As well as necessitating companies to improve the expertise within their own accounting functions and governance arrangements this has, in turn, required auditors to enhance their in-house capabilities and specialist expertise in order to review assumptions and models and audit these account balances; this has further driven the consolidation of complex technical skills within a small number of firms - the market we know today.

This increased level of judgement has also naturally led to greater subjectivity in the financial information published as accounts move away from historic cost to measurement bases that incorporate modelled assumptions about future events. This more forward-looking accounting basis has also led to greater transparency, for example in terms of displaying a company's defined benefit pension scheme liabilities on balance sheet, as well as measuring the fair value of certain financial instruments which would not have been required under a historic cost model. So, accounting standard setters have increasingly opted to favour value-based accounting with increased transparency versus the objective but less relevant certainty of historic cost accounting. This obviously makes the auditor's role much more challenging, due to management's increased use of modelling in preparing the financial statements (with inputs based on judgement versus observable facts).

While in all cases the judgments, models and assumptions remain the responsibility of the company directors (and experienced audit committee members will challenge these bases), considerable time and expert resources is also engaged in the audit of these areas of judgement. They are also key items for discussion with audit committees and will receive due attention. In addition, the enhanced audit committee report and the longer auditor report generally comment on the work done to assure that the final conclusions are appropriate. These disclosures are there for shareholders and other stakeholders to read and interpret; it is likely, however, that only the most sophisticated stakeholder will have the skill to do so. It is incumbent on those stakeholders to positively engage with the audit committee on any matter arising. Additionally, reviewing audit reports, and indeed audit committee reports, over a number of years could enable stakeholders to better identify any change in the risk profile of a company.

Audit Tenders and Statutory Auditor selection
The ultimate clients of a statutory audit are investors not companies, and audit committees act on their behalf. Significant shareholders are therefore interested in a transparent tender process. Audit committees are required to disclose in their annual report that a tender is taking place.

In compliance with their obligations under the UK Corporate Governance Code, the audit committee of a PIE company (which is a subcommittee of the UK unitary board and not a separate entity) has to consider the company's particular needs and circumstances when they make a recommendation to the board and shareholders to change/appoint a Statutory Auditor. An audit committee and its members have a fiduciary duty to find and select the highest quality audit service firm to meet their specific needs.

Audit committees have the time and resources to understand fully the audit requirements of the company and the audit planning and scope proposals being made by the respective audit firms that participate in the tender process. They are in an unrivalled position to make an informed assessment about: the needs of the company; whether the tender selection criteria are met; the proposed engagement team; and to ultimately make a recommendation to the board and to the shareholders as to which audit firm should be appointed.

The members of the audit committee are exclusively non-executive directors, with statutory and fiduciary duties. They do not discharge these duties lightly. The tender is a complex process, which is conducted in compliance with best practice guidance (the FRC and ICAS both issue guidance for audit committees).

3.3 Responsibility for the Financial Statements (including UK Corporate Governance Code Disclosures)

The annual report and financial statements are, by law, the sole responsibility of the directors of the company.

In addition, the UK Corporate Governance Code requires that directors should explain in the annual report their responsibility for preparing the annual report and accounts, and state that they consider the annual report and accounts, taken as a whole, are fair, balanced and understandable and provide the information necessary for shareholders to assess the company's position and performance, business model and strategy. Liability remains with the company and its directors and it is essential to emphasise that these are not the auditor's financial statements.

To help provide clarity on this point International Standard on Auditing 700 (Revised June 2016) 'Forming an Opinion and Reporting on Financial Statements' requires in the inclusion of the auditors' report:

(i) A section on management responsibilities, which includes outlining the directors' responsibilities for preparing the financial statements and assessing the company's ability to continue as a going concern; and
(ii) A section on the auditor's responsibilities, which include obtaining sufficient and appropriate audit evidence regarding the financial information of the entities or business activities within the group to express an opinion on the group financial statements.

3.4 Future of Audit

The current conversations about the future scope of audit are not new.

Following the financial crisis in 2008/9 ICAS looked to the role of assurance in the capital markets and published in 2010 "The Future of Assurance". A copy of this report is included with our submission.

We introduced this work with the following statement:

"Effective capital markets need trust: trust in the integrity, skill and competence of a company's directors and management and trust in their reporting. The role of assurance is to inspire trust in corporate reporting. But assurance is more than external audit - it is a process which begins with the company itself".

We believe that statement was true then and it is equally relevant today as the CMA examines the external audit market in the UK. Indeed, looking back on the ICAS Future of Assurance work today we can see that many of the recommendations made then have since been adopted in one form or another.

3.5 Corporate Failures

The core issues that we believe the public and government want to see addressed are, how to ensure fewer unsignalled corporate failures and also improve the quality of audit.

The public needs to have trust and confidence in the operation of the capital markets and the companies that make up those markets, but it is important to recognise that external audit does not operate in a vacuum. Whilst the current debate is placing considerable focus on the role of the auditor, the wider holistic governance framework has a greater role to play. Audit forms part of the wider governance framework that oversees the governance and reporting of larger corporates. This involves many participants including: directors; audit committees; standard setters (financial reporting, auditing and ethics, including auditor independence); regulators; shareholders; auditors and Government.

Audit is not designed to prevent corporate failures. Companies fail for many reasons unrelated to audit, often involving one or a combination of the following factors (not exhaustive):

- Inadequate, weak, or breakdowns in, internal controls;
- Lack of liquidity/solvency leading to Going Concern, viability issues;
- Raising false expectations through focussing on selective Non-GAAP measures when reporting in public pronouncements;
- Poor corporate governance;
- Flawed business model;

- Fraud;
- Poor ethical culture; and
- Poor/weak management.

We also need to consider the ever-increasing complexity and speed of change of business, and the related increase in the complexity of corporate reporting, despite best endeavours to make this fair, balanced and understandable.

There is no disputing that Society's expectation of audit is changing, and we believe the public interest test is changing with it. However, it is only by properly considering the purpose and role of audit in the wider corporate reporting environment that we can properly consider what changes are required.

3.6 Holistic review of governance and reporting framework

If the shared aim is improving trust in capital markets and corporate reporting, then the wider context of the UK governance framework and the role that audit/assurance plays should not be overlooked.

The focus of the CMA's market review: improving competition and choice in the audit market, will not, of itself, resolve the challenges of audit and audit quality.

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).

ICAS would endorse the establishment of a Government supported multi-stakeholder forum to review the corporate governance and corporate reporting framework. As part of this review, the role of audit would feature prominently and this would provide the opportunity to properly address any issues and seek to close the audit "expectation gap". For example, due consideration should be given to whether the current scope of audit is suitable for the modern world and further, whether extending the scope would give greater protection and assurance to stakeholders, at a proportionate cost. It could also include consideration of the US requirements on the effectiveness of an entity's internal control over financial reporting, including the audit of management's assessment of this, where this is integrated with the audit of the financial statements. Finally, consideration could be given to bringing assurance on non-GAAP measures into the scope of the audit as well as whether there is a need for assurance to be provided on other corporate reported information, such as investor briefings.

This forum should comprise representatives from each of the main stakeholder groups i.e. investors, business, the audit firms, the professional bodies, standard setters and regulators.

We acknowledge that any change in the definition, scope and extent of audit will require a change in law and regulation. It is important that the Government is involved in this multi-stakeholder review, not only so that it can lead on any legislative and regulatory reform, but its participation will be key to ensuring public trust.

4 Audit Market Considerations

A holistic review of the corporate governance and corporate reporting framework will take time and the outcomes may require legislative change, but it is key to restoring public trust in business.

Beyond this review, if increased choice within the audit market can be achieved, then it should be encouraged.

In this section, ICAS seeks to not only suggest ways to help increase choice, but also offers constructive challenge to some of the current CMA assumptions and proposals, all with a view to bringing clarity to the current debate.

4.1 Demand Side Considerations

Any review of the audit market should consider both the "demand" as well as the "supply" side. Looking alone at who is supplying audit services will not be sufficient to fully understand the market.

There are several potential demand-led initiatives which we believe could encourage increased competition within the audit market.

Transparency of FTSE 350 audit requirements

The requirements of the "demand" side for audit merit attention from the CMA, particularly as there appears to have been little research to date, to establish what PIE companies and their audit committees require from their auditors (such as scale, geographical scope and sector/specialist expertise).

We believe that particular attention should be given to the FTSE 350 in any market study; this is an important group which we anticipate might demonstrate the individual and varying requirements that they would present to any prospective auditor, including specialist expertise and sector knowledge, access to technology, global capability and individual engagement team characteristics.

We also consider that there is scope to require FTSE 350 companies in future to be more open and transparent about the qualities they expect of their prospective auditors, enabling firms to assess their suitability at an early stage of the tender process (and to invest in and address any areas of weakness for the future). Whilst audit committees are reporting in compliance with the FRC's current guidance, there is scope for more specification and detail. This should not be to the extent required under procurement rules, but the ability for firms outside of the Big Four to assess their own competitiveness to audit a FTSE 350 company well in advance of any planned audit tender, could be greatly enhanced by increased transparency of the characteristics that audit committees are looking for in their prospective auditor.

Increased transparency and improved accessibility to the tender process will be key factors in encouraging firms to make any necessary investments (and we understand that firms are willing to invest).

Enhanced Investor Engagement

Today's enhanced reporting and the encouragement for further shareholder engagement with company boards, through the Stewardship Code and the other incentives, should allow for shareholders to actively seek out explanations on issues that concern them, including those of perceived audit quality. Ultimately it is the investors who will appoint the auditors of the company at the Annual General Meeting. It is the clear responsibility of board members including non-executive directors, to respond positively to such approaches.

However, as we highlighted in our response to the Review of the FRC, 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 risk impact is considerably higher in matters of audit. 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). This needs to be addressed, at the very least by making provision to this effect in any forthcoming revisions to the Stewardship Code. Indeed, any such provision should take on board recommendations that were made by ICAS in its 2010 Future of Assurance report.

This ICAS 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;
- 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.

4.2 Supply Side Considerations

Supply Market Size

Whilst there are over 5,500 audit firms in the UK, not all can conduct the audit of a FTSE 350 or a large private company. There is a fundamental difference between being “registered” to carry out audit work, and being “fit and competent” to carry out the audit of a large listed company. Less than 1% of these firms are presently undertaking the audit of a FTSE 350 or large private company, and the proportion of firms reduces as the complexity of the company increases.

The capabilities of the top 50 firms will be different. Some audit firms will be able to very quickly challenge the Big Four for some of these audit engagements, and some audit firms may never want to (the required levels of investments and increased risk will outweigh any perceived benefits). Other audit firms may take longer to build the capacity and capabilities.

This is why we consider there is a real need to understand the “demand” side requirements, as it will be critical to determining the level of potential competition that certain reforms can deliver within the audit market, and the likely timescale of those reforms being realised.

4.3 Observations on CMA Themes

The invitation to comment identifies five relevant and appropriate themes that the CMA propose to investigate (but later restricts the focus of its research to incentives, choice and resilience). For the reasons outlined earlier in this response, scope and purpose of audit may not be within the CMA’s expertise, but it needs to form part of the wider programme of reform.

Before exploring the potential outcomes, we would wish to comment on the following CMA assumptions and proposed considerations.

Incentives

There are significant governance arrangements for the appointment of auditors, enshrined in legislation and the UK Corporate Governance Code. There is no evidence that the audit process is incentivised by company management at present.

The selection of auditors is today made through a generally publicly disclosed process by the audit committee of the board of directors, who then recommend their appointment to the full board and to the shareholders. It is the shareholders who ultimately approve the appointment of the auditor, at the Annual General Meeting.

The audit committee, in UK public companies, is a sub-committee of the board and is made up wholly of non-executive directors who are appointed annually to represent the shareholders. There is no reason to believe, nor do we know of any empirical evidence to suggest, that there are cases where non-executive directors who make up the audit committee did not act in the shareholders’ and wider public interest. Indeed, statements being made through public company enhanced audit committee reports would suggest that these committees, and its members, are primarily looking for high quality audit and not the lowest cost, and that company management (who support but are not part of this decision-making process) incentives are not a consideration.

Choice

Since the last Competition Commission review, mandatory retendering and rotation has resulted in a number of FTSE 350 companies switching auditors. This was intended to increase competition which it has, although we acknowledge the result so far has been to increase the dominance of the Big Four in the FTSE 350 audit market (as we have explained above). Despite this, mandatory retendering and rotation remain a good lever to encourage competition over the long term. Although still relatively new these requirements have resulted in considerable switching of auditors which has, it is generally accepted, seen an improvement in audit quality.

Nevertheless, the CMA considers that mandatory retendering and rotation have not been as successful as expected due to other emerging issues, such as demand side barriers to switching, influence of alumni of the large firms on audit committees, limited shareholder capacity to appraise auditor performance, cost to business and access to technology.

To inform the CMA research, we offer the following comments:-

- *Demand side barriers to switching*
  Directors have a fiduciary duty to ensure that the company obtains audit services from a firm that can fully and effectively deliver the full scope of the audit. The current capability of a number of firms outside the Big Four may as yet be untested in certain specialist sectors. This could have been a determining factor in the selection of auditors, as lack of demonstrable experience does create a potential risk to audit quality, and understandably, many audit committees (and audit firms) will be reluctant to tolerate such risks in the current political, legal and regulatory environments.

- *Influence of alumni of the Big Four on audit committees*
  The major professional services firms are a key training ground for the FTSE 350. A number of employees within the Big Four audit firms will leave each year, to translate their skills into a business environment. Mobility of talent needs to be encouraged, and should not be presented or perceived as a negative factor. In the particular context of audit, there are a number of measures to safeguard against threats to auditor independence and objectivity, and these requirements must be followed. The FRC Ethical Standard sets out strict independence rules which prevent former audit partners from joining their audit client as an officer or employee for a prescribed period of time. The UK Corporate Governance Code also reinforces the need for the audit committee to review and monitor the external auditor's independence and objectivity each year, as well as the effectiveness of the audit process. We also highlight that the independence of the chair of the audit committee in the tender process is important. As has been seen in practice, where an audit committee chair has recently been part of one of the firms tendering for the audit, they should recuse themselves from chairing the selection panel. As this process requires to be disclosed in the Annual Report, highlighting such matters should provide confidence to users of the independence of the selection panel.

- *Limits of shareholder capacity to appraise auditor performance*
  As outlined above, the obligations of the audit committee are enshrined in the UK Corporate Governance Code. The responsibility to appraise the auditor's performance and report on that appraisal lies firmly with the audit committee. Incentives to enhance investor engagement with the chair of the audit committee need to be encouraged. The issue could be characterised as limited shareholder engagement, rather than limits of shareholder capacity. We refer you to our earlier comments on how the Stewardship Code could be enhanced to help facilitate greater engagement between institutional shareholders and audit committees.

- *The costs to businesses of switching auditor … reduce the incentive to switch compared with uncertain benefits*
  Admittedly, there is an opportunity and real cost attached to retendering, but rotation is mandatory. Barriers are more likely to take the form of audit committes' safeguarding against a risk to audit quality, or firms not yet being able to meet the key requirements. This is why it is so important for audit committees to better articulate early what they are looking for, thereby allowing audit firms to address any real or perceived shortfalls and confirm to any target companies why they could effectively provide a high-quality audit. Equally, the audit committee should be open with unsuccessful firms so that they can address areas of weakness for the future. Firms need to know what is expected of them, or the level of future investment required to close any gaps in capability.

- *Liability Regime*
  The current auditor liability regime acts to concentrate the audit of the most complex PIE within a very small group of firms who are perceived to have the capacity to invest in the training and technology required to manage this risk and who have the diversification and scale to absorb liability for failings should these arise. If increasing audit choice is a key objective, consideration is required as to how the existing auditor liability regime could be reformed. We believe the CMA will need to engage with the FRC to address this particular challenge.

We would also point out that for any disruptive business model provider to enter the audit market they would have to be able to navigate the regulatory landscape to prove they have the expertise and structures to be registered as an auditor. Sustaining audit quality into the future will require continuing regulation and registration in some form.

- *Resilience*
  It would be an unfortunate backward step should one of the Big Four audit firms exit the FTSE 350 audit market, reducing further choice for companies in this market. Such an event could be triggered by a number of factors including (but not exclusively);
  - a loss of economic viability in the service provided occasioned through tighter market pricing and/or higher costs of regulation;
  - a gradual and increasing imposition of personal liability on individual statutory auditors, which would render the role unattractive to high quality individuals (thereby impacting on the firm's access to people and talent);
  - Regulatory action that results in the same outcome;
  - Audit partners and other staff are subject to ongoing pressure and criticism from regulators with their judgements constantly being questioned, even though the vast majority of audits are performed well and without incident. Continuation of the 'expectation gap' makes auditing an unattractive professional career for future entrants, and could lead to long term succession challenges.

These factors could equally apply to all firms that carry out audits as they are all subject to the same regulatory regime and external factors. Indeed, the financial and regulatory risks attaching to PIE company audit should not be underestimated. There are few firms who could tolerate the reputational risk of public reporting of a poor inspection by the FRC Audit Quality Review Team, or the added financial risk of possible enforcement proceedings.

ICAS is not suggesting that regulation should not be in place and operating effectively, but the current regulatory landscape is not creating a constructive environment for firms outside the Big Four to challenge their larger competitors. ICAS has made some considered recommendations to the Kingman review on how audit regulation may be enhanced, while ensuring that the quality and effectiveness of audit is sustained. This will require careful choreography of a package of reform.

5 Reflections on potential outcomes

We have reviewed the potential outcomes. If audit quality is the prevailing issue, then the optimum outcome, is likely to be a combination of several initiatives. The changes being considered by the CMA must be supported by a fundamental review into the UK corporate governance and corporate reporting frameworks including assurance. This review would include within its scope: what an audit is, and what it is intended to achieve, having regard to the requirements of business and changing public expectations.

The suggested potential outcomes all have unintended or indirect consequences, and we would encourage the CMA to give proper consideration to them, as well as any direct consequences. The CMA should therefore carefully assess the impact of each proposal they wish to bring forward. We would draw attention to several key considerations.

5.1 *Restriction on audit firms providing non-audit services.*

Prohibition on the auditor providing non-audit services to FTSE 350 audit clients
We believe this issue is as much about perception as reality, as along with regulatory requirements, significant processes and procedures are already in place inside audit firms to ensure there are appropriate conflict avoidance and independence safeguards (which go beyond the UK boundaries).

Nevertheless, the profession needs to be receptive to the wider public interest, and challenge the status quo. We therefore believe that there would be merit in introducing a complete prohibition on the auditor providing non-audit services to a PIE audit client (at least in the FTSE 350), subject to a small agreed list of permitted assurance related services. This proposal would help address the perception that management is “too close” to the audit firm. Further consideration would need to be given to the range of audit related assurance services that should be best provided by the auditor. These might include capital raising comfort letters and reports; and assessment of cyber-security frameworks etc. The ability to access such services is essential to help directors in the effective assurance of their business on behalf of shareholders, and would not only help audit to evolve but also ensure it is fit for purpose in the 21st century.

Complete prohibition on audit firms providing non-audit services not only to their audit clients, but also to any other large company or PIE
A complete prohibition on audit firms supplying non-audit services to a large company or PIE would be a severe restriction of choice for the companies concerned. PIE and large companies already face restriction of supply in some service areas and to add to this could be detrimental to their effective operations. As mandatory retendering and rotation continues to create opportunities for increased competition, the environment is already challenging for companies who are forced to find new suppliers for their non-audit services. This is expensive and time consuming, and anything that increased this challenge without any tangible benefit would likely not be desirable or effective. Furthermore, even when there are service providers beyond the audit firms who can advise on certain specialist areas there remain challenges with independence and choice. For example, pensions and actuarial service. Generally, three parties in a corporate environment need such services to carry out their respective duties – the company, the pension fund trustees and the auditor - and for conflict avoidance reasons one party cannot choose the service provider of the other. A total ban would render the situation more complex for companies and could further reduce market choice for such services. This would not be desirable.

Likewise, the split of UK arms of major accounting firms into audit only and non-audit service practices, would require overcoming considerable challenges, including those presented by the CMA. To suggest that there can be a UK only solution is misguided. There are global dimensions, both in relation to the scope of the audit, and the operations of the audit firm. Additionally, there are currently calls for more expertise both within companies and audit firms. To force audit only firms will reduce the level of expertise for the most complex audits where the firm may only have one audit client in that sector. The provision of expert services to non-audit clients enables the firms to gain the necessary level of expertise that helps within the audit environment.

Measures that result in an absolute prohibition on non-audit services, or audit-only/non-audit firms, could perversely reduce market choice.

We would suggest that the key test of the effectiveness of such a major disruption to the operation of service provision in this area is whether it would address the fundamental question raised about the quality and effectiveness of audit in the UK.

We believe it would not.

5.2 Increased competition from non-Big Four firms

Increased choice will require increased competition from non Big Four firms. The CMA has set out a number of proposals which it considers will promote change in the FTSE 350 audit market. We would encourage the CMA to give proper consideration to these proposals, not only the benefits but also any consequences.

Market share cap on the Big Four
This is a supply solution and if properly constituted could create opportunities for mid-tier firms. However, considerable obstacles would need to be overcome in the design of any quota system. Such considerations would include the scope of the market and the basis on which any market cap is set. Whilst basing the cap on numbers of companies would be the easiest way this would not ensure an appropriate allocation of the true value of the marketplace. Therefore, consideration would probably need to be placed on audit fees as a surrogate for the market capitalisation of the entity concerned, although this is likely to prove extremely fluid and problematic.

Additionally, any market cap is likely to leave some audit committees in an untenable position. A restriction of market choice for certain audit committees when tendering, and where appropriate rotating their auditors is our key objection. An example, might be where a FTSE 350 company has a requirement for audit services that can only realistically be supplied by the capability and capacity of one of the Big Four. Such requirements might include a global geographical spread of activities requiring local audit presence; specialist business activities (i.e. insurance or oil and gas) and challenging balance sheet attributes such as capital leasing all in multiple countries. An audit committee and its members have their fiduciary duty to find and select the highest quality audit service firm to meet their specific needs and, in this situation, they may not be able to meet this if the widest choice of service providers were not available to them. This would in effect be a restriction of market choice and it is something that investors in the company concerned would not likely welcome.

We are aware that audit firms and stakeholders favour a market cap, but we would encourage the CMA to fully consider all of the benefits and risks of adopting this approach.

Joint audits, shared audit or peer review
Joint audits are not widely adopted across the world and indeed in the EU only France adopts such a position. Some firms, but not all, that carry out or have carried out joint audits would support their operation as being effective, but there remain issues notably with accountability, liability and cost. Specifically, with regards to the auditor liability regime we would highlight that a major disincentive to non-Big Four firms is that as joint signatories to the audit report they would be subject to the joint and several liability regime.

We are of the view that joint audits (or shared audits) will present difficult challenges for both the auditors and for the audited company and its audit committee. Considerations will include increased costs, potential impact on audit quality, investor confidence and ownership of risk. The latter is particularly important in the current legal and regulatory environment.

Peer review as described in the Invitation to Comment would also provide considerable obstacles to its introduction. These include but are not limited to the other firm's capability to undertake this task prior to the audit report being signed. Audit firms have detailed internal procedures which ensure there has been appropriate peer review and challenge. These include the need to appoint an Engagement Quality Control Reviewer for audits of listed entities and other entities as appropriate (ISA 220 'Quality Control for an audit of Financial Statements'). The Engagement Quality Control Review is a process designed to provide an objective evaluation, on or before the date of the auditor's report, of the significant judgments the engagement team made and the conclusions it reached in formulating the auditor's report. Any peer review would be subject to significant terms and conditions, including obligations of confidentiality and measures to protect the audit firm's methodology.

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

We note the CMA's proposed measure that the professional bodies, such as ICAS, could assist audit firms outside the Big Four to build capability and capacity, with a view to tendering for PIE audits in the future. ICAS is committed to working in the public interest and thus would look forward to exploring with the CMA what those initiatives might be, and the role we might play.

Changes to restrictions on ownership of audit firms
This approach has been adopted in relation to other sectors, most notably in relation to the provision of legal services. It is not without its challenges, and whilst it might enable firms to invest for the future, it might also pose risks to firm culture and behaviours.

Audit firms are presently required to be owned and controlled by a majority of individuals who hold the audit qualification, and are therefore members of a professional body, subject to meeting the highest level of technical, ethical standards and behaviours. To dilute their influence on the firm would need very careful consideration. The CMA could not consider this initiative without close involvement of the Financial Reporting Council, as the Competent Authority for audit in the UK.

5.3 Interface of competition and current review of audit regulation and oversight

ICAS has made a considered response to the Kingman Review to the FRC and we would encourage the CMA to consider the interface of its proposals, with the wider review of audit regulation and oversight. In particular, corporate governance, audit regulation and enforcement are of relevance to the CMA market study. In the context of audit quality, the Audit Quality Review Team, and the FRC's future approach to audit quality, is a priority. We would encourage you to consider our comments.

ICAS will be responding to Sir John Kingman's recent call for submissions on the audit appointment initiatives that are under consideration, including the independent appointment of auditors.

ICAS does not support an independent appointment process for a company's auditor. To go down this route fundamentally disenfranchises the audit committees of PIE company boards and leaves them with the accountability for performance and outcome of an audit whilst not having any direct control over the selection and appointment. Such a situation is neither equitable nor sustainable. In addition, while this regime has operated in recent years in the context of Local Authority audit, the Audit Commission was dismissed in favour of open competition. In our experience, the entities being subjected to audit are very different. Local Authorities and large trusts are broadly similar in their requirements; the FTSE 350 and large private companies are not homogenous. The auditor selection process undertaken by an audit committee is substantive. Even if the practical barriers could be overcome, the Competent Authority has an operational inspection role which would preclude it from engaging in any appointment process.

APPENDIX 1
ICAS Response to Consultation Questions

ISSUES

Question 1. How well is the audit sector as a whole serving its stakeholders?

The primary overarching objective has to be to seek to ensure audit quality, that is the paramount concern in the public interest.

We believe that the audit profession serves its many stakeholders well, and that in no way is the company audit model fundamentally broken although there have been recent instances of corporate failures that require root cause analysis to prevent recurrence and restore confidence. Every year thousands of companies both public and private are audited without any material issues being reported. This reflects generally high-quality financial reporting, supported by the rigour of the accounts having to be independently audited. Our capital and financial systems depend upon reliable financial information and external confidence in our stock markets and financial system more generally is evidence of broad-based trust in the information reported.

ICAS published its Future of Assurance report in 2010 and made a number of recommendations in relation to improving both corporate reporting and assurance, and the need to strengthen the relationship between investors and the companies they invest in. A number of those recommendations were acted on by the FRC but others, such as the need for the auditor to provide explicit assurance over the front half of the annual report, were not. We are, however, aware that the FRC is currently reconsidering this issue, and it is vital that the CMA and the FRC co-ordinate their work in this area.

We also welcome that the FRC is reviewing what is required of the auditor in relation to their assessment of the directors' assessment of whether a company is a going concern and its viability statement.

Whilst we do not believe that the current audit model is broken we believe that the public perception of audit has changed and we agree the time is ripe for a holistic review of the purpose and role of the audit of Public Interest Entities (PIE) companies. This review needs to be undertaken by a multi-stakeholder group as part of a holistic review of the corporate governance and reporting framework of such entities. We believe changes recommended from such a review will be evolutionary not revolutionary and will serve to better reflect the world that we live in today and meet the evolving needs of society from the audit process. We believe that better aligning the audit process with society's expectations is the primary issue that needs to be addressed in the public interest. We provide further detail on this matter in our response to question 2 below.

Some of the matters discussed in the CMA's invitation to comment need consideration in a global context to properly assess their potential impact. We therefore assume that the CMA would consult with other similar regulatory bodies around the globe. The UK is rightly seen by many as the world's leading capital market in terms of governance standards. It is imperative this reputation is retained and due consideration has to be given to the impact of unilateral decisions, that might well have consequences that go beyond the shores of the UK. It would be a surprising and, in our view, unwarranted conclusion to suggest that the financial reporting integrity of UK markets is questionable.

We would also highlight that the audit market being considered is not homogeneous. Indeed, even the FTSE 350 audit market would not satisfy that definition. Individual audit firms have built particular industry expertise in certain markets although this historic competitive advantage is being eroded as all the large firms have been building up their expertise in different areas to respond to recent regulatory changes regarding tendering and rotation.

We note in passing that the UK Government has stated its intention for the UK to be aligned with EU regulation on the day it exits the EU and is currently preparing changes to UK legislation to meet this commitment. This need for alignment will also apply during any transition period and therefore there must be doubt as to whether the CMA will have the ability to implement some of its potential remedies for some time.

As we have stated above, we firmly believe that whilst the issue of choice and competition is important, it masks the need to focus on the real questions which are: what is the purpose and role of the audit of PIE companies in the 21st century and are there lessons from recent corporate failures that would improve trust in business and confidence in audit? We therefore urge the CMA to highlight these matters in its report to be published later this year as matters that need to be addressed by a multi-stakeholder group as a matter of top priority. As we have set out in our introduction we would see this as forming part of a wider holistic review of the corporate governance and corporate reporting framework in the UK.

Question 2. How well does the audit framework support the interests of both direct shareholders and also wider stakeholders in the economy?

Although the audit framework is fit for its statutory purpose we believe that there is a need for a debate in relation to the purpose and scope of the audit of PIE companies. In a recent response to the Monitoring Group's review of the International Audit and Ethics Standards Boards ICAS emphasised that there is a need for different standards to apply to the audits of such entities.

We would highlight that audit in whatever form will not eliminate the risk of future corporate failures. There is undoubtedly a public expectation gap (particularly in relation to the audit of listed entities), although we believe that professional and informed shareholders are well aware of the scope and limitations of the statutory audit of financial statements. Regardless, we believe that there is a need to explore how this expectation gap can be closed, if not removed entirely, with movement from both sides of the gap. This expectation gap appears to centre on three main issues:

(i) The extent to which the statutory audit provides positive assurance around the financial health of an entity and its ability to continue in existence as opposed to negative assurance that nothing has come to the attention of the auditor to suggest otherwise;
(ii) the role of the auditor in relation to the detection of fraud; and
(iii) the auditor's association with other information contained in the front half of the annual report and other reported corporate information.

We are aware that the FRC is already looking at the existing requirements in relation to going concern and viability statements and how these are currently being interpreted and applied in practice. Additionally, audit firms are already providing separate assurance for boards on matters such as the viability statement and we believe that consideration should be given to capturing such assurance within the scope of the modern audit.

In relation to fraud, technological advancements will provide an opportunity for more rigorous testing of populations of transactions, thus enhancing the likelihood that certain types of fraud will be identified, subject of course to overcoming any data access and interrogation issues that might exist. But we emphasise that the purpose of the statutory audit is the expression of an opinion on the financial statements, not the detection of fraud.

ICAS set out the direction in 2010 of the reforms needed to enhance the quality of the audit with the publication of our document – The Future of Assurance. We remain of the view that the primary public interest focus needs be on the role and purpose of audit to ensure that it better meets the needs of modern society as opposed to concentrating on supply side issues, including market concentration and the level of choice available, unless it can be demonstrated these aspects are damaging audit quality.

This review of audit scope and purpose, however, cannot be undertaken in isolation and needs to form part of a wider review of the corporate governance and reporting framework the UK. We believe that as part of this review consideration needs to be given to the audit of non-GAAP measures and other information contained within the Strategic Review along with the US requirements on the effectiveness of an entity's internal control over financial reporting (and the integrated audit approach).

Question 3. To what extent do the decisions made by audit committees support high-quality audits, whether through competition for audit engagements or otherwise?

We believe that the audit appointment recommendations made by audit committees (which is a subcommittee of the unitary board in the UK and is constituted wholly by non-executive directors), and their ongoing subsequent interactions with the external auditors, including the scrutiny of their work and findings, do support high quality audits. We have spoken to several audit committee chairs and they have highlighted the importance that they place on ensuring proper due process during an audit tender and in their subsequent dealings with the statutory auditor.

That audit committees take their role very seriously has also been evidenced by audit partners who have highlighted 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". We would also highlight that in the audit tender guidance that we have produced for members it is emphasised that:

> "At the heart of the assessment criteria must be "audit quality". The overriding objective of undertaking an audit tender should be to seek to ensure that the company has the best possible auditor for the company's needs."

https://www.icas.com/__data/assets/pdf_file/0004/298480/ICAS-Selecting-your-Auditors-Tender-Guidance-2017_FINAL.pdf

The UK has one of the most transparent audit regimes in the world. Not just in terms of auditor reporting where auditors disclose the levels of materiality used on their audits, but also in terms of the findings of the audit inspection reports of the large firms published by the FRC. In recent years there has generally been a trend of improvement in these findings, although this suffered a setback in this year's report. Audit committee chairs carefully review the findings of such reports and, in particular, where the audit of their company has been the subject of an FRC inspection review. Nevertheless, we have highlighted in our response to the FRC Review Call for Evidence that more engagement between the FRC and audit committees would be advantageous.

The audit committee plays a vital role in governance over the external audit process, with regular engagement between audit committee chairs and audit engagement partners providing both parties with ample opportunity to discuss any concerns. We are aware that some investors have expressed concern over their engagement with certain audit committees. In contrast, the non-executive directors that we have spoken to are very clear about their responsibilities to the shareholders, and would welcome increased contact from investors (there is an apparent lack of willingness for investors to engage with audit committee chairs).

Audit committees are well versed in the fact that audit quality must remain at the top of their agenda. Indeed, it is more common than not that in the event of a disagreement audit committees will support the views of the external auditor as opposed to executive management in relation to the accounting treatment of certain transactions.

The responsibility on the audit committee to undertake an annual evaluation of the external audit focussed on its quality is taken very seriously by the audit committee, informing it of circumstances where a change of auditors or audit partner might be required.

ICAS was instrumental in supporting the establishment of the Audit Committee Chairs Independent Forum which was created to provide audit committee chairs with an independent voice and a medium through which they could collectively air their views as, and when, required. See http://accif.co.uk

Question 4. How has this changed following the Competition Commission's intervention?

Prior to the Competition Commission's intervention, audit committees were already focussed primarily on audit quality issues. Since then greater emphasis has been placed on demonstrating the role of the audit committee in relation to the appointment of the external auditor and the ongoing monitoring and reporting of that relationship. This has proven to be beneficial and has added to audit committees' consideration of what they are looking for from their auditors.

Tender processes being undertaken are becoming more rigorous, including subjecting the audit firms to challenges of a technical nature. The need to demonstrate how audit quality is being addressed has contributed to the investment and innovations that the larger audit firms have recently introduced, particularly in relation to their audit methodologies.

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

An effective audit requires experience gathered over a medium timeframe, thus audit competition at the individual client level is periodic rather than ongoing. The audit firms do compete continuously at the macro level in terms of innovation, audit process and most importantly in protecting their reputation. When audit tenders are opened there is plenty of competition at most levels of the audit market. There are cases in niche sectors (i.e. oil and gas and banking) where issues appear to have arisen in terms of market concentration through there being a limited number of firms with the requisite skills and capabilities. Further issues arise where a UK PIE is located in the middle of a global group - where there is no requirement and intention to change the global auditor of the group but where the UK PIE has to retender its audit. In the latter case the issue is that no other firm will compete with the incumbent if it is capable of being reappointed, as the group would most likely seek to retain the same auditor as that of the rest of the group. We appreciate that the latter is not a common occurrence but occurs in relation to the largest PIEs.

However, the main public and political concern is not so much about the level of competition in general, but rather the level of choice and concentration in the FTSE 350 audit market. The level of concentration of audits undertaken by the Big Four has increased from 95% to 97% following the changes that were made to the market by the Competition Commission and the subsequent introduction of the EU Audit Regulation. So, whilst competition has certainly increased within the Big Four as they compete on a more frequent basis on audit tenders, the end result has been to increase the level of concentration within the largest audit firms in the FTSE 350 audit market. This was widely predicted at the time the rules were changed.

Competition from outside the Big Four will only increase if they can meet the tender requirements and provide confidence to audit committees in terms of proposed audit quality. An audit committee needs to act in the best interests of the shareholders of the company. The overriding objective of undertaking an audit tender should be to seek to ensure that the company has the best possible auditor for the company's needs. Any perceived risk to audit quality during a period of transition from one auditor to another needs to be mitigated.

We consider that there is scope to require FTSE 350 companies in future to be more open and transparent about the qualities they expect of their prospective auditors, enabling firms to assess their suitability at an early stage of the tender process (and to invest in and address any areas of weakness for the future). Whilst audit committees are reporting in compliance with the FRC's current guidance, there is scope for more specification and detail. This should not be to the extent required under procurement rules, but the ability for firms outside of the Big Four to assess their own competitiveness to audit a FTSE 350 company well in advance of any planned audit tender, could be greatly enhanced by increased transparency of the characteristics that audit committees are looking for in their prospective auditor.

ICAS encourages the CMA to undertake a review of the demand side of the FTSE 350 market, to establish the key company requirements of this audit market (sector specialism, geography, international considerations etc), and to consider what initiatives to encourage audit committee transparency need to be encouraged (or mandated).

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

The evidence clearly supports the conclusion that there is considerable competition between the Big Four accountancy firms when a FTSE 350 company audit is tendered.

This is illustrated below.

FTSE 350

In the FTSE 350 audit market there is considerable competition amongst the Big Four firms. It is still the Big Four who dominate the composition of this audit market. Of the FTSE 100 only one company is audited by a non-Big Four firm.

FTSE 250 – Auditor Changes

If one looks at the statistics for auditor changes in the FTSE 250 for the years 2017 and 2018 to date, this highlights that the most common occurrence is for one Big Four auditor to be replaced by another Big Four auditor.

Year	Number of Changes of Auditor	Big Four to Big Four	Big Four to Non-Big Four	Non-Big Four to Big Four
2017	21	20	0	1
2018	24	23	1	0
2019*	5	5	0	0

(Source: Accountancy FTSE 250 auditors survey, June 2018)

**Decisions already announced.*

Question 7. How has this changed following the Competition Commission's intervention?

Following the introduction of mandatory tendering of FTSE 350 audits and subsequent mandatory audit firm rotation of PIEs, audit tenders require to be undertaken more frequently. As we stated in our response to question 6 above, there has certainly been increased competition amongst the larger firms in the FTSE 350 audit market. However, this increased competition has done nothing to remove the high level of concentration in the market so far, and in fact in doing so the Competition Commission recommendation has reinforced it – as was widely predicted.

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

Audit quality is certainly enhanced through competitive markets. There are a number of firms who can deliver a high quality audit and who are continuously investing in their processes and technology to be able to compete in each audit tender. Incumbent firms know that the audit committee is focused on audit quality, and that they can be easily replaced as auditors if they deliver poor quality audit services. This reality creates a positive feedback loop which incentivises the incumbent to invest in their processes.

Increased competition amongst the larger accountancy firms has therefore led to a significant increase in investment in technological advancements and although this is not always audit specific, audit has been a beneficiary. Undoubtedly technological advancements will continue to allow firms to further innovate on how they undertake audits, and this should result in higher audit quality over time. However, we would stress that greater competition does not necessarily create better audit quality and attempts to influence the construct of the market in pursuit of competition could pose a risk to this in the shorter-term.

One of the greatest risks to audit quality comes from competition for talent; a FTSE 350 audit will require an audit engagement team with the requisite knowledge, skills and values (as well as access to technology and other capabilities).

In summary, whilst competition may improve quality, increased choice by itself will not necessarily improve quality. There is currently sufficient competition, but certain areas of the audit market would benefit from increased choice. To be competitive some of the non Big Four firms may need to invest further in people, systems and geographical spread.

Question 9. In practice, how much choice do large companies and public interest entities have in the appointment of an external auditor?

The choice will very much depend on industry sector. In many sectors e.g. retail, property, and engineering, companies should have a wide selection of audit firms to choose from. This of course will also depend to some extent on the spread of an entity's operations around the globe. However, it is appreciated that in some sectors i.e. banking and oil and gas, the choice may be more restricted.

Most large companies would regard four firms as sufficient choice – where they get concerned is where one firm audits a key competitor, another chooses not to make itself independent or chooses not to tender resulting in little or no choice. Were one of the Big Four to withdraw from audit services for whatever reason this would be seriously problematic for the audit market.

Audits of Largest Banks in the UK

Looking at this particular segment highlights that there has been increased competition as, prior to the recent regulatory changes, certain of the banks had not changed their auditor in some considerable time.

Bank	Auditor pre-mandatory tendering/rotation	Auditor post-mandatory tendering/rotation
HSBC	KPMG	PwC
Barclays	PwC	KPMG
RBS	Deloitte	EY
Lloyds	PwC	TBA

There has certainly been plenty of competition between the Big Four to date in the banking sector, but client choice appears to be extremely limited. In relation to the audit of the UK entity of Goldman Sachs, there have been claims of recent regulatory intervention. If correct, this might highlight another potential regulatory challenge to increased competition.

Question 10. What are the key factors limiting choice between auditors?

The response to this question depends on the particular segment of the audit market that one is referring to. The further down the chain from the FTSE 100 the greater the choice of audit firms that will be available to undertake the audit in question. In the FTSE 100, in certain sectors, e.g. banking, the complexity of the entities involved and the potential for a regulator to question the appointment of a particular audit firm, do have an impact.

The FTSE 350 is an important group with individual and varying requirements that they would present to any prospective auditor including; specialist expertise and sector knowledge, access to technology, global capability and individual engagement team characteristics.

The requirements of the "demand" side, and the current capabilities of audit firms may be a limiting factor. Additionally, companies use accountancy firms to provide other non-audit services. Such services cover a wide range but could potentially create a conflict if that particular firm was to be appointed as auditor of the entity concerned as audit firms need to comply with the FRC's Ethical Standard which also contains articles of the EU Audit Regulation e.g. the list of prohibited non-audit services. On some occasions, an announcement to tender an audit is made early to allow any potential appointees the opportunity to cleanse themselves of any such perceived conflicts prior to the tender process.

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

In the FTSE 350 we consider the main barriers are:

- The unwillingness of companies to appoint non-Big Four firms as their auditors, due to perceived risks to audit quality, and audit committee responsibilities to ensure the company secures the highest quality audit.
- Non-Big Four firms refusing to tender for an audit despite being asked to do so (or not being invited to do so).

- Audit firms outwith the Big Four may not have the necessary capabilities including geographical scale or knowledge and expertise in certain niche sectors.
- Audit firms outwith the Big Four may not be able to manage the risks associated with FTSE 350 audit work, particularly in the current environment.
- Access to technology. The Big Four are presently making significant investments in technology and therefore can offer more in terms of how such advancements will be used on the audit. As audit committees are primarily focussed on ensuring audit quality this can be a key differentiating factor.

Question 12. Is there a significant risk that the audit market is not resilient? If so, why?

There is undoubtedly a risk that a Big Four firm, or other large firm, could leave the audit space. This could be caused by the potential collapse of a large firm but there is also the risk that a firm makes a voluntary decision to leave this market.

The question is whether any of the mooted remedies can realistically improve the resilience of the audit market, and what the timescales might be. Increased competition and particularly choice, is unlikely to be delivered in the short term.

Question 13. What is the appropriate balance between regulation and competition in this market?

As the CMA identifies in its Invitation to Comment there is a very fine balance between the need for appropriate regulation and the need to ensure sufficient competition amongst audit suppliers in the market place.

Levers to improve choice must not result in reduced audit quality, and vice versa. Increased competition could result in reduced audit quality, at least for the first year after appointment. It is unlikely the regulator would tolerate a drop in audit quality, and would comment publicly to that effect. Likewise, the regulatory burden attaching to FTSE 350 auditors is significant and could outweigh any benefits for a firm (inspection and enforcement outcomes present financial and reputational risks).

POTENTIAL MEASURES

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

Our views on the potential measures are set out below. We cannot stress enough that the changes mooted by the CMA will not get to the root cause, unless supported by a fundamental review of the UK corporate governance and corporate reporting framework for PIEs. This review would include within its scope: what an audit is, and what it is intended to achieve, having regard to the requirements of business and changing public expectations.

The suggested potential outcomes all have unintended or indirect consequences, and we would encourage the CMA to give proper consideration to them, as well as any direct consequences. We would highlight that some of the matters discussed in the CMA's Invitation to Comment need consideration on a global scale to properly assess their potential impact e.g. breaking-up the Big Four firms. We therefore assume that the CMA is actively involved in discussions with other similar regulatory bodies around the globe. The UK is seen by many as the world leading global capital market and to properly ensure that this reputation is retained, consideration has to be given on the impact of unilateral decisions that might well have consequences that go beyond the shores of the UK.

Measures to Increase competition between the Big Four

(a) *greater partial, or complete, restrictions on audit firms providing non-audit services to their audit clients*

We believe this issue is as much about perception as reality as along with regulatory requirements, significant processes and procedures are already in place inside audit firms to ensure there are appropriate conflict avoidance and independence safeguards (which go beyond the UK boundaries).

Nevertheless, the profession needs to be receptive to the wider public interest, and challenge the status quo. We therefore believe that there would be merit, at least in the FTSE 350, in introducing a complete prohibition on the auditor providing non-audit services to an audit client, subject to a small agreed list of permitted assurance related services. This proposal would help address the perception that management is "too close" to the audit firm. Further consideration would need to be given to the range of audit related assurance services that should be best provided by the auditor. These might include capital raising comfort letters and reports; and assessment of cyber-security frameworks etc. The ability to access such services is essential to help directors in the effective assurance of their business on behalf of shareholders and would help audit evolve and ensure it is fit for purpose in the 21st century.

(b) *prohibit audit firms from providing non-audit services not only to their audit clients, but also to any other large company or PIE*

This measure, if implemented, would have to include all auditors of FTSE 350 and large companies, and not just the Big Four.

A complete prohibition on audit firms supplying non-audit services to a large company or PIE would be a severe restriction of choice for the companies concerned. PIE and large companies already face restriction of supply in some service areas and to add to this could be detrimental to their effective operations. As mandatory retendering and rotation continues to create opportunities for increased competition, the environment is already challenging for companies who are forced to find new suppliers for their non-audit services. This is expensive and time consuming and anything that increased this challenge further, without any tangible benefit would likely not be desirable or effective. Furthermore, even when there are service providers beyond the audit firms who can advise on certain specialist areas there remain challenges with independence and choice. For example, pensions and actuarial service. Generally, three parties in a corporate environment need such services to carry out their respective duties – the company, the pension fund trustees and the auditor - and for conflict avoidance reasons one party cannot choose the service provider of the other. A total ban would render the situation more complex for companies and could further reduce market choice for such services. This would not be desirable.

(c) *split the UK arms of major accounting firms into audit-only and non-audit services practices*

The split of UK arms of major accounting firms into audit only and non-audit service practices, would require overcoming considerable challenges including those presented by the CMA. To suggest that there can be a UK only solution is misguided. There are global dimensions, both in relation to the scope of the audit, and the operations of the audit firm. Additionally, there are currently calls for more expertise both within companies and audit firms. To form audit only firms will reduce the level of expertise for the most complex audits where the firm may only have one audit client in that sector. The provision of expert services to non-audit clients enables the firms to gain the necessary level of expertise that helps within the audit environment.

Measures that result in a complete prohibition on audit firms providing non-audit services not only to their audit clients, but also to any other large company or PIE, or indeed audit-only/non-audit firms, could perversely reduce market choice.

Increase competition from non-Big Four firms

Measures to reduce the barriers for non-Big Four firms to build their capacity

(a) Market share cap on the Big Four

This is a supply solution and if properly constituted could create opportunities for mid-tier firms. However, considerable obstacles would need to be overcome in the design of any quota system. Such considerations would include the scope of the market and the basis on which any market cap is set. Whilst basing the cap on numbers of companies would be the easiest way this would not ensure an appropriate allocation of the true value of the marketplace. Therefore, consideration would probably need to be placed on audit fees as a surrogate for the market capitalisation of the entity concerned, although this is likely to prove extremely fluid and problematic.

Additionally, any market cap is likely to leave some audit committees in an untenable position. A restriction of market choice for certain audit committees when tendering, and where appropriate rotating their auditors is our key consideration. An example might be where a FTSE 350 company, which falls below the "defined" market cap and cannot approach the Big Four, has a requirement for audit services that can only realistically be supplied by the capability and capacity of one of the Big Four. Such requirements might include a global geographical spread of activities requiring local audit presence; specialist business activities (i.e. insurance or oil and gas) and challenging balance sheet attributes such as capital leasing all in multiple countries. An audit committee and its members have their fiduciary duty to find and select the highest quality audit service firm to meet their specific needs and, in this situation, they may not be able to meet this if the widest choice of service providers were not available to them. This would in effect be a restriction of market choice and it is something that investors in the company concerned would not likely welcome. Furthermore, there could be risks to audit quality at least in the short term. This could have a negative impact on the resilience of the audit market. In short, a cap does not necessarily provide a solution that is in the public interest.

We are aware that audit firms and stakeholders favour a market cap approach and we would encourage the CMA to fully consider all of the benefits and risks of adopting this approach.

There would also be issues of enforceability. It would be detrimental to the UK, particularly as it enters a new phase of international relations, to see major companies seek to move outside the UK at the holding company level to preserve audit relationships that the directors judge necessary for protection of shareholders' interests which are only being disturbed by an artificial cap.

What audit market would the cap apply to – FTSE 100, FTSE 250, other listed entities?

It is questionable at this moment whether all of the challenger firms would want to be the auditor of all types of entity which are to be found in the FTSE 100 or indeed in some cases the FTSE 250 (i.e. large financial institutions and oil and gas companies). Many of these firms recognise the need to build up scale and further enhance their reputation before breaking into these respective markets. Therefore, as we have highlighted above great care would need to be exercised if it was decided to go ahead with this proposed solution as to what market it should apply to.

(b) Variations of joint and shared audits and peer review;

Joint Audit

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 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.

We are of the view that joint audits present difficult challenges for the auditors, the audited company and its audit committee with a knock-on effect on audit quality and the potential confidence investors may have in the audit process. We do not therefore see this as a solution to the current question. Specifically, with regards to the auditor liability regime we would highlight that a major disincentive to challenger firms is that as joint signatories to the audit report they would be subject to the joint and several liability regime. This latter point is particularly important in the current legal and regulatory environment.

In 2012 ICAS commissioned a literature review of research which had been undertaken on joint audits. Entitled "What we know about joint audits?" This can be viewed at: https://www.icas.com/technical-resources/publication-what-do-we-know-about-joint-audit

The key findings of this 2012 literature review were as follows:

- There is limited empirical support for the frequently stated argument of joint audit supporters that joint audits lead to increased audit quality.
- There is some empirical support for the frequently stated argument of joint audit opponents that joint audits lead to additional costs.

  The joint audit should be seen as a mechanism that is embedded in a broader institutional context and should not therefore be considered in isolation from other factors that might impact the audit market. The results reported by this literature review clearly indicate that various country-level characteristics are simultaneously at play. Joint audits can potentially enhance the competition in the audit market by allowing smaller audit firms to maintain larger market shares. However, the impact of this lower market concentration on the quality of the audit has not been clearly demonstrated. This review indicates that further evidence is needed prior to implementing mandatory joint audit in the European Union. The research indicates that policy makers should examine audit quality and audit market structure enhancement together, as a complex whole. Prior to implementing a policy on joint audit, the relevant regulatory bodies would need to address the following practical challenges:

  - First, the question of the optimal sharing of the audit work and the desirability of a balanced joint audit, which also raises the issue of the auditor pair choice;
  - Second, the need to consider the duration of the audit engagement and possible auditor rotation issues in conjunction with a joint audit regulation;
  - Third, the unexpected effects arising from the need to select two auditors. This applies in particular to industries where the number of industry specialist auditors to choose from is low.

  (Source: *What do we know about joint audit?, ICAS, 2012)*

Shared Audit

We are of the view that shared audits will present difficult challenges for both the auditors and for the audited company and its audit committee. Considerations will include increased costs, potential impact on audit quality, investor confidence and ownership of risk. The latter is particularly important in the current legal and regulatory environment.

Peer review

Peer review as described in the Invitation to Comment would also provide considerable obstacles to its introduction. These include but are not limited to the other firm's capability to undertake this task prior to the audit report being signed. Audit firms have detailed internal procedures which ensure there has been appropriate peer review and challenge. These include the need to appoint an Engagement Quality Control Reviewer for audits of listed entities and other entities as appropriate (ISA 220 'Quality Control for an audit of Financial Statements'). The Engagement Quality Control Review is a process designed to provide an objective evaluation, on or before the date of the auditor's report, of the significant judgments the engagement team made and the conclusions it reached in formulating the auditor's report. Any peer review would be subject to significant terms and conditions including obligations of confidentiality and measures to protect the audit firm's methodology.

(c) *direct support to the mid-tiers by the Big Four and professional bodies*

We note the CMA's proposed measure that the professional bodies, such as ICAS, could assist audit firms outside the Big Four to build capability and capacity, with a view to tendering for PIE audits in the future. ICAS is committed to working in the public interest and thus would look forward to exploring with the CMA what those initiatives might be, and the role we might play.

(d) *reducing the barriers for senior staff to switch between audit firms*

We are not aware that this is a barrier to choice and are therefore not in a position to comment.

(e) *changes to the restrictions on the ownership of audit firms.*

This approach has been adopted in relation to other sectors, most notably in relation to the provision of legal services. It is not without its challenges, and whilst it might enable firms to invest for the future, it might also pose risks to firm culture and behaviours.

The traditional partnership model entails proven benefits regarding auditors' independence, audit quality and firms' capacity to attract and retain talent. It is critical that any alternative ownership model is equally conducive to the profession's long-term sustainability and the delivery of high-quality audit services. External investors only invest money where the investment offers attractive profit perspectives based on a reasonable risk/reward ratio.

ICAS members are trained to behave according to a well-established set of values and principles and commit to acting in the public interest and conducting themselves with integrity, objectivity and courage, and in accordance with the high ethical standards of ICAS.
https://www.icas.com/__data/assets/pdf_file/0006/220110/ICAS-The-Power-Of-One.pdf

There is a risk that these values and principles, and therefore auditor independence, could be weakened if the restrictions around audit firm ownership are removed. To dilute their influence on the firm would need very careful consideration. The CMA could not consider this initiative without close involvement of the Financial Reporting Council, as the Competent Authority for audit in the UK.

Break-up of the Big Four into smaller audit firms

To suggest that there can be a UK only solution is misguided. There are global dimensions, both in relation to the scope of the audit, and the operations of the audit firm. Additionally, there are currently calls for more expertise both within companies and audit firms. To form audit only firms will reduce the level of expertise for the most complex audits where the firm may only have one audit client in that sector. The provision of expert services to non-audit clients enables the firms to gain the necessary level of expertise that helps within the audit environment.

We concur with the views from stakeholders that have been expressed to the CMA that the design and implementation of this measure would pose significant challenges.

Measures to Improve Incentives

Mitigate the effects of current incentives

(a) improving the transparency around the tendering process

We note that the proposed measures to be considered are the following:

1. publish data on an annual (historic) basis on tender participants and their outcomes;
2. publish the names of large companies and PIEs that will tender their audits over the forthcoming 12 months;
3. implement blind tenders so that the names of audit firms and/or audit fees are not disclosed; and/or
4. publish non-confidential examples of winning tenders so that audit firms interested in tendering for the audits of large companies and PIEs can gauge what a good tender looks like.

We have no objection to measures (1) and (2) as they will result in increased transparency. We are not supportive of proposed measure (3) as we are not sure how practical this will be to implement. Provided confidentiality issues can be overcome there would appear to be merit in measure (4).

There should be increased transparency of the audit committee tender process and this should be communicated well in advance of the actual process commencing. In particular, this should include disclosure of the audit committee's key criteria for assessing the qualities they expect of their statutory auditors. This should be at a sufficiently detailed level to enable all firms including those outside of the Big Four to assess their own capabilities to audit a particular PIE company and if necessary to close any gaps in capability. Audit committees already publish their tender requirements (FRC Audit Tender Best Practice Notes, February 2017) but it is not being reported at a sufficiently detailed level to enable all firms including those outside of the Big Four to assess their own capabilities to audit a particular PIE company, or if necessary the level of investment required to close any gaps in capability. Any improvement in supply side choice will, we believe require such investment.

(b) reforming mandatory tendering and auditor rotation; and

The policy of mandatory tendering and rotation is still young. Insufficient time has elapsed to enable a proper assessment of the impact. We therefore believe that no reforms should be made to this regime in the short-term but the impact of the policy should be kept under continual assessment.

(c) further strengthening audit committees and / or their links to shareholders.

The ultimate clients of a statutory audit are investors, not companies and audit committees act on their behalf. Significant shareholders are therefore interested in a transparent tender process. Audit committees are required to disclose in their annual report that a tender is taking place.

In compliance with their obligations under the UK Corporate Governance Code, the audit committee of a PIE company (which is a subcommittee of the UK unitary board and not a separate entity) has to consider the company's particular needs and circumstances when they make a recommendation to the board and shareholders to change/appoint a Statutory Auditor. An audit committee and its members have a fiduciary duty to find and select the highest quality audit service firm to meet their specific needs.

Audit committees have the time and resources to understand fully the audit requirements of the company and the audit planning and scope proposals being made by the respective audit firms that participate in the tender process. They are in an unrivalled position to make an informed assessment about: the needs of the company; whether the tender selection criteria are met; the proposed engagement team; and to ultimately make a recommendation to the board, and to the shareholders.

It is incumbent upon shareholders to engage with audit committees of their investee companies. Many board directors have commented that while investors engage on matters relevant to the remuneration committee, there is little or no engagement on the matters addressed by the audit committee which arguably go to the heart of the quality of their investments. Likewise, audit committees need to be mindful of their wider role and responsibilities.

We do however believe that there is scope to require FTSE 350 companies in future to be more open and transparent about the qualities they expect of their prospective auditors, enabling firms to assess their suitability at an early stage of the tender process (and to invest in and address any areas of weakness for the future). Whilst audit committees are reporting in compliance with the FRC's current guidance, there is scope for more specification and detail. This should not be to the extent required under procurement rules, but the ability for firms outside of the Big Four to assess their own competitiveness to audit a FTSE 350 company well in advance of any planned audit tender, could be greatly enhanced by increased transparency of the characteristics that audit committees are looking for in their prospective auditor.

Wider reforms of the audit sector

(a) an insurance-based system for audit; or

We are not supportive of this potential measure which is not new. It is subject to a lot of very impractical features. An audit is not an insurance policy nor is it intended to be. The audit is designed to provide assurance on the truth and fairness of an entity's financial statements which helps to create trust in the capital markets as opposed to merely just underwriting a potential loss. We also have concerns that the insurance referred to would be too expensive and therefore not widely available in the market place.

(b) an 'NAO-style' national auditor.

For the reasons outlined at paragraph 4.51 of the Invitation to Comment we are not supportive of this possible measure.

Whilst a similar regime operated in recent years in the context of Local Authority audit, the Audit Commission was dismissed in favour of open competition. In our experience, the entities being subjected to audit are very different and this regime will not easily translate to company audit. Local Authorities and large trusts are broadly similar in their requirements; the FTSE 350 and large private companies are not homogenous.

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

We have no further measures that we believe should be considered other than those that we have set out elsewhere in this response.

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

We are not supportive of the creation of audit-only firms. Indeed, we have concerns that this would not increase choice.

To suggest that there can be a UK only solution is misguided. There are global dimensions, both in relation to the scope of the audit, and the operations of the audit firm. Additionally, there are currently calls for more expertise both within companies and audit firms. To form audit only firms will reduce the level of expertise for the most complex audits where the firm may only have one audit client in that sector. The provision of expert services to non-audit clients enables the firms to gain the necessary level of expertise that helps within the audit environment.

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

Some of the matters discussed in the CMA's Invitation to Comment need consideration in a global context to properly assess their potential impact e.g. breaking-up the Big Four firms. We therefore assume that the CMA would consult with other similar regulatory bodies around the globe.

The UK is rightly seen by many as the world's leading capital market in terms of governance standards.

It is imperative this reputation is retained and due consideration has to be given to the impact of unilateral decisions, that might well have consequences that go beyond the shores of the UK. It would be a surprising and, in our view, unwarranted conclusion to suggest that the financial reporting integrity of UK markets is questionable.

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

We believe this issue is as much about perception as reality as along with regulatory requirements, significant processes and procedures are already in place inside audit firms to ensure there are appropriate conflict avoidance and independence safeguards (which go beyond the UK boundaries).

Nevertheless, the profession needs to be receptive to the wider public interest, and challenge the status quo. We therefore believe that there would be merit, at least in the FTSE 350, in introducing a complete prohibition on the auditor providing non-audit services to an audit client, subject to a small agreed list of permitted assurance related services. This measure would need to apply to all firms who provide audit services to a FTSE 350 company.

This proposal would help address the perception that management is "too close" to the audit firm. Further consideration would need to be given to the range of audit related assurance services that should be best provided by the auditor. These might include capital raising comfort letters and reports; and assessment of cyber-security frameworks etc. The ability to access such services is essential to help directors in the effective assurance of their business on behalf of shareholders and would help audit evolve and ensure it is fit for purpose in the 21st century.

Question 19. How should the market shares be measured? - number of companies audited, or audit fees or some other measure?

This is a supply solution and if properly constituted could create opportunities for mid-tier firms. However, considerable obstacles would need to be overcome in the design of any quota system. Such considerations would include the scope of the market and the basis on which any market cap is set. Whilst basing the cap on numbers of companies would be the easiest way this would not ensure an appropriate allocation of the true value of the marketplace. Therefore, consideration would probably need to be placed on audit fees as a surrogate for the market capitalisation of the entity concerned, although this is likely to prove extremely fluid and problematic.

Question 20. Could the potential benefits (greater choice, and resilience) of a market share cap be realised?

Despite our reservations, by its very nature, a properly constituted market share cap could provide greater choice in the market place.

We are aware that audit firms and stakeholders might favour a market cap, and we would encourage the CMA to fully consider all of the benefits and risks of adopting this approach.

Any market cap is likely to leave some audit committees in an untenable position. A restriction of market choice for certain audit committees when tendering, and where appropriate rotating their auditors is our key objection. An example might be where a FTSE 350 company has a requirement for audit services that can only realistically be supplied by the capability and capacity of one of the Big Four. Such requirements might include a global geographical spread of activities requiring local audit presence; specialist business activities (i.e. insurance or oil and gas) and challenging balance sheet attributes such as capital leasing all in multiple countries.

An audit committee and its members have their fiduciary duty to find and select the highest quality audit service firm to meet their specific needs and, in this situation, they may not be able to meet this if the widest choice of service providers were not available to them. This would in effect be a restriction of market choice and it is something that investors in the company concerned would not likely welcome.

Question 21. What do you consider to be the relative scale of the costs of a market share cap, such as increased prices and potentially reduced competition, and potential benefits?

The impact on fees and competition, or any increased benefit of a market share cap would depend on the basis of the cap, the scope of the market, the profile of the FTSE companies and the appetite of the non Big Four firms to compete in this new environment.

Question 22. What should be the appropriate level of such a cap, collectively for the Big Four for the measure to achieve its objective? For example, 90%, 80%, 70%?

If a cap were to be introduced the first decision that has to be made is what part of the audit market this should apply to e.g. would it be the FTSE 350? A detailed analysis of that specific market would then be required before consideration could be given to the appropriate level of the cap.

Question 23. Could a joint audit be an effective means of implementing a market share cap?

We are not supportive of joint audit. We are of the view that joint audits present difficult challenges for the auditors, the audited company and its audit committee with a potential knock-on effect on audit quality and the confidence investors may have in the audit process.

We do not therefore see this as a solution to the current question. Specifically, with regards to the auditor liability regime we would highlight that a major disincentive to challenger firms is that as joint signatories to the audit report they would be subject to the joint and several liability regime. This latter point is particularly important in the current legal and regulatory environment.

Question 24. Should the auditors and those that manage them (e.g. audit committees, or an independent body as described in section 4) be accountable to a wider range of stakeholders including shareholders, pension fund trustees, employees, and creditors, rather than the current focus on shareholders?

This is a matter which would appear to go beyond the remit of the CMA's market review.

As we have highlighted, a review into the UK corporate governance and corporate reporting frameworks including assurance should be instigated. This should encompass the scope of audit, address the audit expectation gap, redefine what the audit looks like in the future and who are the true stakeholders in that audit (and therefore define auditor accountability for the future). Part of this review should look at the auditor liability regime including the auditor's duty of care including precedents established by case law such as Caparo Industries plc vs Dickman 1990 UKHL 2 AC 605

As we have highlighted above there is a need to improve investor engagement in the longer-term. ICAS has provided detailed submissions to the FRC Review, and we support the view that increased governance and stakeholder engagement is necessary.

Question 25. If yes, should audit committees (in their current form) be replaced by an independent body that would have a 'public interest' duty, including for large privately-owned companies? Should this body be responsible for selecting the audit firm, managing the scope of the audit, setting the audit fees and managing the performance of the audit firms?

This question has been posed by the Secretary of State to Sir John Kingman. ICAS will respond to his request for submissions by 9 November 2018.

ICAS does not support an independent appointment process for a company's auditor. To go down this route fundamentally disenfranchises the audit committees of PIE company boards and leaves them with the accountability for performance and outcome of an audit whilst not having any direct control over the selection and appointment. Such a situation is neither equitable nor sustainable. In addition, while this regime has operated in recent years in the context of Local Authority audit, the Audit Commission was dismissed in favour of open competition. In our experience, the entities being subjected to audit are very different. Local Authorities and large trusts are broadly similar in their requirements; the FTSE 350 and large private companies are not homogenous. The auditor selection process undertaken by an audit committee is substantive. Even if the practical barriers could be overcome, the Competent Authority has an operational inspection role which would preclude it from engaging in any appointment process.

Question 26. Please describe the benefits, risks and costs of such an independent body replacing audit committees.

Please refer to our response to question 25.

Question 27. Should companies be required to tender their audits and rotate their auditors with greater frequency than they currently are required to do? What would be the costs and benefits of this?

We would not be supportive of increased tendering and rotation of auditors. This matter was given considerable focus in the UK prior to the finalisation of the EU Audit Regulation in 2014.

The policy of mandatory tendering and rotation is therefore still young. Insufficient time has elapsed to enable a proper assessment of the impact. We therefore believe that no reforms should be made to this regime in the short-term but the impact of the policy should be kept under continual assessment.

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ICAS

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1 Introduction

Effective capital markets need trust: trust in the integrity, skill and competence of a company's directors and management and trust in their reporting. The role of assurance is to inspire trust in corporate reporting.

A global financial crisis has damaged faith in both corporate reporting and assurance and forced us all to ask some difficult questions - many of which are naturally directed towards the accountancy profession. ICAS represents a wide spectrum of stakeholders, including preparers of financial statements, auditors and investors and all have an interest in the preservation and promotion of trust.

With this publication we offer our vision for the future of assurance. Assurance is more than external audit – it is a process which begins with the company itself – and we have not confined our thoughts to the traditional external audit of the financial statements. We have considered the internal processes in the company, the corporate reporting and the role of the audit committee - while recognising the critical role of the independent external audit.

Our working group represents the key stakeholders: preparers of financial statements; institutional investors; audit committee chairs; audit professionals; representatives from banking, academia and the media; and observers from the key UK regulators. We present our thoughts to you in a UK listed company context but we believe they will be relevant across the globe.

ICAS represents a profession with many often competing interests but our overriding consideration must always be the public interest. This publication represents our vision of how to promote the trust in the capital markets that is so fundamental to that public interest.

2 Executive Summary

The working group's recommendations focus on: an improved corporate report; more assurance on the front half of the annual report; and more transparency and accountability on the reporting and assurance.

The Corporate Reporting Model

- An annual report which tells a coherent story of the business - with a new requirement for the Board to outline their rationale and key assumptions for concluding that the business is viable for at least the next twelve months.

The Audit Committee

- An expanded and meaningful audit committee report that will specifically disclose the key areas of discussion between the committee and the external auditor;
- The audit committee should disclose its policy for ensuring an effective external audit process. Building on the annual review audit committees are currently required to perform, the audit committee should declare what they believe to be a suitable timeframe to re-tender the audit appointment. With a focus on audit quality they should then either comply with their own policy or explain why on that occasion they have chosen not to. In addition to the annual review of the audit appointment, the audit committee should perform a more in depth review every 5 years – in particular, this review would include engagement with the shareholders.

The External Assurance Process

- The external auditor to provide an explicit opinion on the directors' going concern judgements;
- Assurance to be provided on the front half of the annual report by a new "balanced and reasonable" opinion. Although not an "audit" opinion in the traditional sense, this new opinion would utilise the auditor's knowledge of the business to provide comfort over the narrative reporting of the Board.

3 Our Vision

the highest quality of reporting facilitating efficient capital markets and an assurance framework to inspire confidence in that reporting.

The Foundation

Our vision is presented in the context of the UK model of corporate governance and its "comply or explain" approach – with the effective audit committee at its heart – and is addressed primarily to listed companies. Our framework is premised on the assumption that shareholders and other stakeholders will engage with companies and that this engagement should be a key driver for quality reporting and assurance. This engagement is a critical foundation of our recommendations– albeit we recognise that not all stakeholders may wish to engage.

The Corporate Report

The corporate report forms the basis of a constructive dialogue between the stakeholder and the company; language is no longer boilerplate; the Board tells a balanced and coherent story of the business – including the business model and strategy, the key risks, assumptions and future prospects; and assurance lends credibility to the reporting, inspiring the confidence of all stakeholders. In the longer term, the key communication document could be shorter and more integrated, containing only the key messages and summary financial information, with the remaining detailed information and full financial statements available and searchable on the company's website.

The Audit Committee

The audit committee's role is further strengthened through increased disclosure and transparency. The audit committee report becomes the primary vehicle for delivering visibility of the assurance processes, both internal and external. Rather than simply a compliance statement, the report allows the user to understand how the audit committee has discharged its duties with respect to the risks to the business and, specifically the external audit process. The reader will gain an insight into the audit committee's relationship and discussions with the external auditor; and its role with respect to the appointment of the external auditor is stronger and more transparent.

The Assurance Processes

Assurance begins with the company. It can take many forms – internal audit; regulatory reporting and oversight; the risk management processes; an independent review of the company's sustainability report; and of course the external audit. The Board relies on a "package" of assurance to mitigate the impact of the risks facing the business – risks which are strategic, operational and financial. The audit committee report clearly maps out the assurance processes which address the risks, and the audit committee is accountable to the shareholder through the Board for the oversight of the company's risk management and assurance.

The External Auditor

The external auditor continues to give an opinion on whether the financial statements are true and fair, with an additional opinion explicitly stating that the Board's review of the going concern status of the company is reasonable. Going beyond the "traditional" external audit of the financial statements, an assurance report is provided on the remainder of the annual report, giving the user comfort that the "story" presented by the Board is balanced and reasonable. The external auditor explicitly states that the Board's review of the going concern status of the company is reasonable. Disclosure of the key areas of discussion between the external auditor and the audit committee is contained within the audit committee report, to which the external auditor explicitly refers in the assurance report. One audit report contains all external assurance opinions. The audit profession is recognised as one comprising highly skilled business professionals valued for their ability to exercise judgement and challenge management.

Achieving our Vision

For our vision to become a reality, there is a need for courage: on the part of the Board to speak honestly to the user; from the external auditors to step beyond their traditional role and be able to provide a meaningful opinion on the "front end" of the annual report; from all stakeholders, including the markets, to make informed decisions based on all the information available and to engage with companies; and from Government and regulators to allow this vision to become a reality.

4 The Challenge

Our greatest challenge as a working group was also our greatest asset: the diversity of our group's membership. Naturally those current and former audit practitioners have a greater in-depth knowledge of the external assurance process, while the preparers were more familiar with the internal mechanisms of a company. Our investor members approached the discussion from their perspective as stewards, while the audit committee chairs considered their own oversight of the executive directors. Even within these broad categories, our members did not always agree – but each member's contribution added a rich spectrum of views to the table and, as a result, the quality of the debate was exceptionally high.

The process by which our group reached its conclusions is as relevant as the recommendations themselves. During the course of our meetings there were a number of important consultations and debates taking place at the UK and European levels, particularly around the external audit. We debated the ideas put forward by these consultations and the robustness of our own recommendations derives from our consideration of a number of often radical ideas. Some members of our working group would have preferred the more radical alternatives, while others felt that some of our recommendations went too far – but following an extensive debate, we present this report with the full support of the group.

Setting the scene

A natural consequence of the timing of this report is the backdrop of the financial crisis. While the UK House of Commons Treasury Committee questioned whether the external audit was useful if it did not alert users to an impending crisis[1], the European Commission has issued a thought provoking Green Paper on audit policy, raising a number of issues and making some controversial suggestions for the future role of the external auditor[2]. The UK House of Lords is currently conducting its own investigation into the role of auditors, specifically focusing on the issue of market concentration in the audit market.[3]

We recognise that high quality reporting must underpin an effective assurance process and the external audit should not be considered in isolation. Many commentators share the view that corporate reporting has lost its focus and become overly complex, and ICAS has made its own contribution to the complexity debate with its publication *Making Corporate Reports Readable*[4] – ideas which the working group considered in developing our own recommendations.

Meeting the Needs?

Identifying the needs of the user is a prerequisite to the development of a suitable framework. A recent ICAS research report[5] suggests that narrative reporting is increasing in its importance but is

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1 House of Commons Treasury Committee, Banking crisis: reforming corporate governance and pay in the city, Ninth Report of Session 2008-09, Report together with formal minutes (House of Commons 12 May 2009) P76 paragraph 221 (see http://www.publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/519/51902.htm)

2 European Commission Green Paper, Audit Policy: Lessons from the Crisis, Brussels, 13.10.2010 COM(2010) 561 final (see http://ec.europa.eu/internal_market/consultations/docs/2010/audit/green_paper_audit_en.pdf)

3 House of Lords Economic Affairs Committee inquiry: Auditors: Market Concentration and their Role (see http://www.parliament.uk/business/committees/committees-a-z/lords-select/economic-affairs-committee/news/economic-affairs-committee-publishes-call-for-evidence/)

4 Making Corporate Reports Readable – time to cut to the chase, February 2010 (The Institute of Chartered Accountants of Scotland) (see http://www.icas.org.uk/site/cms/download/AA/Making_Corporate_Reports_Readable.pdf)

5 Meeting the Needs? User Views on External Assurance and Management Commentary, Fraser, Pierpoint, Collins and Henry, 2010 (The Institute of Chartered Accountants of Scotland) (see http://www.icas.org.uk/site/cms/download/res/Fraser_Users_Report_April_2010.pdf)

often constrained by “boilerplate” language. There is concern that the commentary around risks and future prospects is vulnerable to management “spin” and that some form of external assurance would be desirable. The report also suggests a demand for enhanced reporting from the external auditor, and the research provided a useful basis for discussions.

If it’s not broken...

Our recommendations do not start with a blank canvas. The UK model of corporate governance requires boards to explain how they have satisfied the principles of the Corporate Governance Code[6] and then either comply with the guidance provisions or explain why have chosen not to – a model respected worldwide. Audit committees have evolved into a fundamental part of a company’s governance structure (we use the term audit committee throughout this report but we recognise that some companies may also have risk committees which perform part of the functions we attribute to the audit committee). The audit of the financial statements, conducted against the standards developed by the International Auditing and Assurance Standards Board (IAASB)[7] and the International Ethics Standards Board for Accountants’ (IESBA) Code of Ethics[8], is considered a robust model – strengthened by the recent project to “clarify” and revise the standards. We have used the existing governance, reporting and assurance framework as our starting point.

6 The UK Corporate Governance Code, June 2010 (Financial Reporting Council) (see http://www.frc.org.uk/documents/pagemanager/Corporate_Governance/UK%20Corp%20Gov%20Code%20June%202010.pdf)

7 International Standards on Auditing (ISAs) as issued by the International Auditing and Assurance Standards Board (IAASB). These standards are adopted in the UK and Ireland by the Auditing Practices Board (APB). The “clarified” ISAs will be effective for audits of financial statements of periods ending on or after 15 December 2010. The ISAs (UK and Ireland) are available at http://www.frc.org.uk/apb/publications/isa/oct2009.cfm.

8 The UK Auditing Practices Board (APB) issues its own Ethical Standards for Auditors based on the IESBA Code (see http://www.frc.org.uk/apb/publications/ethical.cfm)

5 The Corporate Reporting Model

BACKGROUND

High quality corporate reporting is fundamental to effective assurance.

A key communication document

The corporate report is viewed by many as an exercise in regulatory compliance. Its function as the key communication document to stakeholders can be lost in a sea of boilerplate and unenlightening disclosures which differ little from company to company.

In 2010 ICAS published *Making Corporate Reports Readable*[9] - representing the Institute's contribution to the debate surrounding the complexity of corporate reporting. The premise is simple: replace the current annual report with a shorter document of approximately 30 pages. This report provides a clear integrated exposition of: the business model, strategy and key risks; the most significant judgements and accounting policies; and summary financial information. It is recommended that all other information, including the full statutory financial statements, are easily accessible and searchable on the company's website.

Our recommendations for the future of assurance are built around the annual report as we know it today. We believe that the integrated short form report contained within Making Corporate Reports Readable represents a vision of where corporate reporting should be heading. Our recommended assurance framework could also be adapted if necessary.

Regardless of its form, the top level corporate report must tell a cohesive story of the business. It should be the primary communication document for all stakeholders, while recognising that there will be other sources of information to complement and enhance this report.

To whom are we speaking?

The content of the annual report is dictated by a wide variety of legislation and guidance – the Companies Act[10] (which reflects the requirements of European law); the UK Listing Rules[11]; the UK Corporate Governance Code[12], to name but a few. But is the audience the shareholder? The regulator? The government? The general public? Identifying the user is the critical first step to effective communication.

The UK corporate governance model is premised on the corporate report and associated assurance reports being addressed to the shareholders. However, the stakeholder community of a company is far wider, increasing as a function of the public interest in that company. We believe it is appropriate for the corporate report and assurance reports to be addressed in law to the shareholders – but the interests of other stakeholders must be considered by the Board in the telling of its "story".

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9 Making Corporate Reports Readable – time to cut to the chase, February 2010 (The Institute of Chartered Accountants of Scotland) (see http://www.icas.org.uk/site/cms/download/AA/Making_Corporate_Reports_Readable.pdf)

10 Companies Act 2006 (see http://www.legislation.gov.uk/ukpga/2006/46/contents)

11 As issued by the UK Listing Authority (see http://fsahandbook.info/FSA/html/handbook/LR)

12 The UK Corporate Governance Code, June 2010 (Financial Reporting Council) (see http://www.frc.org.uk/documents/pagemanager/Corporate_Governance/UK%20Corp%20Gov%20Code%20June%202010.pdf)

A risky business?

An effective assessment of a business by a stakeholder is dependent on an understanding of the risks facing that business and the company's appetite for risk. Companies are currently required to disclose the "key" or "principal" risks facing their businesses[13], but in reality this can amount to a disclosure of a number of generic risks that differ little between companies in the same industry.

An informed user does not need the Board of a financial institution to tell them that the company's risks include market risk, credit risk and liquidity risk – what they need is to understand the relative potential impact on particular areas of the business. For example, is there one particular category of asset where the exposure to credit risk is particularly severe? Or, in a manufacturing company, is the business model premised on winning a particular contract?

Concerns may be expressed that meaningful disclosure of risk and risk mitigation will result in the publication of commercially sensitive information. This would not be in the best interests of the company or its stakeholders. However, we believe that a significant volume of such information is already in the public domain and we simply recommend that this information is made more explicit.

A going concern?

Corporate and financial reporting is based on the premise that the business will continue into the future – to change that premise is to change the very nature of the reporting. Understanding how the Board reached its conclusion that the business will continue is therefore critical to understanding the basis for its reporting.

The corporate report should flow logically through the story of the business, concluding where the Board sees the company in the future. "Going concern" is defined in company law and financial reporting terms[14] as the company continuing for at least 12 months into the future from the date the financial statements are signed – but it does not have to be limited to 12 months. Boards should be encouraged to interpret the company's going concern status to cover a period appropriate for the business – which in some cases could be substantially longer than 12 months.

A principled basis

ICAS has always strongly advocated financial reporting standards based on a clearly articulated set of high level principles[15] – the same is true of corporate governance and narrative reporting. Creating detailed rules increases complexity and can lead to boilerplate disclosures. Principles allow companies to exercise judgement while retaining a degree of consistency. The Board is ultimately accountable to its stakeholders and consequently must be trusted by stakeholders to apply these principles appropriately. The assurance process should then engender confidence in the reporting.

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13 This is a requirement of the Companies Act 2006 as part of the Business Review (s.417) (see http://www.legislation.gov.uk/ukpga/2006/46/section/417). Risk disclosures are also required under the Listing Rules issued by the UK Listing Authority (see http://fsahandbook.info/FSA/html/handbook/LR)

14 See the Financial Reporting Council (FRC) Going Concern and Liquidity Risk: Guidance for Directors of UK Companies 2009 for further background on the assessment of going concern (see http://www.frc.org.uk/images/uploaded/documents/Going%20concern%20and%20liquidity%20risk%20-%20guidance%20for%20directors%20of%20uk%20companies%20094.pdf)

15 See Principles Not Rules: A Question of Judgement (2006, Institute of Chartered Accountants of Scotland). (see http://www.icas.org.uk/site/cms/download/rs_Principles_v_Rules.pdf)

Taking responsibility

The Board is responsible for the quality of its reporting. We believe that this responsibility should be explicit at the front of the annual report: the Board should declare that it believes that the corporate reporting in the "front half" of the annual report provides a balanced and reasonable review of the company. This statement should be immediately followed by the Board's declaration that the financial statements are true and fair[16].

OUR RECOMMENDATIONS

Our recommendations focus on improving the current annual report.

We believe that the primary communication in the "front half" of the annual report (everything excluding the financial statements) should be governed by the following set of principles:

- The narrative should tell a clear, logical and understandable "story" of the business;
- The "front half" of the annual report should present a balanced and reasonable picture of the company.

The "front half" of the annual report should include:

- A sign-off by the Board on the first page of the annual report that it believes that the narrative represents a balanced and reasonable review of the company and that the financial statements are true and fair;
- The rationale for concluding that the business is a going concern and an articulation of whether the period considered is limited to 12 months from the date of signing the financial statements or whether it is longer. This rationale should include:
  - disclosure of the key assumptions on which the Board has based its assessment;
  - a clear exposition of the business model and the strategy;
  - an articulation of the key risks facing the business (these should be limited in number and should reflect the risk discussions of the Board);
- The significant judgements of the Board in producing its annual report and financial statements.

Much of this information will already be found in the annual report. The challenge we envisage will be to present this information as a logical story focusing on what is business critical – and thereby allowing the reader to identify the most important information.

The UK government department for Business, Innovation and Skills (BIS) recently issued a consultation on the future of narrative reporting[17] and we believe that this offers an ideal opportunity to review the plethora of reporting requirements and bring the annual report into line with our recommendations.

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16 The Companies Act 2006 requires that financial statements are "true and fair" (see s.393 at http://www.legislation.gov.uk/ukpga/2006/46/section/393). International Accounting Standard (IAS) 1 contains a similar requirement for the financial statements to be fairly presented. "Fair presentation" has been held by UK independent legal opinion to mean the same as "true and fair" (see http://www.frc.org.uk/documents/pagemanager/frc/T&F%20Opinion%2021%20April%202008.pdf)

17 BIS Department for Business, Innovation and Skills, Corporate Governance, The Future of Narrative Reporting: A Consultation, August 2010 (http://www.bis.gov.uk/assets/biscore/business-law/docs/n/10-1057-future-narrative-reporting-consultation.pdf)

6 The Audit Committee

BACKGROUND

The role of the audit committee has expanded in recent years. It has become fundamental to the corporate governance of public companies.

Enhanced disclosure

We believe that the current structure and remit of the audit committee, as an important sub-committee of the Board, should be retained and strengthened through enhanced transparency and disclosure. It is our view that an enhanced understanding of the function of the audit committee will contribute to greater confidence in reporting and assurance on that reporting. Greater transparency is also a critical driver for improving the quality of both reporting and assurance.

Our recommendations are premised on the existence of an effective audit committee and this effectiveness is dependent on the appointment of the right people. In particular, relevant and recent financial experience is critical to effective oversight of the financial statements and the associated assurance.

The current audit committee report is restricted to a short and bland statement. We believe that the audit committee should communicate to the user how they have discharged their duties. This should not simply be a generic high level description of a process but should explain the rationale for the audit committee's decisions – including its oversight of the external audit process.

The key areas of focus within this report should be:

- How the audit committee has satisfied itself that the Board has mitigated the key risks to the business;
- How the audit committee has satisfied itself of the quality and output of the assurance processes, both internal and external; and
- The issues raised by the external auditor, including the key areas of challenge and how those issues have been resolved.

Managing risks

The UK Corporate Governance Code[18] requires that the audit committee (or a separate risk committee in the case of some entities) is responsible for reviewing the company's internal control and risk management systems. We recommend that the audit committee report should include a "Risk Matrix", mapping the key risks identified by the Board to the assurance processes used to mitigate those risks. Assurance processes are both internal and external to the company and such disclosure would enhance the user's understanding of the different forms of assurance. The "Risk Matrix" would, in particular aid the user's understanding of what the external auditor is responsible for – thus helping to reduce the so-called "expectations gap"[19].

18 UK Corporate Governance Code (May 2010) Provision C.3.2 (see http://www.frc.org.uk/documents/pagemanager/Corporate_Governance/UK%20Corp%20Gov%20Code%20June%202010.pdf)

19 The "expectations gap" is the gap between the expectations of the user of the external audit and what that audit actually delivers.

Effective governance and oversight

Our working group believes strongly in the value of the audit committee and its oversight of the assurance mechanisms, both internal and external. In particular, the audit committee is responsible for ensuring the independence, objectivity and effectiveness of the external auditor. We recommend that the audit committee report should allow the users to better understand that process. The independent external auditor should be accountable to the shareholder and it is one of the functions of the audit committee to ensure that the duties of the external auditor are properly discharged. The audit committee provides an important link between the shareholder and the external auditor.

An independent and objective auditor

The power and value of the external auditor's opinion is distinguished from internal assurance processes by the auditor's independence and objectivity.

The current model in the UK requires the audit committee to recommend the appointment of the external auditor to the Board[20], which is then voted on by the shareholders (there are limited circumstances where the Board can appoint the external auditor without shareholder approval)[21]. Greater transparency is needed around that process to allow the shareholders to make better informed decisions.

We believe the audit committee continues to be best placed to make the recommendation on the appointment of the external auditor.

How long is too long?

The appointment of the external auditor and, in particular the length of tenure of the external auditor of a FTSE 100 company, has been the subject of intense debate[22] at the time of writing. In the UK the external auditor of a FTSE 100 company can, on average, expect to remain in appointment for several decades[23]. So can the external auditor remain independent and objective for this length of time?

External auditors in the UK are bound by the Ethical Standards for Auditors[24] which set out the high professional requirements for auditors to maintain their independence and objectivity. These standards are in addition to the ethical codes enforced by the professional institutes such as ICAS[25] on all their members.

In the UK, the external audit report is signed by the Senior Statutory Auditor – normally the audit

20 UK Corporate Governance Code (May 2010) Provision C.3.2 (see The UK Corporate Governance Code, June 2010 (Financial Reporting Council) (see http://www.frc.org.uk/documents/pagemanager/Corporate_Governance/UK%20Corp%20Gov%20Code%20June%202010.pdf)

21 UK Corporate Governance Code (May 2010) Provision C.3.2 (June 2010 (Financial Reporting Council) (see http://www.frc.org.uk/documents/pagemanager/Corporate_Governance/UK%20Corp%20Gov%20Code%20June%202010.pdf))

22 The European Commission has issued a Green Paper which proposes mandatory rotation of audit appointments (European Commission Green Paper Audit Policy: Lesson from the Crisis (Text with EEA Relevance), Brussels, 13.10.2010 COM(2010) 561 final – see in particular Question 18 (see http://ec.europa.eu/internal_market/consultations/docs/2010/audit/green_paper_audit_en.pdf)). The UK House of Lords Economic Affairs Committee is currently conducting an inquiry into audit market concentration and has asked similar questions. (See http://www.parliament.uk/business/committees/committees-a-z/lords-select/economic-affairs-committee/news/economic-affairs-committee-publishes-call-for-evidence/)

23 See Oxera research prepared for the Department of Trade and Industry and the Financial Reporting Council in April 2006. (see http://www.oxera.com/cmsDocuments/Reports/DTI%20Auditors%20executive%20summary.pdf)

24 As issued by the Auditing Practices Board (APB) (see http://www.frc.org.uk/apb/publications/ethical.cfm)

25 For the ICAS Code of Ethics see http://www.icas.org.uk/site/cms/contentcategoryview.asp?category=191

partner. Under the Ethical Standards for Auditors[26], as issued by the Auditing Practices Board, the audit partner of a public company is required to rotate every 5 years (this may be extended in exceptional circumstances provided the appropriate safeguards are in place). There are also requirements for key audit team members to rotate. In reality staff development needs and natural staff turnover will result in significant change to the team throughout the period of appointment. Within the audited entity there will also be significant turnover of key personnel, in particular at the Board level[27].

A new audit firm will mean a brand new audit team, limited initial knowledge of the business and a steep learning curve. A change of external auditor can be expensive – both for the company issuing the tender and for the audit firms tendering for the appointment. It can, however bring the benefits of a fresh audit approach and an entirely new perspective on the entity.

In reality, the appointment of one audit firm for a considerable period of time may not be a risk to the quality of the audit. The audit firm may continue to perform a thorough and efficient audit – but a perception remains that the passage of time results in a gradual loss of independence and objectivity.

We believe that the audit committee is best placed to determine when it is appropriate to tender the external audit appointment. To aid the transparency of that decision, we recommend that the audit committee decides an appropriate timescale for the re-tendering of the external audit appointment and discloses that policy in its report. Focusing on the quality of the external audit and taking into account the particular circumstances of the company at that time, it should then comply with its own policy or explain why it has chosen not to. This policy should be disclosed alongside the date that the audit firm was first appointed and the date that the external audit appointment was last tendered.

Review of effectiveness

In the UK the audit committee should perform an annual review of the independence and effectiveness of the external auditor[28]. We believe that this process is vital to ensuring audit quality. In addition, we recommend a more detailed review every 5 years, which would involve the audit committee actively engaging with the shareholders. The audit committee report would then include disclosure of the review processes to allow the user to understand how the audit committee has reviewed the external auditor's independence, objectivity and effectiveness; the desirability of continuing the engagement versus appointing a new firm; and the extent to which the shareholders have agreed or disagreed.

Resignation and dismissal of the auditor

The resignation or dismissal of an external auditor before the end of their term is an unusual occurrence and is potentially of particular concern to shareholders when it does happen. Company law provides for a statement of the circumstances of the resignation or dismissal to be provided to shareholders[29] but in practice this can shed little light on those circumstances. The audit committee report should disclose sufficient details of the circumstances to provide that understanding.

26 APB Ethical Standard 3 (Revised) Long Association with the Audit Engagement (see http://www.frc.org.uk/images/uploaded/documents/ES3%20-%20v5%20clean.pdf)

27 One study published by Cantos in 2005 suggested that the average life of appointment of a FTSE 100 chief executive is 4.6 years. (see http://w3.cantos.com/05/imptob-507-kwohs/survey.pdf)

28 Financial Reporting Council Guidance on Audit Committees (October 2008) 4.19 (see http://www.frc.org.uk/images/uploaded/documents/Guidance%20on%20Audit%20Committees%20October%2020081.pdf)

29 Companies Act 2006 s.520 (see http://www.legislation.gov.uk/ukpga/2006/46/section/520)

A transparent audit process

Research[30] suggests that users want to understand more about the external audit process – in particular, what were the areas of difficulty for the external auditor and how were these resolved. We believe that this transparency can be achieved through enhanced disclosure by the audit committee in their report. The audit committee should disclose the key areas discussed between it and the external auditor, including the areas of key audit challenge. This disclosure should allow the user to understand the degree of challenge exercised by the auditor and the key issues of discussion with the company.

The external auditor will then refer to this disclosure in their own report, thereby directing the user of the assurance report to where they can obtain more detailed information on the external audit process.

This transparency will also allow the shareholders to ask more targeted questions at the Annual General Meeting (AGM). We also believe that both the audit committee chair and the audit partner should appear together at the AGM. The audit committee chair should be willing to answer questions on the content of the audit committee report, in particular around the discussions with the external auditor, and the audit partner should answer questions arising from the enhanced disclosure achieved through the audit committee report.

Guidelines for enhanced disclosure

As the primary stakeholders – and therefore the addressee of the annual report and associated assurance reports – the needs of the investors are crucial to the development of our recommendations. In formulating the following recommendations we have drawn on the work of an independent working group comprising members of the Global Auditor Investor Dialogue[31]. The Convener of this group was also a Deputy Chair of our own working group. This group sought to develop guidelines for enhanced disclosure relating to accounting, audit and risk controls and their report provides a framework for improving the disclosure by audit committees.

Appraising your auditors

In 2003 (revised in 2007) ICAS published guidance entitled *Appraising Your Auditors: A Guide to the Assessment and Appointment of Auditors*[32]. This guidance remains highly relevant today and should assist audit committees in carrying out their duties.

Audit market concentration

Our report is written against a backdrop of fierce discussion and debate, in particular around one controversial question: does the current audit market for the largest companies present a systemic risk to the capital markets?[33] In the UK FTSE 350 the market is heavily concentrated in 4 audit firms[34] and many commentators are asking whether there needs to be action to widen the choice of firms.

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30 Meeting the Needs? User Views on External Assurance and Management Commentary, Fraser, Pierpoint, Collins and Henry, 2010 (The Institute of Chartered Accountants of Scotland) Chapter 6 (see http://www.icas.org.uk/site/cms/download/res/Fraser_Users_Report_April_2010.pdf)

31 Guidelines for Enhanced Disclosure to Assist Directors, Audit Committees, Shareowners and Investors, Enhanced Disclosure Working Group (January 2009) (see http://www.enhanceddisclosure.org/view_the_guidelines.html)

32 Appraising Your Auditors: A Guide to the Assessment and Appointment of Auditors, Institute of Chartered Accountants of Scotland 2003 (Revised 2007) (see http://www.icas.org.uk/site/cms/Download/app_aud_2007.pdf)

33 See for example Question 27 European Commission Green Paper Audit Policy: Lessons from the Crisis (Brussels 13.10.2010 COM (2010) 561 Final (see http://ec.europa.eu/internal_market/consultations/docs/2010/audit/green_paper_audit_en.pdf)

34 The firms are: Deloitte, Ernst and Young, KPMG and Pwc. See the Oxera research produced for the Department of Trade and Industry and the Financial Reporting Council in 2006 for further detail. (see http://www.oxera.com/cmsDocuments/Reports/DTI%20Auditors%20executive%20summary.pdf)

For the purposes of our report we have not specifically sought to address this question. The membership of our group is diverse and represents many different interests and perspectives – we felt it would simply not be possible to obtain consensus on this issue.

The quality of the external audit should always be the paramount consideration of the audit committee when recommending the appointment of the external auditor. As a general principle we believe that the choice of the external auditor should be left to the audit committee, reflecting the interests and wishes of the shareholders.

OUR RECOMMENDATIONS

The following guidance should be enshrined in the FRC's *UK Corporate Governance Code* and its associated *Guidance on Audit Committees*:

In relation to risk management the audit committee (or risk committee) report should include:

- Confirmation it has received sufficient, reliable and timely information from management to allow it to discharge its duties;
- How it has satisfied itself that the risk and control processes are operating effectively. This should include a matrix-style report which maps the key risks disclosed by the Board in the corporate report to the assurance processes used to gain comfort over those risks;
- Confirmation that action has been taken where appropriate to address any significant weaknesses in the risk and control framework;
- How it satisfied itself of the appropriateness of management's significant judgements – this should include a substantive discussion of those significant judgements (for example how the audit committee satisfied itself that the models used to value financial instruments are appropriate or how it determined that the value of a decommissioning provision was a reliable estimate of future costs).

In relation to the appointment of the external auditor the audit committee report should include:

- The date the audit firm was first appointed as the external auditor;
- The date the external audit appointment was last subject to a full tendering process;
- The policy on the expected timescale after which the company would normally expect to re-tender the audit appointment;
- Where the auditor has been subject to the normal annual review of effectiveness – the process by which the audit committee concluded that the external auditor was effective or otherwise and the conclusions of that review;
- Where the auditor has been subject to the extended 5 yearly review process – the process by which the audit committee concluded that the external auditor was effective or otherwise, in particular how it engaged with the shareholders during this process; and the conclusions of that review process;
- The reasons for any decision to re-tender the audit other than simply compliance with the policy;
- The circumstances of any resignation or dismissal of the external auditor before the end of their term.

In relation to the external audit process the audit committee report should include:

- Details of the key areas discussed between the audit committee and the external auditor during the audit process, including the main areas of audit challenge.

7 The External Assurance Process

BACKGROUND

Audit is valuable.

At the annual Aileen Beattie Memorial Event in April 2010, ICAS posed a controversial question: "Should the statutory audit be dropped and assurance needs left to the market?"[35] The motion naturally provoked a lively debate – with consensus on one point from the audience: external audit is important and has a vital role to play.

The European Commission, in their Green Paper[36] on audit issued in October 2010 asked a number of controversial questions - but their starting point is noteworthy:

"Robust audit is key to re-establishing trust and market confidence; it contributes to investor protection and reduces the cost of capital for companies."

We believe that the external audit is fundamental to the effective operation of the global capital markets.

But what form should that external audit take? Have the expectations of the traditional statutory audit of the financial statements been stretched beyond what it is capable of delivering? Could the external auditor deliver further assurance that would be valuable to stakeholders?

Audit of the Financial Statements

Still true and fair?

Financial statements are predominantly historic in their nature. Although the application of accounting standards increasingly requires judgements and estimates made on forward-looking information, the financial statements state the company's position at a particular point in time – a point in time in the past. For historical events there is a greater base of supporting evidence available than for future oriented information and therefore a high[37] level of assurance is possible over the financial statements.

We believe that the "true and fair" audit opinion remains the most useful for providing assurance on the financial statements as the concept is well established in law[38] and in the International Standards on Auditing (ISAs).

The meaning of "true and fair" has evolved over the years, developing alongside the financial reporting framework. Financial reporting requires judgement, sometimes based on assumptions about future

35 Held at Stationers Hall, London 28 April 2010. For the transcript see: http://www.icas.org.uk/site/cms/download/AEB_Event_2010_Transcript.pdf

36 European Commission Green Paper, Audit Policy: Lessons from the Crisis, Brussels, 13.10.2010 COM(2010) 561 final (see http://ec.europa.eu/internal_market/consultations/docs/2010/audit/green_paper_audit_en.pdf)

37 International Standard on Auditing (UK and Ireland) 200 (paragraph 5) requires that the auditor obtains reasonable assurance that the financial statements are free from material misstatement, whether due to fraud or error. Reasonable assurance is defined as a high level of assurance by the ISA. (See http://www.frc.org.uk/images/uploaded/documents/ISA%20(UK%20and%20Ireland)%20200%20(final).pdf)

38 For the UK legal opinions on "true and fair" (see http://www.frc.org.uk/about/trueandfair.cfm).

events. "True and fair" has a meaning globally accepted, established in law and supported by the framework of International Financial Reporting Standards (IFRS)[39].

Auditing financial statements and the ISAs

The Board is responsible for preparing true and fair financial statements; the external auditor then opines on whether they agree that the financial statements are true and fair.

The external audit of the financial statements requires the application of the International Standards on Auditing[40]. The external auditor assesses the key risks to the financial statements – the audit risks – and builds an audit approach to address those key risks. Auditors apply a concept of materiality – effectively assessing whether the presentation of the financial statements could mislead the user. The external audit will not, therefore identify every error in the financial statements but provides assurance that any errors are not material to the financial statements. The auditor is required to apply professional scepticism throughout the audit and obtain sufficient and appropriate audit evidence to substantiate the opinion on the financial statements.

The International Auditing and Assurance Standards Board (IAASB) has recently completed its "Clarity Project". It has revised and clarified the existing standards to assist auditors in their application, while retaining the existing model. This project focused in particular on those areas known to be more difficult for auditors – for example the audit of groups of companies and the audit of fair values. The UK is one of the first jurisdictions to apply the new "clarified" ISAs although at the time of writing they were not yet in use. We believe that the new ISAs will improve the quality of external audits.

A quality audit

Audit quality is a difficult concept to define. At its most basic level audit quality is the delivery of the correct opinion. That opinion is based on a review of the evidence available at the time of the external audit – not what was only available with hindsight. Discussions of how to measure audit quality have been the subject of many papers – produced by regulators and academics – and we do not propose to repeat this work in our report.

We believe that an external audit conducted in accordance with the ISAs, taking into account the spirit of those standards – such as the overriding need for professional scepticism – and undertaken by individuals abiding by the Ethical Standards[41] - should deliver a high quality audit with the correct opinion.

39 Listed groups of companies in Europe are required to apply International Financial Reporting Standards (IFRS) as adopted by the European Union. Other companies in the UK apply UK Generally Accepted Accounting Practice or UK GAAP. "True and fair" is the terminology used in the UK Companies Act 2006 (see s.393 at http://www.legislation.gov.uk/ukpga/2006/46/section/393). International Accounting Standard (IAS) 1 uses the term "fair presentation" which has been determined by UK legal opinion to have the same meaning as "true and fair" (see http://www.frc.org.uk/documents/pagemanager/frc/T&F%20Opinion%2021%20April%202008.pdf)

40 International Standards on Auditing (ISAs) as issued by the International Auditing and Assurance Standards Board (IAASB), an operating body of the International Federation of Accountants (IFAC). In the UK audits are performed against ISAs (UK and Ireland) as issued by the Auditing Practices Board (APB) – which are effectively the ISAs applied alongside UK legislation. (See http://www.frc.org.uk/apb/publications/isa/oct2009.cfm)

41 Ethical Standards for Auditors, as issued by the Auditing Practices Board (APB) (see http://www.frc.org.uk/apb/publications/ethical.cfm). The standards are based on the Code of Ethics (see http://web.ifac.org/publications/international-ethics-standards-board-for-accountants/code-of-ethics#code-of-ethics-for-professi-1) developed by the International Ethics Standards Board for Accountants (IESBA), an operating body of the International Federation of Accountants (IFAC).

The power of an audit opinion

A qualified audit opinion is a rare occurrence in the UK – and the rarity of the qualification gives it power. A qualified external audit report sends an adverse signal to the market. The Board will want to avoid that qualification – which puts the external auditor in a strong position to persuade the Board to "get it right". The rarity of audit qualifications suggests that Boards and external auditors normally reach a conclusion acceptable to both parties. An emphasis of matter is not a qualification but draws the user's attention to a matter of fundamental importance – for example where the going concern status of the company is subject to doubt. We believe that the current use of these qualifications and emphases of matter is appropriate.

We accept that users want to understand more about the external audit process but a longer form audit report can confuse who is speaking to the user: is it the company or the auditor? We believe that an improved understanding of the audit process should be achieved through the enhanced audit committee report discussed above without diluting the power of the audit qualification.

Going concern

ISA 570[42] requires that the external auditor reviews the Board's going concern assessment. This is necessary to ensure that the financial statements have been prepared on the correct basis. We have discussed how the Board could better articulate, through the corporate report, the process by which it reached its decision and the assumptions underlying that decision.

We believe that the external auditor should explicitly state in the audit report that they have reviewed the Board's assessment of going concern and whether they believe the Board's conclusion was appropriate. Auditors cannot provide a guarantee that a company will not fail but enhanced reporting by the Board of their own rationale, coupled with an explicit opinion from the external auditor will enhance the user's understanding of what assurance the auditor is providing.

Assurance on the Corporate Annual Report (Other than the Financial Statements)

Looking to the narrative

Stakeholders are increasingly relying on the narrative reporting in the "front half" of the annual report to enhance their understanding of the financial statements and the company's performance and future prospects. The narrative includes many different types of information – including discussion of the future prospects of the business; reporting against Key Performance Indicators; and sustainability reporting – and presents a different challenge to the assurance provider. The information will often be more varied in nature, more forward looking and will be based on a number of assumptions.

We believe that the external auditor can meet this challenge and deliver assurance on the "front half" of the annual report.

The traditional ISA audit, as described above, could never be applied to narrative reporting. The model was developed to provide assurance on financial statements which are largely historical. We do, however believe that the external auditor could offer a different type of assurance. Currently the external auditor states in their opinion on the financial statements that the content of the annual report other than the financial statements is consistent with the audited financial statements. We believe

42 International Standard on Auditing 570 Going Concern (see http://www.frc.org.uk/images/uploaded/documents/ISA%20(UK%20and%20Ireland)%20570%20(final).pdf)

that this opinion should remain as the link between the "front half" and the financial statements, but should be enhanced by a further separate assurance opinion.

Balanced and reasonable

We believe that the external auditor could deliver an opinion on the content of the annual report: that the Board has presented a balanced and reasonable review of the business. Our interpretation of "balanced and reasonable" starts with the ordinary meaning of the words

- "Balanced": the annual report is not subject to "spin"; and
- "Reasonable": based on the information available at the time (directly or indirectly through the audit of the financial statements or other information available in the public domain), a similarly skilled professional would have reached the same conclusion.

The external auditor has a unique and privileged access to a business during the course of the audit of the financial statements – the ISA model of audit is premised on the auditor understanding the business. The auditor: reviews the minutes of the Board and its sub-committees; reviews and tests the budgets and forecasts; and has unique access to the Board. This information provides the ideal basis for providing this additional assurance.

Qualifications and emphases of matter, similar to those used in the external audit of the financial statements, would need to be available to allow the new "front end" assurance opinion to be as meaningful as possible. Our vision of a "balanced and reasonable" assurance opinion is not intended to utilise the current assurance frameworks available[43] – a new framework will need to be developed. That framework will need to be supported by guidance and we acknowledge that the development of such a framework presents a challenge to the auditing profession – but we believe the profession can respond to such a challenge.

We also acknowledge that our recommendation will involve additional work and we understand that the work will come with a cost – but we believe that the benefits of this assurance will far outweigh any additional costs. We would encourage a constructive dialogue between the external auditor and the audit committee around the costs and benefits of this assurance.

The audit report

We believe that the three opinions proposed above – the "true and fair" opinion on the financial statements; the explicit going concern opinion; and the "balanced and reasonable" opinion on the front end of the annual report – could be presented in one assurance report.

This report should be prominently placed at the front of the annual report – following an explicit sign-off by the Board. We believe that this would be a powerful statement to the user: the responsibility for the preparation of the annual report and the financial statements rests with the Board and therefore its sign-off should be first. This would then be immediately followed by the assurance report.

Understanding the assurance process

We acknowledge that there is a desire from users to understand more about the external audit process. We do not believe that this should be achieved through the external auditor's report. The

43 The International Auditing and Assurance Standards Board (IAASB), in addition to issuing auditing standards, has developed frameworks for assurance engagements other than audit (International Standard on Assurance Engagement 3000 is one example. (see http://www.ifac.org/IAASB/Pronouncements.php#Standards.)

power of the audit opinion lies in its clarity and a longer form audit report could dilute that power. It is the responsibility of the company to speak to the user and the responsibility of the external auditor to provide assurance on that communication – a long form audit report could confuse those responsibilities.

The audit committee is responsible for overseeing the external audit process – we therefore recommend that this additional understanding should be achieved through the enhanced audit committee report. In particular, the audit committee would disclose in its report the key areas discussed between the audit committee and the external auditor – this would include the key areas of audit challenge. This would also extend to the additional assurance opinions recommended in this chapter.

The external audit report would then include an explicit reference to the audit committee's report and its discussion of the external audit and assurance process. This reference would draw the user's attention to where additional information can be obtained and ensure that the audit committee makes appropriate disclosure of those key issues.

In addition we envisage that the audit partner and the audit committee chair appear together at the company's Annual General Meeting (AGM) to answer questions arising from the enhanced disclosure achieved through the audit committee report. The improved transparency of the external audit and assurance process should encourage a better dialogue with the shareholders.

A new auditing profession?

We believe that our recommendations represent a challenge to the current auditing profession – but not an insurmountable challenge. External auditors combine their training as chartered accountants with heightened professional scepticism. The value of an auditor is not simply their financial reporting expertise – it is the questioning mind and the courage to challenge the decisions of others. This mindset can be transferred to assurance on narrative reporting.

The external auditor will build on the existing extensive knowledge gained through the audit of the financial statements. The challenge to the auditing profession is to exercise greater judgement. The scope for the exercise of judgement has arguably diminished with the increasing complexity of financial reporting standards and making a judgement against a new and developing framework requires courage. We recognise that this is a significant challenge but one we believe the profession can meet.

The importance of narrative reporting is growing. As a profession, accountants and auditors have demonstrated an ability to adapt with the times. Our recommendations should be seen as an opportunity for the profession – an opportunity to add value to business and its stakeholders.

The Audit Inspection Unit

The Audit Inspection Unit (AIU)[44] in the UK is responsible for ensuring the quality of audits of public interest entities through its inspection and reporting regime.

We believe that the AIU should be a line of last resort for the shareholder if they have concerns over the quality of the audit which have not been addressed by the company. The shareholder should be able to report such concerns and the AIU should have the power to investigate.

44 The Audit Inspection Unit (AIU) is an operating body of the Financial Reporting Council (FRC), the UK regulator of the accountancy profession. The AIU has a remit to ensure the quality of audits of public interest entities – primarily listed companies – and undertakes an annual inspection regime. The decision on which audits to inspect is determined by a risk categorisation. The AIU reports on individual audits to the company and the audit firm. It also produces annual publicly available reports on each of the key audit firms auditing public interest entities. See http://www.frc.org.uk/pob/.

Liability concerns

Liability concerns everyone. Corporate and financial reporting is not an exact science – and audit and assurance is not a guarantee against the future.

We believe that there is a need to consider safe harbours[45] for directors – thereby allowing them the freedom to speak honestly, particularly about their expectations for the future.

Currently statutory external auditors are subject to unlimited liability in the UK[46]. We believe that for auditors to provide further assurance, particularly around future-oriented narrative information, there is a need for a proportionate liability regime where external auditors are only liable for their portion of the fault.

OUR RECOMMENDATIONS

We believe that one report from the external auditor would be the most appropriate way forward.

Immediately following the statement from the Board that it believes that the annual report is prepared on a going concern basis and is balanced and reasonable and that the financial statements are true and fair and properly prepared, there would be a report from the external auditor.

The external audit and assurance report would include:

- An opinion on whether the financial statements are true and fair and properly prepared;
- An opinion on whether the annual report is consistent with the audited financial statements;
- A opinion that, following the review of the assumptions made by the Board in their assessment of the going concern, the conclusion is considered reasonable;
- An opinion that the annual report (excluding the financial statements) is balanced and reasonable; and
- A reference to the content of the audit committee report and confirmation that the audit committee report contains an appropriate reflection of the key issues discussed between the audit committee and the external auditor.

We envisage that the "balanced and reasonable" opinion would become an accepted part of the assurance framework. Initially this could be achieved through companies adopting the regime on a voluntary basis before being subsumed into the statutory assurance.

A framework and guidance will need to be developed to support the auditor in delivering the "balanced and reasonable" opinion.

We also recommend that the liability regime for directors and external auditors is carefully examined. To achieve our vision, there should be safe harbours for directors and a proportionate liability regime for external auditors.

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45 A safe harbour is a provision by statute or regulation which affords protection from liability under the law.

46 The Companies Act 2006 s.534 allows for a Limitation of Liability Agreement – but this must be agreed to by the shareholders. At the time of writing this provision was not widely used. (see http://www.legislation.gov.uk/ukpga/2006/46/section/534.)

8 Engagement with Shareholders: Corporate Reporting and the External Assurance Process

BACKGROUND

Our recommendations are founded in the belief that shareholders and other stakeholders will engage with companies through better quality reporting, increased transparency and an improved assurance process.

Shareholders, as the primary stakeholders, are not a homogeneous group and have a diverse range of interests. Some shareholders may be interested in the long term sustainability of the company going forward several decades, while others may simply be looking to make a short term gain. Such is the nature of markets.

Stewards

We do not envisage that all shareholders will increase their level of engagement with companies – but those institutional investors who have signed up to the Financial Reporting Council's UK Stewardship Code[47] have declared their intention to exercise a stewardship function – and we therefore recommend an additional principle and associated guidance to the Code.

OUR RECOMMENDATIONS

A principle should be added to the UK Stewardship Code:

Institutional investors should be willing to engage with their investee companies on the quality of their reporting and the assurance provided on that reporting.

Guidance on the principle

As part of this engagement institutional 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;
- Seek to engage with the audit committee on the quality of the assurance provided on the annual report including the financial statements and any other assurance provided;
- Seek to engage with the audit committee where there is a formal review of the external audit appointment every 5 years;
- Seek to engage with the audit committee where there is a re-tendering of the external audit appointment;
- Challenge the audit committee and the Board where they have any concerns relating to the independence or objectivity of the external auditor - for example, there could be concern in respect of the re-tendering policy or non-compliance with that policy;;
- Notify the company of any concerns on the appointment of the external auditor; and
- As a last resort, be prepared to vote against the appointment of the external auditor if appropriate, explaining the reasoning to the company.

47 Issued July 2010. As at 19 October 2010 a total of 68 institutional investors had signed up to the Code. (See http://www.frc.org.uk/images/uploaded/documents/UK%20Stewardship%20Code%20July%2020103.pdf.)

About ICAS

The Institute of Chartered Accountants of Scotland (ICAS) is the world's first professional body of accountants, receiving its Royal Charter in 1854. Since then, ICAS has played a leading role in the accountancy profession.

ICAS was the first to adopt the designation 'Chartered Accountant' and the designatory letters 'CA' are still an exclusive privilege in the UK for its 18,800 members. CAs hold key positions right across commerce and industry, the public sector and private practice.

There are currently 3,000 student members of ICAS, which is the only UK professional accountancy body to both educate and examine all of its students. The CA qualification is known around the world for consistency and high standards and ICAS enjoys a widely recognised reputation for providing the 'gold standard' in accountancy education.

The Institute's main objective is to uphold the integrity and standing of the profession of Chartered Accountancy in the interests of society and the membership through excellence in education, the development of accountancy, the enforcement of professional standards and service to members.

The Institute of Chartered Accountants of Scotland
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