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Hermes Investment Management Response to CMA Market Study Invitation to Comment

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About Hermes Investment Management

Hermes Investment Management is an asset manager with a difference.

Our primary purpose is helping beneficiaries retire better by providing world class active investment management and stewardship services. We believe we have a duty to deliver holistic returns – outcomes for our clients that go far beyond the financial and consider the impact our decisions have on society, the environment and the wider world.

Our goal is to help people invest better, retire better and create a better society for all.

Hermes is majority owned by Federated Investors, Inc (Federated), a leading US investment manager with $392.2 billion assets under management. BTPS retains a minority stake, alongside members of Hermes' management. This relationship offers a strong global platform as both firms share a commitment to delivering client-centric investment returns responsibly.

We offer clients access to a broad range of specialist, high conviction investment teams with £33.6 billion assets under management. In Hermes EOS, we have one of the industry's leading engagement resources, advising on £330.5 billion of assets.

We welcome the fact the Competition and Markets Authority (CMA) has launched a market study today to consider whether the market for the provision of statutory audits is working as well as it should. We believe that there are fundamental issues in the audit market, as evidenced by the high profile collapses of Carillion and BHS.

One of the questions posed by the inquiry is Q1: How well is the audit sector as a whole serving its stakeholders?

Our response is, not as well as it should. There are a number of issues. (Note these responses cover many of the questions asked by the study.)

The shift in accounting standards from an approach based on historic cost accounting to one based on fair view accounting. While implemented based on good intentions, this has led to greater scope for interpretation of the financial position of audited companies both by their accountants and by auditors. The situation creates the potential for a situation to arise where company managers pressure auditors to accept a representation of the financial state of a company, that while within accepted accounting standards is unduly optimistic. This makes the independence and integrity of the auditor of paramount importance.

Unfortunately the current structure of the audit industry appears to, at times, have compromised this independence and integrity. This weakens the ability of auditors to play an effective challenge role. As an example recently cited in the FT shows, there have been very significant examples of poor quality audits. More than a decade ago, Goldman Sachs calculated AIG owed $5.1bn on its outstanding swap positions, with a large proportion due to Goldman Sachs. AIG took a very different view, estimating its liability was no more than $1.5bn. Both sides sought the acquiescence of their auditors for these treatments – in this case the same Big 4 firm. The firm allowed these divergent — and mutually beneficial — approaches. Only later did the auditor toughen its line and force its insurance client to take a substantial write-down. In the event, even this proved wildly insufficient[1].

Structural issues with the audit industry.

One of the core issues, as we understand it, is that audit services have often been provided as **loss leader services** by the Big Four[2] – cross-subsidised by the more lucrative consulting arms of the business. This both distorts competition in the market and risks undermining the independence of the audit process through creating conflicts of interest.

We recognise that efficiencies can be created by the same firm providing both auditing and consultancy services, due to the fact undertaking an audit provides great insight into the operational and financial positioning of the company that may not otherwise be disclosed to a firm undertaking consultancy work. However these efficiencies – if gained at the cost of compromising the rigour and independence of the audit process, which is a public good – seem difficult to justify going forward.

One would imagine that professional codes of conduct among senior managers both inside the audit and consultancy arms of the Big 4 along with appropriate firewalls should be enough to mitigate against this risk. However, even amongst the users of audit, there are concerns that the measures in place at the Big Four fail to deal adequately with conflicts of interests.

Lack of choice resulting from cross-subsidy underpinning the market dominance of the Big Four is an ongoing problem. It is almost impossible for auditing firms outside the Big Four to secure the audit contracts for FTSE 350 companies. This is evidenced by the Prudential

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[1] FT 1 August 2018 The big flaw: auditing in crisis
[2] See for examplehttps://economia.icaew.com/opinion/october-2012/does-the-big-four-alumni-stifle-competition and https://www.accountancyage.com/2018/08/07/do-the-big-fours-financial-results-reveal-need-for-an-industry-overhaul/

Regulation Authority's 2018 challenge to Grant Thornton to demonstrate they had the necessary skills and resources to audit Goldman Sachs and Grant Thornton's exit from the FTSE350 audit market this year. Appropriate remuneration for auditing services provided would enable smaller – and non-compromised - firms to compete for contracts as cross-subsidy would no longer be required. It is our suggestion that the CMA request of the Big Four details of the profit margins made on contracts where both audit and consultancy services were provided. These should be broken down by service provided and datasets going back 5-10 years should be requested.

Potential remedies for the CMA to consider

We do not believe that responsibility for audit procurement should be removed from Boards and the task handed to a single publicly owned entity. It is preferable to find alternative ways to strengthen the governance of and Board accountability for the audit process. A range of remedies is suggested here.

Revising accounting standards would be in many ways the most elegant solution. However, these are based on internationally agreed norms, which brings value to investors in that it enables them to compare holdings in companies in multiple jurisdictions. Any remedy of that would be impossible to change in the timeframe of this enquiry. So instead we advise the focus should be on improving the **quality of audit and independence of audit providers.**

Quality of audit should be improved as a priority. The CMA should focus on ensure fair charges are made to enable high quality audits to take place with fully qualified and senior staff deployed[3]. As a first step we have suggested the CMA ask audit firms to disclose the fees they charge and margins made on audit versus consultancy services. This would provide a clearer picture of what is happening and enable the CMA/regulator/Government to move forward from a firmer evidence base.

Independence of audit providers should be improved. There should an active expectation from the regulator that the auditor challenge management over whether the true state of the company has been represented in the accounts. With better resourcing of audits, more senior staff should be in place – who are better able to do this. This independence could further be reinforced with a break-up of the Big Four into separate audit and consulting firms, which we would not be adverse to, although we acknowledge the risk that this approach could weaken audit quality, at least in the short term.

Further increased scrutiny of the appointed auditors: As a further check and balance, we also recommend increased scrutiny over the appointment of auditors. This could be achieved through meaningful consultation going beyond information sharing with major shareholders during the process, which is not currently standard practice. We were involved in the development of the Investment Association's (IA's) Guidelines on Audit Tenders, which lay out how the IA's members consider that a company's shareholders should have the opportunity to engage on the appointment process if they wish.

Two years on since their publication the Guidelines have not had the take up we would have liked to see. This may be due to a lack of stewardship resources available among

[3] For example we understand audits are often undertaken using teams of only partially qualified accountants. This risks compromising both the technical quality of the work and ability of the staff to challenge any irregularities

shareholders – something we hope will be addressed through the Financial Reporting Council's (FRC's) review and potential strengthening of the Stewardship Code. For example, we have suggested to the FRC that the updated Code should require more and better dialogue between investors and audit committee chairs and thus accountability with respect to audit in general and procurement in particular.

In the event, more a strengthened Stewardship Code makes more stewardship resources available in the market, accountability could be further strengthened through a requirement for shareholder committees to be established at FTSE 350 firms. This would create a formal architecture for shareholders to be engaged in a constructive dialogue before the tender. This would create higher accountability to shareholders[4].

<u>Breaking up audit firms:</u> As noted earlier, we would not be adverse to a de facto or actual break up the Big Four, de facto being through prohibiting audit firms from providing consulting services to their audit clients. However, whilst this would address some of the issues with audit quality it would not, on its own, guarantee an overall improvement. It may even have an adverse effect on audit quality in the short-term, which is why we suggest additional remedies such as strengthening the involvement of investors in audit procurement.

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[4] It will be important, however, to ensure that involvement with such a committee did not lead investors to neglect other areas of stewardship and engagement.