1. Introduction and general comments on the audit sector

a. Our general view is that the UK corporate governance, reporting and auditing regime, including its regulation by the FRC, continues to be fit for purpose. This view has remained consistent for some considerable time, despite there being the occasional corporate failure, such as the recent collapse of Carillion and the resulting FRC investigations of KPMG and two Carillion directors. It is also based on our experience of the public reporting of the companies our funds invest in, which continues to see reasonable quality in UK financial reporting, auditing, corporate governance and investor stewardship. As a result we have a high level of confidence and trust in this UK company reporting regime.

b. This is based on us tracking our AGM voting experience over the last three years where we have voted in favour of the reappointment of auditors on all the companies our funds have invested in (indicating our reasonable satisfaction with the audits):
   i. 2015/16: 254 AGMs – KPMG 52, PricewaterhouseCoopers 84, Ernst & Young 34, Deloitte 53, BDO 11, Grant Thornton 11, Others 9
   ii. 2016/17: 261 AGMs – KPMG 63, PricewaterhouseCoopers 74, Ernst & Young 34, Deloitte 53, BDO 12, Grant Thornton 13, Others 12
   iii. 2017/18: 257 AGMs – KPMG 59, PricewaterhouseCoopers 72, Ernst & Young 30, Deloitte 64, BDO 13, Grant Thornton 12, Others 7.

c. You say in 1.2 that despite all the past efforts of regulators and governments, events such as Carillion's demise and recent poor results from reviews of audit quality have raised concerns over whether audits are delivering what is needed. Similar concerns have been raised in a number of other countries. From our perspective, these have not raised concerns with the audits we have received and referred to in 1.b. above. We would also suggest that outliers or exceptions such as Carillion should not overly negatively colour the general view of the audit sector.

d. We also believe that 16 to 17 years of the audit market having four large international auditors indicates that they have been providing audits as needed. Therefore your market study needs to recognise that trying to fix the problem of whether audits are delivering what is needed needs to be done at the international level. If this is not possible, we would suggest that shareholders in the UK will not want UK specific solutions.

e. To answer your question A) 1., we believe from our experience that the audit sector as a whole is serving its stakeholders (primarily members of UK companies) reasonably well.

2. The audit framework – The scope and purpose of audit

a. In our view, the scope and purpose of UK statutory audits are clearly set out in the Companies Act 2006, namely in summary:
   i. To provide assurance to members of companies that their group annual financial statements give a true and fair view of their assets, liabilities, financial position and profit or loss and have been prepared in accordance with the relevant financial reporting framework and the requirements of relevant company law
   ii. To provide assurance to members of companies that information in strategic and directors reports and in a separate corporate governance

statement, if prepared, is consistent with the audited financial statements and have been prepared in accordance with applicable legal requirements

iii. To provide assurance to members of companies that the auditable part of directors' remuneration reports have been properly prepared in accordance with applicable company law.

b. Members of companies should remain the primary stakeholder and customer of UK statutory audits and audit reports and we believe the existing scope and purpose of statutory audits remains sufficient for members of companies.

c. We believe the 'expectation gap' arises due to the frustration of the public with those responsible for the long term viability of companies not being properly held to account where hindsight suggests that, if they had been, the outcomes would have been preferable. Because the system does not seem to effectively hold those responsible, being directors of companies, to account, solutions should not be found where other parties, such as members of companies or auditors, replace them. However, there may be an argument that the processes of holding directors of companies to account by the company reporting and auditing regulator, investors/members of companies and auditors could be improved.

d. We do not believe that the accounting framework negatively impacts competition and outcomes in the market. The purpose of annual reporting should be to answer to shareholders on the use of their financial capital and how the business has performed over the reporting period in terms of profitability and cash generation. Statutory audits should be providing assurance to shareholders that directors are reporting this appropriately and reasonably accurately. The value of assets and liabilities is important, but not the primary focus of investors.

e. To answer your question A) 2., the audit framework supports the interests of direct shareholders. It may not support the interest of wider stakeholders in the economy, but we think it is not meant to. Methods and processes other than statutory audits should be considered to support those wider stakeholder interests.

3. Incentives and governance

a. We recognise the misalignment of incentives. However, we believe the strengthening of audit committees, the tendering and rotation of auditor requirements and the restrictions on auditors providing non audit services will continue to improve audit quality and effectiveness. We also think that some of these are relatively recent changes that have not yet been given a chance to improve audit quality and effectiveness.

b. As a member of the FRC's AQRC, my just under two years' experience suggests to me that the AQR team are high quality, doing a good job of monitoring audit quality and, in general, get the attention of the audit firms to continue improving their statutory audits.

c. To answer your question A) 3., audit committee decisions are moving towards supporting high quality audits. However they could improve their reporting on how they are ensuring that their audits are high quality and their engagement with shareholders on this. Similar to AGM votes on remuneration reports and policies, AGM votes on audit committee reports should be considered.

d. To answer your question A) 4., we believe that audit committee involvement in monitoring audit quality, audit tendering and rotation and audit committee reporting continues to evolve and improve company reporting and supports high quality audits. However, we would make the same point we have made in 3. c..

4. Choice and switching

a. We believe there is competition and choice in the audit market (ie there isn't a lack). There may be insufficient competition and choice in order to put pressure on auditors to provide a good service. However, our experience suggests that a good service has been provided over the past 16 years since the large international audit firms became four. As analysed by the CC six years ago, the problem may be with the selectors of audit services (mainly company management) and the criteria they have used to measure good audit services (such as price). This seems to be improving with the involvement of audit committees, rather than management, being involved in audit service selection and using other criteria than price primarily to assess the potential best provider. As mentioned in 3. above, this may be improved by increasing shareholder engagement in the audit committee selection process and also in the ongoing assessment of audit quality year on year of incumbent and newly appointed auditors.

b. We have concerns that audit fees may be set too low for auditors to provide high quality (as opposed to reasonably satisfactory) services and to invest adequately in the development of future audit services. Again this could be resolved by increased audit committee engagement with shareholders.

c. We do not know how many companies in the FTSE 350 are truly international (eg their UK market revenues are not 80% or more) potentially requiring a large international audit firm to provide a good cross border audit. However, we understand that there are only 64 out of 350 companies potentially requiring specialist knowledge (ten banks, 14 general financial services, three insurance, eight life insurance, eight non life insurance, ten oil and gas and 11 pharmaceuticals and biotechnology). This would suggest that a reasonable proportion of the FTSE 350 do not need to appoint one of the big four. Also, some of the mid tier firms have good non audit specialist knowledge, such as Grant Thornton with their Valuation services.

d. We do not understand why some companies would see a problem in choosing an auditor who audits a competitor, from a conflicts of interest point of view, as confidentiality should be protected in terms of engagement and ethical requirements. However, there may be a practical issue in getting an auditor to complete the annual audits of two or more competitors at the same time.

e. Tendering and rotation requirements are recent changes and it is too early to tell whether these are having the desired effect.

f. We believe that any changes that are eventually considered need to be considered on an international basis. Therefore it would seem sensible to consider whether the issues of the UK statutory audit market are similar in other countries, especially in the top five or ten economies, and how if at all these issues are being addressed.

g. To answer your question A) 5., competition in the audit market is working well enough and we are not aware of anything that may be a hindrance.

h. To answer your questions A) 6. and 7., competition between the big four is effective enough, but may be improved with developments in audit committee and shareholder engagement. It is not clear how effective competition is between other firms and the big four, but it appears to us it has not got worse since the CC review.

i. To answer your question A) 8., competition's role is to provide sufficient choice for audit committees with shareholder advice and input to select from. Consistently higher quality audits will be driven more by the demands of audit committees and their shareholders, by the reputational self interest of audit providers and by regulation and an appropriate regulator.

j. To answer your questions A) 9. and 10., there should be sufficient choice from technically qualified competent auditors for large companies and PIEs. However some practical implications will limit this choice. As mentioned above, we do not know how many of the FTSE 350 have significant international operations (eg revenue outside the UK is more than 20%) requiring a big four firm with sufficiently developed international networks. Some of the mid tier firms may have sufficiently developed international networks. We are sceptical that size and complexity of business is a good enough reason to exclude non big four firms. However, sufficient resourcing may be an issue if you need a large audit team to provide a high quality audit and you either do not have sufficient resources or you have too many audits competing at the same time. This resourcing issue may be resolved in time by advances in technology. Any selection bias of audit committees and their chairs may reduce choice and this could be mitigated by increased audit committee and shareholder engagement. The key factors limiting choice will therefore be specialist knowledge and capabilities required for an audit, business reach outside the UK requiring sufficiently developed international network and sufficient available resources to provide the audit when needed.

k. To answer your question A) 11., the main barriers will be soft or not overt issues such as selection biases.

5. The resilience of the audit market

a. The demise of Arthur Andersen in 2002 increased concerns on audit market resilience and, we understand, resulted in the introduction by the FRC of the Audit Firm Governance Code. The operation of the recently revised version of this Code and the firms' transparency reporting under it (as well as audit regulation) should enhance resilience.

b. There is no evidence that the regulator is afraid of taking tough action with audit firms as shown by recent fines.

c. To answer your question A) 12., we do not believe there is a significant risk that the audit market is not resilient.

6. Regulation of audit in the UK

a. To answer your question A) 13., we believe the current balance between competition and regulation is as optimal as it can be. We cannot see how significant changes can effect increased competition and suggest all the recent changes, including those started by the CC review, are allowed time to improve audit quality. This should include an increased engagement in the future between audit committees and shareholders on monitoring audit quality. Regulation also does not need significant change but needs to continue to ensure that existing regulation is followed appropriately. As indicated in our response to the Kingman Review, a potential significant gap is the answerability of all UK company directors to a regulator, including those who sit on audit committees. To a certain extent this may be improved more by shareholders holding those audit committee directors to account for audit (and reporting) quality.

7. Potential outcomes and measures

a. The over focus on the numbers of company failures and their audits potentially being of a low quality is not helpful when the market taken as a whole with thousands of company audits appears to be working effectively. As mentioned in 2. above, the market working effectively depends on expectations of audits remaining as set out in Company Law and audits not becoming the potential solution for company failures and the abdication of responsibility of directors for these.

b. On the basis of a lot of the views expressed above, we see no benefits of creating audit only firms. It could be argued that the only previously created audit only firm, Arthur Andersen when it split its audit and accounting and management consulting practices into two, did not turn out well.

c. We see no benefit of moving audit appointments to an independent body. This power should remain with shareholders, who may increase its effectiveness through increased engagement with audit committees as indicated above.

d. To answer your question B) 14., we do not have sufficient knowledge to comment on the costs and benefits of each of the proposed measures in section 4. Our views on the measures are outlined in 7. a. to c. above and our further comments below.

e. To answer your question B) 15., we cannot think of any other measures to be considered.

8. Increase competition between the big four - Restrictions on audit firms providing non audit services

a. The current restrictions have only recently been introduced and we should give them time to see how they work to improve competition in practice. There is no need therefore to introduce greater partial, or complete, restrictions on audit firms providing non audit services to their audit clients; or prohibit audit firms from providing on audit services to any large company or PIE.

b. Splitting the UK arms of major accounting firms into audit only and non audit services practices is perceived to result in more problems than solutions for competition and choice. For example, quality audits rely on the resources provided by non audit services of the firms. The internationally developed networks would be severed. The multiple business lines increase the financial resilience of the firms (cf Arthur Andersen?).

c. Our view is that most auditor independence issues are perceived, rather than actual, and are well managed by the firms including mitigating potential adverse outcomes by their protection of their reputation on which they rely.

d. To answer your questions B) 16., 17. and 18., we see no significant benefits to competition or choice in creating audit only firms. Retaining the international affiliations of audit firms is important for the provision of high quality audits to international companies. The current restrictions on audit firms providing non audit services should be given more time to work in practice.

9. Increase competition from non big four firms

a. We reiterate our general satisfaction with the audit market. We recognise the competition, choice and resilience risks in the market and believe these are being reasonably managed. We are not sure what the concerns are and would think these should not have changed over the last 16 years and remain the same as those at the time of the CC review. Our understanding of some of the issues suggests that the changes introduced into the audit market should be given more of a chance to work in practice before any new changes are implemented.

10. Market share cap

a. Of all the measures to reduce the barriers for non big four firms to build their capacity that you are considering, the only one that we see as not having any potential adverse consequences is a market share cap. We would not describe this as being “on the big four” as over time and if it works, it may apply to other firms.

b. To answer your question B) 19., market share should be measured on the number of companies or audits. There may need to be an audit fee restriction so that no one audit represents more than say 15% of a firm’s audit fee income.

c. To answer your question B) 20., we believe a market share cap would open up the FTSE 350 audit market to non big four firms and therefore should result in greater choice.

d. We cannot answer your question B) 21..

e. To answer your question B) 22., the appropriate level should be 20% per firm and therefore for the big four collectively 80%.

f. To answer your question B) 23. We do not believe joint audits are a viable solution. However, to improve audit quality, peer reviews of audits could be considered (as could real time Audit Quality Review team reviews).

11. Incentives and governance

a. To answer your questions B) 24., 25. and 26., auditors and those that manage them should continue to be answerable to shareholders only. This may be improved by increasing the engagement between audit committees and shareholders on monitoring audit quality.

b. To answer your question B) 27., no, as the current requirements for tendering and rotation have only recently been introduced and should be given time to work in practice.

Kind regards, Charles

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