REFORM TO IMPROVE THE RESILLIENCE OF THE UK AUDIT MARKET

THE CBI RESPONSE TO THE CMA'S STATUTORY AUDIT MARKET STUDY - 2018

The CBI welcomes the opportunity to comment on the CMA's important and timely review to establish whether more effective competition could improve audit quality. The CBI sees this as an opportunity to reposition the role and value of audit as a driving force behind UK competitiveness.

This response aims to set out a long-term vision for audit market reform which is realistic and informed by the views of CBI members; including a range of audit firms, the companies which procure audit services, their suppliers, and investors who rely on the UK audit market to take responsible investment decisions.

The CBI agrees with the CMA's own assessment that complimentary measures are required to enhance competition at the top end of the audit market. The key priority should be to help diversify the market, helping mid-tier firms to tender competitive bids for FTSE 350 audits by 2030. Preparatory measures are needed to provide support to these firms in the medium term. In the meantime, it is important that more immediate changes are introduced to ensure consistency in audit quality amongst the Big 4.

There is a clear expectation gap about the function of a company audit. Many people expect the external audit to guarantee the future viability of companies. The CMA and Kingman Review should work together, with the FRC and industry, to re-scope the statutory audit so that it is fit for purpose, ensuring company reports give a clear sense of the company's prospects. The CMA and Kingman Review team should also identify ways to improve board accountability for company audit results and related company reporting.

Summary of CBI recommendations and timeline:

Short term (2019-2020)	Medium term (2019-2025)	Long term (2030)
Enhanced reporting standards Improve the governance of large audit firms Redefine audit and non-audit services and publish a timetable of tender opportunities	Increase knowledge sharing between firms Introduce shared audits which deliver added value Improve access to finance for mid-tier firms	Use a market share cap if no real progress is made by 2030 *Explore industry led innovations, such as insurance products for complex audits*

A joined-up approach with the Kingman Review: *Re-scope statutory audits; Improve board accountability for audit outcomes.*

High quality audit provision underpins UK prosperity and trust in business

The future success of the UK economy depends in no small part on the quality and resilience of the audit market. Boosting business investment in the UK is a key priority. Audit services underpin investment by verifying whether company information is true and fair, which in turn means available capital is directed to companies which are well managed, responsible and competitive. These are the businesses which are most likely to drive our economic growth and prosperity in the future. An audit failure disrupts the capital flowing into the UK which is used to create jobs, drive productivity and support local communities. The quality of UK audit is high relative to many other international markets and investor confidence in audit has been improving, but recent failures have damaged the levels of trust in the market and this must be addressed.

The value of an effective audit market is felt by everyone in society, which means audit failures undermine public trust, not just investor confidence. Without trustworthy company information there is an ever-present danger that savings, pensions and private equity may be invested in businesses which could unexpected lose value or collapse. When a company does fail, the impact can be devastating for the employees, suppliers, pensioners and customers. This stakeholder reliance on the audit market, demonstrates the social value tied to the UK audit market. Action is therefore required to address public concerns and ensure every large employer in the FTSE 350 and all Public Interest Entities (PIE) are audited effectively.

To improve the resilience of the audit market more firms need to compete

If one of the Big 4 firms failed the impact would be significant. In this scenario it is unlikely the remaining firms would be able meet demand, resulting in a serious shock to the capital market. Ensuring the audit market is resilient enough to withstand the exit of one of the Big 4 firms is essential to future proof the health of the UK economy.

The public quite rightly expects that the principal firms operating in this highly regulated market will consistently exceed regulatory standards. Over the last five years UK audit quality has improved, in line with changes to audit tenders. The overwhelming majority of Big 4 audits are delivered to a very high quality, yet investors and audit committee members are concerned that audit quality has deteriorated in the last year, compounded by several high-profile failures. This is further evidenced by the results of this year's Audit Quality Review which found that 27% of the FTSE 350 audits required improvement (19% in 2016/17). Improving the consistency of audit quality is vital to sustain business and investor confidence.

Standards are driven by competition within the market as much as by regulation. The limited ability of the regulator to investigate every audit means the market must be able to eliminate complacency and poor performance. The current status-quo is not delivering consistent, high quality audit provision.

Recent reforms are working but have not sufficiently increased choice within the market

Mandatory rotation and maximum tenures mean more companies are switching provider and shorter audit tenures are becoming more common - 74% of tenders since 2011 have resulted in a new audit firm being appointed. This reduces the risk of an unhealthy closeness developing between the auditor and auditee. However, the improved rate and effectiveness of tendering has largely resulted in a redistribution of audit engagements between the Big 4 firms - 97% of FTSE 350 audits are undertaken by one of these auditors.

Feedback from audit committees highlights a desire for greater choice, without compromising audit quality. Conflicts of interest are limiting the number of viable providers available for appointment, despite mandatory rotation. Anecdotal evidence suggests many firms have trouble finding more than two 'clean' firms to tender for their audit. Greater diversification within the market is required to enable companies to exercise choice and pursue the best quality audit possible.

Significant barriers to entry are holding back potential mid-tier challengers

The level of expertise and resource required to carry out FTSE 350 and PIE audits poses a key barrier to entry. Global business transactions and data flows are substantial and complex, which makes interpreting company information demanding. Many audit committees have raised doubts about the capacity of challenger firms to effectively deliver a global audit:

- Companies and investors want their audit provider to have access to highly qualified professionals and they often require their auditor to have a global footprint, with experts in the countries where they operate.
- Technology could enable more comprehensive audits using automation and machine learning, but embedding this technology requires significant investment. The Big 4 are already spending millions to unlock the data behind complex company accounts. This investment, while entirely necessary, is increasing the gap between the Big 4 firms and the rest of the audit market.
- Typically, an auditor's liability is unlimited, which means challenger firms must weigh-up the risk of potentially crippling legal costs and sanctions when taking on FTSE audits. Even the time and cost involved in the tender process has discouraged many challenger firms from competing against the Big 4.

This analysis highlights the need for the CMA to consider the way audits will be delivered in future and then address the barriers to entry for challenger firms head on.

CBI recommends a complimentary programme of reform to deliver a more resilient and responsive audit market by 2030

The CBI advocates a 3-stage programme of reform to improve market resilience without compromising audit outcomes. These recommendations for reform reflect the need to deliver a more competitive business investment landscape to drive UK prosperity. While the CBI supports the CMA's desire to move swiftly to address perceived weaknesses in the audit market, rushing to restructure the market before supportive measures for mid-tier firms can take effect would be a mistake. Structural changes will only be viable if challenger firms are given the time and support they need to build up their capacity to service FTSE companies first. Realistically it will take several years to achieve this goal. Acknowledging that successful structural reform will take time, a range of specific, well-designed measures are needed to deliver results in the short, medium and long term.

Reform to improve the consistency in FTSE 350 audit quality is vital in the short term

1. Investors currently complain that audit quality is not transparent, and this limits their ability to hold companies to account and increases the likelihood of poor quality audits going unchecked. Improving the quality of reporting around the audit process, and ensuring boards take full responsibility for the quality of the audit is necessary. Greater transparency in audit reporting should contribute to an effective stewardship relationship which can enhance trust, reduce the cost of capital and create added value. The CBI therefore recommends that enhanced reporting standards should be adopted for all FTSE 350 and PIE audit committee reports and independent auditor reports:

   - Audit committee reports should give an opinion on the quality and independence of the audit delivered by the external auditor. Reports should also share outcomes of the committee's own effectiveness review and should account for any investor involvement in the audit process. Committee reports must demonstrate the quality of internal audit controls. Committee reports could also be used to justify the company's balance of audit and non-audit service provision and should detail any recent or forthcoming audit tenders.

   - Auditor reports must give investors meaningful insight into the audit process and scope, providing evidence of professional scepticism and the challenge to management. Investors would also value comprehensive disclosures related to risk, changes to materiality and pertinent comments regarding the approach of the management team and audit committee to the audit process.

2. Improving the governance of large audit firms can improve their ability to deliver high quality, independent audits. Adding an external perspective to the executive management committees of all large audit firms is likely to help focus leadership attention on developing a firm wide culture which promotes good conduct, and decisions which are in the public interest. The CBI therefore recommends that all audit firms which have 2000+ UK employees should create an independent non-executive charged with providing oversight of audit quality standards within their firm. Auditors which have an existing independent oversight mechanism should consider ways to strengthening its effectiveness.

3. Clearly defining which professional services are relevant to audit and which are non-audit services is necessary as current definitions do not reflect modern audit practices. Once defined, the regulator should seek to publish a rolling timetable which captures all planned audit tender opportunities across the FTSE350 and PIE market. This would help firms to eliminate potential conflicts of interest in time to bid for new audit work, improving choice and competition.

The introduction of an independent appointment body should be avoided. This approach would undermine the fundamental duty of company directors to have regard for the interests of the company and to appoint the most appropriate auditor.

Building up the capacity of challenger firms is an essential mid-term priority to future proof the audit market

1. Voluntary agreements to encourage knowledge sharing between the Big 4 firms and mid-tier firms should be encouraged. Targeted support would reduce the barriers to entry facing challenger firms. The Big 4 should consider ways to facilitate secondments, traineeships, peer reviews and voluntary technology sharing agreements and licensing. Incentives to encourage senior audit professionals to move between firms, or to create new specialist challenger firms would also be welcome.

2. Joint audits should be introduced on a voluntary basis, to enhance the experience of professionals at mid-tier firms, and to enable lead auditors to partner with specialist audit service providers. Joint audits should not be mandated - audit committees should retain control to appoint a preferred audit provider. Joint audits which are designed to provide clarity around scope and liability, which bring together unique and complimentary skills, and which avoid duplication are likely to be an attractive option for audit committees seeking to appoint a new provider.

3. Significant investment is required to help mid-tier firms to scale up their operations to meet the demands of FTSE audits. Audit firms should consider how their business model and ownership structure can be adapted to achieve better access to finance, without creating conflicts of interest for existing or prospective clients. The CMA and BEIS should work with the finance community to help identify solutions. One option which could be explored further is a pooled fund which could be used to provide grants to challenger firms while mitigating potential conflicts of interest.

Forcing firms to split into separate audit and non-audit providers is not likely to improve audit quality. Furthermore, it would be extremely difficult to mandate this style of reform, as these are global firms operating across different audit markets. Instead, this may be something firms themselves seek to implement to respond to perceived concerns about auditor independence. The CBI is concerned that formally splitting firms into audit and non-audit providers could reduce the value of the audits they provide to UK businesses, and could weaken their ability to attract and retain highly qualified professionals.

Structural interventions should be introduced if sufficient progress to diversify the market is not achieved by 2030

To safeguard the sector's resilience and maintain the UK's competitiveness the number of firms providing audit services to FTSE 350 companies must be increased over the next 10 years. The short and medium-term measures set out above, combined with mandatory rotation and maximum tenures should reduce the need for significant interventions to re-structure the market. However, if the total market share held by the Big 4 has not been reduced to less than 85% by 2030, then a market cap should be introduced to speed up diversification. The design of this market cap will need careful consideration to mitigate unintended consequences.

The CBI supports innovative market led solutions. Efforts within the sector to collaborate and create new incentives or insurance products are welcome. The investors and corporate businesses we consulted reject proposals to break-up or weaken the Big 4 firms to improve market diversity. Furthermore, the introduction of a national auditor would eradicate competition entirely, and this style of monopoly is unlikely to drive up audit quality or create an attractive environment for talented individuals within the profession. Both measures - splitting the Big 4 and introducing a national auditor - are incompatible with the global nature of the market.

A joined-up approach to regulation and enforcement is needed to improve audit outcomes

Competition alone is not sufficient to improve audit quality; broader regulatory change is required. Audit firms are not responsible for company failures - this responsibility lies with the full board and executive not just the audit committee and the auditor. In future, greater regulatory coherence across the corporate reporting framework will be necessary to build trust in UK markets and to support business confidence.

1. Company directors must play a greater role ensuring a quality audit is completed, and they should be held accountable for the way the company makes use of the audit result. The best boards value internal and external audit, using these tools to manage risk and identify new opportunities; they should be rewarded for this diligence by their investors. The forthcoming Kingman Review recommendations will hopefully address this issue. The CBI's response suggested that the FRC's enforcement powers should be extended to cover company directors, not just chartered accountants, recognising that the adequacy of reporting is the responsibility of the whole board.

2. There is a clear expectation gap which is undermining trust in company reporting. Many people expect the external audit to guarantee the future viability of companies, but audits are not currently designed to do this. The CBI supports industry led action to address this issue. Indeed, work is already underway within the audit community to scope out what a good audit should deliver in future. To inject momentum to this project, the CBI recommends that the audit industry should work with the FRC, under the guidance of the CMA and Kingman Review. In clarifying the scope of an audit, the sector should aim to provide more certainty to investors about a company's prospects and accommodate demands for better non-financial information. The collapse of Carillion points to one key aspect of reporting which needs to be strengthened – providing an opinion on the quality of a company's profits. Furthermore, the Kingman Review should recommend elevating the importance of the viability statement so that it is subject to regulatory oversight.

The CBI is optimistic that complimentary reforms, combined with existing changes to tendering and rotation have the potential to enhance audit quality over the next 10 years. To build consensus and turn proposals into action, the CBI believes the CMA should undertake a 12-week public consultation to test its draft recommendations. An impact assessment would then help to mitigate the risk of unintended consequences and fine tune the CMA's final approach. The CBI looks forward to working with the CMA to deliver an effective package of reform to transform the UK audit market and ensure it is fit for the future.

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