



Statutory audit market study
Competition and Markets Authority
7th Floor
Victoria House
37 Southampton Row
London WC1B 4AD

Date: 26.10.2018

Johnson Matthey response to the statutory audit market study
consultation document

Dear Sir/Madam

Johnson Matthey welcomes the chance to respond to the CMA on the audit market as it recognises the fundamental importance of this market to corporations like ourselves and all of our stakeholders.

Given the tight timelines to respond we have provided you below our overarching thoughts on the audit market and then provide some comments on the questions posed.

There are two key themes running through your consultation document, audit quality and competition. For us audit quality is paramount and at Johnson Matthey both the executives and non-executives are very focussed on receiving a high quality audit as we recognise the considerable benefits of this not only to our board but also to our stakeholders. For us, a high quality audit provides a robust, technical review of our financials and controls, ensuring that we meet the levels of disclosure expected of a FTSE 100 company. It also provides intelligent recommendations about how we can improve the risk mitigation across our business, taking account of best practices the auditor has seen in other clients.

It is important to bear in mind through this consultation process that poor audit quality is not restricted to the Big Four audit firms and our concern is that consistently high audit quality across all businesses will not be achieved just by stimulating greater competition between the audit firms. In addition, we believe that many of the suggested outcomes in your consultation document will have unintended consequences, some significant, which will negatively impact audit quality and we would encourage the focus of the Commission to be to improve audit quality across the board.

Our Audit Committee has recently conducted an audit tender and so we are well placed to comment on the issues arising from the changes made by the Competition Commission in this area. The way we approached the tender was set out in detail in the Audit Committee report in our 2018 Annual Report (<https://matthey.com/investors/report-archive/annual-report-2018>). Our requirements were set out clearly upfront and the tender was very competitive. However, we only had three parties participating despite conversations with other firms and, of course, it would have been better to have a wider pool of firms who had the desire and capability to bid effectively. Despite this we were very pleased with the process and the outcome and we believe that audit quality will improve over time as a result. Feedback from the other firms indicated that they did not have the strength in depth across all of our geographies and industrial areas to provide us with the quality of audit we were looking for.

In your comments on "incentives" you raise a number of concerns over audit committees continuing to select the auditor for the firm. This decision is absolutely paramount for an audit committee as you cannot have confidence around the committee table unless you have confidence in your auditor. Therefore, to have an auditor imposed upon the business, and therefore audit committee, would require the committee to be accountable, but not responsible for that decision. This is a totally untenable position to be in. We are therefore deeply concerned by your suggestions of breaking the link between the company management (ie the audit committee) and the auditors.

The implication that some members of the audit committee maybe biased due to being an alumni of a big four firm implies a fundamental lack of independence of the members. This would mean that the audit committee is not functioning as intended under the UK Corporate Governance Code.

Non-audit fees in major corporations have a great deal of scrutiny and are generally a relatively low percentage of the overall audit fee, as a result of past governance directives. Given this, we don't believe they are a threat to independence, in public companies, however if more restrictions on non-audit fees helped with the perception of independence we would support this. We would also support a consistent approach in private companies. Importantly, we see non-audit fees as providing a platform for the mid-tier firms to get footholds in corporates which will allow them to expand their relationships with those companies over time.

Looking now at your consultation questions:

Theme 1

In our experience the sector has served us well, but we accept that is not true for everybody.

Theme 2

Audit Committees are absolutely focussed on audit quality, the auditors playing a significant role in order to allow the Committee to effectively discharge its responsibilities. This, in our experience, is why the changes made around audit tendering have not increased competition between the "Big Four" and the mid-tier firms. If quality is of paramount importance, then there is no incentive to take a risk by appointing a firm whose current capability to audit complex international businesses maybe untested.

There is no doubt that the Competition Commission's interventions around strengthening the role of the audit committee has helped. It is clear what the Committee's responsibilities are with respect to the auditor and increased disclosure has meant the readers of the Audit Committee report are much clearer on the key actions and decisions taken in the year. The unfortunate thing is the lack of response from the investment community to this increased disclosure.

Theme 3

In our experience competition between the Big Four is alive and well, indeed enhanced as a result of the tendering activity which has forced the firms to try to differentiate themselves, mainly through the use of technology whether around data analytics or audit tracking systems. Competition between the Big Four and the mid-tier is much weaker in the FTSE100/250 audit arena but better in some of the non-audit specialist areas. The reasons in our view for the lack of competition in the audit market are around scale, reach, competences, technology, experience and acceptance of the risks associated with large complex international audits.

Theme 4

We don't see a lack of resilience today, but the demise of Arthur Andersen shows it can happen. Therefore, there needs to be a balance struck between regulation of the market to reduce this risk and the concern that over regulation makes it an unattractive market for high quality participants.

Theme 5

See 4 above

Potential Measures

Restrictions on audit firms providing non-audit services;

As stated above, our prime concern is to have a high-quality audit. Structural changes to break apart the Big Four or ring fence audit from non-audit are fraught with challenge and the potential of significant unintended consequences which could lead to reductions in audit quality is great. It is not clear to us why this will lead to increased competition, some firms could for example just focus on non-audit work. For international companies, where the bulk of their audits will be carried out overseas, the prospect of using existing firms, who would not be audit only would remain, so the benefits are unclear to us.

We believe that a further restriction of non-audit work would have little unintended consequence and we have gone a long way down that road already. It would also increase the pool of work available to mid-tier firms. We would also recommend that the same restrictions apply to large private companies.

If further restrictions are to be brought in they should logically apply irrespective of who the auditor is, ie mid-tier firms should also not carry out work that threatens their independence. The concern about more non-audit work restricting those who can tender for the audit is one that is already managed by audit committees. It should be up to them to continue to manage that in future by tracking non-audit spend by firm and considering well in advance who they want to tender so that any conflict can be managed.

A market share cap however structured will have unintended consequences, many of which are a threat to audit quality. For example, there would be an incentive for the big firms to select the less risky clients, leaving higher risk clients with less experienced auditors. Also, it disempowers shareholders and audit committees from having the auditor that they want and need. Lastly, a cap, by its nature, is anti-competitive.

We don't see joint audits providing the solution. There is little empirical evidence from elsewhere in the world that audit quality is enhanced. In addition, by making mid-tier firms audit more businesses you will be restricting their ability to earn more non-audit work and gain the skills and expertise they need to perform the larger scale audits.

In conclusion, we are not supportive of either of those proposed options, as we cannot see an obvious link to improved audit quality. We are however very supportive of the Big Four providing direct support to the mid-tier firms. As the Competition Commission found there is no doubt that the mid-tier firms are at a disadvantage due to the size differential between themselves and the Big Four. We would be supportive of measures which could make the mid-tier more competitive, such as technology licences. In our audit tender the ability of the audit firms to demonstrate a strong technology offering was vitally important. Removing other barriers that restrict transfers of other skills, expertise or people would also be a good thing.

Incentives and Governance

As is clear from one of our overarching comments we cannot see any benefit from an independent body appointing the auditors. In fact, we see many downsides, including disenfranchising shareholders, as well as placing audit committees in a position where they are accountable for something they are not responsible for. The unintended consequences of such an action will be significant. The accountability of directors and audit committees has been greatly improved and clarified and is enshrined in section 172 of the Companies Act and reinforced by the recently revised Corporate Governance Code. We should see how these changes impact before making further changes.

In terms of tendering the audit more frequently there is an obvious concern that this would not enhance audit quality. Whilst the tender process itself is not overly onerous, the learning curve for the incoming auditor is steep and to go through this too regularly will increase risk, cost and could reduce audit quality. More frequent changes of auditor would however require our organisation to devote more time to educating the incoming firm, for which we do not believe we would get proportional value. We advocate waiting to see how the current cycle plays out, and in the meantime giving consideration to introducing tendering rules for large private companies as a logical extension. This allied to non-audit restrictions for the auditor should create more opportunities for mid-tier firms.

We hope you find our comments helpful.

Yours faithfully,

Alan Ferguson
Chair of Audit Committee

Anna Manz
Chief Financial Officer