

Statutory Audit Market Study  
Competition and Markets Authority  
7<sup>th</sup> Floor  
Victoria House  
37 Southampton Row  
London  
WC1B 4AD

30 October 2018

Dear Sir,

## **Statutory Audit Market Study**

Further to the publication of your consultation document, we are pleased to set out some initial thoughts based on the Company's experience in the audit market.

In overview, we are supportive of recent changes in audit regulation and governance, which have had a beneficial impact on the audit market. These changes have included the CC remedies and EU legislative changes, the mandatory rotation of auditors and the FRC Audit Quality Reviews (AQRs) and publication of summaries thereof. We also recognise the importance of improving investor and public perception (and understanding) of the role of the auditor, and believe that ensuring that the focus on audit quality must continue to be of paramount importance. We believe that care is required in considering any future changes, firstly to ensure that recent changes be allowed to bed down and secondly to avoid unforeseen and negative consequences from some potential remedies.

In summary (and considered in more detail below), we believe it is essential to preserve competition in the audit market, avoiding the significant adverse impact that would occur were one of the Big 4 to exit the market. Based on our recent experiences of audit retendering at Croda and other listed companies, the current competitive market for audit tendering is working well and delivering greater audit quality and innovation at sensibly competitive prices. However, despite encouraging tender participation beyond the Big 4 in our recent tender, we have found that it has been the ability and willingness of non-Big 4 audit firms to participate that has been the constraint to broadening competition and not the willingness of the corporate to engage. In addition, we believe it is important to retain a UK audit approach which is consistent with international practice.

The Audit Committee is working well, alongside the Board, in executing its responsibilities to stakeholders and particularly in acting on behalf of investors in managing the audit appointment and ongoing review process. Creating a public body to appoint company auditors would risk removing responsibility from the Audit Committee.

Looking in more detail and in response to your five themes, we would highlight the following:

1. *Scope and purpose of the audit*: we believe that international consistency in the audit approach is important for multinational corporates, needing to adopt a common system across operating geographies. Regulatory scope has not generally proved a hinderance;
2. *Incentives*: we have seen no issues of misalignment between investors and company management in commissioning the audit. It is clear that the Audit Committee (and not executive management) sets the tendering process and recommends appointment, with this process strengthened by recent EU tendering rule changes. We see a long held recognition that the Board, and its Audit Committee, acts as the representative and agent for the investors in managing the stewardship of the company;
3. *Choice and switching*: we believe that four audit firms is the minimum to ensure a competitive market in audit tendering (particularly given that one firm may be ruled out of participating by its incumbency). Pricing has not proved to be an issue, with Croda receiving three competitive bids in its recent tender. Quality is a focus for the Audit Committee (and executive management, who receive comfort from the additional review by the auditor of delegated management and systems) and, in both this and other audit tenders, we have found the intensive review by newly appointed auditors of systems and controls highly valuable. Tendering also generates innovation, with new ideas and solutions offered by all tendering firms.

We have found the ability of non-Big 4 firms to participate in larger corporate tenders to be low. Audit tenders require some investment by the tendering firms, which may dissuade smaller firms when there are large numbers of tenders to complete; capability (eg international presence) and depth of skills may also be constraining factors.

We have not seen a negative impact from the role of firms alumni in the tender process; alongside an independence of thought of financially trained Board members which owes nothing to where they qualified many years in the past, it should be noted that Board and Committee finance-trained personnel are in the minority of those opining on the tender process.

Finally, we do not find the cost (primarily in time and disruption) of the tendering process to the Company to be excessive for the benefits obtained (provided tendering is not too frequent) and mandatory tendering has been a useful addition to regulation;

4. *Resilience*: as noted, we believe it is key to maintain this in the audit market;
5. *UK regulation of audit*: we believe that appropriate regulation is essential and have welcomed recent improvements, such as AQRs.

With regard to the potential outcomes suggested in your consultation, we would note the following:

- *Increased competition between the Big 4*: this is already dynamic. Non-audit services are restricted by regulation and, in practice, Audit Committees impose tighter restrictions than the regulations, such that the auditor conducts only essential non-audit work with fees well below the statutory cap and thus not risking influence on the audit work. Indeed we would encourage further restriction of non-audit services by the auditor and encourage that such restrictions apply to large private companies, as well as listed corporates, where the public



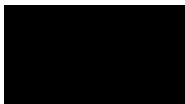
interest is similar. However, it should be noted that there are advantages, as a sounding board during the audit, to the engagement audit partner having access to non-audit service lines within their firm (eg tax) and therefore do not see the mandatory separation of audit and non-audit services within firms as beneficial. This continued co-provision of audit and non-audit services is supported by the need for Big 4 firms to be able to provide non-audit services to meet the needs of non-audit clients;

- *Increased competition from non-Big 4 firms:* as noted earlier, our experience has been that it is difficult to encourage smaller firms to participate in audit tenders. Mechanisms to promote mid-tier firms would be helpful, including helping them to develop the technology platforms and data analytics that are common in Big 4 audits. It is worth noting that the market for non-audit services amongst mid-tier firms is active and may encourage greater audit participation in future tenders through greater knowledge of the client. We do not believe that market share caps would be beneficial, as this would have a significant adverse impact on competition for tenders and the ability of the Audit Committee to consider important areas in the tender assessment, such as cultural fit of the selected audit firm;
- *Increased incentives:* as noted above, there is a danger of overstating the principal-agent risk. The Board's role to act for investors is a fundamental principle of good Board governance. We are supportive of increased transparency in the audit tender process, including greater reporting to shareholders. Audit Committees have a wide range of responsibilities (including external audit oversight, internal audit review, risk assessment and monitoring the system of internal controls) and we are concerned by the impact on Audit Committee responsibility that may arise by moving one part of these - the selection of the external auditor - to a third party or public body. In particular, the integrated operation of external and internal audit could be jeopardised.

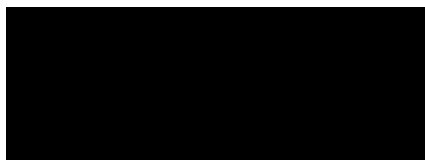
Likewise, moving to an NAO-type auditor could jeopardise the international coordination and responsibility of the Group auditor, reduce the innovation we have seen from competitive audit tendering and lead to increased costs. We are unclear how an insurance arrangement might be priced and do not believe that this solution would promote audit quality.

We trust that this response will be of help as part of your considerations.

Yours faithfully,



**Alan Ferguson**  
Chair of Audit Committee



**Jez Maiden**  
Group Finance Director