

Statutory Audit Market Study
Competition and Markets Authority
7th floor
Victoria House
37 Southampton Row
London
WC1B 4AD

21 January 2019

Dear Sir/Madam,

Re: Statutory audit services market update paper – invitation to comment

I am writing to you on behalf of National Grid Plc to outline our views on the proposed reforms to the statutory audit market in response to the above paper.

Our response also contemplates recent output from the Kingman Review, in terms of a newly formed independent regulator, a stronger enforcement regime that extends to all Directors, and publicly available Audit Quality Review findings. If enacted these measures would represent an enhanced oversight and monitoring regime for companies in the UK, to the benefit of investors and other interested stakeholders.

We also await with interest any consultation from BEIS on the case for a strengthened framework around internal controls in the UK, which, as an existing US registrant¹ we believe may have some merit for UK plc (particularly for larger or more systemically important entities at least), and the Brydon review on the scope of audit more generally.

As regards the remedies proposed in the CMA study, we infer that the remedies are intended to develop competition in the audit market as well as improving audit quality. However, the CMA needs to be clear which of these objectives it is prioritising, as the remedies proposed to develop competition may, in the short term at least, be to the detriment of audit quality.

We do not believe there to be a fundamental issue with audit quality in the UK but always welcome measures which are likely to improve it further. We do of course, recognise an absence of choice of providers in the market for statutory audits and an unfavourable public perception with respect to the quality of external audits.

Challenger firms

We believe there is a significant capability gap between the big 4 and other firms – particularly around complex accounting matters, and experience of auditing large multinational enterprises. In the case of National Grid, the primary records of our US business are maintained under US GAAP, which includes specific accounting provisions relevant to regulated utilities. Our auditors must have sufficient knowledge and experience of both IFRS and US GAAP as it is applied to regulated utilities in order to be able to challenge the approach of management in these specific areas.

¹ National Grid plc has American Depositary Receipts (“ADRs”) in issue and is accordingly subject to SEC and PCAOB external reporting regulations and regulatory oversight as a Foreign Private Issuer (“FPI”), as well as UK requirements.

We support the proposed remedies to boost the “challenger firms” through measures such as sharing technology and changes to non-compete clauses to enable staff to move between the big 4 and challenger firms more easily.

Joint audits

We are sceptical of the merits of a joint audit as a mechanism to improve audit quality. We do however acknowledge that they could be a way to accelerate the development of the challenger firms to compete with larger ones. Over time, this may have the desired outcome but in the short term would likely result in a decrease in audit quality.

We expect that joint audits will add considerable costs for businesses, in terms of higher fees (for multiple audit firms), and will require an increased amount of management time. Therefore, in pursuing this remedy, the CMA must be certain that the investor base believes that the increase in cost is necessary and valued and will lead to the desired increase in challenger firm capability.

In particular, for entities listed on more than one stock exchange (such as the NYSE), mandating joint audits could give rise to a significant inefficiency. In the case of National Grid a single audit firm must take full responsibility for the audit reports required by the PCAOB. To then require two firms to take responsibility for the audit report required under UK auditing standards will mean parts of our business will be subject to concurrent, multiple audits by different firms auditing to different standards. The cost/benefit of this needs to be analysed carefully and fully understood before mandating joint audits. Practicalities around how firms team up together in approaching tenders also need careful consideration.

Accordingly, if the joint audit model is to be pursued, we believe the model must allow for substantial flexibility in the allocation of work between firms, and must avoid a one-size-fits all perspective. Should the plan for joint audits go ahead, from the outset, there should be a requirement for a formal review of the progress of the joint audit model in three years’ time.

Peer reviews

When considered in conjunction with the proposals for joint audits, we believe peer reviews (which would mean a third audit firm engaged in either performing or reviewing an audit) will add significant cost.

The incremental benefit in terms of developing the skills/capabilities of challenger firms through reviews of other firm’s audit files is unlikely to be significant. Further, the stated purpose of such reviews – being to identify and prevent underperformance, would appear to duplicate the intention behind the FRC AQR reviews.

Regulatory scrutiny of Audit Committees

It is not clear whether the remedy proposed (attendance by regulator staff and/or reporting to the regulator by the Audit Committee on pertinent matters) is intended to centre solely on audit tendering activity, or other ongoing business. On the basis that a decision to re-appoint auditors is made at least annually, we presume the remedy is intended to operate on an ongoing basis.

We are unclear as to the benefits this will bring – noting that the Audit Committee is only one of many entity level controls typically in operation, and the scope, extent and role of the Audit Committee varies significantly from Company to Company.

In our view, if considered as a tool for minimising the risk of corporate failures such as Carillion, we do not believe this remedy will have a significant impact in reducing risk. We believe it likely that much of the work currently done by Audit Committees may simply switch to other governance forums, away from the relevant regulatory scrutiny.

We request the CMA clarify the precise purpose of regulatory attendance at Audit Committees, the skills expected to be held by individuals attending, and how any relevant information gained during such attendance will be utilised.

Other observations

With respect to audit tendering funds, the considerations outlined above concerning shareholders accepting that they must pay more to facilitate the evolution in the audit market should be taken into account.

We agree that splitting the big 4 into “audit only” and “non-audit” firms would be inappropriate. We believe it would be detrimental to audit quality, especially given the importance of ensuring audit firms can utilise the pensions, tax, treasury and valuations specialists required to contribute to audits today.

Finally, we believe it is imperative that the audit profession remains an attractive career to ensure high calibre individuals continue to work within it. Measures that reduce this would have a detrimental impact on audit quality.

Yours faithfully,

Mark Williamson - Chairman of the Audit Committee