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## **Hermes Investment Management Response to CMA Market Study Update**

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### **About Hermes Investment Management**

Hermes Investment Management is an asset manager with a difference. Our purpose is helping beneficiaries retire better by providing world class active investment management and stewardship services. We believe we have a duty to deliver holistic returns – outcomes for our clients that go far beyond the financial and consider the impact our decisions have on society, the environment and the wider world.

Hermes is majority owned by Federated Investors, Inc (Federated), a leading US investment manager with \$437 billion assets under management. BTPS retains a minority stake, alongside members of Hermes' management. This relationship offers a strong global platform as both firms share a commitment to delivering client-centric investment returns responsibly.

We offer clients access to a broad range of specialist, high conviction investment teams with £36.0 billion assets under management. In Hermes EOS, we have one of the industry's leading stewardship resources, advising on £359.0 billion of assets.<sup>1</sup>

### **Our response to the consultation questions**

Our goal is to deliver sustainable wealth creation including both a financial and societal return to savers and society at large. The reliability of a company's reports and accounts are vital in providing investors and other stakeholders with trustworthy information on a company's historic performance and prospects. The audit provides assurance to shareholders that the financial statements – on which shareholders and other stakeholders can assess how a company has performed – present a prudent and true and fair view of the results, cash flows and financial position of a company.

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<sup>1</sup> These figures are accurate as at 30<sup>th</sup> September 2018.

Further as detailed in our response to question 1 below, we believe a key area for reform to improve audit quality is the enhancement of the governance and resourcing of audit firms.

Turning to the CMA remedies, we believe it is strongly preferable to have less concentration in the audit market to increase resilience in the market and provide greater choice. We believe the increased competition will create the conditions for more professional scepticism and independence in the audit industry to emerge while mitigating fear of failure of a firm and enhancing audit quality. However, we recognise that none of the remedies discussed are straightforward, and each will have implementation challenges and potentially unintended consequences. We have two criteria for any remedy. The first is that the choice of which auditor audits which company is not a choice made by the auditors themselves. The second is that the market is able to begin functioning again as quickly as possible after an intervention.

We therefore ask the CMA to consider the pros and cons of each carefully, objectively taking into account views of impacted shareholders before making a recommendation.

Notwithstanding the implementation challenges, we believe that reducing concentration in the Audit market should be seen as a key objective to be delivered on, overriding implementation concerns.

Whilst we believe a structural split between Audit and Non-Audit Services would be ideal from a cultural and incentives point of view, given the significant upheaval to the firms concerned, we take a cautious view and advise that an operational or structural split of combined audit or consultancy firms should only be taken at a later stage if other methods prove ineffective.

#### **1. Do you agree with our analysis in section two of the concerns about audit quality?**

We have reviewed the FRC Developments in Audit 2018 report and, whilst we find pages 8-10 on specific quality issues<sup>2</sup> useful in identifying some of the key concerns, we would benefit from significantly greater disclosure on these and how they manifest. We also have a concern that the AQRs do not sufficiently focus on the bigger picture and material risks.

We are supportive of the analysis in Sections 2.39 – 2.78 of the CMA market study update. The quality of an audit is evidenced in the extent that the accounts provide a true and fair view of the underlying performance of a business and its prospects and demonstrate prudence, not just simple adherence to accounting standards. Process is important, but ultimately the desired outcome is a high standard of accounting and audit. We believe it is critical to audit quality that true and fair view and prudence once again become the overriding focus for auditors and management:

- Auditors need to focus their efforts on what is material and the underlying performance of the business and its prospects: investors and other stakeholders expect more from corporate reporting and audit than is currently being delivered (in particular regarding the going concern and viability of companies, long-term value creation for stakeholders and other risks).
- Too wide a range of accounting treatments can currently be used. Some are more aggressive than others (for example, goodwill impairment or long-term contracts).

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<sup>2</sup> <https://www.frc.org.uk/document-library/frc/2018/developments-in-audit-2018>

- As mentioned in the FRC Developments in Audit 2018 report, there is insufficient challenge of management and professional scepticism exercised by auditors, when auditing key judgement areas.
- Mark to market can be dangerous. Before the financial crisis, unrealised gains were posted as profits, as a result of which huge bonuses were paid to executives, only for it to turn out that those profits did not exist at all.
- More information on the quality of profits is needed.
- Distributable reserves should only be paid out of realised profits, in order to uphold the Capital Maintenance Regime.

One issue not covered in any depth in the CMA report is the governance and resources currently deployed in audit firms. We would like to see an overhaul in the governance and skills of the firm (whether audit-only firms or combined audit and consultancy firms) to put in place requirements for the following:

- A majority independent board of audit firms with an independent Chair and Senior Independent Director (SID).
- Disclosure akin to public listed companies, such as through an annual report and an AGM.
- Demonstration that any partner in a firm operating with a partnership model benefits from the success of the whole firm more than the specific audit work they lead on.
- Remuneration taking into account the audit quality delivered and not simply how profitable an Audit client is.
- Demonstration that the audit team has sufficient experience and skills, is appropriately business oriented, and is not over-leveraged with senior team members who are not properly engaged.
- At firms where they do not already exist, internal review teams led by a senior partner to review and challenge each audit team's work.

**2. Do you agree with our analysis of the issues that are driving quality concerns, as set out in section three?**

We broadly agree with the analysis of issues that are driving quality concerns, with further detail and any exceptions included below. As noted above, we would like to stress the importance of a true and fair view and prudence when auditing accounts as a key driver of audit quality. In addition, key to audit quality is an auditor with an independent and sceptical mind-set, that is challenging judgements and estimates made by management.

**In particular:**

**a) Issues relating to the role of Audit Committees and investors in the process of appointing and monitoring auditors;**

We agree with the CMA's analysis.

**b) Limitations on choice leading to weaker competition;**

We agree with the CMA's analysis.

**c) Barriers to challenger firms for FTSE 350 audits;**

We agree with the CMA's analysis

**d) Resilience concerns; and**

We agree that the resilience of the Big Four is important and believe that less concentration in the market by increasing competition would naturally lessen the impact of the failure of a Big Four firm.

**e) Wider incentive issues raised by the multi-disciplinary nature of the large audit firms.**

We agree with the CMA's view that there is 'an underlying tension created by the different objectives of audit and non-audit work', which is reflected in our response to Remedy 5 below.

**3. For all remedies: What should the scope of each remedy be? Please explain your reasoning. For example, should each remedy apply to all FTSE 350 companies, or be expanded to include PIEs or large privately-owned companies that could be deemed to be in the public interest?**

Any remedy implemented should apply to all FTSE 350 companies, PIEs and large privately-owned companies.

**Remedy 1: Regulator scrutiny of Audit Committees**

It is important that the Audit Committee and board remain accountable for auditor selection and monitoring, in order to fulfil their duties to shareholders and their fiduciaries. It is their role as insiders accountable to investors to be more knowledgeable about the business than an external body and they can therefore more accurately assess the skills required in an auditor. We would not advise taking the decision out of the board's hands as Sir Kingman suggests in his letter to the Secretary of State for BEIS.<sup>3</sup> We believe it is important to increase board accountability rather than remove it. Taking away responsibility for selecting the auditor would make them less accountable for the quality of the audit, which it is their role to enforce. However, we support the view that it would be beneficial to have regulatory oversight of the appointment decision, and for the rationale behind the decision to be reported to investors.

The suggested points that companies would be expected to evidence to the regulator in 4.16 a) and b) of the market study are appropriate and sufficiently wide ranging. Regulatory scrutiny could be achieved through mandatory reporting directly to the regulator before, during and after a tender process, as well as a subsequent annual report on the monitoring of audit quality. We agree that greater weighting should be given to independence, scepticism and the ability to challenge when selecting an auditor than factors such as 'cultural fit'; Audit Committees should be able to evidence this clearly. We understand that executives, particularly CFOs, remain deeply involved in the selection process. We believe that this should be the exclusive role of the Audit Committee, and that whilst executives can be consulted for relevant information they should have no undue influence on the selection decision.

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<sup>3</sup>[https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/765547/auditor-appointment-letter-to-greg-clark-december-2018.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/765547/auditor-appointment-letter-to-greg-clark-december-2018.pdf)

It is important that the regulator has the ability to take action should it have reason to believe that audit quality is not of a sufficient quality, for example due to a failure to challenge management or insufficient evidence being sought. This could take the form of recommending a company change auditor, in addition to the placement of an observer on the Audit Committee.

We believe that an observer on the Audit Committee could be useful in enhancing the quality of the Audit Committee's work. However, recognising the significant resourcing requirement, we recommend that this is trialled initially on a selective basis to see if it impacts positively on audit quality. If it is successful, it could be expanded to all of the FTSE 350, PIE and large privately-owned company Audit Committees.

Audit Committee reports should also disclose the rationale for judgements made, and not simply rely on the external auditor's report. Further to regulatory oversight, we would also like to see companies trial the use of Shareholder Committees. Such committees would require mandatory consultation with investor-elected shareholder representatives on matters such as audit, remuneration and nominations. The Audit Committee would evidence their approach in selecting and monitoring auditor to investors through this committee to create transparency and allow investors to formally express their views. In addition to increasing Audit Committee accountability, this could improve investor engagement on the topic. This would enable better informed shareholder involvement with and voting on the audit tender process.

There is a significant opportunity to increase investor engagement with both Audit Committees and auditors, and to challenge their approach to accounting, audit quality and auditor appointment. Currently, most investor stewardship activity is focused on board composition, executive remuneration and most recently climate change. There is relatively little focus on audit matters. A minority of investors engage more widely and comprehensively on a range of different issues, including audit tenure, non-audit fees and audit practice. There is a lot more we can do as an industry, including engaging more systematically with Audit Committee Chairs and using our vote more actively. This would require taking colleagues with accounting skills and experience to meetings with Audit Committee Chairs.

### **Remedies 2, 2A and 3: Mandatory joint audit, market share cap and additional measures to reduce barriers for challenger firms**

We would like to see more competition through a less concentrated market. Whilst none of the recommendations provided are perfect, we believe that one or more should be implemented to deliver less concentration in the market. We would advise the CMA to consider the responses of all stakeholders carefully and conduct further research into potential impacts, positive and negative, of each before making a final recommendation. We would hope to see six to eight well resourced, material audit firms to emerge from this within one to two years.

Whilst disliked by the Big Four representatives we have spoken to, the CMA makes a good case for joint audits. However, it remains debateable whether this measure would actually improve audit quality, independence or choice in the UK market and we therefore advise a more thorough review of likely impacts.

Alternatively, a straight break-up of each of the Big Four into two smaller combined audit and consultancy firms would at a stroke increase choice. It may, however, result in the consultancy divisions of the Big Four deciding to split from the audit divisions, which could lead to a negative impact on audit quality in the short-term at least, as outlined in our response to Remedy 5 below.

An imposed market share cap by an independent body might be the best approach, as the market could be allowed to function again immediately after such an intervention. It may be a less disruptive method of achieving the same aim as the breakup of the Big Four described above. We do have some concerns with this remedy, however, that there would be a reduction of choice and potentially audit quality due to cherry-picking of clients by auditors. Still, an interventionist approach by the regulator to assign auditors to audits is also not attractive as it takes responsibility for the choice of auditor away from the Audit Committee.

#### **Remedy 4: Market resilience**

The best resilience system would be to increase the number of audit firms carrying out the largest audits, by measures outlined elsewhere. Further, we do not believe that the movement of audit clients and staff to another Big Four firm should be prohibited. Companies should attract and retain staff and clients on merit, not through restriction of their choices. As outlined above in our answer to Question 2 d) we believe the focus should be on increasing competition, and that this in itself will increase the resilience of the audit market. We would caution against overcomplicated approaches to market resilience.

#### **Remedy 5: Full structural or operational split**

Ideally, we would prefer audit and advisory to be completely split, as this is cleaner and we understand the concerns about conflicts resulting from the multi-disciplinary nature of the large audit firms. However, we also recognise the disruption that such a split would bring to the current audit delivery model, the quality it could provide and the resource implications. We are therefore reticent to see a break-up of audit and advisory activities as an immediate step, until there is greater evidence that this is the fundamental reason for low quality audit. However, this should be reviewed in three to five years' time, to review whether other methods implemented have had the desired effect.

If a structural or operational split were enacted, we believe that it should be applied to all firms. Much like the Big Four, the majority of income for challenger audit firms comes from non-audit services, albeit to a lesser extent. If it is agreed to be an issue for the Big Four it should be considered an issue for all audit firms.

Given the ring-fencing of profit pools and partners required for an operational split, we do not see a significant practical difference between the structural split and the operational split, as the ownership of the firm under both options would be separate. The only difference would be that the operational split would require supplier agreements between the two entities while the structural split would allow those services to be sought elsewhere.

We would, however, like to see non-audit services provided to audit clients limited to a lower level, or even disallowed completely, as a more immediate step.

### **Remedy 6: Peer review**

We are highly supportive of an additional review process before the signing off on accounts, which could be very effective in ensuring audit quality. There is potentially a significant cost and resourcing impact of introducing peer reviews, and in particular a cost/benefit analysis would need to be performed if mandatory joint audits were also being introduced to compare the two approaches.

Given the potential incentives to find issues with even high quality audits by competitors, we would advise that the review is instead carried out by an arm of the regulator to ensure full independence. Such a review would have the same role, focus and funding as was suggested by the CMA for a peer reviewer to avoid duplication of the AQR's work. This would avoid potential reduction of choice or independence issues in future tender processes.

Alternatively, audit firms could second experienced auditors to the regulator for two years. A similar method is used for the Takeover Panel, where the Executive is staffed by a mixture of employees and secondees.

We would suggest a focus on companies with high risk with additional random allocation, similar to the method used to select audits for review by the FRC AQR.

### **C) Next steps**

#### **27. What are your views, if any, on our proposal not to make a market investigation reference?**

We do not have any views on this issue.