THE 100 GROUP

Main Committee

Statutory audit market study
Competition and Markets Authority
7th floor
Victoria House
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18 January 2019

Dear Sir/Madam,

Statutory audit services market study update paper - invitation to comment

Following the CMA's second market study, please find attached our response to your request to comment on the specific remedies raised. As you are aware, the 100 Group submitted a response to the original consultation on audit market competition and subsequently met with the CMA to discuss our views.

We welcome the CMA's focus on audit quality, which underpins effective capital markets and long-term company performance and are supportive of a number of the remedies proposed. There are also several areas of concern for your consideration, that could lead to a detrimental effect on audit quality output.

Below is a summary of our views on each remedy, the appendix to this letter details these further.

Remedy one: Regulatory scrutiny of Audit Committees (ACs)

- In our view the degree of regulatory scrutiny proposed in the market study is unnecessary and would be overly burdensome for both the regulator and AC;
- The regulator already has the opportunity to meet with the AC to discuss matters in relation to the external audit. We suggest that, rather than having a regulator appointed observer in AC meetings, the regulator engages with the AC on a more regular basis;
- We also support the proposed regulatory review of the audit tender process;
- We suggest that any such regulatory scrutiny should not duplicate other existing regulatory oversight, e.g. by the PRA and FCA for financial services companies.

Remedy two: Joint audits and market caps

- We are not supportive of mandatory joint audits or market caps as we have concerns over the impact these will have, most notably in the short term, over quality and efficiency of audit delivery.

Remedy three: Additional measures to reduce barriers to challenger firms

- We are supportive of the proposed remedy, as we believe this will make challenger firms more effective and as a result will enhance quality and competition across the external audit market.

Remedy four: Resilience

- We are in agreement that the resilience of the market would be a considerable concern if one of the Big Four were to exit. Developing a safeguard to prevent this from happening may be too difficult, given the numerous causes for an exit and therefore would not be a productive use of the regulators time;

- If such an exit were to take place, the remedies would need to be so radical and require engagement with international audit firms, that it may be counterproductive to spend time now pursuing this.

Remedy five: Division of audit and non-audit services into separate organisations within a firm

- We do not have a common view on whether there should be separate ownership of the audit and non-audit practices of UK audit firms;
- In relation to the division of audit and non-audit services into two completely separate firms, we question how this would work from an international perspective, most notably where audit related services may be provided by non-UK audit firms to subsidiaries of UK companies and the associated regulations surrounding this provision;
- We would also note that there are numerous advantages of audit firms having access to non-audit expertise when delivering an external audit and would have concern if these services were prohibited in any division.

Remedy six – Peer reviews

- We would be supportive of peer reviews if they were performed immediately after the audit has taken place and form part of the regulator's Audit Quality Review (AQR) process;
- We do not think peer reviews would be beneficial for audit quality if they were to take place during the year end audit. They pose a risk that both the auditor and company's attention gets diverted to the peer review, which could be at the expense of addressing important matters on the external audit;
- A thorough review after the audit would relieve time pressure and enable a challenger firm to perform a much higher quality, detailed review and provide a better opportunity for them to enhance their understanding of the more complex audits.

We would be happy to meet and discuss in more detail. Please feel free to contact me at [redacted], should you wish to discuss our comments.

Who we are

The 100 Group of Finance Directors represents the views of the finance directors of FTSE 100 and several large UK private companies. Our member companies represent almost 90% of the market capitalisation of the UK FTSE 100 Index. Our aim is to contribute positively to the development of UK and international policy and practice on matters that affect our businesses, including taxation, financial reporting, corporate governance and capital market regulation. Whilst this letter expresses the views of The 100 Group of Finance Directors as a whole, those views are not necessarily those of our individual members or their respective employers.

Yours sincerely,

Brian Gilvary

Chairman, The 100 Group

1) Regulatory scrutiny of ACs

In our opinion, AC Chairs are best placed to comment on the scope and practicalities of this remedy. From a 100 Group perspective, we agree that it may be beneficial for there to be greater engagement between the regulator and the AC. However we consider the extent of oversight and scrutiny suggested to be overly burdensome for both the regulator and AC and have therefore proposed modifications.

In its current form, the remedy may be detrimental to the regulator itself, as it could turn it into a body whose role is to review and summarise large volumes of AC reports and meetings, rather than one that actively engages in the day to day activities of the external audit and AC.

In our experience, the requirements of the Corporate Governance Code are such that ACs are already working independently, effectively and to a high standard. We propose that instead of the regulator appointing someone to observe the AC, the regulator should, as already permissible, engage on a more regular basis with the AC Chair to discuss the activities of the AC. This will provide the regulator with the necessary information to prepare the reports outlined in the remedy and also acknowledges the independence of the AC from the management of the company.

At a time where the market is highly resource constrained, we question how the regulator would identify a sufficient number of people, with the relevant expertise and sector understanding to monitor each of the FTSE 350 ACs. Instead, placing greater responsibility on the AC to engage with the regulator may address this.

In relation to perceived concerns over quality not being a top priority when appointing external auditors, we would support adding a degree of regulatory oversight to this process. This could take the form of reviews of tender materials, (for example the request for proposal and score cards), to ensure that ACs are prioritising independence and challenge in its tender assessment. In our experience, however, audit quality has been the main priority in all audit tenders we have been involved in.

We also note that Financial Service sector ACs are already subject to a greater extent of scrutiny by their regulators, therefore it is important that any remedy is cognisant and not duplicative of this.

2) Joint Audits and market caps

In our opinion, the risks to audit quality are greater than the benefits to competition and market resilience from joint audits. Most importantly, the risk to audit quality will be greater in the short term, as it may take time for audit firms to fully optimise the necessary capabilities and work arrangements, to deliver joint audits to the highest level of quality. We therefore continue to believe that there are no demonstrable benefits to shareholders of a mandatory joint audit. Additionally, we remain concerned that the quality of a joint audit, even once successfully implemented, may not meet or exceed that of what a single audit firm provides today.

Under mandatory joint audits, we are concerned about potential increases to the time taken to address complex accounting issues. If mandatory joint audits cause a delay to accounts being signed off, this could be detrimental to shareholders and potentially negatively impact the attractiveness of the UK listed market to new entrants.

We strongly believe that ACs, as agents for investors, should be able to appoint the audit firm that they consider will best provide a robust and challenging audit. In our view, mandatory joint audits may prevent this from happening.

We also have concerns over the impact mandatory joint audits will have on the provision of non-audit work. Many of our members use challenger firms to provide non-audit services. Mandating that they take on a greater audit market share may reduce their ability to provide such work, which could have detrimental impacts to both challenger firms and businesses.

Market Caps

In our view, market caps may be detrimental to both audit quality and competition, if it means certain audit firms are not able to compete. From an audit quality perspective, market caps are likely to be more favourable than joint audits, as they do not pose a risk of audit issues falling through the gaps or cause a delay to the time it takes to deliver an audit. However, we have serious concerns over how market caps can be practically implemented whilst also allowing ACs to select the audit firm best placed to deliver the audit.

3) **Additional measures to reduce barriers to challenger firms**

Our members often invite challenger firms to participate in audit tenders. As such we believe that certain challenger firms are already capable of competing across the market. We would therefore support reducing barriers to these firms to encourage greater participation. We agree that challenger firms need assistance in building their expertise and capabilities either to compete effectively or allow them to take on more complex audits. We believe all the measures proposed could increase quality and competition of external audits.

Implementation of reducing barriers to challenger firms, should be done in a way that does not have the unintended consequence of causing declines in performance, or divert the attention of the larger firms, such that their own performance or service offerings are compromised. Reducing barriers will also enhance competition which may then lead to new obstacles to be considered. For example if movement of labour is made easier, there may be opportunities for staff who sign audit opinions to move to a new audit firm and work on their former clients; or the potential for technology sharing resulting in two firms having an undifferentiated audit product. These could undermine the benefits to investors from audit rotation and should be considered in any remedy applied.

4) **Resilience**

We understand the underlying concerns that the CMA has in considering the resilience of the external audit market and in having the foresight to consider ways to mitigate and manage an exit. However, if a Big Four firm were to exit the market, the remedies would need to be so radical that depending on the cause of the exit, deciding on what such remedies would look like now would be counterproductive. If one of the Big Four were to leave the UK market, it would have ramifications worldwide. Therefore, how it is mitigated and addressed would require involvement not only of UK audit firms but also their international networks.

We would encourage the CMA to look at other sectors that have sought to increase their resilience and the methods employed for market participants to demonstrate their ability to continue participation. For example, the introduction of a stress test within the Financial Services sector, such a test could be modified and extended to the audit market, testing scenarios which could cause an audit firm to fail.

In our opinion, the more immediate concern to the resilience of the audit market is that of an audit firm voluntarily choosing to exit the market. We would propose that the regulator work alongside audit firms and potentially the government, to determine how best to identify the causes and ways to prevent a voluntary exit from the market.

5) **Division of audit and non-audit services into separate organisations within a firm**

As noted in our original submission, the 100 group does not have a definitive view on whether there should be separate ownership of the audit and non-audit service practices of UK audit firms.

We would urge caution that any form of separation does not unintentionally hinder a firm's ability to continue to provide audits at the current level of quality, for example by loss of specialist resource. It

is not clear what the consequence will be for non-audit services that are provided outside of the UK by the auditor and whether these would need to be moved to a new non-audit provider, who is unaffiliated with the UK audit firm.

6) Peer Reviews

We believe that as currently proposed, peer reviews are equivalent to being a joint audit 'light' approach, which we do not think will sufficiently address the concerns over audit quality. Instead, we propose that the timing of these peer reviews is pushed back so not to take place during the year end audit and instead are made part of the regulator's AQR process. This would alleviate the time pressure for the review to be completed. If the reviewing firm is a challenger firm, this will give them a better opportunity to enhance their knowledge and understanding of what is required to perform these audits and also gives the regulator more time to do a thorough review. We would also be supportive of these AQR reports being published.

In our opinion, peer reviews conducted during the course of the audit would cause duplication of effort and could possibly detract both the auditor and company by focussing their attention on managing the peer review, rather than addressing the audit itself. Furthermore, adding in an additional review of the external audit, on top of those that audit firms conduct internally themselves, could place auditors under undue pressure. This runs the risk of negatively impacting quality and could cause delays to the audit process, which would ultimately have a detrimental impact for shareholders.

We note in paragraph 4.144 that peer reviewers: "*would be incentivised to identify any weaknesses that exist in the audit. The incentives for peer reviewers with a proven track record of high quality reviews could be a greater allocation of peer reviews by the sector regulator and/or financial rewards".* In our view it is not appropriate to incentivise any auditor to find an issue. Incentivising a firm to find weaknesses and potentially rewarding them financially for doing so, may lead to reviewers finding immaterial concerns or reviewing items outside of their remit, in order to be rewarded. This does not drive a focus on audit quality and could potentially put challenger firms at risk of doing more 'peer reviews' than external audit work, if it is of greater financial reward. We would therefore strongly recommend that the CMA does not consider taking forward this remedy on this current basis and as a minimum needs to reconsider the remit and roles of the reviewer.

Other comments

In our view, remedies that apply to audit firms should apply to the Big Four plus challenger firms and remedies that apply to markets should apply at a minimum to the FTSE 350. Once successfully implemented, we would suggest that they are revisited to assess how they could be expanded into other markets.

We note that there are a number of concurrent reviews taking place on the audit market (CMA, Project Flora and the BEIS Select Committee) and therefore suggest that any remedies consider the recommendations of all reviews so not to create any duplication or conflicting proposals.