TheCityUK

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

21 January 2019

Response to Appendix C to CMA audit market study update paper: the 'expectations gap'; the purpose and scope of audit

Dear Sir or Madam,

I write in response to the questions posed in Appendix C to the audit market study update paper published 18 December 2018. TheCityUK is the industry-led body representing UK-based financial and related professional services (FRPS). In the UK, across Europe and internationally, we promote policies that drive competitiveness, support job creation and ensure long-term economic growth. The industry contributes nearly 10 per cent of the UK's total economic output and employs over 2.3 million people, with two-thirds of these jobs outside London.

The market study from the CMA (as well as the Sir John Kingman review and the upcoming Brydon Review) seek to improve audit quality, choice and the overall governance of the sector. Addressing these issues is essential to delivering positive outcomes for clients, savers and investors in the future. It is important the process of assessing the suggested market remedies put forward by the CMA market study can be informed by the findings of the Brydon Review as we believe it would be premature to reach a conclusion on those before fully understanding the kind of audit service its users and stakeholders is demanding.

It is important that any changes to how audit is regulated and structured are made carefully and not in isolation. We recommend that consideration of the scope of audit, and company reporting more generally, should be prioritised as this would naturally have significant implications for other possible future reviews.

As we illustrate below, audit plays an essential role in the wider economy, particularly supporting the effective functioning of lending, underpinning trust in capital markets and attracting inward investment. Beyond Brexit, ensuring that our globally-leading FRPS industry – and its constituent parts – continues to thrive, will be key to the UK's continued success. Our audit industry is a core element of that ecosystem.

We hope the views of TheCityUK will be helpful in assessing the issues discussed. We look forward to continuing to engage on these issues – including through the Brydon Review, with whom we will share this submission – to ensure possible proposals for reform put UK competitiveness at the core of the government's agenda.

Yours sincerely,

Philip Jones
Head of Policy | **TheCityUK**
Our responses to the specific questions posed are set out below:

What is the purpose of an audit as it currently stands?

The purpose of an audit is to provide an independent opinion to a company's shareholders on the truth and fairness of the financial statements, whether they have been properly prepared in accordance with the Companies Act and to report where, in the auditors' opinion, proper accounting records have not been kept. The audit report also provides assurance over a number of other reporting requirements under the Companies Act, ISAs (UK) and, if applicable, the UK Corporate Governance Code and Listing Rules.

In addition, the auditor reviews other important areas of the annual report including directors' renumeration, risks and viability and reports on the directors' statement that the annual report is fair, balanced and understandable.

An audit is a vital mechanism that assists owners of companies in assessing the stewardship of directors and in turn provides an important stimulus for directors to undertake their fiduciary responsibilities.

In considering the purpose of an audit, it is important to note that as well as the primary purpose outlined above, there are a range of stakeholders that rely on the soundness of company reporting. In particular, TheCityUK would highlight and underscore the enabling role that audit plays across the FRPS ecosystem and the wider UK economy:

Audit builds trust and transparency

- The UK, and all modern market economies, are dependent on trust. By providing reasonable assurance under a common audit framework, in respect of financial statements prepared by management under consistent accounting rules, independent audit helps build that trust. In doing so it plays a role in reducing possible inappropriate business, accounting or reporting practices which might otherwise exist. Audit also contributes towards a common language and point of financial reference for the UK economy which helps make corporate financial information more transparent and accessible to would be investors, suppliers, purchasers and other stakeholders who can make informed decisions about where they align their business interests and activities.

Audit helps capital formation in fragmented markets

- The private and public investment and financing market in the UK is vast and diverse. Audit is a key part of the ecosystem which helps give otherwise uninformed and dispersed investors and other stakeholders the confidence to participate in that market. In so doing, audit helps bridge the gap between entrepreneurs who need capital, and investors and lenders who provide it and who are looking for a return.

Audit facilitates the creation of liquidity and reduces the cost of capital

- By helping build trust in corporate economic fundamentals audit helps create the conditions in which equity and fixed income markets can operate, and facilitates the trade in financial instruments which provide market liquidity. By helping to create these conditions, audit helps to reduce the cost of capital for UK businesses giving them the opportunity to compete more effectively.

By contributing to transparent and effective markets, audit enables a wide range of stakeholder engagement in and with the UK economy. In particular:

Long term savings and effective retirement planning

- As a watchdog over UK plc, audit helps create the conditions in which UK employees and the funds and insurers to which they entrust their savings can make long term investment decisions and plan effectively for retirement and long-term health.

SME and corporate lending

- Audit is a building block providing the UK banking, private and peer-to-peer lending communities the confidence they need to back small and medium sized businesses and foster innovation and grass roots growth in the UK economy.

Capital investment

- By helping to build trust in the UK economy, audit supports long-term and sustainable investment in UK industry through initial public offerings, mergers and acquisitions and domestic and foreign direct investment. This in turn creates jobs, promotes innovation and growth, and increases the competitiveness of UK industry on the world stage.

Fair and effective public spending

- By contributing to trust and transparency in corporate financial statements, audit facilitates the effective and timely harvesting of tax by HM Treasury for the public purse. In turn, audit of the public sector helps to ensure spending on public services is open and transparent, and that public sector bodies are accountable for the funds they receive and disperse.

In addition, audit shines a light on the stewardship of companies and provides management and audit committees with valuable feedback on corporate governance, risk and control frameworks and management strengths and weaknesses. Audit provides a rigour and scrutiny which leads to incremental improvement in the quality of management and of corporate governance, reinforcing the trust in the UK economy required for long term investment and growth.

The audit profession also contributes significantly to the UK economy:

- **Employment**: UK accounting and auditing activities employ 271,000 people. Within this, we estimate that 90,000 people work in audit. However, as there is no hard data to indicate the proportion of auditing employment within the total, we assume around a third of the total employment is auditing activity. Our assumption is based on the fact that most companies employ accountants and only auditing and large firms employ auditors (some large firms hire internal auditors).

- **GVA of the auditing sector**: The accounting, bookkeeping, auditing and tax consultancy sector contributed £19.5bn to UK gross value added (GVA) in 2016. We apply the same assumption for employment to estimate the auditing sector alone generated £4.8bn in that year.

- **Number of members in accounting bodies**: According to data from the Financial Reporting Council (FRC), the compound annual growth rate for the number of members in the FRC's seven accountancy bodies was 2.4% between 2013 and 2017, reaching 360,000 in the UK and Republic of Ireland (ROI) in 2017.[1]

- **Number of audit firms registered**: 5,660 audit companies in the UK and ROI registered with the Recognised Supervisory Bodies as at the end of 2017.[2]

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[1] Financial Reporting Council, 'Key Facts and Trends in the Accountancy Profession', (July 2018), p.2, available at: https://www.frc.org.uk/getattachment/27725654-8bd9-4623-a410-ef1661a69649/Key-Facts-and-Trends-2018.pdf

[2] Ibid.

- **Audit fee income for major audit firms**: The average audit fee income per Responsible Individual was up 5.7% between 2016 and 2017, reaching £1.3m in 2017.[3]

What should the purpose of an audit be? Put another way, what do stakeholders require from an audit?

The purpose of an audit should remain primarily focused on providing an independent opinion to a company's owners. However, in considering the purpose of audit as a whole, it must be acknowledged that the value of audit is, as discussed above, embedded in financial systems such that it has value not just for those owners, but for a wide range of stakeholders and users. It also makes an important contribution to overall UK competitiveness given its enabling role across the FRPS ecosystem.

It is vital, for the reasons set out above, that the outputs of an audit continue to generate greater levels of trust and transparency for all that rely on and benefit from it. This is critical in providing assurance and value in relation to key business decisions, for example, investing and lending, and to enable business to be conducted effectively and efficiently.

However, the economy is changing at an increasing pace. Change is driven by technology, big data, changes in working and trading practices, and in standards, expectations and the complexity of accounts. Those changes are being felt by all those who rely on, and benefit from, audit output. Critical review of the audit market, including the purpose of an audit, is therefore welcomed to ensure that audits remain of high quality, relevant, and connected with their core value to the modern market.

To the extent that this second question raises considerations as to whether an audit report should report beyond what the relevant legislation current requires, this is addressed in response to the third question, below. In assessing this it is important to be clear on the primary audience for corporate reporting more generally and the needs of those users. We note that the Financial Reporting Council's Future of Corporate Reporting project might help to address this and believe the work of the Brydon Review should be closely linked to provide further input on this matter.

Does the scope of audit need to change to achieve the desired purpose? If yes, how?

Overall, the quality of audit in the UK is high. Some high-impact corporate failures have, however, had an impact on market confidence. To ensure audit remains relevant and delivers value across the UK economy, and to address the underlying issues of trust and confidence in audit and the audit market, there needs to be a critical review of the scope of the audit process itself.

Key issues which need to be considered for potential change – with the associated incremental costs balanced against potential additional benefits – in this context include:

- Expanding the scope: Consideration should be given to an enlarged scope of audit beyond, as is currently required, reasonable assurance that the financial statements and accounts prepared by management provide a "true and fair view" and are free from material misstatement whether caused by fraud or error. In particular, consideration should be given to implementation of rules providing for a more detailed interrogation of fraud risk by auditors, and more explicit narrative comment on such matters in the audit opinion. This could include consideration of the broader evolution of corporate reporting

[3] Ibid.

to an increasingly integrated financial and non-financial basis. It may therefore be logical for auditors to provide assurance not just on the financial statements, but also on other key financial and non-financial key performance indicators and the holistic view of performance, position and prospects these would provide when taken together.

- Nature of assurance provided: Consideration should be given to:
  - The adequacy of the current "going concern" statement. It could be argued that the current "material uncertainty" sign off is too blunt an instrument. Consideration should be given to allowing for a focus on deeper review of management assumptions and greater detail/colour in the audit opinion.
  - Narrative reporting: The current audit reporting framework is in many respects a series of binary pass/fail statements. Consideration should be given to providing auditors with guidance, including a consistent reporting framework, to enhance the depth and breadth of gradation and narrative content in the audit opinion.

- Ensuring transparency for stakeholders: Whatever the scope and basis for audit going forward, there needs to be greater clarity for stakeholders as to the nature of the testing the auditor carries out, and the level (limits) of assurance which the auditor can provide.

Any review, and ultimately any change in scope must be considered carefully. Any changes, however facilitative or useful, have potential to come at a cost and cause some disruption to those who participate in, and benefit from, audit and its output. The approach to reform of the scope and purpose of audit must therefore be considered, and evidence-based, in order that objectives of all stakeholders can be met in a proportionate manner.

For example, the CMA has acknowledged that the literature they reviewed has not established a clear link between mandatory joint audit and audit quality. While there is no evidence that audit quality is lower in a joint audit regime the assertion that it may result in higher audit quality is not evidence-based.

Do the Companies Act, IAS, ISAs UK, or corporate governance roles need to change to achieve this purpose?

The audit industry is heavily regulated and audit output highly prescribed. Consideration must be given as to whether the current legislative and regulatory instruments facilitate and permit the effective use of tools (including technological tools) now available to auditors.

In addition, there is clearly interdependence between audit quality and accounting standards. In particular, standards are open to interpretation, so a user of audited financial accounts needs to be able to understand the accounting assumptions on which the accounts are based in order to interpret them effectively. However, any possible reforms of accounting standards should be considered against the wider regime of international accounting standards, bearing in mind investors' requirements for global comparability.

In looking at any redefinition and change to the scope and purpose of an audit TheCityUK therefore believes it is important to also consider the purpose of financial accounts and statements. For example, there may be utility for both those who produce audit reports and those who benefit from them in requiring that a company's accounts are more specific about insolvency risk, particularly where that risk is high.

We therefore believe it is important that ongoing review of audit purpose and scope be undertaken in conjunction with an appropriately scoped review of accounting standards and the overarching legislative and regulatory framework governing auditors, their roles, and reporting requirements.

Who should auditors owe duties to? Should auditors' duties and liabilities be expanded? Do directors need to bear more responsibility for financial reporting?

Auditors have a primary duty to the company's owners in line with the core purpose of audit. TheCityUK believes this should continue.

Any review and consideration of change in audit scope and purpose merits consideration of the reporting duties and liabilities of auditors. Similarly, because there is clear interdependency between accounting standards and audit, it would be appropriate to consider director duties and liabilities concurrently.

However, any changes must be considered carefully and with all wider implications in mind to avoid unintended consequences and to ensure that objectives across the market are given appropriate consideration.

In particular, increasing the range of stakeholders to whom auditors and directors may owe duties could result in significant additional risks and burdens for UK industry which would put it at a competitive disadvantage globally.

If some of the issues identified in our response to the preceding question are properly addressed, expanding the range of stakeholders to whom auditors owe legal duties should not be necessary.

Does audit need to align better with the capital distributions regime in Companies Act 2006?

Capital distribution is a key element in investment decision making and a functioning market economy. Audit is central to this process and if some of the changes discussed in this response – and in the audit market study update paper – progress, the capital distributions regime will in turn and by default be strengthened. This would be a good thing.

However, it would be logical to consider how accounts can be supplemented to provide information directly relevant to the capital distribution regime and how auditors should audit that additional information.

Conclusion

The quality of audit and of auditors in the UK is generally high. Auditors are held to high levels of professionalism and accountability by professional bodies and are subject to the oversight of the Financial Reporting Council. However, even a small number of high-profile corporate scandals (whether the auditors were at fault or not) causes potentially significant market disruption.

It is therefore right that the CMA market study (as well as the Sir John Kingman review and the upcoming Brydon Review) are focused on the ongoing evolution of the current audit model.

However, we believe it is in the interests of both savers and investors that possible future change is undertaken through wide consultation, avoids greater cost burdens on clients and is done with appropriate care to protect a national asset. Therefore, proposals should:

- Put UK competitiveness and the avoidance of unintended consequences at the core of the government's agenda and assessing any proposal, including possible reform of business environment/audit and/or corporate governance regime, in that context is especially important in the uncertain environment created by Brexit.

- Be aware of the risks of inhibiting the UK's ability to be competitive by creating a new regime not aligned to global standards. Business will simply move elsewhere, taking employment with it.

- Recognise that multidisciplinary firms offer diverse and rewarding career development pathways for talent from many backgrounds[4], and the ability of firms to attract and retain the best people should not be affected adversely by potential reforms.

TheCityUK
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[4] Six of the top 50 Social Mobility Employer Index 2018 employers are multidisciplinary audit firms: http://www.socialmobility.org.uk/wp-content/uploads/2018/07/SM-Index-Top-50-2018.pdf.