Statutory audit market study
Competition and Markets Authority
7th floor
Victoria House
37 Southampton Row
London, WC1B 4AD
By email: statutoryauditmarket@cma.gov.uk

28 January 2019

Dear Sir / Madam,

GC100 response to the CMA's consultation published on 18 December 2018 in respect of its statutory audit services market study (the "Update Paper")

GC100 is the association for the general counsel and company secretaries of companies in the UK FTSE 100. Membership includes general counsel and company secretaries from over 80 companies listed on the FTSE 100.

Please note that, as a matter of formality, the views expressed in this response do not necessarily reflect those of each and every individual member of GC100 or their employing companies.

GC100 welcomes the opportunity to respond to this consultation.

Overview

As an initial observation, GC100 considers that recent, high profile corporate failures should not automatically be taken as evidence that audit quality in the UK is universally and systemically flawed. In particular, for the reasons explained in more detail in our response to the consultation questions below, we strongly disagree with the CMA's finding that selection and oversight of auditors is not sufficiently focused on quality. On the contrary, the accountability of Audit Committees and the reputational consequences for their members if the audit goes wrong mean that their incentives lie firmly in ensuring that audits are as robust as possible and that the right firm is engaged to achieve this.

We believe choice is key to ensuring greater quality in the audit market. The current reality is that, for a great many large, multi-national corporates, that choice is limited to (at most) three credible bidders (given one of the Big Four will invariably be the incumbent). Challenger firms cannot currently offer the quality of service or the coverage required to audit the largest companies. We believe that this is the dynamic which drives much of how the audit sector operates in practice, and we welcome measures to improve the quality and coverage offered by challenger firms. We do not consider that audited companies are best placed to propose how this should be achieved; nevertheless, such measures must not come at

the expense of quality or choice in the short term, and should not impose a disproportionate burden on audited companies.

We provide our more detailed comments on the CMA's proposed remedies package below.

We also note that there are various reviews of the audit market being conducted alongside the CMA's market study, namely the Independent Review of the Financial Reporting Council ("**FRC**") led by Sir John Kingman (the "**Kingman Review**") and the Brydon Review into UK audit standards. We encourage any audit market reforms resulting from these reviews to be implemented concurrently and coherently.

Part A: Issues

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

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

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

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

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

    d. **Resilience concerns; and**

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

GC100 does not intend to respond specifically to Questions 1-2. Please refer to the Overview section above for GC100's views on the issues identified in the Update Paper.

Part B: Remedies

For all remedies:

3. **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?**

In line with the current direction of travel in respect of corporate governance best practice (for example, the Wates Principles on Corporate Governance for Large Private Companies), and the suggestion in the Kingman Review that the UK definition of "public interest entity" should be expanded, GC100 considers it would be logical for the proposed remedies to apply not only to FTSE 350 companies, but also to large privately-owned companies.

In respect of consolidated groups (whether listed or privately-owned), GC100 considers that the focus of relevant proposed remedies should be on the holding company only (which is where the Audit Committee and related governance sits), and not also that company's subsidiaries.

Remedy 1: Regulatory scrutiny of Audit Committees

4. How could the regulatory scrutiny remedy be best designed to ensure that the requirements placed on Audit Committees by a regulator are concrete, measurable and able to hold Audit Committees to account? Please respond in relation to requirements both during the tender selection process and during the audit engagement.

As noted above, GC100 strongly disagrees with the CMA's suggestion that selection and oversight of auditors is insufficiently focused on audit quality. We would like to make the following key observations in this respect:

- In our experience, Audit Committees take their existing duties seriously and discharge them diligently, ensuring the interests of the company are properly protected throughout the selection process and audit engagement. In performing their duties, Audit Committees have regard to guidance issued by the regulator, as well as to global principles of best practice such as the report published by the International Organization of Securities Commissions on good practices for Audit Committees;

- We are firmly of the view that factors such as "cultural fit" and "chemistry" are more than outweighed in relevance by factors such as the degree of challenge and scrutiny the auditor is expected to demonstrate – Audit Committees adopt a rigorous and highly challenging selection process focused on auditor independence, scepticism and ability to challenge;

- In our experience, Audit Committees are closely involved in all stages of the selection process (with senior management involvement kept to the minimum necessary), and closely monitor the quality of audit work undertaken throughout the appointment (as required by FRC guidance); and

- As the CMA identifies in its Update Paper, a key issue in relation to audit scrutiny is the current lack of shareholder engagement. Increased regulatory reporting obligations for Audit Committees will not directly address this issue. GC100 notes in this respect that shareholder engagement has been examined in the Kingman Review, which has made recommendations in this regard.

Accordingly, GC100 does not consider there to be any need, at this time, to subject Audit Committees to increased reporting requirements of the type proposed by the CMA. Such additional requirements would represent an additional burden for Audit Committees with no obvious or significant benefits for the quality of audit. This view is echoed by Sir John Kingman in his letter to the Secretary of State for Business, Energy and Industrial Strategy (the "**Kingman Letter**"), in which he noted that such an approach "*would inevitably add considerable layers of process*". Kingman further cautions against imposing "*potentially pointless boilerplate 'disclosure' [exercises]*".

Finally, GC100 notes that the reporting requirements proposed by the CMA feed into the wider question of regulatory oversight, which has been examined separately in the Kingman Review. GC100 strongly believes that any new regulatory reporting obligations imposed on Audit Committees should be considered in the wider context of the regulatory changes proposed by the Kingman Review. Reforms to the regulatory framework should be considered holistically, with a view to ensuring that the revised framework is coherent and does not impose a disproportionate burden on audited companies.

For completeness (given that the CMA has at this point decided against proposing such a remedy), GC100 also would not support the replacement of Audit Committees with an independent body responsible for appointing auditors. We note in particular that:

- Audit Committees have a broad and deep understanding of the businesses and the industries in which they operate, which could not be readily replicated by an independent body;

- As noted in the Kingman Letter, Audit Committees have a much broader role in managing companies' relationships with audit firms on an ongoing basis, which could not be assumed by an independent body. Kingman concluded that there is "*no world in which audit committees could workably or sensibly be written out of the script*"; and

- As acknowledged in the Kingman Letter and the Update Paper, investors, who are the principal beneficiaries of the audit process, are strongly opposed to such a measure.

Remedy 2: Mandatory joint audit

5. What should the scope of this remedy be? Please explain your reasoning.

a. Should the requirement to have a joint audit apply to all FTSE 350 companies or potentially go wider by including large private companies?

See response above to Question 3.

b. What types of companies (if any) should be excluded from a requirement for joint audit?

While, as noted above, GC100 is supportive of the overall desire to improve the quality and coverage offered by challenger firms, it does not consider that mandatory joint audit is the appropriate mechanism to achieve this. In our experience:

- Joint audits inevitably give rise to a degree of inefficiency and duplication of work. The CMA contends that a "*well-designed joint audit framework…would not result in unnecessary duplication*", but the view of many companies with experience of joint audit (e.g. where it is mandated by certain local regulatory requirements) is that a certain amount of duplication is unavoidable – for example, even where each audit firm is responsible only for part of the overall audit, they each still need to build up a detailed understanding of the companies' processes and controls. Such duplication means increased audit fees for companies - the CMA itself acknowledges that joint audits are likely to result in an increase in audit fees of up to 20%, with some studies suggesting that fees could increase by up to 50%. Such duplication also involves a heavy drag on management time;

- Conversely, there is a real risk that issues "fall through the gaps" between the two audit firms, given each auditor will only have partial oversight of the overall audit, or may rely on the other's review of certain aspects; and

- Designing and managing a joint audit framework is not straightforward and amounts to a considerable additional burden on Audit Committees and management (for example, challenges

arise in allocating work effectively between auditors, managing audit rotations at different times, etc.).

GC100 also notes the potential implications of such a remedy for choice during the tendering process: i.e. that two audit firms may be precluded from tendering when they are subject to mandatory rotation.

6. Should one of the joint auditors be required to be a challenger firm? If so, should this be required for all companies subject to joint audit? Are there any categories of companies to which this requirement should not apply? Please explain your reasoning for each of the answers.

GC100 does not propose to respond to Question 6.

7. Should a minimum amount of work (and fee) allocated to each joint auditor be set by a regulator? If so, should the same splits apply across the FTSE 350? (please comment on the illustrative examples in section four). Please explain your reasoning.

GC100 does not propose to respond to Question 7.

8. Our provisional view is that there would be merit in the joint auditors being appointed at different times. Should this be mandated, or left to the choice of individual companies? How should companies manage (or be mandated to manage) the transition from a single auditor to joint auditors?

GC100 does not propose to respond to Question 8.

9. Should a joint liability framework be introduced to encourage active participation in the market by the Big Four and challenger firms? Please explain your reasoning. In the context of joint audits, what are the advantages or disadvantages of auditor liability being proportionate to the audit fee of the joint auditors, compared to the auditors being jointly and severally liable?

GC100 does not propose to respond to Question 9.

Remedy 2A: Market share cap

10. How could the risks associated with a market share cap, such as cherry-picking, be addressed?

While, as noted above, GC100 is supportive of the overall desire to improve the quality and coverage offered by challenger firms, GC100 does not consider that a market share cap is the appropriate mechanism to achieve this, given the implications for choice and quality this would entail. Specifically:

- As the CMA recognises in its Update Paper, a market share cap would reduce choice for some companies during the auditor selection process, where an audit firm is already at its capped limit. This reduction in competition may be felt more acutely in sectors requiring specialist expertise or particular geographic reach on the part of the auditor. As the CMA notes, a reduction of competition may, in the short term, result in higher fees and/or a reduction in quality;

- Audit quality would also suffer by virtue of companies being forced to use non-Big Four firms that lack the necessary quality and coverage to audit large companies. Moreover, the fact that Audit Committees may be compelled to appoint a firm despite concerns over its ability to fulfil the role effectively would lead to a blurring of accountabilities and responsibilities for the audit appointment;

- A market share cap may render higher risk audit clients less attractive to audit firms, with such companies accordingly finding it harder to find an auditor (either at all, or of sufficient quality and coverage to meet their more complex requirements); and

- The remedy might undermine the perceived credibility of the London Stock Exchange – major companies might move outside the UK at the holding company level to preserve audit relationships.

11. Would it need to apply only to FTSE 350 companies, or also to other large companies, and if so, which?

See response above to Question 3.

Remedy 3: Additional measures to reduce barriers for challenger firms

As noted above, GC100 welcomes the intention to improve the offering from challenger firms.

Nevertheless, several of the additional measures for supporting challenger firms on which the CMA welcomes views overlook the fundamental issue that challenger firms currently lack the quality of service and the coverage required to audit the largest companies. The introduction of a tendering fund or measures to give challenger firms access to technology will not address this key, underlying concern.

12. We welcome evidence from stakeholders on the existence of barriers to senior staff (including partners) switching quickly and smoothly between firms. We also welcome views on how justified such barriers are, bearing in mind commercial considerations that audit firms have.

GC100 does not propose to respond to Question 12.

13. We welcome estimates on the costs of setting up and running a tendering fund or equivalent subsidy scheme, and views as to how this should be designed.

As noted above, GC100 does not consider that the introduction of a tendering fund will address the key, underlying concern that challenger firms currently lack the quality of service and the coverage required to audit large companies. Moreover, GC100 notes that, in its submission to the CMA's invitation to comment, Legal & General Investment Management proposed that any such tendering fund should be funded by contributions from audited companies. GC100 is firmly of the view that it would be inappropriate and disproportionate to require audited companies to offset tendering costs for challenger firms.

14. We welcome comments as to whether the Big Four should be compelled to license their technology platforms at a reasonable cost to the challenger firms, and/or contribute resources (financial, technical, algorithms and data to enable machine learning) towards developing an open-source platform. In the first scenario, we also welcome comments on how such a 'reasonable cost' might be determined in such a way that it is affordable for challenger firms but does not disincentivise Big Four firms from innovating and developing new platforms.

GC100 does not propose to respond to Question 14.

Remedy 4: Market resilience

15. How could a resilience system be designed to prevent the Big Four becoming the Big Three, not just in the case of a sudden event, but also in the case of a gradual decline? Please also comment on our initial views to disincentivise and/or prohibit the movement of audit clients (and staff) to another Big Four firm.

GC100 is concerned that any resilience system under which a regulator could mandate that a company switches to a particular firm (or remains with a distressed audit firm) removes responsibility for auditor selection from Audit Committees, undermines directors' duties and disenfranchises shareholders. This would lead to a blurring of responsibilities and accountabilities for the audit appointment and oversight, and would not be in the best interests of companies.

As an alternative, GC100 suggests requiring clients of a distressed audit firm to discuss their options with the regulator, and to have due regard to the regulator's recommendations when making a decision on switching auditor in these circumstances.

16. How could such a system prevent moral hazard? Please comment on our initial view.

GC100 does not propose to respond to Question 16.

17. What powers would a regulator and a special administrator require, and how would their roles be divided? At what point should a regulator or a special administrator be able to exercise executive control over a distressed firm? Please comment on our initial view.

GC100 does not propose to respond to Question 17.

18. What could be done regarding the challenges relating to the fact that an audit firm's value lies in its people and clients – which would be complicated to restrict? Please comment on our initial view.

GC100 does not propose to respond to Question 18.

Remedy 5: Full structural or operational split

19. Do you agree with the view that the challenges to implement a full structural split are surmountable (especially relating to the international networks)? If not, please explain why it

would be unachievable, i.e. that the barriers to implement this remedy could never be overcome, including through a legislative process.

GC100 considers that a full structural split would entail considerable costs and challenges. In particular:

- Audit quality would inevitably suffer as a result of audit firms no longer having ready access to non-audit experts. Companies value firms' ability to draw seamlessly on high-quality non-audit expertise to support audit work;

- We strongly believe that audit-only firms would encounter considerable difficulties in recruiting the best candidates, who are more likely to want to pursue a career in a firm which offers a range of experiences and career options. Moreover, companies attach value to the ability of audit firm personnel to move between audit and non-audit teams and thereby develop an all-round understanding of the needs of clients across multiple disciplines;

- Audit-only firms would be more dependent on their large audit clients, which may result in firms being less prepared to challenge management when it would otherwise be appropriate for them to do so; and

- The global nature of audit networks makes the remedy impractical on a UK-only basis. GC100 is concerned that imposing a structural break-up of only the UK parts of these global networks might lead to greater inefficiency in the conduct of global audits.

GC100 considers that existing measures designed to manage conflicts between audit and non-audit activities are working well, and that the CMA should give these measures time to take effect properly (and for their impact to be properly assessed) before implementing new remedies in this area.

20. How could an operational split be designed so that it would be as effective as the full structural split in achieving its aims, without imposing the costs of a full structural split? In your responses, please also compare and contrast the full structural split to the operational split.

GC100 considers that audit firms themselves are best placed to comment on an operational split, and therefore does not propose to respond to Question 20.

21. With regards to the operational split, please provide comments on:

a. implementation risks and whether they are surmountable: e.g. how any defined benefit pension schemes could be separated between audit and non-audit services;

b. risks of circumvention and how they could be addressed e.g. how audit firms could circumvent the remedy through non-arm's-length transfer pricing and cost allocations;

c. implementation timescales to separate the audit firms and how soon the remedy could be brought into effect;

d. ongoing monitoring costs for the audit firms and a regulator;

e. role and competencies of a regulator in overseeing ongoing adherence to the operational split.

GC100 does not propose to respond to Question 21.

22. Under an operational split, how far, if at all, should it be possible to relax the current restrictions on non-audit services to audit clients? For example through changes to the blacklist or to the current 70% limit.

GC100 does not propose to respond to Question 22.

23. Should challenger firms be included within the scope of the structural and operational split remedies?

GC100 does not propose to respond to Question 23.

24. Which non-audit services (services other than statutory audits) should the audit practices be permitted to provide under a full structural split and operational split? Please explain your reasoning.

GC100 does not propose to respond to Question 24.

Remedy 6: Peer review

25. What should be the scope (i.e. which companies) and frequency of peer reviews, if used as a regulatory tool?

While GC100 supports the principle that there should be robust quality assurance of statutory audits by the regulator, GC100 is concerned that the CMA's proposal for peer review would introduce an additional layer of regulation, paid for by audited companies, with no significant incremental benefit.

GC100 notes in particular that the proposal would give rise to a considerable degree of overlap with the FRC's AQR procedures. The Kingman Review has made a number of recommendations aimed at strengthening AQR procedures, such that the introduction of a further layer of regulatory review at this stage, to be funded by audited companies, would be disproportionate and inefficient. As noted above, we encourage any audit market reforms resulting from these concurrent reviews to be implemented concurrently and coherently.

26. How could peer reviews be designed to best incentivise auditors to retain a high level of scepticism, and thus improve audit quality?

GC100 does not propose to respond to Question 26.

Part C: Next steps

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

GC100 does not express a view on the CMA's proposal not to make a market investigation reference.

GC100 nevertheless reiterates that any audit market reforms resulting from the CMA's market study, the Kingman Review and/or the Brydon Review should be implemented in a concurrent and coherent manner, and that the resulting regulatory framework should not impose a disproportionate burden on audited companies.

Thank you for the opportunity to share our views on the consultation. We would be happy to discuss our response in further detail should that be useful.

Yours faithfully,

Mary Mullally
Secretary, GC100