Competition and Markets Authority Statutory Audit Market Study Update Paper: Sarasin & Partners LLP submission

21st January 2019

Summary

We are supportive of many of the CMA's proposals and provide detailed comments on individual remedies in this submission. However, our overarching feedback is that, in common with the Kingman Review, the CMA's initial Update Paper does not tackle the 'elephant in the room'[1]. This is that the auditors are failing to enforce the UK's 2006 Companies Act requirements around capital protection. The audit market is following the wrong rules and therefore increased competition will not be a sufficient solution to the problem of poor audit quality. In essence, a major part of the Companies Act, which is designed to protect investors and the public from unnecessary (and foreseeable) corporate failures, is not being properly implemented.

We believe the solution to inadequate audit quality will require the following core actions (alongside steps to implementation of Sir John Kingman's recommendations):

1) **IFRS accounts should be supplemented:** There is no need to revise the International Financial Reporting Standards (IFRS). IFRS are intended to rise above national law and provide accounts that are internationally comparable. What is needed is for directors and auditors to make supplementary disclosures to satisfy the UK's Capital Maintenance regime requirements. Specifically, the profit number should be broken down between realised (in cash or near cash) and unrealised; and investors and the public should see the components of reported capital that are not distributable in line with Part 23 CA06. This should be provided at Parent and Group levels. This would deliver the UK's 'true and fair' view requirement for accounts.
2) **The Government must own the guidance for calculating distributable profits and reserves**: Currently the audit profession provides this guidance (ICAEW Tech 02/17), but it has never been formally reviewed by an independent government lawyer. We believe the ICAEW guidance is flawed. One major problem is that it treats 'accrued' income as 'realised' for the purposes of distribution. This flies in the face of common sense, as well as the purpose of our capital maintenance regime. It effectively permits distributions out of unrealised profits.
3) **The new Audit, Reporting and Governance Authority (ARGA) should enforce director and auditor duties under the Companies Act**: Key elements of the capital maintenance regime under the Act appear to be being overlooked, and this explains why the accounting and audit system has become misaligned with the law. This needs to be addressed. The regulator should enforce these requirements.
4) **The Stewardship Code needs more teeth**: A widely appreciated market failure is that of 'ownerless corporations'. This was blamed for permitting excessive risk in banks prior to the financial crisis, as well as more recent corporate failures. John Kay (2012) reviewed this problem for the Government, and the Stewardship Code was the first step to address it. It has not led to a necessary increase in the resources that investors (both asset owners and managers) are devoting to company oversight. We believe the Government should consider 1) making part or all of the Code mandatory (and move away from lighter touch 'comply or explain'), and 2) moving enforcement to a financial regulator like the FCA. It makes little sense for ARGA – which needs to view investors as its 'client' – to be responsible for their oversight. This presents a direct conflict of interest.
5) **Enhanced competition**: With the right rules in place (above), increasing competition is important. We support several of the CMA's remedies, including:
    a. More robust regulatory scrutiny of Audit Committees, with results shared with shareholders;
    b. Peer reviews commissioned by the Government, with results shared with shareholders
    c. Structural separation of audit from non-audit consulting - We believe operational separation will be cumbersome to implement, subject to gaming and continue to suffer from conflicts.
    d. Joint audit / market caps - There is a case for further analysis of these options to enhance competition, but we are not in favour of staggered joint audits, which we see as diluting the benefits of the 'fresh pair of eyes' that comes with a new auditor.

[1] The CMA does refer to this issue, and Annex C on the "Expectations Gap" does highlight the need for it to be reviewed. In our mind, the question of audit quality is central to whether competition in the market is working effectively (i.e. in the public interest), so should fall within the CMA's purview.

1. About Sarasin & Partners LLP

Sarasin and Partners LLP is a London-based investment manager serving charities, private clients and other institutions. Our goal is to deliver sustained investment returns through an active long-term investment approach, which emphasises stewardship.

2. Audit sector competition must be judged in terms of whether it improves audit quality

A lack of competition in the audit market has harmed audit quality. However, weak competition is neither the only – nor even the most important – cause of low quality audits. Audits are failing investors and the public primarily because they are not providing vital assurance that the reported capital and performance in companies is prudently calculated (including only realised – not unrealised – profits, and accounting for expected losses). Misleading accounts inevitably undermine responsible stewardship and governance of UK businesses; and they arguably played a central role in recent corporate failures as well as the banking crisis[2].

The underlying cause of failures in our audit system is, in our view, the divergence of accounting standards from the UK's capital maintenance regime. The situation is akin to the police implementing the wrong laws. Having more police (i.e. competition) will not help unless the laws are corrected.

It follows, therefore, that increasing competition in the audit market is unlikely to improve audit quality unless we also fix the accounting standards. We must examine where accounting standards have diverged from our capital maintenance regime, and fix them. We believe the solution would be straightforward: accounts should split out realised (in cash and near cash) from unrealised profits; and show undistributable reserves (including expected unrealised losses and accumulated unrealised profits) as required in s830 and s831 of the Companies Act 2006[3].

Currently, International Financial Reporting Standards (IFRS) accounts mix together realised and unrealised profits and there is no required disclosure of undistributable reserves. This is because IFRS is not intended to meet UK Company Law requirements, and does not have a goal of capital protection. Companies that follow IFRS should be required to provide supplementary disclosures to meet the legal requirement. This is not about replacing IFRS, but enhancing them.

We believe that the UK's audit market has come to this position for a range of reasons. Critically, key actors, including the audit firms, their regulator and even many investors, have lost sight of capital maintenance as a central purpose of accounts and audits. Instead, auditors have limited themselves to providing a partial service by focusing on checking company compliance with accounting standards (IFRS). They appear to have, therefore, misinterpreted the true and fair view requirement in law, and forgotten about the associated requirements to disclose distributable profits and reserves (Part 23, CA06).

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[2] The key role played by accounting and audit failures was identified by the Lord's Economic Affairs Committee (2012) and the Parliamentary Commission on Banking Standards (2013), amongst others. Kingman (2018) also highlights "In fact, the financial crisis as much reflected failings in accounting and financial reporting as anything else." (para 8).

[3] The joint investor Position Paper "Investors need to know what is real" (2017) sets out investor expectations for these disclosures. Our submissions to the CMA and Sir John Kingman, and associated attachments, also expand upon this fundamental point. Please see: http://www.sarasinandpartners.com/responsible-stewardship/policy-outreach/audit-and-accounts

And yet it is well understood by the audit industry that IFRS are not consistent with capital maintenance rules (as noted above), including a requirement to calculate distributable profits and reserves to ensure companies avoid paying illegal dividends that put the viability of the business at risk (see, for instance, the ICAEW's Briefing Paper "Implications of IFRS for Distributable Profits", 2005; and the ICAEW TECH 02/17).

Two legal opinions provided by George Bompas QC in 2013 and 2015 reiterated this core point. Bompas sets out how the failure of IFRS to align with requirements of the capital maintenance regime means that IFRS cannot be presumed to meet the statutory "true and fair" view requirement. In Bompas's (2015) words, therefore, the legal opinion by Moore QC (originally 2008, updated 2014) relied on by the FRC to allow it to conclude that IFRS can be relied on in almost all situations to deliver a true and fair view is "defective"[4].

Bompas (2015) goes on to reject the FRC legal view that "*there is no legal requirement for a company to distinguish in its balance sheet between distributable and non-distributable profits*". He states (para 19): "*The difficulty with this proposition is that it is simply not what was provided for by the Companies Act 1980, or by the replacement Companies legislation, all of which presupposes that properly prepared accounts will enable the user to determine what is distributable and what is not…*"

This is strong and unequivocal language on a serious matter.

The reasons for why the divergence between accounting standards and Company Law has not been dealt with are numerous. Whatever the cause, urgent action is needed. Steps to clarify and reassert Company Law capital protections are needed alongside steps to increase competition.

Against this backdrop, we think the CMA makes some strong recommendations. It is important, though, that the deeper problems are aired and dealt with once and for all. If they are not, the measures proposed by the CMA, as well as Sir John Kingman, are unlikely to materially improve audit quality, and ultimately corporate governance.

The CMA itself "*emphasises the importance of ensuring that the underlying causes of poor audit quality are tackled*". Yet, in relegating the key question of the purpose of audit to Appendix C in its report, it risks putting the cart before the horse. Put simply, it makes little sense to enhance competition in the audit market if we do not first establish what competition is there to achieve. Having eight firms competing to deliver the wrong service is arguably worse than four firms.

Assuming the "*strong case for reviewing the purpose and scope of audit to consider these issues holistically*" which the CMA makes in Appendix C is taken forward, we would support a number of the competition remedies proposed.

3. Comments on the remedies proposed by the CMA

A number of the proposals made by the CMA are likely to be supportive of increased quality and trust in audits. We consider each below. Of course, part of the challenge is deciding which remedies to combine together, since these are put forward as a package. We keep this in mind in our comments below.

[4] FRC true and fair interpretation and Moore Opinion can be found here: https://www.frc.org.uk/accountants/accounting-and-reporting-policy/true-and-fair-concept

Remedy 1: Regulatory scrutiny of Audit Committees

Assuming the regulator is given a clearer statutory mandate with robust management of conflicts of interest as recommended by Sir John Kingman, we are supportive of a more robust regulatory role.

Audit Committees today are inadequately scrutinised or held to account. Few are voted off company boards, and it remains rare for shareholders to seek meetings with Audit Committee directors.

Given the lack of accountability to shareholders, it is perhaps not surprising that Audit Committees are less than robust in their selection and oversight of auditors. We were alarmed to read that less than 40% of the audit tenders which the CMA reviewed included 'auditor scepticism' and 'challenge' as evaluation criteria; and that in some cases they were even considered to detract from an auditor's appeal. This is remarkable given the central importance to shareholders of professional scepticism by the auditor. It is clear that Audit Committees do not have sufficient exposure to interested and engaged shareholders to understand their requirements.

Proactive regulator to supplement and drive shareholder oversight

The challenge will be finding the appropriate scope of oversight given inevitable resource constraints at the new regulator proposed by Sir John Kingman. Investors have little interest in replacing a market failure with government failure. Arguably, we have already seen the harm this can cause with the FRC.

The ability to observe a sample of audit committee meetings and tender processes, for example as part of its Audit Quality Review process, would be a useful regulatory tool. On the other hand, requiring audit committees to report to the regulator before, during and after a tender selection process could create an administrative burden without leading to better outcomes.

In our view, the regulator should have strong supervisory powers, and be able to proactively respond where it is alerted to concerning audit tenders, especially if notified of problems by investors, competing auditors or staff.

Empower shareholders to act

The need for greater regulatory intervention comes about because shareholders have not been effective in exercising oversight over the audit process and audit committee governance. We would argue, however, that steps should be taken to empower investors to use their oversight rights more robustly.

One important obstacle to shareholder scrutiny has been that investors have little information into audit quality due to very limited disclosures and, therefore, have had to trust boards to apply the appropriate level of oversight. Unless evidence emerges to suggest audits have failed, they have assumed everything is working well.

It is therefore essential that regulatory findings are made public to shareholders, along with the rest of the results of Audit Quality Reviews. This was recommended by Sir John Kingman and, alongside the introduction of mandatory graduated audit opinions, should enable shareholders to more effectively hold management, boards and auditors to account.

We would also encourage the audit regulator to provide a public database of audit partners and firms, similar to that maintained by the PCAOB in the U.S. This would enable shareholders to more easily identify whether a partner of firm has been responsible for another audit around which there have been concerns, and use this information to engage with audit committees.

Hold shareholders to account for oversight of Audit Committees and audit
Greater scrutiny of shareholders' efforts to hold auditors and Audit Committees to account is also needed. Auditors are normally reappointed with over 98% support, and the vote tends to be treated as a rubber-stamping exercise. With the exception of SIG plc last year, it is extremely rare for an auditor's appointment to be rejected by shareholders. While shareholders require more information on audit quality, today they are not using the information they do have, whether it is on length of audit tenure, conflicts of interest, or poor performance, like the auditor missing illegal dividends in the past (e.g. at Domino's Pizza, Next or Morrisons).

The proxy agencies that provide research for investors to inform the voting process, or voting recommendations, have equally failed to devote sufficient attention and resource to this key matter. There are signs this is beginning to change with, for instance, ISS offering increasing information, e.g. on the results of the FRC's AQR for specific firms, but they are not yet feeding this into vote recommendations. More needs to be done.

Another action to ensure shareholders take on their ownership and oversight responsibilities is to set out clearer duties for the oversight of audit in the Stewardship Code, and then apply tougher scrutiny of implementation. Given the important public interest dimension to the activities of investment managers, a case can be made that the Stewardship Code should be mandatory.

As we highlighted in our submission to Sir John Kingman, we believe oversight of shareholders stewardship activity should not sit with the new audit regulator. This is because the audit regulator will treat investors as a key 'client', which would make it difficult for it to then oversee their activities. There is an inherent conflict of interest.

More involved shareholders should increase Audit Committee understanding of investors' needs when it comes to audit, and their accountability for delivering higher quality audits. Greater regulatory intervention is vital to facilitate this – through mandating more disclosure of auditors and Audit Committees and itself sharing results from its own inspections. Where Audit Committees and shareholders fail to act, the regulator should retain the ability to intervene more forcefully and directly.

Role of management in auditor selection
We are supportive of the proposal that the auditor "selection process would be a more effective driver of audit quality if the criteria applied were consistently focused on audit quality, and the participation of senior management in the process were kept to the minimum necessary for an effective selection process".

In our initial submission to the CMA, we indicated that this involvement remains excessive in many cases, leading audit committees to place undue weight on the dynamic between the auditor and executive team in managing auditor appointments and evaluation.

The need for intervention on this point is confirmed by CMA's findings that "The weight attributed to factors like 'cultural fit' and 'chemistry' calls into question whether the current tendering approach rewards auditors for being close to management, rather than providing independent challenge", as well as that "management still plays a significant role in the tender process and in advising the Audit Committee".

Remedy 2: Mandatory joint audit/ market share cap
We note the CMA's goal for joint audits/market share caps is "to increase competition without risking audit quality". In our view, increasing competition should be a means to an end, which in this case is higher audit quality, not an end in itself. So we are not entirely convinced that the Government's focus should be on measures that may not improve audit quality. Having said that, we

agree that the high level of concentration creates problems around market resilience and power (the excessive but opaque influence of the audit firms on policy have been an area of concern) that need to be addressed.

The key question, therefore, for joint audits/market share caps is whether the benefits from increased competition (which we think are likely) are offset by any reduction in audit quality. We would like to see more evidence and analysis of this question. Is it true to say that the requirement for joint audits in France has demonstrably led to better quality accounting? Has fraud been detected more frequently? Are accounts in France less aggressive?

An initial look at data from Credit Suisse's HOLT accounting quality scoring system, for instance, suggests that the quality of the 50 largest listed French companies' accounts is in fact lower on average than for UK companies. Our understanding is that academic research is broadly balanced as to the impacts of joint audit on audit quality.

We note, though, that based on CMA interviews those who have direct experience with joint audit are generally favourable to it; while those that have no direct experience with joint audit are most sceptical. This would suggest that many fears are not playing out in practice. We think these questions require further analysis.

We have a particular concern over the proposal for staggered joint audits, where the audit firms change at different times to enable a "smooth transition" (para 4.30 CMA). In this case the benefits of having a new auditor come in and check the performance of the outgoing auditor would be muted (due to the ongoing presence of the second audit firm), thereby putting at risk the goal of having a fresh pair of eyes. In many ways, the idea of a staggered audit raises similar concerns as staggered boards, which are seen as a takeover defence as they limit shareholders' ability to ensure change.

This concern aside, we remain open to steps to promote the entry of more firms, as long as it is not at the expense of audit quality. This means that these reforms would need to be part of a broader package of steps to clarify to role of the auditor in upholding capital maintenance and steps to improve transparency and accountability of auditors and Audit Committees.

Remedy 3: Additional measures to support challenger firms that we propose to consider further

The implication of this proposal is that the audit quality problem is at least partly attributable to differences in experience, skills and technology between the Big Four and smaller firms. While the CMA identifies this perception among some audit committees and investors, evidence of pervasive audit quality weakness among the Big Four (identified by the FRC's AQR results as well as the International Forum of Independent Audit Regulators) suggests it is not a sufficient explanation. As already pointed out, for us the problem of audit quality comes down to the auditor's mindset, the willingness to challenge company management and whether auditors are aligned with implementing the capital maintenance regime to underpin responsible corporate governance.

Remedy 4: Market resilience

We agree that audit provides an important public service in underpinning the integrity of markets, and there is a strong case for heightened government regulation to ensure the sector is resilient to one or more firm failing. We have no specific proposals on this matter beyond those like "living wills" suggested by the CMA.

Remedy 5: Full structural or operational split between audit and non-audit services

At the very least, we support a ban on the provision of non-audit services to audited entities as well as the imposition of a meaningful (at least 3 year) cooling-off period before non-audit services can be provided following the termination of an audit relationship (and vice versa).

On the question of an operational or structural split in firms between audit and non-audit, having reviewed the evidence collected by the CMA, we would tend to favour a structural split.

While a step in the right direction, we are cautious about the proposal for the operational separation (ring-fencing) of audit and non-audit practices primarily because we doubt that the proposal will eliminate the fundamental tension between the two business models.

We also think the practical challenges of implementing and policing an operational split will likely be significant. We would tend to agree with the comment by Grant Thornton, as quoted in the CMA report, that perceptions around conflicts would remain. Indeed, we think that real conflicts would likely persist where there was continued sharing of systems, know-how, back-office support, training etc. The firms audit and non-audit partners would continue to have shared interests.

Importantly, the ability for staff to move between the two parts would undermine the goal of creating separate cultures. According to the CMA only 1% of hours spent on an audit are currently from the non-audit partner (para 4.127(b)). This means that the problem today lies primarily with the contradictory incentives (challenge versus cooperation) of non-partners, and this would not be addressed under this proposed remedy.

Concerns identified with the structural split option also appear overstated. The CMA's analysis indicates that on average 80-90% of a FTSE 350 audit does not require input from non-audit specialists. It seems feasible that audit-only firms will be able to retain the required non-audit expertise, either procured in the market or in-house where there is sufficient demand. The key benefit of this model is the non-audit advisory work would be demonstrably intended to support a high quality audit.

The fact that the combined audit and non-audit model exists overseas, only suggests that audits abroad will suffer similar risks from conflicts of interests. It is not a reason to maintain a faulty model in the UK. This logic would result in a damaging 'race to the bottom'.

It seems feasible to us that audit-only firms in the UK could contract with or form partnerships with audit-only firms internationally where needed (law firms such as Slaughter and May could provide a model of how this might work).

The concern that audit-only firms would be insufficiently attractive to potential recruits also seems exaggerated. Based on the CMA's findings, very few audit staff seconded or permanently moved into non-audit teams at the Big Four and challenger firms during 2011-2018.

Concerns have also been raised that the possibly seasonal nature of audit work would present a greater resource challenge for audit-only firms. The CMA should investigate to what extent this reflects the reality of audit staff activity, since our impression is that work is not limited to the month or so immediately following year-end, certainly in the case of larger audits. Again, the CMA's findings that very few audit staff are seconded to non-audit practice would seem to indicate that they are sufficiently occupied within the audit business.

If it transpired that this might indeed present an obstacle to the functioning of audit-only firms, thought could be given to whether staggered financial year-end reporting could be encouraged among UK firms. We would expect this to lead to improvements in the quantity and quality of stewardship activity among UK investors, allowing more time to be spent analysing reporting and engaging with boards around AGMs, for example. It could potentially be less helpful for the purposes of comparative investment analysis, although again the CMA should investigate how important annual reports and accounts are to this process, compared to more frequent quarterly numbers and others forms of market communication.

Finally, the various concerns around financial resilience of audit-only firms fail to consider how the market will likely evolve in this scenario. If the businesses split, then new pricing models would emerge to reflect changes to their economics. If they are unprofitable, then audit fees would need to rise. If this is the cost of having a more robust and unencumbered audit, we think investors will be willing to pay.

However, we do not think fee increases are inevitable. As the CMA indicates, and this chimes with anecdotal evidence we are aware of, audit divisions are already profitable. With increased competition from challenger firms, so we would not expect substantial increases in fees. We would, though, expect higher quality audits.

Remedy 6: Peer review

Alongside steps to reinforce auditors' responsibility for implementing the capital maintenance regime as suggested under question 1, we see merit in a system of peer review.

In essence, a robust and targeted peer review could enhance (and potentially replace) the AQR process currently undertaken by the FRC. A key feature of the peer review would be an evaluation of the judgements the auditors have taken and whether the right conclusions were reached. This is a significant improvement on the AQR which concerns itself only with whether the auditor has followed correct procedures, and largely ignores whether they get the right outcome. Specifically, the peer review would ask whether the auditor correctly determine that the accounts provide a true and fair view.

We further believe a peer review is likely preferable to shared or joint audit since the reviewer would be appointed by the regulator, thereby addressing problems of conflicts of interest.

Where challenger firms are appointed as reviewers this would also help to build their expertise in larger companies, and exposure to their Audit Committees. It could also increase shareholders' awareness of challenger firms' capabilities (something not identified by the CMA), which is critical to helping to ensure shareholders are willing to vote for challenger firms, and indeed against Big 4 firms.

For shareholder knowledge to improve, however, the results of the peer review would need to be made public. Investors are hampered by a lack of transparency over audit quality, and by providing more information around the key judgements made and weaknesses with these, they would have a basis to form a view on their auditor.