Schroders

21 January 2019

Competition & Markets Authority
Victoria House
Southampton Row
London
WC1B 4AD

Dear Sir/Madam

Statutory audit services market study. Update Paper

Schroders manages or administers over £450 billion on behalf of institutional and retail investors, financial institutions and high net worth clients from around the world, invested in a broad range of asset classes across equities, fixed income, multi-asset and alternatives.

As both an investor and a FTSE 100 company, we welcome the CMA's focus on market resilience, increasing competition and focusing on the quality of reporting and specifically audit quality. We are also looking forward to collaborating with the Brydon Review on the expectations gap, which we believe is a real issue. In this regard, we reiterate our concerns over any intention to extend the auditor's scope into forward looking information, such as long-term forecasts in respect of the viability statement. It is important that investors do not have the impression that there is more certainty over projections than is, in fact, possible.

In the midst of all of this activity, it is important that we do not lose sight of the responsibilities that the Board and management teams have over the preparation of the financial results and accounts. In our experience, well run companies, with fair balanced and understandable reporting, do not generally create issues for auditors or investors.

We recognise the need to pay for a good quality audit, and, as investors, have expressed concerns in instances where the cost of audit seems too low. However, we are not supportive of measures that will increase costs without improving quality. The primary focus should be that audit committees are properly fulfilling their responsibilities to oversee the preparation of financial reports, including confirming that an appropriate control framework is in place and that they agree with any material estimates

Schroder Investment Management Limited
1 London Wall Place, London EC2Y 5AU
T +44 (0)20 7658 6000 **F** +44 (0)20 7658 6965
www.schroders.co.uk

and judgement. In addition, the focus should also be on properly fulfilling the responsibilities of audit committees to monitor audit quality, and to obtain assurance that the auditor has been appropriately challenging and robust. There is the risk that some of the proposals outlined will appear to increase competition but in reality will add cost without an increase in audit quality and in some cases, we believe could be detrimental to quality. Ultimately, these costs are borne by companies and savers.

Joint Audit

As investors, and as a listed company, we are not in favour of joint audits. In our view, the evidence is not compelling that joint or shared audits increase audit quality or grow effective challenger firms from the markets where these take place. This is largely because joint audits end up giving some small firms opportunities of a domestic nature, rather than creating firms who are able to deliver robust audit of an international scale, something that is essential given the nature of the FTSE 100 in particular. Furthermore, where the joint auditors are both Big Four firms, we do not see any evidence that this has necessarily improved audit quality that would justify the additional cost and would further restrict a company's choice where two of only four firms are required to be appointed.

There are practical issues with two audit firms signing off the accounts, including conflicting views and a lack of consistency in approach. We acknowledge the CMA's view but we remain concerned that a joint or shared audit would increase the risk of issues being missed or falling between the gaps. There is a lack of accountability for the overall assessment of the true and fair presentation of the results, the assessment of the strategic report and other aspects of the Annual Report. Liability is a concern, with joint audits liability being jointly held regardless of whether a particular party performed a weak audit; and with a shared audit, one party would always be the junior party and unlikely to increase their market share as a result. Whether there is a tripartite contract or a dual relationship for the company and its auditors, the allocation of responsibility is likely to be challenging to resolve. For example, it might be inappropriate to attribute liability based on the proportion of the fee where one firm might have performed only 10% of the audit but this was the area that drove the majority of loss.

Overall we believe that joint audits are likely to increase costs and create a drain on management and audit committee time. We do not consider this appropriate where there is no greater assurance that audit quality will improve or that competition will increase and, as we consider more likely, that audit quality may well diminish at least in the earlier years. These costs will ultimately be borne by savers, without increasing quality or choice.

Market Share Caps

We are concerned about the unintended consequences of market share caps. For example would this create conflicts in the responsibility of the audit committee, who have a responsibility to select the most suitable firm to provide a quality audit? However, due to the cap, they could be limited in their choice because of other companies filling the quota for the audit firms. The audit committee might then be forced to select a firm who they believe did not demonstrate sufficient expertise to address specific complexities within the company. However, we do accept that, if this were implemented over a reasonable timeframe, it might better achieve some of the objectives, when compared with a joint or shared audit.

Peer review

Ideally, the first line of defence should remain the Audit Quality Reporting Team (AQRT). We note that most firms have similar, real time, quality assurance processes as those proposed by the CMA but through a peer review. These processes can be challenging to manage within the same firm, particularly where new issues arise during the accounts production process. We consider that the focus should be on ensuring that these established real time processes should remain the aim. They should be enhanced where they are not delivering audit quality, rather than introducing a different but similar approach, which has additional logistical challenges, without a greater chance of achieving the required outcome. We are supportive of improving audit firm governance to examine the overall independent review processes for an individual audit, including internal to the firm quality assurance processes and the AQRT process.

We also consider that peer reviews are more self regulation and may diminish the independent drive for higher performance within the audit firms overall. If peer reviews are considered further, it is important that a full cost benefit analysis of this approach is taken and the logistical implications are considered, as well as looking at the overall independent review processes for an individual audit, including internal to the firm quality assurance processes and the AQRT process.

Audit Committee

We are concerned by the unintended consequences of regulatory oversight and that these might inappropriately override the responsibilities of the audit committee as a whole and the potential for responsibilities to be centralised to a regulatory body.

Members of the audit committee are voted on by shareholders annually to discharge important duties on their behalf. If an audit committee discharges its responsibilities effectively, which includes adhering to regulatory requirements and relevant guidance with respect to the auditors, then this should be the most appropriate body to oversee the audit. As well as being approved by shareholders, their familiarity with the company, the industry and their knowledge of where there is complexity and judgement is required to assess the auditor. These are important factors in establishing both whether the potential auditor, in a tendering process, has the necessary skills and focus, and whether the audit performance has focused on the areas that matter most in providing quality assurance on the accounts as a whole. We are concerned that a regulatory body, covering the whole population of relevant audits, would not be able to have the necessary insights that are relevant to each company and we question whether this proposal would result in better outcomes for investors.

Nevertheless, we recognise that there might be situations where an audit committee falls short of shareholder and regulatory expectations. In this regard, we believe that there might be some benefit in engaging with a central body. In particular if this resulted in feedback from that body to the audit committee on ideas or particular issues that the audit committee should focus on, whether in respect of a particular firm or in the audit process more generally. While this process is supported by regular guidance to audit committees from the Financial Reporting Council and the results of the AQRT, more might be done to support audit committees in fulfilling their responsibilities well. This process might also serve to identify where audit committee are not performing well without being onerous for all companies.

We acknowledge that more might be done to ensure that all audit committees perform to the same high standard with respect to supporting audit quality. For this reason, we can see some benefit in sharing of information with a regulator.

The requirement for there to be a member of the Board that has recent and relevant financial experience remains a relatively new concept and we believe that this should be given further time to embed before taking further action with regards to audit committee responsibilities with respect to financial reporting and the audit.

Structural

We are supportive of the largest audit firms creating some form of ring fence around audit. In particular, there should be a governance structure that focuses on the quality and delivery of audit services.

However, we remain concerned that full independence of audit and other services will create challenges. These comprise both the challenge to attract and retain specialist staff where their focus is solely on audit and the loss of experience for those specialists where they are not involved in delivery of current developments in their area of specialism that comes from non-audit services. Furthermore, if specialist services were acquired from third party firms, as auditing standards have a specific requirement for the involvement of specialists in certain circumstances, this might also create logistical issues as well as not necessarily removing the independence that the CMA is attempting to address.

We consider that the ring fence should be permeable to allow staff to work on both audit and non-audit projects and enable specialists to work on audit. However, transfer pricing should be clear and fair. This solution has the benefit of putting the responsibility for driving improvements in audit onto the audit firms themselves. We note that the audit firms have an international network structure and the CMA proposals only address the UK firm. There are clearly complexities, particularly when considering international audit clients, with implementing these structures which requires further consideration.

Within this proposal, we believe that the CMA are attempting to address both the independence of the firm and culture, both of which are assumed to impact upon audit quality, or the willingness of the auditor to not be as challenging or accept inappropriate outcomes because their own financial gain, through non-audit fees, will be affected. Whilst we acknowledge that this is a risk, we note that it is the lead auditor, the signing partner, who is responsible for the delivery of the audit and for ensuring that, on behalf of the firm, there is an appropriate standard of audit quality and challenge.

Non Audit Fees

There is a need to bring real clarity over what appropriate and inappropriate "non-audit services" might be. For example, it is typical in many industries to receive assurance reports on controls. These are most appropriately delivered by the auditor but are not required by regulation. They are, therefore included within required reporting of non-audit fees paid to auditors as a proportion of audit fees and a higher percentage of non-audit fees implies reduced independence. However, in our view, these and other similar services that are non-audit in nature are closely related to the audit and probably enhance the quality of the statutory audit, where they are performed by the company's auditor. The rules should be changed so that there are no services that could be performed that actually, or be perceived as, breaching or impairing independence. We believe the focus should be on very clearly defining non-audit services that may be performed by the company's auditor and banning any other service. Work has been performed in this area in recent years but more could be done to provide companies, and the audit firms, greater clarity and to remove inappropriate public perception of impropriety where the service is potentially enhancing quality.

We also note that if non-audit services are removed, or the audit practice, ring-fenced, an individual company's audit will become a large part of the total fees for the auditing firm. Given the CMA's, and others', concern about the influence of large fees on the independence of the auditor, we acknowledge that the proposed structural change will make the income of audit partners far more reliant on the audit of the firms from which they are required to maintain independence from, which might be a concern.

Concluding remarks

We continue to support efforts to both improve audit quality and to reduce the risk of further reductions in choice of auditor. We support the objective of increasing confidence in financial reporting through a focus on transparent reporting by companies, along with the assurance of a high quality audit.

We have some fundamental concerns with the proposals set out within the CMA's update paper and consider that further work is essential before moving forwards to implementation. We are particularly concerned by the proposal to mandate joint or shared audits.

Furthermore we see some issues in practice, particularly when considering the international nature of many public interest entities, over the fact that the CMA proposals only impact upon the UK audit firms, and wonder how this would operate given the international networks that exist within the larger firms. These are concerns that are not properly addressed within the update paper and we consider to be important to consider further before any changes are made.

Yours faithfully

Richard Keers, Chief Finance Officer

Rhian Davies, Chairman of the Audit & Risk Committee

Jessica Ground, Global Head of Stewardship