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Statutory Audit Market Study
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Dear Sir/Madam

Statutory Audit Services Market Study

The Legal & General group of companies ("Group") is a top 20 global asset manager, the UK's largest provider of individual life assurance products and a market leader in managing retirement risk for pension schemes, both in the UK and US.

In addition, Legal & General Investment Management ("LGIM"), a wholly owned subsidiary of Legal & General Group plc, is one of the largest international investors globally with over £984.8 billion of assets under management (as at 30 June 2018). LGIM manages the largest pools of assets for UK pension schemes and is a leading provider of investment solutions to asset owners globally.

This consultation from the Competition Markets Authority (CMA) is very important from both a corporate and investor perspective. We are pleased to be given the opportunity to respond to this market study and have therefore provided a joint response from both L&G Plc (corporate) and LGIM (investor) to articulate the impact of the remedies on both types of market participants. We believe these insights would be very valuable for the CMA.

The statutory audit is a key tool in underpinning the confidence of investors and therefore the effectiveness of capital markets, and we believe that the primary concern in the audit market is the need to improve audit quality. The CMA has rightly identified this as the key issue and we support this comprehensive review which has attempted to outline a broad set of measures to improve the audit market. This is important to restore trust in audit for different stakeholders, companies, investors and for the public interest.

The question of competition in the audit market is a key focus of the CMA's review, and we similarly recognise that there are currently issues that are preventing firms outside of the Big Four from gaining a foothold in the upper end of the audit market, i.e. the FTSE 100. We are supportive of the principle of increasing competition, and recognise the benefits that this would bring. However, any measures taken must focus on the need to continually improve audit quality, and should not be at the expense of that ambition, even in the short term.

More broadly the CMA has provided the market with the opportunity to openly discuss and debate ways which can support the underlying mission of increased audit quality, including greater competition, for the longer term. Therefore, careful consideration needs to be taken when looking at the proposed remedies and a proportionate approach should be taken with regulation.

We are supportive of a number of the proposed remedies both in terms of their impact on audit quality, but also as a means of improving the resilience and competitiveness of the audit market. In particular, we believe that enhanced interactions between the Audit Committee and the regulator, introduction of peer reviews, and an operational split of audit firms between audit and advisory work would all serve to improve the level of audit quality across the market.

However, there are also a number of areas of concern where we believe that there is a risk of the proposed remedy having a detrimental effect on audit quality. We remain open to these remedies, in recognition of the appetite to disrupt the current status quo in the audit market, but before they are deployed we believe further work is required to be able to demonstrably evidence a positive impact on audit quality.

It is important that the CMA or government conducts a thorough review of the remedies once tested to examine whether they achieved the underlying objective of improving audit quality. This is critical in providing confidence to the market that the proposals are working and are effective.

We hope you find our responses helpful to you in formulating remedies to improve the statutory audit services market. If you would like to have a further discussion, please do not hesitate to contact us directly.

Yours sincerely,

Philip Broadley
Chair of the Audit Committee
Legal & General Plc

Sacha Sadan
Director of Corporate Governance
Legal & General Investment Management

Appendix 1

L&G and LGIM's response to the CMA consultation on the Statutory Audit Market

1. Remedy: Regulatory scrutiny of Audit Committees

1.1. We are supportive of improving the transparency of Audit Committee activity as a means of strengthening the audit process and recognise that this could be achieved through improved and more regular interactions between the Audit Committee and the regulator.

1.2. However, we believe that the proposed level and extent of scrutiny is unnecessary, and overly burdensome both on Audit Committees and the regulator. A remedy that focuses on high quality interactions between Audit Committees and the regulator would be more effective than one which creates excessive volumes of regimented meetings and reviewing of reports.

1.3. It is important that specific regulatory requirements and obligations in this area are considered carefully and potential impacts worked through.

1.4. In our experience, the Corporate Governance Code already ensures that Audit Committees operate independently and effectively. The Board of Directors are accountable to shareholders under the current UK legal framework (Companies Act 2006 directors' duties). We consider it critical that any proposals do not create a separate supervisory process for Audit Committees (a sub-committee of the Board with delegated authority) and confuse this accountability structure (e.g. do not break up unitary Board structure by creating an isolated procedure purely for the statutory audit elements of the Audit Committee's remit). Similarly, any increase in interactions between Audit Committees and the regulator must not be obstructive in allowing Audit Committees to perform their responsibilities.

1.5. In respect of audit tenders, whilst we believe that Audit Committees should maintain the direct responsibility for choosing both the auditor and the audit partner during tendering and partner rotation (and that this is the expectation of shareholders), we support an engagement mechanism between the regulator and Audit Committees that adds a level of scrutiny to ensure appropriate prioritisation of audit selection criteria, i.e. independence and audit challenge, over fees and cultural fit. This could be achieved through issuing guidance on minimum standards, a review of audit tender materials and evidence supporting the Audit Committee's decision making process. This would be best done on an explicitly risk-based basis.

1.6. We accept that engagement between shareholders and Audit Committees could be significantly improved across the listed company market. We believe that a mechanism that provides transparency in the work undertaken by the Audit Committees and how they liaise with auditors could provide a useful tool for investors to initiate engagement with Audit Committees. In Appendix 2, we have outlined three case studies where LGIM has proactively took action in respect of a company's auditors.

1.7. Furthermore, we support the regulator being able to issue public reprimands or direct statements to shareholders, where they believe that the Audit Committees have not followed proper procedures, while taking into account the need to prevent disclosure of commercially sensitive information.

1.8. In addition to the enhanced interaction between Audit Committees and the regulator noted above, we believe that there are additional governance measures which could further deliver an optimal outcome. These measures include:

1.8.1. Nomination Committees mandating a financial expert on Audit Committees (particularly for large complex businesses);

1.8.2. Investors proactively engaging and voting on the appointment of auditors and the annual report and accounts if transparency is unclear or poor;

1.8.3. Large firms not fully outsourcing internal audits to third parties, although recognising that co-sourcing arrangements can be necessary and beneficial in some circumstances, particularly in large complex companies when specific technical expertise is needed to support internal audit; and

1.8.4. Extending the current external board evaluation to include a more comprehensive review of Audit Committee meetings and the level of debate and scrutiny of auditors. A report is sent to the Chairman for the whole board to review and be satisfied with the level of audit quality (note, this process does not analyse the 'opinion' of the audit but the process undertaken).

1.9. Overall, we believe that a combination of good market practice and proportionate regulation would result in stronger accountability structures in the audit market.

2. Remedy: Mandatory joint audit

2.1. We recognise that there is a reliance within the FTSE 350, and particularly within the FTSE 100, on the Big Four audit firms to provide statutory audit services, and that there are currently a number of impediments preventing 'challenger' firms from gaining a foothold in that market. From a pure competition standpoint, a change in the status quo is desirable. Furthermore, we accept that by improving the competitiveness in the audit market, and thereby allowing a larger number of firms to compete for those audits, there is the possibility that this could lead to an overall improvement in audit quality.

2.2. However, any change to the existing market dynamic needs to ensure that there is no detrimental impact on audit quality, particularly in the short term. Therefore, we support further studies and testing in this area, including drawing on the experience of other markets such as France and South Africa (looking at both the domestic and international operating entities), and the option of running pilots on certain parts of the audit market (e.g. the lower end of the FTSE 350), to provide more robust and extensive evidence in this area.

2.3. Possible risks in relation to joint audits include the following:

2.3.1. Confusion and lack of clarity over the accountability of the auditors to Audit Committees and investors;

2.3.2. Poor co-ordination and oversight introducing an element of risk in a company's audit process, including potential delays in the company's reporting;

2.3.3. The likelihood of fees increasing without a clear corresponding demonstration of audit quality improvement;

2.3.4. The ability of challenger firms to attract the depth of capability across their firms to support the increase and complexity of the audit process (in an open market where normal economics apply, larger firms will draw the higher quality people and be able to offer larger rewards); and

2.3.5. The possible outcome in terms of market structure that one party would always prefer to be, or would be designated as, the junior party and unlikely to increase their market share as a result.

2.4. At the same time, we also recognise that there are a number of potential benefits that could arise from a successful implementation of joint audits. These include the following:

2.4.1. Better quality and oversight of an auditor's work given the criss-cross review of each other's work by the two audit firms (this would require very specific operating guidance);

2.4.2. More effective and robust challenge of management's judgements and assumptions in the preparation of the statutory accounts from if it is coming from two audit firms rather than one;

2.4.3. Through staggered rotation of audit firms, a corporate would benefit from both continuity and a fresh pair of eyes during the change of auditors (although an element of this could be achieved through changes in how current rotation requirements are met); and

2.4.4. An overall increase in audit market standards given the competitive tension to conduct a good quality audit (noting that there is already a level of tension in the existing market).

2.5. We believe that, in order for these desired outcomes to be achieved, the CMA needs to consider at least four other market developments that need to occur:

2.5.1.A professional standard needs to be developed which outlines principles that govern how joint audits will be organised and conducted (similar to norme d'exercice professionnelle - NEP 100 - standards in France, the new audit regulator should develop this) and limits should be set on how much audit coverage, in relation to the total balance sheet and income statement, can be undertaken by one firm in order to balance the process;

2.5.2. Transparency needs to be improved for investors of how joint audits are conducted (e.g. a summary of the audit planning process involving both auditors, and signed off by the Audit Committee, should be made public);

2.5.3. A staggered approach in audit rotation (covering audit firm, lead partner and team) needs to be taken to retain the benefits of a consistency as well as a fresh pair of eyes; and

2.5.4. Changes in the application of the current mandatory rotation rules to ensure that choice isn't being adversely impacted, i.e. having to replace two firms with a different two firms, particularly on large, complex, global audits could lead to adverse outcomes.

2.6. It is important to examine the length of time that would be required to successfully implement these developments in an effective and non-market disruptive manner, and a balanced mind-set should be taken alongside consideration of other remedies, to examine what could be achieved faster and with a higher likelihood of improving audit quality (e.g. peer review).

2.7. We understand the need to change the status quo but the market should be demonstrably and convincingly shown the merits of joint audits before these are stipulated more broadly. This way the market will get the chance to better understand the merits and difficulties in its implementation before it becomes widespread.

2A Remedy: Market share cap

2A.1 While we recognise the potential effectiveness of this remedy in opening up the audit market to challenger firms, we are not supportive of it as a means of improving audit quality, and indeed consider that it is more likely to have an adverse impact.

2A.2 We believe the proposal would be difficult to work in practice given the complex and numerous factors that would need to be considered in applying a cap (e.g. sector, skills and industry experience, global reach). There is a notable risk of the introduction of a market share cap driving anti-competitive behaviour.

2A.3 More importantly, during the initial period in which the proposed cap is introduced, we believe there is a high likelihood that audit quality would be adversely impacted, particularly as a result of an inexperienced and inadequately resourced firm taking on a larger and more complex audit. Similarly, Audit Committees may be restricted in the choice of audit firm, partially as a result of the industry 'gaming' the market (e.g. increasing fees, resigning from audits, etc.).

2A.4 The CMA has stated that the proposal would be a "temporary" modification to the structure of the market. Whilst the barriers for challenger firms would be reduced in the short term (a minimum of 10 years), it does not guarantee that audit firms outside the Big Four would be able to compete in the long term.

3. Remedy: Additional measures to support challenger firms

3.1 We support market mechanisms which would allow challenger firms the opportunity to compete on a more even playing field, rather than imposing caps and limitations such as the proposal in relation to non-compete clauses.

3.2 We acknowledge the CMA's comments on an audit tendering fund, and we continue to believe a market mechanism such as this one could be effective to stimulate competition in the audit market, while noting that how any fund is levied requires careful consideration.

3.3 We support the sharing of technology and open licensing of systems for audit services as this enables challenger firms to gain efficiencies and therefore compete against larger audit firms. However, this needs to be done in such a way as to avoid the risk that the larger firms reduce investment in further developments, if it makes such activity uneconomical.

3.4 Whilst the CMA is not provisionally making recommendations on the measures noted in 3.2 and 3.3 above, we would encourage the regulator to promote them in the industry to allow challenger firms to have funding to participate in audit tenders and have access to better systems and processes to run large audits.

4. Remedy: Market resilience

4.1 We are supportive of measures which introduce safeguards against the risk of one of the Big Four audit firms exiting the market, leading to a Big Three and the limitations in choice which that would bring.

4.2 We believe it will be appropriate for the new regulator to examine this issue further given its recommended duties to promote competition, innovation and apply proportionality to all its work.

4.3 We have previously highlighted that in terms of access to capital, partnership structures do not have the same access to capital as other corporate structures. Rather, their capital comes from the appointment of new partners and members, long term loans and other banking facilities. Furthermore, partnership profit distribution structures encourage a short term focus on annual profits as they are paid out in cash annually. Due to the distribution structure, partners are deterred from committing funds to long term investment in their respective audit firms as they would rather receive a return from their investment over the short term. Therefore, partners invest their own human capital in to the firm and rely on the performance of the audit firm as a whole for their remuneration. We believe this could impact the resilience of audit firms when experiencing a large shock in the market as partners may not have the resources to be able to commit capital to future investments where banking facilities and other funding sources may not be available. (Note that proposition of an operational split as part of remedy 5 would alleviate concerns in this area.)

4.4 On the basis that the majority of audit firms operate globally, we also think it is necessary to examine the international impact of these proposals. If not considered, this could damage the market as a whole and have unintended consequences. For example, the collapse of Arthur Andersen was less due to financial pressures than their exclusion from the US listed market.

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

5.1 We share the CMA's concerns that the current structural set-up of the audit firms creates a culture and incentivisation that is not conducive to a relentless and singular focus on audit quality. However, we take the view that an operational split is more desirable than a full structural split. We have outlined what we see as the disadvantages of a full structural split below:

5.1.1 There is a risk of lowering audit quality through the loss of talent and supporting resources from the audit services firm. We have reservations about the ability of pure audit firms to attract and retain the best talent and it is critical that audits retain access to subject matter expertise (e.g. valuation, IT or actuarial) that isn't restricted to pure audit activity.

5.1.2 This remedy cannot be viewed in isolation in the UK and needs to have international reach to be effective. An adverse consequence of a structural split purely in the UK would be that international networks that currently operate in the UK may break-away from audit-only firms impacting the effectiveness of the market as a whole.

5.1.3 There is a risk that the Big Four may retain their dominance for an extended period regardless of the structural split as the new audit services firm would no longer be precluded from participating in audit tenders on the basis of the non-audit services they provide.

5.2 Given the issues with a full structural split, we believe a ring-fencing operational structure is more appropriate. Ring-fencing requires audit firms to separate the assurance side of the business from the rest of the advisory services provided by the auditor. Such a structure aims to protect and enhance audit quality within the audit firm by placing it at the core of their function. There are a number of factors that need to be examined in detail for this proposal to be successful, which include, but are not limited to the following:

5.2.1 <u>Oversight and governance</u>

5.2.1.1 A strong independent governance framework within each firm to oversee the critical function of audit is essential to create and maintain high standards of audit quality. Within a ring-fenced regime for auditors, different governance structures need to be developed for the operational structures of audit and non-audit services.

5.2.1.2 The role of independent non-executives (INEs) ought to be further strengthened and made compulsory within the audit/assurance function of audit firms. Currently, the governance oversight being provided by the INE is voluntarily applied through the Audit Governance Code;

5.2.1.3 The primary purpose of INEs should be clearly defined as "having oversight of audit quality";

5.2.1.4 INEs should also be responsible for whistleblowing procedures and its governance within an audit firm. Cases of whistleblowing ought to be reported directly to the INEs. As part of this INEs should have unrestricted access to investigate any wrong-doing;

5.2.1.5 INEs should have oversight of the compensation structures of senior management within the audit firm and profit sharing amongst the partners;

5.2.1.6 Lastly, INEs should have a regular and direct line to the audit regulator to discuss any matters which it feels appropriate.

5.2.2 <u>Service agreements</u>

5.2.2.1 The ring-fencing structure would require the implementation of an overarching service agreement at a firm level to explain how the advisory (non-audit) and assurance (audit) functions of the auditor will work together to share knowledge, information and specialist resource (i.e. from advisory to audit, not vice-versa). This service agreement should be signed off by the INEs of the audit firm;

5.2.2.2 For example, a principle clause may include the sharing of information and people only if it can be guaranteed that there is no risk in impeding audit quality;

5.2.2.3 Furthermore, additional safeguards can be outlined such as requiring Audit Committee approval for sensitive matters and/or clearly outlining where no overlap should occur;

5.2.2.4 A summary of the agreement should be made publicly available for transparency purposes;

5.2.2.5 Lastly, a written letter should be sent from the Audit Committee to the regulator outlining the structures that have been put in place to ensure that they have satisfied themselves that the assurance function is not influenced by the advisory services function if the same firm provides both services;

5.2.2.6 Further transparency can also be provided by listing where appointed audit partners to a company have previously provided non-audit services to the company. This level of detail will highlight where conflicts may occur with the work of the auditor.

5.2.3 <u>Audit partner remuneration and profit distribution</u>

5.2.3.1 Audit partner remuneration should be primarily based on the profit pool generated from the audit business only. This would emphasise the importance of partner remuneration being driven by audit performance;

5.2.3.2 A ring-fenced structure ensures that profit generated by the assurance function will solely be for the benefit and future investment in audit services; and that partners and senior employees should be protected from the commercial interests of advisory services and therefore can operate without dealing with conflicts arising from such services;

5.2.3.3 Overall profit distribution would need to be structured in such a way as to protect against the risk of losing a substantial number of audit partners with broad skill sets to advisory work. There would potentially need to be some cross-compensation to recognise that most firms originated as audit firms before developing advisory capacity over time;

5.2.3.4 Aligning the incentive structures of senior management across the audit and non-audit functions and profit distribution to partners within the audit section of the firms to the interests of long-term investors will further support the right culture in the audit market and improve accountability.

5.2.3.5 We believe some element of remuneration (both senior staff and partners) should be deferred over multiple years.

5.2.3.6 In addition, malus and clawback provisions should be established to provide a mechanism in which payments can be claimed back from senior management and partners.

5.2.4 Audit/non-audit fees

5.2.4.1 Non-audit related services provided to audit clients of a firm should not exceed 50% of the value of the audit services in any given year. We do not believe this is onerous and note that all of the Big Four firms have committed to not provide any non-audit services.

5.2.4.2 Alternatively, a monetary maximum cap could be introduced on the fees paid for non-audit services, where the audit fee is likely to be small relative to the normal annual level of advisory services purchased by the organisation.

6. Remedy: Peer Review

6.1. We support the introduction of a peer review regime and, as long as it is appropriately structured, we believe that it could be an effective method of improving audit quality.

6.2. For the peer review to be effective, the regulator should ensure that it provides sufficient clarity to the market of the scope and breadth of the reviewer's role and should not inhibit a corporate's ability to meet its reporting timelines.

6.3. In addition, the regulator would need to ensure that the peer review does not set out alternative views on the audit opinion of accounts or areas of significant judgement. It should only look at the process and governance arrangements around audit activity, and evaluate the quality of the execution of the audit.

6.4. From a market perspective, we would like to see an improved and faster (e.g. real time) "feedback mechanism" to share best practice and concerns across the market, in order that they are raised in a consistent manner and addressed in a pro-active way.

6.5. Therefore, it is important that the skills and experience of the reviewers are appropriate and un-conflicted to conduct the task. We would support former audit partners (and appropriately experienced former senior audit personnel) to carry out the reviews as they will have the necessary expertise to carry out the objective.

Appendix 2

Case Studies from LGIM:

CASE STUDY 1 – Royal Dutch Shell ('Shell')

FTSE 100
Sector: Oil and Gas
AGM date: 24th May 2016

What is the issue?
Following the announcement of the recommended combination with BG Group in early April, an assessment of the potential consequences for the outcome of the external audit tender was performed. EY has served as auditor for BG Group since 2013 and the EY lead partner for BG Group at the time of the announcement of the transaction was also the proposed lead partner for Shell.

Why is it an issue?
LGIM believed a conflict existed with the lead audit partner. For example, if it was found that audit quality was poor at BG Group, it would be hard for investors to rely on EY to take an objective approach to analysing the accounts they audited themselves. Therefore, it is important that the auditor is considered independent to ensure audit quality is maintained through and post the transaction.

What did LGIM do?
LGIM engaged with the company on this issue and also noted the company's announcement regarding how potential conflicts will be mitigated.

Despite these disclosures and given the size of the transaction of the Shell/BG Group merger, at the company's AGM, LGIM voted against the appointment of EY as Shell's auditor because of concerns with the appointment of the lead audit partner who was also involved with BG Group.

What was the outcome?
Although the resolution was passed at the AGM, LGIM continues to monitor audit quality at the company.

CASE STUDY 2 – BT Group Plc

FTSE 100
Sector: Telecoms
AGM date: 12th July 2017

What is the issue?
At the start of the year, the company announced a profit warning connected to an accounting scandal at the company's Italian business. Write-downs of approximately £530m were disclosed by the company after concerns were raised by a whistle-blower.

This resulted in over a fifth of the company's value being wiped off the stock market.

Why is it an issue?
Limited oversight of management over global businesses, lack of appropriate internal controls and poor audit processes carried out by the company's auditor, PwC, are all factors that could have contributed to this event.

What did LGIM do?
Following the profit warning, LGIM engaged with the Board Chairman and Chairman of the Audit Committee regarding the incident. The Company informed LGIM that an investigation was being carried out and sought to reassure investors that this was an isolated incident.

In addition, in previous meetings with the Chairman, LGIM encouraged the company to change its long-serving auditors, PwC, who have been in place for 33 years. Following the accounting issue, we encouraged this process to be sped up given that the company has already completed its tender process and ready to appoint KPMG as their new auditors. We also wanted assurance that internal controls and audit processes were strengthened.

Lastly, LGIM highlighted bonus outcomes for Executive Directors this year should take into account the material impact on shareholder value as a result of the Italian scandal.
At the company's AGM in July, LGIM opposed the Annual Report and Accounts and re-election of PwC because of the failure of internal controls linked to the accounting irregularities at BT Italy and the fraud was not uncovered by the auditor.

What was the outcome?
During the year, BT confirmed the appointment of KPMG as its new auditor to replace PwC in the wake of the fraud scandal in Italy. Furthermore, PwC is being investigated by the UK's accounting watchdog, the Financial Reporting Council, in relation to accounting issues in BT's Italian operations.

In terms of remuneration, no bonuses were paid out during the year. The company disclosed that the CEOs total pay has been reduced by approximately £4m as a result of the profit warning connected with the Italian fraud case. Furthermore, the Remuneration Committee exercised its discretion, revising bonus pay-outs and applying clawback and malus provisions in the Deferred Bonus Plan for both Executive Directors and other senior management who sit on the Operating Committee.

Going forward, we will engage with the new Board Chairman to discuss the company's current performance and its future strategic direction.

<u>CASE STUDY 3</u> – Vodafone Group Plc

FTSE 100
Sector: Telecoms
AGM date: 28th July 2017

What is the issue?
LGIM were engaging on a conflict that we believe exists with the external auditors of Vodafone. Auditors should seek to maintain the highest standards of independence, and we believe that they ought to have appropriate processes to reduce the potential for real or perceived conflicts to

develop over other commercial opportunities.

Why is it an issue?
PricewaterhouseCoopers (PwC) has been the external auditor of Vodafone since 2014. After accepting the appointment as Vodafone's auditors, PwC also accepted a role as the administrators to Phones4U. The Phones4U founder has accused Vodafone and other phone companies of colluding to pull contracts from Phones4U, leading to its collapse in 2014. In 2016, PwC informed the board of Vodafone that it may have to pursue legal action against the company in relation to Phones4U.

We believe this causes a conflict between PwC and its responsibilities to both Vodafone and Phones4U.

What did LGIM do?
During the year we engaged with PwC and the Audit Committee of Vodafone on this issue. This led us to vote against PwC's reappointment as auditor at the 2017 AGM of Vodafone.

We also escalated the issue to the UK's Financial Reporting Council, the UK's audit regulator.

What was the outcome?
The engagement has resulted in us reviewing all of the large audit firms' conflicts of interest processes, in order to identify and promote current best practice.