16 January 2019

Statutory Audit Market Study
Competition and Markets Authority
7th Floor
Victoria House
37 Southampton Row
London, WC1B 4AD

By email: statutoryauditmarket@cma.gov.uk

Dear Sir/Madam,

CMA Statutory Audit Services Market Study – Response to Update Paper

We welcome the opportunity to engage with the CMA in its review of the effectiveness of the statutory audit market.

Smiths Group plc ("Smiths") is a global technology FTSE100 company listed on the London Stock Exchange. Smiths employs 22,000 people located in over 50 countries and is a world leader in the practical application of advanced technologies. Smiths delivers products and services for the threat and contraband detection, energy, medical devices, communications and engineered components markets worldwide. We serve a diverse range of global customers including governments and their agencies, petrochemical companies, hospitals, telecommunications companies and manufacturers in a variety of sectors. Greater than 95% of the Group’s revenues originate outside the UK. Our auditors play a key role in ensuring we are able to provide our investors and other key stakeholders (including our regulators) with accurate financial information.

As a Group listed on the London Stock Exchange, Smiths is subject to the UK Corporate Governance Code and the obligations in respect of audit committees and their oversight of the external auditor. Smiths’ Audit Committee takes this role very seriously. Smiths has recently undertaken an external audit tender process which resulted in a recommendation to rotate the incumbent audit firm (who were not invited to tender due to the requirement to replace them). During the tender process, the Audit Committee considered a number of the matters detailed in your Update Paper. Principally:

1) Challenger firms – the external auditor whom Smiths chooses needs a global footprint that matches our own, with sufficient breadth and depth of expertise. There are very few audit firms globally that can meet our requirements. The challenger firms Smiths approached requested not to be invited to participate in the tender as they could not meet our requirements.

2) Big Four rotation and independence – as the incumbent firm was prevented from participating in the tender this left the remaining Big Three as tender participants. As each firm provided non-audit services to Smiths the intention to tender was communicated sufficiently far in advance that all non-audit services provided by each firm could be identified and monitored. Where necessary, plans for tendering those non-permitted services could be implemented should the successful firm be required
to exit existing non-audit engagements. We acknowledge this can cause disruption for management but in our view the audit engagement should always take precedence and the issues posed by the need to re-house non-audit services are not insurmountable. Indeed the successful firm was selected notwithstanding the fact they performed more non-audit services than the other tender participants, and after the Audit Committee had sought additional assurance on quality and that AQR findings where being properly addressed.

We note that the CMA has identified concerns about audit quality which require remedies. However, we are concerned that none of the remedies seek to address the ‘expectation-gap’ about what an audit should cover, and some remedies may not deliver the intended solution, or may indeed have unintended consequences.

There is significant concern that the structure of the UK audit environment may be changed in isolation to other jurisdictional regimes such as the US and Europe thereby creating complexity and inefficiency in the global audit process and for UK listed companies compared to their peers based overseas. Any remedies must therefore be consistent with or facilitate the approach taken by other regulatory bodies and must not act to make the UK a less attractive place for investment or to do business.

In response to the proposed remedies outlined in your Update Paper:

**Remedy One: Regulatory Scrutiny of Audit Committee**

A mechanism already exists for the regulator to have oversight of a tender process. In line with EU regulation companies which undertake an audit tender are required to produce a statutory report on the process which is, if requested, required to be delivered to the Competent Authority (the FRC). There is nothing to stop the FRC from issuing statements at present.

We are against setting up a regulatory structure to oversee audit committees on the grounds of cost and complexity. We have had no significant audit issues to justify this approach and don’t believe this will meaningfully enhance the operation of audit committees’ oversight of the quality of audit firms. Regulatory attendance at meetings is unlikely to significantly enhance the monitoring of audit quality by the audit committee. There is very little incentive for audit firms to perform a low quality audit – quite the opposite due to the liability and personal and firm-wide reputational risk involved.

There is already a requirement in the UK Corporate Governance Code for companies to explain in the annual report how the audit committee has monitored the audit firm’s independence, objectivity and effectiveness i.e. quality, throughout the period. These disclosures could be enhanced to provide better transparency but fundamentally, we do not believe that the regulator should seek to intervene in this way in the relationship between the Audit Committee and the persons to whom that Committee ultimately report and are responsible to, the shareholders.

**Remedy Two: Mandatory Joint Audit / Market Share Cap**

We agree that auditors must be properly incentivised to deliver robust audit opinions and that reducing barriers to entry and increasing competition is desirable. However, we also agree with the opposition comments to a joint audit outlined in paragraph 4.41 of your report and are therefore unsupportive of the idea of joint or shared audits. Joint or shared audits will reduce efficiency, raise costs and lead to potential conflict and diminution of consistent standards. If a joint or shared model is recommended then one of the firms engaged must be a challenger firm. We also agree with the staggered approach to minimise disruption but that the timing of appointments should be the company’s choice.
There is a possibility that a joint or shared model may not enhance the experience of challenger firms due to the proportion of revenue which large UK listed groups derive from overseas operations which the challenger firms may not be able to service. Therefore the Big Four audit firm will likely always be the lead firm and the incentive for challenger firms will diminish.

The global footprint of companies and challenger firms may also prevent challenger firms from achieving any mandated level of audit fees from being achieved if the available challenger firms don’t have the requisite skills or experience in the necessary jurisdictions to meet a fee threshold. Therefore it is not clear that a joint or shared model will improve audit quality. The unintended consequence of a reduction in choice for non-audit services should also be evaluated.

Market share caps are a potentially better route for challenger firms to gain experience as they could accelerate the transition of resource and experience to challenger firms, but this would require further thought. Your evidence clearly highlights the skew of audit fees toward the upper end of the FTSE with a long tail of smaller engagements. It is inevitable that initially challenger firms will perform the audit for smaller FTSE350 clients and will therefore be unlikely to make meaningful inroads into the audit market as determined by fee. Consequently any improvement in competition and audit quality for larger FTSE companies won’t occur in the short term.

The likelihood of firms cherry picking the most attractive audit clients, as described in your paper, would to some extent be addressed naturally through the timing of tenders and the availability and experience of audit partners. Audit quality at smaller companies may initially be at risk from greater participation of challenger firms, reflecting their poorer AQR scores and relative lack of resource.

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

We agree in principle that employment terms should not restrict movement but due to the length of audit engagements and partner independence/rotation rules it is hard to see how non-compete clauses would prevent movement to challenger firms in any event. Measures to facilitate the use of technology transfer should be explored, though as this is one of the principal means of differentiation for each firm this may prove contentious.

Remedy Four: Market Resilience

Having a viable and reputable audit firm is essential for listed companies. However, the resilience of each firm is primarily an issue for the firm, its owners and the audit industry more broadly. Any remedy should equally apply to challenger firms, particularly if a joint or shared audit approach is pursued.

Any restriction of employee movement between firms in the event of a firm failing or even losing market share prior to failure would need to be investigated carefully and be consistent with employment law.

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

Whilst Smiths non-audit spend with the external audit firm as a percentage of the audit fee is low at 5% (FY2017: 8%) we welcome recent statements from some Big Four firms that they will no longer provide non-audit services for audit clients. If this approach is adopted by the whole audit industry it will significantly reduce the level of non-audit spend by audit clients with audit firms thereby reducing the perception that cross-selling in itself prevents audit
challenge and scepticism. In which case this remedy would be unnecessary. Any split should only be undertaken once evidence from this new approach has been evaluated meaningfully.

We note the potential that other Big Three firms will step-in and provide certain of those non-audit services which will no longer be provided by the audit firm, thereby exacerbating the complexity of unwinding non-audit engagements at the time of audit rotation as detailed above and in your report. However, it is possible that challenger firms will also be engaged for some non-audit services and this should be encouraged. This may then increase the breadth and depth of experience of large listed groups at the challenger firms and potentially their ability to tender successfully for audit engagements.

A full structural split between audit and non-audit services would be the cleaner option, but this could more easily be achieved through an operational split, albeit the issue of perception would remain. If non-audit services are to be separated, it should be done without impacting the resilience and long-term sustainability of the audit services provider. This could result in a significant increase in fees without a commensurate improvement in quality.

The CMA should consult with the Prudential Regulation Authority on its experience of the retail banking ring-fencing regime before proceeding with any recommendation to split the audit firms.

Given the increasing level of non-audit services provided by challenger firms any split should apply to those firms also.

Remedy Six: Peer review

As for Remedy One, we would be against peer reviews appointed by the regulator on the same grounds. All major audit firms already have internal peer review mechanisms and as stated above there is little incentive for firms or audit partners to perform low quality audits.

If the principal aim of the study is to enhance audit quality and thereby protect broader stakeholders (beyond shareholders) then all remedies should apply to PIEs and non-listed private groups above a certain size and also to challenger firms outside the Big Four.

I would be very happy to meet with the CMA to discuss any of the points raised in this letter.

Yours faithfully,

Mark Seligman
Non-executive Director and Audit Committee Chair