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MARKET STUDY ON STATUTORY AUDIT SERVICES

Initial consultation on recommendations by the Competition and Markets Authority

We are writing to you on behalf of the UK Shareholders' Association (UKSA) and the UK Individual Shareholders' Society (ShareSoc). Although we are currently separate organisations, we work closely together to represent the interests of private shareholders.

We have responded to the specific questions raised in the consultation below. Before moving on to these there are a few important and overarching issues which we believe need to be stated:

a) **Limitations of the CMA's remit;** the CMA was tasked with looking at the audit market and, in particular, considering ways of addressing deficiencies in current levels of market competition. The CMA has done this and has done it well. However, there is a risk in all this of losing sight of the main reason why audit has come under fire. The key requirement is for better standards of audit following the recent disasters of Carillion, Conviviality, Patisserie Valerie and others. A more competitive audit market should certainly over the long term help to ensure better audit quality. Whilst it is unsatisfactory that 97% of the FTSE 100 market is concentrated in the hands of the Big Four, some of the proposed mechanisms for achieving more competition, such as joint audits, pose potential threats to ensuring a high quality, coherent and seamless audit that provides investors with the assurance they want and need. In short, they may help to achieve more competition between audit providers but, in doing so, potentially jeopardise the main objective of achieving better audit quality, at least in the short term.

b) **Auditor appointment – an alternative approach to market management;** the suggestion made by Sir John Kingman that auditors should be appointed by a third party (probably the new regulator) we believe is a much better way forward. It avoids the potential complexities of trying to reshape the market using joint audits with the risks and uncertainties that this

could involve. It has the potential to put a team of experts in charge of audit tendering and auditor appointment for FTSE 350 companies as well as creating appropriate mechanisms for audit market management. It also avoids the waste of getting every FTSE 350 company to run its own tendering process – a process which could be greatly enhanced with a team of specialists doing the work. Furthermore, it removes the potential conflicts of interest that are inherent in the current system. Clearly, it would be inappropriate for the regulator to perform this function working in isolation. It will need to work closely with, say, a stakeholder panel or steering group consisting of representatives from shareholder groups, FTSE 350 companies and, possibly, other groups. Shareholders would still have an ultimate right of veto over the appointment of a specific auditor.
The objections to Sir John Kingman's proposal, primarily by the Investment Association (IA) and its members, we believe are entirely without merit or justification. Shareholders have not played any meaningful role in the appointment of auditors for at least the last fifty years. The notion that shareholders currently appoint the auditor is a sham, as the vote on the reappointment of the auditors at the AGM is invariably a formality and a foregone conclusion.

c) **A mechanism for holding auditors to account;** there is a real need for auditors and audit committees to be held to account by shareholders. At present there is no effective mechanism for ensuring that this can happen. We believe that the AGM should be in two parts:
    - Part 1: the normal business of the meeting, as at present
    - Part 2: a meeting between shareholders on the one hand and the auditors and members of the audit committee on the other.

    The detail of how this would work is discussed in our response to Question 1 below.

d) **The Big Four audit firms are effectively owned by their consultancy businesses.** Some 75% of their income is from consultancy and we do not know what percentage of their profits, but we suspect it is more than 75%. Inevitably the power in the Big Four firms will therefore lie with the consultancy partners. Cultural norms tend to be driven by the consultancy business. This has not turned out to be good for the world of audit. It is a strong argument for the separation of audit and consultancy into separate firms.

None of the comments we have made in our response to this consultation is confidential. The Department is free to publish them as it wishes. We would also be pleased to discuss any aspect of our submission in more detail with the Department if this would be helpful.

Response to the consultation questions

1. **Do you agree that the new regulator should be given broad powers to mandate standards for the appointment and oversight of auditors, to monitor compliance and take remedial action? What should those powers look like and how do you think those powers would sit with the proposals in Sir John Kingman's review of the Financial Reporting Council?**

The CMA's investigation into auditor appointment suggests that the process leaves much to be desired. It indicates that while audit procurement has a veneer of rigour it falls well short of being professional. For example, although sound criteria are used for assessing tenders from auditors, the weighting of key criteria, such as price, are unclear. It also seems that there is often significant intervention or involvement in the process on the part of the executive directors (including the CFO). This represents a very clear conflict of interests. Coupled with this, there is an almost total lack of input on the part of investors and other key stakeholders.

We are supportive, therefore, of the CMA's view that there should be greater regulatory scrutiny of auditor appointment and management. The requirement that audit committees should report directly to the regulator before, during and after a tender selection process and that the audit committee should report regularly to the regulator throughout the audit engagement may sound draconian. However, **the time is past for fiddling around the periphery** while basically maintaining the status quo. We believe that the CMA's proposals merit serious consideration. **The Siren voices of vested interests arguing for limited change should be dismissed.**

We believe that, in addition to the proposals made by the CMA for closer regulatory oversight of the appointment and management of auditors, there are opportunities to encourage greater oversight by shareholders of the appointment and work of external auditors. We believe that action is needed to ensure that auditors and audit committees are held to account by shareholders. The AGM as it currently stands, is no longer an appropriate forum for allowing investors to raise detailed reporting and audit issues and receive meaningful answers.

We suggest that the AGM should be split into two parts. The first part would deal with the normal business of the AGM. The second part would be a meeting between shareholders on the one hand and the auditors and members of the audit committee on the other. We believe the AGM is the right forum for this questioning. We note that currently many fund managers do not bother to attend AGMs and may prefer a separate meeting with the audit committee. We believe their will be real benefit in fund managers gaining a better understanding of accounting issues and participating in these meetings. It will have the related benefit of making AGMs more useful events. The executive directors, except for the Finance Director / CFO, should probably not be present. Issues covered should include:

- The programme of work of the external auditor;
- Particular aspects of the company's accounting and controls that the auditor has investigated, why and what they found;
- Issues that the audit committee has asked the auditor to look at, why and the conclusions reached;
- Adjustments to the accounts – what were they, how significant were they, what was finally agreed and why?
- The amount of time spent on the contract by the audit partner responsible;
- The programme of work agreed for the internal audit team and the outcomes, conclusions and, where appropriate, the actions resulting from their work.
- Whether the FRC have done an AQR or CRR and if so what were the key issues raised and actions that resulted. Also what was the last AQR rating of the company and why was this so.

- In years when the audit has been retendered, the procurement process followed including, an outline of the specification issued, how the call for competition was advertised, the number of bidders, the tender evaluation criteria and weightings and how the final selection was determined.

Returning to the CMA's proposal that the Regulator should have more oversight of the ongoing management of the audit contract, we would like to see the regulator act as a facilitator of the audit / shareholder meetings proposed above.

With regard to the appointment of auditors we continue to believe that there are good grounds for supporting Sir John Kingman's recommendation that the FRC should be responsible for the appointment of auditors, subject to final approval by the shareholders. We believe that this should be trialled for FTSE 100 companies. Approximately 10 FTSE 100 audits are put out to tender each year. This volume should be capable of being managed by the FRC. The success of the approach can then be assessed after 2 or 3 years to see if it should become the practice for all FTSE 100 companies and extended to other quoted companies.

Interestingly, although this idea was dismissed by the Investment Association and many of its members, it has very recently acquired increased relevance. The decision by Grant Thornton to resign the Sports Direct audit and the likelihood that other auditors will seek to divest themselves of 'risky' clients means that there may be a very real requirement for the regulator to intervene in these cases to appoint a new auditor.

2. What comments do you have on the ways the regulator should exercise these new powers?

a. For instance, do you have any comments on the conditions that should be met for the regulator to exercise its powers to take remedial action?

b. Are there particular events (such as a poor audit quality review, early departure of an auditor or a significant restatement of the company's accounts) which should trigger the regulator's involvement?

In response to **a**. above there are a number of factors that should prompt the regulator to intervene and consider remedial action. These include:

- Concerns by the regulator, following a review of an audit, that it fell well below standard. It is worrying enough that the regulator should be identifying audit failings. It is doubly worrying that the company's audit committee was unaware that the audit was sub-standard. This suggests that they are taking a lax and easy-going approach to their own responsibilities in monitoring the work of their key supplier.
- Cases such as Carillion, Conviviality, Patisserie Valerie, Tesco and BT (fraud in the Italian business) in which there are strong grounds for believing that there have been serious deficiencies in the audit – particularly where these deficiencies have occurred over a number of years.

The regulator should also have the power to attend Part 2 of the AGM (as proposed in the response to Q1 above).

In response to **b**. above we believe that whenever an auditor resigns or is dismissed by the client the regulator should have the power to intervene and investigate the reasons for the termination of the

audit contract. Furthermore, the company should be obliged to circulate an RNS to all members **and all those holding an interest in the company's shares via a nominee**[1]. It is very important, however, that the RNS provides appropriately detailed information for investors. Changes to the law may be required to ensure that this can happen. For example:

- auditors should be given indemnity against any claim for defamation or libel by the client.

- auditors should automatically be released from constraints imposed by any non-disclosure agreement (NDA) they may have signed with the client. NDA's, as we know from experience in other areas, have become an effective form of gagging.

3**. How should the regulator engage shareholders in monitoring compliance and taking remedial action?**

As outlined in the response to Q1 above, there has to be a formal process by which shareholders can hold auditors and audit committees to account. At present there is no effective process for doing this. The large shareholders (mainly fund managers, pension funds and City institutions) can request a meeting with the chair of the audit committee. Any such request is unlikely to be refused. For small shareholders, typically private shareholders, getting an audience with any member of the audit committee is likely to be much more difficult. Two other issues that need to be considered are:

- all shareholders must be given the opportunity to treated alike and the company must act fairly between members; it is not appropriate that institutional shareholders should be privy to information that is not available to all other shareholders;
- anecdotal evidence based on discussions with audit chairs suggests that it is very rare for even the institutional investors to ask to meet an audit committee. This is a damning reflection on attitudes to stewardship by some of the larger shareholders. The recent disasters at Carillion and Patisserie Valerie, and the Muddy Waters report into Burford are examples of the failings of large shareholders to engage in what have proven to be critically important issues.

If a system can be put in place which allows shareholders to meet with the audit committee and the auditors at least once a year, they will be in a much better position to understand the programme of work undertaken by the auditors, the issues raised and to ask appropriately searching questions. If they are still not satisfied and believe that there are audit shortcomings (including lack of compliance) they can refer the matter to the regulator.

4. What would be the most cost-effective option for enabling greater regulatory oversight of audit committees? Please provide evidence where possible.

As outlined above (Question 1), the best approach in our view is that the shareholders should be given greater opportunity to hold the auditors and the audit committee to account. We suggest that in this respect there should be a formal Part 2 to every FTSE 350 AGM at which the auditors and the audit committee would present on the programme of work carried out during the year and work planned for the coming year. In addition to this:

[1] It is unconscionable that some platforms' terms and conditions allow them not to provide information rights to their customers who hold shares via nominee.

- if shareholders have concerns about any aspect of the outcomes of the meeting they should be able to raise these with the regulator;
- the regulator should be able to attend a sample of meetings each year; following the meeting the regulator should draft a brief report (to a standard format) on its observations and pass this to the company with a copy posted on the regulator's website.

We believe that anything which sets out the main principles of good practice when buying audit services would be welcome. This might include guidance on:

- issuing requests for information to identify firms that are able to submit an appropriate bid;
- the number of bids to be sought;
- typical evaluation criteria and typical weightings for each of the criteria;
- make-up and running the selection panel;
- key considerations in making the final selection decision.

This guidance should be referred to in the Corporate Governance Code.

5. **Do you agree with the CMA's joint audit proposal as developed since its interim study in December?**

When we commented to the CMA's on its Update Paper we said that we supported the concept of joint audits. Having reflected further on the idea since then we have become more doubtful about the merits of joint audits for most FTSE 350 firms. Joint audits may well be a way of allowing challenger firms greater access to a market currently dominated by the Big Four and may help to promote greater competition in future. However, in terms of achieving the ultimate aim of better audit quality it is a clumsy solution to the problem in that:

- it could actually compromise audit quality by creating unhelpful and contentious divisions between who does what in performing the audit;
- it could result in duplication of work;
- it could result in unintentional gaps in audit work;
- it could increase audit costs with little demonstrable benefit in terms of better audit quality.

We prefer the alternative approach of a peer review of the audit by another firm, for a sample of companies on a trial basis. The peer review will focus on key assumptions and the underlying data that supports them; not to replicate low value added counting and checking by juniors in the audit teams. Not only should it help to improve competition in the audit market, it also has the potential to improve audit rigour. Also peer review is possible by a non-Big Four firm who might not have the global scale to do a joint audit.

Even if this increases the cost of audit by, say, 25%, it is likely to be a price worth paying if it improves audit robustness and reliability. When large investors are happy to sanction multi-million £ bonuses for directors in return for very average performance, there can be few reasons for quibbling over an increase in audit fees to achieve greater investor reassurance.

It is, however, worth noting that average remuneration per partner is considerably higher at Big Four firms than at the challenger firms. Greater use of the challenger firms may mean that the overall cost of audit can be contained or reduced or that the audit could embrace more work for the same level of fee.

6. Do you agree with the CMA's proposed exemptions to the joint audit proposals? How should the regulator decide whether a company should qualify for the proposed exemption for complex companies?

If joint audits were to be implemented then we agree with the exemptions. It is probably not too difficult to decide the basis for defining the 'largest' companies where to draw the line in terms of size – although, like the FTSE 100 index the composition of the group will probably vary over time. However, there remains the problem of how a 'complex' company is to be defined. Most companies probably like to claim that they are complex when in fact they are no more complex than many others. This is a further reasons why implementing joint audits is likely to be problematical and would be better avoided.

Our recommended approach of peer review overcomes the question raised.

7. Do you agree that challenger firms currently have capacity to provide joint audit services to the FTSE350? If a staged approach were needed, how should the regulator make it work most effectively? If not immediately, how quickly could challenger firms build sufficient capacity for joint audit to be practised across the whole of the FTSE350?

We are not able to comment authoritatively on the capacity of the challenger firms to provide joint audit services. Nor can we comment on how quickly they might be able to build capacity.

We do however note the findings from the CMA's review of the audit market as it currently stands:

- The Big Four accounted for 97% of FTSE 350 audit clients in 2017 – up from 95% in 2011 – and 99% of audit fees. The Big Four were also the statutory auditor for 84% of all UK PIEs in 2017.
  While each of the Big Four firms received between 20% and 35% of audit fees paid by FTSE 350 companies in 2018, the 'challenger firms' combined had less than a 1% share;

This is an unhealthy situation in the any market and, in the case of the audit market, one which will not resolve itself. Intervention by the regulator will be required.

It is tempting to suggest that the regulator should start by addressing the situation in the FTSE 100 market where the need for change appears most pressing. However, if there are doubts about the challenger firms ability to muster the necessary capacity for joint audits it might be better to start with the FTSE 250 companies and develop the joint audit concept in this area before tackling the largest and most complex audits among the FTSE 100 constituents.

We believe that the adoption of peer review should enable Challenger firms to build their capability.

8. Do you agree with the CMA's recommendation that the liability regime would not need to be amended if the joint audit proposal were implemented?

For the time being, and depending on the outcome of Sir Donald Brydon's review, yes. However, this is just one more area of potential difficulty surrounding joint audit.

9. Do you have any suggestions for how a joint audit could be carried out most efficiently?

We have no specific suggestions to make.

10.The academic literature cited in the CMA's report suggests the joint audit proposal would lead to an increased cost of 25-50%. Do you agree with this estimate?

We are unable to comment on this except to say that even if it resulted in 50% increase in fee cost it would be worth it if better quality audits resulted. The purchase of audit services should always seek to obtain the service which delivers best value for money for the shareholders. It should not be based solely on lowest price.

11. Do you agree with the CMA's assessment of the alternatives to joint audit, including shared audit?

Yes. We also share the CMA's reservations about shared audits - namely that a shared audit is less likely to be effective in promoting resilience and choice as challenger firms would be more likely to remain subordinate to Big Four statutory auditors with the Big Four firm dictating how the audit will be carried out and retaining overall responsibility for the engagement.

We think peer review is a good alternative.

12. How strongly will the CMA's proposals improve competition in the wider audit market, and are there any additional measures needed to ensure that those impacts are maximised?

It is hard to say. The market has become so concentrated that achieving change and ensuring greater competition is likely to take some time and will require constant monitoring from the regulator.

Part of the problem in audit at present appears to be the dearth of high-calibre individuals who see audit as a worthwhile, long-term career choice. This will take time to change. However, effective ways must be found of ensuring this change. The claim by the Big Four that they must keep their consultancy practices because, without this escape route from audit, they will never be able to recruit high-calibre individuals to work in audit **is a damning reflection on way in which audit is currently regarded**. It is also a lame and completely unhelpful (and one is tempted to add, 'self-serving') response to the problem. It is unclear whether audit partners in the Big Four are paid less than partners in their consultancy practices. Some transparency on this would be helpful. We remain of the view that audit and consultancy should be separated.

13. Do you agree with the CMA's proposals for peer review? How should the regulator select which companies to review?

Peer Review of FTSE 350 audits by challenger firms would be a very good idea. The emphasis should be on reviewing the key assumptions, not on duplicating low level admin tasks. We suggest that 10% of FTSE 350 companies should be nominated for peer review in year 1 and 25% in year 2, starting from year ending 31 March 2019.

We have no suggestions on how specific companies should be selected for review.

14. Are any further measures needed to ensure that the statutory audit market remains open to wider competition in the long term?

In late 2018 Sir John Kingman put forward a proposal to the then Secretary of State, Greg Clark, that auditors should be appointed by an independent third party. In practice this would probably be the regulator. This idea was denounced by the Investment Association and its members (primarily the City fund managers) on the basis that it interfered with the fundamental right of the shareholders to appoint the auditor. However, the notion that shareholders have any input to auditor appointment at present is risible. The large shareholders have shown almost no interest in the process of (or the outcome) or auditor appointment in the last fifty years or so. The current process whereby the audit committee appoints the auditors is opaque and is riddled with conflicts of interest. We discuss this in more detail in our response to Q22 below. The auditors are supposed to look after the interests of the shareholders. This being the case, we would like to see a system introduced whereby:

- Auditors are appointed by an independent third party thus breaking any element of allegiance to those who reporting work they are supposed to verify and 'mark'
- Auditors are held to account annual by the shareholders as described in the answer to Q1 above.

There is no reason why shareholders should not still have an ultimate right of veto over the proposed auditor appointment if they believed for good reason that it was completely unacceptable to them.

In addition to dealing with the opacity and conflicts of interest in the current system of auditor appointment third party audit appointment by the regulator would also have the benefits of:

- Ensuring that auditor selection and appointment was placed in the hands of a specialist team for whom this was their primary role;
- Avoid the waste of every FTSE 350 company running its own tendering process for audit;
- Providing better scope for management of the audit market with a view to ensuring long term healthy competition.
- Ensuring that auditors could be appointed to companies which had come to be seen as 'toxic' by the audit market.

Clearly, in taking on this role the regulator would need to work closely with a number of representatives (probably audit chairs) from FTSE 350 companies and with shareholders. Agreeing how this will work should not be difficult.

15. What factors do you think the regulator should take into account when considering action in the case of a distressed statutory audit practice?

We find it difficult to comment meaningfully on this. We agree that third party oversight of the large audit firms is required and that the regulator is probably best placed to provide this oversight. The powers suggested by the CMA and outlined in paragraph 3.5 of the consultation paper are well intended. However, existential threat to an audit practice is likely materialise with little warning. Failure to win audit work over the medium term, for whatever reason, would lead to a gradual shrinking of the practice which should be easily manageable.

But what would happen if a series of serious audit failure came to light which resulted in the firm facing one or more serious law suits. Reputational damage, plus legal costs and any settlement costs could threaten the viability of the firm. The situation could also become a huge distraction for senior management. At this point all the audit contracts held by the firm would be under threat. The remedies outlined in paragraphs 3.7 and 3.8 of the consultation paper would almost certainly be inadequate.

This simply serves to underline why dependence on the Big Four firms is so unsatisfactory. Managing the aftermath of the collapse of an audit firm accounting for 20 – 25% of the audit market is always going to cause enormous problems. Simply transferring contracts and staff to other firms quickly and seamlessly is almost certainly wishful thinking.

We are not great fans of setting market caps as these are highly interventionist. However, this approach may be the only effective way of 'managing down' the current over-dependence on the Big Four and the problems that would ensue if one of them ended up in distress.

The current situation in respect of KPMG is clearly a concern.

16. What powers of intervention do you think the regulator should have in those circumstances, and what should be their duties in exercising them?

The regulator would certainly need powers to be able to place audit contracts and the staff responsible for them under the management of another suitable firm. This in itself might not be easy or straightforward. Contractual issues could be complex and staff defections could further jeopardise the handover process (the Andersen example is worth recall, where some practices in some countries went to EY and some elsewhere). Consideration also needs to be given to the question of whether an audit firm failure would trigger an automatic retender of the audit.

17. Do you agree with the CMA's analysis of the impacts on audit quality that arise from the tensions it identifies between audit and non-audit services?

Yes; there are a number of problems associated with audit firms offering consultancy services, including:

- The clear difference between the culture required to build a successful consultancy business and the culture required for a trusted and well-regarded audit practice. Consultancy is project-based; having sold one project the consultancy team have to sell another (and another) to ensure a flow of new work to feed the business.

  Contrast this with the culture needed in an audit practice. Detachment, objectivity and professional scepticism are all things that one might consider to be important. Added to this is the need to understand that, while the client company may be paying for the audit, the auditor is actually supposed to be looking after the interests of the shareholders. With a ten-year audit contract there is no need (or perhaps we should say there should be no need) and no justification for constantly trying to sell more to the client.

- rules designed to limit conflicts of interest by limiting the amount of non-audit work they can do for a client have the perverse effect of limiting competition. If the external audit is tendered and the consultancy arm of one of the Big Four auditors is carrying out a large IT project for the company it may mean that it is excluded from bidding for the audit contract.

If another firm is providing internal audit services (as with Deloitte at Carillion) it may be that there are really only two potential bidders, one of whom is the incumbent.

- Where an audit firm also has a large consultancy business, there are perceptions that the audit practice acts as a source of 'leads' for the consultancy business. Despite the limitations on the amount of consultancy that the auditor can carry out, the consultancy work can still be financially attractive. This can create conflicts of interest. It has the potential to distort good judgement and business culture.

- There is an incentive for audit partners to want to retain audit contracts; no one likes to lose business and audit partners may be under pressure from their own side to go along with the blandishments of senior client-side management - particularly when the issue at stake is likely to affect pay over the long term on both sides.

The claim that only a Big Four auditor can realistically handle the external audit for a FTSE 100 company looks lame. It smacks of the 'nobody-got-fired-for-hiring-IBM' argument. Furthermore, if the market for audit service was working properly FTSE 100 companies would not have allowed themselves to get into a position in which they were dependent on just four suppliers.

The Big Four audit firms are effectively owned by their consultancy businesses. 75% of their income is from consultancy and although we do not know what percentage of their profits, but we suspect it is more than 75%. Inevitably the power in the Big Four firms will therefore lie with the consultancy partners. Cultural norms tend to be driven by the consultancy business. This has not turned out to be good for the world of audit. It is a strong argument for the separation of audit and consultancy into separate firms.

18. What are your views on the manner and design of the operational split recommended by the CMA? What are your views on the overall market impact of such measures?

We agree with and support the measures proposed by the CMA, although we would prefer that at least one firm is mandated to split off its consultancy business. This will minimise the disruption whilst allowing a better evaluation of the benefits, in say two or three years, prior to mandating a complete split for all the Big Four Firms.

19. Are there alternative or additional measures which would meet these concerns more effectively or produce a better market outcome?

Not that we are aware of, but if the split proposed by the CMA fails to have the desired effect then more draconian measures may be required.

20. Do you agree with the CMA's proposal to keep a full structural separation in reserve as a future measure?

If the split proposed by the CMA fails to have the desired effect then more draconian measures may be required.

We would prefer that at least one firm is mandated now to split off its consultancy business. Doing this for only one of the Big Four will minimise the disruption whilst allowing a better evaluation of the benefits, in say two or three years, prior to mandating a complete split for all the Big Four Firms.

21. What implementation considerations should Government take into account when considering the operational split recommendations? Please provide reasoning and evidence where possible.

The key requirement is to ensure that audit is not treated as a 'lead-generator' for more lucrative consultancy work. The proposals put forward by the CMA address this issue.

Old attitudes and cultures, however, die hard. An operational split should not be so difficult to achieve. But **it must also be accompanied by a change of culture** within the audit function which ensures that:

- It hires, trains and retains people of the highest calibre
- Places the highest possible value on competence, independence, **integrity**, professionalism, and willingness to challenge and question.

The audit profession should seek to adopt and emulate the best principles of the legal and medical professions. This sort of change will take time and will need to be managed. It will not happen on its own simply by splitting audit and consultancy services and hoping for the best.

22. Do you agree with the CMA's other possible measures? How would these suggestions interact with the main recommendations? How would these additional proposals impact on the market?

Yes; we believe that these are worth considering.

One area that we believe needs to be considered in much more detail is that of independent appointment of auditors – probably by the regulator.

One of the main problems with audit at present is that, although auditors are supposed to look after the interests of shareholders, they are actually appointed by the company and usually see the executive directors as their client. It is arguable that many see the audit committee as the client but it is actually the executive directors who sign off their invoices and who influence heavily the choice of auditor when it comes to the tender evaluation process.

When an audit partner has a client paying an audit fee of several million pounds per year, virtually the whole of their year is spent auditing that client. **For that partner, to have his firm fired as auditors is normally a career catastrophe.**

Accordingly, audit partners set out to have a good relationship with the CFO, the CEO, the audit committee and the board of directors, forgetting they are meant to retain a certain 'distance' and, above all, independence. The friendlier the auditor is with the client the harder it becomes to challenge them and the auditor becomes less likely to suspect them.

The solution, **starting with PIEs (public interest entities)** is to take away from the company the power to appoint the auditor, to set the fee, and to remove the auditor. Instead, this role should be performed by a specialist outside body. That outside body would rapidly build up expertise and would have a 100% view of the marketplace for PIE audits. It could compare audit firms and audit partners better than anyone. To enable this, the appointing body should receive confidential copies of all documents that auditors present to company boards, most of which are presently never seen by anyone but the client's board. Similarly, the body should have unrestricted right to speak to audit partners.

Shareholders may complain that something important is being taken away from them. Such a complaint is not valid. Limited liability is a privilege conferred on companies, and therefore on their

shareholders, by the rest of society. The costs of audit failure do of course fall upon shareholders, but they also fall upon employees, creditors and taxpayers.

Shareholders simply do not have the knowledge and expertise to choose and remove auditors. Furthermore, their present exercise of that right is a sham, since shareholders effectively delegate it to the board.

The possibility of introducing independent appointment of auditors by a third party was raised by Sir John Kingman. It seems that the idea was dropped following adverse comment by the Investment Association (IA) and its members. We believe however that it would be a very good idea and have made our views clear to the former Secretary of State the Rt Hon Greg Clark. A copy of our letter to him is appended.

Interestingly, regardless of the apparent resistance to this idea from the IA, it looks as though it may be unavoidable in cases in which certain audit clients are deemed 'toxic' – not only by the existing auditor but by the rest of the industry. The recent decision by Grant Thornton to resign the Sports Direct audit comes to mind.

23.Do you agree with the CMA's suggestions regarding remuneration deferral and clawback?

Yes.

The FSA and its predecessor rules have made a dramatic change to the culture of the banking sector and the way their employees are paid. It is always better to only pay for results when you are sure the results have actually been achieved. In many cases, only history tells us the truth about performance.

24.How would a deferral and clawback mechanism work under a Limited Liability Partnership structure?

I cannot see a problem. Contracts would have to be written so that payments from the company to the auditor would be on account. This might require extra capital for the audit firm, but given their current high levels of profitability this should not be a problem.

25. Do you agree that liberalising the ownership rules for audit firms would reduce barriers for challengers and entrants to the market?

- **What positive and negative impacts would this have?**
- **Do you have any specific proposals for a reformed ownership regime?**

We note that the CMA decided not to take this proposal forwards. We believe that this is the right decision for the time being. The CMA has presented plenty of other good proposals for reforming the audit market. These need to be implemented and, if necessary, refined before introducing other less compelling initiatives.

The cynic might argue that the ownership rules have already been liberalised. As noted above (Q17) for all practical purposes **the Big Four audit firms are effectively owned by consultancy businesses.**

26. Do you agree with the CMA's suggestions regarding technology licensing?

- **What changes would you like to see made to the current licensing framework?**

We note that the CMA's consultation with audit firms prompted claims from a number of 'challengers' that their audit technology was 'state of the art'. We also note the willingness of several of the Big Four to share their technology – although they do not say at what price. Similarly we note KPMG's comment that allowing challengers to use the technology of the Big Four could actually reduce investment in audit technology.

We believe that the key issues are:

- The use of technology in audit needs to be encouraged;
- It is wasteful to have different firms developing very similar systems independently of each other;
- Compatibility of systems is essential; it is not helpful to have an Oracle / SAP situation in which users become locked into a particular system – largely to the benefit of the system providers.

We also have questions as to exactly what the 'technology' is going to do. It seems that much of it will remove the need for manual sampling. The auditor's computer will be plugged into the client's MIS systems and will sample the whole universe of data using algorithms to detect patterns and / or inconsistencies in the data. The question has to be asked, however, why wait for the auditor to come and do this on an annual basis? Is this not technology that the client companies should be installing and running themselves on a routine basis to provide their own checks? This in turn raises a further question as to what the role of the auditor then becomes.

27. Do you agree with the CMA's suggestions to provide additional information for shareholders? Do you have any observations on the impact of the Public Company Accounting Oversight Board's database on the US audit market?

We would like to see shareholders being given more information, including things like time spent by audit staff (and in particular audit partners) and fees charged to individual clients. However, we would like this to be provided as part of a more comprehensive approach to holding auditors and audit committees to account. Our proposals for achieving this are described in our answer to Question 1 above.

We have no objection to a public database of audit partners and firms.

28. Do you agree with the CMA's suggestions regarding notice periods and non-compete clauses? Do you agree that the regulator should consider whether Big Four firms should be required to limit notice periods to 6 months?

We agree that notice periods for partners should be set at six months maximum. This should allow plenty to time for a firm to reallocate that partner's work to others. Non-compete clauses in partners' contracts of employment will need to be limited in future to ensure that they can readily move to other firms.

29. Do you agree with the CMA's suggestions regarding tendering and rotation periods?

Ten years for a contract sounds like a long time. In the public sector framework contracts usually run for a maximum of four years although they can be extended.

If no other changes were being proposed (e.g. joint audits, peer reviews, tougher oversight of audit) then we would agree that ten years is probably too long and that seven might be better. However, bearing in mind that the ten-year period is an absolute maximum it is probably better to:

- Monitor the impact of other measures that the CMA proposes should be implemented to disrupt the current 'cosy' nature of the relationship between auditor and client;
- Remind clients that ten years is an absolute maximum for an audit contract and that good practice for many would be to rotate the contract after seven or eight years;
- Simply face the fact that current arrangements for the hiring of auditors are hopelessly conflicted as we have as we have discussed in our response to Question 22 above.

If BEIS is serious about dealing with the problem of excessively close and 'comfy' relationships between auditors and their clients it should look again closely at Sit John Kingman's proposals for independent third-party appointment of auditors. We believe that the logical and most appropriate third-party is likely to be the regulator.

30. Do you have other proposals for measures to increase competition and choice in the audit market that the CMA has not considered? Please specify whether these would be alternatives or additional to some or all of the CMA's proposals, and whether these could be taken forward prior to primary legislation.

We have no proposals other than those already discussed above.

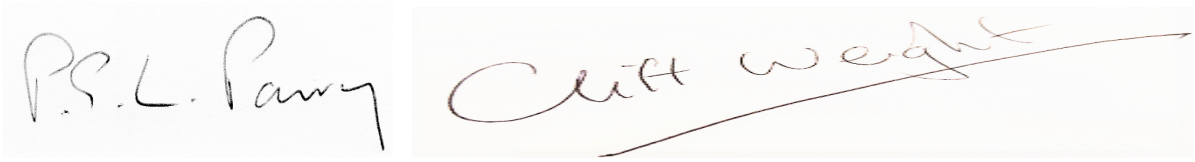
31. What actions could audit firms take on a voluntary basis to address some or all of the CMA's concerns?

It appears that some of the large audit firms are already taking action to effect a better separation of their audit and consultancy operations on a voluntary basis. We do not believe this will address all of the CMA's concerns.

32. Is there anything else the Government should consider in deciding how to take forward the CMA's findings and recommendations?

We have no further suggestions.

Yours faithfully



Peter Parry – Policy Director – UK Shareholders' Association

Cliff Weight – Director - UK Individual Shareholders' Society **ShareSoc**

Appendix 1

UKSA ShareSoc letter to Greg Clark MP regarding independent appointment of auditors.

UK Shareholders' Association
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The Rt Hon Greg Clark MP
Secretary of State for Business, Energy and Industrial Strategy
Department for Business, Energy and Industrial Strategy
1 Victoria Street
London
SW1H OET

18th February 2019

Dear Secretary of State,

Re: Appointment of auditors

We are writing to you on behalf of the United Kingdom Shareholders' Association (UKSA) and the UK Individual Shareholders' Society (ShareSoc). Our two organisations represent the interests of private shareholders. In addition to our own members, there are 5 million people who own shares and have investment accounts with platforms in the UK. The Office for National Statistics estimates that individual investors own 12% of the UK stock market by value. In addition to this there are many more who have money invested in shares via funds, pensions and savings products such as employee share ownership schemes.

Sir John Kingman in his letter to you in December 2018 made a very clear recommendation that auditors of Public Interest Entities (PIEs) should in future be appointed by the new regulator which would replace the Financial Reporting Council. He set out his proposals under the heading 'A different model'.

We believe that Sir John's proposals for the appointment of auditors make eminently good sense. The current system for appointing auditors has failed miserably. It is riddled with conflicts of interest and effectively creates an unhealthy and inappropriate dependency between the auditors and the executive directors of the client companies. It creates a situation in which there is every incentive for auditors to acquiesce to the blandishments of the executive directors over the presentation of the financial statements and to suspend professional scepticism.

We are most unhappy about the resistance from the Investment Association (IA) and its members to Sir John's proposals on auditor appointment. The large institutional shareholders have for many years been complicit in going along with a system which patently fails to protect the interests of their customers, the end-investors. Even in cases recently in which there have been serious audit

failures, it has been common for the auditors be reappointed at the AGM by an overwhelming majority of votes.

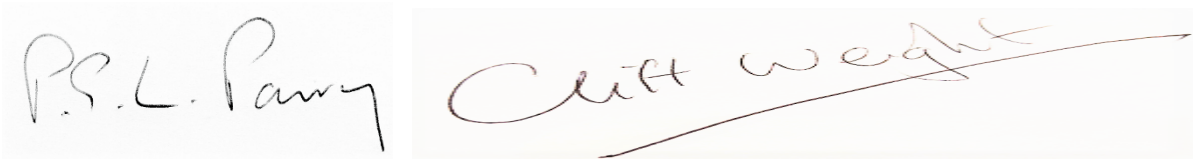
We are particularly concerned that Sir John in his letter to you appears to row back so readily from pressing his case for serious reform in the face of stiff resistance from the IA. The fact that the IA is a powerful lobby with a loud voice is not a reason to cave in to its call for retention of the status quo with minor amendments. The time for fiddling around on the periphery is over. Radical change, as suggested by Sir John, is overdue.

Appointment of auditors by a third party with the relevant skills and expertise would, once and for all, **break the current link of excessive dependency between auditors and those they audit**. It is a change that should not be difficult or costly to implement and would be effective in achieving much greater auditor independence than at present. Auditors are currently appointed for a maximum term of ten years. If, on a trial basis, the Regulator started by managing the appointment of auditors for FTSE 100 companies this would mean an average of ten appointments a year. This should not be a particularly onerous workload for a team of experts. It is low-risk and requires relatively little investment.

We strongly urge you and your Department to consider very seriously the recommendations that Sir John has made. Many of those arguing for minimal change have shown themselves to be very poor stewards of other people's money. Please do not give in to their Siren voices.

We would appreciate the opportunity to meet with you to share our experiences and observations in more detail.

Yours sincerely,



Peter Parry – Policy Director – UK Shareholders' Association

Cliff Weight – Policy Director - UK Individual Shareholders' Society