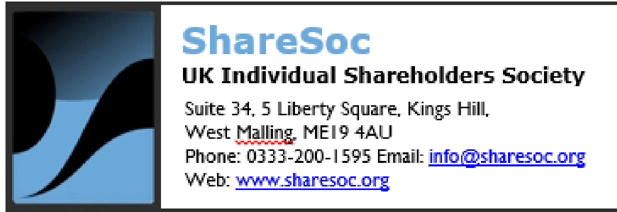

15th January 2019

Response to the CMA's Update Paper

Dear Sirs

This is a joint response from the UK Shareholders' Association (UKSA) and ShareSoc on behalf of individual investors.

UKSA and ShareSoc 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.

The Update Paper suggests six main remedies for improving audit quality. The recommendations put forward by the CMA are appropriately radical and most welcome. The picture that emerges of the audit market and the way in which large public companies procure audit services is less than flattering. It confirms that investors are right to be concerned.

Some of the recommendations made by the CMA depend for their implementation on the implementation of many of Sir John Kingman's proposals for the Regulator (the FRC). For example, the oversight of audit procurement and the management of audit contracts by the Regulator can only work effectively if the Regulator is properly empowered, resourced and funded as suggested by Sir John.

Rather than respond specifically to each of the twenty seven questions in the Update Paper we have summarised below our comments on each of the CMAs main proposals.

None of the information contained in this letter is confidential.

1. Regulatory scrutiny of audit committees

The CMA's investigation into auditor appointment suggests that it 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 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 promote regular contact between the shareholders and the auditor. The AGM is no longer an appropriate forum for allowing investors to raise detailed reporting and audit issues and receive meaningful answers. There should, in addition to the AGM, be at least one meeting a year between shareholders on the one hand and the auditors and members of the audit committee on the other. The executive directors 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.

2 Mandatory joint audit. The CMA review reveals that the Big Four audit firms undertook 97% of FTSE 350 audits in 2017. Intuitively this feels unhealthy from an investor point of view. Audit is hardly a capital intensive industry with high intrinsic barriers to entry – although the larger firms and their clients have made a good attempt at making it so by stressing the importance of global reach.

This stranglehold could be further tightened as the use of sophisticated analytical systems based on 'big data' sweep into the audit market. A way has to be found of ensuring that mid-sized and smaller audit firms are not further excluded from the audit market for FTSE 350 companies.

We support the concept of joint audits for most FTSE 350 firms. Not only should it help to improve competition in the audit market, it also has the potential to improve audit rigour. For firms outside the FTSE 350, joint audits should be optional. Even if this increases the cost of audit by, say, 35%, 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 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.

Although it is a point of operational detail, the use of 'lotting' for audit procurement might be appropriate. This is widely used for framework agreements in public sector procurement. In the case of audit, the overall audit contract could be split into at least two lots. The regulator could provide guidance on appropriate lotting structures. Bidders would be able to bid for one or more lots. At contract award at least two firms would have to be awarded work covering different lots. At least one firm would need to be a 'challenger' – as the CMA recommends.

This approach would give companies more flexibility in deciding how to structure their audit contracts to meet their own specific needs. It would also encourage them to think innovatively. Coupled with the audit committee oversight requirements from the regulator outlined in 2.1 above, there should be limited scope for the process to be subverted to compromise the wider purpose and objectives of the CMA's recommendation.

2A. Market Share Cap. We agree with the CMA that, whilst this is a viable option for encouraging greater market participation by the mid-sized and smaller audit firms, the joint audit solution is better. The joint audit is less interventionist in terms of the working of the market for audit services and it has the likely advantage of ensuring better audit quality.

3 Additional Measures to support challenger Firms. The proposals made by the CMA are all interesting and worthy of further discussion. Given the mixed reception that they have received, we concur with the CMA's conclusion that they should held in reserve for further consideration if necessary. We do agree, however, that limiting the duration of non-compete clauses for partners when changing employers would be appropriate.

4. Market resilience. We agree with CMA that this issue requires further consideration. We do not have any specific proposals to add at this stage.

5. Full structural or operational split between audit and non-audit services. We fully support this proposal for reasons outlined in 5.1 below. We accept the CMA's conclusion that it would be difficult

to achieve, particularly in relation to firms' international networks. However, just because it is difficult is not a valid reason why it should not be done. Difficulty of implementation should not become an excuse for inaction. We believe that splitting audit from 'consultancy' is such an important issue that it must be implemented. There is also the possibility that if the UK takes a lead in this matter it will prompt change in other countries around the world.

If concerns about culture are one of the key justifications for suggesting a split, then it is very difficult to argue that any such split should only apply to the Big Four firms. Quite apart for the fact that is seems manifestly unfair that this ruling should only apply to the Big Four, it also raises questions over what happens as some of the challengers start to grow and expand as they gain greater access to the audit market for FTSE 350 clients.

5.1 Cultural issues and conflicts of interest. There is a 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. This might be an extension to an existing project or a completely new project. It is also good if they can get a referral to a new client. To be effective at doing this the senior consultant needs to build close working relationships with the executive management team within the client company. It pays not to upset them. As a consultant it makes sense to go along with whatever the client wants. It is a case of just helping them to do it a bit better. If the client is uneasy with the consultant's recommendations, the consultant usually amends them. There is no point in trying to force the client to do something he or she feels is unworkable.

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 and no justification for constantly trying to sell more to the client.

And yet, all too often there appears to be pressure on the auditor to pass leads and consultancy opportunities to colleagues in the consultancy side of the business. Consultancy can be highly lucrative – often much more so than audit work. The audit partners in most firms benefit from this as well in that they enjoy bonuses based on the overall performance of the firm – not just the audit part. A situation is thereby created in which both parties, the directors of the audit client and the auditors themselves, stand to benefit financially from a conflicted and easy-going relationship with regard to the conduct of the audit.

From an ethical point of view, consultancy and audit do not sit well alongside each other. The culture required for success in each case is fundamentally different. The measures of success should also to be different. Growing revenue by keeping the client happy is not an appropriate measure of success for an auditor. Unfortunately, the likelihood that the consultancy culture will assert itself within any firm providing both consultancy and audit is very real and is potentially damaging and dangerous.

We do not believe that simply banning auditors from doing non-audit work for audit clients provides the right answer. Such a move can only serve to reduce choice and competition in the audit market.

No audit firm is going to dump its consultancy work with a non-audit client just so that it can bid for the audit contract. Despite the fact that auditors are already banned from doing certain types of non-audit work for audit clients there are still plenty of other areas of well-paid consultancy advice that they are allowed to provide, including many areas of IT upgrade and implementation, corporate strategy, new product development and M&A work.

We believe that the only viable solution is to implement a complete split between audit and advisory (consultancy) work and impose a ban audit firms providing consultancy services. In this context the following point should be considered: are the large global firms auditors with a consultancy sideline or are they really consultants with an audit sideline? Looking at the 2017 results for two of the largest firms is revealing. Ernst and Young, for example, had UK revenues in 2017 of £2.35 billion of which £689 million was accounted for by assurance (audit) services. PWC had UK revenues of £3.8 billion of which assurance accounted for £1.3 billion. For these two firms true audit work accounts for 25 -30% of total UK revenue. Given this level of dependence on consultancy work, it is not hard to see what sort of culture is likely to prevail.

6. Peer Review

We agree with and support your provisional view is that peer review would be a useful remedy as part of the regulator's toolkit. [1]

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.

Peter Parry – Policy Director, UK Shareholders' Association

Cliff Weight – Policy Director, UK Individual Shareholders' Society

[1] CMA Update Paper; page 124 - para 4.139