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Via email: auditmarketconsultation@beis.gov.uk

Dear Claire,

The Corporate Reporting Users' Forum (CRUF) welcomes the opportunity to comment on the BEIS consultation: *Statutory audit services: initial consultation on Competition and Markets Authority recommendations*, (final report 18 April 2019) issued 18 July 2019. The CRUF recognises that there is a widespread perception that audit quality has declined and this needs to be addressed.

Users are primarily interested in competition in the audit market insofar as it relates to audit quality, which is paramount as this underpins users' confidence in corporate reporting, which is a precondition for healthy capital markets. The CRUF notes that the link between competition and quality is not straightforward. In the sub-prime mortgage market, for instance, there was a race to the bottom on lending standards.

The CMA recommendations need to be seen in the context of other important reviews. Sir John Kingman's proposed important reforms to the FRC, suggesting its successor body, the ARGA, will focus on audit quality and have new powers to do so. Sir Donald Brydon's review of the quality and effectiveness of audit, could fundamentally change the scope and purpose of audit.

Responses to the questions raised in the BEIS consultation that concern investors are set out below.

- 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 primary purpose of the regulator should be to ensure informative and high quality corporate reporting. Included in this purpose are the related needs of appropriate corporate governance and a consistent and high audit quality. The regulator can support quality directly by reviewing audits and indirectly by supporting scrutiny by both audit committees and shareholders.

The CRUF believes that both the regulator and investors should pay more attention to the key role played by audit committees. The FRC already has significant monitoring powers and the ARGA will have more. Importantly, it should have the power to sanction directors in the same way as it can sanction those who are accountants and auditors.

As mentioned above, the appointment of auditors and the criteria set by (non-executive) audit committees to encourage rigorous scrutiny of the executive is of great interest. Better disclosure on this, and greater regulatory attention, would be welcome. But there is some concern that the proposed monitoring of audit committees may be bureaucratic and intrusive. The NEDs themselves, on behalf of investors and to protect their own reputations, have an interest in high standards of auditing.

One CRUF participant notes that audit committee engagement with investors varies a great deal, and in some cases can be hugely disappointing. Enhanced monitoring could help improve NED promotion of higher audit standards.

Disclosure of the audit fees, relative to both the firm's total audit revenues and, also the audit fees relative to the lead partner's total fees would be helpful to assess if there is overreliance on a particular audit at either a firm or partner level. This information would also encourage investors to engage. One specific suggestion from a CRUF participant is to establish a database of audits undertaken by the lead partner and also audits which audit committee members had been involved with. This would allow investors to easily check the history of both the partner and audit committee.

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

The [report](#) notes that there is significant variation in the performance of audit committees within the FTSE 350. It would be helpful to define specific performance criteria and task the regulator with reviewing audit committee performance against these.

Please see comment above on new powers to hold directors to account.

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

Audit committees play an important role in appointment of auditors and oversight of auditors. The CRUF believes that their role is not fully appreciated by investors. The more specific the description of what the committee does, the more investors are likely to engage. For instance, investors are very interested in the way auditors are appointed. How long was spent on the appointment process? What were the criteria for choosing the audit firm?

Then they will be interested in how audit committees and auditors have held management to account in reporting on how they have dealt or are dealing with significant (material) issues, especially those that could lead to corporate failure. This is an area where increasing and improving investor engagement with audit committees could improve the quality of corporate reporting/disclosures and audit and regulatory scrutiny of audit should encourage this.

Some CRUF participants note that the appointment and oversight of auditors should be based on an interaction between executive management, internal audit, audit committee and investors. These participants voiced their support for more investor engagement, by both large and small shareholders.

Other CRUF participants note that investor engagement is not always practical. Firstly, investors have limited time and have a duty of care to their own clients. Consequently, if there is a concern around auditor appointment or oversight it may be easier to sell the shares rather than engage.

Secondly, investors need to be mindful of receiving material non-public information (MNPI) thereby making their entire firm an insider, unable to trade the shares.

The key to engaging shareholders is to provide detailed company specific disclosure, in the public domain, as a hook for investors to ask further questions. The thematic reports and quality reviews of the ARGA will also feed this process.

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

Several CRUF participants are strongly opposed to joint audits as they believe that the costs and problems significantly outweigh any benefits. Participants note that a UK requirement for joint audit would penalise UK listed companies relative to non-UK listed companies which would not have a joint audit requirement. One participant suggested that the choice of joint audit could be put to a shareholder vote at an AGM.

A joint audit could potentially reduce audit quality because of gaps between the work of the parties leading to unintentional omission, and audit efficiency because of unnecessary duplication of work.

It is unclear whether key audit matters would be identified and commented on by one or both firms in the auditor's report. One CRUF participant noted that it would be interesting if both auditors gave their opinions on key audit matters.

Challenger firms have arguably had a worse record on audit quality than the Big 4. Page 11 of [CSFI report](#) by Paul Boyle notes that over a four-year period the challenger firms' were generally assessed to be poorer than the Big 4.

One further suggestion would be to see data on how the joint audit approach taken in France has improved audit quality.

The CRUF believes that the quality of audit and the utility of audit reports would be improved if there were a move towards graduated audit opinions. In the case of a joint audit, the CRUF accepts that it would be harder for both firms to agree on a graduated opinion. However, for users, having two different grades with clear reasons given would be very helpful in constructing forecasts of different scenarios.

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?

The CRUF is not qualified to comment on the capacity in challenger firms. It would be worthwhile to research if the 30% minimum requirement is realistic. The CRUF notes that the majority of FTSE 100 profits come from overseas. Unless challenger audit firms have large overseas operations, it seems doubtful that they would be able to audit the overseas parts of many groups.

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?

The CRUF does not believe it is reasonable for a firm to assume joint liability for a minority of the fee.

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?

Audit fees are normally immaterial to the profit and valuation, so the real question is the improvement in quality. Quality would need to be clearly defined. For example, under a more robust audit environment what percentage of "sub-standard" audits would be caught? If quality improves, then the benefits would be substantial, both for the reputation of audit and in the efficient allocation of capital.

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

The CRUF's view is mixed. It seems that the primary purpose of requiring a joint audit, or the alternatives, is to enhance the capability and access of challenger firms to audit FTSE350 companies. Once this has been achieved, will there be a need for joint audits? Some CRUF participants argue strongly that shareholders should be allowed to choose how their company is audited.

Of the alternatives to joint audit, users will more generally accept a market share cap per audit firm to be a more pragmatic solution to open a market to challenger firms. They do not necessarily accept that challenger firms, who must be qualified to the same level as the top firms, do not have the necessary capabilities or capacities to take on FTSE350 audits to provide quality audits.

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?

One CRUF participant noted that auditor choice under joint audit proposals may be reduced as both a challenger and Big 4 firm would presumably be ineligible to be reappointed at the point of audit firm rotation.

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

The CRUF supports the suggestions for a 'hot' peer review where the regulator deems it would catalyse improved quality (see paragraphs 6.82-84). As mentioned in paragraph 6.84, a cold review would risk cutting across the ARGAs' audit quality review work, which is due to be stepped up in the wake of Kingman. The CRUF believes that having an independent and informed second opinion is valuable and publication of findings would be of great interest.

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

The CRUF can see the advantage of peer reviews as an incentive to improve audit quality. These could be carried out by suitably qualified and experienced employees on secondment from

challenger firms appointed for the purpose by the regulator thus ensuring the necessary independence.

Given its knowledge and experience, the CRUF would expect the regulator to put in place an appropriate system for selection of audits for peer review.

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

The CRUF shares the concern that distress in, or the potential failure of a Big 4 firm would be destabilising for the market. It also notes that audit firm reputation is paramount and can be destroyed rapidly if confidence is lost.

The CRUF agrees that regulatory monitoring of the Big 4, especially in sectors that are important for overall financial stability such as banking, is necessary. For these critical sectors, contingency plans should be developed so that areas in distress could be separated from the remainder of the firm to allow it to continue.

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 CRUF believes that in the case of a distressed statutory audit practice the regulator should have been aware that there could be failure. In any event the regulator should have a distress programme to implement should the need arise. That programme should cater for all sizes of audit firm.

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

The CRUF notes that there are clear cultural differences between audit and non-audit services, and these cultural differences may create a conflict of interest. It also notes that potential conflicts arising when a firm provides the same company with audit and non-audit services are covered by the latest EU regulation and by the proposed tightening of the UK's auditing and ethical standards. Some CRUF participants believe that this is sufficient, others are in favour of an operational split between audit and non-audit practices.

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?

The CRUF is unclear on the reasons why a full separation was rejected by the CMA. This would be the clearest way to avoid conflicts of interest between audit and non-audit. The operational split would presumably draw on the experience of the ring-fencing of UK retail banks. The specific proposals include the separate preparation of income statements for audit and non-audit practices, but why not balance sheets also?

The scope of audit is likely to expand over time, with investor appetite for more aspects to be reviewed, including ESG issues and potentially cyber-related risks. Access to specialists outside traditional audit will become increasingly important, so any separation of audit and non-audit should not be a hindrance.



If in future the scope of audit is expanded to include services that are currently non-audit, then the boundary between audit and non-audit will move.

One CRUF participant disagrees that separation is necessary, as they consider current audit regulations to be adequate in dealing with potential conflicts of interests between audit and non-audit services.

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

This would seem sensible.

About the Corporate Reporting Users' Forum (CRUF)

The CRUF was set up in 2005 by users of financial reports to be an open forum for learning about and responding to the many accounting and regulatory changes that affect corporate reporting. In particular, participants are keen to have a fuller input into the deliberations of accounting standard setters and regulators. CRUF participants include buy and sell-side analysts, credit ratings analysts, fund managers and corporate governance professionals. Participants focus on equity and fixed income markets. The Forum includes individuals with global or regional responsibilities and from around the world, including Australia, Canada, France, Germany, Hong Kong, India, Japan, New Zealand, South Africa, UK and USA.

The CRUF is a discussion forum. Different individuals take leadership in discussions on different topics and in the initial drafting of representations. In our meetings around the world, we seek to explore and understand the differences in opinions of participants. The CRUF does not seek to achieve consensus views, but instead we focus on why reasonable participants can have different positions. Furthermore, it would not be correct to assume that those individuals who do not participate in a given initiative disagree with that initiative. This response is a summary of the range of opinions discussed at the CRUF meetings held globally. Local country differences of opinion are noted where applicable.

Participants take part in CRUF discussions and joint representations as individuals, not as representatives of their employer organisations. Accordingly, we sign this letter in our individual capacity as participants of the Corporate Reporting Users' Forum and not as representatives of our respective organisations. The participants in the Forum that have specifically endorsed this response are listed below.

(Signatures)

Jeremy Stuber

Anna Czarniecka
Financial Reporting consultant



Jane Fuller
FSIP

Greg Collett
Pictet Asset Management

Charles Henderson

Chris Moore
Evenlode

Peter Parry
UK Shareholders Association