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Dear Sirs

ICSA response to the questions set out in the CMA statutory audit services market study – update paper.

We welcome the opportunity to comment on the questions set out in the CMA statutory audit services market study update paper published on 18 December 2018.

ICSA: The Governance Institute is the professional body for governance. We have members in all sectors and our Royal Charter purpose is to lead 'effective governance and efficient administration of commerce, industry and public affairs'. With more than 125 years' experience, we work with regulators and policy makers to champion high standards of governance and provide qualifications, training and guidance. ICSA is the professional body that qualifies Chartered Secretaries, which includes company secretaries. Company secretaries have a key role in companies' governance arrangements, including companies' statutory audit services and the role of the Board and Audit Committee in both the audit process and audit tendering.

In preparing our response we have consulted, amongst others, with members of the ICSA Company Secretaries Forum, a group of company secretaries from more than 30 large UK listed companies from the FTSE 100 and FTSE 250. However, the views expressed in this response are not necessarily those of any individual members of any of this group, nor of the companies they represent.

We set out below some general comments, followed by our responses to the specific questions set out in the consultation document.

GENERAL OBSERVATIONS

We understand that the CMA's remit is limited to competition in the statutory audit market, however we do not believe the proposals set out in the paper will address the issues with statutory audits that have been identified. The concerns highlighted in the update paper relate to audit quality, which is acknowledged as being the most important factor for all stakeholders. The majority of the remedies proposed by the CMA focus instead on increasing the number of providers in the market as if breaking up the dominance of the 'Big Four' will be some sort of panacea. In most markets, the presence of four strong competitors would be seen as more than adequate provision.

In our view, this focus on breaking up the 'Big Four' is a distraction from the fundamental requirement to improve the quality of the work done by the appointed auditor and has the appearance of an ideological solution to a different problem. ICSA is concerned that the UK audit market will not improve unless issues of education, training and trust are first addressed.

1. **Education**

   There needs to be clarification of the role of audit. The political, press and public expectation of the role of audit is very different from what an auditor would perceive it to be. The CMA analysis of the 'expectations gap' in appendix C to the update paper is very helpful and rightly identifies the need for a review to consider whether the purpose and scope of audit needs to change. We do not believe that the proposed remedies address this issue.

2. **Training**

   A number of the 'accounting scandals' seen in recent years have at their heart questions of judgement. Whether particular value could, or should, be regarded as crystallised in the accounts should, in ICSA's view, be a question of fact rather than of opinion. We believe much more training is required to foster a greater spirit of professional scepticism among auditors and accounting standards need to be revisited to give greater clarity on where judgement has been applied by both the preparer and auditor. This is the question of audit quality which the update paper rightly identifies as the critical concern. But again, we do not believe that the proposed remedies address this point.

3. **Trust**

   The chief weakness of the audit market is the lack of confidence, not just on the part of companies, but also on the part of investors and some regulators, in the ability of auditors outside the 'Big Four' to provide an audit of an adequate standard for large, particularly multi-national, companies. The accuracy of this perception should be tested by an independent body and the CMA are well placed to undertake this task. If it can be shown that mid-tier firms are up to auditing the very largest companies then we believe that companies, investors and regulators will welcome them with open arms. If, on the other hand, it is shown that they are not, alternative solutions will be necessary. In either event, the remedies proposed by the CMA do not address the issue of audit quality.

RESPONSES TO SPECIFIC QUESTIONS

A. Issues

1. Do you agree with our analysis in section two of the concerns about audit quality?

Yes, partly. We agree the main concerns about statutory audit lies with the issue of quality. However this needs to be considered alongside the lack of understanding of the role and purpose of the statutory audit, and our concerns over accounting judgements, as highlighted in our general comments above.

2. Do you agree with our analysis of the issues that are driving quality concerns, as set out in section three?

a) The role of the Audit Committee and investors in appointing and monitoring auditors

No. The paper appears to misunderstand the roles of the Audit Committee and management in the selection and oversight the auditor. The Audit Committee comprises independent non-executive directors and is independent of management. Whist the Audit Committee would take management views into account, the Audit Committee alone recommends the appointment of the auditor to the Board which, in turn, recommends the appointment to shareholders. Management does not have the power to appoint or recommend the auditor and our members have cited examples where an auditor has been appointed in the teeth of management opposition. The Audit Committee it is solely responsible for the selection and oversight of the auditor, and has a key responsibility for ensuring the independence of the auditor.

Audit quality is the most important element of overall value that is taken into account by the Audit Committee when an auditor is selected. However, there are many elements of added value that the audit process frequently delivers, such as suggestions for improvements in processes or ways of working. We believe the issue of 'cultural fit vs audit quality' set out in the paper has misunderstood this additional value confusing the sustainability and diversity aspects of culture, which are an important part of many commercial tenders with a desire for a cosy relationship. The Audit Committee must ensure the independence of the auditor and ensure sufficient scepticism and challenge, but much more can be gained from the audit process by maintaining a working relationship with the auditor, with free-flowing dialogue and constructive challenge.

b) Limitations on choice leading to weaker competition

No. We do not agree that there is generally a lack of competition due to limitations on choice although there are some isolated examples where a company with multiple relationships with 'Big Four' firms can be constrained. The CMA proposals will tend to exacerbate any such limitation. There is intense competition between the 'Big Four' audit firms and also between 'challenger' audit firms. As noted in our general comments above, the most significant constraint is the lack of confidence from market participants of all types in the ability of challenger auditors to provide audits of adequate quality to the largest companies, particularly multi-national companies. The accuracy of this perception should be tested.

c) Barriers to challenger firms for FTSE 350 audits

We believe the perception that challenger audit firms cannot provide quality audit services to the largest and, in particular, multi-national companies should be tested. If it can be shown that challenger firms are a viable alternative to the 'Big Four' we believe they will be welcomed. If, however, it is shown that challenge firms are not, alternative solutions should be sought rather than focusing on efforts to increase competition between existing firms or to create artificial barriers in the market.

d) Resilience concerns

We understand the concerns that a failure of one of the 'Big Four' firms would result in reduced competition. The paper discusses examples of mitigation action plans already in place by the 'Big Four' firms to deal with such an event. We believe that he biggest driver of audit quality and the biggest asset of any audit firm is its people. In the event that an audit firm should fail, completely or in part, we would see this as an opportunity for challenger audit firms to acquire the skills and expertise needed to compete with the 'Big Four' audit firms.

e) Wider incentive issues raised by multi-disciplinary large audit firms

We believe that changes to the limits on the amount of non-audit work that the company may engage with its audit firm has reduced the risks to independence such that is no longer a concern. Many companies no longer engage the audit firm for any non-audit work unconnected with the audit, except in exceptional circumstances, and many audit firms have taken similar action. However, we believe it would be a mistake to prohibit all non-audit work being undertaken by the auditor as there are occasional circumstances when the auditor's understanding of the company is essential to providing the level of quality needed for the non-audit work. We are concerned that separating the firms will lead to the better employees gravitating towards the better remunerated consultancy roles and leaving the basic audit work to others. We do not see how this will serve to improve the standards of auditing. There is some anecdotal evidence that partners in other areas of practice within 'Big Four' firms are becoming irked by damage to the brand associated with the exposure of deficient audits and the need for them to defend audit scandals when they are pitching for business. Internal pressure of this kind brings a commercial imperative for audit firms to improve their own quality and this will be lost if the businesses are separated.

B. Remedies

3. What should the scope of each remedy be?

Given that we do not support any of the proposed remedies, it is a little difficult to answer this question, but for consistency any remedy should be applied to the same group of companies to whom similar requirements already apply.

Remedy 1: Regulatory scrutiny of Audit Committees

4. How could the regulatory scrutiny remedy be best designed to ensure that the requirements placed on Audit Committees by a regulator are concrete, measurable and able to hold Audit Committees to account? Please respond in relation to requirements both during the tender selection process and during the audit engagement.

We do not support the regulatory scrutiny remedy. We believe the role and composition of the Audit Committee has been misunderstood, as set out in our answer to question 2 a) above. The responsibilities of the Audit Committee are clear and the Committee's focus is on delivering a quality audit that provides value. Undertaking an audit tender is a very expensive process and Audit Committees will make every effort to ensure a successful outcome. The independent non-executive directors that comprise the Audit Committee are well aware of their legal duties to the company as directors. The Audit Committee and each individual member of that Committee are already externally accountable. They are held to account by investors, who will not hesitate oppose their re-election as directors and replace them if they feel the Audit Committee, or any individual appointed to it, has not acted properly in fulfilling its responsibilities.

We believe any involvement by the regulator should be by exception, and only in circumstances where a failure to the existing process has been identified and there is a need for regulatory oversight.

Remedy 2: Mandatory joint audit

5 What should the scope of this remedy be? Please explain your reasoning.

a) Should the requirement to have a joint audit apply to all FTSE 350 companies or potentially go wider by including large private companies?

We do not support mandatory joint audits. We agree with those respondents to the invitation to comment who believed that this would increase the cost of the statutory audit considerably, yet see no added value that would be obtained. We also have concerns over the duplication of work or, if work is shared, the level to which one audit firm would feel able to rely on work carried out by another audit firm. One of our more experienced members has told us that some years ago joint audits were not uncommon, but experience was that the model was abandoned for exactly these reasons. We do not believe it is appropriate to assume the experience of joint audits in France will be replicated in the UK as the audit markets in France and the UK are very different. This remedy seems to be more about increasing the commercial opportunities available to firms outside the 'Big Four' than about improving the quality of audit and we find it interesting that one of the leading supporters of the joint audit model is a firm headquartered in France.

b) What types of companies (if any) should be excluded from a requirement for joint audit?

If, however, it is decided that joint audits are to be mandated we would highlight the fact that the increased costs associated would impact smaller companies disproportionately.

6. Should one of the joint auditors be required to be a challenger firm? If so, should this be required for all companies subject to joint audit? Are there any categories of companies to which this requirement should not apply? Please explain your reasoning for each of the answers.

We do not believe it is necessary to mandate joint audits using one 'Big Four' firm and one challenger firm to provide exposure of challenger audit firms to larger companies. This is already being achieved by challenger firms providing non-audit services to such companies, as a result of the restrictions placed on the audit firm providing non-audit services. If challenger audit firms can demonstrate the ability to deliver quality services to large, complex companies we believe they will be invited to tender for the statutory audit at an appropriate time. Requiring the use of a challenger firm as one of the partners in a joint audit seems to be more a matter of giving work to the challenger firm than improving audit quality.

7. Should a minimum amount of work (and fee) allocated to each joint auditor be set by a regulator? If so, should the same splits apply across the FTSE 350? (please comment on the illustrative examples in section four). Please explain your reasoning.

We believe it would be inappropriate for the regulator to mandate any level of work and/or fee that should be allocated to each joint auditor. The remit of the statutory audit and fees paid for the work are the responsibility of the Audit Committee of independent non-executive directors. The Audit Committee understands the business of the company, and what is needed from the statutory audit, in a way that cannot be understood by the regulator. This would also transfer elements of Audit Committee's responsibilities to the regulator and reduce shareholders' ability to hold the Audit Committee to account if the audit work was subsequently found wanting.

8. Our provisional view is that there would be merit in the joint auditors being appointed at different times. Should this be mandated, or left to the choice of individual companies? How should companies manage (or be mandated to manage) the transition from a single auditor to joint auditors?

Audit Committees are free to appoint joint auditors to the company if they wish, for example, if they feel it would produce a higher quality audit be of benefit in some other way. They are also free to make additional appointments at any time if they feel this would be useful. However, such matters should be left to the Audit Committee to decide, taking into account the views of management, as they are in a position to understand the needs of the business. We do not believe this should not be mandated as there are no perceived benefits in most circumstances.

9. Should a joint liability framework be introduced to encourage active participation in the market by the Big Four and challenger firms? Please explain your reasoning. In the context of joint audits, what are the advantages or disadvantages of auditor liability being proportionate to the audit fee of the joint auditors, compared to the auditors being jointly and severally liable?

We have concerns that the proposal to introduce a joint liability framework for joint audits between 'Big Four' and challenger firms would be fraught with difficulty. We understand the attraction of having liability proportionate to the audit fee rather than joint and several liability but believe this would be impossible to implement in practice. In the event of an audit failure it is frequently difficult to establish exactly which part of the audit process had caused the failure – and therefore, in a joint audit situation, which audit firm should be held liable. In addition, where an audit failure resulted in loss to a company, the company would need to protect itself by ensuring the audit firm with the 'deepest pockets' could be held liable.

Remedy 2A: Market share cap

10. How could the risks associated with a market share cap, such as cherrypicking, be addressed?

We do not believe it has been demonstrated there is sufficient capability amongst challenger firms to allow a market share cap to operate without substantial risk to the quality of statutory audits overall. We would emphasise the importance of an independent body establishing whether or not challenger firms have the capability to audit the very largest companies before imposing any market share cap. If they can, we believe that companies, investors and regulators will welcome them – and there will be no need to introduce such measures as a market share cap. If, however, it is shown that they are not, alternative solutions will be necessary. Otherwise this proposal would simply reduce the choice of auditor for large, complex companies and thereby reduce competition and audit quality.

11. Would it need to apply only to FTSE 350 companies, or also to other large companies, and if so, which?

As the FTSE 350 and other large firms are the primary users of the 'Big Four' firms, it would make sense to apply a market share cap in relation to these companies if the aim is to increase the use of challenger audit firms by these companies. Our understanding was that the intention of the remedy was, conversely, to improve audit quality. In a market share cap environment, the impact on individual companies would vary, depending entirely on the level at which the 'cap' is set. If the market share cap resulted in some FTSE 350 companies experiencing difficulty in appointing an auditor with the capability to carry out a quality audit, then these companies should be given priority over large private companies in accessing the capability of 'Big Four' firms, because of the risk to the shareholders who own the company, but have no involvement in its management.

Remedy 3: Additional measures to reduce barriers for challenger firms

12. We welcome evidence from stakeholders on the existence of barriers to senior staff (including partners) switching quickly and smoothly between firms. We also welcome views on how justified such barriers are, bearing in mind commercial considerations that audit firms have.

We have no experience of unreasonable barriers to senior staff switching between audit firms. There are perfectly reasonable justifications for firms having some restrictions, for example notice periods, in place but, if unjustified barriers exist, we would support measures to address this.

13. We welcome estimates on the costs of setting up and running a tendering fund or equivalent subsidy scheme, and views as to how this should be designed.

Audit tenders are expensive but it seems to us to be anti-competitive to oblige some firms to subsidise the business models of others. On this basis we believe the establishment of a tendering fund to be inappropriate.

14. We welcome comments as to whether the Big Four should be compelled to license their technology platforms at a reasonable cost to the challenger firms, and/or contribute resources (financial, technical, algorithms and data to enable machine learning) towards developing an open-source platform. In the first scenario, we also welcome comments on how such a 'reasonable cost' might be determined in such a way that it is affordable for challenger firms but does not disincentivise Big Four firms from innovating and developing new platforms.

Once again this remedy seems to be more concerned with addressing the market dominance of the 'Big Four' than improving audit quality. It seems anti-competitive to oblige some firms to subsidise the business models of others.

Remedy 4: Market resilience

15 -18 We believe that these questions are better directed to the FRC and the audit firms. They are important ones for the market and the CMA to address, but we do not believe that they impact audit quality.

Remedy 5: Full structural or operational split

19. Do you agree with the view that the challenges to implement a full structural split are surmountable (especially relating to the international networks)? If not, please explain why it would be unachievable, i.e. that the barriers to implement this remedy could never be overcome, including through a legislative process.

We believe that requiring a full structural split would be particularly onerous, and do not believe it is either necessary or helpful. As we noted in our response to question 2(e) above, changes to the limits on the amount of non-audit work that the company may engage with its audit firm has reduced the risks to independence such that is no longer a concern. Many companies no longer engage the audit firm for any non-audit work unconnected with the audit, except in exceptional circumstances, and many audit firms have taken similar action.

We are concerned that separating the firms will lead to the better employees gravitating towards the better remunerated consultancy roles and leaving the basic audit work to others. We do not see how this will serve to improve the standards of auditing. There is some anecdotal evidence that partners in other areas of practice within 'Big Four' firms are becoming irked by damage to the brand associated with the exposure of deficient audits and the need for them to defend audit scandals when they are pitching for business. Internal pressure of this kind brings a commercial imperative for audit firms to improve their own quality and this will be lost if the businesses are separated.

20. How could an operational split be designed so that it would be as effective as the full structural split in achieving its aims, without imposing the costs of a full structural split? In your responses, please also compare and contrast the full structural split to the operational split

We believe changes in recent years limiting the amount of non-audit work that may be carried out by the auditor have had a substantial impact on the level of non-audit work carried out by auditors. We are aware that companies tend to keep all non-audit work to a minimum, well below the level permitted. We believe appointing the auditor to carry out such work should be only in exceptional circumstances. If the overall level of non-audit work carried out

by auditors remains a concern, we would support further restrictions, however we would not support a full operational split. There are occasions when the auditor's knowledge and understanding of the company are essential to the carrying out of quality non-audit work and, for smaller companies in particular, the costs may be increased substantially when appointing another audit firm.

21-24 We would suggest that these detailed operation questions are better directed to the FRC and audit firms although do believe that any requirements for a structural or operational split within audit firms should apply to all, including challenger firms.

Remedy 6: Peer review

25 What should be the scope (ie which companies) and frequency of peer reviews, if used as a regulatory tool?

We see little evidence of the behaviours and deficiencies described in the paper that suggest a need for 'peer reviews' but believe this would be appropriate in certain circumstances, where concerns had been identified by the regulator.

26 How could peer reviews be designed to best incentivise auditors to retain a high level of scepticism, and thus improve audit quality?

Again, we see little evidence that auditors are not already incentivised to carry out high quality audits with an appropriate level of scepticism, but 'peer reviews' would be helpful in circumstances where concerns had been identified by the regulator.

C. Next steps

27 What are your views, if any, on our proposal not to make a market investigation reference?

We agree. The report of the Kingman review of the Financial Reporting Council proposes substantial changes to the operations of the regulator and this will impact the statutory audit market. Sir Donald Brydon has been tasked with carrying out a further review and there remains the possibility of further legislative action resulting from the BEIS Committee inquiry. We therefore do not believe a market investigation reference is appropriate at this time.

We hope you find our comments helpful and would be happy to expand on any of these points should you wish to discuss them further.

Yours faithfully

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Policy & Research Director