THE INVESTMENT ASSOCIATION

Business, Energy and Industrial Strategy Select Committee

Inquiry into the future of audit

Response from the Investment Association

11 January 2019

EXECUTIVE SUMMARY

The Investment Association[1] (IA) welcomes the BEIS Select Committee undertaking this inquiry into the future of audit. In preparing this submission, feedback was sought from the IA's members and also from members of the Company Reporting and Auditing Group (CRAG). CRAG is the main UK grouping of institutional investors that specifically focuses on accounting and auditing issues, and provides input to the IA's responses.

In managing assets for both retail and institutional investors, the IA's members are major investors in listed companies. They rely on the quality and robustness of audits when making investment decisions and holding company management to account. A high quality audit is vital to ensure the markets trust and have confidence in the information companies report.

The Select Committee is specifically asking for views on the CMA's Statutory Audit Services Market Study Update Paper and Sir John Kingman's report on his conclusions from his Independent Review of the FRC. Both of these papers were published on 18 December and the IA and its members are still considering their responses to both. Thus the answers in this submission are largely based on previous submissions to the CMA and Sir John and may further develop as we consider these latest reports.

In this context, set out below are the IA's key observations on the matters covered in the inquiry, and in the attached Annex our answers to the particular questions raised.

- For investors audit quality is key but their views vary on whether and how it needs to be improved. Whilst for many investors recent high profile failures and declining audit inspection scores have undermined trust in audit such that they consider measures are needed, others consider that on the whole in the UK audit quality is satisfactory and that recently introduced mechanisms should be given more time to take effect.

- There are concerns about the dominance of the Big Four as auditors for FTSE 350 companies and the lack of choice an entity can have when it tenders its audit (audit firms can be precluded from participating if they provide prohibited non-audit services) can impact audit quality. With such limited choice, investors question whether audit

[1] The IA champions UK investment management, a world leading industry which helps millions of households save for the future while supporting businesses and economic growth in the UK and abroad. Our 250 members range from smaller, specialist UK firms to European and global investment managers with a UK base. Collectively they manage £7.7 trillion for savers and institutions, such as pension schemes and insurance companies, in the UK and beyond. Forty per cent of this is for overseas customers. The UK asset management industry is the largest in Europe and the second largest globally.

firms are really competing on quality issues. The IA thus welcomes the market for audit services and audit quality being looked at.

- A factor that impacts audit quality is the conflicts that arise when the auditor provides non-audit services. This can impair the perception of auditor independence and objectivity in that the significant revenues generated and the nature of the services can lead the auditor to identify themselves with the interests of company management rather than investors. It is the latter that rely on the auditor's work and to whom the auditor reports. Auditors need to start to consider investors as their clients and not the audited company.

  The EU Audit Regulation went some way to address conflicts in prohibiting a wider range of services and limiting others. Nevertheless there are still concerns. Independence is important for quality and the IA supports a limited ban such that the provision of non-audit services to audit clients in the FTSE 350 and/or PIEs is prohibited.

  Many investors are concerned about going further than this and requiring a structural split and "audit-only" firms (as proposed in CMA Remedy 5). The Big Four are international and often responsible for the audit of global companies. They need to remain connected to their international network to service global clients leaving questions over the non-audit services provided by that network. A quality audit also requires quality staff who can challenge and apply economic rationale. The seasonality of audits (the majority of companies have 31 December year ends) could impact the ability of an audit only firm to retain such staff. An operational split, on the other hand, would be simpler and not give rise to these same issues. However, it would require detailed regulatory oversight to ensure it is effective in delivering the anticipated benefits for the audit market without the issues that arise with a structural split.

  That said, certain investors consider the actual and/or perceived conflicts and lack of independence that arise through the provision of non-audit services merit consideration being given to the creation of audit-only firms. In particular, the complex structures and range of non-audit services provided by the Big Four can be a substantial barrier for entry for the non-Big Four or challenger firms. An audit-only firm environment could encourage new entrants.

- One of the proposals to help increase competition and choice in the market is to require joint or shared audits on the basis this could lead to an improvement in the quality and capability of the non-Big Four or challenger firms (CMA proposed Remedy 2). This Remedy brings the benefit of additional scrutiny and challenge. However, if it is to be explored further then investors would need to be persuaded that it would work in practice in that: there is no evidence that joint or shared audits increase audit quality, independence and choice; there would be practical issues with two audit firms signing off the accounts, including lack of consistency in approach and increased costs; there is a risk of issues being missed or falling between the gaps; with joint audits liability is jointly held regardless of whether a particular party performed a weak audit; and with a shared audit, one party would always be the junior party and unlikely to increase their market share as a result.

- As an alternative to joint or shared audits, we consider a market share cap and a limit on the proportion of large companies and PIEs the Big Four can audit could be a direct way of increasing the number of audit firms in the market (CMA proposed Remedy 2A). However, there are a number of issues that would need to be addressed before this could be taken forward such as: ensuring enough firms have sufficient sector expertise and global reach; the fact a cap could blunt competition and reduce the choice of audit candidates if firms are at their cap; and the need for safeguards so that the Big Four do not cherry pick the less risky audits.

- Audit committees and investors also have an important role to play in this. Whilst the best audit committees are very good and genuinely independent, not all are and do not necessarily appoint the auditor that will deliver the best audit, improve reporting and add challenge to the boardroom. Too often we see the audit committee of a FTSE 350 company being reticent to appoint a non-Big Four or challenger firm on the basis they do not consider they are credible for the scale and complexity of their business. This can lead to a more concentrated market-place. Some also still consider that reducing the audit fee is in the interests of shareholders when the opposite is true. Nor do all committees sufficiently challenge auditors on the depth of their work.

  Requiring audit committees to report to the regulator on any audit tenders and throughout the audit engagement will help ensure they carry out their role more effectively (CMA proposed Remedy 1). In addition to this, investors would like more insight into how an audit committee has ensured there has been a quality audit. The committee should report why it had recommended a particular auditor following a tender. Annually it should assert why it believes the auditor has been challenging and exercised professional skepticism.

  We recognise that investors have an important role to play in ensuring quality audits. The enhanced transparency by audit committees proposed above and in question 5 would enable investors to see how the committee has ensured a quality audit and enable them to engage and better hold audit committees and auditors to account.

- We welcome Sir John Kingman's recommendations in his final report on the Independent Review of the Financial Reporting Council (FRC). These include a number put forward by the IA, notably:

    - The regulator should have a more focused remit, objective and mission statement.
    - The regulator should have a statutory footing and ultimately be accountable to Parliament.
    - CRR and AQR outcomes should be published.
    - The regulator should have wider powers to take enforcement action against all directors, not just members of professional bodies.
    - The voluntary levy which currently funds the FRC should be replaced with a statutory levy.

  Sir John was also asked to look at how audits are procured, and audit fees and scope set. He is now proposing that auditor appointments for public listed companies should be made, and audit fees set, by the new independent regulator proposed in his Review. We had been concerned about this in that it disenfranchises shareholders and removes directors' responsibilities to them in this respect. Cognisant of this, Sir John has specified that the new regulator would only become involved in three specific circumstances: where quality issues have been identified with a company's audit; where a company has parted company with its auditor, other than as part of the normal rotation; and where there has been a meaningful shareholder vote against an auditor appointment. Our initial view is to welcome this - these instances are indicative that the current construct for appointing a quality auditor is not working effectively. We are working with members to confirm this position.

We trust that the above and attached are self-explanatory but if you require any clarification of the points raised or wish to discuss any issues further then please contact Liz Murrall at liz.murrall@theia.org or on +44 (0) 207 269 4668.

THE IA'S ANSWERS TO THE DETAILED QUESTIONS RAISED

The IA's detailed answers to the questions raised are set out below.

AUDIT QUALITY AND COMPETITION

1. What is the relationship between competition and quality in the audit market? How should reforms in one area complement the other?

The IA's members are major investors in listed companies. They are key users of the information in a company's annual report and accounts which provides them with the information they need to make investment decisions and fulfil their responsibilities as owners in holding company management to account. The fact the annual report and accounts is subject to an audit is vital to investors' confidence in these companies and the information reported.

For investors it is vital that audits are high quality, trusted and there is a well-functioning market for audit services. However, their views vary on whether and how these matters should be addressed.

Recently there have been some high profile failures which have had have serious implications for companies, the people they employ, their suppliers and shareholders. In addition, whilst in the past the FRC's AQR noted that its audit inspection results were improving, in June 2018 it indicated that "the Big Four audit practices must act swiftly to reverse the decline in this year's audit inspection results if they are to achieve the targets for audit quality set by the Financial Reporting Council[2]".

For many investors these trends have undermined trust in audit and they consider measures are needed to re-establish it. Others, on the other hand, consider that on the whole in the UK audit quality is satisfactory and that recently introduced mechanisms should be given more time to take effect.

Audit quality can be particularly impacted by a lack of independence and objectivity which can arise from:

- The limited competition and choice in the market.
- Non-audit services and the conflicts that result.
- The incentives that operate.

As regards competition, the dominance of the Big Four firms as auditors of companies in the FTSE 350 is a sign that there is a competition issue in the audit market. It is also apparent that previous reforms which aimed at addressing this have not been effective: indeed the proportion of FTSE 350 audits carried out by the Big Four has only increased[3]. There is also a risk that one of the main four firms could fail which would further aggravate the situation.

[2] The FRC highlighted that 73% of FTSE 350 audits reviewed in 2017/18 were categorised as requiring "no more than limited improvements" as compared to 81% in 2016/17.

[3] Page 22 of the CMA's Statutory Audit Services Market Study update paper: "the overall share of the Big Four by number of audit clients [in the FTSE 350]has remained stable since 2011 – increasing slightly from 95% to 97% in 2017".

This lack of competition creates limited choice when an entity tenders its audit which can be further impacted when audit firms provide certain prohibited non-audit services and are precluded from participating. Thus the incumbent may be time-barred and unable to participate in the tender process; other audit firms could be precluded as they provide prohibited non–audit services to the entity; and others could audit competitors of the entity. An entity may be faced with only one or two viable "choices".

For investors audit quality is key and there are concerns that this lack of competition and choice can impact it. The two are often related. Investors want the auditor that will provide the highest quality service appointed. But with so few players, some investors question whether auditors are really competing on quality issues. Even between the Big Four they can appear to be largely "cosily competitive" with each other in that there is little evidence of the development that a fully competitive market can bring to meet the market's needs for quality audits. The absence of real competition has led to a lack of innovation which could impact quality.

To ensure confidence in corporate reporting and quality audits, there needs to be a well-functioning market for audit services and more competition and choice. This would be helped by the non-Big Four or challenger firms scaling up their operations so that they can compete for the audit of large, complex entities in the FTSE 350. However, we do not believe it likely that there will be an organically developed competitor to the Big Four in the medium term. We set out below our views on the various proposals that are looking at this.

CMA PROPOSALS

2. **Do you agree with the CMA proposals (when published)? Will the remedies proposed be likely to increase quality and trust in audits? Are there any potential unintended consequences?**

As noted under question 1, investors want to see more competition and choice in the audit market in the interests of ensuring high quality audits. We welcome the CMA's Update Paper proposing remedies to deliver this. We will be responding to that Paper and detailed questions raised in full. In the meantime, an overview of the IA's members' initial views on the remedies are set out below.

Remedy 1: Regulatory scrutiny of audit committees. The IA supports more regulatory scrutiny of audit committees. It is vital that the non-Big Four or challenger firms scale up their operations so that they can compete for the audit of large, complex entities. Audit committees have an important role to play in helping this.

THE IA'S ANSWERS TO THE DETAILED QUESTIONS RAISED

We supported the EU Audit Regulation from June 2016 requiring audit committees to be responsible for the audit tender process and the final recommendation to the board. However, too often we see the audit committee of a FTSE 350 company being reticent to appoint a non-Big Four or challenger firm on the basis they do not consider they are credible for the scale and complexity of their business. This can mean that challenger firms are reticent to participate in a tender. Also the costs of tendering a major audit can be more easily absorbed by a large audit firm and be a barrier to entry for challenger firms.

Investors have been clear that they expect the committee to ensure a wide range of firms are invited to participate in a tender and, where practical, firms other than the Big Four should be included. Each candidate should have a genuine prospect of being successful. Investors consider that, depending on each group's circumstances, only the larger multinational groups should have to restrict their choice to the Big Four audit firms. See IA's Audit Tender Guidelines.

In undertaking the tender, the audit committee should consider audit fees in that they should be reasonable, i.e. not too low to suggest audit quality could be impaired and not too high as to be excessive. However, they should not be the main factor, particularly in the early stages of the tender process. Although the evidence in the Update Paper is that audit committees focus on quality rather than price, investors still hear that certain committees consider reducing the audit fee is in the interests of shareholders when the opposite is true. Moreover, if the audit firms invest in more and better technology then this should ultimately result in a reduction in the cost of audits and associated fees.

When the committee recommends the appointment of a particular auditor to the board, investors want the auditor that will provide the highest quality audit appointed. We are concerned that selection criteria can include matters such as "easy to work with", "cultural fit" and "chemistry". In view of this, certain investors consider that company management should be prohibited from being involved in any decisions related to audit tenders. It is a company's shareholders that rely on the auditor's work and to whom the auditor reports. Audit committees and auditors should consider the investor community to be the auditors' true clients and ensure their needs for a quality audit are met. Prospective auditors should demonstrate clearly that they can provide a quality service, compete on quality issues and challenge management. This should help drive innovation in the market place and achieve consistently higher quality audits over time.

The audit committee also has an ongoing role in ensuring the appointed auditor delivers a quality audit. In this context, investors are concerned in that while the best audit committees are very good and genuinely independent, too many are not and do not necessarily use the relationship with the auditor to improve reporting and add challenge to the boardroom. Nor do all committees sufficiently challenge management on their judgements or auditors on the depth of their work and analysis. They are not necessarily carrying out their role effectively.

We thus support the CMA requiring audit committees to report directly to the regulator:

- Before, during and after a tender selection process.
- Throughout the audit engagement.

We consider this will help ensure that audit committees fulfil their function properly. That said, there is little in the Update Paper on how any of this will be made transparent to investors. Whilst the Paper states that the regulator will be able to issue public reprimands or direct statements to shareholders, this is only likely to be exercised in extremis when the regulator considers the committee has not followed proper procedures.

Investors welcomed the increased transparency by audit committees following successive revisions of the UK's Corporate Governance Code. Audit committees are required to report on how they assessed the independence and effectiveness of the external audit. Nevertheless, investors have been disappointed that in practice often the description is generic and based on the answers to questionnaires which in the main have been drafted by audit firms.

The real issue for investors is whether the company in which they have an interest has appointed an auditor that can deliver, and has delivered, a quality audit. This goes beyond checking compliance with accounting standards and gives assurance to investors that the accounts can be relied on to provide a true and fair view of performance and ultimately that capital is maintained.

Investors would like audit committees to give more insight into the steps they have taken to ensure a quality audit in their audit committee reports. If there has been a tender then the committee should be transparent as to why it recommended a particular auditor and considered that firm would provide a quality audit. Annually it should assert whether it believes the auditor has provided a quality audit, been challenging, the granularity of key accounting issues and how the auditor challenged management's judgement and assertions, and exercised professional scepticism. The committee should report on what it itself challenged and the specific areas it asked the auditor to look at and why. At present these matters are rarely transparent. More transparency would facilitate more and better investor engagement with both audit committees and auditors– see question 5.

THE IA'S ANSWERS TO THE DETAILED QUESTIONS RAISED

Remedy 2: Mandatory joint audit. This Remedy brings the benefit of additional scrutiny and challenge. However, if it is to be explored further then investors would need to be persuaded that it would work in practice in that:

- We do not consider there is any evidence that joint or shared audits increase audit quality, independence and choice. Indeed they could reduce the number of firms that could be invited to tender in that there would be two incumbents as opposed to one. They would also reduce the number of providers for other services that an auditor is prohibited from providing to the audited entity.
- There would be practical issues with two audit firms signing off the accounts in the case of a joint audit, including lack of consistency in audit approach and increased costs.
- There is a risk of issues being missed or falling between the gaps. We note that audit regulators have noted examples of poor co-ordination and oversight of component auditors' work. Joint or shared audits may only serve to exacerbate this.
- As noted in the Update Paper, both joint auditors sign off the same audit and liability for any issues is jointly held regardless of whether a particular party delivered a weak audit.
- With a shared audit, we would be concerned that one party would always be the junior party and unlikely to increase their market share as a result.

Remedy 2A: Market share cap. Investors support a market share cap as a means of reducing the barriers to challenger firms expanding the number of large companies they audit. A limit on the proportion of large companies the Big Four audit could increase the number of audit firms in the market by allowing challenger firms to achieve greater scale and experience. It could also trigger more mobility of ambitious audit staff conscious of the limits to opportunity within the Big Four. Nevertheless, there are a number of complex factors that need to be addressed:

- Ensuring there is sufficient sector expertise and global reach in the market. There could be a decline in audit quality if firms are appointed that do not possess the necessary capabilities.
- Whilst a market share cap may open the market to new entrants, it could blunt incentives for audit firms to compete, reducing competition and resulting in audit fees increasing or quality falling.
- Companies would have less choice if an audit firm is at its capped limit. This could also impact the attractiveness of the UK for international companies to list.
- As acknowledged in the Update Paper, it is important that safeguards are introduced so that the Big Four do not cherry pick the less risky audits. For example, say a cap was imposed of 20% of the audit market for any one auditor. The Big Four would thus take 80% and the remaining 20% is likely to be particularly risky, costly in terms of geographic distribution, complex and have reputational issues. Prohibiting the Big Four

resigning without the audited company's approval and limiting the Big Four's choice as to which company they can bid for, as proposed, would each have unintended consequences.

In conclusion, more work is needed to determine how the cap should be constructed, monitored and reviewed before this remedy could be taken forward.

Remedy 3: Additional measures to reduce barriers for challenger firms.

Senior staff switching. The Update Paper states that if senior staff could switch easily between firms it would allow challenger firms to hire experienced staff from the Big Four, and thus help build their capacity. It asks about the barriers to this. We consider these are:

- The risk that the Big Four staff switch only among the Big Four, and not to the challenger audit firms. As we note under Remedy 2, a market share cap could trigger more mobility of ambitious audit staff conscious of the limits to opportunity within the Big Four.
- It is likely that only those staff that have little chance of future promotion would move from the Big Four.
- Each firm has its own audit processes/ software giving rise to a huge learning curve.

The CMA favours helping challenger firms build their capacity through prohibiting, or limiting the length, of non-compete clauses on the basis such clauses can make it harder for audit partners and staff to switch firms. This may not necessarily be effective in that it assumes that partners and staff switch from the Big Four to the challenger firms when the reverse may be the case.

Licensing technology platforms and/or contribute to an open resource. The IA has reservations about such a measure. First, each of the firms has its own audit processes/ software giving rise to a huge learning curve. Secondly, it is highly likely that the Big Four would only put their worst resource into the open source pool available for all. There is also the possibility that innovation could stall if a firm no longer had exclusive access to the systems it had developed. Lastly, the international ramifications would be likely to be complex to resolve.

Remedy 4: Market resilience. Investors are concerned that the present level of market concentration compromises regulatory oversight in that the regulator might not be willing to impose significant sanctions for fear of driving one of the major players out of the market - they are 'too big to fail'. Also should one of the Big Four fail and its staff and clients transfer to another Big Four, as happened with the demise of Anderson where staff transferred to Deloitte, this would exacerbate the choice issues and result in the Big Three as opposed to the Big Four. We thus welcome the CMA looking at designing a resilience system where:

- If audit firms in same network in another large market are at risk, it incentivises and/or mandates the movement of clients and staff to challenger firms. (Although we question whether the regulator would be able to do this internationally.)
- If the problem is limited to the UK network firm, it incentivises and/or mandates that clients and staff of the failing firm remain with the firm while a special administrator attempts a turnaround.

We also support the CMA's initial view that moral hazard could be addressed by ring-fencing the equity within the firm relating to audit and non-audit partners with partner drawings under regulatory review. A distribution to the partners should only be made if the turnaround is successful or if staff transfer to a challenger firm.

Remedy 5: Full structural or operational split. Independence is important for quality and investors support a limited ban on non-audit services such that the provision on non-audit services to audit clients in the FTSE 350 and/or PIEs[4] is prohibited. Once the firm has stopped providing non-audit services there should be a cooling off period before it can be appointed as an auditor. Any restriction should be applied consistently across all audit firms and in the interests of efficiencies the auditor should still be allowed to provide certain audit-related services, such as reviewing preliminary announcements or auditing regulatory returns.

Many investors do not support a structural split and "audit-only" firms where the ownership of the audit and non-audit services practices of UK firms are separated. First, such a remedy cannot be viewed in isolation but needs to have international reach to be effective. The Big Four audit firms are international and often responsible for the audit of global companies. The UK audit-only firm would need to remain connected to the international network to service global clients leaving questions over the non-audit services provided by that network. There is also a risk that the international networks break away from the UK audit–only firms again impacting the firms' global reach and the attractiveness of the UK market.

Secondly, a quality audit requires quality staff who can challenge and apply economic rationale (not simply box tick). If firms were restricted to providing only audit services, particularly due to the seasonality of audits (the majority of companies have 31 December year ends), it could impact their ability to retain such staff. Moreover, due to the level of complexity and judgement required in undertaking a major audit, specialist non-audit staff are often needed to help and advise. Investors want auditors to exercise professional scepticism which necessitates firms having access to the widest possible experience so that their staff can see economic substance over form and who are up to date with accounting requirements. If this resource is not available to audit-only firms this is likely to reduce rather than enhance audit quality.

[4] A PIE, as defined, is an entity incorporated in an EU Member State with equity or debt listed on an EU regulated market; or a credit institution or insurance undertaking.

Lastly, smaller firms may not have the necessary economies of scale to recruit and fund such resources in an audit-only environment. Moreover, a structural spilt may only serve to exacerbate the dominance of the Big Four in that they would no longer be precluded from participating in audit tenders on the basis of the non-audit services they provide.

The IA's members' views are more divided on an operational split in that it does not give rise to the same issues as a structural split. However, it would be complex to implement and would require detailed regulatory oversight to ensure it is effective in delivering the anticipated benefits for audit without the downsides of a structural split, such as reviewing transfer pricing and information-sharing arrangements.

Certain investors would go further and consider the actual and/or perceived conflicts and lack of independence that exist by allowing audit firms to provide non-audit services merit the creation of audit-only firms. In particular, the complex structures and range of non-audit services provided by the Big Four can be a substantial barrier for entry for the non-Big Four or challenger firms. An audit-only firm environment could encourage new entrants. They also consider that an audit-only firm would be able to procure the specialist knowledge required in the market or if there is sufficient demand retain it in-house.

Remedy 6: Peer review. We consider there is merit in exploring the introduction of peer reviews in that they could benefit audit quality by providing an additional, independent quality check. We note under question 1 that the FRC's AQR noted in June 2018 that there had been a decline in this year's audit inspection results. This trend is concerning and undermines investor confidence in audit which is vital to the effective operation of the capital markets. Peer reviews could help in addressing this.

KINGMAN PROPOSALS

3. **Do you agree with the Kingman proposals regarding the FRC (when published)?**

The IA responded to Sir John Kingman's Independent Review (the Review) of the FRC. On the whole we agree with the recommendations in his final report and very much welcome the Review recognising investors' key role as the clients of the audit process. We also called for and support a number of the recommendations being put forward for the regulator, as follows (recommendation number in brackets):

- Clear statutory powers and objectives, and a new name for the FRC (1 and 3). We consider clarifying the former will help the organisation better determine its

responsibilities and ensure it has the right remit. The FRC currently covers a much broader range of activities and remit than its name suggests.
- A new strategic objective which emphasises protecting the interests of the users of financial information, investors, and the wider public interest (4). The current mission statement is too wide ranging to provide any real strategic guidance for the organisation.
- A diversity of perspective in both governance and the teams with the latter including economists, analysts, investment experts and corporate lawyers (9, 67 and 68). This will help address the perception among investors that the FRC is staffed by too many ex-auditors.
- The publication of AQR and CRR results. This will give investors a better understanding of the FRC's findings and concerns and enable them to make more informed investment decisions and guide their stewardship activities. We note that it is proposed that AQR reports will initially be anonymous until there is greater confidence in the AQR process (20 and 26).
- Enforcement powers over all directors of PIEs regarding the preparation and approval of accounts, not just members of professional accountancy bodies (36 and 37).
- Enforcement performance to be monitored and be more transparent (32), together with powers so the regulator can be more proactive (46). We called for more transparency over the FRC's enforcement and how it holds companies, auditors and individuals to account to demonstrate it is fulfilling its regulatory duties effectively.
- An updated Stewardship Code that emphasises outcomes and effectiveness not just policy statements (42). We firmly believe there should be a greater focus on how individual signatories to the Code have carried out their stewardship responsibilities.
- Wider and deeper engagement with investors (43). The IA considered that the FRC could do more to take the investors' voice into account and some investors feel that the FRC does not consider shareholders, the end users of the products the FRC regulates, are key stakeholders.
- Ultimate accountability to Parliament (54 and 55).
- The replacement of the voluntary levy with a statutory levy (64).
- A review of the powers needed to regulate the actuarial profession which should not fall to the FRC or its successor (74 and 75).

The Review has produced a wide ranging package of recommendations - some we called for and many others we support. We welcome their implementation as soon as practicable in order to address the issues identified and restore confidence in the UK's accounting and auditing regime. While the final report is challenging for the FRC, it acknowledges that the FRC continues to have a number of strengths and retains respect amongst the international and regulatory community. Implementing the recommendations will have resource implications for the new regulator and we would be concerned if this were to impact significantly its day-to-day operations and areas of strength.

Separate to the above, Sir John was asked to look at how audits are currently procured, and audit fees and scope set, particularly for major companies of public interest. In his response, he proposes for public listed companies, instead of the auditor being proposed by the company board and approved by shareholders, the appointment should be made, and audit fee set, by the new independent regulator proposed in his Review – the Audit, Reporting and Governance Authority.

Our response to Sir John on this did not agree with auditor appointments being the responsibility of an independent body. We supported the current construct where the audit committee effectively oversees the audit tender and makes a recommendation to the board. If the board does not accept that recommendation then, in accordance with the UK Corporate Governance Code, the audit committee has to explain why in its report. The investors then ratify the appointment at the AGM. Making the appointment the responsibility of an independent body would disenfranchise shareholders and remove directors' responsibilities to shareholders in this respect.

Sir John is cognisant of investor concerns and explicitly acknowledged the IA's views in his response. His recommendation is that the new regulator has the right to appoint an auditor in three specific circumstances:

- Where quality issues have been identified with a company's audit.
- Where a company's auditor has resigned, other than as part of the normal rotation.
- Where there has been a meaningful shareholder vote, even one well short of 50%, against an auditor appointment.

Our initial view is to support appointments by the regulator in these specific instances in that they are indicative that the current construct is not working effectively in ensuring a quality audit or that there may be other issues. There is a case for the regulator intervening when a significant proportion of the share register has requested it to do so. We are working with members to confirm this position.

We would also like to see shareholders, prior to a change of auditor, being given the opportunity to approve the appointment of the new auditor. This would provide a focus for the tender process and oblige the audit committee to set out the process, and why it chose that particular auditor and considered the fee to be at the right level – see comments under question 2 remedy 1.

THE IA'S ANSWERS TO THE DETAILED QUESTIONS RAISED

CONFLICTS OF INTEREST

4. To what extent do conflicts of interest undermine trust in audit? How best can they be removed or mitigated?

IA members have concerns over the conflicts of interest that can arise:

- Through audit firms providing non-audit services.
- At the regulator (FRC).
- Where audit committee members include recent past partners and employees of audit firms.

We set out below our observations on each of these.

Non-audit services

For auditors to deliver a quality audit, it is vital that they are independent of management and objective in making decisions. However, auditors' independence and objectivity can be compromised when they provide non-audit services to an audited entity. The EU Audit Regulation went some way to address this. It extended the list of prohibited non-audit services for PIEs to include services such as tax advice, book keeping and internal audit, and permitted non-audit services up to a cap of 70 per cent of the average audit fee paid in the last three consecutive years. However, there is no outright ban.

We set out under question 2, Remedy 5 our views on a structural or operational split to address this.

At the regulator

As noted in the IA's response to Sir John's Review, there is a perception that the FRC is staffed by too many ex-auditors, especially from the Big Four, and that they may have conflicts of interest which could, or be perceived to, impact the regulator's effectiveness. There is also concern that the FRC's Board does not comprise enough individuals from non-audit backgrounds.

While it is clearly important to have people in the FRC with the technical skills to deal with audit matters, there is a need for it to ensure there is an appropriate diversity of thought. As noted under question 3, we welcome Sir John's recommendations that the new regulator includes a diversity of perspective in both its governance and teams.

Within audit committees

Investors also have concerns that an audit committee's members often include those that until relatively recently were a partner in, or employed by, an audit firm. This can give rise to a conflict of interest if that same audit firm is a tender candidate and can cause stakeholders to question the objectivity of that tender.

A balance needs to be struck between ensuring the audit committee has the right skill set and managing such conflicts. Thus potential conflicts should be identified well in advance of the tender process. In general, investors' preference is that at least three years should have elapsed from when a company director was a partner in, or employed by, an audit firm before the firm can be considered for appointment as auditor.

AUDIT QUALITY AND CHALLENGE

5. **How important to the quality of audit is the relationship between auditor and audited company? How can we ensure that there is the right level of challenge? What role should shareholders have in ensuring high quality audits?**

In the past auditors appeared to be too close to management in that they were appointed largely by a company's finance function. As noted under question 2 remedy 1, we welcomed the EU Regulation for PIEs which in part addressed this by requiring audit committees to be responsible for the audit tender process and the final recommendation to the board. Whilst the tender process may still involve operations and finance functions, oversight by the audit committee is important in the interests of ensuring the tender is managed and directed in the interests of a company's shareholders.

The audit committee should direct the planning and oversee the process, including identifying candidates, setting the audit quality criteria for selection and conducting the interviews. This should involve the whole committee in that the tender should not just be the responsibility of the audit committee chair. See IA's Audit Tender Guidelines, developed in consultation with members.

During the audit, the auditor will understandably develop a close relationship with the audited entity's management. This means that all too often audit firms consider the audited entity to be their clients. This can result in auditors not always challenging management sufficiently on their judgements. In particular, over time accounting standards have moved from historic cost to an approach based on fair value which requires more judgement due to the difficulties in valuing and auditing certain assets and liabilities. Professional scepticism is vital when key areas of accounting and disclosure depend on management's judgement.

THE IA'S ANSWERS TO THE DETAILED QUESTIONS RAISED

Audit committees have an important role in ensuring that auditors challenge managements' assumptions and judgements.

We also recognise that investors have an important role to play in ensuring quality audits. However, there is largely a lack of transparency and information about audit tenders and the audit process. Both the audit committee and the auditor provide an important independent check for shareholders and yet certain investors have highlighted concerns that auditors and audit committee chairs often want their respective reports to be as aligned as much as possible before they are published.

Under question 2 remedy 1 we set out how investors would like audit committees to give more insight into how they have ensured a quality audit in their audit committee reports. How audit committees assess the quality of the audit and ensured that it was challenging and scepticism exercised.

The IA Audit Tender Guidelines set out the information investors want when an entity undertakes a tender. They state that when a company plans to enter into a tender it should issue an RNS announcement so that its investors can, if they wish, engage with it on the tender. It should also contact its major shareholders and engage with them on the process. For example: on the timetable; how the audit committee intends to assess audit quality; the selection criteria and assessment mechanism that will be applied; and the conclusion reached.

In terms of the audit tender candidates, the Guidelines clarify that investors would like disclosure of:

- Any restrictions on a firm being able to tender.
- Whether any mid-sized firms will be invited to tender and an explanation where this is not the case.
- How any conflicts between audit committee members and tender candidates will be managed and mitigated.
- Whether the incumbent will be invited to re-tender.

Following the tender, the audit committee should consider reporting on the following:

- The various stages in the tendering process and the timetable.
- How firms were assessed and the issue of fees addressed.
- Details as to why the firm concerned was chosen.
- A summary of the handover process.

The audit committee should also ensure there is an RNS announcement when the decision is made.

Shareholders currently vote to reappoint the incumbent auditor at the AGM. As many tenders are completed significantly before the new auditor takes office due to the need to 'cleanse' of threats to independence, such as when an auditor provides non-audit services, consideration could be given to giving shareholders the opportunity to approve the appointment of the new provider. This would provide a focus for the audit committee to set out the process, and why it chose that particular auditor and considered the fee to be at the right level. This vote to approve the new auditor would be a significant new power for shareholders at a time when there is more scope for influence, and ought to add an important new dynamic to the appointment process.

As regards the auditors themselves, we welcomed the enhanced audit report in particular the clarity around the risks of material misstatement and what the auditor did. However, many of these reports are now becoming quite boilerplate. In addition, only one audit firm reported on their findings – what they found, graduated as appropriate – for around nine audits. That firm wrote to all the companies they audit asking if they would agree to their audit reports being enhanced in this way. The entities refused in spite of investors asking for this. This does not send a particular good message to investors who rely on the auditor's work and to whom the auditor reports. Auditors should consider the investor community as the true clients. This would help ensure auditor objectivity and that investors' needs for a quality audit are met. (We note and welcome Sir John's recommendation 53 that the regulator considers requiring "graduated" findings in the audit report).

Investors already periodically engage with certain audit committees when there are reporting and accounting issues with a company. They engage with individual audit firms, both the Executive and Independent Non-Executives, on governance and audit quality issues. They also vote on auditor's and audit committee members' re-appointments annually. With improved transparency, it will enable investors to hold auditors and audit committees to account better for the judgements and scrutiny exercised. But also, as noted, investors would like to know when a company is tendering its audit so that they can engage on the process if they wish. Others would welcome auditors at the outset discussing the planning process with them so that any significant concerns they have can be addressed. If an auditor was required to approach a company's top ten shareholders for discussion and input, they could make their views known on the big issues and the auditor could then report on them in their audit report.

PROPOSED REFORMS

6. **Are the proposed reforms of audit consistent with other recent reforms of corporate governance? Are there any other consequential reforms required?**

THE IA'S ANSWERS TO THE DETAILED QUESTIONS RAISED

We consider the proposed reforms of audit are consistent with other recent reforms to corporate governance and do not believe other consequential reforms are required, except for more widespread adoption of the disclosures outlined in question 5 above. Recent reforms have informed investment, engagement and voting decisions. Improving audit committee reporting and thus accountability, and transparency of AQR/CRR findings (Sir John Kingman's recommendations 20 and 26) are consistent with this.