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From: The Rt. Hon Lord Tyrie  
Chairman

Direct line: XXXXXXXXXX

9 October 2018

*Dear Greg,*

**Competition and regulation in the audit sector**

Thank you very much for your letter.

High-quality independent audits are essential for ensuring that investors and the public can have confidence in the numbers that companies produce on their performance. The CMA has been examining these issues for some time. Carillion's demise, and recent poor reviews of audit quality, cannot remain unaddressed.

With that in mind, the CMA is launching a market study to see whether the market for statutory audit services in the UK is working effectively.

In a well-functioning audit sector, regulation and competition should work together to produce high-quality outcomes. Regulation should set and enforce the standards against which auditors can be assessed. Firms should compete to provide the best possible audits. It has been widely argued, both in Parliament and elsewhere, that neither of these is adequate.

The invitation to comment accompanying the launch of our market study describes five potential types of issue:

1. **Choice and switching.** The audits of the largest companies remain highly concentrated in the hands of four firms. Furthermore, the CMA has been told that conflicts of interest from non-audit services mean that choice for big companies is often limited to fewer than four big firms.

2. **Resilience.** The CMA has heard concerns that to continue indefinitely with only four firms competing successfully for the biggest audits carries 'too big to fail' risks.
3. **Auditors' and companies' incentives.** As the consumers of the assurance that an audit provides, investors may benefit from rigorous audits. The CMA has been told that the audited company, which selects and pays the auditor, may not always do so. This apparent misalignment of incentives would suggest that consumers do not obtain audits of sufficient rigour in all cases.
4. **Regulation.** The market was formed through mandatory audits, supported by regulatory requirements overseen by the Financial Reporting Council (FRC). The joint Select Committees' report into Carillion identified serious concerns about the effectiveness of the FRC. The independent review of the FRC, led by Sir John Kingman, is examining this issue at your request and is expected to report by the end of this year.
5. **The audit framework.** Public expectations appear to be for an audit which can give a higher level of assurance about a company than the internationally agreed framework currently requires.

The CMA's market study will look at choice and switching, resilience, and incentives. The CMA intends to consult on provisional views by the end of the year and complete its work as soon as possible thereafter.

The fifth issue above, the audit framework, is in the remit of neither the independent review of the FRC nor the CMA. The CMA is aware that a sector-led review of 'the future of audit' is being considered. This work – the appropriate purpose and scope of statutory audits – is of crucial importance. The CMA would urge the Government to address this issue, either itself or by means of an independent review.

The CMA will consider the evidence of detriment as a consequence of insufficient choice. Three groups of remedies, put to the CMA, appear to merit attention, either individually or in combination:

1. **Reduce the barriers to non-Big Four firms auditing major companies;** for instance through a market share cap, mandated joint audit, or other measures.
2. **Maximise choice among the Big Four;** for instance by separating audit and non-audit services, creating audit-only firms.
3. **Address the incentive problems underlying the audit sector;** for instance by moving responsibility, in certain circumstances, for procuring audits away

from audited companies to an independent body with a public interest mandate.

You have asked Sir John Kingman to look at audit procurement, as well as to review the work of the FRC. Both, of course, have implications for competition. The CMA will work closely with Sir John to ensure that each takes account of the other's work.

The implementation of many of the potential remedies, whether from the CMA, the independent review of the FRC, or others, would be likely to require legislation, as well as rigorous monitoring. The Government should consider carefully how this might be accomplished.

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Andrew Tyrie

