



Dr Andrea Coscelli  
Statutory Audit Market Study  
Competition and Markets Authority  
Victoria House  
Southampton Row  
London

Copy: Will Hayter, Project Director

By email

30 October 2018

Dear Dr Coscelli,

## **STATUTORY AUDIT MARKET STUDY – INVITATION TO COMMENT**

Thank you for the opportunity to provide comments at this early stage of the CMA's market study into the audit market.

Confidence in company audits is critical to the functioning of the economy. We recognise that the quality and purpose of audit has been placed in the spotlight by recent company failures and that this has led to further scrutiny of how the audit market functions. We agree that the issues raised in the CMA's Invitation to Comment must be addressed and we are open to considering and assessing fully many of the ideas that have been put forward. We recognise that this is a moment for change and we are ready to work with the CMA and other stakeholders to do what is necessary to restore trust and confidence in the audit, by supporting measures that address problems in the market.

We set out below our initial thinking on three broad areas: quality; independence; and choice. We have provided more detail on the specific questions raised by the CMA in the attached Annex.

### **Quality**

As we have seen recently, company failure – particularly of a large or of what might be considered to be a systemically important company – can cause far-reaching harm to businesses and individuals. That, inevitably, leads to scrutiny of the quality of the company's audit. Although audit quality as measured by the FRC has generally followed an upward trend, we recognise that where a high profile company failure occurs and there are actual or perceived deficiencies in the audit, that can affect public confidence in the audit more broadly. Audit quality therefore needs to be consistently of the highest standard and we are committed to continuous improvement in the quality of our audit work. We believe audit quality should be at the heart of any reforms to the market, including those proposed to address concerns around competition and choice.

Effective regulation is a key component to ensure that the entire framework of corporate governance is monitored and enforced. This applies equally to the preparing and auditing of corporate reporting. We therefore welcome the CMA's intention to conduct its study of the audit market in conjunction with the review of the FRC being carried out by Sir John Kingman.

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*PricewaterhouseCoopers LLP, 1 Embankment Place, London, WC2N 6RH*  
www.pwc.co.uk



We also look forward to confirmation of the “future of audit” project initiated by the Audit Quality Forum, which we expect to consider issues relating to the audit framework, including the “expectation gap” between the role of the statutory audit under current regulations and what many stakeholders and the wider public believe is, or should be, the function of the audit. We believe this is a fundamental issue, and without addressing the expectation gap, the concerns raised about the audit market cannot be fully dealt with. While we understand that the CMA does not intend to focus on issues relating to the expectation gap, we invite the CMA to join us in encouraging government to lend their support to an independent review.

In terms of assessing the impact that any reforms might have on audit quality, we would emphasise that we have built up and rely upon our multi-competency expertise and international network to deliver our audit service. Any measures that inhibit our access to this expertise and network would jeopardise audit quality. We have noted in our detailed responses to the CMA’s questions those areas where audit quality could be put at risk by some of the measures suggested and, where possible, have set out how that risk might be mitigated.

### **Independence**

We recognise that maintaining the independence of the audit firm and ensuring objectivity is paramount to preserving the quality of the audit. We accept that if a firm provides extensive non-audit services to a company it can create actual or perceived conflicts of interest if that firm is also the company’s audit firm. As the CMA has noted, there are already measures in place to control the non-audit services that an audit firm can provide to a client (as part of the FRC’s Ethical Standard, which was revised in 2016).<sup>1</sup> We look forward to understanding the CMA’s analysis of the effectiveness of these measures, recognising that they have been in operation only for a relatively short period.

Depending on the results of this analysis, we appreciate that further commitments to limit non-audit services to audit clients could be necessary to promote confidence in the independence of audit firms, particularly for those companies in the listed market where there is a marked separation between shareholders and management.

We also think it is right that the CMA look again at measures to ensure the independence of audit firm appointments. In our view, large company audit committees understand and take seriously their duty to select the most appropriate audit firm and we have experienced much more active audit committee involvement since the remedies enhancing the role of the audit committee were introduced by the Competition Commission. Even so, we recognise that there may be a perception that the audit firm appointed by a company may not be seen to be sufficiently independent from the company’s management. We would be open to the involvement of a third party or oversight body to address this concern.

One suggestion has been that the appointment decision should be removed from the company (acting on the recommendation of the audit committee) and entrusted instead to an independent body. We believe that it is fundamentally important that the audit committee continues in its role of selecting the audit firm, particularly given their knowledge and experience of specific company risks. It is also necessary to avoid any uncertainty as to the basis on which the auditor is appointed (including the way in which company’s shareholders are being represented) and who is responsible should there be an issue with the audit. Further, the non-executive directors who have roles on the audit committee have a wider responsibility to represent the company’s shareholders, which in our view would risk being undermined should they be stripped of the obligation to select the audit firm on behalf of the shareholders of the company. There would also be substantial practical challenges in implementing such a remedy. As such, we believe that the involvement of third parties or oversight bodies would

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<sup>1</sup> See in particular section 4 of the Revised Ethical Standard 2016.

need to be an enhancement to rather than a substitute for audit committee selection and that greater shareholder engagement should be encouraged.

## **Choice**

In recent years there has been a substantial intervention in the audit market, in the form of the mandatory tendering regime introduced by the Competition Commission, which was supplemented by a mandatory rotation component in the European Audit Regulation.<sup>2</sup> In the last five years, this new regime has led to materially increased tendering and increased switching. Nearly half of FTSE 350 auditors were in place for five or less years in 2017, as compared to fewer than one quarter in 2012.<sup>3</sup>

When the Competition Commission considered mandatory tendering, an objective was to address barriers to entry, expansion and selection faced by the mid-tier firms<sup>4</sup> - and in practice, mid-tier firms have not increased their market share of the large company audit market. This means that, despite increasing the level of competition, the new regime has not resulted in a practical increase in the “choice” (i.e. number) of audit firms operating in the audit market for the largest public companies. The CMA has raised in its Invitation to Comment a number of possible measures that would seek to increase choice, and which may also address concerns around resilience in the market. We would welcome more choice in the market and think that these measures are worth considering further, although in order to achieve such an outcome without damaging the competitive process or audit quality, the CMA must consider carefully the combination and timing of any measures.

Whatever approach is taken to increasing choice, it will also be important to ensure supply-side barriers to entry and expansion are addressed. We observe that the financial disincentives for firms to enter the UK statutory audit market for large, listed companies are significant and it is possible that some firms may calculate that the risk of operating in this segment of the market outweighs the potential reward.

However, we recognise that to achieve a measurable increase in the short term in the number of firms appointed by the largest companies, interventionist measures may be needed. A market share cap could lead to greater choice of audit firms for the largest public companies over time. As the CMA acknowledges, this would not be straightforward to implement. A system that in effect creates a segment of the market in which the four largest firms cannot operate would potentially restrict choice for certain companies. So how the system was initially introduced, operated and (presumably) then phased out over time would have to be carefully planned. Such a regime would almost certainly require the close ongoing involvement of the FRC and/or the CMA.

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<sup>2</sup> Regulation (EU) No 537/2014 of 16 April 2014 on specific requirements regarding statutory audit of public-interest entities OJ L 158, 27 May 2014, p. 77–112.

<sup>3</sup> FRC, Development in Audits 2018, page 22.

<sup>4</sup> Competition Commission’s Final Report, paragraph 16.7.



**We recognise that the issues outlined above are interconnected and will require a holistic package of measures to address them effectively particularly in the context of the wider global market. We also believe that the sequencing of those measures will be important in ensuring that the right solutions are put in place to support the audit of the future. We look forward to engaging further with the CMA on these matters as it proceeds with this market study. In the meantime, please do let me know if we can be of any further assistance to the CMA.**

**Yours sincerely,**

**Kevin Ellis  
Chairman and Senior Partner**



## CMA Audit Market Study

### ANNEX TO RESPONSE TO INVITATION TO COMMENT

We set out below our responses to the CMA's questions in the Invitation to Comment. These should be read together with our accompanying letter, which sets out our overarching views on the issues raised by the CMA's market study. In a number of places below, we have combined related questions into a single answer.

#### **A) Themes**

##### **1 How well is the audit sector as a whole serving its stakeholders?**

###### **Theme 1: The audit framework**

##### **2 How well does the audit framework support the interests of both direct shareholders and also wider stakeholders in the economy?**

- (a) Audits in the UK form part of a wider governance framework which is effective and supports vibrant capital markets which are internationally respected. For those stakeholders who are familiar with the scope and purpose of the audit in our current regulatory framework, there is evidence that the audit sector is, in general, working well. While audit quality is generally high and as measured by the FRC has been on an upwards trajectory, any audit failure can have potentially far-reaching implications and must be taken seriously. Audit quality therefore needs to be consistently of the highest standard and we are committed to continuous improvement in the quality of our audit work.
- (b) Where a high profile company fails, inevitably there are questions asked about the quality of the audit process. However, just as a poor audit does not cause business failure, a good audit cannot always prevent it; and a good audit may later be followed by a company failure, or, for example, the discovery of a fraud. This leads to the so-called "expectation gap" between the role of the statutory audit and what many stakeholders and the wider public believe is, or should be, the function of the audit. For those stakeholders whose expectations of the statutory audit do not match its remit, the system as a whole is seen as ineffective. Further, in our view the current level of dissatisfaction with how audits work is not about the process of audit in isolation, but instead relates to a number of aspects of the whole system for corporate reporting – including director responsibilities as the primary preparers of corporate reporting, and the wider regulatory framework. Any reform, whether about audit scope, auditor independence, corporate governance, regulatory oversight or accounting standards, needs to consider the operation of the system as a whole so that the resulting measures address stakeholders' concerns effectively.
- (c) We believe that the proposed independent review of the "future of audit", initiated by the Audit Quality Forum, will be fundamental to addressing these issues and we would invite the CMA to encourage government to lend their support for this independent review.

**Theme 2: Incentives and governance**

- 3 To what extent do the decisions made by audit committees support high quality audits, whether through competition for audit engagements or otherwise?**
- 4 How has this changed following the Competition Commission’s intervention?**
- (a) In our experience, audit committees, particularly those of larger listed companies, generally function to a high standard. There has been a noticeable change in the status, role and behaviour of audit committees of large companies since the Competition Commission’s intervention, together with changes in the Corporate Governance Code and other regulatory interventions. There has been a trend of greater engagement by audit committees in two main areas, both of which contribute to high quality audits:
- (i) overseeing the appointment of the audit firm in tender situations, with more focus being placed on audit quality than historically; and
- (ii) monitoring auditor effectiveness (including agreeing scope and fees) and working with auditors in challenging key accounting judgements. For example, in our experience it is now standard for audit committee chairs of larger companies to meet individually with the audit partner before audit committee meetings, in order to talk through how key judgements are arrived at and consider areas for potential challenge.
- (b) Auditor appointment and reappointment is one of many decisions that can support high quality audits. The audit committee’s knowledge of the company’s circumstances and its specific risks, together with its culture and complexity helps them determine the scope of work and the capabilities the audit firm must have. As we explain in response to Question 8, audit committees drive fiercely competitive tender processes.
- (c) Audit committees also contribute to high quality audits by discussing and challenging key accounting judgements. Throughout the audit there are many discussions about the reasonableness of accounting judgements and it is sometimes the case that management and the auditor do not reach the same conclusion on an accounting matter. In such cases we have noticed a shift in recent years with many audit committees becoming more prepared to challenge the company management. This rigour helps ensure that the underlying accounting treatment has undergone a robust review and discussion. A more engaged and empowered audit committee also contributes to corporate culture, ethics and internal controls, thereby having a positive impact on the broader approach to corporate reporting.

**Theme 3: Choice and switching**

- 5 Is competition in the audit market working well? If not, what are the key aspects hindering it?**
- 6 In particular, how effective is competition between the Big Four and between other firms and the Big Four?**
- 7 How has this changed following the Competition Commission’s intervention?**
- (a) In our view, the audit market is highly competitive. Among the largest listed companies, the new tender regime has had a material impact. Around 10% of companies in the FTSE

350 will run tenders in any given year, as opposed to less than 3% per year in the ten years prior to the Competition Commission's investigation.<sup>5</sup> In 2017, nearly half of FTSE 350 auditors were in place for five or less years in 2017, as compared to fewer than one quarter in 2012.<sup>6</sup> Competition is fierce in this segment. We dedicate substantial resources to competing for and winning audit appointments, responding to the demands of audit committees, who are sophisticated buyers and demand a commitment to high quality work. By way of example, we have invested some US\$500m globally in new technologies to support the provision of audit services over the last few years.

- (b) While there has been a substantial increase in opportunities (through tendering), it does not appear that mid-tier firms have succeeded in being appointed to audit the largest listed companies. We recognise that there is a concern that their failure to win such appointments may be due to a reluctance by large company audit committees to appoint from outside the four largest firms in part driven by a perceived pressure from other stakeholders (including regulators).<sup>7</sup> We would suggest that the CMA might explore further the reasons why mid-tier firms have not been able to use the increased number of tenders to win more appointments.
- (c) In other segments of the market, competition is no less fierce and in many, the mid-tier firms are much more successful. For example, both BDO and Grant Thornton audit more AIM listed clients than any of the four largest firms.<sup>8</sup>

## **8 What is the role for competition in the provision of audit services in delivering better outcomes (i.e. consistently higher quality audits)?**

- (a) Healthy competition drives higher quality, in this market as in others. The Competition Commission's remedies have strengthened the role of the audit committee, and increased its ability to drive competition between providers on a number of factors, including audit quality.
- (b) In our experience, audit committees require audit firms to provide extensive evidence to demonstrate their quality. It is longstanding practice that technical audit skills are tested during a tender process, but increasingly audit committees test other aspects of the audit firm's capabilities. For example, it has become normal to test a firm's technology, including its data analysis capabilities (e.g. by sending large tranches of data and requiring the audit firm to identify issues in the data sets). It is now standard to have a session specifically focussed on quality, which may include the audit firm's leadership as well as the pitch team. These sessions will cover internal and external results on audit quality, and the steps that the firm is taking to improve performance. Similarly, audit committees are testing firms on wide-ranging aspects of quality that matter to the company, including industry specific know-how and understanding, and commitment to diversity and inclusion. Further, given the global nature of the largest listed companies, this process can involve dealings with audit committees in multiple jurisdictions.

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<sup>5</sup> Competition Commission's Final Report, paragraph 7.22. The Competition Commission estimated between 85 and 103 competitive tender processes were carried out in the previous ten years.

<sup>6</sup> FRC, Development in Audits 2018, page 22. The FRC considers that the regime "has resulted in strong competition".

<sup>7</sup> For example, Grant Thornton has announced that it will no longer compete in tenders after routinely coming "a glorious second place" in tender processes. See Financial Times, *Grant Thornton exits audit market for big UK companies*, 29 March 2018.

<sup>8</sup> See the FRC's *Key Facts and Trends in the Accountancy Profession*, July 2018.

- (c) In this regard, we note that while audit committees could simply rely on the FRC's AQR results to help judge aspects of audit quality, in practice the audit committee takes responsibility for assessing a wide range of factors which contribute to audit quality.

**9 In practice, how much choice do large companies and public interest entities have in the appointment of an external auditor?**

**10 What are the key factors limiting choice between auditors?**

- (a) The factors we consider to be the most important in limiting choice are listed below, which would be unlikely all to apply in a particular case. While these do limit choice, taken together they are less significant in practice than they may appear and in our experience it is very rare that they restrict even the largest companies from having a choice of audit firm.
  - (i) Mandatory rotation removes the option of appointing the existing audit firm.
  - (ii) Potential competitors that are providing non-audit services to the company may not be available to be selected as the audit firm without that firm transitioning away from the non-audit services, in some cases for a specified number of years.
  - (iii) There are a limited number of firms that have the global capabilities required to deliver a multinational group audit without outsourcing large parts of the work (thereby adding risk and complexity to the audit).
  - (iv) There are a limited number of firms with the strength and depth of expertise to conduct a high quality audit in specialised sectors (such as global financial services institutions). The complexity of the operations of many large clients means the market for greater specialisms is only increasing.

**11 What are the main barriers to entry and expansion for non-Big Four audit firms?**

- (a) The primary impediments facing mid-tier firms are financial and they comprise the investments in people, technology and infrastructure that are required to carry out large company audits. For audits of multinational companies, global reach is an important criterion and a firm not part of a comprehensive global network could be at a disadvantage.
- (b) While tendering gives firms a greater number of opportunities to compete, the costs associated with tendering can be off-putting (and so firms may choose not to tender for every possible appointment). We acknowledge that it is difficult for a smaller audit firm to take what would be potentially material investment risk in exchange for an uncertain reward.
- (c) In addition, there are specific regulatory disincentives for firms to enter or expand into the UK statutory audit market for large, listed companies. In particular, auditing a large listed company in practice involves taking on the risk of unlimited liability. This may be a risk that smaller firms are unwilling to take, relative to the reward of the audit fee. Further, the ongoing regulatory compliance cost of providing audit services to the largest listed companies is material.



- (d) We note that the CMA will be considering evidence from tender processes as part of this study. We think this will be valuable in understanding the reasons mid-tier firms have not won audit appointments in specific cases.

#### **Theme 4: Resilience**

##### **12 Is there a significant risk that the audit market is not resilient? If so, why?**

- (a) The possibility of failure is one of a number of commercial and competitive pressures that audit firms face. There are a number of reasons that a firm might fail, including:
  - (i) reputational damage arising from audit failures<sup>9</sup>;
  - (ii) market changes that render the audit business of a firm economically unviable; and
  - (iii) the effect of regulation and risk of material sanctions being imposed on an audit firm.
- (b) Having said that, we do not think that there is a significant risk that the audit market lacks resilience. For example:
  - (i) We have a stated commitment to maintaining high quality and to fulfilling our public interest commitments.
  - (ii) The network multi-disciplinary model of the largest audit firms mitigates the risk of firm failure.
  - (iii) Should a firm that is part of a global network fail nationally, it would be possible for a new network affiliate to re-enter the national market (as has happened with PwC in Japan).
  - (iv) Should a large audit firm fail at an international level, we would expect one or more of the remaining firms (across the largest firms and the mid-tier) to be appointed to take on the audits of the failed firm. Depending on which other audit firm(s) were appointed, there may or may not be a reduction in the number of firms able to take on the largest, most complex audits.
  - (v) As required by our regulatory obligations, we have appropriate contingency plans in place.

#### **Theme 5: Regulation**

##### **13 What is the appropriate balance between regulation and competition in this market?**

- (a) We think it is critical to recognise the interplay between regulation and competition in this market. We therefore welcome the CMA's commitment to coordinate this study with the Kingman review.

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<sup>9</sup> Reputation is vital in this market. It would be damaging to an audit business if its reputation was compromised, and companies, investors and other stakeholders no longer trusted the quality of its work.

- (b) The balance between regulation and competition in this market is multi-faceted. Regulation affects how competition operates, whether directly (e.g. it dictates how often firms should compete to win mandates through mandatory tendering and mandatory switching) or indirectly (e.g. by restrictions on audit firms providing non-audit services). We think regulation can also set an important audit quality standard, which then allows for competition on both quality and price, and so guards against competition driving selection of the audit firm on price alone. Regulation should also seek to protect the interests of the beneficiaries (shareholders) who are not making audit purchasing decisions directly.
- (c) It is also important to ensure that regulation does not operate in a way so as to impede innovation as this is and will continue to be critical to audit quality.
- (d) At present, the regulatory framework does not endorse or have regard to competition<sup>10</sup>, but we think that this is something that should be re-considered. We note that the Competition Commission recommended that the FRC amended its objects to include the need to have due regard for competition but the FRC has not done so.

## **B) Potential measures**

### **14 Please comment on the costs and benefits of each of the measures in Section 4 and how each measure could be implemented.**

- (a) In our view, assessing how different interventions interact together will be of utmost importance.

#### ***Restrictions on non-audit services***

- (b) Please see our responses to Questions 16 to 18 below.

#### ***Market share cap***

- (c) We recognise that market share caps could lead to there being a greater number of audit firms appointed to audit the largest companies, as some of those companies would be effectively forced to use mid-size and smaller audit firms.
- (d) However, as the CMA acknowledges, this would not be straightforward to implement. A system that in effect creates a segment of the market in which the four largest firms cannot operate would potentially restrict choice for certain companies. The mechanics of how it would be initially introduced, operated and (presumably) then phased out over time would need to be carefully designed and monitored to ensure that the dynamics of competition are protected (i.e. to increase quality and innovation while reducing price).
- (e) In our view, any market share cap could only work based on the number of companies and cannot sensibly be based on audit fees. A system based on number of companies audited by each firm would be the most straightforward to administer and, we think, would be better understood by stakeholders. Conversely, a system based on audit fees could be problematic as firms would not know the fees to be billed to companies at the beginning of any relevant reporting period, and as fees change, it may be that any “cap” is broken through no fault of any one firm. In addition, apportioning fees to the UK that are

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<sup>10</sup> The Competition Commission’s Final Report, paragraph 16.635.

agreed at a global level would involve an element of subjectivity, which would add complexity without giving rise to measurable benefit.

- (f) If a market share cap were to be put in place using number of companies, we think it would be necessary to work through a number of design issues, including:
- (i) how to ensure quality and price are not adversely affected by the use of a cap;
  - (ii) the relevant set(s) of companies to which the cap would apply (and how the cap would apply as that set evolves);
  - (iii) how in practice companies would be identified and transitioned away from the four largest audit firms;
  - (iv) how to incentivise mid-tier firms to take up the capacity made available;
  - (v) how to ensure that there is no cherry-picking or gaming from market participants;
  - (vi) how to maintain competition between the four largest audit firms;
  - (vii) how to ensure that companies continue to be able to exercise choice (and in particular how companies are able to replace a mid-tier audit firm should they choose to do so);
  - (viii) how to deal with transitional arrangements as capacity is developed, including ensuring that mid-tier firms taking on more complex audits have the right skills and capacity in segments of the market that they have not historically served; and
  - (ix) how the cap is monitored, enforced and reviewed, including how success is measured.

### ***Joint or shared audits***

- (g) A mechanism to encourage or even require the use of joint<sup>11</sup> or shared<sup>12</sup> audits has the potential to enable mid-tier firms to build capacity and gain experience in conducting audits of large listed companies.
- (h) Notwithstanding these potential benefits, there are some well recognised concerns around the use of joint audits in particular. Our primary concern, as the CMA already recognises, is that joint responsibility could lead to some issues “falling through the gaps” and audit quality may be adversely affected.<sup>13</sup> Shared audits may alleviate that issue to an extent.
- (i) Historically, companies and shareholders have not been keen on the use of multiple auditors, in particular because of the additional cost, complexity (in particular where there are different views on key issues between the audit firms) and risk involved. While the use of joint audit is encouraged by the current regulatory regime (through allowing extra time before mandatory rotation is required<sup>14</sup>), companies remain reluctant to

<sup>11</sup> As the CMA notes, joint audits refer to audits signed by two audit firms.

<sup>12</sup> As the CMA notes, shared audits refer to situations where audit work is carried out by more than one firm, but one firm retains responsibility for the audit.

<sup>13</sup> Invitation to comment, paragraph 4.20.

<sup>14</sup> European Audit Regulation, Article 17(4)(b).

appoint audit firms jointly. These issues were identified by the Competition Commission when it considered the audit market in 2013.<sup>15</sup>

- (j) Any measures that sought to increase the use of joint or shared audits could be for a limited period, for example as a transition towards a market share cap, until more firms have gained large company audit experience and therefore have increased prospects of winning sole audit appointments.

***Direct support by the Big Four and/or professional bodies to the mid-tiers***

- (k) We are open to ideas that would lead to mid-tier firms benefitting from the experience and know-how of the largest firms, provided that they were carefully designed to enhance - and not undermine - competition.

***Reducing barriers for senior staff to switch between audit firms***

- (l) In our experience, individuals move between firms in both directions (i.e. to and from large and mid-tier audit firms), and it is not uncommon for directors to move from a large firm to become a partner with a mid-tier firm. We do not think notice periods are a material barrier to senior staff switching firms.

***Changes to restrictions on ownership***

- (m) We think that this is worth considering and we are prepared to discuss potential changes to the current legal requirements on ownership of audit firms. However, we do not believe that ownership restrictions are a material barrier to entry.<sup>16</sup>

***Break up of big four into smaller audit firms***

- (n) We agree with the CMA that this suggestion would pose “potentially insurmountable challenges”, particularly those relating to the effectiveness of the measure in the face of the international networks of the largest firms and the transferability of staff.<sup>17</sup>

***Mitigate the effect of current incentives - by increased transparency on tender process, reforming the tendering regime and/or strengthening audit committees and/or their links to shareholders***

- (o) We consider the impact of increasing the frequency of tendering in response to Question 27.
- (p) We are generally in favour of greater transparency in relation to tendering. However, we believe that blind tenders are undesirable, and likely unworkable. Audit committees have a legitimate interest in knowing the credentials of the auditors that they are considering. To achieve blind tenders, the identities of the individuals and the work that the firm had previously undertaken would have to be anonymised to such a degree that the audit committee would be making recommendations to the board on materially incomplete information.

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<sup>15</sup> Competition Commission’s Final Report, paragraphs 17.98 to 17.100.

<sup>16</sup> Competition Commission’s Final Report, Annex 8.2.

<sup>17</sup> Invitation to comment, paragraph 4.28.

- (q) We are supportive in principle of measures that would further strengthen the role of audit committees in managing tender processes, particularly to raise the overall standard and effectiveness across the market to that of the best performing audit committees.

***Break the link between company management and auditors - by transferring power to appoint auditors to shareholders, a shareholder group or independent body***

- (r) We discuss the involvement of an independent body in the appointment process in response to Questions 25 and 26.
- (s) In relation to the involvement of a shareholder group, the Competition Commission considered and rejected such an approach in its investigation, preferring instead to bolster the role of the audit committee. A concern was the challenge of creating a group that adequately reflected the interests of disparate shareholders.<sup>18</sup> No respondent supported the remedy; the costs were thought to be significant; and it would involve reshaping UK corporate governance and company law.<sup>19</sup> Further, in our experience, shareholders tend to be relatively passive when it comes to audit matters, and so trying to create a subset thereof to make key decisions in relation to the audit process may have a detrimental impact on the quality of the decision making. We consider that it would be preferable to focus on further enhancing the role of the audit committee as an effective representative body for shareholders, and considering ways of encouraging shareholders to be more engaged, and so more likely and better able to hold audit committees to account.

***Insurance-based system (theme of wider reforms in the audit sector)***

- (t) While we think this is an interesting idea and may be worth considering as a longer-term goal, we do not see this as a solution in the short to medium term (not least because it would require significant engagement between insurance companies and audit firms to develop a workable product).

***NAO style auditor***

- (u) We agree with the challenges that the CMA consider such a proposal would face, including its ability to recruit appropriately experienced staff and to engage with specific sectoral issues impacting individual companies, the difficulties it would face in dealing with international companies, and the lack of competitive forces to drive quality and innovation.<sup>20</sup> We do not think it is a workable solution, and it would of course deprive the companies in question of any choice in the appointment of their auditor. This would in turn risk disempowering the audit committee (which would run counter to the effective measures put in place by the Competition Commission in 2013) and would also raise serious questions as to the liability for any audit failure.

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<sup>18</sup> Competition Commission Final Report, paragraph 17.105.

<sup>19</sup> Competition Commission Final Report, paragraph 17.106 and 17.107.

<sup>20</sup> Invitation to comment, paragraph 4.51.

**15 Are there any other measures that we should consider that address the issues highlighted in section 3? If so, please describe the following: a) aim of the measure, b) how it could be designed and implemented, and c) the costs and benefits of each such measure.**

- (a) We do not have any suggestions in addition to those discussed elsewhere in this response, but remain open to considering further measures in due course.

**Restrictions on audit firms providing non-audit services**

**16 One way to create audit-only firms would be through separate ownership of the audit and non-audit services practices of the UK audit firms. Could this be effective, and what would be the relative scale of benefits and costs?**

**17 How do the international affiliations of member firms affect the creation of audit only firms? What is the extent of common ownership of audit firms at the international level?**

**18 What should be the scope of any measures restricting the provision of non-audit services? For example, applying to the Big Four only, the Big Four and the mid-tier audit firms, or any firm that tenders for the audits of large companies and PIEs?**

- (a) We are committed to the highest quality standards in our audits. We believe that this is best achieved as a global multi-disciplinary firm. To separate ownership of the audit and non-audit services practices of the UK audit firms would be detrimental to quality for the following reasons:
- (i) Large, complex audits need specialist skills beyond accountancy - often at short notice - such as technology experts, tax specialists and actuaries. A multi-disciplinary structure allows us to do this, without creating longer supply chains and requiring us to vet the independence of those suppliers. Indeed, we consider that the need to address the expectation gap may lead to an expansion of the remit of an audit to include areas of specialisms that may be considered to be non-audit services (for example cyber security assessments). In any event, audit firms should be able to continue to draw on the skills and expertise of specialists from across their multi-disciplinary practices to provide high-quality audit services.
  - (ii) As a multi-disciplinary firm we are also able to leverage resources and expertise to allow us to invest in new technologies and specialist input to ensure audits keep pace with a rapidly changing world and are fit for the future. As we have referenced in 7(a), we have made significant investments in new technologies in the last few years. As an audit-only firm, the pace and extent of investment in such technology could be expected to reduce.
  - (iii) Being able to offer a range of career opportunities also allows us to attract and retain talented people. Providing varied experiences helps to build their understanding of business and industries and makes them better, more sceptical auditors, which feeds into audit quality.
  - (iv) Many large company audits require international coordination, and our current international network allows us to provide a seamless service across the operations of our audit company clients.

- (b) We recognise that maintaining the independence of the audit firm and ensuring objectivity is paramount to preserving the quality of the audit. We accept that if a firm provides extensive non-audit services to a company it can create actual or perceived conflicts of interest if that firm is also the company's audit firm. As the CMA has noted, there are already measures in place to control the non-audit services that an audit firm can provide to a client (as part of the FRC's Ethical Standard, which was revised in 2016). We look forward to understanding the CMA's analysis of the effectiveness of these measures, recognising that they have been in operation only for a relatively short period.

Depending on the results of this analysis, we appreciate that further commitments to limit non-audit services to audit clients could be necessary to promote confidence in the independence of audit firms, particularly for those companies in the listed market where there is a marked separation between shareholders and management. Any new restrictions would need to apply to all of those firms auditing companies in such a market, as perception issues regarding the independence of audit firms apply equally regardless of the size or nature of the audit firm.

### **Market share cap**

- 19 How should the market shares be measured? - number of companies audited, or audit fees or some other measure?**
- 20 Could the potential benefits (greater choice, and resilience) of a market share cap be realised?**
- 21 What do you consider to be the relative scale of the costs of a market share cap, such as increased prices and potentially reduced competition, and potential benefits?**
- 22 What should be the appropriate level of such a cap, collectively for the Big Four for the measure to achieve its objective? For example, 90%, 80%, 70%?**
- 23 Could a joint audit be an effective means of implementing a market share cap?**
- (a) Please see our response to Question 14 above.

### **Incentives and governance**

- 24 Should the auditors and those that manage them (e.g. audit committees, or an independent body as described in section 4) be accountable to a wider range of stakeholders including shareholders, pension fund trustees, employees, and creditors, rather than the current focus on shareholders?**
- (a) At present, an auditor's legal obligation is to the shareholders of the audited company. In contrast, a company's board has to consider the interests of a wider range of stakeholders under Section 172 of the Companies Act 2006. Whether the auditor also ought to have legal obligations to a wider range of stakeholders, and what effect that might have on the nature and extent of the auditor's work and liability, is an important debate. We think the work proposed to consider the future of audit, initiated by the Audit Quality Forum, will help to move that debate on. We are open to ways of meeting the needs of a wider group of stakeholders; but how that is done must be carefully considered and in particular it would need to be achieved in a manner which avoids the prospect of enhanced liability or wider liability for the auditor, as this could be a deterrent to market entry.

- (b) In particular, it would be critical to identify the appropriate stakeholders whose interests need to be considered. Thereafter, consideration would need to be given to the nature of the engagement between auditors and those stakeholders and how the interests of the different groups of stakeholders are to be balanced and reconciled.

**25 If yes, should audit committees (in their current form) be replaced by an independent body that would have a ‘public interest’ duty, including for large privately-owned companies? Should this body be responsible for selecting the audit firm, managing the scope of the audit, setting the audit fees and managing the performance of the audit firms?**

**26 Please describe the benefits, risks and costs of such an independent body replacing audit committees.**

- (a) Regardless of whether an auditor were to have regard to the interests of a wider stakeholder group, it may be effective to incorporate a degree of independent challenge in the selection of the audit firm. Such a measure would help address concerns that appointed audit firms are insufficiently independent of the management of the company. An independent body could provide insight, rigour and challenge in a role with a mandate to prioritise audit quality, whether strictly in the interests of shareholders, or in the interests of a wider group of stakeholders. In terms of the different forms this independent challenge could take:
  - (i) The audit committee could be required to report to an independent body on its preliminary appointment, fee and scope decisions and respond to challenges before final decisions are made. We consider that such an independent body monitoring and challenging the functioning of audit committees may help to continue the upward trend in audit committee engagement and quality. Such oversight may also take advantage of the existing reporting requirements that audit committees must adhere to.
  - (ii) An independent observer from the audit regulator could attend the audit committee meeting in certain situations – for example where issues had been identified. The observer would have the opportunity to add challenge to the debate in relation to auditor selection and discussion on fees and scope. We think that the routine involvement of such an independent observer on audit committees could give rise to serious practical issues. However, there may be a benefit if observer involvement was limited to situations where such involvement was necessary to address the needs and issues affecting particular companies. We would also be cautious of a system that placed responsibility for ensuring quality too heavily on the independent observer, lest that lead to the abrogation of responsibility from other members of the audit committee.
- (b) Regardless of which form may be used, in our view it is critical for the company to retain its responsibility for appointing the auditor, to avoid uncertainty as to the basis on which the auditor is appointed or who is responsible should there be a problem with the audit. Further, the audit committee will continue to have greater knowledge of company circumstances, and therefore what capabilities its audit firm must have, and can continue to drive competition between firms based on the needs of each company. They can also judge the right relationship as between the audit committee chair, CFO and lead audit partner (and are better placed to maintain it). This would also ensure that the company



and its board retain the appropriate regard for the audit process, as something run by the company rather than something that happens to the company.

- (c) Removing responsibility from the audit committee could jeopardise audit quality. In that regard, we note that the Competition Commission considered whether the FRC should become responsible for the appointment of auditors for FTSE 350 companies. It rejected the idea, noting that the FRC may not have sufficient understanding of the nature of individual companies to choose the auditor best able to protect shareholders' interests and that it may not make "optimal" decisions.<sup>21</sup> The concerns raised by the Competition Commission could also apply to any independent body responsible for auditor appointment.

**27 Should companies be required to tender their audits and rotate their auditors with greater frequency than they currently are required to do? What would be the costs and benefits of this?**

- (a) The mandatory tendering and rotation regime introduced in 2013 has led to a marked increase in competition. Around 10% of companies in the FTSE 350 will run tenders in any given year, as opposed to less than 3% per year in the ten years prior to the Competition Commission's investigation.<sup>22</sup> Moreover, we think the regime has increased audit committees' engagement and focus on quality, as they compare the services offered by the competing firms (rather than focusing on monitoring the performance of an existing audit firm). However, it has not led to mid-tier firms growing their market share among the largest listed companies. This suggests that further increasing the number of tenders, or reducing the maximum period of tenure, is unlikely in itself to increase the choice available to large companies.
- (b) The Competition Commission considered and rejected a tendering period of five years in its Final Report for reasons that we think remain valid today. Moreover, we think that there would be practical difficulties in shortening the tendering period:
  - (i) For large companies the tender process (and for the successful firm, the subsequent shadowing process) can last up to two years, so companies could be involved in transition processes around 40% of the time.
  - (ii) Shortening the tendering period would change audit firm incentives to respond to tenders, and may lead to increases in price.
  - (iii) More frequent rotation could have a negative impact on quality, given the period it takes for a new audit firm to become familiar with the audited entity.

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<sup>21</sup> Competition Commission Final Report paragraphs 17.109 to 17.112.

<sup>22</sup> Competition Commission's Final Report, paragraph 7.22. The Competition Commission estimated between 85 and 103 competitive tender process were carried out in the previous ten years.