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Dear CMA

We write to you as the Independent Non-Executives of the firm, appointed under the Audit Firm Governance Code. Our attention having been drawn by the firm to your consultation paper, *Statutory Audit Market: Invitation to comment*, we should like to offer our responses as INEs to the 27 consultation questions.

We have seen, and support, the terms of the firm's Chairman's letter to you, and hope you will find our comments in answer to your consultation questions helpful.

Our overall suggestions are that:-

- there are structural issues, peculiar to the statutory audit market in the UK, that need to be comprehensively addressed, in an imaginative yet proportionate way, in order to better serve the public interest
- whereas reducing audit market concentration will not, of itself, bring about improved audit quality, any such improvement may well not happen without it
- there is an unhelpful dynamic whereby restrictions on competition and choice lead to heavier regulation that further restricts entry and so increases the likelihood of continued levels of concentration
- making the audit market more attractive to firms, and supporting those firms, is sound and purposive public policy, and regulation has an important role to play
- regulatory and competition-objectives should be harmonised, with the regulator working collaboratively with the CMA and Sir John Kingman to produce a new 'regulatory chemistry', assisting the 'challenger firms' with their transition to the conduct of more Public Interest Entity (PIEs) engagements
- the specification of the public, ie societal, interest in audit should be more fully defined so that the responsibilities of auditors are made clearer
- the enforced creation of a larger-firm population, and separating the audit and non-audit businesses of firms auditing a significant number of PIEs, have potential, and
- the sorts of focused regulatory intervention the firm suggests (market quotas, joint and shared audit, and access to Big 4 methodologies and technologies) are proportionate and will produce a lessening of concentration in themselves.

As INEs, we welcome a deep review of the market's structural issues, as it provides a unique opportunity: there are clear and severe structural problems restricting competition and reducing choice compared with a typical CMA/Monopolies and Mergers situation, and we support the options the firm has offered to you.

We now answer the consultation questions the Authority asks in the attached appendix.

Yours faithfully,

**THE POWER OF BEING UNDERSTOOD**  
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PP Sir Ian Byatt

PP Roger Alexander

### **Appendix - answers to list of questions:-**

#### **A) Issues**

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

In our view, not well: investors are dissatisfied; choice is restricted; entry into the PIE market deliberately sclerotic, being discouraged by regulation; the public interest is poorly articulated; and the lack of competition has set regulation down the wrong path, effectively eschewing an improvement objective.

The design of statutory audit is predicated on the purpose it is given in statute, yet its design and its purpose may have become disconnected over time, so that design and purpose may now be dissonant. There may now be a need to more effectively set out the societal role of the audit and examine its content in that light.

The value of audit is dependent upon the quality and usefulness of the audited financial statements and there is either a need for greater public awareness with respect to the objectives and scope of the audit or a redesign of the scope of audit. The apparent lack of public awareness results in unreasonable expectations of the audit and in the disregard of other factors that contribute to the core systemic risks (for example, weak internal control processes and corporate governance arrangements) that the Kingman Review and the Vadera Review seek to address: this is the source of the 'information asymmetry' issue the consultation paper refers to.

#### **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?

Only to a limited extent. The definition of the public interest is unclear and appears to be shifting under the pressure of events. Unless it is better specified, there is a risk of more intrusive regulation.

The consultation paper makes reference to the 'expectation gap'. The failure of the audit profession to fulfil public expectation is not new and has been a constant of debate ever since the last financial crisis. It is not that the profession has failed to address the problem but that a solution has proved elusive.

Battle-lines were drawn early: whereas the audit profession coalesced around a belief that non-auditors failed to appreciate how an audit is carried out and therefore its limits in predictive terms, public opinion demanded that audit serve a virtually forensic purpose.

Whereas we agree that considerations of audit quality should take into account stakeholder needs, there has to be a balance between the costs of carrying out an audit and the corresponding benefits to shareholders, investors, and other stakeholders. Audit quality is simply not improved by the performance of work where the related costs exceed the benefits. This applies similarly to services throughout the financial reporting supply chain.

Expressing with any purposeful accuracy the meaning of audit quality is stubbornly complex: the perspectives and expectations of the users of financial statements and their preparers, auditors, audit committees, regulators, and standard setters may not be fully aligned and the expectations of stakeholders can be expected to change over time in any event.

It is therefore important that audit is continuously refined, in the same way as technological and pharmaceutical development, measured against need and expectation.



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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?

The dynamic between audit committees and companies' management is for the most part opaque but insofar as the appointment of audit firms is concerned, we think it is well understood that subliminal bias and risk aversion have played a very considerable part in bringing about the current audit market concentration.

Audit committees are often insufficiently independent of management and governments have done nothing about the 'regulatory asymmetry' problem – the emphasis on auditors while the conduct of company directors receives scant enforcement attention. We see little or no evidence of enforcement of the duties that directors owe their companies under section 172 of the Companies Acts and a failure to carry out the kind of investigations under the same legislation that used to be quite common. There is an innate unfairness in allowing this asymmetry to obtain in the future.

FRC enforcement through the use of large fines is one-dimensional and a discouragement to entry into the PIE market, with proper judicial processes being short-circuited to make up for structural inadequacies, and a presumption of guilt.

Little has changed to remedy these matters since the Competition Commission's intervention. Regulation is no longer proportionate and a widespread perception, particularly among young aspiring accountants, that honest mistakes may destroy the careers of conscientious auditors. This sort of trend may be existential for the auditing profession, an observation that has been made to Sir John Kingman already.

4. How has this changed following the Competition Commission's intervention?

In truth, any difference has been imperceptible.

Theme 3: Choice and switching

5. Is competition in the audit market working well? If not, what are the key aspects hindering it?

Competition is too limited in the PIE market because there are too few suppliers, especially given the the inherent risk of one of the Big 4 exiting the market.

We believe that the market is a self-reinforcing regulated oligopoly, with the size of the Big 4 meaning that their ability to invest in innovation and technological support to auditors may outstrip the capacity of the competition. The Big 4 are becoming synonymous with the audit profession in the eye of the public, obscuring the diversity of access to the profession offered by other firms and the fact that many talented auditors go on to very fulfilling careers outside the Big 4.

Attempting to change behaviours among the buyers of audit has been a fruitless pursuit and an appetite for only minimum regulatory change will be wasted. We say in the preamble hereto that only a decisive and invasive degree of regulatory intervention will bring about purposeful change and we believe that knowledgeable commentators, politicians, and those working in the profession all agree.

Greater competition would stimulate the larger firms to improve their audit quality and better serve the public interest, so that reducing barriers to entry by mid-tier audit firms would put more competitive pressure on the bigger firms.

In practice, large companies have limited choice in the appointment of an external auditor as a result of the barriers to entry by mid-tier audit firms and non-proportionate regulation is one of the causes. The main barriers to entry and expansion of non-Big 4 audit firms are non-proportionate regulation, particularly the prospect of escalating fines for conduct no more reprehensible than making an honest mistake in the course of making judgements on difficult issues.

6. In particular, how effective is competition between the Big Four and between other firms and the Big Four?

Whereas a relatively small number of companies (SIFIs and the biggest PIEs) are capable of being audited only by the Big 4, the expertise residing in challenger firms is perfectly adequate to service the others. The fact that

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they are not is down to a number of factors (customer-bias, risk aversion, low-balling) and in the absence of market intervention, the situation will not change.

#### 7. How has this changed following the Competition Commission's intervention?

It has not improved. Although there has been some invigorated circulation of audit appointments among the Big 4, there is no sign of assignation by companies of audit appointments to firms outside the Big 4.

The Competition Commission recommendations on rotation were sensible but have not increased rotation other (predictably) than among the Big 4.

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

Greater competition would stimulate the bigger firms to improve their audit quality and better serve the public interest. Reducing barriers to entry by mid-tier audit firms would put more competitive pressure on the bigger firms.

If statutory audit did not already exist, then it would have to be invented – it may have its detractors and it may not always be executed as well as it might have been, but it is the tothing-stone of confidence in the capital markets, particularly where the ownership of companies is more disparate and where the owner-manager paradigm is not present.

Auditors are professionals and their profession is moved by a persistent, restless, dissatisfaction with the boundaries of professional knowledge and expertise. This is how the boundaries of capability are constantly pushed. Were it not so, professional capability would become stagnant. Unfortunately, the scarcer the number of 'players', the more those few players are able to dictate the pace of change, or rather dictate the market conditions that best suit their own interests.

There are parallels in other industries – in the pharmaceutical industry, for example, competition authorities world-wide have to strike a balance between companies whose input of R&D resource has to be rewarded but not at the permanent expense of other players: using the knowhow underpinning patented drugs they do not own in order to drive innovation of their own making is what pushes the frontiers of professional knowledge and capability. Competition authorities are very sensitive to the competing public policies at play in pharmaceuticals, and are used to calibrating the interfaces between legitimate commercial advantage and supporting the clear public interest in fostering technical advances.

This is the situation that the audit profession is in – it is virtually synonymous now with the Big 4, which is not a healthy situation and which allows the pace of change to be dictated by a number of key players, denying others entry to those 'laboratories' so that their own interests can be secured for as long as possible.

Whereas it is true that the Big 4 are doing some highly promising work in the AI and data analytics spaces, the danger is that they will 'own' those spaces in perpetuity, denying other businesses the opportunity to do likewise. This is the situation the audit profession finds itself in now, and access to open source technology, or licensed access to it, is such an important part of the package of measures.

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

The short answer is probably more than the subliminal biases to which audit committee members are subject will allow. Tenders are difficult for the challenger firms to commit too much cost to, and we are aware of ideas of the Investment Management Association, that 'tendering-lite' processes could be deployed for challenger firms, and a fund, provided by IMA members, could support challenger firms' tenders, allowing them to demonstrate their capabilities in a subsidised environment.

In practice, large companies have limited choice in the appointment of an external auditor as a result of the barriers to entry by mid-tier audit firms, arising from non-proportionate regulation by the FRC.



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

The key factors limiting choice between auditors are the dominance of the Big 4 and the barriers to entry of mid-tier firms.

It is, in relation to the audits of the majority of fully listed entities, the attitude of the demand-side that creates limitations: scalability is not.

Some form of positive discrimination, in favour of Joint/Shared Audit, manifesting perhaps in legislation mandating it, may be necessary.

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

One of the main barriers to entry and expansion of non-Big 4 audit firms is the non-proportionate regulation by the FRC, particularly the prospect of escalating fines following honest mistakes in assessing the balance of judgement on difficult issues.

We have set out in the executive summary the principal pillars of a properly competitive audit market, and we refer the reader back to it.

Theme 4: Resilience

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

The audit market, as long as it depends so heavily on the presence of four main firms, will be subject to stress that could eventually lead to a failure of one of those firms – this may come about through regulatory action or litigation but it is, in the view of many, a case of when, not if.

The biggest risk to the global capital markets in terms of the failure of a Big 4 audit firm stems from the litigation culture, and legal systems in certain countries where auditor liability is unlimited and uninsurable. The Authority may wish to explore further the extent to which liability reform in the auditing profession might result in less risk for the marketplace. Liability reform might also be a significant factor in lowering entry barriers for the challenger firms as well.

Theme 5: Regulation

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

The balance of regulation needs to be shifted so that competition exerts a heavier influence on the market and that regulation can become more proportionate and outcomes-focused.

It will have been seen from the executive summary hereto that regulation (we agree with the consultation paper) is an important concomitant of how to stimulate competition in the market. The tone-at-the-top and purpose of the regulator have to be optimised, though, and 'outcomes-focused' regulation should inform its structure and processes.

It was perhaps telling that the FRC refused, or at least failed, to adopt the competition term of reference that the Authority recommended earlier in the decade. That recommendation should be adopted now, which step, we feel, will cause regulatory developments to be properly informed by competition theory and practice as time goes on.

**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.

The most far reaching measure referred to in Section 4 would be the break-up of the Big 4, restoring the range of choice available before the mergers of recent decades. The disadvantage to the Big 4 firms should be outweighed by the gains resulting from greater competition, especially easier entry by mid-tier firms. It would also provide a benchmark for the future consideration of other mergers.

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Further measures designed to strengthen the recommendations of the Competition Commission would have limited costs, but more importantly limited advantages, risking, inter alia, unexpected and unwelcome effects such as those increasing barriers to entry by mid-tier firms.

We comment now on the possible measures cited at para 4.3 of the consultation paper (audit-only firms; market caps + joint/shared audit; and independent appointment of auditors).

Insofar as audit-only firms are concerned, the Authority may find the support of the CEO of the FRC in evidence to the BEIS Select Committee earlier in the year persuasive.

The market quotas solution favoured by RSM and by a number of other large firms holds a great deal of promise yet comparatively little consequence in terms of cost. Coupled with joint or shared audit (to give the challenger firms the capability to compete in all of the listed market), the challenger firms' capabilities can be brought to bear early, though it may still take several years to transition to the optimal effect.

So far as costs of these measures are concerned, it is difficult to apportion reliable numbers and the Authority may care to instruct further work, either in the course of the Study or of an Investigation.

Aside from the package of measures we have referred to, we should make mention of a further measure that has come up in the course of discussions among the firms, the audit licensing bodies and government, and it relates to audit firms' entitlement to provide non-audit services to audit entities.

The division between the provision of audit and non-audit services in the PIE market would radically change incentives dealing with the large difference in rewards arising for the provision of audit and non-audit services. A cost could be the potential loss of economies of scale in a limited range of specialist expertise in audit services, unless there was scope for audit firms to contract some specialist services from non-audit firms. The division could be affected by ring-fencing or separation of ownership.

This dual-provision right was limited under the FRC's new Ethical Standard to 70% of the audit fees a firm charges<sup>1</sup> but we feel that, in perception terms, it may be right that such right is, for SIFIs and the very largest PIEs, removed.

We stress, however, that this independence perception-addressing suggestion should not affect the rest of the audited population, many of which benefit from the multi-disciplinary model that the challenger firms offer – indeed, the fact that the challenger firms often act for SMEs and that the SME sector is the engine of growth of UK plc, persuaded the FRC to introduce an 'SME listed entity' derogation in the new Standard<sup>2</sup>

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. Restrictions on audit firms providing non-audit services

We refer again to the potential for licensing of the Big 4's AI and data methodologies to the challenger firms, which, we suggest could be done at marginal cost to the Big 4.

One measure in relation to auditors' entitlements which could be of considerable value would be to provide auditors who had worries about the accounts they were auditing, including absence of the provision of relevant information by management, discreet recourse to the regulator who could provide help in ensuring that the public interest was being met. To be fully effective this would require a clearer definition of the public interest than currently exists.

This clearer definition could also perform a similar function to that performed by the *Tebbit* test<sup>3</sup> in contested merger cases.

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<sup>1</sup> Para 4.34R

<sup>2</sup> See the Glossary

<sup>3</sup> Sir Norman Tebbit, then Secretary of State for Trade and Industry, announced in the House of Commons that competition would be the predominant feature of the Monopolies and Mergers Commission's focus in any contested merger, *House of Commons Library Report, 27 November 1991 HC 90 1991-92, para 233*



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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?

Separate ownership would be the most effective way of ensuring separation. We have seen a number of suggestions that the Big 4's audit practices should be 'ring-fenced' from the rest of their firms, but we have not seen any supporting specification that would allow us to judge the effectiveness of the measure.

Ring-fencing is an alternative to wholly separate ownership but there can be ways of avoiding its objectives. The scale of costs and benefits would depend on having a clearer definition of the public interest so that events did not lead to regulatory drift. Given the scale of the disparity between the rewards of the provision of audit and non-audit services, the benefits of separation might outweigh its costs.

Separation might be useful in the upper reaches of the PIE section of the market but would be of less benefit and greater cost in the sub-FTSE 350 and other markets where help with other financial issues are of great importance.

We suggest that the Authority should explore further all of the separation options it has.

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?

The Authority will want to have regard to the effectiveness of the major firms' (including the challenger firms' networks) but we should not think that the international dimension unduly complicates the overall picture.

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?

The scope should be related to the market to the PIE entity market and not to the supplier.

Our answer to Q14 refers – any complete embargo on the provision of non-audit services to an audit client should attach to the size and nature of the entity, not the audit firm, and care should be taken to apply the Proportionality principle: any such embargo should not extend to many of the companies in the List.

#### Market share cap

19. How should the market shares be measured? - number of companies audited, or audit fees or some other measure?

There is always something arbitrary about any particular market share which can mean that it is all too easy to impose unintended constraints and perverse incentives – as we say, a market cap should be flexible, and regularly reviewed by the CMA, or by the regulator.

20. Could the potential benefits (greater choice, and resilience) of a market share cap be realised?

We believe that most, if not all, of the major firms, together with the licensing bodies, support the workability of a market caps/quotas scheme, and that greater market resilience will follow from its adoption.

Much will depend on the boldness of the quotas adopted and assessment of costs and benefits would depend on the circumstances. If the quota suggestion is followed, it should be subject to review by the CMA or the regulator (FRC, when reformed). All permanent restrictions on competition are likely to be damaging both to audit quality (currently the most worrying aspect) and to audit prices. They should only be considered in the context of regular reviews of the state of competition.

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?

We do not envisage there to be any material additional costs to audited entities but in any event we expect the benefits to outweigh the costs.

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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%?

We note a number of commentators say that an 80% cap might be the appropriate level and we agree.

As argued above, such a cap should only be temporary, consistent with fulfilment of purpose and no more. In the present state of knowledge and analysis any initial number should be regarded as flexible, subject to CMA review.

23. Could a joint audit be an effective means of implementing a market share cap?

It (along with Shared Audit) will certainly be effective, and essential, in relation to the larger Listed companies. In some particular circumstances, perhaps when specific expertise is required in relation to a complex business model, it may also be useful. Its potential should be explored and if implemented compulsorily, monitored and subject to approval by the regulator.

#### 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?

We suggest that this should properly be left to the Vadera Review but our initial view is that *communication* with stakeholders should be the focus and not accountability to them, which presents extreme difficulties of duty of care and remoteness of liability.

We therefore believe that wider accountability will need careful investigation in the light of a clearer definition of the public interest. It is probably right to widen the range of stakeholders to include shareholder and pension fund trustees but important not to widen the definition to include one-off media interest which is usually characterised by public *curiosity*, not interest.

Consideration must be given to what wider-focused audits could rationally achieve: firms should be encouraged to use audit judgements widely, and to include consideration of prudence, possibly after discreet consultation with the regulator (our response to Q15 refers).

A reasonable amount of communication with stakeholders is an integral part of a high-quality audit and we would support enhanced dialogue in areas where such communication is useful and relevant to stakeholders. However, the extent of communication to stakeholders needs to be considered with respect to cost-effectiveness and subject to a cost/benefit assessment.

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?

Paragraph 5 of our answer to Q14 refers but overall we believe that assignment of this task to a single server (such as the National Audit Office or a new independent body) might only serve to introduce a further aspect of monopoly into the system: as apparent in other regulatory activities, the use of a single server imposes rigidity and replaces markets with command and control.

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

Our answer to Q25 refers but (although not asked directly) we do advocate that the task of ensuring the market quota solution is working should be assigned to an independent body

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?

Whilst we do not support greater frequency of the audit tendering and rotation in general, it may however be necessary to provide for 'transitional rotation', simply to make the quota solution work within a conscionable time.