

30 October 2018

Statutory Audit Market Study
Competition and Markets Authority
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Victoria House
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Dear Sir or Madam

Statutory Audit Market – Invitation to Comment

Introduction

Deloitte is grateful for the opportunity to respond to the Competition and Markets Authority's ("CMA") Invitation to Comment.

We recognise the considerable thinking that has gone into producing this paper, and we share the CMA's objective of delivering a UK audit sector that works well for the UK and international companies, their shareholders and the wider stakeholder community served by the audit market.

The CMA's Invitation to Comment is understandably focused on the issues of choice and switching, resilience and incentives.

As the CMA acknowledges, these matters cannot be considered in isolation. It is important that these matters are considered in the broader context and in conjunction with adjacent ongoing reviews of the financial reporting ecosystem. We highlight three points.

1. The UK audit profession contributes over £17 billion to UK GDP and employs over 150,000 people, providing for the efficient operation of the UK financial markets. The six largest firms recruit a young person every two hours of every day, and five of the six firms are ranked in the top 10 list of social mobility employers. Accountancy is one of the UK's success stories and is widely respected internationally. It is clear, however, that trust and confidence in the role of the profession has been damaged and change is required. Care needs to be taken that any remedies are focussed on the UK but do not damage the international competitiveness of the UK, particularly in a post Brexit world.
2. Recent events have highlighted the expectation gap and demonstrated the need to reconsider the role and purpose of an audit and examine whether it is still meeting the needs of 21st century stakeholders. Audited financial statements continue to provide the bedrock of trust and confidence for the capital markets. Today tough financial insight is mainly generated from an abundance of real time, forward looking financial and operational information.

We support an independent review that examines the question “*what is the very nature of audit?*”. It needs to explore how artificial intelligence and technology can reinvent audit and look at expectations around the business model, future viability, fraud and the front half of the annual report. This review needs to be established quickly and report no later than June 2019 so that any conclusions can be considered alongside other changes that are required to improve audit regulation and to drive more choice in the listed audit market. The review needs to be forward looking and reflect the fact that changes to the audit product may well in itself lead to major disruption, opportunities for new entrants (subject to independence considerations) and increased competition.

3. Changes are also required more broadly in the financial reporting ecosystem. All participants have a role to play in improving the overall quality of financial reporting.

The primary responsibility for the quality and integrity of financial reporting rests with the company’s management and board. We support the introduction of a proportionate UK Sarbanes-Oxley equivalent type regime for the largest listed companies in the UK. This will place appropriate accountability on companies’ boards and management to ensure the quality of their financial reporting. Data¹ shows that restatements in the US spiked in the years following the introduction of Sarbanes-Oxley, as a result of the new requirement to report on the effectiveness of internal controls over financial reporting.

Guiding principles for reform on choice, resilience and incentives

We are clear that there is no one simple or quick solution that addresses all of the CMA’s concerns. A small number of the solutions that have been discussed, such as breaking up the largest four firms, would not solve the question of choice and will undoubtedly impair audit quality. Consequently a constructive, aligned and complementary set of remedies is required. We acknowledge that no effective group of remedies is likely to be challenge-free or have no potential for negative consequences. We have used the following principles to guide our response:

- a) Audit quality should be the overriding objective of any remedies pursued by the CMA. An essential element of the ability to deliver audit quality is the ability to draw on a wide range of skills within a multi-disciplinary firm;
- b) An increase in choice of providers of audit services to the UK’s largest companies is in the public interest;
- c) Restoring trust is essential, but any remedy must work within the international context, given the requirements of investors and stakeholders in large UK listed and private public interest entities.

Our remedy proposal

We do not want to be in the same position in five years’ time. We have put forward below a cohesive and comprehensive package of proposals that combined with substantive changes to the financial reporting ecosystem and the audit product, will deliver significant and lasting positive change. These proposals will be challenging for Deloitte and other market participants to deliver, but we believe this package of measures are most likely to address the concerns around choice and switching, long-term resilience and incentives. In the time available we have carefully considered the mechanisms that can make these remedies practicable and avoid, to the extent possible, negative collateral consequences. We do not have all the answers but would welcome engagement with the CMA on this issue.

We believe that the following measures will be the most effective:

- a) A market share cap or caps, for particular segments or subsets of the market, which would over time seek to address choice and competition issues, reducing barriers to entry as well as concerns around resilience of the audit market;

- b) A stronger, fully accountable governance structure around the audit practice, which seeks to address issues around incentives and conflicts and increases resilience; and
- c) A ban on non-audit services provided to FTSE350 and large unlisted public interest entity audit clients, which seeks to address issues around incentives.

We provide more details on each of these proposals below.

1. Increasing choice: from four to more

1.1 The FTSE 350 audit sector in the UK is fiercely competitive, and has been made more so by the remedies put in place following the Competition Commission's market investigation. However, it is undoubtedly highly concentrated, with 98% of FTSE350 companies audited by the four largest firms. Recent regulatory interventions in the UK and the EU aiming to reduce concentration have not led to a decrease in the proportion of companies audited by the four largest firms – in fact, the opposite has occurred.

Considering the listed company market as a whole

1.2 In the US, the Fortune 500 has similar levels of concentration to the UK FTSE 350 market. This is not surprising. Big international companies require big international audit firms with sufficient global coverage and capabilities, expertise and scepticism to challenge management.

1.3 However, there are significant differences between the UK and US when the entire listed market is considered. In the US, the four largest firms audit between 45-50% of the entire listed market, compared with 75-80% in the UK.

1.4 With this in mind, we believe that the CMA's remedies should take into account the entire listed market. This will allow firms outside of the four largest firms to build their skills and capacity over time.

1.5 We also recognise that greater choice over time within the FTSE 350 market is in the public interest. In a mandatory rotation environment, at the top end of the market, the choice of auditor is currently limited to three firms which have the expertise and international footprint and, in some cases, fewer than that. We support changes that increase choice and reduce concentration.

Splitting up the largest firms would be very damaging for all stakeholders

1.6 Splitting the four largest firms into a smaller eight would not address this issue. We strongly oppose any such proposal.

1.7 This proposal would not substantively increase choice. Only four of the newly-created UK firms could remain as part of an international network. The choice of firms with an international footprint would not change.

1.8 The proposal would potentially undermine audit quality. Deloitte in the UK is currently a Partnership with over £3bn of revenues. Being part of such a large and balanced business affords a number of benefits. It offers a high degree of resilience to allow weathering of adverse events. Its size and scale mean that it is not reliant in any way, actual or perceived, on even the largest clients as they individually represent a very small proportion of the overall revenues. This independence allows the firm to make entirely objective judgements on all client matters.

1.9 Scale also provides an ability to invest in the people, methods, infrastructure and quality required to identify risks and challenge management.

Measures to improve incentives will not have a material impact on market share

1.10 We do not believe that any of the remedies suggested around incentives would have a material impact on market share and many of them run counter to and perhaps reduce board accountability and responsibility. We are not supportive of an independent body to appoint auditors. However measures that will improve the transparency of the audit appointment and reappointment decision and that will stimulate greater investor involvement in the tendering process and indeed strengthen the links between audit committees and investors are welcome. We would also suggest that audit committees are required to manage their relationships with suppliers of audit services such that they have a choice of at least three credible suppliers at the time of any audit tender.

Supporting the emergence of new players

1.11 The only durable solution is the emergence of at least one other large firm as a major competitor to the four largest firms, with a significant share of listed (and, in time, FTSE 350) company audits. We would welcome a discourse with the CMA on this issue. A target of 20% of the FTSE 350 companies audited by a firm outside of the four largest firms in five years' time would represent a sevenfold increase from the current position.

1.12 However based on our analysis a firm outside of the largest four firms would need to win 60% of all tenders in the next five years, to reach the 20% FTSE 350 target by 2023/4 and wait for another one to two years before these audits go live. If this share was to be spread between the firms it is arguable that they may continue to have insufficient scale to compete effectively, leading to an outcome that may never be self-sustaining. We note that prior to its collapse in 2002 Arthur Andersen only had a market share of 8% of FTSE350 audits.

1.13 Market based changes on their own are therefore unlikely to lead to a significant durable change in concentration; some intervention is required.

A market share cap remedy is most likely to be effective

1.14 On balance we believe that market share caps, if introduced for a set period of time and judiciously planned and monitored, are the only effective mechanism for moving 'from four to more', within an acceptable timescale. In the time available Deloitte has considered this issue carefully. It seems clear that at least currently, there are some companies that, due to their size and complexity, will continue to require an auditor from among the four largest firms. We have therefore considered the possibility of applying different caps to different segments of the market and flexing the level of those caps over time. These caps should be applied by number of companies to the entire listed market as well as a FTSE 350 subset. We would welcome the opportunity to discuss with the CMA in more detail how this might work in practice, and, in particular, how we think this would be consistent with the principles we have set out above.

1.15 Market share caps on the four largest firms will provide a guarantee of other large firms being able to win work in segments in which they have not been able to make sufficient progress to date. However, two related issues need to be addressed:

- a) we note that the leading firms outside the four largest firms consider that they already have the capabilities to audit large listed companies and other public interest entities (PIEs) (as they explained to the Competition Commission) but more is needed to build skills, capacity and scale; and
- b) the economics of the marketplace need to be attractive for these firms. The returns from investment in top-end audit capability are uncertain and long-term, and the risk environment is challenging.

Additional support measures

1.16 Consequently, we believe a package of additional measures is required to support the market share cap and help other large firms to compete effectively and sustainably, while maintaining or improving audit quality. These measures should be understood as transitional in nature: we would propose that they have an agreed five-year sunset clause.

1.17 To address skills and capacity we support measures such as:

- a) shared audits, where the four largest firms would partner with a firm outside this group to audit a particular component but retain overall responsibility for signing off the group accounts. This is distinct from joint audits which we do not support. They add cost and are detrimental to audit quality;
- b) staff secondments to the four largest firms from firms outside this group and or the provision of training by the four largest firms or the Institutes on particular technical topics; and
- c) the licencing of technology platforms between the four largest firms and firms outside this group in the context of delivering a shared audit.

1.18 We are confident that the market can support more than four large players, but we recognise that some additional support may be necessary for a transitional period to support investment. Consequently, for a five year period we support measures such as:

- a) an appropriate and proportionate sanctions regime for all firms that acts as a catalyst for an improvement in audit quality rather than acts as a deterrent and barrier to entry for firms into the FTSE 350 and PIE audit market; and
- b) additional funding from the four largest firms to a third party that can be used to support and develop skills, training, and technology across the audit market.

Conclusion on a market share cap remedy

1.19 We acknowledge that market share caps are not an easy solution. Feedback we have received suggests that caps may not be popular with companies, some of whom feel that their choice may be restricted further rather than improved for a period of time. We acknowledge these concerns, but believe that they can be managed. In particular, the caps should reflect the capability, capacity and credibility of the relevant firms as these develop over time. It may therefore be necessary to introduce caps gradually over time and flex them accordingly.

2. Stronger governance around the audit practice

2.1 We understand the concerns voiced when conflicts of interest arise between the firms' public interest audit responsibilities and the advisory services provided to non-audit clients. We believe that these conflicts arise very infrequently.

2.2 The CMA will be aware that conflicts of interest may arise in any company or firm that is not a monoline operator, and the key is in ensuring that any such conflicts are appropriately minimised and managed.

The benefits of a multi-disciplinary firm

2.3 The careful management of potential conflicts of interest is all the more important because there are clear benefits to audit quality of a multi-disciplinary model. The scope of international standards on auditing requires the extensive use of specialists and high quality audits require high quality specialists. On complex audits we regularly use specialists from across corporate tax, transfer pricing, actuarial, IT and cyber risk advisory, data analytics, valuations and financial instruments together with industry specialists to identify risks and challenge management.

- 2.4 Auditors are required to communicate Key Audit Matters (“KAMs”) in their report in the financial statements. Communicating KAMs provides additional information to users of the financial statements to assist them in understanding those matters that, in the auditor’s professional judgment, were of most significance in their audit. It also provides users of the financial statements a basis to engage further with management and those charged with governance about certain matters relating to the entity and the audited financial statements.
- 2.5 We have analysed the KAMs included in all of the audit reports for the FTSE 350. Over 55% of all reported KAMs require specialist input from the broader multi-disciplinary firm outside of Audit. Only 7% of such audit reports contain no KAMs that require the input from a specialist.
- 2.6 Specialists are drawn from across the Firm but are subject to the same quality, ethical and independence standards. In the year to May 2018, over 2,100 people from service lines outside of audit worked on statutory audits contributing particular expertise and specialisation. This need for specialist input is only likely to increase as the audit product develops, particularly in areas such as cyber risk, artificial intelligence and blockchain. A potential outcome of the current debate around the scope and purpose of audit is more rather than less specialist input being required e.g. in respect of providing assurance over a company’s viability. A multi-disciplinary firm helps to futureproof audit quality against a backdrop of these areas of emerging importance and may well in itself prove a significant catalyst for disruption.
- 2.7 The multi-disciplinary model also provides the best opportunity to attract the highest quality talent and provide for their rounded development. It provides the scale, financial resources and skills needed to innovate and invest in artificial intelligence and technology to continually improve quality and evolve the audit product to meet the needs of 21st century stakeholders. This can only be achieved if there is full financial consolidation across the firms to support investment in quality and innovation.
- 2.8 For these reasons, we are strongly opposed to any measures that split the audit practice from the rest of the firm (or as posited at 4.8b to prohibit or limit audit firms from providing non-audit services to any large company or PIE irrespective of whether they audit the company). We believe it would be enormously detrimental to audit quality and would not improve choice. We are clear that those remedies are not necessary to achieve an effective answer to concerns about conflicts of interest - to say nothing about the risk they pose of unintended adverse consequences.

An effective governance remedy

- 2.9 We believe long-term resilience can be improved by strengthening the existing governance structure around the audit business and by developing a clearer separation of the governance frameworks that are in place for both the audit and the advisory businesses.
- 2.10 The current audit governance framework is strong, but we believe it can be improved. We support the creation within each firm of a separate, independent, governance body with clear public interest reporting responsibilities. Such a body would:
- a) be required to monitor and report publically on any potential conflicts and how they have been dealt with to ensure there are no actual or perceived conflicts with the firm’s public interest responsibilities. They could be required to ratify certain types of appointments; and
 - b) have a dedicated focus on audit quality with an emphasis on root cause analysis and a requirement to report publically on audit quality metrics.
- 2.11 Appointments to this independent body and other key appointments within the firm would need to be approved by the audit regulator.

3. Ban on non-audit services to audit clients

- 3.1 Non-audit services were a key focus of the EU audit reforms, which introduced a raft of prohibitions and other limits on the non-audit services that auditors can provide to the public interest entities they audit. As a result, the proportion of revenues that auditors earn from such services have declined in recent years².
- 3.2 However, we recognise that in the UK there are still concerns around auditor independence. These concerns are not generally held elsewhere around the world, but given the UK environment we support a ban on all non-audit work by a firm to those FTSE 350 companies and large public interest entity private companies which it audits.
- 3.3 This will require a clear definition of large public interest private companies as well as a clear definition of 'audit services'. We would suggest that as well as the annual audit, this includes the half-year review, bond offerings, grant applications, reporting on historical financial information, work on offering circulars and similar services. All other services, with no exceptions, would be banned.

Conclusion

Deloitte is committed to achieving a UK audit sector that works for its stakeholders. While the Competition Commission's market investigation and other reforms that have taken place since then have further increased competition among the four largest firms for audits of the UK's largest companies, we believe that more needs to be done to alleviate the concentration issue.

We believe that any remedy seeking to split up the largest audit firms, whether vertically or horizontally, is not workable and would lead to a deterioration in audit quality. Neither of these proposals would address the issues identified in the Invitation to Comment nor would they be consistent with the principles set out at the start of this paper. We strongly believe that they would not be effective in improving audit quality or increasing effective competition or resilience in the market. On the contrary, both would damage audit quality.

However, we do acknowledge that to improve choice, mere incremental changes would not be effective. A remedy package with a market share cap (or caps) at its heart would over time bring about more choice. A set of supporting measures would help to ensure its effectiveness by allowing firms outside the current largest four firms to invest with confidence in their capabilities. However, all of these measures needed to be considered in the context of changes required in the broader financial reporting ecosystem.

We look forward to further engagement with the CMA in support of its goal of bringing the right set of changes to the UK audit sector.

Our views on potential remedies that have not been explicitly referenced above are dealt with in our response to the detailed questions in the appendix.

Yours faithfully

David Barnes
Deloitte LLP

¹ In 2006, companies filed 1,859 restatements after a rise to 1,632 the year before. The numbers have dropped dramatically since.

² <https://www.frc.org.uk/getattachment/27725654-8bd9-4623-a410-ef1661a69649/Key-Facts-and-Trends-2018.pdf> FRC data shows that the percentage of fee income of the four largest firms derived from non-audit services provided to the entities they audit was 9.7% in 2017, down from 12.0% in 2014; and was 48.7% of the audit fees in 2017, down from 56% in 2014.

Deloitte.

**Statutory Audit Market –
Invitation to Comment: Appendix**

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

- 1.1 Many audit committee chairs and investors have commented that the audit product is not fundamentally broken. Audit quality scores over the last five years have generally increased. However, it is clear that certain stakeholders and commentators have lost confidence in auditors and the audit sector. The public perception is that the audit sector is no longer serving its stakeholders well.
- 1.2 We believe that an important driver of this loss of trust is the difference between the level of assurance stakeholders believe an audit should provide on a company's financial reporting and what is required by the audit framework. This is often referred to as the audit "expectation gap".
- 1.3 Audited financial statements continue to provide the bedrock of trust and confidence for the capital markets. But today financial insight is mainly generated from an abundance of real time, forward-looking financial and operational information, provided to an ever-changing stakeholder population.
- 1.4 There are clear expectation gaps around the auditor's responsibility on much of this information – for example, around fraud, the future viability of a company and the level of assurance provided over the "front-half" of annual reports.
- 1.5 We support an independent review that examines the question, "what is the very nature of audit?" This review needs to be established quickly and report no later than June 2019 so that any conclusions can be considered alongside other changes that are required to improve audit regulation and to drive more choice in the listed audit market. The review needs to be forward-looking and reflect the fact that change to the audit product may well in itself lead to major disruption, opportunities for new entrants (subject to independence considerations) and increased competition.
- 1.6 We believe that changes are also required more broadly in the financial reporting ecosystem, as all participants have a role to play in improving the overall quality of financial reporting.
- 1.7 A company that has strong systems and processes, governed by experienced directors with appropriate accountability, combined with a high quality audit focused on the current and future needs of stakeholders, will produce the best outcome for the capital markets.
- 1.8 As a result, we support the introduction of a proportionate UK Sarbanes-Oxley equivalent type regime for the largest listed companies in the UK. This will place appropriate accountability on companies' boards and management to ensure the quality of their financial reporting. Data shows that restatements in the US spiked in the years following the introduction of Sarbanes-Oxley, as a result of the new requirement to report on the effectiveness of internal controls over financial reporting. Similar regulation in the UK that compels management and directors to take greater responsibility for the quality of their companies' internal controls, coupled with the transformation of the FRC, should lead to a significant improvement in the quality of corporate financial reporting.

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

- 2.1 The CMA invitation to comment acknowledges that the audit framework is set at an international level, with overlays from the IAASB, EU directives and then to a limited extent by the FRC and ICAEW.
- 2.2 This framework is well defined, but we believe it has not evolved sufficiently to be able to support the current interests of shareholders and other stakeholders. As a consequence, the expectation gap we refer to in question 1 has widened.

- 2.3 As a result of FRC innovations in the last decade, a company’s annual report in the UK does contain much more information relevant for a broader group of stakeholders. For example, the “front half” of the annual report has evolved considerably with many new disclosures. We also note the increased availability of other information through, for example, shareholder presentations and Regulatory News Service (“RNS”) announcements.
- 2.4 However, based on our discussions, we think many stakeholders (whether direct shareholders or other stakeholders) are unclear on the extent to which this information is within the scope of the audit framework and therefore subject to audit.
- 2.5 On the “back half” of the annual report, we note that the changes made to the audit report following the introduction of ISA 700 in 2016 have significantly increased the information available to the users of the financial statements (and will include more in the coming years), and that this supports the interests of both shareholders and wider stakeholders.

3. To what extent do the decisions made by the audit committees support high quality audits, whether through competition for audit engagements or otherwise?

During the Audit

- 3.1 We have observed an increasing level of engagement between audit firms and audit committees in recent years. This is a critical part of enabling a higher quality audit process.
- 3.2 More time is allocated in audit committee meetings to discuss financial reporting and the external audit as audit committee members have sought to understand and challenge auditors on their approach - including scope, independence, team and conclusions.
- 3.3 We also note more time being spent by committee members seeking the auditor’s views on the quality of the company’s financial reporting processes, people and systems.
- 3.4 As part of the review of the future of audit, the role and responsibilities of audit committees could be reviewed. Areas for consideration might include requiring formal meetings with the audit regulator to discuss audit matters, or whether audit committees should have a more definitive responsibility over the internal controls of an organisation.

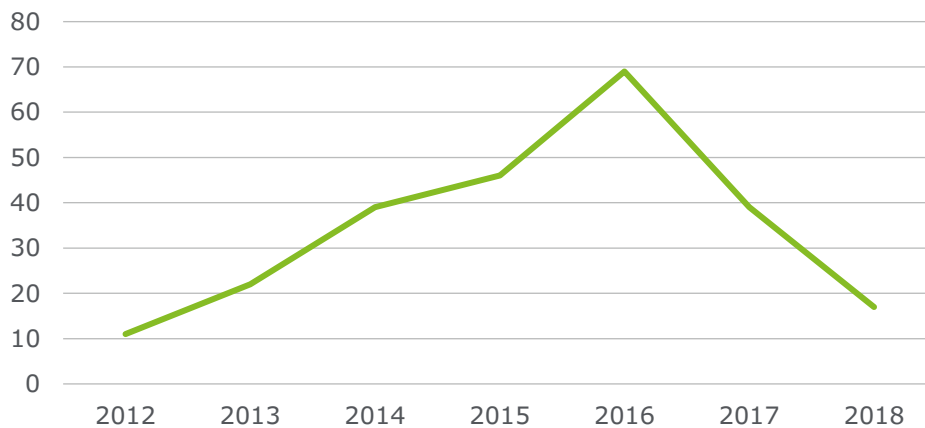
During the Tender Process

- 3.5 In our experience, audit committees have taken responsibility for defining how the audit tender will run and they are heavily involved throughout the process.
- 3.6 This has provided audit committees with a greater level of insight into how audit firms plan to undertake their audit and therefore given them more information on which to challenge the quality and effectiveness of their audit, particularly where they see inconsistencies between the tendering audit firms.

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

- 4.1 Although it is still too early to fully assess the effect that the Competition Commission’s intervention has had on the audit sector, our view is that the interventions have increased audit committees’ focus on ensuring that audit quality is improved.
- 4.2 The Competition Commission intervention has given rise to a higher number of tenders, as noted in figure 1 below. 74% of the 213 FTSE 350 companies that tendered between 2011 and 2017 resulted in the appointment of a new audit firm, although nearly all mandates have been awarded to the four largest firms.¹

Number of Tenders across the FTSE 350 from 2012 to 2018



Source: Deloitte's Audit Capture Office

- 4.3 It is our view that this increased level of audit tendering and the competitiveness of the tendering process has led to improved audit quality. To compete effectively, audit firms are spending more time planning the most effective audit approach. The quality of the challenge provided on the more complex and risky judgement areas is evident to the audit committees and also to the users of the accounts through enhanced audit reports. Audit tendering has also accelerated the development of innovative tools and methodologies, again so that the audit firms are able to demonstrate their commitment to continual improvement to audit committees.
- 4.4 It is also our experience that during the transition to a new auditor and in the first year of the audit, the new auditor is able to bring a fresh perspective on a company’s processes, judgements and financial reporting, which has also improved audit quality.

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

- 5.1 Competition works well if there is healthy and competitive rivalry between competitors, and if this leads to better services and/or lower prices that are passed onto customers. On this criteria, we consider that competition is working well in the audit market as audit quality has generally improved² and prices have not risen significantly.

¹ FRC Developments in Audit 2018, October 2018, p24

² FRC Developments in Audit 2018, October 2018, p7

- 5.2 However it is also true that the FTSE 350 audit market has become more concentrated over recent years with only 3% of FTSE 350 audits now being conducted by those outside the four largest audit firms. At the top end of the market and perhaps across the FTSE 350, Audit Committee Chairs perceive that they have limited choice.
- 5.3 As the largest companies have increased their scale and complexity, their audits increasingly require an audit firm with extensive domestic and international coverage access to a wide range of specialists as well as deep technical and industry expertise and experience across the globe.

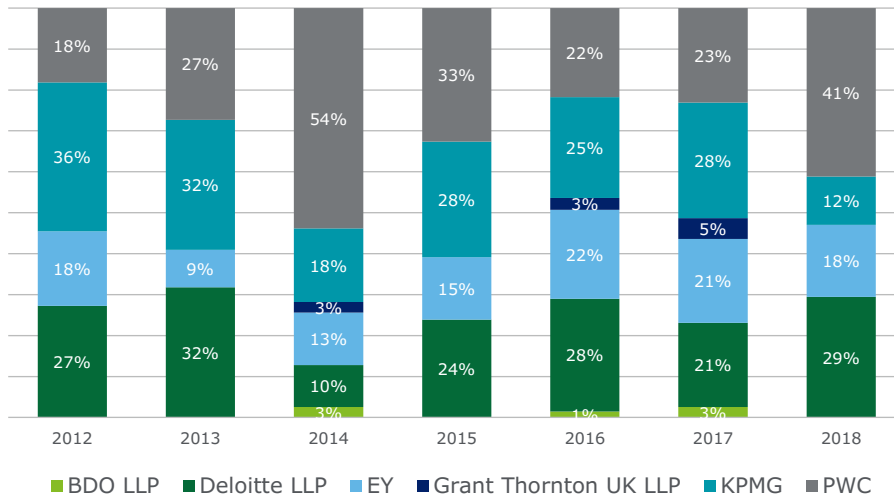
6. In particular, how effective is competition between the Big Four and between other firms and the Big Four?

- 6.1 There is strong competition between the largest firms on any audit tender.
- 6.2 Competition between the largest four and other firms is less frequent, either because those other firms compete in different market segments to the four largest firms, or because they have not been invited to tender, or, if invited, they are not selected to be one of the final two firms. Earlier this year Grant Thornton announced it would withdraw from competing for FTSE 350 audits. Apart from BDO, we rarely see direct competition from firms outside the four largest in the FTSE 350.
- 6.3 Outside the FTSE 350, we do see more competition from firms outside the largest and in some of these market segments the four largest firms are relatively small players. For example:
- 6.3.1 In 2017 there were eleven different firms auditing the AIM top 100 in 2017 (source: Accountancy)
- 6.3.2 There are 80 different auditors involved in the market for the top 200 International track firms (as defined by The 2018 Sunday Times HSBC International Track 200, which ranks Britain's private mid-market companies with the fastest-growing international sales)
- 6.4 Whilst we are of the view that competition is effective both between the four largest firms and between the four largest and other firms, we do recognise that there is a high level of concentration of the audits of the FTSE 350 with the four largest firms.
- 6.5 We recognise there are barriers that are either preventing or hindering audit firms that are not one of the four largest firms from competing for a larger share of the FTSE 350 audit market. We are supportive of actions that will seek to reduce the level of concentration of the FTSE 350 audit market over time whilst maintaining and improving audit quality.

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

- 7.1 Although it has been only a few years since the Competition Commission's interventions our preliminary observations are as follows.
- 7.1.1 The audits of the FTSE 350 have become more concentrated to the Big Four. The chart below sets out the proportion of FTSE 350 tenders won by firms in recent years. Of the 244 tenders for which we have data, only eight have been won by BDO or Grant Thornton.

Proportion of tenders won by firms each year



7.1.2 The concentration of the audits of the largest companies in the UK to the Big Four is also reflected in the US audit market where the audits of the US Fortune 500 are dominated by the Big Four. However we do note that if the entire US listed market is considered, only 45-50% is audited by the Big Four compared with 75-85% in the UK.

7.2 With this in mind, we believe that any remedies adopted by the CMA should take into account the entire listed market. We commented at the time of the Competition Commission’s market investigation that looking only at the FTSE 350 was an artificial segmentation and we continue to believe that a wider appraisal is necessary (and that any remedy should reflect this wider appraisal). We strongly support changes that increase choice across the whole listed market, whilst maintaining high audit quality.

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

- 8.1 The FRC’s assessments of firms’ audit quality, as carried out by its Audit Quality Review Team, show that quality has generally improved over the last decade in every firm that carries out large company audits, and all firms have expressed commitments to continue to improve quality.
- 8.2 The rise in quality has been driven by both regulation and competition, although competition has clearly been the more important driver. For example, firms started to adopt analytics technologies well before the FRC started to comment on them as part in their quality reviews.
- 8.3 An argument, which is set out in the recent House of Commons Library Briefing Paper “Company audits: problems and solutions”, suggest that if quality differences are difficult to convey or assess, competition will drive down prices at the expense of quality. Contrary to the assertion in that paper, and as described above, the audit market does not exhibit these characteristics.
- 8.4 As we have noted in our response to Question 3, Audit committees, as the buyers of audits, are aware of the need to consider audit quality in determining which audit firm to appoint.

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

- 9.1 There are thousands of registered audit firms in the UK. However, given the size, scale and complexity of most of the listed companies and particularly those companies in the FTSE 350, there are only a small number of those audit firms that are capable of or that have the experience of or appetite for carrying out their audits. In some cases, at the top end of the market due to mandatory rotation the number is three, in other cases because of conflicts it can be even less.
- 9.2 Our analysis of the tenders of FTSE 350 audits indicates that since 2014, when mandatory tendering first started to have a significant impact on the number of audits tendered, the majority of audits that have been put up for tender have attracted bids from at least three or four audit firms.
- 9.3 Whether an audit firm is capable of undertaking the audit is driven by a number of factors including whether the audit firm has the geographic footprint to provide audit services where needed, the access to the large range of specialists and experts often drawn from outside the audit practice, and the audit tools and methodologies capable of auditing companies of that scale and complexity.
- 9.4 We recommend that audit committees be required to manage their relationships with providers of audit services so that they have a minimum of three credible tender options for each tender process.

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

- 10.1 Two key factors limit a company's choice of auditor: (a) the number of eligible firms in the marketplace and (b) the extent to which firms are qualified to audit the company in question.
- 10.2 In terms of the number of eligible firms in the marketplace, the upper limit of competitors that can be sustained by a market is determined by:
- The overall size of the market; and
 - The minimum scale for any audit firm to be sustainable. This, in turn, is determined by a range of factors including the margins available, the range of skills and capabilities required by buyers, and the level of financial strength required.
- 10.3 In terms of firms being appropriately qualified, audit firms need to have sufficient experience and reputation to be seen as a credible choice by buyers. A firm that has a share of, say, 3-5% of the market is likely to have much greater difficulty in building its share to 10% than a firm with a 20% share will have in growing its share to 25%.
- 10.4 As a result:
- Firms outside the largest four firms have understandably decided to focus their strategies predominantly outside the FTSE 350
 - Creating a credible competitor from outside the four largest firms is likely to require sustained external intervention, using some of the remedies we discuss in our response to question 14.

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

- 11.1 The four largest firms have invested significantly in their business over many decades. This leads to advantages in a range of ways:
1. The strength and depth of their technical and industry skills;
 2. Technology, including technology platforms, methodologies and processes
 3. The breadth and depth of their global networks;
 4. Financial strength; and
 5. The strength of their brands - which effectively is how the combination of the four elements above are perceived externally.
- 11.2 These factors could all be seen as barriers to entry, though we would contend that they are necessary elements required to execute the highest quality audits to the most complex global clients.
- 11.3 We recognise that firms outside the largest four firms possess all of the above, to a greater or lesser extent, and that as a result they are well equipped to carry out a range of audits, including a proportion of those in the FTSE 350.
- 11.4 However, they do not currently have the scale or strength in depth, across all the above factors that enables them to compete effectively and consistently for large, complex FTSE 100 audits. Additionally, the commercial risk of undertaking very large audits – including the unlimited liability of audit firms and the current risk of large regulatory fines – is significant.
- 11.5 Buyer behaviour might also be seen as a barrier to entry for firms. This is based on experience and reputation, so inevitably lags behind the other factors listed above.

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

- 12.1 In our view a resilient market is one in which there is sufficient competition and choice of auditor for any company, and where an incidence of a market participant leaving the marketplace (whether forced or otherwise) does not result in a lack of choice.
- 12.2 We believe that there are firms outside the four largest firms that are able to audit many of the constituent companies of the FTSE 350. However, capability and capacity constraints – as well as the barriers to entry described above - prevent them from taking much larger shares.
- 12.3 There is a risk that the regulatory regime, either through the level of sanctions or the independence requirements, causes a disincentive to audit firms to increase their exposure to audits in the FTSE 350 in particular or for new participants to enter the market. We are supportive of an appropriate and proportionate sanctions and independence regimes for all firms that acts as a catalyst for an improvement in audit quality rather than acts as a deterrent and barrier to entry for some firms into the PIE audit market.
- 12.4 Deloitte, in common with the other four largest firms, are a partnership with significant revenues in the UK. Being part of such large and balanced businesses affords a number of benefits. It offers a high degree of resilience to allow weathering of adverse events. The size and scale of the respective firms mean that they are not reliant in any way, actual or perceived, on even the largest clients as each client individually represent a very small proportion of the overall revenues. This independence allows the firms to make entirely objective judgements on all client matters.

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

- 13.1 Both competition and regulation play a key role in this marketplace. We consider these to be complementary and not in opposition with each other. Over the last few years both have served to improve audit quality, and because quality is key to this market, regulation of market participants is critical. However, too much regulation or the wrong kind of regulation can and will affect competition.
- 13.2 For the balance between regulation and competition to be appropriate, regulation and regulators should focus on improving the quality of both financial reporting and audits.
- 13.3 In our response to the Kingman Review we made a number of comments as to how the quality of audit regulation could be improved. These included a mindset shift to that of being an “improvement regulator”, looking at the root causes of audit failures and driving improvements consistently across the audit market. A regulator that demands a high standard, but works with audit firms if that standard is not met to educate and improve them is critical.
- 13.4 We also suggested that changes are required more broadly in the financial reporting ecosystem. All participants have a role to play in improving the overall quality of financial reporting.
- 13.5 The primary responsibility for the quality and integrity of financial reporting rests with the company’s management and board. We support the introduction of a proportionate UK Sarbanes Oxley equivalent type regime for the largest listed companies in the UK.
- 13.6 This will place appropriate accountability on companies’ boards and management to ensure the quality of their financial reporting. Data³ shows that restatements in the US spiked in the years following the introduction of Sarbanes-Oxley, as a result of the new requirement to report on the effectiveness of internal controls over financial reporting.

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

- 14.1 In the table in 14.4 we have considered each of the measures suggested by the CMA in Section 4 of the Invitation to Comment. For ease of reference, we have grouped these measures into three categories:
1. Measures that we propose as a package for discussion and further evaluation;
 2. Other measures that appear to have merit, based on our initial assessment; and
 3. Measures that we do not support
- 14.2 We have provided commentary in 14.5 on the costs, benefits and challenges of implementation in respect of each of the measures as requested. To facilitate discussion on the merits or otherwise of each of the measures we have provided our initial views on the relative impact of the costs, benefits and challenges of implementation from the perspective of the capital markets, users of the financial statements and other stakeholders. Our assessment of costs and benefits is based on the costs (or benefits) to the market rather than to Deloitte or other audit firms.

14.3 In considering the relative impact of a cost, benefit or challenge of implementation we have used the guiding principles we set out in the executive summary:

- Audit quality should be the overriding objective of any remedy
- An increase in choice of providers is in the public interest
- Any measure must work within the international context

We would welcome the opportunity to discuss these views with the CMA, other stakeholders and respondents to the CMA Invitation to Comment.

14.4 Summary analysis of measures:

Measure	CMA reference	Initial view on the likely impact on:			Reference to further detail on analysis	Reference to other parts of our response
		Costs	Benefits	Implementation challenges		
Measures that we propose as a package for discussion and further evaluation:						
Non-audit services ban to audit clients	4.8(a)	Medium	High	Low	14.5.1	Exec sum and Q18
Market share cap	4.14 to 4.17	High	High	High	14.5.2	Exec sum and Q19 –Q23
Stronger governance around the audit practice	None	Medium	High	Medium	14.5.3	Exec sum and Q15
Other measures that appear to have merit based on our initial assessment:						
Shared audits and peer review ¹	4.18	Medium	Medium	Medium	14.5.4	Exec sum and Q20
Direct support including secondments and technology licencing ¹	4.23	Medium	Medium	High	14.5.5	Exec sum
Reduce barriers to senior staff switching audit firm ¹	4.24	Low	Medium	Medium	14.5.6	None
Changes to restrictions on ownership of audit firms	4.26	Medium	Low	Medium	14.5.7	None
Improve transparency of the tendering process	4.32	Low	Medium	Low	14.5.8	None
Reform mandatory tendering and auditor rotation	4.34	High	Low	Medium	14.5.9	Q27
Strengthen audit committees and/or links to shareholders	4.37	Low	Medium	Low	14.5.10	None
Measures that we do not support:						
Prohibit audit firms from providing non-audit services to all large clients and PIEs	4.8(b)	High	Low	High	14.5.11	Exec sum and Q18
Split UK firms into audit only and non-audit services practices	4.8(c)	High	Low	High	14.5.11	Exec sum and Q16
Joint audits	4.18(a)	High	Low	Medium	14.5.12	Q23
Break-up of the four largest firms into smaller audit firms	4.27	High	Low	High	14.5.13	None
Break link between company management and auditors	4.40	Low	Low	High	14.5.14	None
Insurance-based system	4.47	High	Low	High	14.5.15	None
“NAO” style national auditor	4.50	High	Low	High	14.5.16	None

¹ These are supplemental measures we believe are needed to address implementation challenges in relation to executing a market share cap

14.5 In the notes below we have provided an overview of our considerations of the costs and benefits of each of the measures as well as some considerations for implementation.

14.5.1 Ban on non-audit services to audit clients

- We support a ban on all non-audit work provided by a firm to those FTSE 350 companies and large public interest entity private companies that the firm audits. However, we would recommend that “audit services” also includes the half-year review, bond offerings, grant applications and reporting on historical financial information in offering circulars
- Higher costs would arise as the synergies that can often exist when an audit firm performs non-audit services would no longer be available to the audited entity. These synergies include the disruption caused to the companies themselves when there is duplication between service providers. (There will be significant costs, or loss of benefits, to the audit firms themselves)
- However we believe the benefit from a reduction in the perceived and actual incentive for an audit firm to supply non-audit services would potentially outweigh the costs of the measure
- The challenges on implementation would be less significant and would mainly be in relation to defining audit services as noted above so that the capital markets are best served and the UK is not but at a competitive disadvantage

14.5.2 Market share cap

- We support the introduction of a judiciously planned and monitored cap on market share for a set period of time together with a package of additional measures. Together they would lead to wider choice and provide incentive for all firms to compete within what we believe would be an acceptable timescale.
- The cap established should be flexed over time to reflect the capability and capacity of audit firms and the level of the cap should vary by market segment reflecting the size and complexity of the companies being audited A third party would be required to administer the capping process and there would be difficulties with dealing with entries and exits from the FTSE 350
- A third party would be required to administer the capping process and there would be difficulties with dealing with entries and exits from the FTSE 350
- In the short to medium term it is likely that the choice of auditor will be further restricted than today for some companies if an audit firm is already at their limit
- Without other measures being introduced at the same time there is a risk that audit quality could decline through the a lack of experience and capacity
- It may also undermine the perceived credibility of the LSE to international companies if companies were forced to limit the choice of auditor
- As outlined above, while there are significant costs and implementation challenges associated with this proposal, we believe the benefits from increasing choice will potentially outweigh the costs and the implementation challenges

14.5.3 Stronger governance around the audit practices

- The CMA has not included this as a measure however as we have set out in our executive summary (section 2) we consider this could improve the long-term resilience of the audit market. We have provided more detail on this possible measure in the executive summary and in question 15.

14.5.4 Shared audits and peer review

- We would potentially support the introduction of a shared audit or a peer review process (particularly in combination with another measure, such as a market share cap) to enable firms outside the four largest firms to develop skills and increase capacity
- However it is likely that audit fees would increase reflecting the additional time needed to undertake the audit under both these measures
- As regards peer review as a possible alternative to shared audits, the complexities in determining the scope of the peer review and the liability levels for both audit firms, together with the likelihood that a peer review will lengthen the audit process, causes us to conclude that this is unlikely to be as effective a measure as a shared audit
- Key considerations for the implementation of a peer review would include the process for appointing the peer reviewer, defining the scope of the review and the contractual terms between the audit firms and the company

14.5.5 Direct support including secondments and technology licencing

- We would potentially support a measure to second staff and/or partners to the four largest firms to further develop skills and increase capacity, again as a transitional arrangement either as a separate measure or as part of a shared audit
- We are also supportive of a measure to licence intellectual property including technology to assist in performing shared audits
- The implementation of these measures is likely to be very challenging particularly in relation to the provision of licencing intellectual property and the costs would include a significant investment of time to retrain staff in all firms which may be passed onto companies

14.5.6 Reducing the barriers to senior staff switching between audit firms

- We do not believe the barriers to switching to be significant currently but recognise that matters such as greater access to particular clients and industries, faster career progression opportunities and higher rewards and benefits could be cited as barriers While we believe that some of the other measures being considered would address some of these barriers, we would be supportive of actions to reduce other barriers insofar as they do not jeopardise independence through long-association with audit clients
- While we believe that some of the other measures being considered would address some of these barriers, we would be supportive of actions to reduce other barriers insofar as they do not jeopardise independence through long-association with audit clients
- Consideration would also need to be given to implementing a solution that would ensure a net migration from the four largest firms

14.5.7 Changes to restrictions on ownership of audit firms

- While this could facilitate new entrants into the audit market (or provide incentive for consolidation of those firms outside the four largest), any new entrants would need to build up credibility, skills and capacity and therefore they are likely to suffer from some challenges as experienced by other firms now
- In addition we note there will be challenges for a new entrant to the market to ensure they are independent (for example, should a large technology company wish to enter the audit market)
- For this measure to be effective we believe it would need to be combined with other measures

14.5.8 Improve transparency of the tendering process

- We would potentially support the measures suggested by the CMA but would note that implementing a tendering process that is blind to the names of audit firms would be very difficult to achieve given the importance of the credentials of an audit firm and the proposed audit partner and that the name of the audit partner for a company is a matter of public record
- There is likely to be concern amongst the audit firms to publishing winning tenders as that may infringe on an audit firm's ability to safeguard their intellectual property

14.5.9 Reform mandatory tendering and auditor rotation

- The costs associated with tendering are already high and if frequency was increased the costs would further increase and would likely give rise to increased audit fees as it would become increasingly untenable for the costs of audit tendering and transition to be borne only by the audit firms
- We are supportive of measures that will improve the transparency of the audit appointment and reappointment decision and that will stimulate greater investor involvement in the tendering process and indeed strengthen the links between audit committees and investors
- Consideration would need to be given to the transitional rules that would apply if tendering and/or rotation became more frequent to avoid a situation where a large number of tenders and rotations had to be undertaken in a very short period of time

14.5.10 Strengthen audit committees and/or their links to shareholders

- We are supportive of measures that would strengthen audit committees and also supportive of measures that would strengthen the audit committee's links to shareholders although it is not clear to us that this will give rise to significant benefits to the audit market. We agree with the CMA's analysis of potential difficulties set out in 4.39
- However we would not support the suggestion that the audit committee's decision on the audit firm be cleared by a sector regulator

14.5.11 Restrictions on audit firms: audit only firms and break-up of the four largest firms

- We strongly oppose any such proposal that would lead to the split up of the four largest audit firms in the UK whether vertically or horizontally
- We believe the measures suggested by the CMA in section 4.8(b) and (c) would likely lead to the same outcome because the non-audit service lines of firms would not be able to operate with such a heavy restriction on the clients they could work for
- We believe that these proposals would likely undermine audit quality as access to specialists within the firms is likely to reduce significantly as audit only firms are unlikely to be able to attract, develop and retain the specialists needed to audit many of the complex and judgemental aspects of the audit
- In addition the size and scale of the four largest firms mean they are not reliant in any way, actual or perceived, on even the largest audit clients. This independence allows the firms to make entirely objective judgements on all matters. Without this scale there would be greater potential for an auditor's judgements to be impaired
- Scale also provides an ability to invest in the people, methods and infrastructure to ensure that audit quality is continually improving
- This remedy would add complexity, challenge and cost to international audits. We agree with the point raised by the CMA in 4.10(a) that UK audit-only firm would need to remain connected to an international network in order to service global clients

14.5.12 Joint audits

- We strongly oppose joint audits as an effective measure to address the issues highlighted in the market study and do not believe there is evidence that supports that joint audits improve audit quality
- We note that companies are currently able to appoint joint auditors but in the most part have chosen not to do so
- Unlike a shared audit, or a measure for direct support to be provided by the large audit firms, a joint audit does not necessarily ensure that scale and capability is built into the firms outside the largest audit firms as there is not necessarily an incentive for the audit firms to work collaboratively together to ensure there is a development of skills and experience
- We believe that joint audits are highly likely to lead to higher audit fees due to duplication of work

14.5.13 Break-up of the four largest firms into smaller audit firms

- We strongly oppose this proposal as we believe it would be very damaging for all stakeholders and we do not believe it would substantially increase choice
- Only four of the newly-created UK firms could remain as part of an international network and therefore the choice of firms with an international footprint would not change
- We believe that any such proposal would likely undermine audit quality as access to specialists within the firms is likely to reduce significantly as audit only firms are unlikely to be able to attract, develop and retain the specialists needed to audit many of the complex and judgemental aspects of the audit
- In addition the size and scale of the four largest firms mean they are not reliant in any way, actual or perceived, on even the largest audit clients. This independence allows the firms to make entirely objective judgements on all matters. Without this scale there would be greater potential for an auditor's judgements to be impaired
- Scale also provides an ability to invest in the people, methods and infrastructure to ensure that audit quality is continually improving
- There would also be significant challenges in implementing this measure and ensuring that the challenges highlighted by the CMA (impact on international network, staff movements) do not make the measure ineffective
-

14.5.14 Break link between company management and auditors

- We do not support this measure as we do not consider it would increase audit quality
- We recognise that this may remove the risk, or perception of risk, of conflicts of interest as the auditor would not be reliant on the company they are auditing to appoint or manage their performance
- We believe this benefit would be considerably outweighed by the risks presented by shareholders, shareholder groups or an independent body not having a sufficient understanding of the business to enable them to make informed decisions
- New regulation would be required to implement this measure to ensure directors are not impeded from undertaking their fiduciary duty under Section 172 of the Companies Act 2006

14.5.15 Insurance based system

- We do not support this measure. It would take significant action and changes in legislation to implement without delivering benefits that would outweigh these costs.
- It is not clear to us how this measure would increase choice in the audit market given insurers may still have a tendency to appoint one of the four largest firms
- It is also not clear how achievable this solution would be as insurers are typically reluctant to operate in the Professional Indemnity insurance market for audit firms and so there may likewise be little enthusiasm for closer involvement in audit
- This measure would require significant change to the audit framework which would be difficult, if not impossible, to achieve without international agreement

14.5.16 NAO-style national auditor

- We oppose this measure. We agree with the challenges and drawbacks identified by the CMA in paragraph 4.51 and do not believe the benefits of this measure would outweigh the costs
- It is not clear to us how this measure would improve the quality of audits as it is not clear how a NAO style national auditor would have access to a major international network and access to the requisite specialists
- We believe the costs with funding a national auditor could be significant particularly in the early years as audit methodologies, tools and associated IT platforms are developed.

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.

15.1 In addition to the measures discussed in Q14 we would support the following:

Increasing the choice from four large audit firms – additional measures

15.2 In our view the most effective way to increase the choice from four large audit firms would be to introduce market share caps. We have provided our views on the costs, benefits and implementation challenges associated with this in our response to question 14.

15.3 It is also our view that market share caps could only be used in combination with other measures, which should be used for a set period only to support implementation. These supporting measures include:

- Audits that are shared between one of the largest four audit firms and another firm (CMA 4.18)
- The licencing of technology platforms between the four largest firms and firms outside this group in the context of delivering a shared audit (CMA 4.23)
- Staff secondments to one of the four largest audit firms from firms (CMA 4.23)
- Additional funding from the four largest firms to a third party that can be used to support and develop skills, training and technology across the audit market (see 15.4 below)
- An appropriate and proportionate sanctions regime for all firms that acts as a catalyst for improvement in audit quality (see 15.5 below)

In our response to question 14 we have provided our views on those measures included above that are also within section 4 of the CMA's Invitation to Comment.

- 15.4 We believe that implementing a funding scheme is an approach that could be taken to supporting the faster development of skills across the audit market. Our view is that this would be a measure that would only need to be in place for a relatively short period of time (possibly up to five years) and that it would be maintained and governed by an independent body. The scheme would collect funds from the four largest audit firms and these would be used to develop skills, training and technology across the audit market
- 15.5 It is our view that the cost of regulation and in particular the fear of the impact of regulatory sanctions has acted as a barrier to entry for some firms into the FTSE 350 and PIE audit market. We are supportive of actions being taken to reconsider the current sanctions regime in the UK to ensure that it remains appropriate but that it is also proportionate for all firms and to ensure that it acts as a catalyst for an improvement in audit quality rather than a barrier to entry.
- 15.6 A final measure that we believe would be effective in helping to increase the number of large audit firms would be to require audit committees to manage their relationships with suppliers of audit services such that they have a choice of at least three credible suppliers at the time of any audit tender.

Stronger governance around the audit practices

- 15.7 As we set out in the executive summary, we believe there are clear benefits to audit quality of a multi-disciplinary model within the firms that provide audit services. These benefits include access to specialists and the ability to attract, develop and retain the highest quality talent. A multi-disciplinary model also enables firms to provide the scale, financial resources and skills needed to innovate and invest in new technologies to ensure the audit product evolves to meet the needs of stakeholders.
- 15.8 We are strongly opposed to any measures that split the audit practice from the rest of the firm as we believe it would be enormously detrimental to audit quality and not improve choice. We do not believe these measures are necessary to achieve an effective answer to concerns about conflicts of interest. However we do believe long-term resilience will improve by strengthening the existing governance structure around the audit business and by developing a clearer separation of the governance frameworks that are in place for both the audit and the advisory businesses.
- 15.9 Our proposal for strengthening the governance would be to create a separate, independent governance body within each firm that would have clear public interest reporting responsibilities. Appointments to the body and other key appointments within the firm would need to be approved by the audit regulator.
- 15.10 The independent body would have a clear focus on audit quality and be required to monitor and report publically on any potential conflicts and how they have been dealt with to ensure there are no actual or perceived conflicts with the firm's public interest responsibilities.

Other measures

- 15.11 We support an independent review that examines the question "what is the very nature of audit?". It needs to explore how AI (Artificial Intelligence) and technology can reinvent audit and look at expectations around the business model, future viability, fraud and the front half of the annual report. This review needs to be established quickly and report no later than June 2019 so that any conclusions can be considered alongside other changes that are required to improve audit regulation and to drive more choice in the listed audit market. The review needs to be forward looking and reflect the fact that changes to the audit product may well in itself lead to major disruption, opportunities for new entrants (subject to independence considerations) and increased competition.
- 15.12 The primary responsibility for the quality and integrity of financial reporting rests with the company's management and board. We support the introduction of a proportionate UK Sarbanes-Oxley equivalent type regime for the largest listed companies in the UK. This will place appropriate accountability on companies' boards and management to ensure the quality of their financial reporting. Data1 shows that restatements in the US spiked in the years following the introduction of Sarbanes-Oxley, as a result of the new requirement to report on the effectiveness of internal controls over financial reporting.

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?

- 16.1 We understand the concerns that are voiced when conflicts of interest arise between the firms' public interest audit responsibilities and the advisory services provided to non-audit clients. We believe that these conflicts arise infrequently.
- 16.2 The CMA will be aware that conflicts of interest may arise in any company or firm that is not a monoline operator, and the key is in ensuring that any such conflicts are appropriately minimised and managed.
- 16.3 We strongly believe that the benefits of a multi-disciplinary model, in terms of the knowledge and expertise it brings about the entities we audit; and access to technology, innovation and a diverse pool of quality talent with the necessary skills and industry experience, are absolutely essential to deliver a high quality audit.
- 16.4 The scope of International Standards on Auditing requires the extensive use of specialists: high quality audits require high quality specialists. On complex audits we regularly use specialists from across corporate tax, transfer pricing, pensions, IT risk advisory, data analytics, valuations and financial instruments together with industry specialists to identify risks and challenge management. Over 90% of the FTSE 350 include at least one Key Audit Matter that requires specialist input from the broader multidisciplinary firm. Specialists are drawn from across the firm but subject to the same quality, ethical and independence standards. Deloitte has 4,000 audit personnel who perform audits every day, but over 2,100 people drawn from other areas who support audits with specialist input from other parts of the firm.
- 16.5 The multi-disciplinary model also provides the best opportunity to attract the highest quality talent and provide for their rounded development. It provides the scale, financial resources and skills needed to innovate and invest in artificial intelligence and technology to continually improve quality and evolve the audit product to meet the needs of 21st century stakeholders. The UK audit profession contributes over £17 billion to UK GDP and employs over 150,000, providing for the efficient operation of the UK financial markets. Accountancy is one of the UK's success stories and is widely respected internationally. However, it is clear that trust and confidence in the role of the profession has been damaged and change is required.
- 16.6 For the above reasons, we are strongly opposed to any measures that split the audit practice from the rest of the firm (or as posited at 4.8b to prohibit audit firms from providing non-audit services to any large company or PIE irrespective of whether they audit the company). We believe it would be enormously detrimental to audit quality and would not improve choice. We are clear that those remedies are not necessary to achieve an effective answer to concerns about conflicts of interest.
- 16.7 As a result we believe splitting firms between audit services and non-audit services presents serious risks to audit quality and would not achieve CMA's objective around choice. We do however believe long-term resilience will be improved by strengthening the existing governance structure around the audit business and by developing a clearer separation of the governance frameworks that are in place for both the audit and the advisory businesses.
- 16.8 The current audit governance framework is strong but we believe it can be improved. We support the creation within each firm of a separate, independent, governance body with clear public interest reporting responsibilities. Such a body would:
- Be required to monitor and report publically on any potential conflicts and how they have been dealt with to ensure there are no actual or perceived conflicts with the firm's public interest responsibilities. They could be required to ratify certain types of appointments; and
 - Have a dedicated focus on audit quality with an emphasis on root cause analysis and a requirement to report publically on audit quality metrics.

16.9 Appointments to this independent body and other key appointments within the firm would need to be approved by the audit regulator.

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?

17.1 The global Deloitte network comprises a number of international member firms. In some cases the member firms represent one country; in other cases a cluster of countries. Each member firm is owned by the relevant partners. There is no common ownership at the international level.

17.2 Deloitte operations in different geographic markets are tightly bound together through common standards and methodologies, mutual commitments and global oversight. In the main each geographic grouping is economically separate and has responsibilities to regulators and other stakeholders in that geography.

17.3 As a result, we share best practice and methodologies across borders, have a common purpose, benefit from global investments in infrastructure, technology and people and critically are bound by common member firm standards. Each member firm makes an annual subscription payment to DTTL.

17.4 This structure has evolved to respond to the global complexity that our largest clients have and also as a mechanism for enhancing the quality and consistency of our client service approach. An example of where this structure has contributed to audit quality is in the results of PCAOB inspections of Deloitte firms; between 2012 and 2016 the percentage of engagements with Part 1 findings reduced by 37 percentage points. A key driver of this reduction was sharing findings across the member firms and including additional training in response to those findings. This helped ensure that best practice was spread across the network and not retained within one member firm.

17.5 SEC rules, EU Law and UK standards have the concept of a “network”⁴, which effectively negates – on a network basis – the operation of a separate audit only firm. Therefore, the conflict risk arising from non-audit services remains due to the co-operation with the rest of the member firm network.

17.6 There are significant challenges in how independence of the audit practice can be maintained when delivering across the global member firms. It is likely that if the audit and advisory services were to be split into two separate firms only one of these entities would be part of the international network.

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?

18.1 Audit quality is our number one priority. An important contributor to stakeholders’ view of audit quality is both the actual and perceived independence of the audit firm.

18.2 Non-audit services were a key focus of the EU audit reforms, which introduced a wide range of prohibitions and other limits on the non-audit services that auditors can provide to the public interest entities they audit. As a result, the proportion of revenues that auditors earn from audit clients for such services has declined significantly in recent years⁵.

18.3 However, we recognise that there are still concerns in the UK around auditor independence. We therefore support a ban on all non-audit work provided to FTSE 350 companies and large public interest entity audit clients.

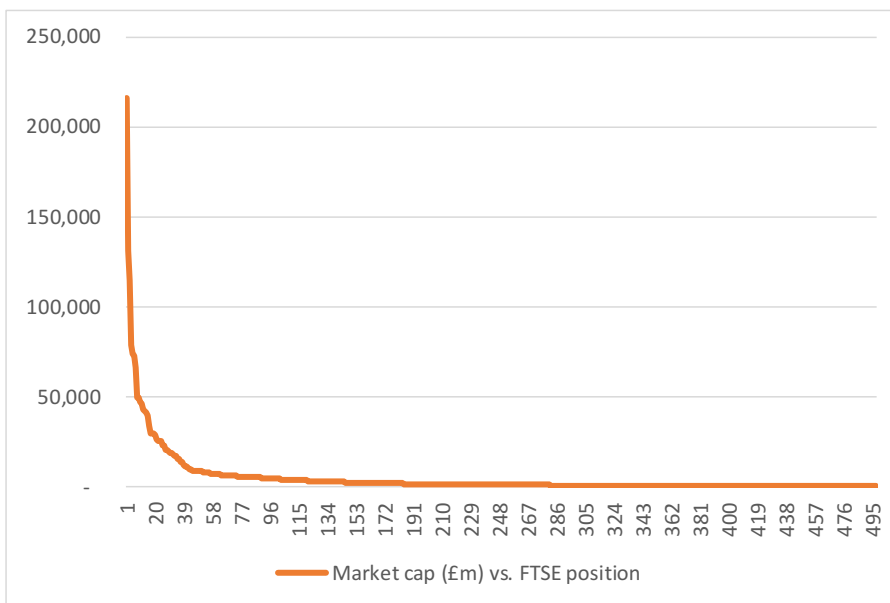
18.4 This will require a clear definition of large public interest private companies as well as a clear definition of ‘audit services’. We would suggest that as well as the annual audit, this definition includes closely-related services that, for reasons of time and cost, are best carried out the auditor, such as the half-year review,

bond offerings, grant applications, work on offering circulars and similar services. All other services, with no exceptions, would be banned.

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

- 19.1 There are a range of ways in which market share could be measured, including by number of companies audited, by market capitalisation of the audited companies and by the aggregate size of audit fee.
- 19.2 The size of UK listed companies varies very significantly. There are a small number of very large companies and a long tail, as illustrated below.

Market capitalisation (£m) vs. FTSE rank (1-500), as at 8 October 2018



- 19.3 As a result, a measure of market share based on companies' market capitalisation or audit fee will be very heavily skewed towards the firms that audit the very largest companies.
- 19.4 In addition, because market capitalisations and the size of a company's audit fee change, a measure of share based on market capitalisation or audit fee will be unstable. A cap could be exceeded because of underlying market conditions, rather than because of new wins in the market segment.
- 19.5 Therefore we think the only workable way to measure market share is on the basis of the number of companies audited.

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

- 20.1 The use of a market share cap is very unusual. We are not aware of market share caps being used as a remedy for other markets where there are similar competition dynamics. Market share caps work better where access is granted to an asset – for example, for the 3G mobile spectrum auctions, the five lots allowed an additional market entrant.
- 20.2 Consequently, although we have tried to analyse how market share caps could work in practice, we urge the CMA to do more work on the remedy's feasibility before proposing its adoption. That being said, our initial conclusions, set out in our responses to these questions, are that the use of market share caps will create

greater opportunity for firms outside the four largest and that we would support their use as part of a package of remedies.

- 20.3 Our hypothesis is that a market share cap would initially be applied to all listed companies, as well as the FTSE 350 subset rather than the FTSE100, as this provides a realistic way for firms outside the four largest to build capacity. Further segmentation may be required to set caps at an appropriate level, for example, initially the CMA may wish to exclude certain industries from the cap initially, but set a lower cap on (for instance, domestically focused companies). As capacity and capability is built, and those firms are able to compete for the audits of larger and more complex companies, capping levels may be adjusted (though adjustments and exceptions should be kept to a minimum to avoid creating a major bureaucracy).
- 20.4 Firms outside the four largest currently perform 11 audits of the FTSE 350 today, generating a total of £5m in fees. A look at the timing of future audit tenders gives an indication of how quickly those firms could build their shares. We estimate that in order to hold a 20% share of the FTSE 350 audit market in the next five years, firms other than the four largest would need to win about 60 tenders, or 60% of the FTSE250 tenders in this period (ignoring any tenders that could take place outside the normal tendering cycle, and ignoring the more challenging FTSE100 audit tenders).

21. What do you consider to be the relative scale of costs of a market share cap, such as increased prices and potentially reduced competition, and potential benefits?

21.1 The costs of a market share cap can be considered as:

- a) The investment required by firms outside the four largest to build their capabilities to address a much greater share of the listed company market than at present. Our high level estimate, based on our experience of the investment in capability required at the four largest firms to reach a share of 20% by number of companies is in the range of £40m - £70m over a five year period. Our estimates do not take into account any significant investments in new technology at the four largest firms required to meet the evolving needs of the client base.
- b) The costs to clients of any uplift in fees.

21.2 The benefit of a market share cap is that it provides a guarantee of other large firms being able to win work in the FTSE 350 and listed market segments. This improves choice and resilience in the market.

21.3 There is a risk that choice for audit committees will be limited rather than increased for a period of time and that they will be prevented from choosing their preferred audit firm.

21.4 However, we are very clear that maintaining and improving audit quality throughout the market share cap transition process must be the most important priority for regulators and audit firms. The caps should reflect the capability, capacity and credibility of relevant firms as these develop over time; it may be necessary to introduce caps gradually and flex them over time. This in turn should help to assuage the concerns of audit committees.

22. What should be the appropriate level of such a cap, collectively for the Big Four to achieve its objective? For example 90%, 80%, 70%?

22.1 In setting a target, the CMA should consider the current position of firms outside the four largest, the opportunity they have to build a significantly larger share in the medium term and the share required to be considered a viable alternative to the four largest firms.

22.2 A target of 20% of the FTSE 350 in five years' time would represent a sevenfold increase in the number of FTSE 350 companies audited by a firm outside the four largest firms. Based on our analysis, firms outside the

largest four firms would need to win 60% of all tenders in the next five years, to reach 20% of the FTSE 350 target by 2023/4 (and wait for another 1-2 years before the first audit is complete).

- 22.3 If the share of the firms outside the four largest was to be spread between several firms it is arguable that they may continue to have insufficient scale to compete effectively, leading to an outcome that may never be sustainable (although we note that prior to its collapse in 2002 Arthur Andersen only had a market share of 8% of the FTSE350).

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

23.1 We are strongly opposed to the concept of joint audits on cost and quality grounds. This potential remedy was explored in great detail in the Competition Commission's previous investigation of the audit market, and by the European Commission when it considered the audit market at around about the same time. In both cases it was rejected on the basis that issues can "fall between the cracks" if either firm misunderstands or misinterprets the other, it is involves duplication of work, so is less efficient and more expensive than the alternatives, and because it requires firms to carry the liability for others' work.

23.2 However, we see greater attraction in the concept of a shared audit, covered in our response to question 14.

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?

24.1 The annual report is a stewardship document designed for shareholders, but it has evolved considerably in recent years and now includes additional information of interest to many other parties. In 2020, annual reports will include still further information about how the directors have fulfilled their duties under s172. However, it is not designed to provide an analysis of all information these other might parties consider material. Under the current construct therefore it is difficult to see how accountabilities can be expanded. Directors owe their duty to the company. As such, we think that the answer to this question is 'no'.

24.2 We do believe that stakeholders and other third parties are interested in an expanded range of information, so we are fully supportive of an independent review to determine what should be the contents of an annual report and what should be the role of directors and auditors in respect of each its component parts.

24.3 Deloitte welcomes the opportunity to participate in a thorough review of responsibilities and frameworks to ensure that the annual stewardship report is fit for the future, meeting society's needs for the decades to come.

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?

25.1 As noted above, we think that the answer to question 24 is no.

25.2 We are strongly supportive of the roles that audit committees play. As noted in our response to question 26, there are significant risks in using an independent body in place of an audit committee.

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

26.1 We do not consider that an independent body is a workable solution and therefore we have only focused on the risks and costs of the suggestion.

26.2 Key points we have identified include:

- An independent body would cut across existing governance arrangements and would dilute the accountability of the non-executive directors.
- An independent body may not fully understand the complexities of a group and appoint a firm that does not have the requisite skills, scale, expertise or sufficient industry experience to carry out the audit to a satisfactory quality.
- An independent body may not be sufficiently knowledgeable of certain areas of the business which are specialist in nature and require regular input from management. This could result in uninformed judgements being taken which are not in the best interests of stakeholders.

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?

27.1 Recent measures implemented by the Competition Commission mean that companies in the FTSE 350 must tender their audit every ten years and are forced to rotate auditors every twenty years. We are still in the formative years of this legislation and therefore have not been through one ten year cycle, never mind a twenty year cycle.

27.2 We only consider that a greater frequency of rotation would be appropriate if it were to be a means to an end; for instance to facilitate a market share cap remedy as set out in our response to questions 19-22.

27.3 By insisting on shorter rotation requirements, there would be an increased cost for companies as well as audit firms in tendering and any subsequent transition as new auditors. The cost of tenders has been referenced by mid-tier firms as a deterrent to taking part in tenders.

¹ FRC Developments in Audit 2018, October 2018, p24

² FRC Developments in Audit 2018, October 2018, p7

³ In 2006, companies filed 1,859 restatements after a rise to 1,632 the year before. The numbers have dropped dramatically since.

⁴ Definition is in Article 2(7) of the Directive: https://eur-lex.europa.eu/search.html?DTN=0043&DTA=2006&qid=1539866097135&DTS_DOM=EU_LAW&type=advanced&lang=en&SUBDOM_INIT=CONSLLEG&DTS_SUBDOM=CONSLLEG

⁵ <https://www.frc.org.uk/getattachment/27725654-8bd9-4623-a410-ef1661a69649/Key-Facts-and-Trends-2018.pdf> FRC data shows that the percentage of fee income of the four largest firms derived from non-audit services provided to the entities they audit was 9.7% in 2017, down from 12.0% in 2014; and was 48.7% of the audit fees in 2017, down from 56% in 2014.



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