



STATUTORY AUDIT MARKET

Issued 30 October 2018

ICAEW welcomes the opportunity to contribute to the Competition and Markets Authority's market study into the supply of statutory audit services in the United Kingdom, which it launched on 9 October 2018, available from this [link](#).

ICAEW is a world-leading professional body established under a Royal Charter to serve the public interest. In pursuit of its vision of a world of strong economies, ICAEW works with governments, regulators and businesses and it leads, connects, supports and regulates more than 150,000 chartered accountant members in over 160 countries. ICAEW members work in all types of private and public organisations, including public practice firms, and are trained to provide clarity and rigour and to apply the highest professional, technical and ethical standards.

We believe that the key focus of the CMA's market study should be audit quality - ensuring that it continues to improve and continues to meet the existing and evolving expectations of customers and other stakeholders. Despite several high-profile corporate collapses and audit failures in recent years, we are sceptical that the number of competitors – as such – available in the market for large corporate and Public Interest Entity audits has a direct causal link to auditor performance. However, ICAEW is confident that a consensus now exists across the accountancy profession that increased choice in this market is both necessary and desirable. This will require a basket of measures which address three interconnected aspects of the current situation: implementing changes to how the Big Four operate, reducing the obstacles which currently deter their potential challengers from entering that market and, finally, supporting audit customers to exercise their extended freedom of choice.

Regarding the question of whether the CMA should make a market investigation reference under section 131 of the Enterprise Act 2002, ICAEW believes that the following two factors need to be considered.

First, we note the relatively recent work conducted by the CMA's antecedent organisations, the Office of Fair Trading and the Competition Commission. This culminated in an investigation of the market for statutory audit for large companies, conducted between October 2011 and October 2013. In the short time since the Order implementing the package of remedies to emerge from that investigation came into effect in January 2015 (followed by the EU Audit Directive and Regulation in June 2016) there has been, as the CMA observes, 'some positive change' in the operation of the audit market. It is still too early to assess the longer-term impact of these measures, and ICAEW recommends that the CMA concentrates on addressing those areas where there has been little movement in the last two years – such as the presence of mid-tier firms in the market for FTSE 350 audits – rather than revisiting or repeating the Competition Commission's thorough analysis.

Second, ICAEW feels strongly that early and urgent action to address public concerns regarding concentration in the audit market is vital to maintaining the confidence of investors and wider

stakeholders. If the CMA can bring forward supplementary remedies in relation to this in the same time frame as the recommendations from the review now being led by Sir John Kingman into the operation of the Financial Reporting Council, then this will constitute a coherent programme to tackle underlying issues of regulation, quality and competition. Chartered accountants accept the need for change, and regulators and Government can expect the profession to cooperate with the implementation of further market reforms - for example, by the acceptance of undertakings in lieu.

ICAEW believes the natural follow-on to the work of the CMA and the Kingman Review should be a fundamental and independent examination of the role of audit itself. The expectations of investors and wider society have quite rightly increased in recent years, and we need to ensure that audit keeps pace. If that means extending assurance and embracing new tools and new technology, then we must look at that.

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MAJOR POINTS

1. Without detracting from the importance and impact of a series of high-profile corporate failures in recent years, ICAEW notes that as a whole the audit sector in the UK is working well and its customers are satisfied. It operates to rigorous professional and technical standards, and is recognised internationally as high calibre. Outside the FTSE 350, medium-sized companies and small businesses across the UK economy are served by thousands of audit-registered firms: competition is strong and quality is high. For large corporate clients and Public Interest Entities (PIE) choice is much more restricted, because relatively few firms other than the Big Four are currently perceived to possess the scale and capacity to conduct audits at this level. Even this choice is further limited by independence considerations.
2. ICAEW is confident that a consensus now exists across the accountancy profession that increased choice in the market for large corporate and PIE audits is necessary and desirable. The largest audit firms and their potential challengers are willing to cooperate, and to work with government and regulators, to bring this about. There is also a collective readiness to see a fundamental and independent examination of the role of audit itself. The expectations of customers – and, other stakeholders, including investors, employees, pension-holders, customers, suppliers and wider society – have quite rightly increased in recent years, and audit must keep pace, which may mean extending assurance and embracing new tools and new technology.
3. ICAEW believes that the audit sector plays a key role in creating and sustaining domestic and international investor confidence in the UK business sector and wider economy. Possible measures to increase competition in the market for large corporate and PIE audits must be seen in the context of the need for the UK after its exit from the European Union to be perceived positively as a global trading partner and as a place where the business and investment environment is both attractive and well regulated.
4. ICAEW believes that the key issue is audit quality, and ensuring that it continues to improve and continues to meet the existing and evolving expectations of customers and other stakeholders. The actual number of competitors operating at any time is an important but secondary aspect, and not necessarily directly connected to audit quality. It would not be a positive outcome if regulatory or legislative interventions brought more firms into the market for large corporate and PIE audits, but jeopardised quality and increased costs for customers.
5. ICAEW believes that achieving increased choice in the market for large corporate and PIE audits will require a balanced and integrated package of measures, rather than any single major regulatory or legislative intervention. These measures will need to address the three main aspects of the issue: implementing changes to how the largest audit firms, specifically the Big Four, operate; reducing the obstacles which currently deter their potential challengers from entering that market; and finally, supporting audit customers to exercise their extended freedom of choice.
6. ICAEW counsels against any expectation that major changes will happen quickly. For example, it will take time – perhaps a few years – for potential challengers to gain the experience and capacity to be regarded by customers as viable competitors to the Big Four in the market for large corporate and public interest entity audits. A graduated approach to implementation will also mitigate the possibility of causing one or more of the Big Four to withdraw from the market or significantly reduce their commitment to it.
7. One of the issues which runs directly contrary to any attempt to encourage new entrants to the audits of the largest companies, is the deep concern of firms outside of the Big Four regarding the potentially significant reputational and financial damage which they could suffer

under the current regulatory regime for performing a poor audit. Indeed, firms outside of the Big Four view multi-million pound penalties, such as those imposed recently for a breach of the independence rules where there was no underlying issue with the quality of the audit, as being far too high a price to bear for entering this market. ICAEW believes that firms outside of the Big Four will be seeking assurances that the current Financial Reporting Council (FRC) sanctions regime will be amended to be much more proportionate by, for example, tying any potential sanction to a multiple of audit fees rather than basing the financial sanction on the total revenues of the firm for its last financial year so that the firms can understand the extent of the financial risk that they would be taking in entering this market.

8. ICAEW supports a number of the potential remedies proposed to change how the largest audit firms operate. We believe a collective market share cap on the Big Four in the FTSE 350 would be difficult but is worth investigating further. Any such cap will need to offer the Big Four the prospect of enough business to keep them in the market, while encouraging their challengers to invest in the capacity and resources required to operate at this level. If this route is pursued, ICAEW believes that the cap should be set at the lower, tighter end of the options under discussion. Market capitalisation is one of the bases for calculating that, although it would be complicated and subject to volatility in company share prices. We also suggest that the option of a market cap of around 65 clients for any single firm is a practicable alternative approach to a collective cap. In either case, we see the setting of a market share cap in the listed market beyond the FTSE 350 as necessary, to limit the extent to which Big Four firms simply displace downwards. We also strongly recommend that any capping mechanism is subject to a regular review of its impact, initially after three-to-five years.
9. For several reasons, we do not see that breaking up the Big Four would be helpful, although we believe that ring-fencing within the largest firms to separate audit and non-audit services is an option worth investigating.
10. ICAEW supports a number of the potential remedies proposed to reduce the obstacles which currently deter potential challengers from entering the market for large corporate and PIE audits. We believe there may be a role for joint and shared audits: they would certainly help challenger firms acquire experience and credibility, but to date these have not been popular in the UK market. There is a readiness in the profession to consider initiatives which would facilitate the transfer of skills, technology and even staff between firms. However many of the possible entrants to this market are wary of the regulatory burden and financial liability, both for firms and on individuals.
11. ICAEW supports some of the potential remedies proposed to encourage audit customers to exercise their extended freedom of choice. We regard the idea of an independent public body to appoint auditors in the market for large corporate and PIEs as problematic, and recommend instead practical measures to strengthen the audit committee and its ability to monitor and challenge auditors. We question the possible value of establishing a new large national auditor.
12. ICAEW is encouraged by the evidence that the scope, conduct and timing of this market study by the Competition & Markets Authority (CMA) interlock and align with those of the concurrent review of the operation of the FRC commissioned by the Secretary of State for Business, Energy & Industrial Strategy (BEIS) in April, and now being led by Sir John Kingman. Between them, these two investigations are examining underlying issues of regulation, quality and competition in the audit market. We believe the natural follow-on to their work should be a fundamental and independent examination of the role of audit itself.

SPECIFIC QUESTIONS

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

13. The audit sector as a whole is large and diverse. While much of the recent attention has been on the FTSE 350 and large corporates, there are a significant number of small and medium sized companies who are served by thousands of audit-registered firms. We are not aware that any of these companies have complained that they have been unable to find an auditor, or that there has been insufficient choice of audit suppliers.
14. At the top end of the market there can be restricted choice, due to conflicts of interest of some of the Big Four firms, and fewer market participants. We would question however whether this lack of choice is in fact the cause of the problems seen in recent corporate failures.
15. The UK audit sector operates under a range of stringent professional and accounting standards. Where audits are found to have failed in meeting these standards, there is a regulatory regime that applies sanctions for such breaches. The UK audit sector is highly regarded by other jurisdictions around the world. Previous reviews of the audit market found no evidence of collusion or price fixing between audit firms.
16. However, there is a growing perception among some stakeholders – including shareholders, pension trustees, employees and the general public – that the audit sector is failing to meet their needs. The statutory audit market has been in existence for a long time. While different types of assurance engagement exist, their recognition in statute is different. ICAEW recognises the need for a fundamental review of audit, and together with the FRC and BEIS is looking at setting up an independent enquiry to that effect.

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

17. Audits are carried out in accordance with the Companies Act 2006, and auditors report to shareholders as a body. The statutory purpose of audit is well established in case law. The audit framework is therefore designed to provide assurance to shareholders over the financial statements of the audited entity. In our view, within the scope of company audit as it is currently defined, it fulfils that purpose well, and does so on the basis of internationally-agreed standards.
18. The statutory audit framework does not consider the interests of wider stakeholders, which results in an expectation gap. This view may also be shared by some shareholders. To address this gap there may be a need for some form of assurance over other non-financial information, or summarised financial information that has been prepared to meet the needs of other stakeholders, such as pension trustees, employees and creditors.
19. ICAEW has recently published a report into the **Local Public Audit Expectation Gap** which explores the debate in a public sector context.

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

20. The importance of high-quality audits has featured strongly on the corporate governance agenda for some time. For example, since 2012 the Corporate Governance Code has included a provision which requires audit committee reports to include an explanation as to how it assessed the effectiveness of the external audit processes, and in 2015 the FRC published the **Audit Quality Practice Aid**, which includes an evaluation pyramid. The question is why this theory is not being translated into practice.

21. When audit committees decide to recommend the largest audit firms they often base their decision on quality in line with the FRC's [Audit Tenders Notes on Best Practice](#). There is a wide perception that, because of their experience, expertise and global reach, the largest firms are in the strongest position to deliver high-quality audits.
22. Cost considerations may be constraining the quality of audits even when the audit firm has the experience which is needed to be more thorough. Companies often seek to reduce their audit costs year-on-year. Part of the role of audit committees is to disrupt this narrow focus on costs by insisting on high quality, but the question is whether they are sufficiently empowered to do this. This imbalance could be addressed by strengthening audit committees.
23. The FRC's recent review of the Corporate Governance Code did not focus on audit committees, and therefore resulted in very few changes in this area. The composition of audit committees remains unchanged (three independent non-executive directors), but there may be benefits to increasing their size and composition.
24. The new Corporate Governance Code (issued in July 2018) still only requires one audit committee member with recent and relevant financial experience. While we support the need for a diversity of background and experience on audit committees, we note that the NYSE and Securities Exchange Commission (SEC) set a far higher standard for accounting and financial management expertise for US audit committee members.
25. We remain strongly in favour of the audit committee as a model for corporate governance, but the model needs to be made more effective, and members of audit committees held to account for their decisions.

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

26. As the new Competition Commission/EU tendering rules were only introduced in mid-2016 it is too early to make a comprehensive assessment. However, the CMA may be interested in the [FRC Developments in Audit, October 2018](#). There has been greater rotation of firms, although much of this rotation has been between the Big Four firms. There is also anecdotal evidence that firms are using new technologies in the delivery of audits, as a more efficient way to provide their service. This may be a way to maintain profitability if competition is resulting in lower audit fees.

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

27. The audit market is competitive, and outside the FTSE 350 there is a lot of choice for companies procuring an audit. As noted in the market study notice, there is a greater concentration of audit firms operating in the large company market. There are several reasons for the lower number of market participants in the FTSE 350 than elsewhere in the market. These are detailed below.
28. Audit committees and institutions within the FTSE 350 tend to choose Big Four firms, even when presented with the option to appoint a mid-tier firm. This may be due to a disconnect with the views of the company shareholders, a perceived or real need for a firm with a global network, or a perceived or real difference in quality between a Big Four and a mid-tier firm in terms of familiarity with large listed company audits and the specialisation of such work. There may also be a peer pressure issue among FTSE 350 audit chairs not to be out of line with their peers in using the Big Four.

29. On the supply side, there may be challenges for smaller firms to handle the very largest audits, either due to constraints in their sector experience, the size of the firm, or their network coverage. This can lead to a paradoxical situation where the firm needs to grow in size and network to be able to deliver a very large audit, but would need the higher fee income to fund such expansion. An investment in the costs of tender for large company audits can also be prohibitive.
30. There are a number of disincentives for mid-tier firms to enter the FTSE 350 audit market, including the commercial risk of undertaking very large audits, and whether the reward in terms of fees sufficiently compensates for this. Increasing regulation of PIE audits is making entry to this market increasingly unattractive, due to the risk of very large regulatory fines and reputational damage for both the audit firm and the audit partner involved. These fines are often based on firm turnover and not the fee earned from the audit. Indeed, some mid-tier firms have chosen to exit the PIE audit market in response to this potential liability. The regulatory focus should be on improvement rather than harsh penalties for non-compliance. The US regulator, the Public Company Accounting Oversight Board (PCAOB), has recently announced a **new approach to audit inspections** which will focus on preventing deficiencies in audit work from happening in the first place.

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

31. In a tender situation, competition between the Big Four is fierce, and there is evidence that this pushes prices down. The risk however is that there is then pressure on the winning firm to deliver a high-quality audit within a tight budget, and still maintain profitability.
32. To the extent that other firms are participants in the tender process, there is similarly intense competition between these firms and the Big Four. However, many mid-tier firms are reluctant to participate in a tender where they may perceive they have little chance of success, due to the high investment costs of participating in such a tender process.
33. Where choice is restricted due to some of the Big Four firms being prevented from participating under the independence rules, we observe that competition between the remaining participants is still strong.

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

34. Mandatory rotation of audit firms has meant that the incumbent firm has had to step away from the tender, resulting in fewer audit firms to choose from. Initial results suggest that the rotation of audit firms has generally resulted in the audit work remaining within the Big Four. However, as the mandatory tendering and rotation rules were only introduced in mid-2016 it is too early to make a comprehensive assessment.

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

35. The market for audits is more complex and less transparent than other markets, in that it is difficult for the public to assess the quality of an audit. The only information available in the public domain is the name of the firm, the audit fee, and some high-level reports from the regulator about the general quality of the audit work done by each firm. Audit committees have access to contemporaneous information on the audit work, but this is not available to external stakeholders. Increasing competition in the audit market is therefore not necessarily linked to increased quality of the audit work undertaken.

36. Greater competition in the audit market tends to reduce the price of an audit, which could conversely damage the quality of the audit work delivered, by putting greater pressure on the firm to deliver the work within a reduced budget. In the short term, this may impact the profitability of audit work, and firms would need to innovate to find ways to deliver the audit in a profitable way. In the absence of innovation, the extreme outcome could be that significant audit judgements end up being pushed down to junior audit staff. There is a further possibility that increased competition between audit firms could weaken audit quality, if the fear of losing the audit work to a competitor discourages the audit firm from challenging management too strongly on disputed areas within the financial statements. It may be that increasing the tenure for auditors would mitigate this risk and encourage auditors to be less deferential, but this would need to be balanced with the down sides of longer tenure.

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

37. The companies themselves are best placed to answer this question. However, some large companies have a limited choice of potential audit firms to appoint due to the existing independence restrictions prohibiting some of the Big Four and mid-tier firms from acting as auditor. In particular, some large financial institutions can have a very limited choice.

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

38. As we have outlined in Question 5 above, audit committees and institutions within the FTSE 350 tend to choose Big Four firms, even when presented with the option to appoint a mid-tier firm. This may be due to a disconnect with the views of the company shareholders, a perceived or real need for a firm with a global network, or a perceived or real difference in quality between a Big Four and a mid-tier firm in terms of familiarity with large listed company audits and the specialisation of such work.
39. On the supply side, there may be challenges for smaller firms to handle the very largest audits, either due to constraints in the size of the firm, or their network coverage. This can lead to a paradoxical situation where the firm needs to grow in size and network to be able to deliver a very large audit, but would need the higher fee income to fund such expansion. An investment in the costs of tender for large company audits can also be prohibitive.

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

40. As we have outlined in our response to Question 5 above, there are a number of barriers for mid-tier firms to enter the FTSE 350 audit market. These include the commercial risk of undertaking very large audits, and whether the reward in terms of fees sufficiently compensates for this. Increasing regulation of PIE audits is making entry to this market increasingly unattractive, due to the risk of very large regulatory fines for both the audit firm and the audit partner involved. Indeed, some mid-tier firms have chosen to exit the PIE audit market in response to this potential liability. The regulatory focus should be on improvement rather than harsh penalties for non-compliance.
41. The unlimited liability of audit firms is also a disincentive for firms to enter the large company audit market.

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

42. There is a risk that one of the Big Four could either fail, or voluntarily withdraw from the large company/PIE audit market. However, compared to some markets that are immediately

critical to the functioning of the economy, the risk of audit firm failure is of lower impact. Banking, energy and the digital economy are examples of sectors where resilience is crucial – in some cases these sectors are more concentrated than the market for PIE audits.

43. Nevertheless, there is a risk that should a firm be subject to major reputational damage, the resulting loss of business and/or substantial regulatory fines could put unsustainable financial pressure on the firm and ultimately lead to their collapse. Should such a failure or withdrawal occur, some regulatory flexibility would be needed to provide extensions and support in the short-term for those companies left without an auditor. The FRC Market Participants Group (MPG) considered this in 2007 and recommended enhanced regulatory protocols (**FRC MPG report 2007**).
44. Alternatively, the firm could decide that the large company/PIE audit market is no longer attractive for them to operate in and they may withdraw voluntarily.
45. We understand that the risk of failure of a large audit firm is high on the FRC's agenda, and we are aware that the FRC propose to undertake a programme of governance reviews of the Big Four and selected mid-tier firms to test their governance and stability, and provide early warning signs of potential issues. We encourage this review to consider the use of 'Living Wills' by these firms as a continuity plan, such as those that are currently used by the banking sector to determine how continuity of service would be provided to clients in the event of a bank's collapse. We note however that there are great differences between the banking and audit sectors in terms of how easily clients could be transferred to another provider.
46. While we support the FRC governance review initiative, the funding structure for such work must be carefully considered to avoid heaping further large regulatory costs on firms. Indeed, this would be a further disincentive for mid-tier firms to enter the large company/PIE audit market.

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

47. In a market where competition and quality do not automatically complement each other, regulation is necessary to ensure high quality. Regulation must have regard to competition so as, at worst, not to stifle it unnecessarily, and at best to enhance it to ensure adequate choice and incentives for innovation and efficiency. Regulation should be proportionate to the risks to the economy and society, so small and medium company audits should receive less intervention than large company and PIE audits.

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

48. We do not have the data to evaluate financial costs and benefits, but comment here on the potential advantages and drawbacks that each proposal brings:

4.8 Restrictions on firms providing NAS (a) to their audit clients, (b) to any large company or PIE, (c) by way of audit-only firms

49. The consultation itself sets out the pros and cons very well in paragraphs 4.9 to 4.11, in particular that further restrictions on the provision of non-audit services would increase the perceived independence of auditors. However, this may reduce choice in future tenders because some audit firms would be conflicted from having already provided non-audit services, or have the incentive to continue to provide non-audit services.

50. In relation to audit-only firms, we agree that this could increase choice by removing the possibility that large firms could be conflicted from bidding for audit work. On the down side, the international nature of these firms would complicate the exercise of splitting the firms, and make it very difficult for a UK audit-only firm to service global clients. Further, this could reduce audit quality if specialist and high quality staff could not be retained or recruited.

4.13a Market share cap

51. Please see our comments in relation to Questions 19-22 below.

4.13 b Variations on joint and shared audit

52. Please see our comments in relation to Question 23 below regarding joint and shared audit. As regards the third suggestion of peer review (effectively a 'hot review' by another firm), hot review is already a possible safeguard in independence regulation. Perhaps it may be appropriate to establish a panel to make such reviews easier to arrange, but review by another firm which could be a competitor, could present problems.

4.13c Direct support to the mid-tier

53. We are aware that some large firms are already providing staff training to mid-tier firms on specialist skills needed for particular kinds of audits (on a fee-paying basis). Specialists from large firms also provide substantial input into guidance produced by professional bodies, which benefits all the body's members and member firms. Professional body support on technical and ethical issues is of great value to the smaller firms in the market as they have fewer in-house resources.
54. To transform the quality of audit throughout the market, a more radical approach could be taken. In the age of big data and artificial intelligence, the profession needs to share data and audit methodologies so that all firms have access to the collective experience of the industry. This shared information would increase audit quality for everyone and therefore be in the public interest, rather than the competitive advantage of a few particular firms. The downside however is that it could reduce the incentive for firms to innovate. ICAEW would be keen to participate in any discussions exploring how wider information sharing could help to improve audit quality.

4.13d Reducing barriers to staff switching

55. From a regulatory perspective, there are few barriers to staff switching. There can however be independence implications if staff who have moved firms end up working on the same audits they did before they moved. Reducing notice periods should be approached with caution as it may impact disproportionately on the ability of smaller firms and small offices of larger firms to plan ahead.

4.13e Changes to restrictions on ownership

56. We have long supported reducing the percentage of ownership requirements that currently exist in law, provided there are mechanisms to assure against inappropriate influence on audit work, such as investor backed consolidation models. We would question however whether this is a major barrier to entry into the audit market in practice.

4.27 Break up the Big Four

57. The consultation itself sets out the pros and cons very well in 4.28 and 4.29, in particular that you would end up with a greater number of firms providing both audit and non-audit services. We agree that the challenges would be complex and problematic, and would

include the loss of affiliation of one of the separated businesses to the international network, and the competitive disadvantage of the firm that loses its international network.

58. While the potential break-up of the Big Four looks plausible on one level, we are concerned that there would be significant unintended consequences, that it would be difficult to safeguard against. These would likely include large numbers of staff moving between the firms after break-up, and the impact this could have on the sustainability of the firms. It would not be possible to prevent staff from moving, or restricting where they choose to work in a free labour market.

4.31a Improve tendering transparency

59. Implementing blind tenders is superficially attractive as it would mitigate against a 'safest with the Big Four' mindset. However, as much of audit selection is based on personal interaction, it would be difficult to ensure the best selection was made. The reality of making a tender truly blind would also be challenging. It may be that the role of fee-blind tenders could be considered, where the first stage of the tender process assesses quality only, before price is then taken into consideration at a later stage. The other proposals (reforming mandatory tendering and auditor rotation and further strengthening audit committees and their links to shareholders) could support challenger firms currently less familiar with the tendering process and – if not too expensive to implement – are worth exploring.

4.31b Reform mandatory tendering and rotation.

60. The consultation itself sets out the pros and cons very well in 4.35 and 4.36. In particular, that increasing the frequency of tendering could increase the independence of auditors by interrupting the close relationship that may develop between management and the audit firms. We agree that the down sides may include increases in audit fees, and a potential reduction in audit quality if recently appointed audit firms did not fully understand their audit clients' business. Please also see our comments in relation to Question 27 below.

4.31c Strengthening audit committees

61. Although this proposal will inevitably impose some extra costs it is one of the most cost-effective of the measures being suggested. Improving audit committees would certainly be far less costly than creating a new independent body as suggested in Question 24, but if a new body is created then strengthening audit committees would help to mitigate its cost. Our preferred independent body is a Corporate Governance Office (CGO) which has a public interest mandate covering all stakeholders, as outlined in our responses to Questions 24 and 25.

4.41 Transfer appointment to shareholders or an independent body

62. As regards an independent body, please see our comments in relation to Question 25 below.
63. If shareholders became responsible for the appointment of an auditor, this would realistically need to be a group acting on behalf of the shareholders as a whole. This might make auditors more directly accountable to shareholders, but it is a concern whether such a group would have access to the same type and detail of information currently available to audit committees. Without such quality of information, the shareholders may not be sufficiently informed to make a good decision. Also, different shareholders might have different time horizon perspectives, which could detract from the aim of long term stability of the company.

4.47, 4.50 Wider reforms such as an insurance based system or an NAO-style national auditor.

64. These interesting ideas are part of a wider debate on the future of audit. ICAEW would be keen to be involved in this debate as it develops. In particular, ICAEW has been running an 'AuditFutures' project to enhance debate. ICAEW, together with the FRC and BEIS, is looking at setting up an independent enquiry into this subject.
65. The UK statutory audit market does not exist in isolation, and any reform that removed the UK from the mainstream international audit market would be very damaging. Any review of such wider reforms must therefore consider the international aspects of the large audit firms, and the associated co-ordination issues that would arise from making substantial changes to the UK audit sector in isolation.
66. The concept of a NAO-style national auditor may at first glance appear attractive, as the NAO undertakes some audits under the Companies Act. While an NAO-style body may have some of the skills to perform Companies Act audits, scaling up at pace to deliver the vast numbers of audits required would be a significant challenge. To build capacity, such a body may well need to compete with the Big Four firms for talent - including relative remuneration. An even greater challenge is the unlimited liability that such a body would have (assuming no change in legislation), and the resulting risk to the public purse that could arise were the body to be subject to claims in negligence.

Question 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.

67. No further comments.

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

68. While separating the ownership of the audit and non-audit services practices would increase the number of firms in total, this would not result in greater choice of auditor for large companies who are currently restricted on choice.
69. Separation of ownership may increase the perceived independence of audit firms, but would also entail costs, as outlined below.
70. There are already principles-based rules that govern which services auditors are permitted to provide to audit clients. These rules have recently been significantly strengthened and now exclude nearly all non-audit services to PIEs. If it were deemed necessary, these independence rules could be made even stricter, so that all non-audit services were prohibited for audit clients. It would therefore seem an unnecessary further step to split the ownership of the audit and non-audit practices. It should also be noted that many of the 'non-audit services' provided to audit clients are audit-related, such as interim reviews, regulatory reporting, capital markets transaction work, etc.
71. In addition to the logistical costs of splitting firms into audit-only practices, the resulting firms providing only audit services may find it challenging to attract talented staff. The best staff are usually seeking a variety of work experience and opportunities for diverse career progression.
72. There is a great deal of technical and sector-specific knowledge required to perform a high-quality audit on a complex client. Without a separate income stream from non-audit work, it may not be cost-effective to maintain such operations within an audit-only firm. This would mean that the firm would be unable to compete for the audits of those entities for which this

in-depth industry knowledge is required. This would be likely to impact on non-Big Four firms more than the Big Four.

73. As an alternative we consider whether ring-fencing of capital and assets might be a solution. Although the recent introduction of these requirements for banks mean that the mechanics of such structures will now be familiar to many UK professionals, we would caution against a simple analogy. Ring-fencing is needed for banks to ensure protection of deposits and continuity of payment services, both of which are crucial to financial stability. Audit firms do not need to hold capital like banks do to ensure they remain solvent and can continue to provide payment, their capital is reputational and cannot be ring-fenced in the same way. There should not be a 'one size fits all' approach when considering the structure of banks and audit firms.
74. See also our comments on the international dimension under Question 17. They are also relevant here.

Question 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?

75. The international operations and affiliations of audit firms means that the UK cannot be considered in isolation.
76. Capital is global and as a result the management and operations of many large companies are international too. This is particularly the case for London markets, which are notably international both in the sources of capital and the activities of the firms listed on them. In many cases the listed entities are domiciled outside the UK. Similarly, many large UK companies have international operations. The audit firms are one component in the sophisticated global system of capital. We have international audit firms because there are international client service needs. The exact ownership structure of the audit firms differs, but many are affiliated to an international network of firms bearing their brand.
77. In contrast to the international nature of business, the majority of regulation is local. This is due to the specific legal systems within each jurisdiction. It is important that domestic regulation does not constrain the ability of audit firms to operate on an international basis.

Question 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?

78. The current independence requirements are principles based and assess the independence threats of providing the proposed services to a particular audit client. The size of firm providing the services is not relevant unless there are factors in its ownership, staffing, etc that themselves pose a threat to independence.
79. The rules around provision of non-audit services apply to the type of client, not to the type of firm who is providing those services. We note that the independence requirements have recently been enhanced to significantly restrict the non-audit services that auditors can provide to PIEs. These enhanced safeguards do not apply to large private companies.
80. There are only a small number of private companies of sufficient scale to be considered in the 'public interest'. It may be appropriate to restrict the provision of non-audit services to these public interest private entities too. Any such proposals would need to carefully consider the scope of what is a 'private PIE' as well as whether it is desirable to apply all of the restrictions that relate to listed PIEs.

81. We acknowledge that despite the rules that exist to restrict provision of non-audit services to audit clients, there remains a perception that such services impair the independence of audit firms. It may therefore prove necessary to completely prohibit the provision of non-audit services to PIE audit clients. This would therefore be a restriction based on the nature of the client rather than the type of firm who provides the services. We believe this is the correct approach.

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

82. If a market share cap were introduced, the incentive for the Big Four firms could be to resign from their highest-risk and lowest-profit audit engagements. This would mean that the audits available for mid-tier firms to take on may not be particularly attractive and may not incentivise them to enter as far into the market as desired. The structure of any such cap therefore needs to be carefully considered. The level of any such cap would need to have a buffer built in to avoid inadvertent breaches caused by changes to membership of the index, for example.
83. There are three main ways to measure a market share cap, each of which has pros and cons. We outline these below:
84. A cap measured on the **number of companies** audited could result in concentration at the top end of the market being maintained, as the Big Four would be looking to relinquish smaller audited entities and retain the largest ones. However, it is a simple measure and may therefore be relatively easy to implement.
85. If the assumption holds that the more straightforward the audit, the lower the fee, using **market capitalisation** as a measure of the cap may incentivise the Big Four to resign from the audits of large entities which are relatively easy to audit (for example through centralised systems and control) and thus have lower fees. These audits should be relatively easy for the mid-tier firms to pick up, and deliverable without significant initial investment. This should allow the mid-tier firms to build greater capacity to deliver more large company audits in the medium-term. However, using market capitalisation as the measure may prove complicated, and would be subject to volatility in share prices.
86. Use of **audit fees** as a measure would presumably result in the Big Four resigning from the audits of entities which are more difficult to audit (for example through decentralisation and multiple operations) and thus command higher fees. This would make it harder for the mid-tier firms to enter the FTSE 350 market, as they would have to run before they can walk.
87. An alternative to a collective market share cap, would be an individual cap for each of the Big Four firms, in terms of the number of companies they could audit. For example, each Big Four firm could be restricted to auditing 65 of the FTSE 350 companies. If such a cap were introduced, the CMA may also have to consider applying a numerical cap to the wider listed market, to prevent shifting the FTSE 350 market concentration to the middle market.

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

88. In principle, expansion of competition and choice through reducing barriers to entry for the mid-tier firms would be a more positive outcome than seeking to break up current participants in the FTSE 350 audit market (see Question 14 above). A gradual market share cap scheme could achieve that, though it could, at least in the short-term, restrict choice as four firms would be barred from tendering and perhaps only one or two willing and able to do so. The effects would need to be reviewed after a three-to-five year period to evaluate whether such a cap was effective.

89. From a regulatory perspective, the FRC should consider basing any regulatory fines on the audit fee of the engagement so that they are predictable and proportionate, and do not act as a disincentive for firms to enter the market.

Question 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?

90. The advantages could be significant if the process is managed in an orderly fashion: a more competitive market for large audits without the potential consequences of a direct break-up; the at least theoretical advances in efficiency and innovation that competition should bring; and a reduced likelihood of instability through one firm withdrawing. Given the findings of the Competition Commission in its previous enquiry, it is not immediately obvious to us that there would be a significant change in audit process as a result of such a measure. Disadvantages such as restriction of ability of audit committees to make an unfettered choice are a matter of principle rather than cost, though it is to be noted that ability to choose is already restricted in some cases as a result of auditor independence restrictions and conflicts of interest.
91. The most significant concerns would be that: a) as noted in Question 20 above, in the short-term there may be a very limited choice in some instances for companies looking to procure an audit. It is important that any cap be gradual to mitigate this; b) Firms being required to reduce their share of the market would inevitably be likely to resign from the least desirable clients, which might reduce the appetite of mid-tier firms to occupy the space created.

Question 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%?

92. If the ultimate aim is to have a significant number of competitors in the market for large company audits, we suspect a figure toward the lower end of the range of options may ultimately be necessary. However, as capacity is challenging and expensive to build, restrictions would need to be introduced gradually. The level of the cap would need to be subject to periodic review.

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

93. A mandatory joint audit requirement would be a way of increasing the number of firms involved in the PIE audit market and would increase the market share of the smaller firms involved in that market. It would also allow smaller firms to build their expertise in those markets. However, we consider that the introduction of such requirements should be tested rigorously against the criteria of audit quality and the balance of costs and benefits for users of audit services.
94. We note that the French audit market has for some time had a requirement for joint audit, and that there is a fifth firm participating in their large company audit market. There is nothing to suggest that this model is ineffective in France.
95. Whether a joint audit system would be effective in the UK market is unclear based on research that has been done in this area. There are potential downsides in that joint audit may prove to be less efficient, and the extended communication requirements can lead to an incomplete picture being gained with a resulting loss in audit quality. Critics of joint audit cite that they are intrinsically more expensive, although if the aim is improvements in audit quality, cost should not be the primary concern. Proponents of joint audit believe that having more than one firm involved can result in better judgements and improve audit quality.
96. It may be that in the short term a joint audit system would be inefficient, as auditors unfamiliar with operating jointly adapt to a new regime. As the market becomes familiar with a joint audit system, benefits may be realised over the medium term. Whether the

introduction of such disruption is worthwhile would depend on how confident the CMA would be of the likely benefits.

97. A further option would be shared audits, where one firm takes overall responsibility for the audit, but other firms carry out parts of the audit and are directed by and report to the firm taking overall responsibility. Again, there are issues connected with cost and quality for this option which would need thorough assessment.

Question 24. Should the auditors and those that manage them (eg, 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 a current focus on shareholders?

98. Accountability has a variety of meanings and our response is nuanced on this basis. Legal or regulatory accountability includes enforcement and sanctions for non-compliance. However, indirect accountability can be equally if not more effective, for example the influence of investors and their advisers.
99. We support a broadening of the scope of corporate governance, to establish a multi-stakeholder model. The role of audit committees is just one part of this, and we acknowledge that the remit of the CMA only extends as far as audit committees.
100. Auditors are directly accountable to regulators, who also have a public interest mandate, for example the FRC and ICAEW. Auditors can also be held directly accountable, for example Institutional Shareholder Services is currently seeking views on their proposal that lead audit partner involvement in accounting controversies should influence their recommendations to shareholders on auditor ratification.
101. Individual members of audit committees are legally accountable as board directors. In theory at least, they may be subject to derivative actions for breaches of s.172¹. If steps were taken to make audit committee members more accountable, it should also be expected that there would be an increase in audit committee fees, commensurate with the risk-reward profile of the role.
102. Making boards and directors accountable to stakeholders through engagement was considered in depth in the 2017 BEIS Green Paper on Corporate Reform. This consultation led to the Companies (Miscellaneous Reporting) Regulations 2018, which will require: a statement in strategic reports describing how directors have had regard to s.172, and statements in directors' reports about engagement with employees, suppliers, customers and others.
103. ICAEW's response (ICAEW representation 92/18) to the Review of the FRC by Sir John Kingman referred to the establishment of a CGO or similar, and described the functions of this new body as being: to monitor and improve technical, ethical and other standards in corporate governance; and to certify and monitor directors of listed and very large private companies so that all directors can be held to account. Such a body should have a public interest mandate and could be made legally accountable to stakeholders through the mechanism of judicial review.
104. In summary, in theory at least, auditors and audit committee members are already directly and indirectly accountable to some stakeholders. Transparency for all stakeholders has also been improved. However, stakeholder interests should form a core part of the thinking and planning which goes into the formation of any new independent body.

¹Directors' duties under s.172 of the Companies (2006) are pertinent to some of the stakeholders listed in Q24, and directors also have duties customers, community and the environment. Although there is a debate about whether the priority given to shareholders in s. 172 is appropriate, and whether additional stakeholders should be added to s.172 (eg creditors who are not suppliers), we understand that BEIS does not intend to reform the statute.

Question 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?

105. We do not believe that replacing audit committees with an independent body would have the desired outcomes. Any such body would need equivalent or greater experience than the collective knowledge of audit committees across a wide range of industries and accounting practices, which would be very difficult to achieve. We would prefer any new body to oversee and even support audit committees, rather than replace them. Audit committees are best-placed and most informed to choose an appropriate firm to audit the company.
106. ICAEW’s recent work on audit committees includes responding to an International Organization of Securities Commissions (IOSCO) consultation on good practices for audit committees in supporting audit quality (ICAEW representation 84/18), and our joint report with Deloitte, *Making a difference*, which covers the practical issues faced by audit committees across seven countries in Central and Eastern Europe. We concluded from this work that the UK’s audit committees are world leading. Any new body should only make changes where necessary to address flaws, and tread carefully so as not to undo the achievements of audit committees to date. Abolishing audit committees altogether would be very damaging and a retrograde step for the UK. It would also be damaging for other countries which look to the UK to provide best practice to help them meeting rising international expectations for audit committees.
107. While the UK’s audit committees are highly regarded, we support measures to strengthen their powers and responsibilities.

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

108. Such a body is likely to be costly to establish and run. Expertise in all UK sectors would be required, as well as individuals with sufficient audit experience in PIE, large companies and international businesses. The body would also need expertise in audit fee negotiation and an understanding of the drivers of costs for audit work.
109. The funding structure for any new body would also need to be considered. Ideally, the companies and their auditors would not bear the cost, but it is unclear how else such a body could be funded. There could be a perceived conflict of interest were it to be funded by those entities from which it is seeking independence.
110. An allegation sometimes posited against audit committees is an ability to objectively monitor their chosen auditor’s work. There is a potential conflict of interest because any criticism of the auditors’ work is an implied criticism of the audit committee’s choice of auditor. A new body with limited scope could work alongside audit committees to separate responsibility for the appointment and monitoring of auditors. For example, such a body could act as an Appointment Review Panel, able to review whether an audit committee has facilitated a competitive tender for audit services, as opposed to taking over the whole appointment process.
111. When considering the risks and costs of establishing an independent body to appoint auditors, it is important to consider the experiences of other bodies who have been involved in the appointment/removal of auditors:
 - (i) Financial services regulators who can block the appointment of an auditor. For example, the Prudential Regulation Authority (PRA) can make reasonable requests for information

about an auditor's qualifications, skills, experience and independence. The Financial Conduct Authority (FCA) must be notified of auditor vacancies and appointments, and can appoint an auditor in some circumstances.

- (ii) The Audit Commission, which between 1983 and 2015 managed the market for local authority and NHS audits. They have now been replaced with the Public Sector Audit Appointments (PSAA) Ltd. The Audit Commission's remit included appointing auditors to a range of local public bodies, setting the audit scope through a code of audit practice and monitoring the quality of audit work. The Audit Commission acted as a conduit between government departments and auditors on audit issues. It also set audit fee scales but took a percentage of the fees to support its own functions. The Commission maintained its own in-house practice. In this model, there was market concentration, with 70% of the work going to their in-house audit teams, and the rest split between seven private sector firms. Cost was one of the reasons given for the abolition of the Commission. As noted above, some of the Audit Commission's functions are now undertaken by PSAA Ltd, and public bodies are given a chance to opt-in to have their auditor appointed².

112. Although it could be informative to draw on the experience of the public sector audit procurement bodies, it should be noted that a public sector audit has a different scope to a corporate audit. A public sector audit is a more commoditised product to commission with respect to the client base than an audit in the diverse private sector.

Question 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?

113. Mandatory auditor rotation and tendering has only been in force for a short time. An evidence base should be established before any changes to the model are considered. Any such research could also consider the experiences of other EU member states who have opted for more frequent rotation, for example Poland.
114. Tendering was expected to increase competition and audit quality. There is merit in investigating whether or not this has been the case. As noted above, there may be an enhanced role that audit committees can play in ensuring tender effectiveness.

² The Local Audit and Accountability Act (2014).

Appendix A: Summary of Recommendations

Paragraph number	Recommendation for action
18.	The statutory audit framework does not consider the interests of wider stakeholders, which results in an expectation gap. There may be a need for some form of assurance over other non-financial information, or summarised financial information that has been prepared to meet the needs of other stakeholders.
20.	Audit committees could be strengthened, to empower them to disrupt the narrow focus on costs and insist on high quality audits.
25.	We remain strongly in favour of the audit committee as a model for corporate governance, but the model needs to be made more effective, and members of audit committees held to account for their decisions.
30.	Increasing regulation of Public Interest Entity (PIE) audits is making entry to the FTSE 350 audit market increasingly unattractive, due to the risk of very large regulatory fines and reputational damage for both the audit firm and the audit partner involved. Indeed, some mid-tier firms have chosen to exit the PIE audit market in response to this potential liability. The regulatory focus should be on improvement rather than harsh penalties for non-compliance.
45.	We encourage the FRC's proposed governance and stability reviews of the Big Four and selected mid-tier firms to consider the use of 'Living Wills' by these firms as a continuity plan, such as those that are currently used by the banking sector to determine how continuity of service would be provided to clients in the event of a bank's collapse.
47.	Regulation must have regard to competition so as not to stifle it unnecessarily, and to enhance it to ensure adequate choice and incentives for innovation and efficiency. Regulation should be proportionate to the risks to the economy and society, so small and medium company audits should receive less intervention than large company and PIE audits.
54.	ICAEW would be keen to facilitate in any discussions exploring how wider information sharing could help to improve audit quality. The profession needs to share data and audit methodologies so that all firms have access to the collective experience of the industry, thus increasing audit quality for everyone. It could however, reduce the incentive for firms to innovate.
55.	From a regulatory perspective, there are few barriers to staff switching. There can however be independence implications if staff who have moved firms end up working on the same audits they did before they moved. Reducing notice periods should be approached with caution as it may impact disproportionately on the ability of smaller firms and offices of larger firms to plan ahead.
65.	Any review of reforms to the UK's position in the mainstream international audit market must consider the international aspects of the large audit firms, and the associated co-ordination issues that would arise from making substantial changes to the UK audit sector in isolation.
73.	Ring-fencing of capital and assets might be an alternative solution to separating the ownership of audit and non-audit services practices of UK audit firms
77.	It is important that domestic regulation does not constrain the ability of audit firms to operate on an international basis.

Appendix A: Summary of Recommendations

Paragraph number	Recommendation for action
80.	It may be appropriate to restrict the provision of non-audit services to those private companies that are of sufficient scale to be considered in the 'public interest'. Any such proposals would need to carefully consider the scope of what is a 'private PIE' as well as whether it is desirable to apply all of the restrictions that relate to listed PIEs.
81.	We acknowledge that despite the rules that exist to restrict provision of non-audit services to audit clients, there remains a perception that such services impair the independence of audit firms. We believe the correct approach would be to completely prohibit the provision of non-audit services to PIE audit clients, based on the nature of the client rather than the type of firm who provides the service.
82.	The structure of any market share cap needs to be carefully considered. The level of any such cap would need to have a buffer built in to avoid inadvertent breaches caused by changes to membership of the index, for example.
88.	The effects of a gradual market share cap would need to be reviewed after a three-to-five year period to evaluate whether such a cap was effective.
89.	The FRC should consider basing any regulatory fines on the audit fee of the engagement so that they are predictable and proportionate, and do not act as a disincentive for firms to enter the market.
92.	We suspect a collective Big Four market share cap of around 60% may ultimately be necessary to achieve a significant number of competitors for large company audits. However, restrictions would need to be introduced gradually and the level of the cap would need to be subject to periodic review.
93.	We consider that the introduction of any mandatory joint audit requirements should be tested rigorously against the criteria of audit quality and the balance of costs and benefits for users of audit services.
104.	Wider stakeholder interests should form a core part of the thinking and planning which goes into the formation of any new independent body that replaces audit committees.
105.	We do not believe that replacing audit committees with an independent body would have the desired outcomes. We would prefer any new body to oversee and even support audit committees, rather than replace them. Audit committees are best-placed and most informed to choose an appropriate firm to audit the company.
106.	Any new independent body should only make changes where necessary to address flaws, and tread carefully so as not to undo the achievements of audit committees to date. Abolishing audit committees altogether would be very damaging and a retrograde step for the UK. It would also be damaging for other countries which look to the UK to provide best practice to help them meeting rising international expectations for audit committees.
110.	A new body with limited scope could work alongside audit committees to separate responsibility for the appointment and monitoring of auditors. For example, such a body could act as an Appointment Review Panel, able to review whether an audit committee has facilitated a competitive tender for audit services, as opposed to taking over the whole appointment process.

Appendix A: Summary of Recommendations

Paragraph number	Recommendation for action
113.	An evidence base should be established before any changes to the mandatory auditor rotation model are considered. Any such research could also consider the experiences of other EU member states who have opted for more frequent rotation, for example Poland.