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Dear Sir/Madam

### **Statutory Audit Market**

Legal & General Investment Management (LGIM) is one of the largest international investors globally with over £984.8 billion of assets under management (as at 30 June 2018). We manage assets for a wide range of global clients, including pension schemes, sovereign wealth funds, fund distributors and retail investors.

Over the past 40 years, LGIM has built a business through understanding what matters most to clients (both institutional and retail) and transforming this insight in to valuable, accessible investment products and solutions. This enables pension funds to meet their key long-term financial objective of ensuring fund assets match future financial liabilities and pay pensions.

As a significant equity and credit investor, there is a responsibility to ensure that global markets operate efficiently and uphold the highest levels of transparency to protect the integrity over the long term. Therefore, the opportunity to respond to the consultation by the Competition Market Authority (CMA) is very important to LGIM.

In 2012, LGIM responded to the Competition Commission's review of the audit market and pushed for mandatory auditor rotation. More recently, LGIM has also responded to the latest government review of the Financial Reporting Council (FRC).

We believe that the primary concern in the audit market is that of poor audit quality. This is due to a number of issues associated with the audit market structure:

1. Lack of competition (we note that one of the main objectives of the CMA's review is considering choice and switching)
2. Auditors viewing company management as the client (due to incentive arrangements of partners)
3. Audit committee quality and experience
4. Accounting rules not keeping up-to-date with the growth of intangibles and the materiality of management assumptions underpinning the accounts.

We believe that the consideration of audit quality in relation to the issues highlighted above have led to a lowering of audit quality and a lack of willingness to move away from a 'tick-box'

approach to define a true and fair view of a company's financial health. Professional scepticism can be improved.

Therefore, the ultimate problem we are trying to resolve is one of audit quality, not just competition.

Another issue which is critical is the importance of strengthening the tripartite relationship between auditors, companies and investors. These lines of accountability should be enforced given it is important for clarity and consistency in the audit market.

We recognise that the audit market does need to be changed in order to restore trust in audit for investors and other stakeholders. We propose five main solutions:

- 1) Ring-fencing regime – separating the assurance side of the business from the rest of the advisory services provided by the auditor will protect and enhance audit quality within the audit firm by placing it at the core of their function.
- 2) Appointment of Independent Non-Executives – within the ring-fencing structure, the assurance and advisory services of the audit firm should have separate governance structures with the appointment of sufficient INEs to oversee audit quality within the firm.
- 3) Incentive structures – aligning the incentive structures of senior management and profit distribution of partners to the interests of long term investors will support the right culture and behaviours in the audit market.
- 4) Strengthening Audit Committees – we recognise the critical function of Audit Committees in holding auditors to account, including during the tendering process. Strengthening oversight of the auditor by the Audit Committee and having sufficient experience will reinforce high expectations on good audit quality.
- 5) Improving audit and assurance across the whole market – designing a feedback mechanism to share best practice and concerns across the market will ensure that audit quality is constantly reviewed and improved for the benefit of all stakeholders.
- 6) Non-audit fees – these should be limited to ensure that focus is on good audit quality work.

We hope you find our proposals helpful in developing a better solution. If you would like to have a further discussion, please do not hesitate to contact us directly.

Yours sincerely,

Sacha Sadan  
**Director of Corporate Governance**  
**LGIM**

## **Appendix 1**

### **LGIM's Response to the CMA of the Statutory Audit Market**

#### **A) Issues**

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

1.1. Please see comments below.

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

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

2.1. LGIM believes that confidence in audited numbers is a fundamental part of an investor's (both equity and credit) decision making process. Being regular users of financial reports, we feel let down by poor audit quality and believe that trust in audit has been shaken due to the recent high profile accounting scandals that have occurred. This has had a knock-on effect on not only investors but other stakeholders such as employees and the public.

2.2. Whilst the Carillion collapse drew attention from politicians and the public media in the UK, we have seen other examples of poor audit quality impacting market confidence. For example, profit warnings from companies such as G4S, Serco, Mitie, Capita, Balfour Beatty and Cobham, should have raised concerns with the quality of audit undertaken by audit firms when reviewing long term contracts and the assumptions made by management.

2.3. Despite these events, we have seen limited action taken by the audit market and regulators to address this fundamental market failure and improve practices.

2.4. The expectation gap between the scope and responsibility of the auditor versus public expectations of the role of the auditor also still exists in our view.

2.5. However, over the years, we have seen this gap close with the auditor taking on additional oversight of the front half of the annual report to ensure consistency in statements and increased education from investors of what the market expects. We believe there is a strong argument for an extended scope of an audit to ensure it remains relevant in today's business environment in meeting the needs of shareholders.

2.6. We believe audit work has increasingly been seen as a commoditised service which has led to lower audit quality and less professional scepticism in the audit profession. Audit work has evolved in to a tick box mind set being applied in accounting rather than challenging the accounting rules on a firm-wide basis when weaknesses in the accounting standards have been identified.

2.7. Whilst the CMA's consultation on the audit market may help to resolve some of these issues, it is important to bear in mind that the ultimate goal is to improve audit quality to restore investor confidence in the public interest.

## **Theme 2: Incentives and governance**

- 3. To what extent do the decisions made by audit committees support high-quality audits, whether through competition for audit engagements or otherwise?**
- 4. How has this changed following the Competition Commission's intervention?**

4.1. We believe Audit Committees are critical to oversee and challenge the audit partner on a continual basis to develop high-quality audits. The ability of Audit Committees to monitor the way the audit is conducted, understand the culture and mind set applied by the auditor and encourage the use of professional scepticism to challenge management assumptions are all crucial factors to support high quality audits.

4.2. Furthermore, during the tendering process, Audit Committees should be taking the lead on the tendering process. This is important to set the tone on audit quality from the start of the relationship between the auditor and Audit Committee. This sends a clear signal that the auditor reports to the Audit Committee.

4.3. We have seen a dramatic change since the Competition Commission's last review and the EU Audit Directive on the role of audit committee's in the tendering process. This has been positive as Audit Committees are becoming increasingly actively involved and engaging with shareholders prior to the audit.

4.4. In addition, we see best practice being developed by Audit Committee's to appoint audit firms based primarily on audit quality, with fees being a later consideration in the tendering process. This is important as it focuses on the interests of long term investors and the market as a whole.

## **Theme 3: Choice and switching**

- 5. Is competition in the audit market working well? If not, what are the key aspects hindering it?**
- 6. In particular, how effective is competition between the Big Four and between other firms and the Big Four?**
- 7. How has this changed following the Competition Commission's intervention?**
- 8. What is the role for competition in the provision of audit services in delivering better outcomes (i.e. consistently higher quality audits)?**
- 9. In practice, how much choice do large companies and public interest entities have in the appointment of an external auditor?**
- 10. What are the key factors limiting choice between auditors?**
- 11. What are the main barriers to entry and expansion for non-Big Four audit firms?**

11.1. We acknowledge that the audit market has evolved since the intervention by the Competition Commission. For example, audit re-tendering is now a different process since the introduction of mandatory rotation. This was despite the audit profession and

regulator being reticent to any change in the implementation of mandatory tendering and rotation.

11.2. In practice, we have also seen clear benefits with increased investment in audit processes through the use of technology and innovation.

11.3. However, whilst competition may appear fierce amongst the Big Four, when undertaking the tender, deep-seated biases remain in the market structure which inhibits mid-tier firms from competing for larger audit work. This includes:

- Companies unwilling to ask mid-tier firms to tender due to importance placed on non-audit work being undertaken, or inability to wind down the relationship within the required time frames;
- Investors still uncertain on the quality of audit conducted by audit firms outside the Big Four;
- Mid-tier firms are out-matched when tendering for large contracts due to resource, technology and scale.

11.4. These issues have led to concerns with the dominance of the Big Four and low auditor switching to mid-tier firms.

## Theme 4: Resilience

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

12.1. We believe that there is significant risk that the audit market is not resilient and have observed this issue looking at the way audit firms access capital and incentivise partners.

12.2. Partnership structures & access to capital:

12.2.1. Partnership structures do not have the same access to capital as other corporate structures. Rather, their capital comes from the appointment of new partners and members, long term loans and other banking facilities.

12.2.2. Furthermore, partnership profit distribution structures encourage a short term focus on annual profits as they are high and paid out in cash annually. For example, it was reported by Deloitte that the average profit distribution was £865,000 for 800 partners in the UK.<sup>1</sup>

12.2.3. This profit pool is shared within the audit firm between audit and non-audit services which results in internal cross-subsidisation at partner level with regards to their compensation. This cross-subsidisation skews internal incentives and could explain the concerns we are seeing in the market in relation to partners being equally incentivised to maintain and grow the non-audit business.

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<sup>1</sup> <https://www2.deloitte.com/uk/en/pages/about-deloitte-uk/articles/impact-report-metrics-2017.html>

12.2.4. Partners are deterred from committing funds to long term investment in audit firms as they would rather receive a return from their investment over the short term.

12.2.5. Therefore, partners invest their own human capital in to the firm and rely on the performance of the audit firm as a whole for their remuneration. We believe this could impact the resilience of audit firms when experiencing a large shock in the market as partners may not be able to commit capital to future investments or banking facilities may be withdrawn.

## **Theme 5: Regulation**

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

13.1. We do not have any comments on this issue.

## B) Potential measures

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

14.1. In Appendix 2, we have outlined our views on the CMA's proposals as set out in Section 4 of the consultation.

### 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. The proposals set out below should be read in conjunction with our comments in point 18 regarding ring-fencing.

#### 15.2. Role of Independent Non-Executives within the assurance functions

15.2.1. A strong independent governance framework is essential to oversee the critical function of audit. This will help create and maintain high standards of audit quality.

15.2.2. In developing this framework, the role of independent non-executives (INEs) ought to be further strengthened and made compulsory within the audit/assurance function of audit firms. Currently, the governance oversight being provided by the INE is voluntarily applied through the Audit Governance Code.

15.2.3. The primary purpose of INEs should be clearly defined as "having oversight of audit quality." This should be the key focus of their role and central to the activities they carry out within the audit firm. This is different to the current remit which is significantly broader encompassing oversight of public interest and the firm's reputation, both of which can conflict with the primary purpose of high audit quality.

15.2.4. There are a number of key features which need to be incorporated in the governance framework in order for INEs to perform their function successfully.

- I. INEs should have sufficient powers within the audit firm to perform their duties effectively and hold management to account where required. Currently any recommendations from the INEs are only voluntarily applied.
- II. INEs should have the right skills, knowledge and access to resources within the audit firm to carry out their primary purpose. In addition, the number of INEs should also be sufficient to carry out its function to oversee audit quality in the audit firm.
- III. INEs should be responsible for whistleblowing procedures and its governance within an audit firm. In addition, cases of whistleblowing ought to be reported directly to the INEs. As part of this INEs should have unrestricted access to investigate any wrong-doing.
- IV. INEs should have oversight of the compensation structures of senior management within the audit firm and profit sharing amongst the partners.

- V. INEs should have a regular and direct line to the audit regulator (and other relevant regulators).
- VI. Given the important role we see for INEs, the audit regulator should approve the appointment of the INE to the audit firm.

15.2.5. We see a number of benefits to the creation of this independent governance framework. These include:

- An increase in independent oversight of the audit function
- Greater accountability of auditors to investors
- Restoring trust and transparency for the overall market
- Providing a key contact point for stakeholders (e.g. investors and regulators) for the escalation of issues

15.2.6. We expect there to be minimal costs in our proposals as similar structures are voluntarily in place within audit firms already. However, we believe these structures need to be strengthened to unlock the oversight benefits associated with having INEs in audit firms.

### 15.3. Incentive structure within audit firms

15.3.1. Aligning the incentive structures of senior management and profit distribution to partners within audit firms to the interests of long term investors will further support the right culture in the audit market and improve accountability.

15.3.2. We consider a good incentive structure to be long term with individual accountability embedded in its framework. Below, we have outlined key features of the incentive structure for senior management and profit distribution for partners:

- I. Profit allocation amongst partners to be re-distributed from the profit pool generated from the audit business only.
- II. Incentive structures for senior staff within the audit function to be made from the audit side of the business.
- III. Payments (both senior staff and partners) to be deferred over multiple years.
- IV. Allocation of payments to senior staff and partners to be linked with audit quality.
- V. Payments to senior management and partners are linked with the cultural behaviours expected to be created from high quality audits.
- VI. Malus and clawback provisions established to provide a mechanism in which payments can be claimed back from senior management and partners.

15.3.3. There are a number of benefits to creating a new incentive framework for senior staff and partners. These include:



- Drive culture and behaviours focused on audit quality firm wide
- Empowering partners internally to drive improvements in audit quality
- A mechanism being established to enable regulators and companies to hold partners directly to account for poor quality audits
- Encourages a longer term outlook for investment
- Removes conflicts inherent in audit firms
- Raising the stature and reputation of audit work and its importance within the profession

15.3.4. We see few obstacles to the implementation of this incentive framework. Many of these concepts are seen as market leading practice in both private and public corporations. The Corporate Governance advisory services of the audit firms will be aware of these best practice remuneration principles.

#### 15.4. Strengthening Audit Committees

15.4.1. A strengthened Audit Committee enables the Board to make the right decisions and ensure the highest quality of audit is being conducted by the auditor, on behalf of investors.

15.4.2. We recognise the critical function of Audit Committees in holding auditors to account. We also welcome Audit Committees improving their reporting and engagement with investors over the last few years. However, we believe this can still be improved further and have outlined areas for attention below:

- I. Audit committees should be required to report whether their accounts were subject to a review by regulators during the year, the outcome of that review and any action taken by the Audit Committee. Currently this disclosure is voluntary.
- II. The audit report should be sent to regulators annually as part of the oversight process so the auditor behaves in a way that maintains the highest levels of professional scepticism when auditing a company's accounts.
- III. The manner in which a tendering is undertaken sets the tone of the relationship between management, the board, shareholders and the auditor. Therefore, during the tendering process, Audit Committees should be proactively leading the procedure. It is important that the whole committee is involved from the start of the process, including overseeing the planning stages, formulating criteria for selection, leading the interviewing process and ensuring there is appropriate disclosure to shareholders. Meetings with prospective auditors should also be held separately, without management present. This is to ensure that audit firms understand that they report directly in to the Audit Committee.
- IV. Given the importance of the relationship between the Audit Committee and auditor, Audit Committees should be directly in charge of choosing the audit partner during tendering and partner rotation.

- V. To provide for a robust challenge by the Audit Committee to the auditor, there should be more than one additional financial expert on Audit Committees (particularly for large complex businesses).
- VI. The quality of an external audit relies on the control environment within the company. Internal audit plays a critical role in this control environment. However, we have seen a number of cases where large complex companies continue to outsource this essential function. Therefore, we believe that the internal audit function should not be outsourced to a third party, have sufficient resources and report directly in to the Audit Committee (particularly for large complex businesses).

15.4.3. We believe implementing the structures above will strengthen the oversight of auditors by the Audit Committee and increase accountability. Furthermore, these processes will reinforce that audit quality is at the centre of the work carried out by Audit Committees in line with investors' expectations.

15.4.4. We do not foresee there to be any long term costs associated with implementing these procedures.

15.5. Improving audit and assurance across the whole market

15.5.1. As a long-term investor, we have an interest that the audit market as a whole is working efficiently for the investment community in addition to our expectations that high quality audits are being undertaken at the individual companies in which we invest. As highlighted in section 2.2, we have seen that in the undertaking of individual audits, consistent questions or areas of concern seem to arise across a sector or accounting standard. We would like a better "feedback mechanism" to share best practice and concerns across the market, in order that they are raised in a consistent manner and addressed in a pro-active way.

15.5.2. We believe the design of the feedback mechanism is important in order to formalise the process.

- I. Processes embedded to share best practices or commonly seen concerns across the audit partners within an audit firm
- II. Key trends and themes to be escalated to the INE's and audit function executives
- III. Responsibility for the audit firms to inform the regulators, investors and accounting standard setters areas of common concern, so that the regulator/standard-setters can determine next course of action

15.5.3. Many of the accounting scandals that have so damaged public trust in the value of audit have come from areas of known concerns (e.g. long-term contract accounting, valuation of intangibles or loan-loss provisioning). Formalising a mechanism to pro-actively address these concerns at market level may assist in the prevention of further scandals in the future by embedding continuous improvement rather than ad-hoc review.

15.5.4. Furthermore, a transparent structure will demonstrate to stakeholders that the audit firms are seeking to improve audit quality across the market, not just for the corporate they are auditing.

15.6. Audit/Non-Audit fees

15.6.1. An external independent audit provides the verification and assurance as to the financial statements of a company to its investors. The quality of the assurance work undertaken by the audit firm is therefore important and audit fees should be reflective of the actual cost of a high quality audit being conducted, rather than just being based on last year's fees plus inflation.

15.6.2. LGIM also does not expect excessive non-audit work to be conducted by the company's external auditors, as this will bring into question the independence of their judgement. However, where the external auditor does provide non-audit services, these should be fully explained and disclosed in the appropriate annual disclosures.

15.6.3. Due to the potential conflict and commercial pressures arising from non-audit work, we believe minimum standards need to be set to ensure that this does not occur. Therefore, LGIM expects:

- I. Non-audit related services to not exceed 50% of the value of the audit services in any given year.
- II. A maximum cap introduced on the fees paid for non-audit services.

15.6.4. These principles are already considered in LGIMs voting policy.

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

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

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

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

18.1. LGIM agrees with the CMA's intention to limit a firm's ability to develop potential conflicts between audit and non-audit services.

18.2. In particular, we see three main issues with audit firms providing non-audit services:

- I. There are inherent conflicts in the provision of non-audit services by audit firms. Some of these conflicts are limited due to the regulatory prohibition of certain non-audit services to companies. However, some conflicts do not neatly fall in to the categories as defined by the current regulatory regime and therefore are difficult to manage. For example,

conflicts between the different services being provided by the audit firm as a whole means that issues may arise and be interrelated at a market level. These conflicts go beyond just the provision of audit and non-audit services at the company level.

- II. The audit practice has to compete with other higher margin business services internally for capital and investment. Therefore, as investors we believe that if capital was allocated to the audit function, we may receive a higher quality of audit being conducted and focussed.
- III. As highlighted in 15.3, the audit function appears to be cross-subsidised by other non-audit services provided by the audit firm. Therefore, partner incentives are not necessarily aligned to ensure audit is appropriately priced as they potentially receive the profit share from the auditor business as a whole.

18.3. As expected in all large complex businesses, conflicts exist and therefore need to be managed.

18.4. Acknowledging the points above, we are aware that there are some positive benefits from audit firms carrying out non-audit services. For example, auditors gain valuable knowledge and insight in to the way a sector operates and identify trends which benefit the company. Costs are reduced and the speed of execution is also quick given audit firm's familiarity with the company. In addition, non-audit services is seen as a mechanism by which key talent can be retained within audit firms given that audit work itself is not currently viewed as attractive.

18.5. Given that splitting audit and non-audit services carries high execution risk, we have developed an alternative solution worth considering. LGIM believes that 'ring-fencing the audit function within the audit firm will achieve the objective set out in 18.1 whilst retaining the benefits of a combined entity and mitigate the conflicts within the current structure.

18.6. Ring-fencing within audit firms

18.6.1. Ring-fencing requires audit firms to separate the assurance side of the business from the rest of the advisory services provided by the auditor. Such a structure aims to protect and enhance audit quality within the audit firm by placing it at the core of their function.

18.6.2. There are two key features of the ring-fencing structure which need to be implemented in order to ensure that the framework is successful in achieving its aim:

- I. Oversight and governance – as highlighted in 15.2, we believe a strong independent governance framework to oversee the critical function of audit is essential to create and maintain high standards of audit quality. Therefore, within a ring-fenced regime for auditors, different governance structures need to be developed for audit and non-audit services. This includes having separate boards with different objectives. For example, the role of the Audit Function Board would be to maintain high audit quality with oversight by INEs. The Non-Audit Function Board would have a broader objective aligned with the auditors other commercial interests.

- II. Service agreement – the ring-fencing structure would require the implementation of a service agreement to explain how the advisory and assurance functions of the auditor will work together to share knowledge and information. This service agreement should be signed off by the INEs highlighted previously in 15.2 and a summary made publicly available to investors for transparency purposes.

18.6.3. Currently the inherent pressures within audit firms have very limited the development of the assurance side of the business. We see numerous positive benefits from implementing a ‘ring-fencing’ structure which aims to improve audit quality and provide a better balance between audit and non-audit work.

- Within the ring-fence structure, partners and senior employees are protected from the commercial interests of advisory services and therefore can operate without dealing with conflicts arising from such services.
- We consider the need to function as a standalone entity will lead to more informed pricing of audit work to reflect appropriately its cost and value.
- A ring-fenced structure ensures profit generated by the assurance function will solely be for the benefit and future investment in audit services.
- If there are large external shocks to the market, audit firms should be more resilient limiting systemic risks.

18.6.4. We believe that there will be some costs and disruption to audit firms in applying a ‘ring-fencing’ structure. This should not be too onerous because similar systems have been implemented in other sectors.

## Market share cap

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

23.1. We acknowledge that having a cap on market share between the Big 4 Audit firms would resolve the concentration issue in the audit industry. However, we believe that this remedy will not solve the underlying issues of increasing competition in the long term and importantly quality of audit in the market.

23.2. For more information, please see appendix 2.

## Incentives and governance

**24. Should the auditors and those that manage them (e.g. audit committees, or an independent body as described in section 4) be accountable to a wider range of stakeholders including shareholders, pension fund trustees, employees, and creditors, rather than the current focus on shareholders?**

24.1. No, we do not believe that auditors and those who manage them should be accountable to a wider range of stakeholders.

24.2. LGIM believes audit is for shareholders and therefore auditors are primarily accountable to them. Given that the investment chain is interlinked, the needs of other stakeholders would be met if auditors are already primarily accountable to shareholders. This is currently weak and needs to be strengthened.

**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 highlighted in Appendix 2, we do not think an independent body should replace Audit Committees in selecting audit firms.

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

26.1. As highlighted in Q25, we do not believe there should be an independent body to replace Audit Committees. Please see Appendix 2 for more detail.

**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. Yes, please see Appendix 2 point 4(b) for our views on mandatory rotation.

27.2. Audit Tendering

27.2.1. An issue with the audit tendering process are the high barriers to entry and lack of interest from mid-tier firms to compete for FTSE 350 audits. This is because the process is expensive and they are at a significant disadvantage in terms of resources and audit-related technologies to compete with the Big Four on equal footing.

27.2.2. To create a more even playing field for audit tenders, we propose the following solutions:

- I. Audit Tendering Fund – to generate more choice for companies to select audit firms during a tendering process, an independent fund could be created with contributions from companies. If mid-tier firms meet the criteria set out, these mid-tier audit firms would be eligible to draw in extra capital in order to compete with the Big Four for large audit work.

- II. Sharing of audit process platforms, technology and knowledge – a public open source platform could be developed to enable all audit firms, including mid-tier auditors, to share knowledge and insight in to optimal audit processes. By licencing these audit practices, all audit firms will compete on a more level playing field, sharing best practice in the audit market. In addition, if the platform is properly developed, companies are able to add their own IP on top of the platform which will drive competitive behaviour and differentiate their audit services. This platform should be monitored and licenced by a third party such as the ICAEW.

27.3. The main benefit of these two proposals is to increase competition within the audit market using dynamic market forces rather than imposing caps and limitations.

## Appendix 2

<b>CMA Proposal</b>	<b>LGIM's View</b>
<b>Restrictions on audit firms providing non-audit services</b>	
1(a) greater partial, or complete, restrictions on audit firms providing non-audit services to their audit clients	<p>Although we understand that these measures may reduce the conflicts in audit firms, we believe that there is high execution risk and the possibility of losing some of the benefits (see 18.4) from the combined structure.</p> <p>Therefore, we propose an alternative 'Ring-Fencing' solution (see 18.6) of how this can be better managed.</p>
1(b) prohibit audit firms from providing non-audit services not only to their audit clients, but also to any other large company or PIE	See above.
1(c) split the UK arms of major accounting firms into audit-only and non-audit services practices	<p>Although we understand that these measures will completely remove the conflict between audit and non-audit services, we believe that there is high execution risk and the possibility of losing some of the benefits (see 18.4) from the combined structure.</p> <p>Therefore, we propose an alternative 'Ring-Fencing' solution (see 18.6) of how this can be better managed.</p> <p>Furthermore, this solution may not completely resolve the issue of mid-tier firms being able to compete on an even playing field with the Big Four.</p>
<b>Measures to reduce the barriers for non-Big Four firms to build their capacity</b>	
2(a) market share cap on the Big Four	<p>We believe this proposal would be difficult to work in practice given the complex and numerous factors that would need to be considered in applying a cap (e.g. sector, global reach).</p> <p>Furthermore, the outcome of a cap could lead to Audit Committees being further restricted in the choice of an audit firm and lower audit quality.</p>
2(b) variations of joint and shared	Although we understand that this solution has been



audits (mandatory, shared and peer)	applied in some regions (e.g. France on joint audits), we believe that this could create difficulties in identifying accountability if poor audit quality is identified.
2(c) direct support to the mid-tiers by the Big Four and professional bodies	<p>We support the concept of enabling the mid-tier audit firms to compete at a level playing field with the Big Four.</p> <p>However, this should not come from the Big Four themselves but from companies where audits are taking place.</p> <p>Please see section 27 for our proposals of how this can be carried out.</p>
2(d) reducing the barriers for senior staff to switch between audit firms; and/or	No comments
2(e) changes to the restrictions on the ownership of audit firms.	<p>As highlighted in section 12.2, we believe there is a market resilience issue arising from the partner ownership structure of audit firms and how they are incentivised.</p> <p>Whilst we are not proposing restrictions to the ownership of audit firms, our solutions of how partners can be better incentivised to focus on audit quality can be found in section 15.3.</p>
<b>Break-up of the Big Four into smaller audit firms</b>	
3) Impose structural changes in the biggest existing firms, forcibly to increase the number of firms in the market. This measure would split the audit practices of the Big Four in the UK into separate businesses. Each of the separated businesses could continue to provide audit and non-audit services.	<p>Although we understand that these measures may increase competition in audit firms, we believe that there is high execution risk and the possibility of losing some of the benefits from scale.</p> <p>However, we have proposed in section 27 of how best practice audit processes can be shared on an open access platform.</p>
<b>Mitigate the effects of current incentives</b>	
4(a) improving the transparency around the tendering process;	We support additional transparency in this area.
4(b) reforming mandatory tendering and auditor rotation;	As highlighted in 2012, LGIM believes that there should be mandatory rotation of an audit firm every 15 years in order to preserve the independence and integrity of audit activity for investors.

	<p>This is shorter than the current maximum period of 20 years in the UK which we consider is too long and still allows deep relationships being development.</p> <p>Therefore, audit firm tenure, which has been a factor in misaligning incentives, will be eliminated if mandatory rotation is implemented over a shorter period.</p>
<p>4(c) further strengthening audit committees and / or their links to shareholders</p>	<p>Please see our comments in section 15.4 of how Audit Committees can be strengthened.</p>
<p><b>5) Break the link between company management and auditors</b></p> <p><b>6) Insurance-based system</b></p> <p><b>7) 'NAO-style' national auditor</b></p>	<p>Currently, the responsibility of appointing and dismissing an auditor falls on the duties of the Audit Committees and shareholders (through voting on resolutions at general meetings). This provides clear lines of accountability and is consistent with other legal powers given to board directors and shareholders to manage a company's affairs.</p> <p>Furthermore, Audit Committees have the right level of company awareness, knowledge and skills to select the most appropriate audit partner to carry out audit on an on-going basis.</p> <p>Therefore, we believe there will be strategic and operational problems if alternative models and systems are developed which changes this accountability structure (e.g. the appointment of an independent regulator to replace Audit Committees). These are outlined below:</p> <p><b><u>Strategic issues</u></b></p> <p>If an independent body was appointed to replace Audit Committees, it is unclear whether this body would have the appropriate resources and skillsets to appoint, dismiss and assess on an on-going basis the right audit partner for the company. They will also have limited insight and understanding of the material issues affecting the company in order to examine audit firms when bidding for audit work.</p> <p>Furthermore, any alternative models risk removing a key tool which enables Audit Committee to hold management to account for their actions.</p> <p><b><u>Operational Issues</u></b></p> <p>There would be added confusion of where the independent body would fit in the current tripartite</p>

	<p>relationship between shareholders, auditors and the company. Furthermore, it is unclear how the independent body would oversee the internal conflicts between company and auditors and who would be held accountable if issues arise with the audit.</p> <p>To conclude, we are not supportive of alternative models as we believe the current accountability framework between Audit Committees, investors and auditors is fit for purpose.</p>
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