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Copy: Will Hayter, Project Director

By email

21 January 2019

Dear Dr Coscelli,

Statutory audit services market study - response to the Update Paper dated 18 December 2018

Thank you for the opportunity to respond to the questions in the CMA's Update Paper. We have set out detailed responses in the attached annex.

We recognise that the four concurrent reviews – by the CMA, Sir John Kingman, Sir Donald Brydon and the BEIS Select Committee – represent a chance to revisit and rethink what an audit does, how the market and regulatory framework operate, and how best to ensure that audits address the needs of stakeholders now and in the future. We remain open to change and understand the need to rebuild trust in the corporate reporting system, of which audit is an important part.

Yet, we are concerned that the CMA is presenting a series of far-reaching recommendations to government without taking into account the important work and conclusions of the other reviews; without having gathered sufficient new evidence that supports these recommendations since it last looked in detail at the audit market in an investigation that only concluded in 2013; and in the face of opposition from many key stakeholders, in particular Audit Committees and investors, who point to serious and unintended consequences for audit quality of implementing some of the proposed recommendations. We ask the CMA to address these concerns before completing its market study. If the CMA is seriously considering major intervention, we believe it must consider a market investigation.

The CMA has acknowledged that at present there are questions as to the purpose of audit and how best to address the “expectation gap” between what the audit covers under current regulations, what the public expects it to cover and stakeholders’ expectations of the audit of the future. The CMA accepts

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that “*Standing back, there is a large range of important issues about the purpose and scope of whether the existing framework is able to deliver the audit outcome stakeholders expect*”.¹ These issues will be considered by the Brydon review. The CMA similarly recognises that competition and regulation should work together to incentivise the delivery of audit quality. Changes to the regulatory oversight of the audit market, following the Kingman review, will have a significant impact on how the audit market operates, and in particular should help improve and protect audit quality. In our view it is important that any reforms proposed by the CMA should take in to account the timing of these reviews and be complementary to the recommendations from this work which has not yet concluded.

We also believe that there needs to be a thorough evidence-based examination of the issues and are willing to work with the CMA to spend the time needed to analyse the market, how it is changing, and how audit quality can be improved and protected. We believe this is necessary in order to ensure that any remedies designed are proportionate and effective in delivering both quality and choice.

Audit quality and the current market environment

The CMA has acknowledged the “*unanimous agreement among stakeholders...that audit quality should be the key focus in assessing whether the market was producing good outcomes*” and has rightly suggested that quality should be at the heart of its thinking.² But we do not believe that the evidence the CMA has relied on to support its recommendations as regards audit quality justifies the interventionist measures it proposes. In particular, the evidence does not justify a conclusion that a combination of issues in selection and oversight, choice, firm structure and regulation “*lead to the market failing to deliver high-quality audits*”.³ In this, the CMA’s view runs contrary to the evidence which is that Audit Committees consider the choice in the market to be sufficient⁴ and that Audit Committees and investors consider audit in the UK to be “*generally of a high quality*”.⁵

In our view, the evidence instead demonstrates a market in which competition generally works well, and shows that previous market interventions have had a positive impact. The mandatory audit firm rotation regime has given all firms the opportunity to compete for audit appointments from the largest companies, with over half of FTSE 350 companies having tendered their external audit since 1 January 2013.⁶ The rotation regime allows the competitive tender process to play out frequently and the CMA recognises that the appointments made have focused more on quality than on price.⁷ Recent restrictions on the provision of non-audit services also appear to be working well: the CMA has not found significant independence concerns at the client level.⁸ Independent challenge has been introduced in to the governance structures of audit firms through the appointment of independent non-executives.⁹ These rules have been in place for a relatively short time and it will be important that any proposed reforms build on this framework and do not divert from audit quality.

¹ Paragraph 38 of Appendix C to the CMA’s Update Paper

² For example, paragraphs 6 and 2.37 of the CMA’s Update Paper

³ Paragraph 4.1 of the CMA’s Update Paper

⁴ Paragraphs 3.65 and 3.75 CMA’s Update Paper

⁵ Paragraph 2.62 of the CMA’s Update Paper

⁶ Paragraph 2.20 of the CMA’s Update Paper

⁷ Paragraphs 3.112 and 3.115 of the CMA’s Update Paper

⁸ Paragraph 3.155 of the CMA’s Update Paper

⁹ The Audit Firm Governance Code applies to firms auditing 20 or more listed companies



The CMA's proposed remedies

In terms of the proposed remedies, we have considered these proposals in light of the principles of quality, effective implementation, proportionality, potential risk and unintended consequences referred to by the CMA in its Update Paper.¹⁰

We are supportive of the recommendations the CMA has made in relation to regulatory oversight of Audit Committees. As noted above, the CMA's evidence is that audit quality is a key driver in the selection and appointment process. But we can see how greater transparency and disclosure between the regulator and Audit Committees, when they assess audit quality at the tender stage and beyond, could assist in maintaining that prominence and reduce any perceived concerns around the influence of *'cultural fit'*. It could also facilitate a more consistent approach between selection processes and address the concerns observed by the CMA around the current differences in approach, time and resource between Audit Committees, *"including between similar companies"*.¹¹ We provide details in the annex as to how such reforms might be introduced.

In considering how both to improve choice whilst protecting audit quality we would also be supportive of the introduction of a temporary market share cap for the FTSE 350 audit market. We agree with the provisional view of the CMA that a market share cap *"could deliver a substantial increase in the number of challenger firms auditing the largest companies in a relatively short period of time"*¹² and believe such a remedy would be more effective than joint audits in increasing choice. The introduction of a temporary market share cap combined with changes to the regulatory oversight of auditor appointments and a new regulator with a focus on competition would provide a structure for substantial change. We believe that, with careful implementation, market share caps could be introduced in a manner so as to mitigate risk to audit quality and would support the CMA in exploring this further. We set out our thoughts on this below, including the potential for Audit Committees or the regulator to choose to use shared audits to facilitate that transition.

We have also carefully considered the proposals put forward for joint audits but do not believe that persuasive evidence has been produced as to why this remedy would deliver on choice or quality. The CMA reports that most of the Audit Committee Chairs it spoke to opposed mandatory joint audits and investors were no more than "mixed" in their view.¹³ We are open to measures that increase the number of audit firms serving the largest companies. But as we explain in more detail below, we do not think choice would necessarily increase and we are concerned that the proposals could create significant audit risk. The CMA only has *"some confidence"* based on *"limited evidence"* *"that choice would increase as a result"* of mandatory joint audits.¹⁴ Further, the CMA is aware that prices will increase, and can only *"expect that the introduction of mandatory joint audit in the UK would not lead to a reduction in audit quality"*.¹⁵ This is at odds with the finding of the Competition Commission, which, following its in-depth market investigation, ruled out joint audit in part on quality grounds.¹⁶

¹⁰ Paragraph 4.5 of the CMA's Update Paper

¹¹ Paragraph 3.40 of the CMA's Update Paper

¹² Paragraph 4.87 of the CMA's Update Paper

¹³ Paragraph 4.41 of the CMA's Update Paper

¹⁴ Paragraph 4.49 of the CMA's Update Paper

¹⁵ Paragraph 4.55 of the CMA's Update Paper

¹⁶ Paragraph 17.101 of the Competition Commission's report on the provision of statutory audit services to large companies in the UK, dated 15 October 2013: https://assets.publishing.service.gov.uk/media/5329db35ed915doe5d00001f/131016_final_report.pdf



We also consider that any operational or structural split of the firms would be a disproportionate response, would not lead to increased choice and would undermine rather than enhance audit quality. The multi-disciplinary practice enables us seamlessly to draw on specialist expertise in the audit, to invest in audit technology and to attract top talent to the audit profession. Our continuing ability to draw on our international network is also key. The CMA recognises the threat to quality, but has said that “*these risks to quality and efficiency could be mitigated*”.¹⁷ Given the fundamental importance of audit quality, and the fact that almost all relevant stakeholders referenced were opposed to structural separation, we do not believe that the CMA should be recommending such an interventionist and potentially harmful remedy. We also do not see how an operational split, of the kind suggested by the CMA, would improve choice. Given the complexity of the international regulatory frameworks which govern independence restrictions on many companies, it is unlikely that the advisory business could avoid most scope of service restrictions within the current framework. Agreement to change would need to be discussed and accepted by the international regulators and there would likely need to be legislative change.

We remain open to working with the CMA and others (including the new regulator) to analyse the evidence, examine how the market is changing and design remedies which improve and protect audit quality. Any remedies will need to work in both a UK and international context and not undermine the UK’s standing as a place to do business and to procure audit. We would be pleased to discuss these issues with you at any point in the market study.

Yours sincerely

Margaret Cole
General Counsel and Chief Risk Officer

¹⁷ Paragraph 4.128(a) of the CMA’s Update Paper



CMA Statutory Audit Services Market Study

ANNEX TO RESPONSE TO UPDATE PAPER

We set out below our responses to the CMA's consultation questions in the Update Paper dated 18 December 2018. These should be read together with our accompanying letter, which sets out our overarching views on the issues raised by the CMA's Update Paper. In a number of places below, we have combined related questions into a single answer.

A) Issues

1. Do you agree with our analysis in section two of the concerns about audit quality?

- (a) The CMA is right to focus on the improvement of audit quality as the primary objective of this market study. As the CMA notes at paragraph 2.4 of its Update Paper *"The unanimous view of stakeholders is that the most important outcome in this market is audit quality."*
- (b) The CMA reaches three key conclusions regarding audit quality as a result of its assessment:
 - (i) audit quality is difficult to observe;
 - (ii) there have been a number of high profile corporate and audit failures which have had a wider societal impact; these have undermined trust in audit; and
 - (iii) poor audit quality is likely to be more widespread; these audit failures are unlikely to be isolated events.

We have commented below on the first two of these conclusions where our views are broadly in alignment with the CMA's. However, we disagree strongly with the third conclusion and do not believe that the CMA has gathered a compelling evidence base to support this view.

Our overall views on audit quality

- (c) We do not agree that poor audit quality is widespread, or that recent audit failures are unlikely to be isolated events. In our view, the quality of the many thousands of audits performed each year in the UK is considered to be high. Much of the evidence gathered from key stakeholders supports this. For example:
 - (i) Paragraph 2.5 of the Update Paper: *"On the whole, Audit Committee Chairs did not share the view that there was a systemic and significant quality problem."*
 - (ii) Paragraph 2.62 of the Update Paper: *"Overall, the balance of views from Audit Committees and investors was that audit in the UK is generally of a high quality."*
 - (iii) Paragraph 2.62 of the Update Paper: *"...the recent FRC survey of ACCs..suggested that 86% of respondents rated their external auditor as either "excellent" or "above average"."*
- (d) It is notable in this evidence that those most able to observe the actual performance of audit (Audit Committee Chairs) are a community with the consistent view that audit quality is generally high.
- (e) In addition:

- (i) The CMA has relied on the FRC's Audit Quality Review Team (AQRT) results to support its conclusion that poor audit quality is widespread. The AQRT approach, which necessarily focuses on compliance and documentation, does not give a complete insight into the overall quality of the audit; it is also based on a small sample size. Notwithstanding this, we note that over the period since 2011, as illustrated in Figure 2.17 of the CMA's Update Paper, the AQRT results show an overall upward trend of improvement, with only a small downturn in 2018.
- (ii) The CMA concludes that recent corporate failures are also indicative of a widespread quality problem. These failures, although very important, do not provide compelling evidence of quality issues in the thousands of audits undertaken each year by the audit profession.
- (iii) At paragraph 2.60 of the CMA's Update Paper, the CMA sets out "*some recent international examples of audit problems*". Each of the territories listed operates within a different framework, with corporate governance and regulatory approaches which are different from those within the UK. It is therefore not possible to use this data as evidence of the likelihood of systemically poor audit quality within the UK.

Observing audit quality

- (f) As noted at paragraph 2.39 of the CMA's Update Paper, there is no single agreed definition of audit quality. We believe that it will be important for Sir Donald Brydon to tackle this foundational issue in his independent review of audit standards.
- (g) The inspection results of the FRC's AQRT are the most commonly used measure of audit quality, and the CMA draws heavily on these results in the analysis in chapter 2 of its Update Paper. We agree that the inspection results are useful, but it is important to understand properly the context and approach of the AQRT's work before reaching conclusions. In particular:
 - (i) The AQRT does not seek to evaluate the overall conclusion of the audit i.e. whether the right audit opinion has been issued. Instead, the AQRT considers a sample of the work performed in a selection of audit areas, and makes an assessment of whether that work has complied with auditing standards.
 - (ii) The AQRT bases its work upon a review of the audit documentation assembled by the audit team, and the review takes place after the completion of the audit. This means that there is no way for the AQRT to observe the actual challenge which may have taken place during the audit. It is often difficult to capture the reality of this challenge process within the constraints of audit file documentation.
- (h) The CMA itself notes (in paragraph 2.51 of the Update Paper) that "*findings may not be representative of the population of FTSE 350 audits and we need to be particularly cautious in interpreting trends over time. The FRC itself recognises that "as that sample is not statistical, we have to be careful in drawing definitive conclusions"*.¹⁸ The AQRT selects audits for review using a risk-based approach, choosing those audits where it considers there are more likely to be issues.

¹⁸ p.6 FRC's Developments in Audit 2018:

<https://www.frc.org.uk/getattachment/5e1ac2d1-f58c-48bc-bb91-1f4a189df18b/Developments-in-Audit-2018.pdf>

- (i) In addition to the AQR results, there are other sources of evidence that can be used to assess audit quality. These include the recently introduced long-form audit reports published in respect of the audits of public interest entities, and the extensive information disclosed by large audit firms in their Transparency Reports. As yet, this type of evidence is not used consistently by Audit Committees, investors and other stakeholders in their assessments of audit quality. We suggest that the newly-established audit regulator could consider ways to encourage better engagement with this information.
- (j) Establishing a common understanding of good audit quality is an important issue to address. We suggest that the following interventions should be considered:
 - (i) Engagement between Audit Committees and the new regulator, the Audit, Reporting & Governance Authority (ARGA) to develop a common understanding of the Audit Committee's role and responsibilities in assessing audit quality. This could form part of the design and implementation of the CMA's Remedy 1; and
 - (ii) Consideration of changes to the AQR's scope, approach and reporting to make AQR results a more useful guide to good audit quality.

The impact of high profile corporate failures

- (k) We agree with the CMA that a number of recent high profile corporate failures have damaged stakeholders' trust in audit. While the causes of corporate failures vary, it is clear that the public tends to conclude that they arise from audit failures regardless of the facts. As a result, we have been consistent in recognising that action is needed to restore trust in audit, and that audit firms must be ready to embrace change as a consequence.
- (l) In considering these incidents, we also believe that it is important to properly diagnose the issues which have led to failure. In particular:
 - (i) We must improve audit quality in order to minimise the risk of future audit failure, but more could be done within the corporate reporting framework to raise business risks and challenges. Sir John Kingman has made a number of recommendations in this regard including powers for the new regulator to require rapid explanations from companies about reasonable concerns raised by the regulator and consideration of a strengthened framework for internal controls in the UK, similar to the Sarbanes-Oxley regime in the US. This warrants further consideration; and
 - (ii) In some cases, the perception of audit failure has been exacerbated by the gap that exists between the public's expectation of what audit should do, and the statutory framework that governs auditors' responsibilities. The CMA notes that one of its respondents states "*unless we are clear on the scope and purpose of audit, it is difficult to comment meaningfully on the quality of audit provision*".¹⁹ We agree with this statement and look forward to the outcome of Sir Donald Brydon's work in this area.

¹⁹ Paragraph 2.70 of the CMA's Update Paper



2. Do you agree with our analysis of the issues that are driving quality concerns, as set out in section three? In particular:

- a) Issues relating to the role of Audit Committees and investors in the process of appointing and monitoring auditors;**
- b) Limitations on choice leading to weaker competition;**
- c) Barriers to challenger firms for FTSE 350 audits;**
- d) Resilience concerns; and**
- e) Wider incentive issues raised by the multi-disciplinary nature of the large audit firms.**

Role of Audit Committees and investors in the process of appointing and monitoring auditors

- a) In our experience, Audit Committees take their responsibilities for auditor selection and monitoring very seriously. They understand the fundamental importance of audit quality and use this to guide their decisions. We do not agree with the CMA's assertion at paragraph 3.4(a) of the Update Paper that "*Selection and oversight of auditors is insufficiently focussed on quality*".
- b) The CMA also states (at paragraph 3.10 of the Update Paper) that "*Audit Committees cannot observe directly the quality of the audit work undertaken.*" Again, this is not our experience. High performing, engaged Audit Committees ask the right questions of auditors in order to assess the quality of their work; they also have frequent opportunities to observe the challenges that auditors present to management. We recognise, however, that standards can vary, and we would encourage the regulator to share examples of Audit Committee good practice in order to improve consistency.
- c) The CMA notes (at paragraph 3.42 of the Update Paper) that most stakeholders interviewed suggested that investors have little engagement with audit matters. We agree with this observation. Although in recent years, the level of detail disclosed in both audit reports and in Audit Committee reports has increased greatly, in our experience it is unusual for shareholders to engage with this disclosure. We support the recommendation of Sir John Kingman for a fundamental shift in approach in stewardship. Increased engagement and challenge from shareholders would sharpen the focus of Audit Committees on audit quality even further.
- d) In order to encourage this greater engagement, Audit Committees' actions in terms of selection and oversight of auditors could be made more transparent. We discuss this further in our response to Remedy 1.

Limitations on choice leading to weaker competition

- e) In our experience, competition is fierce in the large company audit market; the CMA notes at paragraph 3.71 of the Update Paper that rates of tendering and switching have increased dramatically since 2012. Moreover, we believe that the market interventions made by both the Competition Commission and by the European Parliament have increased the degree to which competition focuses on audit quality. This means that we do not agree with the premise that the level of choice in the large company audit market has impacted audit quality.

- f) Notwithstanding this, we would welcome increased choice in the large company audit market.
- g) The CMA observes in paragraphs 3.89 to 3.94 of the Update Paper that conflict issues can limit choice of auditors in this market. Whilst we recognise this issue, we also note that, increasingly, Audit Committees are taking proactive steps to manage conflicts in advance of audit tenders in order to maximise their choice at the point of tender. The CMA suggests that this practice should be monitored by the regulator as part of Remedy 1; we support this proposal.

Barriers to challenger firms for FTSE 350 audits

- h) The CMA has identified a number of demand-side and supply-side issues that may have impacted the ability of challenger firms to participate fully in the FTSE 350 audit market. Whilst we recognise some of these factors, we do not believe that there is a substantial evidence base to demonstrate that they have created insurmountable barriers to entry for the challenger firms.
- i) Notwithstanding this, we do not believe that these factors have had a negative impact on audit quality. As noted above, competition among the four largest firms is fierce and a key driver for Audit Committees' selection decisions is quality. Since the challenger firms have not yet participated in a significant proportion of the FTSE 350 audit market, the impact on audit quality of their entry into this segment cannot yet be fully evaluated although we note that the CMA points to evidence suggesting that the larger firms are likely to provide higher quality audits.²⁰

Resilience concerns

- j) As the CMA recognises, the resilience of the statutory audit market is vital to maintain choice and competition. We also agree that, whilst the risk is small, the failure of one of the large audit firms could have a negative impact on audit quality as any unplanned process of transitioning audit clients to another firm would increase audit risk.
- k) We also note that the provision of audit services by firms is a choice and therefore, when considering resilience in the light of other proposed reforms, there should be an evaluation of how to maintain the attractiveness of the market, in particular the FTSE 350 market, for all firms.

Wider incentive issues raised by the multi-disciplinary nature of the large audit firms

- l) At paragraph 3.156 of the Update Paper, the CMA notes a concern that the culture of the four largest firms is driven by non-audit services, with a suggestion that this therefore has a negative impact on audit quality. We do not believe that the CMA has gathered empirical evidence to support this concern.
- m) Non-audit services to audit clients have reduced significantly since the implementation of the Ethical Standard,²¹ which requires that at a client level there is very limited opportunity or

²⁰ Paragraph 3.112 of the CMA's Update Paper

²¹<https://www.frc.org.uk/getattachment/Obd6ee4e-075c-4b55-a4ad-b8e5037b56c6/Revised-Ethical-Standard-2016-UK.pdf>



incentive to sell non-audit services to audit clients due to caps on non-audit services. This is supported by the CMA's analysis in paragraph 3.155 of its Update Paper that *“overall, we found limited evidence of conflicts between audit and non-audit work at the client level, primarily because of the restrictions in place on cross-selling”*.

- n) At the level of the audit firm, there remains significant incentive for the audit practice to generate growth in the market as it currently stands.
- o) We discuss the CMA's proposed separation remedies (Remedy 5) in further detail below. We do not support any such remedies as they could have a negative impact on audit quality and have been insufficiently supported by an evidence base.

B) Remedies

For all remedies:

3. What should the scope of each remedy be? Please explain your reasoning. For example, should each remedy apply to all FTSE 350 companies, or be expanded to include PIEs or large privately-owned companies that could be deemed to be in the public interest?

Where relevant, we deal with this in our comments on the remedies below.

Remedy 1: Regulatory scrutiny of Audit Committees

4. How could the regulatory scrutiny remedy be best designed to ensure that the requirements placed on Audit Committees by a regulator are concrete, measurable and able to hold Audit Committees to account? Please respond in relation to requirements both during the tender selection process and during the audit engagement.

- a) We understand that the objective of Remedy 1 is to ensure that Audit Committees fully protect the interests of shareholders when making decisions about auditor selection and monitoring the audit engagement, which, in turn should improve incentives for high quality audits.
- b) In our experience, Audit Committees, particularly of larger listed companies, take their responsibilities for auditor selection and monitoring very seriously. They understand the fundamental importance of audit quality and use this to guide their decisions.
- c) This said, we understand that additional regulatory oversight of Audit Committees could help reinforce their role as representatives of shareholders in appointing and monitoring auditors. It could also facilitate sharing of good practice in assessment of audit quality which, as the CMA notes in paragraph 2.73 of the Update Paper, is a challenging exercise. Therefore we support the principle of proposed Remedy 1. We suggest that the remedy should be applied to Audit Committees of FTSE 350 companies; it is in this segment of the market where public scrutiny is most focussed and where there is the greatest need for a restoration of trust. It would be most effective for the finite capacity of the regulator to be focussed on this segment.

- d) In our response²² to the CMA's Invitation to Comment²³ we emphasised the importance of the company (through the board and the Audit Committee) keeping responsibility for auditor selection and appointment and we are pleased that the proposed Remedy 1 upholds that principle. Audit Committees form a critical element of the corporate reporting framework and we would not support any remedy that disempowered them in this role.
- e) We do not believe that proposed Remedy 1 will be effective in increasing choice in the large company audit market. However, in the event that policy-setters decide to pursue a market share cap remedy, an enhanced version of Remedy 1 could be used to effect a managed transition to market share targets.

Design of the remedy

- f) As we explain below, there are existing reporting requirements which mean that Audit Committees must disclose publicly their approaches to audit tendering and to ongoing monitoring of audit effectiveness. We believe that the most efficient approach to designing this remedy would be to take advantage of existing reporting requirements, with enhancements to these requirements where necessary. This would reduce the need for additional reporting and other oversight procedures between Audit Committees and the regulator, and would have the added benefit of increased transparency to stakeholders.
- g) In Sir John Kingman's report of his Independent Review of the Financial Reporting Council,²⁴ at Recommendation 29, he suggests that the newly formed Audit, Reporting and Governance Authority (ARGA) should extend its corporate reporting review process to the entire annual report, including corporate governance reporting. This review process could be used as the "first line" of regulatory review, with additional oversight, including inspection of evidence and interviews with or observations of Audit Committees, being deployed on the basis of criteria, and with a frequency, determined by the regulator.

Existing reporting requirements - over tendering processes

- h) Increased scrutiny of Audit Committees, through enhanced reporting on tender processes, could be implemented through existing regulation, as set out below.
- i) All premium listed companies (whether incorporated in the UK or overseas) are already subject to a UK Corporate Governance Code (UK CGC) disclosure provision on tendering that requires the Audit Committee, to explain "*how it has assessed the effectiveness of the external audit process and the approach taken to the appointment or reappointment of the external auditor, information on the length of tenure of the current audit firm, when a tender was last conducted and advance notice of any retendering plans*". This could be enhanced with guidance from ARGA. The Audit Committee could also be asked to justify any decisions made regarding the inclusion of challenger firms in the tender process.

²² <https://assets.publishing.service.gov.uk/media/5bec32bc40f0b667a46ce0c4/pwc.pdf>

²³ https://assets.publishing.service.gov.uk/media/5bbc66f3e5274a222b994bfd/invitation_to_comment.pdf

²⁴ https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/767387/fr-c-independent-review-final-report.pdf

- j) All UK incorporated FTSE 350 companies are subject to the CMA Order²⁵ which requires that where their Audit Committee has not tendered the audit for five consecutive financial years, they set out in the company's annual report the financial year in which they plan to tender the audit and to justify why that is in the best interests of the shareholders. There is also a requirement for this to be set out in each subsequent annual report until the tender process has taken place. This reporting requirement could also be enhanced or refined.
- k) Similarly, the EU Audit Regulation Article 16(3)(f) requires that "*the audited entity shall be able to demonstrate, upon request, to the competent authority referred to in Article 20 that the selection procedure was conducted in a fair manner.*" This requirement was introduced into the UK Companies Act 2006 via the Statutory Auditors and Third Country Auditors Regulation (SATCAR) 2016. The Companies Act 2006 now states in section 489A that "*Before the audit committee makes a recommendation or the directors make a proposal under subsection (3) the committee ... must carry out a selection procedure in accordance with Art 16(3) of the Audit Regulation*". Again, how this provision is interpreted could allow for greater reporting on how the tender process was carried out.
- l) The CMA also suggests that companies could report to the regulator during an audit tender process. Such real-time reporting would not fit naturally with a company's regular annual reporting cycle. We would propose that following the disclosures made before an audit tender (as contemplated by the UK CGC), the regulator could select (on the basis of risk) a sample of companies who would be required to report to the regulator during the tender.

Existing reporting requirements - over ongoing monitoring activities

- m) All premium listed companies are already subject to provision C.3.8. of the UK CGC which requires that a separate section of the annual report should describe the work of the Audit Committee in discharging its responsibilities. The provision notes that the report should include an explanation of how the Committee has assessed the effectiveness of the external audit process. In existing UK CGC guidance the FRC suggests a number of areas that could be considered in an assessment of audit quality, including consideration of mindset and culture; skills, character and knowledge; quality control; and judgment, including the robustness and perceptiveness of the auditors in handling key judgements, responding to questions from the Audit Committee, and in their commentary where appropriate on the systems of internal control. However, it is rare to see a discussion of some or all of these criteria.
- n) As with tendering reporting requirements, ARGA could review this disclosure as the "first line" of review, and supplement this review with more active oversight where specific risks are identified. ARGA could also update the disclosure guidance to include a suggestion that Audit Committees should give examples of what they have done to monitor audit quality.

Other proposed elements of the proposed remedy

- o) With regard to making public the results of audit quality assessments, we support a more transparent approach. However, this recommendation should not be implemented under the FRC's current Audit Quality Review approach and grading system. Currently, the grading issued reflects only those areas of the audit which have been examined, rather than the audit

²⁵ CMA Order 2014:
https://assets.publishing.service.gov.uk/media/54252eae40f0b61342000bb4/The_Order.pdf



as a whole, and therefore could easily be misinterpreted. Making such information public would run the risk of destroying confidence in the integrity of the associated financial information when this may not be warranted.

Remedy 2: Mandatory joint audit

5. What should the scope of this remedy be? Please explain your reasoning.

- a) **Should the requirement to have a joint audit apply to all FTSE 350 companies or potentially go wider by including large private companies?**
- b) **What types of companies (if any) should be excluded from a requirement for joint audit?**

6. Should one of the joint auditors be required to be a challenger firm? If so, should this be required for all companies subject to joint audit? Are there any categories of companies to which this requirement should not apply? Please explain your reasoning for each of the answers.

7. Should a minimum amount of work (and fee) allocated to each joint auditor be set by a regulator? If so, should the same splits apply across the FTSE 350? (please comment on the illustrative examples in section four). Please explain your reasoning.

8. Our provisional view is that there would be merit in the joint auditors being appointed at different times. Should this be mandated, or left to the choice of individual companies? How should companies manage (or be mandated to manage) the transition from a single auditor to joint auditors?

9. Should a joint liability framework be introduced to encourage active participation in the market by the Big Four and challenger firms? Please explain your reasoning. In the context of joint audits, what are the advantages or disadvantages of auditor liability being proportionate to the audit fee of the joint auditors, compared to the auditors being jointly and severally liable?

- a) We do not support the proposals to introduce mandatory joint audit as we do not believe an evidence based case has been made to demonstrate that these proposals will lead to improved choice and quality. The CMA acknowledges that most of the Audit Committee Chairs expressed opposition to this remedy (many on grounds of audit quality) and the views of investors were mixed (paragraph 4.41). Mandatory joint audits were also rejected by the Competition Commission at the conclusion of its thorough market investigation in 2013 for a number of reasons including cost implications for businesses and the threat they posed to audit quality. We do not see any evidence that would contradict those findings. Further, we do not consider that joint audit would enhance choice, or effectively remove barriers faced by challenger firms.

Quality considerations

- b) The CMA has acknowledged that the economic and empirical evidence it has reviewed does not point to a reduction or increase in audit quality if joint audits were to be implemented. However, it is vital that audit quality is not diminished and we think there are material risks to audit quality in a joint audit regime. A number of stakeholders that we have spoken to with

experience of joint audits have expressed concerns about the risks to audit quality and effectiveness that arise from fragmentation of accountability inherent in such a regime. The CMA itself highlighted a number of quality concerns such as the potential for “*the smaller of the joint auditors... to ‘free ride’ on the effort of the larger audit firm*”,²⁶ or the increased risk that management may try to ‘opinion shop’ between the two auditors.²⁷ We believe that joint audits could lead to a lack of clear accountability between the two firms which increases audit risk and complexity.

Choice considerations

- c) A mandatory joint audit remedy may not lead to more choice as every company would need two auditors and the CMA has indicated this would be one from a challenger firm and one from the larger four firms. This would effectively create two audit markets for FTSE 350 companies: the first would involve the largest audit firms competing for one of the joint audit mandates; and the second where challenger firms compete for the other joint audit mandate.
- d) In the first of these markets there would be no change in the number of audit firms from which the Audit Committee could select the auditor, and therefore no increase in choice for today’s market. In the second of these markets the level of choice would be determined by the number of challenger firms with the capability, capacity and willingness to compete. For choice in the second market to equal that of the first there would need to be at least four challenger firms able and willing to compete across the whole FTSE 350. Unless choice in the second market equalled that of the first there would be an effective reduction in choice for companies.
- e) In some circumstances such as the bank audit market, where the CMA suggests that a joint audit between two of the largest four firms would be needed, in the short to medium term this would leave UK banks with less or potentially no choice at the point of rotation.
- f) This remedy would only give rise to any significant change in choice and competition once the joint audit requirement was removed. At that point, there could be competition for audit mandates between a greater number of firms. The time required to reach this point would be significantly longer than, for example, the time it would take to impose and reach a market share cap target.
- g) In France, where joint audits have been operating for over 50 years, Mazars remains the only challenger firm with a significant market share of audits within the CAC40, suggesting that joint audits are ineffective in significantly increasing choice of auditor for the largest companies.

Barriers faced by challenger firms

- h) The main stated aim of this remedy is to reduce the barriers to auditing large companies faced by the challenger firms. This remedy does not address the barriers but allows challenger firms to bypass them by relying on the capacity and capability of the larger audit firms. This may not enable challenger firms to compete directly with the larger firms.

²⁶ Paragraph 4.53 of the CMA’s Update Paper

²⁷ Paragraph 4.53 of the CMA’s Update Paper

- i) Our view that the barriers are not addressed by this remedy is consistent with that expressed by the Competition Commission following the conclusion of its full market investigation in October 2013:²⁸
- “17.99: In relation to joint audit, we considered that companies would continue to have incentives to engage audit firms who could demonstrate experience and global coverage and that such a remedy would have little effect on barriers to entry, expansion and selection.”*

Other considerations

- j) There are also significant practical and operational impacts with a mandatory joint audit remedy that need to be considered more fully. These include considerable cost increases and demands on Audit Committees and the regulator.
- k) Were joint audits to be pursued as a remedy, the UK liability regime for auditors would need to be re-considered. We suggest that the guiding principle would have to be what is fair and reasonable in all the circumstances for the stakeholders and for liability to be proportionate to the degree of responsibility taken by each auditor for the work. In addition, although the Companies Act 2006 provisions²⁹ which permit liability capping for audit (subject to shareholder approval) have not gained market acceptability, we cannot envisage conducting a joint audit without liability caps.
- l) Having reviewed the published responses to the CMA’s invitation to comment we question why the CMA is pursuing a remedy that would mandate something that is already available but not widely used and does not appear to have the support of the majority of Audit Committees or investors. Joint audits are rarely required, with France being a notable exception. Whilst the 2014 EU Audit Regulation incentivises companies to adopt a joint audit through increasing the permissible audit tenure, joint audits have not been adopted by a significant number of European companies.

Remedy 2A: Market share cap

10. How could the risks associated with a market share cap, such as cherry picking, be addressed?

11. Would it need to apply only to FTSE 350 companies, or also to other large companies, and if so, which?

- a) We believe that the introduction of a market share cap as a temporary measure for FTSE 350 companies would be more effective than joint audits in increasing choice for large listed companies. Taken together with reforms to regulatory oversight of the appointment of auditors and a new statutory regulator with a focus on competition this would create a framework for significant change.
- b) A market cap that limits the market share of the largest audit firms to 80% in aggregate would allow the challenger firms to build their capability and develop their experience of auditing FTSE 350 companies. A market cap would not be straightforward to implement and further

²⁸ https://assets.publishing.service.gov.uk/media/5329db35ed915doe5d00001f/131016_final_report.pdf

²⁹ Sections 534 to 537 of the Companies Act 2006



consultation with Audit Committees, audit firms and the new regulator would be required to ensure the design of the remedy was effective.

Choice considerations

- c) We agree with the CMA's assessment that in the short term this remedy would reduce choice for a number of companies in the FTSE 350 but would lead to a substantial increase in the number of challenger firms auditing the largest companies over the short to medium term. This would lead to increased competition in the FTSE 350 once the cap was removed. We believe that the increase in competition would be achievable in a shorter time frame through a market cap than through mandatory joint audits.
- d) We believe this remedy should apply to the FTSE 350 because the objective is to increase choice and outside of the FTSE 350 there is more choice. The challenger firms have a greater than 20% market share of all companies listed on the London Stock Exchange and a market share of approximately 60% of AIM listed companies.

Quality considerations

- e) We believe that an 80% cap could be reached in the medium term (approximately 5 years) through the expected mandatory firm rotation schedule. This would prevent the larger audit firms 'cherry picking' their clients. Whilst change would have to be mandated for 20% of companies in order to achieve greater choice, the Audit Committee (as representatives of shareholders) would retain the decision over the form that the transition takes to protect quality. This could be done in consultation with the new regulator. For example, for a UK based company in an industry where the challenger firms have experience and can demonstrate capacity the Audit Committee may make the transition to a challenger firm as sole auditor with a larger firm not being invited to tender for the audit. For a global multinational, particularly in an industry where the challenger firms have limited experience, the Audit Committee may choose to transition through using a shared audit mechanism whereby specific components of the audit could be performed by a challenger firm. Such shared audits could count as being part of the market segment occupied by challenger firms.
- f) With a market cap each company would continue to have one auditor responsible for the overall audit. This would allow Audit Committees and the new regulator to form a clear view of the audit quality achieved by each firm operating in the market, which Audit Committees could then use to directly compare firms. This may be harder to do under a joint audit regime. A market cap would also ensure that each audit would have a clear, single point of accountability.

Barriers faced by challenger firms

- g) As with mandatory joint audits, a market share cap would not address all of the issues faced by the challenger firms. However, we believe that a number of these issues would be better addressed through a market cap than through mandatory joint audits. In particular a market cap would ensure that the challenger firms receive the maximum financial return for the audits they perform.

Conclusion

- h) Working within the current tendering timetable, we consider that it would be possible to facilitate the introduction of a temporary 80% cap on the number of FTSE 350 companies audited by the largest four firms over a five year period. We believe that a market cap of this nature could lead to improvements over time in both the breadth of experience and capacity of challenger firms. It is also the only clear route to improving choice by enabling direct competition between all firms in the market once the cap is removed as set out in paragraph c) above.

Remedy 3: Additional measures to reduce barriers for challenger firms

12. We welcome evidence from stakeholders on the existence of barriers to senior staff (including partners) switching quickly and smoothly between firms. We also welcome views on how justified such barriers are, bearing in mind commercial considerations that audit firms have.

13. We welcome estimates on the costs of setting up and running a tendering fund or equivalent subsidy scheme, and views as to how this should be designed.

14. We welcome comments as to whether the Big Four should be compelled to license their technology platforms at a reasonable cost to the challenger firms, and/or contribute resources (financial, technical, algorithms and data to enable machine learning) towards developing an open-source platform. In the first scenario, we also welcome comments on how such a 'reasonable cost' might be determined in such a way that it is affordable for challenger firms but does not disincentivise Big Four firms from innovating and developing new platforms.

- (a) We would be open to discussing arrangements that would enable challenger firms to benefit from the experience, resources and know-how of the largest firms, provided that any such arrangements were carefully designed to enhance - and not undermine - competition.
- (b) Our experience is that there are limited barriers to partners and senior staff moving between firms and it is common for individuals to move firms in both directions (i.e. to and from the four largest firms and challenger firms), for example for directors in a larger firm to move to become partners in a challenger firm. Reasonable notice periods are necessary to ensure continuity in the provision of high quality audit services, and the complete elimination of notice periods could be detrimental to the provision of those audit services. We would be open to exploring with the CMA whether there is evidence that suggests there are barriers preventing individuals moving quickly and smoothly between firms, and if so what can be done to address those barriers.
- (c) The creation of a tendering fund or equivalent subsidy scheme could incentivise challenger firms to participate in more tenders, by helping to mitigate some of the financial risk involved. However, our view is that this in isolation would not be effective in supporting challenger firms in being selected as auditor.
- (d) In our opinion, the implementation of a temporary market share cap would negate the need for a tendering fund as challenger firms would compete directly with each other for the company audits within the cap with a greater likelihood of being appointed and receiving the



financial reward (i.e. the audit fee).

- (e) We would be open to exploring potential commercial arrangements for the sharing or licensing of technology between firms although this may be complex and would need further consideration. (By way of example, much of PwC's technology is held at a global level). In addition, the unintended consequences of technology sharing would need to be thought through. For example it could lead to dis-incentivising firms to innovate, which in turn could have a detrimental effect within the market on the development of new audit technologies.
- (f) As we have noted above, we would be willing to share our experience with staff from challenger firms, for example by means of secondment arrangements and/or involvement in internal training days.

Remedy 4: Market resilience

15. How could a resilience system be designed to prevent the Big Four becoming the Big Three, not just in the case of a sudden event, but also in the case of a gradual decline? Please also comment on our initial views to disincentivise and/or prohibit the movement of audit clients (and staff) to another Big Four firm.

16. How could such a system prevent moral hazard? Please comment on our initial view.

17. What powers would a regulator and a special administrator require, and how would their roles be divided? At what point should a regulator or a special administrator be able to exercise executive control over a distressed firm? Please comment on our initial view.

18. What could be done regarding the challenges relating to the fact that an audit firm's value lies in its people and clients – which would be complicated to restrict? Please comment on our initial view.

- a) As the CMA recognises, the resilience of the statutory audit market is vital to maintain choice, competition and audit quality. It will be important that any reforms work to support market resilience and not to undermine it. This means that the audit market needs to continue to be commercially attractive and audit firms need to remain robust. In this regard, we would reference the CMA's own conclusions in paragraphs 3.136 and 3.137 of its Update Paper that recent experience suggests the four largest firms appear to be resilient and that one of the contributing factors to this is likely to include *“the size of these firms and the support provided by their international networks.”*
- b) We are supportive of work to design a system to enhance the resilience of the market further, particularly as the continuity of audit firms and/or orderly transfer to another provider is not the focus of the current legislative framework, as the CMA has recognised,³⁰ and the regulator does not have the power to intervene or to promote a market solution to a crisis event affecting an audit firm.

³⁰ Paragraphs 4.105 and 4.106 of the CMA's Update Paper

- c) However, as recognised by the CMA in its Update Paper, designing such a system is complex. Audit firms are businesses with people and knowledge at their core: partners and staff are able to move firms and to other employers with few restrictions. Audit firms are highly dependent on trust and confidence in their brand for their continued existence and it is highly likely that, if trust or confidence was significantly eroded, the firm would quickly be in distress and partners and staff may seek to leave. Any incentives to retain audit partners or staff would need to be financial. Under the current arrangements for auditor appointment, it would be challenging to prohibit the movement of audit clients to another audit firm as the appointment is made by the company, not the audit firm.
- d) We suggest that an approach to designing a resilience system might follow three stages:
 - i) The large audit firms could be required to produce plans which reflect an orderly wind up of their business. This is already encompassed within the FRC's Audit Firm Monitoring and Supervisory Approach as we note below (at (e)).
 - ii) The new regulator might consider how to foster the appropriate regulatory conditions to enable orderly resolution. This might include, for example, a market solution whereby the firm or parts of its business might be transferred to another firm with the provision of regulatory reliefs as necessary to achieve this. This would be likely to require regulatory and/or legislative change.
 - iii) Plans could also be developed for directing resolution through a central agency such as a regulator or special administrator, which might step in as a last resort to manage the situation in the short term.
- e) There are practical advantages to adopting this approach. The largest firms already have business continuity plans in place and are in the process of documenting resolution plans. Under the Audit Firm Monitoring and Supervisory Approach, the FRC already reviews these plans and monitors the firms' risk. We are supportive of the Kingman recommendation for the new Audit, Reporting and Governance Authority to be given a statutory mandate to keep the market under review and would support ongoing discussions with the new regulator as to the sufficiency and application of the firms' resolution plans.
- f) Any measures which provide for a special administrator regime for large audit firms would need careful implementation. The challenges of continuing the business of a large audit firm in a special administration for any length of time should not be underestimated.

Remedy 5: Full structural or operational split

19. Do you agree with the view that the challenges to implement a full structural split are surmountable (especially relating to the international networks)? If not, please explain why it would be unachievable, i.e. that the barriers to implement this remedy could never be overcome, including through a legislative process.

20. How could an operational split be designed so that it would be as effective as the full structural split in achieving its aims, without imposing the costs of a full structural split? In your responses, please also compare and contrast the full structural split to the operational split.

21. With regards to the operational split, please provide comments on:

- a) **implementation risks and whether they are surmountable: e.g. how any defined benefit pension schemes could be separated between audit and non-audit services;**
- b) **risks of circumvention and how they could be addressed e.g. how audit firms could circumvent the remedy through non-arm's-length transfer pricing and cost allocations;**
- c) **implementation timescales to separate the audit firms and how soon the remedy could be brought into effect;**
- d) **ongoing monitoring costs for the audit firms and a regulator;**
- e) **role and competencies of a regulator in overseeing ongoing adherence to the operational split.**

22. Under an operational split, how far, it at all, should it be possible to relax the current restrictions on non-audit services to audit clients? For example through changes to the blacklist or to the current 70% limit.

23. Should challenger firms be included within the scope of the structural and operational split remedies?

24. Which non-audit services (services other than statutory audits) should the audit practices be permitted to provide under a full structural split and operational split? Please explain your reasoning.

- a) We understand that in examining forms of potential separation between the audit and advisory businesses of multi-disciplinary audit firms the CMA is aiming to achieve two outcomes: to change the culture of an audit firm by removing any “mixed” incentives for audit partners; and to improve choice in the audit market. However, we do not believe that the CMA has assembled an evidence base to demonstrate that any type of separation remedy would benefit audit quality or, in the case of operational split, improve choice. To recommend such intrusive and disproportionate remedies following a market study would be unprecedented. We remain of the view that the implementation of any form of structural separation would present insurmountable challenges because commercially both the UK audit and non audit businesses need to remain part of the international network.
- b) We agree with the CMA that promoting the right culture within an audit practice is critical; we are open to remedies designed to enhance audit firm governance in order to better embed the right culture and increase the focus on audit quality. But we do not consider that the interventionist separation remedies that have been put forward by the CMA are supported by evidence (see (c) below), nor do we consider they are a necessary or proportionate response.

Audit quality now and in the future

- c) We believe firmly that a multi-disciplinary model is fundamental to delivering audit quality. Our ability to draw on a range of specialist skills from across the firm coupled with the ability to attract and retain talent will continue to be essential in delivering high quality audits, particularly as the audit evolves in the future. This ability would be jeopardised in any form of separation. The maintenance and improvements of high standards of audit requires considerable ongoing investment in technology, methodologies and training. Currently, the large multi-disciplinary firms benefit from economies of scale in making these investments.



Smaller economic units (either separate audit firms, or the economically separate audit business in an operationally split firm) would lose these scale benefits and investment levels needed to sustain the audit for the future would inevitably fall.

Damage to the UK economy

- d) Separation would also undermine the UK's global standing as a place to do business and, specifically, procure audits. Audit quality in the UK is generally regarded as high, as demonstrated by the FRC's survey of Audit Committee Chairs on the subject. Business is global and audits take place in multiple countries. Large global companies require audit firms which belong to international networks with scale and reach. Separation remedies could potentially threaten network membership, with the consequence that UK audit firms may no longer be able to service multinational companies; such companies could instead turn to non-UK audit firms. The UK's large multi-disciplinary audit firms employ thousands of UK citizens and make a significant contribution to the UK's economy. We cannot support any remedies that threaten this UK success story.

Culture

- e) We do not believe that the CMA has gathered empirical evidence to show that the culture of multi-disciplinary audit firms negatively impacts audit quality. In addition, there have been many reforms implemented in the recent past (including those introduced by the Competition Commission and by the European Parliament) where insufficient time has passed to properly assess the impact of the reforms. The description of cultural concerns set out in paragraph 4.113 of the CMA's Update Paper are assertion-based: *"There are underlying cultural concerns where audit and non-audit services are provided by the one firm, given the key objective of the former is to be sceptical and the key objective of the latter is typically to be collaborative."* We do not believe that the collaborative approach taken, for example, by our advisory practice has had a negative impact on the approach taken by our audit practice. In paragraphs 3.188 and 3.189, the CMA recognises that the large multi-disciplinary audit firms have put in place a range of measures to ensure that auditors retain an over-riding focus on audit quality. These include promoting a culture of professionalism and integrity, rigorous training and controls on quality, performance assessment and incentivisation based on delivery of high quality audit work and accountability through a governance framework. However, paragraph 3.189 of the CMA's Update Paper then discusses these measures as ineffective, with no further justification for this conclusion. Whilst we accept we have had audit failings, we do not believe that these are in any way demonstrative of a culture in our firm that undermines incentives to focus on independent, high quality audit.

Choice

- f) We are unclear, given the current UK, international and US independence rules that many companies are subject to, how the CMA's operational split remedy would achieve its desired outcome of increasing choice. The CMA raises the prospect that choice might be increased, in an operational split scenario, through freeing the separated advisory practice from scope of service restrictions which cause conflicts of interest. Such an outcome would mean that a multi-disciplinary firm would not have to evaluate the economic alternatives when deciding whether or not to tender for an audit.

- g) We do not see, given the international framework that exists, how it would be possible to free the advisory practice from such restrictions. This is because independence restrictions (including non-audit service provisions) are always applied to the audit firm and to members of its network. The definition of a “network firm” is set by IESBA (International Ethics Standard Board for Auditors); audit regulators in all major economies have agreed to comply, as a minimum, with the IESBA rules. Although the FRC, or its successor, could apply some limited discretion in the application of scope of services restrictions in the UK, it is unlikely that the advisory practice, as a network firm of the audit practice, could avoid most scope of service restrictions. This is not a straightforward area but we would certainly welcome the opportunity to be involved in a more detailed discussion on how the suggested relaxation of independence restrictions would work in practice. Agreement to change would need to be discussed and accepted by international regulators and there would likely need to be legislative change.

Resilience

- h) In paragraphs 3.131 to 3.133 of the Update Paper, the CMA notes the importance of the resilience of the large company audit market; we agree that this is a critical consideration. Later (paragraph 3.136), the CMA suggests that the four largest firms appear to be resilient. The separation remedies proposed by the CMA would materially impact the resilience of the large audit firms. They would become economically smaller, becoming reliant on a smaller number of clients and engagements. Consequently they would become more exposed to shocks, whether financial or reputational and less able to make the investments needed to sustain high levels of audit quality. There is some evidence that adequate insurance protection would be more difficult, or more expensive to obtain for a smaller audit practice. We cannot support a remedy that would prompt such a material impact on the resilience of the market.
- i) As discussed in our response to questions 10 and 11, we believe that the temporary imposition of a market share cap would be a proportionate and effective remedy to address the CMA’s concerns over choice in the large company audit market. Seeking to address these concerns through separation remedies would either be ineffective (operational split) or disproportionate and hence unjustifiable (full structural separation).

Remedy 6: Peer review

25. What should be the scope (ie which companies) and frequency of peer reviews, if used as a regulatory tool?

26. How could peer reviews be designed to best incentivise auditors to retain a high level of scepticism, and thus improve audit quality?

- a) Reviews of audits are an important part of the regulatory framework. We explain in our answer to question 1 of this response that the work performed by the FRC’s AQRT, whilst valuable, is not able to assess certain aspects of audit quality - notably the real-time challenge provided by auditors to management. It is often difficult to capture the intensity and impact of such challenge in the audit documentation assembled on the audit file.
- b) Reviews of audits conducted pre-signing would be better able to assess the quality of the audit work performed and therefore we are supportive of this concept, although there are a number

of practical challenges. The results of such reviews may reassure stakeholders of the robust challenge exercised by auditors and therefore go some way to restoring trust in audit.

- c) However, we believe that any such reviews should be conducted by the regulator, not by a peer audit firm. If a peer audit firm were to be instructed to conduct such a review, there would be an immediate negative impact on competition and choice. A peer review firm would need to be independent of the audited company and would therefore not be able to compete for non-audit services work; the reduction in choice for such work would be even more stark were a mandatory joint audit regime to be introduced. If a peer review firm were to tender for the audit appointment in the future, careful consideration would need to be given to the ability of that firm to be objective; there would be a clear disincentive for the peer review firm to reach a conclusion which differed from a judgement made under the previous audit regime.
- d) There are also important practical issues which would need to be considered if any form of pre-signing review were to be implemented, whether performed by the regulator or a peer audit firm. These include:
 - i) Delays in reporting - pre-signing reviews would inevitably result in delays in reporting timetables, especially for companies with December year-ends where the audit profession is already operating at full capacity.
 - ii) Dealing with disagreements - were the pre-signing reviewer and the statutory auditor to disagree on a judgemental area, the Audit Committee would need clear guidance from the regulator on how to proceed.
 - iii) Cost and capacity - whoever performs the pre-signing review, there would be inevitable cost and capacity issues. The regulator would need to recruit significant additional resource to perform such reviews; audit firms would likely not have sufficient capacity at busy times of year to perform the reviews. Either approach would require significant investment in resource.
- e) If pre-signing reviews are implemented, we believe that the scope of the review programme should be designed by the regulator. However, we suggest that the reviews should be limited to FTSE 350 companies; a broader application would be disproportionate and consideration must be given to the finite resource available to the regulator, which should be focussed on the segment of the market where there is the greatest need to restore trust.

C) Next steps

27. What are your views, if any, on our proposal not to make a market investigation reference?

- (a) We consider that:
 - (i) the CMA's process has been unduly fast, especially considering the broader context of multiple overlapping reviews taking place in the audit sector;
 - (ii) the speed of the process means that the CMA has recommended remedies without proper consideration of the underlying evidence base – leading to some recommended remedies that are disproportionate and unsupported by the evidence;
 - (iii) this is particularly important, given that the remedies the CMA is proposing are highly interventionist, and risk doing more harm than good in this important market; and

- (iv) the CMA should carry out a thorough investigation before making a decision on what measures to take forward – recommendations of this nature are not an appropriate outcome of a market study in these circumstances.
- (b) As explained elsewhere in this response, there are three other major reviews into the audit market on foot or about to begin: the Brydon review, the Kingman review of the FRC and the BEIS Select Committee inquiry in to the future of audit. In our view, the first step should be to decide whether the scope of audit ought to be adjusted; then ensure that the regulatory framework supports that purpose; before considering whether the operation of the market is working well in that context.³¹
- (c) We believe the CMA should wait to make any necessary market interventions until after the Brydon review is concluded, and with the benefit of the strengthened regulatory framework post-Kingman. This ordered approach would allow the CMA sufficient time to conduct a full review, and to liaise with, for example, ARGA on the practicalities of any changes for the regulator. To recommend intrusive interventions at this stage, without attempting to analyse the effect of other changes, risks material intervention. Not only should the CMA be wary of making specific orders in a changing landscape (as it recognises³²), but also of making sweeping recommendations, with potentially serious unintended adverse consequences.
- (d) The speed with which the CMA has conducted its study has led to a lack of evidence and material deficiencies in its assessment of the evidence that has been gathered. In this response we have identified a number of specific concerns about individual remedies being proposed by the CMA – most notably around joint audit and separation remedies. We also have some more general concerns about the CMA’s analysis:
 - (i) In a number of places, the CMA has discounted the views of the consumers of the audit services supplied; namely investors, and Audit Committees. For example, the CMA expressly says that “*most of the ACCs we spoke to [...] expressed opposition to [joint audits]*” but maintains this as its main remedy despite these concerns.³³ Its conclusion that the market is “*failing to deliver high-quality audits*” is at odds with the evidence before it, including the views of Audit Committee Chairs.³⁴
 - (ii) The CMA has not attempted to define a relevant market. This is important given the CMA’s concerns appear to focus on audit services provided to a subset of companies, but some of the measures suggested by the CMA would affect all audit clients. Identifying the correct market, and weighing up how competition operates within that market, and how forces from outside the market influence competition in the market, is an essential step in conducting an analysis of competition.
 - (iii) The CMA notes the complex legal framework that audit services sit within,³⁵ but has expressly not considered the subject.³⁶ It is crucial that both competition and regulation are considered in tandem, in order to avoid, as the CMA has done,

³¹ At paragraph 2.72 of the CMA’s Update Paper: “*Changing the purpose and scope of audit would not alter the incentives and interests at play; whatever the purpose and scope, the market needs to operate in a way which creates the incentives to prioritise quality.*” In our view, changing the purpose and scope of audit would have a material impact on the way the market operates.

³² Paragraph 5.3(c)ii of the CMA’s Update Paper

³³ Paragraph 4.41 of the CMA’s Update Paper

³⁴ Paragraph 4.1 of the CMA’s Update Paper

³⁵ Paragraph 5.3(a)iii of the CMA’s Update Paper

³⁶ Paragraphs 3.4(d) and 4.1(d) of the CMA’s Update Paper

proposing remedies which do not appear to have taken account of the impact of international regulation (see our response to Remedy 5).

- (e) All of the above contrasts with the Competition Commission's market investigation into the audit market just a few years ago, which came to different conclusions on the basis of more comprehensive evidence. The CMA has not considered or addressed the reasons why the Competition Commission rejected remedies the CMA now favours, nor explained how the evidence for its conclusions has fundamentally changed.
- (f) If the CMA is considering major interventions, we believe that it must seriously consider a market investigation. In this case, the CMA has not even made use of a full statutory timetable to conduct a thorough market study. The CMA's Guidance states that "*market studies are examinations into the causes of why particular markets may not be working well*". Market investigations, on the other hand, are "*detailed examinations*".³⁷ The CMA's Guidance makes clear the limited types of issue that are appropriate to deal with by way of recommendation (e.g. recommended changes to public policy). The CMA has a two-step investigative process with a referral mechanism (MIR process) so that interventionist changes to a market are only implemented following careful consideration and a robust evidence-gathering process, during which the parties have the opportunity to consider and challenge the evidence. We do not consider that the CMA gives adequate reasons in its Update Paper for seeking to shortcut that process and, in particular, we note that the CMA does not address any possible advantages to following an MIR process.
- (g) We believe the recommended remedies as set out in the Update Paper are not suitable to be the outcome of a market study, and that the CMA should give serious consideration to carrying out a market investigation in order to provide a thorough evidence base for any changes to the market.

³⁷ Paragraph 1.11 of the CMA3 Guidance 'Market Studies and Market Investigations: Supplemental guidance on the CMA's approach':
https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/624706/cma3-markets-supplemental-guidance-updated-june-2017.pdf