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Dear Sirs

Statutory Audit Market Study Update Paper

We are grateful for the invitation to comment on the important issues raised in your Audit Market Study Update paper. We also appreciate the great care that you have taken in compiling a comprehensive and detailed analysis of the issues affecting the audit market, and your proposed remedies.

In our recent submission to the BEIS Select Committee Inquiry into the Future of Audit, we confirmed our support of your initial recommendations and commented that if some combination of your proposed remedies is eventually enacted, then with the right incentives, for example a reasonable commercial price for the performance of high-quality audits, a proportionate regulatory environment, and enough time to build scale and expertise, we believe several challenger firms (including RSM), acting not only in their own commercial interest but also in the public interest, will likely willingly play their part in helping to reform the audit market.

Turning to the questions raised in your paper, we confirm that we agree with your analysis, in section two, of the widespread public concerns about audit quality. We also agree with your further analysis, in section three, of the various issues that are to a greater or lesser extent driving those quality concerns. And while it is certainly possible to question some of the finer points of detail, we do not believe the public interest will be best served if large firms simply seek out issues with which to try and find some fault.

Here then are some of the further related points and concerns we raised in the introduction to our submission to the BEIS Select Committee:

- According to the recent CMA audit market study update, the Big Four currently receive 99% of the FTSE 350 audit fees, 86% of the FTSE AIM 100 audit fees and 85 to 90% of the Top Track 100 (largest private companies) audit fees. If this is not the very definition of a highly concentrated market, we do not know what is.
- This extreme level of concentration (a Big Four oligopoly) has plainly not happened overnight. It has taken two or three decades of straightforward market forces – and the lack of any effective government or regulatory intervention over that period of time – for the present market state to become established. And, given that current state, it is clear to most informed observers that there are now no easy solutions available to reform the market. There are also, it should be noted, no quick solutions or perfect ones.

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- Furthermore, given the obvious inherent difficulty in making a belated but meaningful intervention in a complex market, it is remarkably easy for any critic of any of the CMA and Kingman proposed remedies and reforms to highlight issues, problems, concerns, risks and probable costs associated with any or even all of the proposals.
- Moreover, statements of the obvious, even well-intentioned ones, will ultimately do very little to contribute to a genuine, combined effort by government, parliament, regulators and market participants to find, perhaps imperfect but nonetheless, workable solutions.
- In addition, market intervention by way of legislation and changes in regulation can only go so far to provide the necessary foundation for much needed reform. A change in the approach and attitude (or a refusal to change the approach and attitude) of market participants on the supply and buy sides can plainly hasten, or hinder, any programme of reforms. In this respect the Big Four can either be a major obstacle by lobbying against change or, if they were to accept that reform is not only in the public interest but also in their commercial interest, they can become a real force lobbying for change, over a reasonable timescale, by working constructively with the challenger firms and all the relevant stakeholders.

Turning to your proposed remedies, we confirm our agreement with your view that joint audit for the FTSE 350 (with a challenger firm being mandated as one of the joint auditors) would increase competition without risking audit quality. Furthermore, it is perhaps the only proposed major remedy that (within a relatively reasonable timescale of perhaps five to ten years), is likely to bring about a significant intervention in the audit market for FTSE 350 companies.

Importantly, however, and as your summary of that particular remedy rightly notes, there will most likely be a need for some exceptions in certain market segments: such as where the nature of the company (eg investment trusts) would not sensibly justify a joint audit or simply because, at the other end of the scale, there are perhaps twenty five or thirty very large, systemically important companies (for example: some of the major banks, insurance or oil and gas companies) where the Big 4 are for the foreseeable future going to be the only firms with sufficient scale to carry out an effective global audit within the required reporting timescales of the capital markets.

As for a market share cap, we agree with your summary that while this remedy could deliver, in a relatively short period of time, a substantial increase in the number of challenger firms auditing the larger companies, we think it is unlikely in the near term that challenger firms will have the scale or resources to take on a significant number of the very largest audits, in particular for example many, if not most, of the companies in the FTSE 100. A market share cap remedy might well however open up the FTSE 250 market to a number of challenger firms, and that result alone would then probably go a long way to help over the medium to longer term to create real opportunity for further penetration of the upper reaches of the capital markets by challenger firms as they have time to build scale and competencies.

Noting that the Big Four already now audit 86% of the FTSE AIM 100 companies, and 85 to 90% of the Top Track 100 (largest private companies), we believe that if joint audit and/or a market share cap is introduced into the FTSE 350, it will still be necessary to implement (and actively monitor) some form of a market share cap in the rest of the main list, and the large AIM and large private companies audit markets, in order to remove any incentive for the Big Four to seek to replace any lost current audit market share in the FTSE 350 by attempting to dominate the larger segments of what would then be simply other, less regulated (or monitored), audit markets.

Plainly the most controversial remedy is an enforced full structural separation of the audit and non-audit parts of the Big Four. However, it is perhaps easy to understand why so many informed commentators and academic observers may have lost patience and reached the conclusion that it is time to adopt truly radical reform measures, as over many, many years almost every other less commercially intrusive avenue for reform has

been investigated, then heavily criticised and ultimately effectively blocked or just kicked into the long grass by a formidable Big Four lobbying campaign against change.

Times and Big Four leaderships have now changed, and so there may be some reason for seeing a glimmer of hope for meaningful reform this time around as a number of senior partners within the Big Four have fairly recently openly acknowledged, and seemingly embraced, the need for substantive change. Accordingly, provided that last sliver of hope does not soon turn out to be misplaced, it may not be necessary to invoke either full legal (or even operational) separation of the audit and non-audit parts of the Big Four. But if all the inevitably less than perfect, but still sensible and eminently workable, CMA proposed remedies are ultimately rejected (or just fiercely lobbied against), then government may have little option left but to enact the more radical reform measures.

We look forward to meeting with you soon to explore in more detail our comments and observations on all of your proposed remedies.

Yours faithfully

Laurence Longe
Chairman RSM UK