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Competition and Markets Authority
7th Floor, Victoria House
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Our Ref:

Dear Sirs

Statutory Audit Market – Response to update paper

We are pleased to provide our comments on the Competition and Markets Authority's (CMA) Update Paper published on 18 December 2018 as part of its review of the Statutory Audit Market.

Crowe in the UK is one of the top 10 audit firms by audit fee income. We are ranked eighth in the Advisor Rankings of stock market auditors both by number of clients and by market capitalisation of audit clients. The firm is the UK member of Crowe Global, the eighth largest international accounting network with revenues of approximately US$3.8bn, around 45% of which is derived from audit.

Broadly we support the CMA's overall analysis of the state of the FTSE 350 audit market and many of the proposed remedies. We are pleased that the CMA has recognised that remedies are needed not only in respect of the supply-side issues (e.g. the availability and capability of challenger firms) but also the demand-side issues (e.g. factors that prevent audit committees from appointing firms other than the Big Four).

We agree that measures should be introduced to provide regulatory scrutiny of the audit committees and particularly around oversight of the audit tender process. The Financial Reporting Council (FRC) issued 'Audit tenders – notes on best practice' in February 2017. We recommend that this is developed into a 'comply or explain' code which is used for reporting to the regulator and including in annual reports to support accountability to shareholders.

The CMA has expressed a preference for joint audits over a market share cap and, as a measure that can have an immediate impact on lessening the concentration of the Big Four in the FTSE 350 market, we support this recommendation.

We agree that joint audit is preferable to shared audit as the joint audit model means that both audit firms sign the audit opinion and both would be a presence in the boardroom; this, we believe, is a vital ingredient for ensuring that the challenger firms can deal with the preconceptions (and misconceptions) held by audit committees.

It is not necessarily the case that the challenger firms do not have the capability to conduct the audits of larger, more complex clients. Many of the challenger firms (including ourselves) audit large, international private businesses which, if listed, would sit comfortably in the FTSE 250. In his oral evidence to the BEIS 'Future of Audit' inquiry on 15 January 2019, Professor Humphrey stated "If you do not trust Big Four audits, why do you trust them to train challenger firms to do an audit?". 'We challenge this understanding of how joint audit works and also the preconception that the quality and ability of the challenger firms is less than the Big Four, which we take issue with.

For choice, competition and improved quality there is a recognition that remedies need to be wider than changes focused on the Big Four. Challenger firms have a key role to play and the joint audit proposal provides an opportunity to have wider involvement of Big Four and challenger firms together. Increased quality should be the output and a key focus of all firms involved.

We acknowledge that joint audit is not accepted as an appropriate remedy by all interested parties but some of the arguments, particularly around cost, need to be resisted. As well as completion and concentration, there remains a concern over levels of quality. We support the contention that joint audit can improve quality as the major issues arising during an audit will be considered by both auditors and they will need to jointly form their opinion.

The primary focus of any remedy has to be on driving improvements in audit quality through greater choice and competition in a manner in which the impact on cost is reasonable, proportionate and appropriate to meet the objective of improved audit quality from the remedy implemented. If quality will increase, then to complain that costs will increase seems curious.

Our major concern about the proposed remedies surrounds those concerning structural or operational splits of audit firms.

In our initial response to the CMA in October 2018, we urged the CMA to "*ensure that any remedies that it does develop are targeted on addressing the issues where there appears to be most concern… There is a danger that some of the remedies proposed could have consequences that are either unintended or, indeed, unnecessary for those parts of the audit market that are functioning well*".

We foresee considerable difficulty with the remedy for either full structural or operational split between the audit and non-audit parts of firms. Our point on targeting remedies is germane. Any remedy that causes a firm to reorganise itself will, necessarily impact the whole of its client base, not just the large, listed clients that are really in the focus of the CMA study. Notwithstanding that the Big Four has nearly 100% of the FTSE 350 market in total, for all of those firms, those audits will still represent a minority of their total audit client base.

The CMA has questioned whether this remedy should also apply to challenger firms. Clearly, given our remarks above, we believe this should be resisted given that the large, listed company audit clients, even if they gained greater market share as a result of other proposed remedies, would represent a very small minority of their audit client base.

We also support the observations raised by the CMA in Appendix C in relation to the 'expectations gap' and the challenge as to whether a review is required to determine if any change to the purpose and scope of audit is required.

We provide our response to the specific questions in the update paper on the attached schedule. We will, of course, be very happy to provide any clarity, further input or involvement as necessary.

Yours faithfully

Crowe U.K. LLP

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CMA question	Crowe comment
A Issues 1. Do you agree with our analysis in section two of the concerns about audit quality? 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.	We agree, broadly, with your analysis although we continue to make the point that is important to be very clear on the parts of the audit market where there are concerns about audit quality and issues of competition and concentration. The audit quality measures that included in Section 2 of the Update Report are drawn from the results of the FRC AQR inspections together with the FRC enforcement actions. Whilst the FRC retains audit quality oversight for PIEs and certain other listed companies (for example those that are not incorporated within the EU and very large AIM companies), audit quality of all other audit assignments is carried on by the relevant Recognised Supervisory Bodies (for example ICAEW) and there are no public reports (either by firm or generally) on the results of those reviews. As a result, the picture presented in Section 2 of the report is not necessarily indicative of the quality within the whole of the audit market. We agree broadly with you analysis of the issues driving audit quality concerns. In particular, we recognise the issues relating to challenger firms that are described in section 3.
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?	In the first instance we believe the remedies should be applied to FTSE 350 companies. There will probably be the need to have some qualification parameters to reflect that the constituents of that index are decided periodically by reference to market capitalisation and so companies that are on the periphery (both inside and outside) will need clarity on whether and when they come into scope. The Kingman Review has suggested that the UK should revisit the definition of PIE and we believe this is a necessary step before deciding whether appropriate to expand any remedies to PIEs generally. At this stage, we do not recommend applying any of the remedies to large private companies.

CMA question	Crowe comment
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.	Our suggestion is that the FRC's best practice note on audit tenders could be developed into a 'comply or explain' code. The proposed approach should be communicated to the regulator before the tender with a formal report back at the conclusion. This report (or a version thereof) should be included in the first annual report after an audit tender has taken place. By including the report in the annual report, it will be within the scrutiny of the auditor to confirm that the report does not contain any material misstatements and is not inconsistent with the auditor's knowledge.
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	We support the general approach that there should mandatory joint audit for the FTSE 350. We do not support extending the remedy beyond that at the moment. There will need to be careful consideration given as to how the requirement for joint audit will apply to companies who are near the threshold for the FTSE 350 (both inside and outside) to ensure that companies do not fall in or out of scope in successive years. We support the proposal that at least one of the joint auditors should be a challenger firm. We recognise, however, that there may be certain types of companies (e.g. large banks) where it may be necessary for both joint audit firms to be from the Big Four but we would see this very much as 'by exception'. We would expect that any such exceptions would be with the prior agreement of the regulator. Given that both parties in a joint audit will be signing the audit opinion, the split of work undertaken and fee needs to be organised in such a way that any joint auditor undertaking a minority of the work has sufficient input and involvement that will enable them to sign the opinion. We would expect each joint auditor to contribute at least 30% of the planned audit hours. This would be consistent with the expectations in the French market.

CMA question	Crowe comment
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?	Having parameters around fees may be difficult given the different sizes of firms and the cost/fee structures that might exist within them. The geographic location of the joint audit firms might also be a factor in this. Notwithstanding, there may well be a perception that if a joint auditor is earning less than a certain percentage of the fee then they will not be contributing appropriately to the audit and, indeed, may not be in a position to challenge the company or the other joint auditor effectively. We agree that there is merit in joint auditors being appointed at different times. Given the rules on mandatory retendering and rotation, this would allow for continuity in elements of the audit arrangement when new auditors are appointed and so provide a level of continuity that should be beneficial. Any proposals for the introduction of joint audit and the timing for the appointment of each joint auditor should provide appropriate flexibility and choice to business to be able to manage this in a measured but timely manner. We suggest that the appointment of second joint auditor should take place at the earliest opportunity, say for accounting periods commencing on or after 1 January 2020, but may be deferred if an audit tender process is already planned to take place in that year. We agree that there will need to be reform to the liability framework with a joint liability basis rather than joint and several. Given the disparity in size between the Big Four and the challenger firms, a joint and several arrangement is unattractive and, indeed, may increase substantially the cost of insurance cover for the challenger firms.
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?	If the risk of cherry-picking is perceived to be so important, then one response would be to take the choice out of the hands of the firms themselves. Means to achieve this could include requiring a firm to participate in a tender unless it was either conflicted or was at a point of mandatory rotation. An alternative approach

CMA question	Crowe comment
	would be to prohibit firms from resigning from an audit assignment except in very limited circumstances.
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.	We have not experienced barriers to partners and senior staff joining us other than under what we regard as normal terms.
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.	We do not support the creation of an audit tendering fund.
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.	We agree that it is appropriate to consider how further measures such as technology-sharing could be developed. The focus for such a remedy would be for the profession to play its role in promoting audit quality by sharing such tools or resources to enable all participants to have access to them at a reasonable cost and in a manner which promotes and does not disincentivise innovation.
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.	We do not comment in detail on the questions regarding market resilience but support the CMA's desire to explore this area further.
16. How could such a system prevent moral hazard? Please comment on our initial view.	

CMA question	Crowe comment
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.	
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;	We do not support the creation of audit-only firms. Not only do we think this is not the appropriate remedy for the UK, we do not see how this would achieve the desired outcome when the FTSE 350 audits, on the whole, comprise businesses most of which have substantial international operations and where elements of the audit work will be undertaken by network firms of the UK auditor, where there will have been no such structural or operational separation. Our more substantive concern on the concept of both structural and operational split is that this potential remedy is not sufficiently targeted and proportionate to the perceived problem. Any structural or operational split will have an impact on all audit clients of the Big Four (and any other firms required to implement such a remedy) and we contend that the impact of a split could be detrimental to unlisted audit clients where there is, largely, less disparate ownership, and the needs of other stakeholders may be different. Notwithstanding that the listed audit clients command, at least at the upper end, very large audit fees, in terms of a proportion of audit work, they will represent a minority of audit assignments. It is our view that any operational split would still be poorly understood by the public whose trust in audit the CMA is seeking to improve. Legally splitting firms is not practical but a clear ban on non-audit services is. Such a ban works in other countries and we encourage the CMA to revisit this point. We will leave detailed comments on the difficulties or otherwise of effecting a structural or operational split to those likely to be impacted in the first instance.

CMA question	Crowe comment
(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.	We note the CMA is resistant to the more obvious remedy of a simple ban on non-audit services as it believes this may curtail choice further. We contend that this would be less of an issue provided that the other remedies being proposed, in particular that of joint audit, are successful. Having regard to our comments above, we do not think it appropriate to require any form of split for the challenger firms. We do suggest that further development of the Audit Firm Governance Code (AFGC) could be effective in dealing with some of the issues that this remedy is seeking to address. The AFGC is a voluntary 'comply or explain' code issued by the FRC that applies to certain audit firms, currently based on the number of listed audit clients.
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?	We do not support the CMA's view that peer review would be a useful remedy. In particular, we do not see why this should be necessary if a joint audit arrangement was in place. We have noted that Clause 4.153 of the Update Paper states that a peer review would create an additional level of activity where the first level is "*the work of management would be checked by the auditor*". We believe this assertion misses a vital ingredient as the work of management should first be checked by the audit committee, which is comprised of independent non-executives. If the aim of this remedy is to improve quality then we contend that a more effective remedy could be that the AQR team of the FRC carry out some functions of audit review on audits as they happen, rather than just the 'cold reviews' of completed audits. This approach would support the premise of the FRC acting as an improvement regulator.
C Next steps 27. What are your views, if any, on our proposal not to make a market investigation reference?	We agree with this proposal.