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Monday, 21 January 2019

Statutory audit market study
Competition and Markets Authority
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Dear Sir or Madam

STATUTORY AUDIT MARKET – UPDATE PAPER

1. Introduction and overall recommendation

Objectives and context of the CMA study

1.1 Thank you for the opportunity to comment on your Update Paper on the issues facing the statutory audit market and the potential remedies to address them.

1.2 We support the CMA's policy objectives to increase choice in the listed audit market, ensure that the market structure and competition incentivises the delivery of high quality audits and improve market resilience.

1.3 You have highlighted the need to rebuild trust in the audit profession and address perceptions of conflicts within multidisciplinary firms and the alignment of incentives between company and auditor. We understand these concerns, and whilst we believe these are more perception than reality, we believe the package of remedies we propose will build on the CMA's provisional recommendations to address these concerns.

1.4 The CMA's study is closely aligned with two other reviews:

- The Kingman Review, which has considered how to deliver more effective regulatory oversight. We support the objectives of this review and the majority of its recommendations; and
- The Brydon Review, which has the potential to fundamentally change the audit product, materially increase the reliance on emerging technologies and deliver on an increasing range of stakeholder expectations which is in our view at the heart of the loss of trust in audit referred to above.

1.5 The recommendations of the Brydon Review need to be available before the CMA concludes on the appropriate remedies it is to recommend; increased competition and choice around the wrong audit product might make things worse and stifle innovation.

1.6 The conclusions of the CMA, Kingman and Brydon reviews need to be considered in aggregate. Collectively, they offer a unique opportunity to restore trust and confidence in audit and corporate reporting and maintain the UK's position as a world-leading financial market. It is particularly important that at a time that the UK is leaving the EU any changes do not put the UK out of line with global norms or add significant costs and complexity for companies, their shareholders or auditors. Such changes could materially damage the UK's competitive position and particularly London's place as a leading capital market. This is one reason why the CMA should seriously consider whether a

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market investigation reference is appropriate, contrary to the preliminary view set out in the update report.

Summary of our submission

1.7 The CMA has proposed a set of radical proposals to transform the market. We are supportive of some of these measures but we have strong reservations about joint audits, structural separation and in the proposed current form of operational separation because they may have severe unintended consequences. We believe they will both be detrimental to audit quality and reduce resilience.

1.8 Instead we have put forward alternative measures that we believe, in aggregate with the other related recommendations from Kingman and subsequently Brydon, will meet the CMA's objectives and make a significant positive difference to the audit market. Together these reviews represent a unique opportunity to transform the UK corporate reporting and audit environment, support the business environment in the 21st Century and strengthen the UK's competitiveness. In particular:

1.8.1 Our proposed measures to deal with increasing choice can generate participation of challenger firms in about 75 FTSE 350 audits within five years versus 11 today and pick up a meaningful share of audit work within the FTSE 100 market. Challenger firms would potentially receive over 25% of FTSE 350 audit fees excluding the FTSE 30. We estimate that over 5 years, these firms would need to recruit c.1,000 audit practitioners (net, in the UK). This would be achieved without requiring those firms to transform at such a rate that would threaten audit quality and the resilience of the audit sector; and

1.8.2 We propose an alternative to the CMA's structural or operational separation remedy. This separate governance and performance management structure will address any actual or perceived cultural issues resulting from a multidisciplinary structure. To support this we still propose a ban on non-audit services[1] being provided to FTSE 350 and large private entities in recognition of the challenging public perception of conflicts in the UK at present. The latter will demonstrate that there is no possibility of any conflict of interest.

1.9 We believe that these measures referred to in paragraph 1.8.1 above and in more detail in paragraph 11.3 in the Appendix will make a significant impact on the audit market place within a five year period. At that time, we would recommend that an appropriate body examines their impact. If the results are as expected, then the measures should be sunsetted and normal competition rules would apply.

1.10 We concur with the CMA's view that there is no clear evidence that joint audits enhance audit quality (paragraph 4.55 in the Appendix) and they are unproven in the UK. In fact, some countries have actively moved away from joint audits. There is no evidence that they improve choice and encourage new entrants capable of leading large listed audits into the market. In the only market where joint audits are used extensively, France, the vast majority of audit mandates in the CAC 40 are held by Big Four firms.

1.11 They cause significant increases in cost and complexity and do not appear to be welcomed by many companies, investors or other stakeholders.

1.12 A joint audit system will require the challenger firms make a very significant investment in hiring, training and developing 3,600 net new staff within their UK audit businesses over five years (according to our estimates), all capable of auditing FTSE companies. At the same time, the challenger firms will assume unlimited and joint liability at all companies in the FTSE 350 and both the challenger firms and the four largest networks will be grappling with how to perform a joint audit in practice.

[1] A clear definition of non-audit services would need to be developed. We would suggest that as well as the annual audit, this definition includes closely-related services that, for reasons of time and cost, are best carried out by the auditor.

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1.13 Having joint audits that only involve Big Four firms for the more complex sectors (e.g. Financial Services) does not help meet the CMA's objectives of increasing choice and improving the capabilities of challenger firms. It would also significantly reduce choice in this segment at the time of re-tendering, moving in all likelihood from two of the Big Four to the other two Big Four firms.

Structural or Operational Splits

1.14 We do not support a structural separation. It will not achieve the CMA's aims of increasing choice by removing conflicts and improving culture. It is also detrimental to resilience and will have a negative impact on audit quality potentially separating the UK audit business from both the rest of the UK multidisciplinary firm where it draws significant specialist audit support from and potentially from the international network required to support the audit of the UK's leading multinational companies.

1.15 Structural and operational separation as contemplated will reduce resilience and investment capacity. For example, the audit practice of Deloitte in the UK is part of a £3.5bn business. Were it standalone, it would have revenues of c. £500m or less and would be substantially reduced in overall strength, resilience and investment capacity.

1.16 Any separation will also damage audit quality. We have over 2,000 practitioners outside of the audit practice in the UK who act as specialists on audits and who share the same culture and training as our audit practice of delivering audit quality. The CMA have agreed that the use of specialists is vital to audit quality, but a structural separation will place these specialists in another firm. Structural separation could also result in the UK audit business being separated from the international network which will further damage audit quality as the ability to draw on audit colleagues in other jurisdictions and the basis on which they would be engaged would change.

1.17 Operational separation as currently proposed by the CMA also has material negative unintended consequences. Those downsides, while slightly less than structural separation, will have negative impacts on both audit quality, resilience and investment capacity. It will make the relationship with specialists less seamless, more contractual and less culturally-aligned in the delivery of quality audits. Specialists outside the operationally separate audit business may have less of a focus on our public interest audit responsibility over time.

1.18 An operational separation will neither reduce conflicts nor increase choice. The audit business will remain within the same network as the non-audit business and be subject to the multiple UK, EU and international regulations that govern auditor independence and will remain in place.

1.19 Instead, we believe that separation achieved by a new and robust separate governance and performance management structure for the audit business will achieve the CMA's Policy Objectives. This will provide far reaching and fundamental enhancements to the current governance model, will provide independent and transparent oversight and the enforcement of the culture and incentives required to drive quality audits. It will address any perceived cultural issues resulting from a multidisciplinary structure. It will preserve the financial resilience of audit in a multidisciplinary firm and will importantly retain the cultural alignment of auditors and specialists. To avoid market distortion we believe that this measure should apply to all audit firms and not just the Big Four.

1.20 In addition, we continue to propose a ban on non-audit services being provided by a firm to companies it audits, for UK FTSE 350 and large UK private companies. We concur with the CMA that there is limited evidence of conflicts between audit and non-audit work at the client level, but such an unequivocal position will address public perceptions about conflicts of interest.

2. Our principles to assess your proposed remedies

2.1 In our response to your Invitation to Comment we set out three overall principles to guide the design of remedies:

a) Audit quality should be the overriding objective of any remedies pursued by the CMA. An essential element of the ability to deliver audit quality and innovate the audit approach is the ability to draw on a wide range of skills within a multidisciplinary firm.

b) An increase in the choice of providers of audit services to the UK's largest companies is in the public interest.

c) Restoring trust is essential but any remedy must work within the international context, given the requirements of investors and stakeholders in large UK listed and large private public interest companies.

2.2 We have used these principles in considering the remedies you have proposed.

3. Remedy 1: Regulatory scrutiny of audit committees

3.1 We believe that this remedy could generate greater assurance that the process to appoint auditors and oversee their work is rigorous, unbiased and fair. Care will be needed to ensure that additional regulatory scrutiny adds to the effectiveness of the UK corporate governance structure rather than merely creating further bureaucracy, and does not damage the attractiveness of audit committee membership in such a way as to deter the most able candidates from joining.

3.2 Implementing this remedy will require close cooperation with the Kingman Review and BEIS to ensure that the powers of the Audit, Reporting and Governance Authority (the new regulator proposed by the Kingman Review) are proportionate and aligned appropriately.

4. Remedies 2 and 2A: Mandatory joint audit and market share caps

4.1 The CMA has recognised the risk of asking challenger firms to develop scale, skills, insights and experience, and their international networks, too quickly. Mandatory joint audits and market share caps are both mechanisms to help build the market share of challenger firms, and are considered by the CMA as alternatives. Both will require an increase in the scale, skills, experience and international network of the challenger firms. We have considered both to assess which is preferable. Since our conclusions about joint audits are different from the CMA's, we have sought to explain our position on this remedy in greater detail than for other remedies.

Joint audits

4.2 Both joint and shared audits will create more "slots" for firms outside the Big Four to build experience and capability. Where challenger firms work alongside Big Four firms, there is also likely to be increased transfer of skills and knowledge to challenger firms, and a "four eyes" approach could reduce the perception that audit firms have too close a relationship with the companies they audit.

4.3 The most significant difference between the two is that with joint audits, both firms and both engagement partners have to sign the overall audit opinion and both accept overall responsibility for the whole audit. In shared audits there is a clearer distinction between the lead firm and the secondary firm, and only the lead firm and lead engagement partner takes responsibility for the overall audit report. This has three important consequences:

4.3.1 Building the level of capacity to be an effective joint auditor is much harder than to be an effective shared auditor. Ideally, joint auditors should carry out balanced shares of the audit work, including the higher risk areas, and both auditors should have the skills and reach to be able to properly review and challenge the work of the other. Working on the principle that

challenger firms would be one of the joint audit pair in most cases, this places significant pressure on challenger firms to develop capacity, industry experience, technical skills and international networks in a timescale that may not be possible.

4.3.2 Auditor liability is unlimited and under UK common law and statute, both firms are jointly and severally liable for errors in the audit opinion. A proportional liability regime would be more attractive to all participants, where the risk and fees were more closely aligned, but this will require an amendment to the Companies Act. Without liability reform there could be significant threat that an audit failure could lead to the collapse of a challenger firm and a resulting reduction of choice[2].

4.3.3 Since both audit firms need to interact much more under a joint audit system, revised auditing standards will be required. Such standards do not currently exist in the UK and would need to be developed. Joint audits will introduce additional cost and complexity also putting the UK out of step with international practice.

4.4 We do not believe that it is workable for either firm to have a joint audit arrangement whereby one party takes a significantly lower share, creating the sense of a "senior" and "junior" party in the audit. This concurs with CMA's view in its boxed comment after paragraph 4.60. Joint audits are not an effective mechanism to help challenger firms build up their scale and capability gradually.

4.5 There is limited empirical evidence that mandated joint audits have a positive effect on audit quality, and indeed may damage it. A meta-study carried out in 2013[3] considered 20 separate studies carried out between 2007 and 2012 on joint audit in markets where it has operated, including France and Denmark. Among its findings, the study notes the difficulty in allocating work between the firms and that uneven distributions in the split of work can lead to one firm becoming dependent on the other, limiting the effectiveness of the "four-eyes" review.

4.6 The lack of popularity of joint audits with companies, investors and audit firms reinforces their unattractiveness. Companies and investors in the UK can currently choose to appoint joint auditors but they do not. The CMA has pointed to France as a market where joint audits operate successfully, but the circumstances of the French market – where auditors are appointed for a period of six years and where an industrywide fund for auditor liabilities exists – are significantly different from the UK. Even in France, where there is more than 50 years' practical experience of joint audit, only one national challenger firm has gained a foothold in the CAC 40 audit market.

4.7 We do not understand the suggestion that requires two Big Four firms to take on the joint audits of the largest, most complex companies. This measure does not help challenger firms build capability or increase choice in any way. Indeed, it would actually reduce choice. Consider, for example, joint audits involving Big Four firms at the UK's four largest retail banks. Each bank would be audited by two firms and when the audit was rotated, they would have to appoint the other two firms – they would have no choice at all.

Joint audit vs market share caps + shared audit

4.8 The CMA believes that joint audits generate a similar benefit to market share caps in increasing the participation of challenger firms in large audits, but without the risks to short-term quality that come with market share caps and concludes, therefore, that joint audits are preferable. We disagree.

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[2] We understand that in France there are profession-wide insurance arrangements, and that this helps encourage cooperation between different firms involved in a joint audit. Such arrangements do not exist in the UK.

[3] Ratzinger-Sakel et al, 2013 "Joint Audit: Issues and Challenges for Researchers and Policy Makers".

4.9 In practice, implementing either market share caps or joint audits will carry significant challenge. Both remedies carry the danger of giving challenger firms responsibility for complex audits before they have the necessary capability.

4.10 Under market share caps, though, we think the phased introduction of the remedy can be controlled more carefully (for example using different levels of cap depending on the industry and size of companies) to ensure that the market share of challenger firms grows in step with their capacity. In addition, market share caps could be introduced without the need for new auditing standards or a revision of auditor liability, and without significant opposition from stakeholders.

4.11 Rather than using joint audits, an equivalent change in the structure of the market can be achieved more effectively with a combination of shared audits and market share caps. Such an approach would:

4.11.1 Allow challenger firms to build up their skills over time more easily. The second auditor in a shared audit could start with a lower share of audit hours, say 10-20%, and build up over time (with the split potentially overseen by the new regulator). This could apply to all companies including banks;

4.11.2 Be flexible to the existing industry skills and geographic networks of the challenger firms. The initial share of work could be designed to reflect where the challenger firms are already strong and with planning for the evolution of this share over time, this gives the firms time to develop the reach and expertise they will need to carry out a larger share;

4.11.3 Be capable of being introduced more quickly, because it does not need to align with or interfere with the overall group auditor appointment;

4.11.4 Be carried out under existing audit standards and liability arrangements, reducing the need for lengthy processes to develop, consult and endorse new standards and statute; and

4.11.5 Be more compatible with peer reviews (Remedy 6). This would help challenger firms develop their capabilities through engagement quality control reviews.

4.12 We estimate that if challenger firms were to be joint auditors for all FTSE 350 companies, in a five year period they will need to grow their revenue from FTSE 350 audits from their current level of £5 million to approximately £400 million, with a corresponding increase in headcount. FTSE auditing requires some different and additional skillsets.

4.13 The challenger firms will be required to make a very significant investment in hiring, training and developing up to 3,600 net new staff in the UK over five years (according to our estimates). At the same time, these firms will assume unlimited and joint liability on all companies in the FTSE 350 whilst simultaneously grappling with how to perform a joint audit in practice.

4.14 The CMA has raised concerns that market share caps will allow firms to cherry pick the companies that they audit. We understand these concerns and believe that they can be carefully managed by temporarily excluding Big Four firms from participating in FTSE 250 audit tenders within certain sectors. This would include industries that are not high risk and where the challenger firms already have a market presence. This could be coupled with increased scrutiny of the tender process akin to the mechanisms outlined in Remedy 1. We understand that this will not be popular with companies as it reduces choice in the short term but it will provide increased choice in the longer term.

5. Remedy 3: Additional measures to support challenger firms

Ease of movement of staff

5.1 Employment contracts should be designed to avoid significant business disruption, but should not act as an unreasonable barrier to prevent people switching firms. We do not believe contract restrictions are a significant and widespread issue, but agree that there is merit in the CMA investigating the issue further.

5.2 Our own hiring data suggests that there is no restriction on movement of people between accounting firms.

Tendering fund

5.3 The use of other remedies – particularly market share caps and shared audits – should reduce the need for such a fund, since they will give greater opportunity to challenger firms, who in many cases will not be competing against Big Four firms. The CMA has also acknowledged that audit prices are likely to increase and this will provide an additional incentive for challenger firms to compete. We would suggest that the CMA to keep this under review and revisit it if other remedies do not increase tendering activity by challenger firms.

Access to technology

5.4 We recognise that access to large firms' proprietary technology platforms might help challenger firms to compete and could reduce the risks of poor quality. However, our technology platform is owned at a global level so providing access would require global approval. Alternatively challenger firms should either develop their own proprietary systems or come together to develop a shared platform.

6. Remedy 4: Market resilience

6.1 We agree that the market would benefit from a greater resilience regime that would protect against the effects of a catastrophic failure or voluntary withdrawal of a large audit firm.

6.2 It will be challenging to develop such a regime that keeps a failing firm together because the firm's main assets – its experienced partners and staff – cannot be prevented from leaving, and nor can companies be prevented from switching audit firm. Nevertheless, we agree that there is merit in the CMA considering this further through, for example, plans for a regulator and other appointees temporarily taking over failed firm to ensure its stability while a long-term plan is invoked.

6.3 In recent years the FRC has encouraged firms to develop their own contingency plans to manage a catastrophic collapse. Any contingency plans need to consider not only the collapse of a large firm in the UK, but also the effect of a large network collapse precipitated outside the UK.

7. Remedy 5: Full structural or operational split between audit and non-audit services

7.1 A full structural separation or an operational separation as defined by the CMA would not achieve the CMA's policy objectives of removing conflicts nor will it increase choice. We believe that any cultural or incentive issues are best dealt with by the alternative separation approach of a new and robust separate governance and performance management structure which we outline below in further detail.

7.2 A full structural separation faces unsurmountable challenges. We have over 2,000 practitioners who act as specialists on audits, and who share the same culture as our audit practitioners of delivering audit quality. The CMA have agreed that the use of specialists is vital to audit quality. For Deloitte all of our FTSE 350 audits required the use of specialists from outside the audit practice and over 55% of the key audit matters – the most significant audit risks - required the use of specialists. Separating these specialist from the audit business creates in our view insurmountable challenges to audit quality. In addition to the significant challenges of contracting for these specialist services from the structurally

separate non audit firm, we believe the potential loss of the full cultural alignment over time from these specialists to deliver quality audits as part of the same firm will create a new audit risk. Any separation will make the relationship less seamless, more contractual and less culturally-aligned in the delivery of quality audits.

7.3 Separation of any kind will reduce resilience. For example, the audit division of Deloitte in the UK is part of a £3.5bn business. Were it standalone, it would have revenues of less than £500m would be substantially reduced in overall strength and resilience to withstand financial shocks, loss of large audits, economic cycles or any other similar events.

7.4 Under an operational split, the audit business will remain within the same network (as defined for independence purposes) as the non-audit business and subject to the multiple UK, EU and international regulations that govern auditor independence that will remain in place. An operational separation as defined by the CMA will not address conflicts nor increase choice.

7.5 In terms of the CMA's culture objective, we believe that Deloitte has an extremely strong set of governance principles and procedures that mean that audit partners' incentives are aligned with audit quality and have not seen evidence that our culture harms audit quality in any way. But we are proposing a separate audit governance and performance management structure as set out below.

A separate audit governance and performance management structure

7.6 The proposed separate governance and performance management structure has significant and far-reaching enhancements that will:

- Create a separate, transparent, independent governance and management structure for the audit business with an overriding responsibility to act in the public interest, an overarching performance management structure aligned solely with the delivery of audit quality and management process and systems to reinforce that;
- Maintain the audit business' ability to readily access overseas auditors and specialists of requisite experience, to avoid jeopardising audit quality; and
- Underpin resilience.

This structure would in our view address the concerns of culture and conflicts without the significant unintended negative consequences of structural or operational separation in its current proposed format. We have explored a range of organisations where some form of separation or ring-fencing exists, including the ring-fenced banks in the UK, BT Openreach and the recently-introduced enhanced governance regime for audit firms in the Netherlands[4].

7.7 Our proposal will demonstrate to external stakeholders that a culture of quality, independence and objectivity is pervasive within the audit business and that such a business operates separately, independently and without undue influence from the wider (non-audit) business. It would have the following attributes:

- An audit business with its own CEO, overseen by a new separate governance board and a completely independent Chairman;

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[4] Effective from 1 July 2018 and enacted in Dutch law through the Act on Additional Measures for Audit Firms (*Wet Aanvullende Maatregelen Accountantsorganisaties*), which amended the Audit Firms Supervision Act (*Wet Toezicht Accountantsorganisaties)(Wta)* and introduced mandatory independent (internal) oversight over audit firms who audit Public Interest Entities.

- The Audit Governance Board would have a majority of Independent Non-Executives. It would have clear terms of reference including maintaining a culture of audit quality within the audit practice;
- Clear reporting obligations to external stakeholders by the Audit Governance Board, including the new Audit, Reporting & Governance Authority;
- Oversight and enforcement of clear, transparent policies that link partner and staff remuneration to audit quality, overseen by the governance board;
- Oversight of scope of services restrictions for the audit practice that seek to prevent conflicts but also allow the skills of audit practitioners to be developed;
- A firm-wide strategy and budget set at a firm level, with the level of investment in audit agreed by the Audit Governance Board, to ensure investment levels are consistent with its aims of safeguarding audit quality;
- Financing and investment provided at a firm level; and
- Disclosures akin to a listed company together with an annual report and an AGM.

Such a separate governance and performance management structure in combination with an appropriate ban on non-audit services provided by audit firms to FTSE 350 and UK large private entities that they audit (as set out in our original response to the CMA's ITC document) provides a clear mechanism to address the perceptions around culture and incentives.

8. Remedy 6: Peer review

8.1 We can see merit in a peer review process as a mechanism to enable challenger firms to develop skills.

8.2 However, we see little need for extensive peer reviews to be introduced in conjunction with joint or shared audits, unless the reviews were carried out by one or other of the joint or shared audit firms. Otherwise three firms would be involved in every company's audit, which would be cumbersome and further restrictive of choice.

8.3 Alternatively the peer review could be carried out after the audit opinion had been signed which would address concerns around any associated liability and disruption to the audit process and timetable.

9. Conclusions

9.1 We are committed to playing our role in delivering change that embraces audit quality, improves choice in the market and restores trust, particularly in the way our firm's multidisciplinary structure is perceived by wider society. We have assessed your proposed remedies and built on these to suggest a basket of measures that we believe will deliver effective and sustainable change in the public interest.

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Components of the Deloitte proposal	Issue addressed: Choice	Resilience	Alignment of incentives	Culture	Deloitte comment
1. Regulatory scrutiny of audit committees			✓		We agree this proposal is worth exploring
2. Market share caps + shared audits	✓				Market share caps + shared audits provide the most effective and low risk option for increasing choice.
3. Additional measures	✓				We agree the proposal is worth exploring
4. Market resilience		✓			We agree the proposal is worth exploring
5. Refined audit governance and management structure + ban on NAS		✓	✓	✓	This will address the perceived cultural and incentive concerns and serve to increase audit quality
6. Peer review	✓				We agree this proposal is worth exploring

9.2 Our responses to the 27 questions in Section 6 of your paper are covered in the appendix.

We look forward to continuing to work constructively with you and others on this crucially important study. Please do not hesitate to contact us if you would like to explore any of the points set out in this letter.

Yours faithfully

David Barnes
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Statutory Audit Market – Responding to the Update Paper: Appendix

Monday, 21 January 2019

A. Issues

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

1.1 We recognise concerns about quality and trust in the audit sector following a number of high profile company collapses, and acknowledge that we - and others - need to work hard to address them.

1.2 However, we do not believe that the evidence supports the view that there is a widespread or systemic issue of poor quality or inappropriate culture. Each year firms like Deloitte sign off tens of thousands of audits in the UK and global networks invest hundreds of million pounds annually on audit quality. Whilst we recognise that audit quality is hard to define or measure, according to many informed stakeholders (including our main regulator), audit quality has improved significantly over the last decade.

1.3 Whilst we deeply regret any weaknesses in audit quality and work hard to rectify them, we strongly disagree with the inference that a relatively small number of corporate failures (which the evidence shows were driven overwhelmingly by the actions of company management, rather than their auditors) is indicative of a widespread problem with audit quality.

1.4 We agree with the CMA's statement that the responsibility for recent corporate failures does not rest solely with auditors. It is suggested, though, that had the auditors identified and exposed problems earlier, this would have provided shareholders and other stakeholders with an opportunity to make informed decisions. As auditors, we regularly identify issues as part of our work and ensure that these issues are addressed and appropriately exposed. We welcome the Brydon Review to clarify the purpose of audit (for example around fraud and viability) and the role of the auditor in addressing the needs of an increasingly wide range of stakeholders.

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.

2.1 We broadly agree that these are sensible issues to consider in relation to quality concerns. However, these are complex issues and, having considered the views set out in the Update Paper and the evidence, our views are not fully aligned with the CMA.

2.2 Audit committees and investors:

- In our experience audit committees are highly focused on quality, and their views are not inappropriately swayed by company management. This is particularly true for the largest and most complex companies.
- The CMA makes a significant issue of the fact that "cultural fit" and/or "personal chemistry" plays a significant part in the selection of auditors. This should not be a surprise. The audit team's relationship with company management, the audit committee and other members of the board needs to be challenging, but if it is constantly antagonistic it will not get its job done effectively.

This requires a professional working relationship with management, and it is entirely appropriate that audit committees consider this in the selection of the auditor. This is what we recognise by "cultural fit" and/or "personal chemistry", and aligns closely with the view of the audit committee chair mentioned in 3.25 of the Update Paper. It does not mean that the auditor will be more lenient than otherwise in its dealings with the company. The CMA cites no evidence from investors nor from any other stakeholders to the contrary: the CMA's view that this is a concern is unsupported by any evidence.

- As acknowledged by investors at the BEIS Select Committee hearings on 15th January, there is scope for higher levels of engagement between investors and audit committees.

2.3 Limitations on choice and barriers to challenger firms:

- The limitation of choice does not drive poor audit quality. Although the market is concentrated the evidence shows that this competition has become even stronger since the reforms instituted by the Competition Commission. Firms compete on quality and are looking to innovate and use new technologies to constantly improve audit quality.
- We believe that the biggest concerns are around quality and the relevance of audit rather than limited choice. That is why the conclusions of the CMA, Kingman and Brydon reviews need to be considered in aggregate. Collectively, they offer a unique opportunity to restore trust and confidence and drive improvements in audit and corporate reporting.
- That having been said we recognise that more choice is in the public interest in terms of resilience and the broader corporate reporting ecosystem. A very significant barrier that needs to be addressed is the capacity and ability of challenger firms to invest in competing for large company audits.

2.4 Resilience:

- We agree that the withdrawal or failure of a Big Four firm could be catastrophic for the market. That being said no firms should be too big or too powerful to fail.
- Large multidisciplinary firms are likely to be substantially more resilient than smaller monoline firms.
- The CMA states that fines imposed on firms are relatively small (e.g. paragraph 3.150). We consider that this view is subjective and wrong. Fines in the UK tend to be higher than anywhere else in the world. In considering the size of fines the relevant denominator is the size of profits of the audit practice (approximately £50m for Deloitte in 2018). We acknowledge the role of sanctions in incentivising high quality, but in recent years we have seen regulatory authorities significantly increase the level of sanctions imposed on firms, even as quality has improved.
- Whilst we do not dispute the appropriateness of a tough regulatory regime, it is important the CMA recognises that this could potentially act as a deterrent to new entrants into the large listed audit market.

2.5 Firms' structure and culture:

- As we have set out previously, we firmly believe that firms' multidisciplinary models make a very significant contribution to audit quality, resilience and independence.
- The multidisciplinary model creates stronger, more capable firms that deliver higher quality audits than audit-only firms could ever hope to achieve. We are certain that this view is supported strongly by UK companies and their investors. We believe that firms with a wide range of services are essential to delivering audit quality, and we welcome the CMA's recognition of this. The scope of large company audits – reflecting the increasingly complex and global nature of companies – necessitates the extensive use of specialists in areas including tax, actuarial, IT, cyber risk, data analytics, valuations, debt restructuring and reorganisation services, and capital

markets and UK listing rules. To be up to date and leaders in their fields, these individuals need to develop and sustain their knowledge through advisory as well as audit work.

- Notwithstanding the above, we take very seriously the CMA's concerns that the mix of skill sets and disciplines at multidisciplinary firms could adversely influence the way audits are carried out, but believe this is overstated. We note that the evidence presented by the CMA in this respect is theoretical in nature. Audit partners have clear regulatory responsibility and accountability for their work (they sign off accounts in their own names and are at risk of personal sanctions), and this drives a culture of challenge that is not influenced by non-audit service lines.
- At Deloitte, audit partners are not appraised on the basis of revenue sold to audit clients, and in fact are explicitly instructed that this is not permitted; they are appraised and reviewed throughout the year on their delivery of audit quality on their clients and contribution to the development of the audit quality culture and the development of our audit staff – this is what drives their reward and seniority in the firm. Furthermore, a culture of high quality, driven by intellectual rigour and challenge within a strict ethical framework underpins all of the work we do across the firm. We do not see evidence in the Update Paper that this has been considered properly.

B. 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?

3.1 The remedies that the CMA have proposed fall into two categories: those that apply to audits of particular companies (remedies 1, 2, 2A, and 6), and those that apply to audit firms (remedies 3, 4 and 5). This question focuses on the first type. However, this answer also briefly considers the second type.

Remedies that apply to particular companies (1, 2, 2A and 6)

3.2 Market capitalisation is not necessarily the only important factor in determining whether a remedy should be applied to a company. Indeed, the division between the FTSE 350 and other companies is permeable, with a number of companies passing in and out of the index every quarter.

3.3 However, remedies 1, 2, 2A and 6 require challenger firms (and, in the case of remedy 1, the regulator) to build up significant capacity, which will take time to develop. In addition, there may be segments of the market that challenger firms will initially find it difficult – or may not want - to serve (at least with their current capabilities), primarily the largest and most complex global companies.

3.4 We suggest therefore, that the remedies 1, 2, 2A and 6 are initially applied to FTSE 350. Within the FTSE 350, segments may be excluded on a remedy by remedy basis if there was an inappropriate increase in risk to audit quality. For example:

3.4.1. For market share caps, we have suggested that initially caps should apply to the FTSE 250, though not to the specific segments where challenger firms lack the skills or capability to carry out the audit, or where the risk profile of the audit is particularly high. For FTSE 100 companies, shared audits could be applied to help build the capabilities of challenger firms subject to a certain de minimis audit fee (to capture for example investment trusts). Further details are shown later in this paper.

3.5. We have also considered a further remedy to ban non-audit services provided by audit firms to companies they audit (as set out in our original response to the CMA's Invitation to Comment). This should be applied to the FTSE 350 and large private entities.

Remedies that apply to audit firms (3, 4, and 5)

3.5 We believe that remedies 3, 4 and 5 should apply to all audit firms that are involved in audits covered by remedies 1, 2, 2A and 6.

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.

4.1 The Update Paper argues that is that there is insufficient evidence that audit committees are "consistently prioritising quality" and therefore that they are not fulfilling their responsibility to protect the interests of shareholders. If the regulatory scrutiny remedy is going to be effective, there will be need to a robust and clearly defined set of expectations against which the behaviour

and activities of audit committees will be measured without creating a box-ticking mentality. It will be important to ensure that these expectations are able to be evidenced and observed.

4.2 The four matters which are listed in 4.16(a) are capable of being evidenced and observed, and it would be relatively straightforward to introduce a reporting requirement for audit committees to explain to the regulator how they had addressed those four elements. Where the regulator felt that the explanations provided were insufficient and/or inappropriate, the regulator would be able to raise further challenges. It is unclear whether this would be private reporting to the regulator although it seems appropriate that shareholders are able to understand the audit committees' decision-making process.

4.3 We have some concerns over the expected requirements set out in part (b) of 4.16. Greater clarity would need to be provided on what was judged to be a "meaningful intervention to assess quality". As has been identified during the CMA review, the focus should be on the key financial reporting judgements and the reasoning behind those. Clear expectations should be developed in relation to the work an audit committee should undertake (and be able to evidence) to challenge management on their judgements and the auditors on their evaluation of those judgements.

4.4 In addition, a requirement to "provide the regulator with an account of material disagreements between the audit firm and management" seems rather incongruous. It is difficult to understand what such a requirement would achieve and how that would demonstrate that the audit committee is monitoring audit quality. It should be noted that a material disagreement would be exposed in the audit report and were it not corrected, the auditor would report such a matter and potentially resign.

4.5 In our view the focus should be on key financial reporting judgements and explaining precisely what the audit committee has done in relation to those. The existing audit committee reporting disclosures have become, in some cases, rather too bland and unspecific to be of benefit in instilling confidence that the audit committee has fulfilled its responsibilities. As highlighted by past reports from the FRC's Financial Reporting and Audit & Assurance Labs, there are steps that can be taken to improve this reporting. We believe the regulator should focus on driving up better quality disclosures in this area so that shareholders can also benefit from enhanced transparency on these important matters.

4.6 Implementing this remedy will require close cooperation with the Kingman Review and BEIS to ensure that the powers of the Audit, Reporting and Governance Authority (the new regulator proposed by the Kingman Review) are proportionate and aligned appropriately.

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?

Note: our response to this question goes into some detail on joint audits before answering parts a and b. We believe it is important to set out our views given our opposition to joint audits.

The evidence collected by the CMA

5.1 There is limited empirical evidence for the effect of mandated joint audit on audit quality – and certainly for the suggestion that joint audit would lead to any improvement in audit quality. A meta-study carried out in 2013[1] considered 20 separate studies carried out between 2007 and 2012 on the joint audit in markets where it has operated, such as France and Denmark. It is difficult to

[1] Ratzinger-Sakel et al, 2013 "Joint Audit: Issues and Challenges for Researchers and Policy Makers"

draw a conclusion that mandatory joint audit has been associated with a significant improvement in audit quality. The CMA has drawn a similar conclusion in para 4.55 of the Update Paper. Companies and investors in the UK can currently choose to appoint joint auditors but they do not.

5.2 There is also a risk that the change in audit quality could be negative as well as positive, given that joint audits are more complex to administer. The Ratzinger-Sakel study notes the difficulty in allocating work between the firms and that un-even distributions in the split of work can lead to one firm becoming dependent on the other, limiting the effectiveness of the "four-eyes" review.

5.3 The research is more conclusive around the likelihood of increased costs in a joint audit setting, but this does not appear to be a key consideration for the CMA in the application of this remedy.

5.4 Research also highlights that a joint audit remedy will be effective at improving choice in the market by allowing challenger firms more audit "slots" and opportunities to participate although in France joint audits have been in place for more than 50 years but have not been successful in creating a 5th large global accounting Firm.

5.5 The joint audit approach in France was codified within their joint audit standard, NEP-100, in 2011 in order to require balanced shares of the audit work between firms. Mandatory joint audit in Denmark was abandoned after it became apparent that many joint audits were run on an 80/20 split and solo firm audits were preferable.

Other concerns with joint audits

5.6 Joint audit opinions require each audit firm to have enough knowledge of the audit subject to carry out their own risk assessment for the entire group. Each firm should then undertake a balanced allocation of the audit testing and then review the work and conclusions of the other firm in order to conclude on the whole. We do not believe that it is workable for either firm to have a situation where one party is taking a significantly lower share which could create the sense of a "senior" and "junior" party in the arrangement. A junior auditor would have less knowledge with which to complete their risk assessment and might become too reliant on the technical skills and judgements of the senior auditor. This creates a situation where one auditor loses their independence in the relationship and is unable to effectively carry out their role. Equally, situations could arise where audit firms align their views with management to either defend or try to build their share and, in doing so, lose objectivity or promote "opinion-shopping" by the audited entity.

5.7 Whilst it is difficult to put an absolute measure on what might constitute an appropriate balance of work between auditors (because the correlation of cost and effort to audit the respective account balances and levels of audit risk will be different for each audited entity) we assume that this might be towards 40% of the fees and audit hours. In a joint audit environment, the challenger firms will need to be ready to provide a significant volume of listed company audit work from the point of transition. We estimate that the FTSE 350 market fee base is over £1.0 billion, so this is a substantial volume of work and would require significant and sustained long term growth at the challenger firms.

5.8 The CMA has recognised the potential threat to audit quality of asking challenger firms to develop audit capability, industry skills and experience, and their international networks too quickly. We agree with this view as our own analysis shows that to achieve a meaningful number of joint audits would move the challenger firms from FTSE 350 fees of £5 million to around £400 million, a CAGR of over 140%[2] in their FTSE 350 delivery teams over the next five years. This would require challenger firms to add 3,600[2] net new audit staff over five years, an increase of around 70%, and build teams in all industries and technical specialisms – the extent of which we would consider impracticable. We think a more practical and sustainable market change could be brought about if shared audits rather than joint audits were introduced. In this model one firm has overall responsibility for the group opinion but allocates a certain % of the audit work between 10-20% to a component auditor from a different firm.

[2] Deloitte analysis based on market simulation

5.9 We would be concerned if interim measures were imposed that required two Big Four firms to take on the joint audits of the largest, most complex companies as in interim measure. This would be unworkable and would actually reduce choice. Consider, for example, joint audits involving Big Four firms at the UK's four largest retail banks. Each bank would be audited by two firms and when the audit was rotated, they would have to appoint the other two firms – they would have no choice at all. The remedy would make no difference to the capability or scale of challenger firms in contrast to shared audits.

5.10 The CMA observes that the French market operates successfully with joint audit, but there are some fundamental differences between the French and the UK, not least that the French audit market has a significantly different history and that auditors tend to be appointed for a period of six years. In addition, we understand that audit firms in France are members of a common fund to cover auditor liabilities and our response on the liability framework is covered in question 9. Audit firms in the UK do not benefit from either of these and we have developed our proposals with the specifics of the UK market in mind. If the CMA wishes to base its conclusions on evidence from the French market, it is clear that significant further work would be required.

Shared audit would be a more effective and proportionate remedy to the identified concerns

5.11 A shared audit approach would:

- Allow challenger firms to build up their skills over time more easily. The second auditor in a shared audit could start with a lower share, say 10-20%, and build up over time. This could apply to all companies, including banks;
- Be flexible to the existing industry skills and geographical networks of the challenger firms. With appropriate planning over time, this gives the firms time to develop the reach and expertise they will need to carry out a larger share;
- Be capable of being introduced more quickly, because it does not need to align with or interfere with the overall group auditor appointment and it does not rely on challenger firms having developed significant additional delivery capability;
- Be carried out under existing audit standards and liability arrangements, reducing the need for lengthy processes to develop, consult on and endorse new standards and statute; and
- Be more compatible with peer reviews (remedy 6). This would help challenger firms develop their capabilities through engagement quality control reviews.

Oversight and responsibility of the audit committee

5.12 Audit committees should have oversight of how the split of work between the two auditors in a shared audit arrangement is allocated, as part of their role of overseeing audit quality and the suitability of the audit process to the entity in question.

5.13 Each audited entity is unique in terms of industry, geography and technical demands, and each audit firm is different in terms of its ability; setting rules which prescribe auditor selection too narrowly may be detrimental to audit quality.

5.14 The Audit Committee needs to have the ability to make decisions in the best interests of shareholders and audit quality. This is also consistent with the requirements in s172 of Companies Act 2006, which require directors to promote the success of the company for the benefit of the members as a whole.

5.15 The measures in remedy 1 set out enhanced regulatory oversight of the audit committee's role in selection of the auditor and the conduct of the audit. This presents a mechanism via which interventions can be applied if the regulator believes that the audit committee is not operating shared audit in an appropriate way.

Conclusion on effectiveness of a joint audit remedy

5.16 We believe that the CMA's proposal for joint audit has been designed with good intentions but at a time when UK markets are already affected by the uncertainty of Brexit, the introduction of a fundamental change in the cost, conduct and potentially quality of audit is unlikely to be welcomed by investors or companies. We believe that our proposal to allow a shared audit approach combined with market share caps on a selective basis for an agreed period of time is less damaging to the competitiveness of the UK markets as a whole, but is just as likely to have the impact on participation of challenger firms in the FTSE audit market.

Entities in scope

5.17 We do not believe that joint audits should be applied to the FTSE 350 or large private companies. We believe that market share caps should apply in certain sectors of the FTSE 350 and that shared audits should apply for the remaining FTSE 350 companies subject to a de minimis audit fee.

Excluded entities

5.18 We comment in questions 10 and 11 on how shared audit might work in conjunction with a market share cap and this might address some of the difficulties of applying joint or shared audit throughout the market.

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.

6.1 Please refer to our response to question 5.

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.

7.1 Our response to question 5 outlines that in a true joint audit with a joint audit opinion, we believe that the work should be balanced between the participating firms. This is to avoid the risk of one auditor becoming dependent on the decisions of the other. This is strongly supported by evidence from other geographies, which must be considered before coming to the conclusion that joint audit can be an effective remedy.

7.2 The requirement for balanced audits will need to be captured in a joint audit standard and then further action by the regulator should not be required.

7.3 In a shared audit situation it might be more appropriate for the regulator to set guidelines on minimum share and how that should build up over time, along the lines of the examples set out in para 4.35 of the Update Paper. In our view, setting the share by size of entity and introducing different segments of the market at different times (4.35a) would be undesirable because individual entities and the composition of the FTSE 100 and FTSE 250 change over time.

7.4 The audit committee should be responsible for challenging and approving the proposed split of responsibilities between the participating audit firms.

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?

Appointment

8.1 The experience of the French market is that appointments are made at the discretion of each entity and that in practice, some companies rotate both auditors at the same time and others stagger them. The French rules require that each auditor is appointed for a minimum six year term, which better aligns with the EU requirement for joint audit appointments to last a maximum of 24 years (compared to 20 years for a solo auditor).

8.2 Staggered appointment retains some knowledge in the combined audit team, but refreshes the challenge that each firm faces during their term. However, it creates an environment of more frequent re-tendering and more disruption in the availability of other non-audit services as each firm cycles in from non-audit provider to auditor.

8.3 Changing both at the same time is operationally simpler and could, in the extreme, give ten years of certainty over which firms are independent and which are not. This does, however, give challenges of bringing on two new firms at once and keeping all firms independent in advance of appointment (early tenders would give time for this will reduce negative impact of this).

8.4 Each audit committee will have its own view on their priorities for audit rotation and the need to use firms for non-audit services and should be left to adopt an approach that works best for them.

8.5 When we consider the aims of the remedy, to improve the choice in the audit market, we do not believe that the staggering of the appointments is essential for bringing about change and consider this is a decision best left to audit committees having regard to what works best for them.

Transition

8.6 In contrast, the timing of the transition to new rules will affect how quickly the market participation of challenger firms can be increased.

8.7 Almost all FTSE 350 entities have now addressed the problems of long-association audit appointments and are into a five or ten year audit tendering cycle. There are many new audit relationships that are still bedding in and others are planned to switch in the coming years.

8.8 Given that joint audit is a fundamental change to the market, it would be more sensible to pursue a balanced timetable, giving audit committees and existing auditors time to adapt to the change. There are obvious risks to introducing a second firm and existing auditors may not wish to continue if they are not satisfied by the appointment of the second firm. An alternative timeline would be to wait until the next rotation of audit firm or partner, at which point a re-tender could be used to confirm that the group audit firm is willing to work with the proposed second firm (or give them an opportunity to resign).

8.9 Group audit tenders take place normally two years ahead and cycles are generally five years, so this will take longer to implement. Assuming legislation during 2019, this change could be no earlier than 2021-25 for most businesses, as above.

8.10 In contrast companies transitioning to a shared audit approach will not need to change their group auditor or amend their rotation cycle. Audit committees could appoint a second firm and introduce them within an existing audit relationship. Depending on the timing of the finalisation of the findings from this review, the second firm could potentially be appointed and independent as early as December 2020, and working on the audit of December 2021 year ends.

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?

9.1 Any form of joint or shared audit relationship will make the claims process significantly more complex.

9.2 One of the core principles of joint audit is that both firms take responsibility for the entire opinion and are comfortable with the work done by both firms. In the event of a claim following negligence by the joint auditors, under joint and several liability, claimants are entitled to only pursue one firm, presumably the larger one. There is also a concern that one firm might end up covering the costs of another in the event of a failure. This would act as a disincentive for audit firms to be involved in joint audit, potentially reducing choice in the market.

9.3 For joint audit, we consider that the evidence would support the view that proportional liability would be preferable, because it reflects a sharing of the risk, potentially in proportion to the share of fee, and encourages the two firms to work co-operatively in completing a high quality audit. We also believe that all firms would benefit from an established framework as to how liability should be shared, to provide an element of clarity to the claims process.

9.4 The common law framework in England is based on joint and several liability. More specifically, Section 532 of the Companies Act 2006 will "void any provision exempting an auditor of a company (to any extent) from any liability that would otherwise attach to him…" We are concerned that it will be difficult for firms to include proportional liability within their audit engagement letters, as such contract terms would be void, unless they were approved by the company's members each year (under Section 534-7). We recommend that an amendment to Companies Act 2006 or additional legislation will be required to allow for proportional liability in the case of a joint audit.

9.5 Further, firms outside the Big Four typically have much less access to professional indemnity cover. Broadly speaking, professional indemnity cover is not available in the open market, so the largest networks have established captive insurance companies. Without liability reform there could be significant threat that an audit failure could lead to the collapse of a firm and a resulting reduction of choice.

9.6 For shared audit, the group auditor would retain liability for the group audit opinion and if the failing was related to the second auditor, then that would be a matter for the two audit firms to resolve. This is no different to the situation currently and would need no further statutory amendment.

Remedy 2A: Market share cap

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

10.1 We welcome that the CMA's Update Paper remains open to a remedy based on the concept of a market share cap or caps ("cap"), for particular segments or subsets of the market. As we have set out above we continue to believe that such a remedy could over time address choice and competition issues. We believe that the evidence shows that it could do so more effectively than other remedies considered by the CMA and that the CMA should not dismiss this remedy on the basis of the evidence that it has gathered to date.

10.2 We propose that the market share cap could be designed in a way that develops the capability of challenger firms in a controlled way, without risking audit quality, and avoiding cherry picking.

10.3 A cap (based on the number of audits) could be applied to upcoming tenders within the FTSE 250. This cap could be implemented by temporarily excluding the Big Four firms from bidding for audits

in certain sectors that are deemed not to be complex or have large scale international operations. An independent third party could define the segments of the market in which the Big Four firms would be excluded from bidding for, based on objective criteria. There would also be an option for that body to introduce a public interest override if necessary.

10.4 The sectors which we propose the Big Four are initially prevented from bidding for are the FTSE 250 investment trusts, Consumer Business, Infrastructure Services & Real Estate, Manufacturing and TMT. These are selected on the basis that:

- These are sectors in which challenger firms already have a FTSE 350 presence.
- These sectors have been identified as less complex and lower risk, but with a critical mass in terms of audit size and number to create a base for future growth.

10.5 A cap designed in this way would mitigate the risk of (i) cherry picking on the basis of expected profitability or risk profile, and (ii) firms being appointed as auditor that potentially do not possess the required capabilities, which may otherwise lead to a decline in audit quality.

10.6 The market share cap could be complemented by mandating shared audit for the largest companies that are audited by the Big Four, over an agreed audit fee. This would help challenger firms build the experience, credentials, and capacity to take-on larger and more complex audits and ultimately expand the number of sectors where market share caps would apply.

10.7 The complementary use of shared audits can also help to address the problem of 'cherry-picking' appointments if the four largest auditors dilute their participation without needing to resign entirely from current roles.

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

11.1 A market share cap should only apply to segments within the FTSE 250.

11.2 The segments which we propose are the FTSE 250 investment trusts, Consumer Business, Infrastructure Services & Real Estate, Manufacturing and TMT, on the basis that:

- These are sectors in which challenger firms already have a FTSE 350 presence.
- These sectors have been identified as less complex and lower risk, but with a critical mass in terms of audit size and number to create a base for future growth.

11.3 Under a joint audit model (assuming a 40% share in FTSE 350 audit work after 5 years) we estimate that the challenger firms would move from FTSE 350 revenue of £5 million to around £400 million. They would need to recruit an additional estimated 3,600 audit practitioners (net, in the UK) over 5 years. We estimate that this will represent an increase of over 70% in audit practitioners amongst the challenger firms and requires that they develop capability across all industries and audit specialisms.

11.4 We contrast this with our proposal of a combination of market share cap and shared audits. Such a model could enable challenger firms to significantly develop their capability through an additional 25% market share of FTSE 250 companies by 2024 alongside a meaningful share of audit work of the largest and most complex FTSE 100 companies. This would result in the challenger firms being well positioned to compete with the largest four firms for the audits of FTSE 100 companies after 5 years. We estimate that over 5 years, these firms would need to recruit c.1,000 audit practitioners (net, in the UK) and by 2024 these firms would have a c.25% share of audit fees within the FTSE 350 (excluding audit fees of the FTSE 30). Importantly, the rate of growth (on a CAGR basis) would be half the rate of joint audits described above and allows each firm to focus on particular specialisms and industries. This allows capability to be developed in a more controlled manner, reducing the risk to audit quality.

11.5 We consider that our proposal would therefore address the CMA's objective of reducing barriers facing challenger firms auditing listed companies, and achieve a balance between short and long term competition and audit quality, without the need to extend the cap beyond the FTSE 350. We do not believe that the cap needs to be applied to large private entities.

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.

12.1 From a contractual point of view, barriers to senior individuals moving quickly and smoothly between firms are limited to a six month notice period for partners and others that sign audit opinions and a three month notice period for staff below partner down to the manager grade. The reason for this is that as a firm we think a six month time horizon is required to ensure that all audit obligations can be delivered and handed over in a way that doesn't compromise quality by expecting, for example, a partner to take on signing responsibility mid-way through an audit. Our view is that such a time frame is appropriate given the length of elapsed time in delivering a typical audit and the need to arrange for appropriate handover.

12.2 Our own hiring data suggests that there is no restriction on the movement of people between accounting firms. Two thirds of our experienced external audit hires come from other UK and overseas accounting firms.

12.3 The other barriers will be commercial in nature i.e. the attractiveness of the firm that a senior individual might move to, in terms of both remunerative potential and the work they would be engaged in. We believe the removal of any such barriers is worth exploring.

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.

13.1 It is difficult to provide an estimate on this without defining what it is that a tendering fund would be looking to support and why. In its paper, the CMA recognises that one of the likely barriers to tendering is the fact that it is not worth the investment if there is no chance of a successful outcome. The CMA also notes that there are remedies being proposed that would address this. We are supportive of the CMA continuing to keep this under review and to the extent that it is determined that other remedies are not resulting in a larger number of firms tendering for audit work, revisiting the proposal.

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.

14.1 The UK Deloitte firm does not wholly own the IP behind the technology platform we use to execute audits. The IP is owned by a global holding company in which we have a minority interest. As such even if compelled to do so we would not be able to license technology platforms to challenger firms without our global firm agreeing to this. They would also need to agree the price for doing so, which is likely to be at a commercial rate.

14.2 In terms of financial contribution, we do not think it is in the long term interest of the market to have an effective subsidy being paid from the Big Four to the challenger firms. We would be supportive of challenger firms pooling their resources to develop a single technology platform if they felt that was appropriate. We are not supportive of the Big Four firms providing an open ended subsidy. We would be willing to have discussions on provision of SME support to assist in platform design.

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.

15.1 In common with other big firms, Deloitte has been encouraged by the FRC in recent years to develop contingency plans to address threats that could lead to the collapse of the firm. This could be precipitated by actions or events in the UK firm or the international network. We believe there could be merit in develop an industry-wide contingency plan.

15.2 Our plans have not hitherto considered the creation of a special insolvency regime. However, while a relevant consideration, we do consider it will be much harder to create a such a regime for audit firms than it would be for, say, banking or care homes, because sustaining our business is much more dependent on keeping our partners and staff at the firm and maintaining the confidence of our clients. If the firm is in trouble, either through a sudden event or a gradual decline, there is little we can do to prevent either people or clients from leaving us. A regime that encourages clients and staff to stay, or to move to another firm in a coordinated fashion, might help but would be very difficult to enforce – ultimately staff and clients will go where there is trust and confidence.

15.3 The experience of Arthur Andersen in the UK in 2002 is instructive here. Following the collapse of trust in the US in the aftermath of Enron's failure, the firm itself could not be rescued. Instead, Deloitte in the UK "took over" most of the firm in the UK. This was not through an M&A transaction, but through a process that was in effect a mass recruitment and a purchase of some assets. Further "rescues" of collapsing firms by others may need to use a similar mechanism. The difference between then and now is that social and digital media will accelerate and magnify any loss of confidence much more quickly, so it will be that much harder to keep the failing firm intact while negotiations are pursued.

15.4 Nevertheless, we agree that there is merit in the CMA considering this further through, for example, plans for a regulator and other appointees temporarily taking over a failed firm to ensure its stability while a long-term plan is invoked.

15.5 Partners are, to some degree, incentivised to stay through the threat of losing the capital they have invested in the business, but they may decide it has little value if the firm is collapsing. Putting in place temporary measures to increase the notice period that people need to give to leave a firm under threat, and further tightening covenants to prevent people from working at former clients at new firms might also help retain staff, at least in the short term. It would be very difficult, though, to prevent clients deserting a threatened firm – and audit committees could well argue that any action that did so would be against the interests of companies and their shareholders.

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

16.1 At the moment there is a danger that firms could be seen as too big to fail, and that therefore regulators are overly lenient in imposing sanctions on firms. In recent years the FRC has tried to address this in two ways: by reviewing the sanctions regime and by ensuring firms have contingency plans in place. As a result, the level of fines imposed on firms has generally increased and firms have increased their focus on resilience.

16.2 The CMA recognises in paragraph 4.110 that a resilience remedy of the sort described in remedy 4 could create a moral hazard by tacitly incentivising excessive risk-taking by a firm in the expectation of a "bail out" if the firm is threatened as a consequence. As we set out above, measures including withholding partners' equity, changing people's notice periods and further tightening covenants would have a material impact on firm's partners' and employees, and could therefore be an effective deterrent to excessive risk-taking.

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.

17.1 As above it is hard to answer this question given the likely difficulty in setting up a special administration regime.

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.

18.1 We agree that this is the most significant challenge in designing a resilience system. The CMA's initial views of incentivising or mandating the movement of clients and staff are correct, but may underestimate the challenge of finding a mechanism that is both effective and acceptable from the point of view of multiple stakeholders.

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.

19.1 No. We believe that the practical challenges to implementing a successful structural separation of the UK audit business (as described in section 4.117) are unsurmountable and if undertaken would be to the detriment of audit quality and we have set out the reasons for this below.

19.2 There are four principal challenges:

i. access to international network;

ii. access to audit specialists;

iii. resilience and scale; and

iv. access to talent.

19.3 The first and one of the most significant challenges emanates from the potential inability of a structurally separated audit firm to maintain an international network that is free of conflicts. A structurally separated UK audit practice would have no right, or operating leverage, to prevent the multidisciplinary international audit firm (to which the UK audit firm is a member of) from managing conflicts of interest as it currently does. This is likely to be exaggerated by any economic disincentive of the international multidisciplinary audit firm from maintaining independence from the largest and most complex UK companies. This challenge would arise for all firms contemplating auditing these companies.

19.4 We accept that a structurally separated UK audit firm would have discretion to use a variety of other audit firms in undertaking an international audit. However, under the current independence

regulations it would be completely impracticable to source appropriately skilled auditors who are not part of an international network that can adequately safeguard its independence.

19.5 Secondly, as the FRC has acknowledged[3], specialists used in the audit make a fundamental contribution to audit quality. Furthermore, the participants of a joint study undertaken by the Institute of Chartered Accountants in Scotland (ICAS) and the FRC[4] supported the use of in-house experts for the purposes of "ensuring a consistency of approach and an adherence to confidentiality undertakings." However, it would not be practicable to source specialists of requisite experience to assist the structurally separated audit firm in undertaking an audit due to:

- the likelihood that specialists directly employed by the structurally separated audit firm would not have the requisite experience due to solely working on audits (as opposed to developing their specialism through working within a multidisciplinary firm);
- the difficulties of sourcing specialists from a professional services firm that are independent and free from conflicts (similar to the challenges in sourcing an international audit team as described above); and
- the inability of the structurally separated audit firm to adequately manage its liability. We do not believe that professional services firms would be prepared to provide input into audits based on unlimited liability nor do we consider it credible to suggest that a small service company of audit specialists would have the financial resources to provide specialists on this basis. Furthermore, it may not be possible for an audit firm to limit its liability with specialist providers under existing independence rules.

19.6 Thirdly, a structurally separated audit firm with a less diversified business model would not only be significantly smaller in scale but also more vulnerable to shocks. A structural separation may therefore have an unintended consequence of reducing resilience in the audit market.

19.7 Lastly, we consider that a structurally separated firm would be less able to attract the highest calibre of talent. The consequences of this may be exasperated by any broader changes to the audit product, which could require highly skilled graduates and professionals to deliver the audit of the future.

19.8 In summary, we believe that a remedy of full structural separation is not just impracticable to effect but is also completely disproportionate.

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.

20.1 An operational separation as described by the CMA in section 4.118 has a number of drawbacks, as we have described above. As defined by the CMA such a separation would not address conflicts nor improve choice as the IESBA standards and other overseas requirements would still apply to the audit business.

20.2 As an alternative, a form of separation effected through a governance and performance management structure would address the CMA's objectives of addressing cultural and incentive concerns. This will:

- Maintain the audit business' ability to readily access overseas auditors and specialists of requisite experience (as noted in our paragraph 19.4), to avoid jeopardising audit quality; and

[3] FRC report on Deloitte, June 2018 (https://www.frc.org.uk/getattachment/ce810efe-9597-4303-a209-d507cd0ca333/Deloitte-LLP-Public-Report-2017-18.pdf)

[4] https://www.icas.com/__data/assets/pdf_file/0003/239457/The-capability-and-competency-requirements-of-auditors-in-todays-complex-global-business-environment.pdf

- Create a more transparent and separate governance and performance management structure for the audit business. This would help address perceived issues that the culture of the audit practice is not aligned to the public interest.

20.3 We have explored a range of organisations where some form of separation or ring-fencing exists, including ring-fenced banks in the UK, BT Openreach[5] and the recently-introduced enhanced governance regime for audit firms in the Netherlands[6].

20.4 Our proposal will demonstrate to external stakeholders that a culture of quality, independence and objectivity is pervasive within the audit business and that such a business operates separately, independently and without undue influence from the wider (non-audit) business. It would have the following attributes:

- An audit business with its own CEO, overseen by a new governance board and a completely independent Chairman;
- The Audit Governance Board would have a majority of Independent Non-Executives. It would have clear terms of reference including maintaining a culture of audit quality within the audit practice;
- Clear reporting obligations to external stakeholders by the Audit Governance Board, including the new Audit, Reporting & Governance Authority;
- Oversight and enforcement of clear, transparent policies that link partner and staff remuneration to audit quality, overseen by the governance board;
- Oversight of scope of services restrictions for the audit practice that seek to prevent conflicts but also allow the skills of audit practitioners to be developed;
- A firm-wide strategy and budget set at a firm level, with the level of investment in audit agreed by the Audit Governance Board, to ensure investment levels are consistent with its aims of safeguarding audit quality;
- Financing and investment provided at a firm level; and
- Disclosures akin to a listed company together with an annual report and an AGM.

20.5 Such a separate governance and performance management structure in combination with an appropriate ban on non-audit services, to be defined, provided by audit firms to FTSE 350 companies and large private companies that they audit (as set out in our original response to the CMA's ITC document) provides a straightforward means of addressing the misperceptions around culture and incentives. Since the definition of the audit product will be covered by the Brydon Review, we recommend that the CMA works closely with it in considering this remedy further.

[5] Whilst the objective for separating the ring-fenced banks and Openreach is different to the CMA's Audit Market Study, we found it useful to consider the governance structure of those case studies to test the credibility of our proposals.

[6] Effective from 1 July 2018 and enacted in Dutch law through the *Act on Additional Measures for Audit Firms* (*Wet Aanvullende Maatregelen Accountantsorganisaties*), which amended the *Audit Firms Supervision Act* (*Wet Toezicht Accountantsorganisaties*)(Wta) and introduced mandatory independent (internal) oversight over audit firms who audit Public Interest Entities.

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.

21.1 For the reasons described above we believe that the CMA's proposed model for operational separation has material unintended consequences. These downsides, whilst slightly less than structural separation, will lead to lower audit quality and reduced resilience.

21.2 Firms may have to transfer substantial payments to pension schemes in the event that the schemes need to be split as a result of the underlying business being separated. This payment may have an impact on the separated business' viability.

21.3 We believe that our proposed separate governance and performance management structure including independent oversight would adequately address the cultural concerns highlighted in the CMA's update paper.

21.4 We consider that our proposed framework has a low risk of circumvention by the audit firms.

21.5 We believe that our proposed separate governance and performance management structure could be brought into effect within 12-18 months.

21.6 We propose that the costs of operating our proposed separate governance and performance management structure would be borne by the audit firms individually.

21.7 We propose that the governance board responsible for overseeing the audit business would have a direct line of communication to the regulator. Furthermore, we consider that extensive regulatory monitoring and enforcement will be essential to ensuring the successful implementation of our proposed separate governance and performance management structure.

21.8 The Audit Governance Board (as described in 20.4) would be responsible for maintaining and system of control, and a culture of, audit quality within the audit practice. Accordingly, they will be responsible for receiving inspection reports from the regulator and responding to the regulator's comments on the firm or its work.

22. Under an operational split, how far, if 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.

22.1 We do not believe that the operational split would allow any relaxation of restrictions. Firms and companies are subject to a range of international regulatory requirements from bodies such as the SEC and IESBA. We also believe that there will still be an understandable perception of conflict if audit and advisory services are provided to the same company from entities within the same network – albeit operationally separate.

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

23.1 Yes. We believe that all audit firms should be included within the scope of any remedy that changes the construct, operating model or governance of such firms. This is for a number of reasons:

- There is no reason to suggest that the concerns around the negative effects on culture (paragraph 4.116(b)) would not be equally applicable to all firms;
- It is more clearly understandable a proposition for all stakeholders, especially those outside of the audit firms;
- It allows for a level playing field across all firms and could be viewed as discriminatory if not applied consistently;
- There is no obvious threshold to apply as to at what point the requirements would apply that is not arbitrary;
- By not applying the remedy across all firms, it could provide a disincentive for challenger firms to breach any designated threshold and could provide an additional, unintended barrier to entry;
- Similarly, a firm could move above and below a threshold over a period of time which could provide instability for that firm; and
- The separate governance and performance management structure set out in our response to question 20 are good practice and the opportunity should be taken to apply these across all firms.

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.

24.1 As we have noted above, we are not supportive of a full structural split or operational split (as currently defined by the CMA) as we do not believe that it either removes conflicts or increases choice.

24.2 Instead we advocate a separate governance and performance management structure and a ban on non-audit services provided by audit firms to FTSE 350 and large private entities that they audit (as set out in our original response to the CMA's ITC document), as this provides a clear mechanism to address perceptions around culture and incentives. This will require a clear definition of 'audit services'. We would suggest that as well as the annual audit, this definition includes closely-related services that, for reasons of time and cost, are best carried out by the auditor, such as the half-year review, reporting accountant engagements for investment circulars, grant applications, due diligence and similar services.

24.3 Separately, we believe that it is important that individuals within an Audit division are entitled to provide non-audit services to non-audit clients. This enables those individuals to further develop industry and technical specialisms which they can then utilise as part of their audit work, to help drive higher quality audits.

24.4 In addition, it will enable them to keep their skills and knowledge up to date such that where a firm has no client in a particular industry such as banking (due to auditor rotation) allowing them to be credible and improve choice in any upcoming tender.

24.5 Whilst not directly relevant to this question, care is needed about restricting indirect non-audit services (for example involving banking syndicates), which could severely restrict choice in certain non-audit services markets. We would be happy to explore this further with the CMA if necessary.

Remedy 6: Peer review

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

25.1 The CMA's proposal is that the regulator would select which entities were in scope for a peer review. Entities in certain industries might be defined as higher risk and always have a review, but the regulator would need to balance this against the need to include an element of random selection, so that there is a chance that any engagement could be selected. They will also need to ensure that there is sufficient coverage of each audit firm.

25.2 Al peer review that is completed before the audit sign off will need to be planned for well in advance, including the need to make the appointment, confirm independence and start the review process during the planning phase of the audit. In practice, this will mean that the selections need to be made before the start of the financial year in question to give all parties, and the reviewer in particular, the opportunity to prepare for it.

25.3 There is a potential stigma associated with those entities who are selected for peer review, where this might be taken as a sign that the regulator is concerned about that industry or specific company.

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

26.1 Any form of peer review will add time and cost to audit engagements and, ultimately, this will end up being paid for by the audited companies, not only in the form of any fees but also in an additional burden on management where differences of opinion arise. It could also potentially disrupt the year end reporting process.

26.2 The review is most effective when it is carried out before the audit is complete and the peer reviewer gives their confirmation that the review findings have been addressed before the audit opinion is issued. The review should take place over the period of the audit, so that issues can be identified and resolved as the work progresses.

26.3 The unavoidable consequences are that the peer review firm will ultimately have some risk attached to their opinion that the audit has been carried out appropriately and that the review firm will need to be independent from the audit client under the ethical standards.

26.4 The profession will need to develop a framework for doing these peer reviews that addresses scope, access, responsibility and legal liability. This will also need to consider access to the audit documentation prepared by international networks where UK regulations may have no jurisdiction.

26.5 We do not believe that this remedy is compatible with a proposal for joint audit opinions, because the two firms are already performing peer reviews of each other's work. However, peer review might be compatible with a shared audit approach or a market share cap system.

26.6 If combining this with the shared audit concept, we believe that the independent peer review team could be drawn from the firm of the shared auditor – indeed involving a third firm would be cumbersome. ISA 220 acknowledges that the EQCR team needs to be separate from the client-facing audit engagement team and this would still be possible, even where the shared audit firm was providing both the peer review team and component audit teams, provided that they were separate from each other. All firms are familiar with working in this manner already. The benefit of this is that the shared audit firm would already have met the independence standards for the audited group in question and it would avoid a situation where three firms needed to be independent for each audit.

26.7 Peer review can also be a factor in developing audit capability and, ultimately, improving choice in the market. The effective challenge of an EQCR team is important in the delivery of a quality audit of a listed business and this will allow challenger firms that get involved in providing these services

to develop the EQCR skills of their more experienced auditors at the same time as facilitating knowledge sharing between firms that review each other's work.

C. Remedies

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

27.1 Deloitte appreciates that the CMA's update report has been prepared at speed, and Deloitte has collaborated fully with the CMA. The remedies now under consideration are liable to have an enormous impact on the UK audit market, and, more importantly, on a very large number of UK corporates (including but not limited to the UK's largest listed companies).

27.2 Given the seriousness of these issues, and the remedies that are under consideration, it is incumbent on the CMA seriously to consider whether or not a market investigation may be more appropriate than the making of recommendations after such a curtailed review period. This is true not just of the publication of the update report, but also of what Deloitte understands to be the timetable for the conclusion of the market study. Given the seriousness of the issues, it may not properly be open to the CMA to conclude that it can make recommendations of the nature currently under contemplation based on the evidence that it has gathered over such a short period of time, without making a market investigation reference.

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