



CMA STATUTORY AUDIT SERVICES MARKET STUDY - UPDATE PAPER

Issued 23 January 2019

ICAEW welcomes the opportunity to comment on the *Statutory audit services market study* update paper published by the Competition and Markets Authority on 18 December 2018, a copy of which is available from this [link](#).

ICAEW is a world-leading professional body established under a Royal Charter to serve the public interest. In pursuit of its vision of a world of strong economies, ICAEW works with governments, regulators and businesses and it leads, connects, supports and regulates more than 150,000 chartered accountant members in over 160 countries. ICAEW members work in all types of private and public organisations, including public practice firms, and are trained to provide clarity and rigour and to apply the highest professional, technical and ethical standards.

We have broadly welcomed both this update paper from the CMA and the report of the independent review led by Sir John Kingman of the operation of the Financial Reporting Council (FRC), which was published alongside it. Taken together we see them as the kind of bold systemic intervention necessary to tackle underlying issues of regulation, quality and competition in the audit market. However, given the radical - indeed, the untried - nature of many of the proposals under consideration by the CMA and their potential consequences, not just for the audit sector but for business in Britain generally, ICAEW recommends that sufficient time is allowed for further consultation, debate and development. We also believe that the interventions implemented as a result of the market study should be periodically reviewed (probably by the new regulator proposed by the Kingman Review,) to assess whether the desired effect has been achieved, and whether their continued operation is necessary and beneficial.

We have also previously argued that the natural follow-on to the work of the Kingman Review and the CMA should be a fundamental and independent examination of the role of audit itself. The expectations of investors and other stakeholders - such as employees, customers, suppliers and pension-holders - have increased in recent years, and the purpose, scope and practice of audit need to keep pace. We are therefore pleased that Sir Donald Brydon, outgoing Chair of the London Stock Exchange Group, has been appointed by the Secretary of State to lead a new independent review of UK audit standards.

ICAEW believes that the key purpose of the CMA's work should be to ensure that the market produces high quality audits. We feel strongly that early and urgent action to address public concerns regarding audit is vital to maintaining business confidence. Chartered accountants acknowledge this as a watershed moment for their profession and embrace the need for change. We look forward to working with all parties to produce effective recommendations for regulation and legislation which will improve quality and increase choice in the market, while ensuring that audit meets the future needs of the British economy and wider society.

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MAJOR POINTS

1. December 2018 saw not only the publication of the CMA's update paper on its market study of statutory audit services and the recommendations of the Kingman Review of the operation of the FRC, but also the launch of the Brydon Review of the quality and effectiveness of the UK audit market. Necessarily these projects have had different starting points and terms of reference, but they must now be aligned and coordinated so that together they constitute a coherent programme of reform, implemented in a practicable, pragmatic and proportionate fashion. ICAEW believes that the audit sector plays a key role in creating and sustaining domestic and international investor confidence in UK business, capital markets and the wider economy. Measures to tackle underlying and interlocking issues of regulation, quality and competition must therefore be seen in the context of the need for the UK after its exit from the European Union, to be perceived positively as a place where the business and investment environment is both attractive and well-governed.
2. ICAEW welcomes the Kingman Review's vision of a strong and credible new regulator - the Audit, Reporting and Governance Authority (ARGA) – with enhanced powers to intervene in the large corporate market. At this stage, ICAEW has some questions about the very wide scope of entities that ARGA's new regulatory powers would apply to, their extent, and the time and resources necessary to implement them. However, we agree that the core remit of this regulator should be to take responsibility for the quality of financial information, the structure of the audit market, to assure confidence in the quality of audit and encourage market competition. We also welcome the proposals that give greater powers to hold company directors to account, which represent an important improvement in accountability.
3. While ICAEW believes that the paramount issue is audit quality, and ensuring that it continues to improve and continues to meet the existing and evolving expectations of customers and other stakeholders, we agree with the CMA that increased choice in the market for large corporate and public interest entity (PIE) audits is necessary and desirable, and we are confident that a consensus in support of this now exists across the audit sector. The largest audit firms and their potential challengers are willing to cooperate – and to work with government and regulators – to bring it about. There is also a collective readiness to see a fundamental and independent examination of the role of audit itself. The expectations of customers – and, other stakeholders, including investors, employees, pension-holders, customers, suppliers and wider society – have quite rightly increased in recent years, and audit must keep pace, which may mean extending assurance and embracing new tools and new technology.
4. The CMA's market study aims to identify ways to improve audit quality and increase competition in the FTSE 350 market. ICAEW has previously argued that this will require a basket of measures which address three interconnected aspects of the current situation: implementing changes to how the Big Four operate, reducing the obstacles which currently deter their potential challengers from entering that market and, finally, supporting audit customers to exercise their extended freedom of choice. Overall, while further analysis is required before firm decisions can be taken, we welcome the draft Remedies set out in the CMA's update report as a good basis for further discussion and development. We also believe that whichever Remedies are subsequently implemented should be subject to future review, ideally by ARGA, to assess whether their continued operation is necessary.
5. Greater regulatory scrutiny of Audit Committees is consistent with the direction of travel taken by the Kingman Review, and this may be a Remedy that can form part of the remit of ARGA.

ICAEW agrees that this may have some place in situations where there are specific concerns about the competitiveness of an audit tender, or quality of audit work. We would question however whether a regime of detailed and regular reporting by all Audit Committees to the regulator would be a proportionate remedy. ICAEW believes that the use of peer review, as also proposed by the CMA as a potential Remedy, raises some significant practical issues and will require further analysis.

6. ICAEW agrees that implementation of mandatory joint audit (as specifically envisaged by the CMA) or a market share cap would be effective in achieving a greater number of participants in the FTSE 350 audit market. While we do not agree that a market share cap is a less desirable option than joint audit, either of these remedies could, with time, effort and goodwill, be made to work, and the accountancy profession will cooperate with government and regulators in implementing whichever is taken forward.
7. However, at this stage, ICAEW does have a number of concerns in relation to the impact and implications of mandatory joint audit as a market Remedy. As specified by the CMA, this would see each FTSE 350 audit jointly conducted by a Big Four and a non-Big Four firm. At least initially, this could significantly increase the costs and timescales of these audits, which would ultimately be borne by investors and customers. Also, it cannot be assumed that many firms outside the Big Four will be able very quickly to assume all of the commercial and regulatory responsibilities of such audits. These include obtaining insurance cover for the joint liability attached to the audit opinion of FTSE 350 companies, which may prove difficult and necessitate a significant increase in audit fees. Under the existing joint and several liability regime, it may even be the case that challenger firms are effectively unable to act as joint auditors.
8. While a market share cap would have some complexities in design and application, ICAEW believes that it could be introduced with significantly less disruption and cost than mandatory joint audit and could be implemented in a shorter timeframe. Our tentative estimate is that an initial market share cap could be put in place within as little as two years, but that the introduction of mandatory joint audit across the FTSE 350 might require at least five years.
9. While ICAEW welcomes the CMA's conclusion not to seek the break-up of the Big Four into a larger number of multi-disciplinary firms, we note that the market study update paper proposes that they split either structurally or operationally, to separate audit and non-audit practices. We believe that although it would be difficult to justify not extending this principle to challenger firms outside the Big Four, doing so is likely to handicap significantly their ability to compete in the market for FTSE 350 audits.
10. In any case, ICAEW does not see any net benefit to the UK market for large company audits from requiring the Big Four to adopt full structural separation. Proceeding with even operational separation, as described by the CMA, would raise practical difficulties that require further analysis.
11. Alongside that, ICAEW recommends that consideration is given to whether the necessary effect could be achieved by strengthening the application of existing safeguards. Each of the large integrated multi-disciplinary firms operates to a single standard of professionalism and ethics: this underpins a consistent and coherent culture which is shared across a firm's operations. The work these firms do - and the values they follow in doing it – reaches into a wide range of capital markets and business settings where transparency and reliability are important: these are much broader than audit alone. Consequently, we believe that much

greater focus should be given to strengthening and sustaining this positive culture in firms, which will help ensure the confidence of capital market participants in contexts beyond their use of audited financial statements.

12. ICAEW strongly endorses the aims of the forthcoming Brydon Review of the future of audit. The Review should consider what society wants from audit and, alongside that, what auditors may be capable of delivering in the future - especially as a result of transformations in business practice and the impact of technology. Any changes proposed by the Review now must not constrain or stifle further development: whatever framework emerges from the Review should encourage and allow innovation in the audit market, rather than acting as a straitjacket on future progress.

SPECIFIC QUESTIONS

A) ISSUES

Question 1: Do you agree with our analysis in Section Two of the concerns about audit quality?

13. Yes. There are over 93,000 audits every year in the UK, the vast majority of which are completed to a high standard. However, any failure is one too many. We agree that public trust in audit has been damaged as a result of a series of high-profile failures, and concern has focussed especially on audit quality, on choice and on regulation of the market. The expectations of a widening range of stakeholders have rightly increased in recent years, and a gap has developed between what they want and what audit delivers. ICAEW believes that audit must keep pace, which may mean extending assurance and embracing new tools and new technology. The largest audit firms and their potential challengers are willing to work with government and regulators to bring about change.
14. There is also a collective readiness to see a fundamental and independent examination of the role of audit itself. Any reforms must be implemented in a practical, pragmatic and proportionate way, and taking care that no individual measure, or combination of measures, has the unintended consequence of undermining audit quality. The strong interdependency between the various investigations underway means that close coordination is vital; the Brydon Review of the role and future of audit will have a significant bearing on the proposals emerging from the work of the CMA and Sir John Kingman.

Question 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.

15. Yes. The analysis effectively sets out the developments, challenges and unintended consequences of regulatory change. Overall, ICAEW believes that the paramount issue is that the market functions to deliver audit quality, but specifically with regard to choice and competition, our view is that the most important factors are contained in points b and c (respectively 'limitations on choice leading to weaker competition' and 'barriers to challenger firms for FTSE 350 audits'). These should be the main areas for focus and resource. We would also suggest a root cause analysis of audit failure to further inform the debate.

B) REMEDIES**For all Remedies:**

Question 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?

16. Please see our answers below in respect of each Remedy.

Remedy 1: Regulatory scrutiny of Audit Committees

Question 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.

17. Any regulatory scrutiny applied to Audit Committees must be risk-based and proportionate, bearing in mind that the appointment and monitoring of external auditors is only one of the Committees' responsibilities. ICAEW believes that the proposal that a representative from the regulator should observe all (or a random sample) of Audit Committees' meetings is unrealistic. Such omnipresence on the part of the regulator could undermine Committee chairs and discourage other independent non-executive directors (INEDs) from joining.
18. ICAEW would argue that in most situations, a risk-based approach will deliver both more effective regulation and stronger Audit Committees. The support of the regulator is likely to be welcomed by most Audit Committees as they embrace whatever measures emerge from the CMA's market study, especially if these include potentially complex mechanisms such as mandatory joint audit or market share caps. Persuading Audit Committees of the advantages of any reforms will be key to successful and timely implementation.
19. The regulator should be able and willing to impose strong interventions on Audit Committees when justified, but needs a range of powers, including, but not limited to, a power of real-time observation. If process or quality issues have been established, an appropriate regulatory response may be to observe Audit Committee meetings. We would, however, expect this power to be used sparingly and only as a temporary measure until the regulator is sufficiently assured that the Committee is working well and understands its responsibilities. Public reprimands or direct statements to shareholders may also be appropriate alternatives in some circumstances. Where there are significant concerns, the regulator may have a greater interest in overseeing changes in the membership and leadership of Audit Committees.
20. Risk-based regulators rely upon strong information flows. Some compulsory reporting could serve as a salutary reminder to Audit Committees that their responsibility to protect fully the interests of shareholders is subject to regulatory oversight. However, there is also a significant risk that, over time, reporting is reduced to meaningless boilerplate language. Proportionality is key to maximising the potential advantages and minimising the potential disadvantages of reporting. Dependent upon its frequency, routine reporting throughout audit engagements could be debilitating for Audit Committees, auditors and the regulator. The introduction of targeted reporting at key stages of the tendering process would be more acceptable.
21. ICAEW agrees with the CMA that during the tender selection process, Audit Committees should be able to demonstrate that they have: prioritised independence and challenge; made decisions independently; managed conflicts of interest so as to maximise choice; and given fair consideration to challenger firms. We also agree that during the audit engagement, Audit Committees should be able to demonstrate that they made interventions to assess quality beyond seeking management feedback. However, rather than requiring all Audit Committees to report on all of these points on a routine basis, we suggest that the regulator occasionally asks

specific Audit Committees to evidence their performance in these areas. A targeted approach would yield a far more accurate picture for the regulator, and is also more likely to generate goodwill through dialogue. If Audit Committees actively seek support from the regulator, then this will be an important demonstration of success.

22. One of the recommendations arising from Sir John Kingman's Review of the FRC is for auditors to report viability or other serious concerns, and in some circumstances the new regulator will be the appropriate recipient of these *in extremis* reports. It may also be appropriate and helpful for Audit Committee members to be able to make similar reports to the regulator, either on record or anonymously. Audit Committee members may wish to report - and the regulator may wish to be informed about - serious and material disagreements which arise in the tripartite relationship between Audit Committees, company management and audit firms.
23. If reporting were on a proportionate, exceptional basis, we see no reason why the scope should not cover all PIEs. However, the more onerous procedures implied in the proposed Remedy could take significant resource and, if adopted, should be limited to the FTSE 350 at most, until time has evolved to assess and refine the process.

Remedy 2: Mandatory joint audit

Question 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?

24. ICAEW agrees that implementation of mandatory joint audit (as specifically envisaged by the CMA) could be effective in achieving a greater number of participants in the FTSE 350 audit market. This Remedy could, with time, effort and goodwill, be made to work, and the accountancy profession will cooperate with government and regulators to implement it if taken forward. However, as we noted in our previous response in October to the CMA's original invitation to comment on its market study, while joint audit might be able to enhance smaller firms' market share and expertise, it has proved unpopular in the UK market due to concerns over cost, extended communication requirements and, at least initially, efficiency issues until firms become accustomed to acting jointly.
25. The CMA's proposal for the mandating of joint audit would be a very significant measure and could complicate matters significantly for Audit Committees. The additional consultation steps might require reporting deadlines to be re-assessed. Also, it cannot be assumed that many firms outside the Big Four will be able to assume very quickly all of the commercial and regulatory responsibilities of such audits, including obtaining insurance cover for the joint liability attached to the audit opinion of FTSE 350 companies, which may prove difficult and necessitate a significant increase in audit fees. Under the existing joint and several liability regime, challenger firms may even be effectively unable to act as joint auditor.
26. If mandatory joint audit as envisaged by the CMA were implemented, there would need to be significant time for the arrangements to settle in, and for assessment as to whether the impact on quality is positive and whether the benefits outweigh the costs. In the first instance, any application should therefore be restricted to the FTSE 350 market at most. There would need to be lengthy transitional roll-out arrangements to ensure adequate capacity (perhaps matched to tendering dates) and to allow for companies moving into the FTSE 350 in future. However, ICAEW's preferred approach would be to test this Remedy before full implementation through a programme of trials under 'safe harbour' conditions. These trials could be overseen by

inspectors from the FRC or its successor body and could help with assessing the potential wider impact on audit quality and costs.

27. In summary, the mandatory appointment of a non-Big Four joint auditor to each FTSE 350 company is a radical proposal that would involve significantly more disruption and cost than a market share cap, with much less predictable results. In particular, sharing liability has economic consequences that are difficult to reconcile - for example, in the availability and cost of insurance. Very significant increases in the costs of audit might result. Restructuring the market to introduce greater competition will take time and significant resources to achieve and it is crucial that resources are targeted on the measure that can most effectively deliver that objective.

Question 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.

28. If mandatory joint audit is introduced, a requirement to use a challenger firm would introduce a pro-competition element that would otherwise be missing; a 'two Big Four' default would likely ensue without this. However, it is possible that no challenger firms would wish to be involved where they may face capacity or insurance constraints, for example with large financial services companies. Indeed, as suggested by examples in the CMA's update report, even two Big Four firms may not be willing and able to take up an appointment. There may therefore need to be provision to allow for such a requirement to be relaxed where necessary.

Question 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.

29. The scale and complexity of audits vary too much for such an allocation to be mandated sensibly. Some businesses include a large number of stand-alone entities, while others can be centred around one integrated unit. The allocation of both the work and the fee would need to be agreed on a case-by-case basis. Audit firms would be unlikely to agree to be involved if the proportion of work was too small, in any event.

Question 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?

30. ICAEW agrees that if mandatory joint audit is proceeded with, appointment at different times might help with the carrying forward of knowledge, which is a concern when new auditors are appointed. Again, we believe that circumstances are too variable to mandate this, but it should certainly be encouraged. We note that an EU concession exists that allows joint audit appointments to extend to 24 years, rather than 20 years for a single appointment. This was not enacted in the UK due to the limited use of joint audits but could be revisited.

Question 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?

31. We believe that the joint and several liability regime may inhibit potential challenger firms from pursuing larger audits; they are not just held accountable for their own actions, but also, potentially, for the actions of those in the company. In a joint audit regime, the impact of this would be exacerbated significantly as each auditor would also be liable for the actions of the other. A proportionate liability regime, based around the audit fee, may reasonably reflect the risk associated with the work undertaken. As auditors are required to have sufficient practice indemnity insurance, this should not disadvantage claimants. This merits further investigation.

Remedy 2A: Market share cap

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

32. ICAEW is not convinced that a market share cap is a less desirable Remedy than joint audit. While such a cap would have some complexities in design and application, if introduced gradually, we believe that it could have just as positive an impact on the market, with significantly less disruption and cost, and could be implemented in a shorter timeframe than mandatory joint audit. We estimate that an initial market share cap could be put in place within as little as two years, but that the introduction of mandatory joint audit across the FTSE 350 may require at least five years.
33. Ideally, the audits becoming available to the challenger firms would be those which would be less difficult for them to pick up, deliverable without significant initial investment, and allowing them to build the capacity to take on more large company audits over the medium term. Some large entities are relatively straightforward to audit - they tend to have high market capitalisation but relatively low fees. A market cap based on the number of companies would not necessarily ensure these companies are the ones made available to challenger firms, and the CMA's proposed series of multiple caps seems very complex.
34. We accept that using market capitalisation or audit fees as the measure would be subject to volatility, thus requiring arrangements to ensure auditors do not have to resign before their term is up as a result of short-term variations. However, we do not see this as more complex than the proposals set out in the update paper and would be pleased to engage further in discussions on any potential mechanism.

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

35. If the Big Four firms are required to reduce their share of FTSE 350 audits, they will be inclined to compensate by developing their presence in the middle market, and potentially dominating it. To prevent this, ICAEW believes therefore that an appropriate cap might need to be applied to the market outside the FTSE 350.
36. ICAEW expects that the CMA will keep the effectiveness of this Remedy (and any others taken forward) under close review. In due course if it achieves the desired market effect, consideration should be given as to whether its continued operation remains necessary.

Remedy 3: Additional measures to reduce barriers for challenger firms

Question 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.

37. We note that Remedy 3 is recognised by the CMA as ‘largely redundant’ if the headline measures are adopted. We concur with this assessment but have responded below to the questions posed regarding detailed aspects of the Remedy.
38. As regards staff switching, we are not aware of any significant barriers to partners and staff switching firms and would encourage the removal of any barriers that are found to exist.

Question 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.

39. We have no relevant data but this is an interesting idea and worth exploring further if tendering costs prove to be a barrier in practice.

Question 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.

40. ICAEW believes that a willingness exists among the Big Four to share technology and recommends that this is encouraged and facilitated. However, like the CMA, we are wary of compulsion. Fixing a ‘reasonable cost’ that would incentivise purchase but not disincentivise innovation would be difficult by law or regulation and almost inevitably arrive at the wrong answer. We also note that Big Four firms are not the only source of technological innovation in the audit sector: independent suppliers currently play a significant role, and we expect this to increase over time. Such matters should be left to the market, at least in the first instance.

Remedy 4: Market resilience

Question 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.

41. ICAEW considers the concerns about resilience to be the least likely to merit significant action. The focus should be elsewhere in the first instance and any actions should be proportionate to the likely risk.
42. Preventing staff and/or audited entities moving to another audit firm cuts significantly across core rights and market operations. Any resilience system should focus on incentivising and supporting challenger firms to take on additional audits in the event of a decline or sudden event, rather than mandating or controlling which audit firm companies should move between.

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

43. Moral hazard can be prevented by establishing a resilience system built around the expectation that any costs arising from a sudden event or decline are kept within the sector. This could be characterised both by ensuring that firms are liable for fees associated with the activity of a special administrator when intervention is required, and by strengthening challenger firms’ ability to take on additional staff and audits to reduce market dependency on individual firms.
44. The resilience system could also reduce moral hazard by requiring audit firms to produce ‘living wills’. As we noted in our original submission to the CMA’s market study in October, these

would be continuity plans, similar to those in the banking sector, setting out how service would be maintained if an audit firm collapsed. The regulator would be able to monitor these plans to ensure they are adequate. In this way the likelihood of an audit firm failing due to lack of planning could be significantly reduced.

Question 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.

45. The regulator should be adequately equipped to deal in an orderly fashion with the consequences of the failure of a major audit firm. We would expect the regulator to undertake regularly simulations of such scenarios, and to propose realistic and achievable resolutions. Nevertheless, designing the resilience system in too much detail risks it being inappropriate for the actual circumstances of any particular scenario, and so the focus should be on principles rather than proscription.
46. It would be better to give the regulator the necessary powers, usable in certain situations, to intervene and appoint an administrator to take executive powers when it identifies the need to do so. Such powers would include the right to address quality control and partner remuneration, but not to block movement of staff and audited entities.

Question 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.

47. Any resilience system should not attempt to restrict the movement of an individual audit firm's staff or clients, but should seek to ensure that there are strong challengers in the audit market which staff and clients from the Big Four firms would be prepared to transfer to.

Remedy 5: Full structural or operational split

Question 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.

48. The CMA sets out a process by which structural separation might be achieved. However, ICAEW believes the key issue is not whether structural separation could be done, but whether it should be done. As the CMA acknowledges, there would be significant costs and potentially adverse consequences. In particular, we believe that the complexities of contracting independent expertise, often during a condensed 'busy season', and the potential reaction of the international networks, should not be underestimated. We do not see any net benefit to the UK market for large company audits from a full structural separation.

Question 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.

49. Again, we believe the key issue is not whether separation could be done, but whether it should be done. Even proceeding with operational separation would raise practical difficulties that merit further work. The integrated multi-disciplinary firms operate to a single standard of professionalism and ethics, and share a consistent professional culture across their firm's work.

This work reaches into a wide variety of capital market contexts where transparency and reliability are vital.

50. Assuming one of the headline Remedies discussed above is put in place, the benefits of incremental measures such as Remedy 5 would certainly be reduced. In particular, it becomes difficult to justify allocating the significant time and resources that would be necessary to separate the audit and non-audit elements of a firm.
51. It is also important to consider the forthcoming Brydon Review of the role and future of audit. That Review should consider what society wants from audit and what auditors may be capable of delivering in the future - particularly as a result of transformations in business practice and the impact of technology. Any changes implemented now must not constrain or stifle further development following from that review and should encourage and allow innovation in the audit market.
52. We believe the focus should be on strengthening and reinforcing culture within firms, with positive implications across all of these activities, rather than segregating parts of a firm. As we discuss below under Question 22, we do not believe that a structural or operational split is justified by independence concerns, as these are robustly dealt with by restrictions on the provision of non-audit services to audited entities. The crucial factor is the maintenance of an objective mindset when conducting audits. We believe this can best be achieved by strengthening and reinforcing culture within firms. This would have positive implications across all of the activities these firms perform in the capital markets and wider UK economy, rather than segregating parts of a firm. It might be possible to address external perception by enhancing the transparency report to discuss the approach taken in greater detail. We suggest that the CMA explores this option.

Question 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.

53. Given the importance of perception to regaining trust in audit, if an operational split were required, we see little incentive for any audit firm to try to circumvent the process. Trust will require assurance of the process, and the independent audit regulator would need to be able to review the nature of cross-charging for shared systems and other resources, and related cost allocations. We believe that such cross-charging would need to be transparent.
54. The firms affected are best-placed to assess the detailed changes that would be necessary and the potential costs that would be incurred. The potential change to the independent audit regulator proposed in Sir John Kingman's Review of the FRC may also be relevant, given the need for that regulator to be involved.
55. As regards the competencies required by the regulator, we have referred to the need for the regulator to oversee cross-charging arrangements, which will necessitate transfer pricing expertise. Other aspects of oversight are likely to fall within the regulator's existing oversight role for audit.

Question 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.

56. The existing auditor independence requirements, included primarily in the FRC Ethical Standard, have regard to the independence requirements in the EU Audit Directive and Regulation, and the Code of Ethics of the International Ethics Standards Board for Accountants. ICAEW's own Code is based on the latter. Changes in audit firm structure would have no impact on whether different parts of the firm were considered to be part of the audit firm network for independence purposes, and we do not see that these proposals should require or permit a change to the independence requirements.

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

57. As noted above, we believe that a cross-firm cultural focus, with enhanced transparent reporting, is a better approach all round. Even an operational split would cause significant disruption and cost. Setting a scope which would include any audit firm that, for example, audits a FTSE 350 company could act as a significant disincentive to auditors looking to move into that market on a small scale. Were operational separation applied, it would be better to restrict the scope in the first instance and reassess the costs and impact after a period of time, before extending the requirement.

Question 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.

58. The FRC Ethical Standard, in discussing the boundaries between audit and non-audit work, notes that there are a number of 'audit related services', which are typically carried out by the audit engagement team and which are related to the work performed in completing an audit. Such services include regulatory and other reports, and extended audit work on financial information and controls in certain circumstances.

59. The FRC Ethical Standard further notes other 'additional services', for which it is generally accepted that the auditor of the entity is an appropriate provider. Examples cited include; '*audit and other services relating to public reporting as reporting accountant on financial or other information of the audited entity in a prospectus or circular (including reports that may be required by the Prospectus Rules, the Listing Rules and the Takeover Code)*'; and, '*reports, that are not 'audit related services', required by the competent authorities / regulators supervising the audited entity, where the authority / regulator has either specified the auditor to provide the service or identified to the entity that the auditor would be an appropriate choice for service provider*'.

60. It would be appropriate and logical for the audit element of the practice to be able to carry out such work, and it would cause significant disruption were such services required to be offered by any non-audit element of the practice resulting from an operational split.

Remedy 6: Peer review

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

61. The proposal envisages a pre-sign-off, regulator-appointed peer review in addition to the established subsequent audit quality reviews carried out by the FRC and/or the RSBs. ICAEW agrees with the CMA's assessment that this would not of itself improve choice and resilience.

62. Although we believe this Remedy could potentially enhance quality, a complete review of files would be very expensive and add to sign-off time. If restricted to a discussion on the key issues, this could be useful in the event of uncertainty by auditors.

63. Such uncertainty could be resolved without the practical downsides through the auditor having the ability to gain a second opinion from a regulator-appointed panel, rather than mandating a peer review of all FTSE 350 audits. If the route of a regulator-appointed panel was pursued, it should be accessible to any auditor undertaking a review of a FTSE 350 company.

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

64. If a regulator-appointed panel was created, we believe that scepticism among auditors could be strengthened by ensuring there is no regulatory penalty or intervention arising from engagement with it. This would give auditors the confidence to approach the panel for a second opinion rather than keeping the discussions 'in house'. Scepticism on the part of the panel would also be maintained by ensuring that the representatives on the panel that auditors engage with are from separate firms.

C) NEXT STEPS

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

65. In general, ICAEW understands and supports the CMA's proposal not to make a market investigation reference. We note the requirement for legislation to underpin implementation of much of what is proposed, and we believe the CMA should assess its route forward in light of: discussion with government on the likelihood of a legislative window; the likely timetable for any re-organisation of the audit oversight regulatory function; the nature of the CMA's final proposals; and, critically, any developments emerging from the Brydon Review of the role and future of audit.