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21 January 2019

Statutoryauditmarket@cma.gov.uk

Dear Sirs

BDO LLP Response to the Statutory Audit Market Study Update Paper 18 December 2018

We welcome this market study. We are broadly supportive of remedies which improve audit quality and address demand-side issues which break down the purchasing bias that favours the Big Four regardless of the audit quality proposition of Challenger firms thus opening up the audit market to BDO and others.

We are however concerned that the update paper treats the Challenger firms as a homogenous group facing consistent barriers to increasing their impact on the FTSE 350 audit market. We believe there to be at least two distinct groups of Challenger firm.

BDO itself extends across 162 countries and territories, with over 80,000 people working out of 1,591 offices. We are considerably more focussed on Audit and Assurance than the larger networks, with approximately 45% of our global revenue being derived from this area. As such, we are big enough to be able to access our own group of experts and invest in global audit tools and methodologies to deliver high quality consistently for all but the largest and most complex entities; the key barriers for us predominately lie on the demand-side of the equation. Our UK firm has an enormous presence in the audit market – for example' we are the leading auditor to AIM companies by some margin. The key barriers to entry into in particular the FTSE350 and other PIEs predominately lie on the demand-side of the equation.

In terms of their UK presence, a similar case could be made by Grant Thornton as indeed both firms have a foothold in the FTSE 350 market. This differs somewhat from some of the smaller Challenger networks that will benefit greatly from a sharing of resources, or a mechanism to jointly contribute towards large audits.

With this backdrop, we would have some concern if the ultimate package of proposed measures did not recognise these key differences in terms of readiness and capabilities of the individual Challenger firms as it has a material impact on the pace at which change can occur and indeed the direction of that change.

The supply side of the audit market clearly does not work and needs to change. Over the next few weeks including through submissions to yourselves and the BEIS Select Committee on audit market reform and through lobbying, we believe that those with a vested interest in the status quo will seek to persuade regulators and politicians that the current supply side is not so broken and that radical measures are not required. They will also say that the measures proposed will

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have unintended consequences and do more harm than good. Finally they will seek to persuade you that the Challenger firms do not have the same adherence to quality, or resources, or sector skills or global reach to enable them to undertake large audits, either alone, or through a joint audit. Indeed this is already happening.

We urge you to treat such representations with scepticism particularly where they are opinion based and request evidence to support these contentions, particularly where they concern BDO.

Introduction

We believe that each remedy that forms part of the package of remedies must satisfy the criteria of improving quality and opening the market up to more choice. Only in this way can trust be restored to the key role audit plays in corporate reporting. As one of the leading Challenger firms we have a responsibility to support and engage with whichever remedies are enacted in order to bring about meaningful positive change. We have attempted to comment on each remedy in a constructive manner, seeking to shape effectiveness through the dual lenses of quality and choice and reflecting our experiences and viewpoint.

However, our considered view is that market share caps will address quality, by ensuring audit quality is the dominant determinant in every tender and effect change more quickly than any of the other remedies. We believe there is a real need to demonstrate change is happening in the short term not delaying change for further consultation and research which will only result in the dilution of proposed remedies.

A quick to implement and powerful remedy, market share caps will start to normalise the market perception and position between the firms. Audit Committees will adjust and make plans to broaden and update their knowledge of Challenger firms whilst focussing on audit quality. Such a move will build momentum and allow market forces to operate effectively. The regulator has a key role to play here by producing data that Audit Committees can use and rely on.

By contrast the joint audit model will take a number of years to get going, take at least 10 years to settle and will almost certainly cement the market position and perception of Big Four and the Challenger firms. It involves huge change to every FTSE 350 company, a substantial increase in cost and duplication to create a joint audit product which is not proven to be superior to a single auditor solution. In addition, audit quality grades will become muddied by the joint nature of the assignment and subsequent apportionment of blame.

A) Issues

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

We believe that the general view is that the UK has some of the highest standards of both corporate reporting and audit in the world. Nevertheless, recent financial reporting and audit failures, particularly concerning large public interest entities ('PIEs'), have shown that quality is not consistently high enough and does not meet stakeholders' expectations. We also firmly believe that moving corporate reporting and audit to a place that meets stakeholders' expectations will require a coordinated review of both the audit product and the regulatory environment; we are therefore pleased to note that the CMA are working alongside the Kingman and Brydon reviews.

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.***

Focussing solely on audit quality, we believe that one of the most critical issues that the CMA has drawn out of their review is the poor linkage between auditor selection and audit quality which in turn may be a causal factor in failing to drive good audit quality. As the report points out, audit, being a credence good, imposes significant challenges to this premise. In our view, unlocking this is the most important remedy to effect change.

In relation to the appointment of auditors and the involvement of investors we believe there is an important additional point. Audit Committees are often trying to interpret what investors (primarily long-term institutional investors) want without a clear line of communication. This can lead to a Big Four bias and as a result we have encouraged Audit Committee Chairs running tender processes specifically to ask their largest investors' views regarding the appointment of a Challenger firm. This removes the semi rhetorical question often asked at key moments as to how the institutional investors would react to the appointment of a firm such as BDO rather than the perceived (nearly always incorrectly) safer option of the Big Four (this is consistent with 3.122). In our experience these consultations in advance have not ruled us out of a single tender. Speculation on the views of investors are rarely based on fact.

Your analysis identifies perceptions regarding the strength of Challenger firms' international networks as a limitation on choice. This is an area where we believe the differences between the Challenger firms is relevant. Given BDO extends across 162 countries we rarely find companies have operations where we lack presence and we have $9bn of revenue of which over $4bn relates to audit services which provides depth in addition to range. We have been told that our international strength was a weakness in certain tenders but it appeared this was based upon either a lack of diligent research or outdated views from decades past. The analysis also cites examples where weaker AQR scores of Challenger firms were a factor. Whilst we are sure the quotation is accurately recorded, it is not correct. Our recent AQR scores are at least comparable to any Big Four firm. We are confident that factors such as these should not act as a limitation on choice however, what we believe the analysis is actually demonstrating is the manifestation of some of the demand side issues covered earlier in the analysis.

B) Remedies

For all remedies:

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

In considering the scope of the remedies we think it is important that, to avoid confusion, the scope is consistent across each of the remedies. The remedies should therefore focus on the FTSE 350 and be best practice (comply or explain) for other PIEs. We believe that this provides both clarity and certainty as to who is impacted.

We note that following the Kingman review the definition of PIEs may be expanded and therefore these remedies may, in time, be applied to a wider group of entities.

Remedy 1: Regulatory scrutiny of Audit Committees

As an objective we are broadly supportive of this. These measures will help to remove the demand-side bias towards the Big Four and will help address the need for quality to be the dominant determinant in auditor appointment.

This remedy should also be considered in conjunction with the Kingman recommendations to strengthen the regulators powers to prevent corporate failure. In particular, this proposes giving auditors a duty of alert to report serious concerns (recommendation 45) and the regulator power to commission a 'skilled persons review', inter alia, where there is intelligence that an audit committee is not doing its job effectively, or being unduly influenced by executive directors (recommendation 47). This auditor duty and regulator power will help ensure that Audit Committees run their tendering processes with the appropriate focus on audit quality.

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.**

Regulatory resource is valuable and we believe that it will have most effect if focussed, primarily but not exclusively, on auditor appointment rather than ongoing monitoring, as we believe Audit Committees generally work well in this regard. We would envisage that a regulator could:

- Have involvement ahead of the audit tender process to assess how the Audit Committee has determined who is being invited to tender, how the criteria and scoring system have been drawn up and whether there is appropriate weight to audit quality.
- Ensure the process is managed by the Audit Committee not Management.
- Attend the auditors' presentations to the Audit Committee as an observer.
- Review the Audit Committee's completed scorecards to make sure they are appropriately focussed on audit quality.
- Assess the proposed split of audit work between the selected auditors (see question 7).
- Make a formal Report to the company at completion.
- Review the Audit Committee's disclosures in their next annual report on how they ran the process and the result. This may require some guidance from the regulator as to what this reporting should include.

Inevitably the physical presence of a third party observer may impact behaviours and could lead to more discussions taking place privately between Audit Committee Chairs, Management and Auditors rather than at the meeting itself which we would view as a negative development. There are also likely to be confidentiality issues that need to be overcome: how will information obtained by the third party be used in the event of FRC Corporate Reporting Reviews, whistle blowing, subsequent enforcement, litigation etc?

Remedy 2: Mandatory joint audit

Although we understand the reasons for the CMA expressing a preference for joint audits over market caps, we do not have confidence that joint audits will be sufficient on their own to improve competition and choice. We remain of the view that market caps will result in the most significant market change in the short to medium term.

Joint audits do not increase choice or reduce conflicts (assuming operational separation does not give rise to a major U-turn on non-audit services). There are risks attached to such a fundamental change in the audit model that needs to be carefully thought through. Some of these are more operational which can be managed by the firms (different methodology etc) but some are broader (disagreement between the firms or delays to the reporting timeline).

Unless safeguards are imposed, under a joint audit regime there is a very real risk that the Big Four will become the majority joint auditor across the whole FTSE 350. If this were to happen then it could ‘lock in’ Challenger firms to being the minority parties rather than providing a mechanism for these firms to increase their participation and influence to a level that stakeholders are asking for, and hence have little impact in reducing Big Four dominance in this market. That is why the long term goal must be an equal sharing of work between the joint auditors.

In the absence of these safeguards we believe that a market analysis in ten years’ time would show the major auditor roles continuing to be dominated by the Big Four and, for this reason, we are more confident that market caps will be a more effective remedy to increase competition and choice outside of the Big Four. We request that consideration is given to a combination of joint audits and a market cap for majority joint auditors, which would help to prevent this by ensuring there are sufficient audits with a Challenger firm as the major auditor where they can credibly pitch for greater market share.

We comment on this further in our responses to the specific questions.

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?

All other things being equal, we remain unconvinced that joint audit is a superior product that enhances audit quality. The remedy does however bring significant change to the market by giving Challenger firms the opportunity to engage with a wider group of companies and increase their capability and capacity.

We are concerned that the current dominance of the Big Four will be reinforced by this remedy with companies appointing a Big Four firm as their major auditor and a Challenger as their minor auditor. Challenger firms will gain some expertise and size but will not be able to reference examples of where they act as the major auditor and therefore they will be continually locked into the secondary role. This limits the extent to which they can develop and, in the longer term, effectively challenge the dominance of the Big Four. This is reinforced by the experience in France where joint audit has been in operation for a number of years and where a Big Four auditor is appointed as one of the joint auditors in the vast majority of audits.

Within the FTSE 350 there are a number of subcategories. Amongst the FTSE 250 there are a high number of entities that some, or all, of the leading Challenger firms could service in full or in a majority auditor role. Whilst at the top end of the FTSE 30 the Challenger firms do not yet have sufficient capability or capacity to act as the majority auditor or the minority auditor. For the group in between (FTSE 31-100) whilst firms such as ourselves and Grant Thornton could act for a number, the stretch on capacity would mean a joint audit with a Big Four auditor for this sector of the market would seem to be appropriate at least for some of these companies at the current time.

We believe consideration should be given to segmenting the market according to size and complexity, with a combination of joint audit with a market share cap being applied to the majority auditor, providing opportunity for Challenger firms to operate as majority auditors, further building their capability and capacity. Over time, once the Challenger firms have built sufficient resources, a market cap on the majority auditor for the FTSE 100 could also be applied.

We agree that there are some FTSE 350 entities, such as investment trusts, where joint audit will not provide any tangible benefits to outweigh the additional costs and therefore appointment of a sole auditor would be appropriate. To ensure that these decisions are appropriate the regulator scrutiny set out in Remedy 1 should consider the Audit Committee's rationale for appointing a sole auditor.

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.**

This proposal creates a language in which the firms are different and implies that the norm or best practice will be to have a Big Four auditor (possibly with a majority share) and a Challenger firm auditor (with a minority share). This runs the risk of locking in the current failing structure with a Big Four auditor continuing to be appointed to nearly all FTSE 350 audits.

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.**

We have two key concerns if a minimum work allocation is set. Firstly, if a joint auditor is allocated work below a certain level then it is not truly a joint audit. There is a risk that the majority auditor has too dominant a position making it difficult for the minority auditor to review the majority auditor's work, exercise sufficient challenge or have sufficient voice with the Audit Committee. In an established market for joint audit, the French auditing standard for joint audits requires that participation levels are set at a minimum of 30%.

Secondly, there is a risk that the work allocated to the Challenger firms will default to the minimum percentage following pressure by a coalition of management and the majority auditor. However, we do recognise that in the short term there will a capability and capacity gap for Challenger firms to service a meaningful percentage of the audit work in some industries, such as utilities, and at the upper end of the FTSE 100. For some of the smaller Challengers there will be an even bigger gap and it may therefore be appropriate in the short term that a smaller proportion of the overall audit work is allocated to them (recognising the risk above).

We would therefore propose that where the appointed Challenger firm does not yet have the capability and capacity to service at least 30% of the audit that they are awarded a smaller share that will increase over time. Where a proportion of the audit work below 30% is allocated, a shared audit, rather than joint audit, would be a more appropriate arrangement. The interdependence with Remedy 1 is again critical as we would expect Audit Committees to agree a roadmap with their auditors to move towards a meaningful joint audit arrangement in a reasonable timeframe.

Rather than setting minimum levels across the board we would propose that, in conjunction with Remedy 1, regulatory scrutiny of the audit tender process should include an assessment of the divisibility of work between the joint auditors. This would ensure that it does not inappropriately limit the contribution of the minority auditor, it fairly reflects the capability and capacity of the minority joint auditor, and importantly, sets out a path for how their contribution can increase over time as that firm builds its capability and capacity. For joint audits we believe that there should be a rebuttable presumption that this is set at a level of initially at least 30%, with some roadmap to increasing this allocation in future years to an equal sharing of the audit. Levels lower than this risk not achieving either objective for market change or increased audit quality.

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?

We agree that it should not be coterminous as this would be introducing unnecessary risks of too much change in one year. Audit Committees should be able to intelligently manage the process, particularly given complexity of lead partner rotation, major changes in the business etc.

This will work better where the joint auditors have a more balanced share of the audit work. This would give opportunity, in situations where the majority auditor is rotating, for the existing minority share auditor to move into the majority auditor role, providing both the benefits of retention of audit knowledge and a fresh pair of eyes from the incoming joint auditor. This could result in improved audit quality compared to the current position when there is an auditor change.

Again, regulatory scrutiny under Remedy 1 should include a discussion with the Audit Committee as to how best to manage this transition with the prime objective being audit quality.

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?

Poor quality audit work should expose the responsible audit firms to regulatory fines and claims from shareholders. This is a necessary incentive to focus on quality.

We do believe that there should be a mechanism in law where liability is proportionate to 'blame' taking into account the share of the relative work performed and the specific roles and responsibilities of the firms on the audit. However, for companies with the greatest public interest the public want to see fines that are effective in sanctioning poor quality auditors. Therefore, audit firms participating in this market should be prepared to accept this risk.

Remedy 2A: Market share cap

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

The key risk is the Big Four exiting audits with the lowest return / highest risk. Challenger firms taking on these audits will struggle to make an economic return and risk seeing poor AQR scores for these more difficult audits. Challenger firms therefore risk becoming being seen as delivering poor audit quality and will therefore become less competitive. Significant protections and monitoring will be required to ensure audits exited to meet the cap are representative of the overall portfolio.

The second risk is short-term choice. All companies should be able to have reasonable choice in selecting their auditor. Once a Big Four firm has agreed its divestment plan with the regulator it should be free to compete on a one in one out basis (it may choose to divest below the cap in anticipation of winning new work). However, it may choose not to pursue tender opportunities of high risk or low return audits given the opportunity cost of having to exit from another audit if successful. Whilst this would highlight problematic audits, which is a positive and would require companies to positively address, it could create choice issues. The lack of appetite to take on high risk or low return clients differs from the current position because a combination of both opportunity cost and market share of the FTSE 350 audit market will no longer be a dominant KPI.

The risk of market disruption is sometimes raised but given the frequency of retendering already and with a sensible transition period this is, in our view, very manageable. Indeed if the Big Four firms divestment plans create a more fluid market that is focussed on quality we would regard this as a positive impact.

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

Ultimately, the remedies are trying to achieve improved audit quality, greater auditor choice and more active participants in the audit market for the largest companies but with the minimum impact of regulation on market forces.

A cap on market share requires a tightly defined, fairly stable market. The FTSE 350 does fluctuate from time to time but it is easy to monitor. Applying an average over a three-year period may also make application of the remedies, as companies enter and exit the FTSE 350, easier to manage.

Private companies with a large number of employees and large pension schemes are in the public interest. The constituents of this group are harder to identify and monitor and therefore we would not propose specifically including them within a market cap. This group also contains subsidiaries of foreign parents which would create extraterritorial issues. Applying a market cap to the FTSE 350 will overtime create stronger challengers and that should rationally spill over into large private companies.

Remedy 3: Additional measures to reduce barriers for challenger firms

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

We have not experienced significant difficulties in attracting senior staff. We find there is a sufficiently fluid market for talent and like our competitors put in place protective measures to prevent leavers from poaching clients and staff, including cooling off and notice periods, however we have not seen many excessive practices.

Some of the remedies under consideration could cause significant change and dislocation over a relatively short period which would place stress on the current market for senior staff. It is possible that radical change could require measures akin to the TUPE requirements. This not only has practical difficulties but also qualitative aspects. If a partner and their team are simply lifted into a new firm to service the same client there is no reason to expect quality to improve. It is only by immersing people into a different culture and operational framework that improvements can be ensured.

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.

Whilst we have said that the economics of tendering are an important consideration for us, and this remedy would clearly benefit us, we believe that other remedies which increase the probability of winning audit work, and therefore justifying the tendering costs expended, will solve the issue more efficiently.

We also think that this might create a moral hazard risk that, where tendering costs are underwritten, firms might submit proposals where there is no reasonable prospect of being successful.

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

We are supportive of investment and innovation to drive improvements in quality but we do not believe this proposed remedy will have a meaningful impact for us or the other larger Challenger firms. As noted at the outset we have global methodologies and tools and, as such, we have invested significantly in our technology and are seeing real benefits in terms of audit quality and market proposition. We also derive some of the benefits from this technology from the expertise of the individuals who have developed it. A licencing arrangement that only includes the technology would not deliver the same level of benefits.

Further, there is a risk that this would undermine a powerful driver of innovation and investment, namely the opportunity to obtain a competitive advantage. Ultimately, this could undermine longer term audit quality improvements. We also note that there are likely to be significant practical barriers to this remedy as in most instances the IP is held within the international network.

This remedy however is most relevant to the smaller Challenger firms who often acquire their technology from independent third party providers. One option, perhaps a preferred one, would be for a technology fund to be made available to which the smaller Challenger firms could apply for funding to either develop or purchase additional technology platforms.

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.

There is no easy way to protect from further contraction other than to have more large market participants. In the event of a firm becoming distressed, prohibiting the movement of audits to another firm is feasible, but an exodus of staff would impact the ability to deliver those audits. A prohibition could be placed on the Big Four UK audit firms from hiring staff from a struggling firm but it would be impossible to stop individuals leaving the firm under employment law into non-audit roles with other organisations or, given how international the workforce of the audit firms is, leaving the UK.

The lift and shift option for a struggling Big Four firm to a Challenger firm is currently unfeasible due to the gap in size. Indeed, if one of the major Challenger firms ran into trouble it is difficult to see how the "ring-fenced good firm" could be merged into another Challenger firm without creating further issues. The whole lift and shift strategy of living wills simply requires stronger challengers.

We think it is therefore preferable to have a regulatory regime that allows risks to be identified at an early stage so that all reasonable steps to manage these risks can be taken before they reach a critical point. The FRC has already started work on its Audit Firm Monitoring and Supervision Approach ('AFMAS') which will actively monitor the leadership and governance; values and behaviours; business models and financial soundness; risk management and control; and audit quality of the largest audit firms. This aims to identify resilience issues at the earliest opportunity and work with firms on how these are to be resolved before they become critical. The FRC has already carried out work on firms' contingency planning under AFMAS which identified that firms needed to do more work on 'resolution' planning to consider how audit services can be delivered to entities that they audit where a firm's existence in the UK is under threat. The Kingman review of the FRC has proposed that AFMAS is put on a statutory footing and we are supportive of this.

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

The risk that systemic poor quality work could threaten the ultimate viability of a firm is a right and appropriate risk. This is particularly true in setting tone at the top and culture. However threatening the viability of the firm is akin to a 'nuclear option' and for this reason we support the AFMAS approach that seeks to ensure interventions are made before getting to this point.

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.

As noted above we consider that this is a question that should be explored by project initiated by the Kingman Review in further developing the AFMAS approach.

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.

As noted above we consider that this is a question that should be explored in developing the AFMAS approach.

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.

We have stated that we do not support a full structural split and remain of this view. The significant additional costs and loss of cost saving synergies would undermine the viability of our business model unless audit pricing increased significantly. We also do not believe it would improve quality; it would make the audit firm less resilient and more vulnerable.

Furthermore, given the global independence framework promulgated by IESBA and the concept of network firms, it is unlikely that such a split, full structural or operational, would reduce independence-related conflicts of interest, or increase auditor choice.

Whilst we believe that this remedy is primarily targeted at the Big Four, it is difficult to see how all FTSE 350 auditors would not be impacted.

Whilst it could improve choice by removing some conflicts we question whether public perceptions would really change and public trust be restored if a recently split non-audit firm was providing prohibited services to a client that was also audited by the split audit firm.

We and other Challenger firms will need to make significant investments in both scale and deep specialists over a transitional period. Economic separation would limit the investment pool / payback period. We really need the weight of the whole firm to support significant investment, particularly in the area of audit technology where in some cases the innovation derives from the non-audit parts of the business.

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.

Whilst we do not support complete economic separation we do believe that, if there is an operational split, it needs to be clearly demonstrable that the audit practice is not being subsidised or have business models that are economically irrational. This includes publically available financial statements for the ring fenced audit entity.

We are therefore broadly supportive of operational ring fencing to create a separate entity for all audit work. We support increased governance of that entity by auditors, including responsibility for quality and public interest considerations, and INE oversight. We believe that these measures, combined with a complete ban on non-audit services to PIE audits, would be a significant step forward.

The CMA highlighted how within multi-disciplinary firms the ‘consultancy’ culture of the non-audit practice can negatively impact the audit practice. However, the reverse is also true where the audit practice can positively impact the culture of the wider firm. The brands of the accounting firms are largely influenced by the audit practices, a strong audit practice that is well-respected does and should have a positive value for the remainder of the firm. We therefore believe it is worth considering the ring fencing of the consultancy practices to address the issue of mixed culture at Big Four firms.

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.*

We can only answer this in relation to our own business as the firms differ significantly in a number of areas. We do not have significant defined benefit schemes and the division of the balance sheet should not create any insurmountable barriers. There would be transfer pricing issues on separation of the income statement but again they are manageable. The biggest issues would be the divorce bill created by economic separation and the organisational structural separation. For example, firm wide roles such as sector leaders, strategic leadership, quality and risk roles that span the firm.

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

To be really effective and to restore trust we believe a full ban on non-audit services for PIEs is required. Where two divisions of the same firm are performing audit and non-audit services we are not confident that this would be sufficient to change the public's perceptions about conflicts of interest. We have consistently said this is an area where the profession should go further than regulation and we are therefore against any relaxation.

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

If there were to be different structural or operational models between the Big Four and Challenger firms it may increase the view that these two groups of firms are different and therefore that the Big Four are more independent. If a split model improves public views of the independence of audit firms then it should be applied to all firms operating in this part of the market. However, the reality is that none of the Challenger firms has the types of consultancy divisions that, through their association with an audit firm, have so offended public opinion.

For the smaller Challenger firms, and firms outside of the PIE market, their business models have greater focus on entrepreneurial companies that want and need their auditors to provide a range of services. Applying this model to these firms does create a significant barrier to entry for Challenger firms entering the PIE market due to the significant increase in costs that this structure presents.

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.

As noted in our response to earlier questions we believe there should be a full ban on the provision of non-audit services for PIEs. Only those services where it is an extension of the auditors' role (for example half-year reviews, consent opinions, working capital reviews) should be permitted. A full ban would remove real and/or perceived conflicts of interest and may therefore mean that a split of the audit and non-audit parts of the business are unnecessary.

Remedy 6: Peer review

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

We do not believe that peer review would be a meaningful intervention.

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

Refer to our response to the previous question.

C) Next steps

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

We agree with the proposal not to make a market investigation reference at this time.

Yours faithfully

BDO LLP

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