ACCA Think Ahead

Statutory audit services market study

Comments on the proposed remedies contained in the Update Paper issued by the Competition & Markets Authority on 18 December 2018

Comments from ACCA to the Competition & Markets Authority

January 2019

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SUMMARY

Our original response to the CMA's Invitation to Comment (ITC) warned against the unintended consequences of action taken in haste. We encouraged the CMA to use its unique position to collect sufficient data and evidence to form a view of the market impact, cost and efficiency of proposals before concluding. Moreover, we encouraged that all proposals were considered in the context of enhancing audit quality. We are therefore concerned that the CMA is moving ahead hastily with a number of proposals that we believe will be damaging to audit quality and therefore confidence in audit.

In particular, the proposals for far-reaching regulation over audit committee activity, joint audits and for the separation of audit and non-audit activity within firms do not appear to be supported by a robust evidence basis. Indeed, some of the readily available evidence indicates that these remedies would reduce audit quality.

In our original response to the ITC, we proposed three interventions, which we reiterate below. We continue to believe these represent more targeted interventions which are based on meeting the CMA's objectives and support improvements to audit quality and we urge the CMA to review:

- Whether there should be a "cooling-off" period following the end of an audit relationship during which the former audit firm is prohibited from selling services to the entity. This may help to allay public concerns that the auditor's judgement in the final year of the audit relationship could be affected by the firm's desire to sell consulting services to that entity in the following year. A cooling-off period of two years might be an appropriate balance between protection of independence and choice of service provider.

- Considering a prohibition on management from firing their auditors during their terms of service.

- Whether there are non-regulatory ways of encouraging best practice among audit committees in ensuring auditor independence and audit quality.

We support the CMA's suggestion not to take forward its proposal for an NAO-style auditor for private sector audits.

As we highlighted in our October 2018 response to the CMA's consultation entitled 'Statutory audit market', we recognise the significant public concern over issues of the audit market and wider financial reporting. However, the CMA's hurried timetable does not provide adequate time for respondents to consider the full impact of the proposals. The government's guidance on consultation principles states that 'consultations should be clear and concise' and that 'consulting too quickly will not give enough time for consideration

and will reduce the quality of responses'. In particular, 'when the consultation spans all or part of a holiday period, consider how this may affect consultation and take appropriate mitigating action'. The CMA's latest consultation does not reflect these reasonable standards. We reiterate our concerns over the haste of the CMA's actions and we call again on the CMA to ensure that it has the robust evidence it needs before making wide-sweeping changes to audit and corporate governance that may be damaging to UK investments. While we support the CMA's proposal not to make a market investigation reference, the additional time this creates should be used wisely to seek proper, balanced evidence and to undertake a full analysis of the costs and benefits of each remedy.

Our responses to the individual questions posed by the CMA are outlined below.

AREAS FOR SPECIFIC COMMENT:

A) Issues

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

ACCA's report 'Tenets of a quality audit'[1] sets out the factors that contribute to a quality audit. The report identifies six pairs of factors and argues that the debate about how to enhance audit quality should recognise that these factors can act in tension. For example, thoroughness and timeliness both contribute to audit quality, but a detailed, thorough audit may not be timely and a fast audit may not be thorough.

This model of audit quality allows for the concept of audit quality to change over time in response to changing public expectations. It is also more realistic about the need for an open and honest debate about how the tensions implicit in audit quality can be managed to maximise overall audit quality.

Much of the analysis in the CMA's section two is problematic, as it fails to put the audit into context. With approximately 1,200 companies listed on the London Stock Exchange main market, the enforcement cases listed in Figure 2.16 represent about 2% of the listed company audits. That Figure also amalgamates cases of all types as if they are all equally serious; in practice, FRC enforcement actions have a range of causes and require firms to adopt different responses. The CMA's analysis makes no attempt to measure the positive impact of audit, such as where interventions by the audit firm have changed corporate behaviour or alerted regulators to possible fraud.

The analysis in paragraph 2.6(a) notes a 'persistent failure of the sector as a whole to meet the FRC's AQR targets for quality', even though the trend in Figure 2.17 shows

[1] https://www.accaglobal.com/gb/en/professional-insights/global-profession/Tenets-of-quality-audit.html

an improvement in quality over six years. Although the data address different data sets (FTSE 350 audits for the Big Four and all audits for challenger firms), Figure 2.18 indicates that challenger firms require greater improvements in inspected audits than Big Four firms do. We would also have expected some analysis of how the 'significant increase in the number of audit engagements with a tenure of less than five years' (paragraph 2.24) has impacted quality. The CMA's analysis suggests that increasing competition and reducing barriers to entry for challenger firms to the FTSE 350 audit market are the right answer, even though the evidence that this will increase audit quality is mixed at best.

We believe there are two issues at play: how to increase audit quality and how to expand choice in the market for FTSE 350 audits. The CMA's contention is that expanding choice will increase audit quality. We do not believe the evidence supports this, at least in the short term.

Paragraph 2.40 states 'while it may be possible to observe whether suitable audit processes are in place and whether the audit report is properly evidenced, it is much harder to assess whether an auditor is demonstrating professional scepticism and independence'. We do not agree with this statement. Throughout the auditing standards there are requirements for the auditor to exercise professional scepticism. As a result, the application of 'suitable audit processes' and the 'proper evidencing' of the audit report require the exercise of professional scepticism. ACCA's publication *Banishing Bias*[2] provides some background on how cognitive bias can impact the exercise of professional scepticism and what the auditor can do about it. Auditor independence is set out in standards issued by IESBA (the International Ethics Standards Board for Accountants). Therefore we cannot agree that it is 'much harder to assess independence'.

Paragraph 2.44 suggests that 'had the auditors identified and exposed problems earlier, this would have provided shareholders and other stakeholders with an opportunity to make informed decisions'. Paragraph 2.75 states that 'had auditors carried out their work to a higher standard it is possible that the commercial or other problems could have been identified earlier. We find these claims difficult to square with the observation in paragraph 1.2 that 'most people will never read an auditor's opinion on a company's accounts'. An audit opinion that contains a qualification or other modification or an emphasis of matter does not receive the press coverage that company failure does. Therefore it is unclear how audit reports can be either misleading or an effective early warning system when they are not widely read.

Paragraph 2.45 claims that 'there are quite likely a wider set of audit problems that never come to light'. We do not accept this allegation, which is unsupported by the

[2] https://www.accaglobal.com/gb/en/professional-insights/global-profession/banishing-bias.html

firms' records of steadily increasing audit quality across recent annual FRC inspections.

Paragraph 2.49 seems to make a distinction between 'the quality of the audit process' and 'underlying professional judgements'. It is not clear to us what this distinction is intended to convey, as we understand the quality of the audit process to encompass the proper exercise of professional judgement.

2. Do you agree with our analysis of the issues that are driving quality concerns, as set out in section three? In particular:

    a. Issues relating to the role of Audit Committees and investors in the process of appointing and monitoring auditors;
    b. Limitations on choice leading to weaker competition;
    c. Barriers to challenger firms for FTSE 350 audits;
    d. Resilience concerns; and
    e. Wider incentive issues raised by the multi-disciplinary nature of the large audit firms.

We do not agree with the analysis of the issues that are driving quality concerns.

In particular, the analysis of the role of audit committees does not consider how changes to the role of audit committees introduced by the European Audit Regulation and Directive have impacted behaviour. A fundamental question – which the CMA's analysis does not identify – is whether the existing regulatory and policy framework incentivises audit committees to select from a narrow group of large firms. And, if so, what can be done to respond if this is felt to be risky from the perspective of market resilience or to be undesirable from a public policy point of view.

As noted above, Figure 2.18 indicates that challenger firms require greater improvements in inspected audits than Big Four firms do. And the CMA's evidence shows that 'the winning bid was not the cheapest bid in the majority of cases' (paragraph 3.20) and 'the evidence so far does not suggest that the Big Four are systematically under-biding the other challenger firms' (paragraph 3.170): further indication that price is not a significant factor in audit committee decision-making. It is therefore difficult to make the case that audit committees are not focusing on audit quality when preferring a Big Four firm.

We are also concerned that the analysis simply accepts a lack of engagement by investors in auditor appointments, instead of seeking to understand the root causes and whether anything should be done to address them.

In paragraph 3.4(c) we reject the claim that 'the structure of accounting firms results in weaker incentives to deliver high quality audits, because a significant majority of the firms' business is outside audit'. This is simply untrue. Firms are incentivised to deliver

– and in most cases succeed in delivering – high quality audits, as evidenced by the FRC's annual inspection regime.

In paragraph 3.33, the CMA claims that there is 'an incentive for auditors to minimise costs, given that audit quality is very difficult to observe unless things go wrong'. ACCA's research into key audit matters in audit reports[3] found that, by providing a focus for discussions between the audit committee and the external auditor, key audit matters enhance the quality of these discussions. We therefore do not agree that audit quality is difficult to observe, and we certainly reject the idea that auditors would seek to reduce their costs even if it were.

Paragraph 3.85 indicates that challenger firms do not participate in all the tenders for which they are approached and that the reasons for this are not clear (paragraph 3.96). We think it is important for the CMA to understand these reasons better, as they may indicate whether any remedy is expected to be effective.

In paragraph 3.89, we are unconvinced by the CMA's argument that the multi-disciplinary nature of the large audit firms can lead to a significant reduction in choice. This issue is the responsibility of the audit committee to manage: under the EU Audit Regulation and Directive, effective since June 2016, audit committees are responsible for managing the tendering process for (re-)appointing the company's auditor. As such, it is up to the audit committee to seek assurances from management that there are sufficient candidate firms with the competence and independence to serve as the company's auditor when a tender is anticipated. This may involve, for instance, guidance on which firms may be used by the company to provide non-audit services. Generally speaking, the pool of firms that are capable of providing a non-audit service would be expected to be wider than the pool of firms that are capable of serving as the company's auditor.

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?

While we support the CMA's study of the statutory audit market, we do not support the CMA's proposed remedies. We find the proposals to be disproportionate, not sufficiently focussed on the impact of audit quality and not supported by the full range of available evidence.

[3] https://www.accaglobal.com/gb/en/professional-insights/global-profession/key-audit-matters.html

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To the extent that the CMA does move forward with any of its proposed remedies, we would advise doing so cautiously so the downside risk of each of the remedies can be understood and minimised.

In our original response to the ITC, we proposed three interventions, which we reiterate below. We continue to believe these represent t more targeted interventions which are based on meeting the CMA's objectives and support improvements to audit quality and we urge the CMA to review:

- Whether there should be a "cooling-off" period following the end of an audit relationship during which the former audit firm is prohibited from selling services to the entity. This may help to allay public concerns that the auditor's judgement in the final year of the audit relationship could be affected by the firm's desire to sell consulting services to that entity in the following year. A cooling-off period of two years might be an appropriate balance between protection of independence and choice of service provider.

- Considering a prohibition on management from firing their auditors during their terms of service.

- Whether there are non-regulatory ways of encouraging best practice among audit committees in ensuring auditor independence and audit quality.

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.

The audit committee is an important part of effective corporate oversight and audit committees play a vital role in capital markets' investor protection. We believe that the audit committee's role and the accountability mechanisms supporting the effective operation of their functions should be further considered. This should go beyond the provision of guidance and support a constructive engagement and enhanced accountability.

The responsibilities of audit committees changed in 2016 as a result of the implementation of the EU Audit Regulation and Directive, which gave audit committees of Public Interest Entities (PIEs) a pivotal role in monitoring the quality and independence of the external auditor. This was a key improvement in which best practice is still emerging.

The proposed remedy, which proposes close regulation of audit committees, risks undermining audit committees' accountability and would reduce transparency in decision-making. There is a risk that the proposed regulatory intervention (by confusing accountability) could limit innovation and encourage audit committees to default to a 'tick-box' approach.

The proposed remedy presumes that audit committees are somehow making the 'wrong' decision. No evidence is presented to support this presumption. Indeed, it could be argued that the CMA's evidence – for example, Figure 2.17 – shows that audit committees are already prioritising audit quality in their audit tendering decisions. The CMA already accepts (paragraph 3.17) that there is 'little evidence that Audit Committees focus overly on price in the selection of auditors'.

As highlighted in our response to question 3, we recommend the adoption of non-regulatory mechanisms to further encourage the adoption of best practice by audit committees. To this end, we are pleased to see the recent publication by IOSCO of its 'Report on Good Practices for Audit Committees in Supporting Audit Quality'[4]. This document provides good practices that audit committees may consider when recommending the appointment of an auditor, assessing potential and continuing auditors, setting audit fees, facilitating the audit process, assessing auditor independence, communicating with the auditor and assessing audit quality.

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?

We are not supportive of this proposal. The full body of available evidence does not show that joint audit increases audit quality. Moreover, mandatory joint audit would introduce a veneer of competition which may instead further crystallise the distinction between Big Four and challenger firms and codify Big Four involvement in all FTSE 350 audits.

In addition to the views expressed in the CMA's original paper (at paragraph 4.41), with which we would concur, there are a number of practical barriers which would have unintended consequences. These include proprietary issues in respect of methodology, the increased challenge of effective communication and appropriate oversight across the audit team and the increase in the number of tenders in which

[4] http://www.iosco.org/news/pdf/IOSCONEWS518.pdf

firms must participate, further increasing the burdens of audit tendering on challenger firms. It would also not reduce barriers to entry related to the scale and geographical reach required of an audit firm because both audit firms would take responsibility for the audit as a whole.

The CMA's original alternative proposal of shared audits would introduce a challenger firm in a more controlled way which could help to address institutional bias. This use of shared audits could be expanded over time as the implications for audit quality are assessed.

Given the lack of available evidence as to its positive contribution to quality, we believe that it would be irresponsible to require joint audit across the FTSE 350. If the CMA wants to develop an evidence base, it could seek to convince investors and audit committees of the merits of joint audit in order to encourage some companies to adopt joint audit voluntarily. This will allow a much better comparison of the benefits and disadvantages of joint audit and should help investors assess the impact of joint audits on audit quality

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.

Requiring one of the joint auditors to be a challenger firm creates new market distortions. Under the CMA's stated preference of each firm being appointed at different times, there would be double the number of tenders. If one of these tenders is officially reserved for challenger firms only, the other tender will unofficially default to being Big Four only. As a result, it will serve to reinforce the existing divisions between Big Four and challenger firms.

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.

Under a joint audit, both auditors are jointly responsible for – and therefore jointly liable for – the financial statement audit. The proposal for a 'minimum share' of audit work being 'set by a regulator' appears to indicate a misunderstanding of what joint audit is and how it might work in practice. The CMA's proposals for a regulator-defined minority auditor share do not fit with joint audit and more closely resemble a shared audit model.

We are also concerned about the practicalities and implications for quality of a single audit fee being divided between two firms, rather than the work of each joint auditor being costed and paid for separately. It is unclear to us how the audit committee can

operate an effective tender process in an environment where there is no clarity over the work that the incoming joint auditor will perform.

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?

Our understanding is that in countries that have mandatory joint audit, it is uncommon for joint auditors to be appointed at different times. If there were benefits of 'staggered' appointments that enhance audit quality and outweigh the costs of doing so, we would expect this practice to evolve organically. That it has not done so suggests that the benefits are minimal.

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?

The proposals being put forward in remedy 2 are unlike the existing regulatory framework for joint audit. We see it as unlikely that any firm would voluntarily submit to joint audit under the existing liability framework. As such, a new liability framework that recognises more equitably the relative contribution of each joint auditor seems an inevitable consequence of the CMA's proposals for joint audit.

Remedy 2A: Market share cap

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

The analysis provided by the CMA highlights that a market share cap increases the risk of lower quality audit (paragraphs 4.81 to 4.83) at least in the short term. It is not in the public interest to implement a proposal which would increase the risk of audit failure.

The remedy may ultimately reduce choice and therefore competition, and will restrict audit committees' ability to select an auditor based on quality. This undermines the accountability of the audit committee and reduces transparency.

The underlying detail raises further concerns regarding the practical implementation of this proposal. Option 1 for remedy 2A is unnecessarily complex and would act in an arbitrary way, as a company could 'decide' to have a Big Four auditor based on the timing of their audit tender process, whereas another company would be precluded

from doing so because the Big Four audit firms had reached their cap. The risks of such 'cherry-picking' are a consequence of the design of the CMA's intervention.

We are concerned that the proposal for Option 2 would prevent an auditor from resigning. An auditor must always have the option to resign an audit engagement where the relationship is unworkable. In our original response to CMA ACCA proposed introducing a prohibition on management from firing their auditors (see paragraph 36), which might go a small way to reducing the opportunities for management to 'cherry-pick' a Big Four firm.

That the CMA considers 'cherry-picking' a risk worth highlighting indicates that the CMA expects remedy 2A to be ineffective in producing a market in which challenger firms are seen as equals to Big Four firms.

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

We do not support this remedy, whether applied solely to FTSE 350 companies or to a wider group.

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.

This remedy includes tentative proposals to ease restrictions on movement of staff, establish a tendering fund and provide access to Big Four firms' technology.

Remedy 3 addresses the supply of audit services by challenger firms, whereas the available evidence indicates that the market structure issue is caused by demand for audit services by challenger firms. The primary issue appears to be the preconceptions of audit committee members. As a result, we do not think remedy 3 will make meaningful change to the market structure.

We do not share the CMA's view that there is a widespread issue of 'unreasonable' non-compete clauses (paragraph 4.94); however we would not oppose limited intervention in this area. That said, we believe the CMA should produce a more robust case for action in this area.

13. We welcome estimates on the costs of setting up and running a tendering fund or equivalent subsidy scheme, and views as to how this should be designed.

We do not support the creation of a firm-funded or government-funded tendering fund, which would reinforce a distinction between the Big Four and challenger firms. However, if investors were to set up a fund to support the tendering activities of particular firms, we would be supportive. Indeed, we would encourage any activity that stimulates greater involvement of investors in the audit tendering process.

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.

Sharing technology platforms and resources would reduce competition and innovation in audit as it would reduce diversity in audit methodologies. Therefore we cannot support this proposal.

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.

The system of audit inherently lacks a certain amount of resilience. As we noted in our original response to the CMA, 'there is a risk that a firm's reputation becomes so tarnished that companies abandon it as auditor, as happened to the Arthur Andersen network'.

Some of the remedies proposed by the CMA would (if implemented) serve to reduce market resilience. For example, higher non-audit fees would appear to make a firm more resilient to audit failure and therefore a proposal for firms to reduce their reliance on non-audit fees would harm resilience. This would be more pronounced in respect of the application of remedy 5.

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

In respect of 4.110(b), the CMA suggests that equity/partner drawings could be ring fenced to pay for the administrator or regulator to turn the company around. This assumes that sufficient funds are available. It is unclear who would fund this if this were not the case and whether in such circumstances the regulator would meet these costs (i.e. state funded).

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.

    Our view is that firm failure, if it happens, is likely to originate outside the UK and it will be difficult for the UK regulator or special administrator to do anything to prevent it. Once concerns about the quality of a firm's audits snowball, it is impossible to prevent a succession of companies removing the firm as auditor. As highlighted above, we are particularly concerned about the impact of remedy 5 on the robustness of audit firms in response to external shocks.

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, there is very little that can be done once companies and employees take the view that an audit firm is irredeemable: the outflow of employees and audit clients cannot be stemmed. We are concerned that, by focusing only on audit rather than the wider financial reporting and corporate governance environment, the government may be giving a misleading impression that audit is to blame for corporate failure. As a result, this may be disproportionately undermining confidence in audit and increasing the risk of firm failure.

    ACCA is undertaking some original research on the nature of the expectation gap in audit in the UK and other countries. We would be happy to share our findings with you in more detail upon request. We have published some preliminary findings from the UK[5].

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 do not agree that the challenges are surmountable. Paragraph 4.121(a) references ACCA's response to the first CMA paper to support the CMA's claim that the challenges to a structural split could be addressed. This misunderstands ACCA's position: our comment was in respect of the very specific question as to whether membership of an international affiliation of firms would constrain the creation of audit-only firms.

[5] https://www.accaglobal.com/uk/en/news/2018/november/audit-expectation-gap.html

However, there are other reasons as to why remedy 5 would be difficult to implement. For example, the suggestion in paragraph 4.119 that 'the audit practice would also be permitted to provide services closely related to statutory audits' is incompatible with the proposal for a 'prohibition on non-audit services provision' in paragraph 4.117. The CMA provides no evidence that firms, faced with the choice between a structural/operational split and ceasing audit, will choose to split. Some may choose to cease providing audit, further reducing choice in the audit market. Given that providing non-audit services is one way that challenger firms can demonstrate professional competence in providing services to FTSE 350 companies, it may even hinder the ability of challenger firms to tender successfully for FTSE 350 audits.

We believe the CMA's argument for audit-only firms is flawed. There is no evidence that audit-only firms have higher quality than multi-disciplinary firms. And there are many reasons, as have already been communicated by respondents to the first CMA paper, as to why the existence of non-audit services can support higher audit quality. As such, splitting firms would be costly, disruptive and ineffectual in driving up standards across the audit market. It also seems likely to harm the ability of challenger firms to compete for FTSE 350 audits.

20. How could an operational split be designed so that it would be as effective as the full structural split in achieving its aims, without imposing the costs of a full structural split? In your responses, please also compare and contrast the full structural split to the operational split.

21. With regards to the operational split, please provide comments on:

    a) implementation risks and whether they are surmountable: e.g. how any defined benefit pension schemes could be separated between audit and non-audit services;

    b) risks of circumvention and how they could be addressed e.g. how audit firms could circumvent the remedy through non-arm's-length transfer pricing and cost allocations;

    c) implementation timescales to separate the audit firms and how soon the remedy could be brought into effect;

    d) ongoing monitoring costs for the audit firms and a regulator;

    e) role and competencies of a regulator in overseeing ongoing adherence to the operational split.

The proposed remedy of an operational split between audit and non-audit services would not in reality address the substance of the concerns raised by CMA. The analysis on which it is based does not adequately demonstrate that separation would enhance audit quality and therefore confidence.

A full structural split could lead to cases of artificial compliance, where firms have separate ownership but continue to work closely together due to historical ties. Further consideration needs to be given to the cross-territorial implications for this in international network firms. The conclusion that auditor choice would be improved assumes that no firm elects to leave the audit market if faced with a requirement to split and the proposed severe penalties for non-compliance. In practice, we believe it is at least likely that some firms will do so.

The analysis presented overemphasises the importance of non-audit profits to the professional judgements of audit partners and underemphasises the importance of audit profits to the professional behaviour of non-audit partners and staff. It also fails to distinguish between non-audit assurance services and non-audit consulting services. Contrary to the CMA's claim in paragraph 4.113(c), we believe that there is a very close cultural fit between non-audit assurance services and audit services. Audit engagement partners need to use experts to support their audit judgements. Where these non-audit experts are sharing in audit profits, as they do currently, they have a financial and cultural incentive to work together to deliver audit quality.

Paragraph 4.117(b) seeks to prohibit 'financial subsidies from the international network to the UK audit firm'. This may require some clarification as we interpret this as prohibiting the common arrangement whereby one network firm receives the group audit fee and then apportions it between network firms acting as component auditors.

Paragraph 4.117(e) understates the process auditors must follow when appointing an auditor's expert in accordance with ISA 620. In particular, the requirement to evaluate the competence, capabilities and objectivity of the auditor's expert is a key reason that many firms retain such experts within their firms. Conversely, it is more difficult to assess the quality of a service that has been purchased from an external organisation. An internal expert is currently likely to be subject to firmwide policies and procedures over quality and has a shared culture of quality. Again, this is not the case for an externally-hired expert.

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

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

24. Which non-audit services (services other than statutory audits) should the audit practices be permitted to provide under a full structural split and operational split? Please explain your reasoning.

We do not agree that the separation of audit and non-audit services would permit a ‘relaxation’ of the conflicts rules as this would conflict with ethical and independence standards, to which all firms providing audit, assurance and related services engagements must comply.

This remedy would introduce additional independence risks and increase market entry costs for challenger firms. However, we would not support excluding challenger firms from the scope of the remedy as this would further reinforce the distinction between the Big Four and challenger firms.

Paragraph 4.117 proposes a ‘prohibition on non-audit services provision’, which would be incompatible with certain non-audit services being permitted. In practice, there are some non-audit services which are required by law to be provided by the auditor, some which it makes no sense for any firm other than the auditor to provide and some where it is convenient for the company to invite the audit firm to provide. Since the 2016 changes to the EU Audit Regulation and Directive, all non-audit services that are not prohibited by the Regulation/Directive must be specifically pre-approved by the audit committee and are in any case subject to a cap set at 70% of the audit fee. Feedback from larger firms is that they do not actively seek to win non-audit services from the companies they currently audit.

A more effective remedy to remove conflicts between the audit and non-audit businesses of firms would be to adopt ACCA’s proposal for a cooling-off period after an audit firm rotates off as auditor (see our response to question 3 above).

Remedy 6: Peer review

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

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

In order to support effective oversight of audit it is imperative that there are clear accountability lines. The engagement partner is fully responsible for the audit opinion provided on the accounts.

The remedy for peer review would not support an increase in audit quality. The asymmetry of information between the engagement team and an independent firm would severely limit effectiveness. The ability to undertake the full range of work proposed (review of the audit file, process and conduct financial analytical reviews, re-perform audit tests on material and risky audit areas, identify any weaknesses that exist in the audit and report to the audit committee and the sector regulator) in advance of the accounts being signed off would require significant time and resources

and therefore would delay results to the market. The proposal duplicates many of the functions of an engagement quality reviewer, but in much greater depth, undermines the accountability of the signing auditor and will increase future conflicts of interest.

Paragraph 4.142 suggests that this remedy could be funded by a levy on the audit fees of the FTSE 350. We disagree. It is important that the costs of this remedy are transparent to investors. Therefore we suggest that it should be levied on companies and disclosed transparently to investors in the annual report.

C) Next steps

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

We support the proposal not to make a market investigation reference. As noted above, ACCA believes that concerns over financial reporting, corporate governance and the wider commercial environment go far beyond audit. It is therefore sensible to coordinate a single set of responses that incorporate the outputs of the final CMA study, Kingman review and BEIS inquiry rather than acting individually. While the CMA's terms of reference are solely on the statutory audit market, we hope that by not making a market investigation reference the CMA can suggest remedies with a wider scope than just audit.

However, our support is based on the expectation that any future regulatory or legislative change will be subject to the same requirement for evidence and scrutiny as would a market investigation reference.