

Statutory audit markets study  
Competition and Markets Authority  
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[Submitted via email to: [statutoryauditmarket@cma.gov.uk](mailto:statutoryauditmarket@cma.gov.uk)]

Dear Sir or Madam

***CMA update paper: Statutory audit services market study***

Having responded to the October 2018 Competition and Markets Authority (CMA) consultation paper on 6 November 2018, Chartered Accountants Ireland (the Institute) welcomes the opportunity to also comment on the CMA update paper issued on 18 December 2018.

The Institute has 27,000 members worldwide, almost 6,000 of which are in the UK, and is a Recognised Supervisory Body (RSB) under Schedule 10 of the Companies Act 2006. As such, our membership includes statutory auditors registered in the United Kingdom and Ireland and executives and non-executives of listed companies.

As with the submission to the October 2018 consultation, the working group formed to respond to the update paper consists of representatives of the nine PIE audit firms in Ireland.

**Introductory comments**

Consistent with our comments on the October 2018 consultation, we would once again emphasise our serious concerns about the length of the consultation period. As a consequence of the limited time available, our comments in this submission are necessarily high level, focusing by necessity on the individual remedies proposed rather than the supporting analysis, and do not address all of the individual questions posed. Some of the comments we make below refer to further work/analysis being necessary. We do not consider this to be the appropriate manner in which to make decisions which may have far-reaching implications for the audit profession, the FTSE 350 companies/public interest entity reporters and business in general.

The Institute fully supports increased competition and measures that would enhance choice in the UK PIE audit market. However, it remains of paramount importance that supporting and enhancing audit quality is the highest priority. As such, measures taken to enhance competition and choice should only be implemented where there is a high degree of certainty that the measures will not impact audit quality.

Equally, stakeholders should not automatically assume that measures increasing competition will inevitably lead to higher quality audits in all cases. Also in the context of maintaining and enhancing audit quality, the audit regulator plays a key role. It is essential, therefore, that any changes to be implemented arising from the CMA study are carefully coordinated with those arising from the Kingman review, and indeed the upcoming Brydon review.

We would also reiterate the comments we made in our submission to the October 2018 consultation as regards the importance of finding global solutions and coordinating these proposals with developments in corporate reporting in general. As we emphasised in that submission, we are supportive of changes which will enhance audit quality and public confidence in the statutory audit process.

Our comments under the headings of ‘issues’, ‘remedies’ and ‘next steps’ are set out below.

## **A) Issues**

Whilst we recognise the importance of the issues/concerns relating to company failures and restatements of company financial statements, we consider it important to point out that they arise from a relatively small number of cases. We do not accept the extrapolation that “there are quite likely a wider set of audit problems that never come to light”. There is no objective basis underpinning such commentary. Moreover, corporate failures are a natural part of a functioning capital system and can occur for a combination of reasons such as flawed business models, poor corporate governance and liquidity issues unrelated to audit. Changes in the audit market will not eliminate the risk of future failures.

In our submission to the October 2018 consultation we noted that firms are seeing evidence of greater levels of audit committee engagement with the auditor selection/tendering process, given their greater responsibilities now under the law in that regard. We note the analysis of the range of time spent by audit committee chairs and members on audit related matters; however, we are unconvinced by the assertion that audit committees are over-reliant on executive management in assessing the progress of the audit.

As mentioned above, we consider it is important to distinguish audit quality from competition issues and choice in the audit market. Whilst increased competition is a desired outcome, enhanced audit quality would not automatically flow from such competition. Also, the lack of a larger choice of candidates for an audit engagement does not mean that competition amongst candidates currently is weak.

The CMA analysis does not reflect the impact of the tight corporate reporting timelines currently in place in the UK and the implications these may have on quality. We consider that the potential implications of the CMA proposals on these reporting timelines should be factored into the final assessment of the proposals.

As discussed under remedy five below, we do not concur with the assertion that in a multi-disciplinary firm, a culture of professional scepticism in the audit function cannot co-exist with a culture of collaboration in the consultancy business.

## **B) Remedies**

### **Remedy 1 - Regulatory scrutiny of audit committees**

We welcome that proposed measures in the October 2018 consultation to remove responsibility for the selection of auditors from companies and transfer this responsibility to an independent body are not now being pursued by the CMA. In our original submission we noted some of the very significant difficulties which would be involved in such measures. We suggested that there may be potential for a more involved role for the regulator in terms of the governance and transparency over the selection process, akin to the enhanced involvement of certain regulators in regulated sectors such as financial services.

We note that the update paper also proposes more on-going involvement of the regulator in the management of the audit relationship and audit engagement. The update paper discusses that audit committee approaches to their responsibilities can vary widely, particularly in terms of hours applied to consideration of audit matters by chairs and members of audit committees. Whilst we would question the prevalence of audit committees being over-reliant on executive/management feedback as to the progress of the audit, as asserted by some respondents, we could see some benefits arising from the audit regulator supporting continuous improvements in this aspect of the work of audit committees. Further guidance to audit committees on meeting their 'challenge' responsibilities would be welcome. We can also see potential benefits of an enhanced monitoring role for the regulator, as envisaged in the update paper, with the proviso however that the regulator is sufficiently resourced to allow it to carry out this monitoring role in an effective and timely fashion.

We note that the CMA position is that this remedy should be applied at least to the FTSE 350 companies. This will undoubtedly involve a very significant resourcing requirement and we therefore consider that the remedy should not be extended, at least initially, to other PIEs/large private companies.

### **Remedies 2 and 2A – Mandatory joint audit and market share cap**

Different audit firms will have different views on the proposed remedy of mandating joint audit, both in terms of the principle of mandating it for the audit of PIE entities and also in terms of how it should be applied in practice, once mandated. Some firms may be relatively speaking more in favour of joint audit based on their network's experiences of joint audit in France; others may not be in favour of mandatory joint audit and may favour instead alternative measures such as a market share cap as a means of achieving the market choice and competition objectives.

The primary purpose of introducing mandatory joint audit would be to encourage more firms to develop the scale and expertise to compete for PIE audits. We therefore consider that, if joint audit is mandated, the general principle should be that a challenger firm should be included. To do otherwise would reduce choice for entities in their subsequent selection process, as two Big Four firms would be excluded due to independence considerations. Further, we recognise, as discussed in the update paper, the particular difficulties that could arise in mandating joint audit in certain specialised sectors. We support the CMA's conclusion that the introduction of such measures in these sectors needs careful consideration and would at

least need to be implemented on a phased basis to allow challenger firms to develop the necessary scale and expertise for the measure to be successful.

We note the CMA provisional view of the merit in appointing joint auditors at different times, but consider that it should not be mandated - companies should be able to decide their own timeframe for the appointment of their joint auditors.

In the context of the proposal to introduce mandatory joint audit, and specifically referring to question nine in the update paper, we consider that the current auditor liability legal framework needs to be revised. The profession has called for many years for a revision to the auditor liability regime, and certainly our view is that the introduction of mandatory joint audit would need to be accompanied by a revision of the liability regime.

We note the discussion in the update paper of the complexities and challenges involved with the implementation of a market share cap – individual firm versus collective firm caps, caps based on market capitalisation, audit fees or numbers of clients and the potential for “cherry-picking”, weakened competition and negative impacts on audit quality. Without sufficient time for further and deeper analysis, it is very difficult to identify a clearly optimal approach, representing a measure which would be effective in achieving the objective of enhanced competition over time and practicable in terms of its implementation. Whichever approach to a market share cap might be chosen, it certainly appears to us to be, by necessity, a longer term remedy in nature, as appropriate transitioning arrangements would need to be established.

Our working group considers that, to encourage competition and choice in the UK PIE audit market, there may be merit in considering a combination of market share cap and incentives for having joint audit as an alternative to mandating joint audits or mandating that challenger firms be included in a joint audit arrangement. For example, where firms undertake joint audit with a challenger firm on a voluntary basis, these audits could be excluded from the calculation of the cap.

We consider that a lot more analysis is required before making a decision whether and how to implement mandatory joint audit and/or a market share cap in the UK. We consider that before any changes to the joint audit regime are introduced, it would be essential to review the framework and overall structure for the operation of joint audit – including dealing with issues like the allocation of the audit work, disagreements in terms of opinion, liability arrangements. Similarly, a framework for a market share cap would need to be established to deal with the key challenges such as those discussed above. Both frameworks should be subject to wide and extensive consultation. We furthermore consider that any measures should be implemented in a timeframe that as best as possible ensures no detrimental effects on either audit quality or audit market choice.

### **Remedy 3 – Additional measures to support challenger firms**

We are not aware of “significant and unreasonable barriers to senior staff switching between firms”. In our submission to the October 2018 consultation, we emphasised the importance of ensuring that any measures introduced to reduce barriers to switching firms, be balanced with the need to ensure audit quality is not impacted.

We do not see how a tendering fund can be effectively implemented. We agree with the comment in the update paper that other measures if implemented successfully will increase the potential for challenger firms to be successful in tender processes and thereby reduce the cost of tendering as a barrier.

Other than noting the significant levels of investment made by challenger firms in their proprietary knowledge and systems, we do not have a view on the proposal to compel Big Four firms to license technology, or contribute to developing an open source platform. This is a matter for individual firms to consider.

#### **Remedy 4: Market resilience**

In our view, there should not be specific restrictions placed on the movement of people or clients in circumstances where one of the Big Four firms ceases to operate. We consider that the issue of resilience will largely be addressed by the successful implementation of measures to strengthen the competitive position of challenger firms and widen the choice of auditors available to PIEs. Of the measures under consideration, the introduction of a market share cap would appear to offer the most potential to strengthen market resilience (i.e. following the withdrawal/failure of a Big Four firm the ability for audits to move to the remaining Big Three firms would be limited to the market share cap limits in place for each firm).

An analysis of market resilience needs to consider the attractiveness of the market to firms, both existing and potential new entrants. The update paper recognises that the loss of one of the Big Four firms to audit may not only happen as a result of a single event, but rather also due to “gradual decline”. Indeed, one cannot exclude the possibility that a firm might exit the PIE audit market due to a loss of economic vitality of the audit service, liability issues and/or increasing regulatory burdens, on the firms or on individuals in the firms. Market resilience may be more likely to be impacted by regulatory actions and such pressures could also act as barriers to attracting new service providers into the market. The achievement of an appropriate regulatory balance will therefore also strengthen the market’s resilience. In this context, we consider that an overhaul of the liability regime to introduce proportional liability would also substantially contribute to supporting market resilience.

We have not had sufficient time to consider the involvement of a special administrator in the market, nor the interaction between a special administrator and the regulator. We would however be happy to engage on concrete proposals in this context in due course.

#### **Remedy 5: Full structural or operational split between audit and non-audit services**

In our response to the October 2018 consultation we stated that we do not support the concept of audit-only firms and we reiterate that position here. We do not agree with the analysis that this option (“full structural split”) would represent the best solution and do not agree that objections to full separation are overstated. In fact, in the event of the implementation of a UK-only measure of audit-only firms, we would have very significant concerns about the future strength of UK statutory audit in the context of maintaining pace with global audit network developments in technology and expertise.

The update paper questions the validity of the following objections to full separation raised in the consultation:

- **Recruitment as a major obstacle.** Recruitment of the brightest and the best candidates into the profession is, and has been for some considerable time, an ever-increasing challenge, for both audit firms and accounting bodies alike. As well as perceptions as to the level of difficulty and length of time required to qualify and establish oneself in the profession, in comparison to other potential career paths, issues such as increasing regulatory and public scrutiny and criticism are considered to be some of the key recruitment challenges facing the profession. The implementation of measures which may reduce the links of UK firms to their international networks, and reduce the capacity of firms to offer potential new entrants into the profession experience in a wide range of professional services, cannot but negatively impact on the attractiveness of the UK profession in our view.
- **Access to non-audit expertise.** The update paper suggests that audit firms could agree long-term retainer contracts with non-audit firms, allowing access to the specialist advice at short notice. A number of key aspects are not recognised in this analysis. Firstly, as regards multi-jurisdictional audits, access to specialist knowledge would be necessary in various jurisdictions, and the subject matters experts would remain within the audit firm structures in such other jurisdictions. Also, currently the work of such specialists on audit engagements is subject to the unlimited liability basis applying to statutory audits in the UK, and is covered by the firms' professional indemnity insurance arrangements. One would expect that non-audit firms providing this expertise following full separation would not contract to provide services on such an unlimited liability basis. This would result in significantly heightened risks and costs for the audit function.
- **Scale.** The update paper analysis suggests that audit-only firms would remain profitable and therefore continue to be in a position to "make necessary investments". This argument does not reflect the scale of investment being made internationally by the larger networks of audit firms in audit related technology and know-how. UK firms operating outside of such international structures would not be able to match the level of international investment on a stand-alone basis, impacting on their ability to remain at the forefront of developments in audit quality. Also, the CMA analysis is high level and has not carried out an assessment of the profitability of audit on a standalone basis. At present, audit departments require staff to meet the peak demands of a busy season based around the majority of audits being in respect of December year-end financial statements. Outside of peak audit season, these same staff are deployed on other audit department assignments (accounting projects; secondments to finance teams; etc.) and into projects outside of the audit department. Restricting services to audit-only creates a fundamental issue in how resources are deployed to meet the peak corporate reporting cycle and the cost of holding these staff in the rest of the year when there is no audit demand. As such, the question as to whether an audit-only firm sector in the UK would be profitable and viable remains open, in our view.

In our submission to the October 2018 consultation, we also explained that not all UK firms are structured in the same manner and that some firms are organised on an all-Ireland basis, i.e. the Irish firm is responsible for Northern Ireland and separate from the UK firm, or has a separate Northern Ireland firm. Fully

separating such firms into audit-only and non-audit service firms is likely to prove even more complicated and may not result in viable audit firms in Northern Ireland.

As regards an operational split, we have not had sufficient time to digest the proposal, and be able to come to a conclusion on whether the measure would be effective, or form a view on the appropriate design of such a measure. This would, in our view, require much more consideration and consultation. We would be happy to engage in detail with such consultation in due course. We would, however, make the following initial comments:

- We are not convinced that the operational split measures proposed would necessarily have a significant impact in achieving the CMA objectives. It should be pointed out that larger firms already incorporate operational splits to a large extent within their organisations to reflect the audit quality agenda – application of the audit firm governance code, the Public Interest Oversight Committees, audit accountability frameworks. However, we do agree that changes could be made to strengthen audit firm governance standards expanding on the existing frameworks and increasing regulatory oversight.
- We are not convinced by the assertions in the update paper that the culture of multi-disciplinary firms is such that the collaborative approach of consulting engagements is detrimental to the professional scepticism of the audit function. It is not the experience of members of our working group that audit judgements are unduly influenced by the culture and/or commercial considerations in the non-audit services business. Whilst there are naturally commercial pressures associated with the conduct of an audit (which will not change due to the implementation of an audit-only system), audit partners in larger audit firms are primarily assessed on the basis of the quality of the audit work. We do not agree with the assertion that it is not possible to have appropriate incentives in a multi-disciplinary environment.
- The update paper analysis discusses the possibility of a relaxation of the independence rules on implementation of an operational split of firms into audit-only and non-audit functions. The independence rules devised by the European Commission as well as by standard setters such as the International Audit and Assurance Standards Board ('IAASB') and the FRC have been developed over many years and have been subject to wide consultation. Whilst it is not argued that these rules are operating perfectly, we have significant concerns about the unintended consequences and implications of relieving firms from some or all of these rules as suggested. This would be of particular concern again in the context of international audit engagements.
- In our previous submission, we encouraged the CMA to give further consideration to a prohibition on the provision of non-audit services to audit clients as an effective and practical alternative to audit-only firms. We note that following the closing of that consultation, at least two Big Four networks have made public their decision to cease providing non-audit services to audit clients internationally. We maintain our position that this would be a preferable approach to re-aligning incentives.

## **Remedy 6: Peer review**

In our submission to the October 2018 consultation, we noted the significant challenges that we foresee to an effective peer review process being implemented, including sharing of responsibility and liability, dealing with material disagreements between the auditor and the reviewer and implications for independence. One of the primary concerns is to understand how the proposed peer review could operate effectively given the short reporting cycles that currently exist in the UK. The proposal is that a peer review would take place in advance of the signing of an audit opinion. As it stands, as mentioned earlier in this submission, short reporting deadlines post year end represent a very significant challenge to auditor. We find it very difficult to see how peer review of audits by other firms in advance of the signing of audit opinions could be introduced in a workable/practicable manner that would not be unduly disruptive to corporate reporting cycles and could well result in increased risks to audit quality.

We note that regulators in some other jurisdictions include peer review, carried out by other firms, within their regulatory processes, but these are carried out retrospectively, rather than in a 'live' fashion. We believe that further consideration should be given to the merits of peer review post audit as part of the regulatory monitoring process.

## **Next steps**

We agree with the CMA's proposal to make recommendations to Government and not to make a market investigation reference. We consider that the matters being discussed are complex and extensive further consultation on the design of measures to be absolutely critical to achieving the CMA's objectives while as far as possible avoiding unintended consequences impacting negatively on audit quality or choice in the market. We called in our submission on the October 2018 consultation for a coordinated response, linked to the outcomes of other relevant reviews, in particular the Kingman review of the FRC and the Brydon review on the purpose and scope of an audit, announced in December.

Please contact me if you would like to discuss any aspects of our submission with us in more detail. We look forward to further engaging on this very important issue as the recommendations are taken forward.

Yours faithfully

**Mark Kenny**

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