David Lindsell MA FCA

Statutory audit services market study
Competition and Markets Authority
7th floor
Victoria House
37 Southampton Row
London, WC1B 4AD

21 January 2019

Dear Sir or Madam

The CMA's Update paper dated 18 December 2018

I am grateful for the opportunity to respond to the CMA's Update paper dated 18 December 2018 on its study of the statutory audit services market in the UK.

I am responding to the CMA's Update paper in an individual capacity. By way of background, I would mention that during the past 11 years I have chaired the audit committees of three FTSE 350 companies, a major charity and a university, and have been a member of the audit committee of another FTSE 350 company and a non-departmental public body. I also served for four years as deputy chair of the FRC's Financial Reporting Review Panel. Prior to this, I was the audit engagement partner for a number of FTSE 100 companies, in most cases for the maximum period of seven years that was then allowed.

The Study and CMA's strategic goals

In any profession or business, there will always be some degree of performance variability and performance failure. The key issue is whether the extent and severity of the variability and failure is sufficiently significant and the consequences are sufficiently damaging to society as to require intervention by the State in the public interest. This is a highly complex issue and any assessment of the need for intervention must be based on a proper understanding of the required performance standards and on objective analysis of wide-ranging, direct and reliable evidence regarding the damage that has been directly caused by failure to achieve those standards. The CMA's Update paper is not based on such an assessment and the case for the remedies proposed by the CMA is, therefore, not made.

However, the shortcomings of the Update paper are more serious and are very concerning. One of the CMA's five strategic goals is "achieving professional excellence – by managing every case efficiently, transparently and fairly, and ensuring all legal, economic and financial analysis is conducted to the highest international standards". achieving professional excellence – by managing every case efficiently, transparently and fairly, and ensuring all legal, economic and financial analysis is conducted to the highest international standards".

The CMA's Update paper comprehensively fails to meet this goal. Its analysis not only falls a very long way short of the highest international standards but is neither fair nor balanced.

My detailed response is attached. It explains why the evidence on audit quality cited by the CMA does not support its conclusions on audit quality which, at their core, claim that audit failures are responsible for corporate failure. The CMA's conclusions on audit quality, unsupported by relevant and reliable evidence though they are, lead almost ipso facto to the conclusion that the current mechanisms for the selection and oversight of auditors, notably audit committees but also implicitly the FRC, are ineffective and that greater competition and choice in the market is required. However, the CMA's analysis of these mechanisms is fundamentally flawed. In addition to an almost total absence of empirical evidence from its analysis, the CMA shows a marked bias in favour of accepting the views of stakeholders and other, mainly circumstantial rather than direct, evidence that supports these conclusions rather than evidence that does not support them. Further, in some cases the CMA misinterprets or quotes out of context the evidence it cites.

Since the CMA's analysis of audit quality concerns and the issues that are driving such concerns are fundamentally flawed, it follows that the CMA has not made a case for imposing on auditors and companies the radical and unprecedented so-called "remedies" it proposes. Moreover, it is far from certain that the remedies proposed by the CMA would achieve the improvements in audit quality that the CMA claims, while the additional regulatory burdens and costs to which they would give rise would be significant.

The CMA's analysis of audit quality

The CMA Update paper implies, based on very selective evidence, not only that "audit failure" (a pejorative term which the CMA uses throughout the Update paper but does not at any point define or explain) is a feature of most corporate failures but also that corporate failure can result directly from audit failure. For example, the CMA states at paragraph 2.42 that "In recent years a number of high profile cases of audit failures have been exposed by corporate failures and fraud". It then asserts at para 2.43 – without any supporting evidence here - that "these [audit failures] appear not to be isolated incidents". The CMA goes on to say in paragraph 2.44 that "responsibility for recent corporate failures does not rest solely with auditors…." which, of course, implies that auditors are at least partly "responsible for recent corporate failures". Further, in its "Conclusion on audit quality" the CMA, in effect, holds audit failures responsible for "the financial harm and distress to many people caused by corporate failures, including to members of pension scheme, owners and employees of suppliers, customers" and for good measure adds "in the case of Carillion, there was harm also to the taxpayer and users of public services".

These are extraordinary allegations regarding what the CMA describes as "the potential impact of audit failures". Even in the case of Carillion, the highest profile recent corporate failure, which set in motion the events that resulted in the CMA study and report, the Joint Select Committees' report states in its summary "Carillion was unsustainable. The mystery is not that it collapsed, but that it lasted so long", and at paragraph 216 "The directors of Carillion ….. are responsible for the collapse of the company and its consequences". Moreover, even the CMA itself recognises in paragraph 15 of Appendix C to its Update that "The purpose of an audit is not to prevent a company collapsing or to assure the future viability of the entity".

In the case of the other recent high profile corporate collapse, BHS, the basic issue is that BHS had for several years relied for its survival on continued financial support from the group of which it was part. It collapsed when that financial support ceased on the sale of the company to a third party. There is no basis for suggesting in the case of BHS that the auditors have any responsibility whatever for the corporate failure.

There are clearly major questions about the quality of the audits in Carillion and BHS, in particular regarding whether the auditors obtained sufficient appropriate audit evidence to conclude whether or not there was a material uncertainty about the entity's ability to continue as a going concern that should have been disclosed in the financial statements by the directors. In no sense, however, can this be said to make the auditors responsible in any way for either of these corporate failures.

The CMA's attribution of responsibility for corporate failures to auditors colours the CMA's entire discussion of audit quality and in particular its interpretation of what it describes as "several indicators [that] suggest a persistent problem of variable and sometimes poor audit quality" (para 2.41). In fact, the significance and reliability of the different sources of evidence considered by the CMA as indicators of audit quality varies greatly. None of the sources of evidence considered by the CMA, such as FRC enforcement actions audit quality review results and international cases supports the conclusion that audit quality is a widespread, systemic problem and conclusions about audit quality as a whole cannot fairly be drawn simply by aggregating such disparate evidence.

Furthermore, although the CMA reports the views of those individuals and groups with the greatest knowledge and understanding of the operation and financial reporting of companies and the audit of their financial statements, namely audit committee chairs, finance directors and auditors, it chooses to give far greater weight to the views of stakeholders such as investors and investor groups who have very little, if any, first-hand knowledge and experience of these matters and who have provided very little empirical evidence to support their opinions.

The section "Conclusion on audit quality" in the Update report in fact avoids any explicit evaluation of quality. Instead, it merely reiterates its earlier statements about the links between "audit failure" (undefined) and corporate failure, including the "potential impact of audit failures" which the CMA says "are illustrated by the financial harm to many people caused by corporate failures". This is not objective analysis but, rather, innuendo.

The CMA's analysis of "the issues that are driving quality concerns"

The CMA's analysis of what calls "the issues that are driving quality concerns" is fundamentally flawed. In particular, the CMA hugely overstates the effect of competition in ensuring what it describes as "the right incentives" to deliver high quality audits. Competition has never been the or even a principal driver of audit quality. The principal drivers of audit quality are the professional standards, values and cultures of the audit firms and the audit staff they employ, underpinned by increasingly demanding auditing standards and backed up by the need to avoid reputation or financial loss from litigation or criticism by audit regulators. The drivers of quality in the auditing profession are therefore similar to the drivers of quality in many other professions. However, the CMA does not even refer to, let alone recognise the importance of, any of these drivers in its analysis.

The CMA bases its view that audit committees cannot provide effective oversight of audit quality on what it calls "the principal-agent problem" which it paints as a major dichotomy, together with the fact that audit committees cannot observe directly the quality of the [audit] work undertaken". Its conclusions, such as that "the whole system" is "fragile, by diluting the incentives on auditors to focus on providing high quality audit based on professional scepticism and challenge" are based on theory and surmise, rather than relevant and reliable empirical evidence. In particular, the CMA's consideration of information about the amount of time audit committee members spend on audit-related matters is extremely superficial, failing to consider, for example, the knowledge of financial reporting and internal control issues that audit committee members develop from their wider role as directors and bring to bear in their interactions with the auditors. As with its analysis of audit quality, the CMA cites several submissions by investors who expressed concern that "audit committees do not sufficiently challenge management on their judgements or auditors on the depth of work or analysis they have undertaken" and that some audit committees "appear to rely on executive feedback on the auditor as the main input into their annual reviews of performance". Given the lack of engagement by investors with audit committees, it is not clear how these investors have sufficient knowledge of the facts to enable them make such statements and in fact some of the submissions which, according to the CMA, expressed such concerns in fact did not. Again, the CMA gives greater weight to such views than to the views of audit committee chairs and others who are directly engaged in the activities under discussion.

The CMA's views are predicated on the belief that greater competition between auditors could "sharpen the incentives for auditors to deliver a consistently higher standard". In order to justify radical market intervention designed to force greater competition, it is necessary to demonstrate firstly that a very substantial sharpening of incentives is required, secondly that radical market intervention would definitely achieve that result, and thirdly that there are no other measures that could bring about that result but that would involve less upheaval and cost.

The CMA has not demonstrated in its analysis of audit quality that a very substantial sharpening of incentives is required. Its analysis of the limitations on competition and choice in the audit market focuses heavily on what it (somewhat misleadingly) describes as "challenger firms" and the barriers to their expansion. Certain of these barriers, such as the lack of experience and expertise of challenger firms necessary to be able to deliver high quality audits in a number of sectors, lack of sufficient international presence, and necessary investment in audit technology, would be difficult to overcome but in any event would take years to do so, during which time far from improving the overall quality of audit would increase the risk of inadequate audits. This would in turn expose challenger firms to significant regulatory, financial and regulatory risk during the lengthy transition period.

As regards the question of whether there are other, less burdensome and costly measure that could sufficiently "sharpen the incentives for auditors to deliver a consistently higher standard", whilst it refers to the importance of the interaction of competition and regulation, the CMA does not actually consider how this interaction should operate, on the grounds that this is the territory of the Kingman review. However, this does not inhibit the CMA from proposing very significant increases in regulatory oversight of audits. The absence of any discussion in the Update paper of the relative effectiveness of imposing fundamental changes on the audit market on the one hand and possible regulatory change on the other is a major weakness in the CMA's analysis and its justification for the "remedies" it proposes.

The CMA's proposed "remedies"

Regulatory scrutiny of audit committees

As explained in the attached detailed response, not only has the CMA failed to make a case based on evidence concerning shortcomings in the quality of audits and of audit committee monitoring of auditors that would justify the introduction of such direct and pervasive oversight of audit committees but also it is very doubtful whether the regulatory regime it proposes would be truly effective.

Mandatory joint audit

The CMA favours mandatory joint audit principally because by enabling non-Big Four firms to become joint auditors of FTSE 350 companies (and possibly mandating that one of the joint auditor is a so-called "challenger firm") competition in the audit market would, in the long term, increase. However, the fundamental issue is audit quality and there could be no justification for imposing such a radical and far-reaching change on the audit market if there were a reasonable likelihood that mandatory would not result directly in improvements in audit quality, let alone if there were a reasonable possibility that it would result in reductions in audit quality. As regards the impact of joint audit on audit quality, the CMA notes that the conclusions of such empirical studies as have been conducted on the impact "are mixed" and that the literature "has not established a clear link between mandatory joint audit and audit quality". The only study it cites in this regard, however, "shows that joint audits by one big firm and one small firm may impair audit quality, because, in that situation, joint audits induce a free-riding problem between audit firms and reduce audit evidence precision". The CMA nevertheless concludes that since "there is no clear evidence that audit quality is lower in a joint audit regime", "we therefore expect that the introduction of mandatory joint audit in the UK ….. may result in higher quality through creating incentives for greater professional scepticism". This is a non sequitur. It certainly does not provide sufficient assurance regarding audit quality to justify the imposition of such a radical and far-reaching change on the audit market.

Market share cap

A market share cap would ultimately be anti-competitive. As regards the effect of a market share cap on audit quality, at least in the case of a joint audit where one of the joint auditors was a non-Big Four firm, the Big Four firm concerned would do what is necessary to ensure that audit work of a sufficiently high quality was performed in the parts of the company audited by the non-Big Four firm. No such safeguard would exist in a sole audit obtained by a non-Big Four firm as a consequence of a market share cap on the Big Four firms. This consideration by itself should be of sufficient concern to end any discussion of a possible market share cap.

Structural or operational split between audit and non-audit services

This is another remedy which the CMA is able to justify only on the basis of the simplistic and misleading view that the "culture" required in an audit practice is incompatible with the "culture" of a firm that provides advisory services. The one specific piece of evidence – the FRC's Thematic Review of Audit Culture - that the CMA implies confirm that this is an issue in fact does no such thing. Arguments against splitting the firm include the weakening of resilience of audit firms that would result.

Particularly if the CMA's overstatements and misinterpretations are discounted, there are good grounds for believing that operational separation of the audit practices of the firms could address sufficiently any legitimate concerns that incentives for auditors in multidisciplinary firms to focus on independent, high-quality audit are somehow negatively affected by the structure of the firms.

Peer review

As explained in the attached detailed response, the CMA hugely understates the practical problems that would arise from imposing a "hot" peer review regime. High quality peer review in the course of, rather than following, an audit would need to have a wider scope than that described by the CMA in that it would need to encompass a review of the entire annual report and not just the financial statements, would require great expertise, an independently acquired understanding of the business of the company concerned to provide essential context when examining key audit areas, and much more time than the CMA appears to think would be the case.

As with all the CMA's proposed remedies, the justification for the peer review remedy should be based on an informed analysis of the extent of the problem to which it is seen to be a solution, and an informed analysis of the value of the likely benefit of the remedy as compared with its cost, both direct and indirect. And as with all the CMA's remedies, its justification for its peer review proposal does not meet either of these tests.

What should be the next steps?

The fundamental flaw in the CMA's study is the absence of direct empirical evidence to support any of its conclusions about audit quality, the quality of oversight of audit exercised by audit committees, the effects on quality of limited competition in audit tenders, and the culture (or cultures) of firms that earn a majority of their revenues from non-audit services. In the absence of such relevant and reliable evidence, there can be no justification for implementing the remedies proposed in the CMA's Update paper.

The next steps therefore need to include the following:

- Allow the independent review of the quality and effectiveness of the UK audit market led by Donald Brydon to be carried out and to report its findings;
- Request the FRC to perform a review of audit committee effectiveness, applying a risk-based approach designed to assess in particular the extent to which audit committees do in practice, help to address the "principal-agent problem". The review would involve the active participation of investors and audit committee chairs, and should make significant use of case studies (based on real circumstances to the extent possible without breaching confidentiality);
- Request the FRC to carry out a detailed survey and analysis of FTSE 350 audit tenders within the past few years focusing on the process involved and how it was managed, the firms involved, and the basis on which the successful firm was chosen. The survey would be conducted with audit committee chairs and would be supplemented by discussions with audit committee chairs based on case studies;
- Hold in-depth discussions with audit and financial reporting regulators in other countries, in particular the US but also in other countries such as the Netherlands with mature capital markets, to assess their views on the quality of audit and financial reporting and remedies they have implemented or contemplated in order to address any quality problems.

This is not intended to be a comprehensive list of the steps that should be taken as the touchstone here is the need for the CMA to obtain sufficient relevant and reliable evidence on the basis of which to bring forward proposals that respond to a fair and balanced assessment of the need to impose greater regulation and oversight of financial reporting and audit, and proposals that respond to that need, accompanied by analysis of all the resource and cost implications together with careful consideration of the risk and potential effect of any unintended consequences.

Yours faithfully

David Lindsell

Detailed response to CMA Audit Services Market Study Update paper

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

No.

The evidence of concerns about audit quality cited by the CMA

1.1 The CMA states that "there was unanimous agreement among stakeholders we spoke to that audit quality should be the key focus in assessing whether the market was producing good outcomes"[1]. It follows from this statement that in order to justify proposals for fundamental changes in the regulation and oversight of auditing and fundamental changes to the structure of the audit market, it is necessary to prove conclusively that there is a systemic audit quality problem.

1.2 The CMA states that "several indicators suggest a persistent problem of variable and sometimes poor audit quality"[2]. On the face of it, this statement does not suggest that audit quality is such a serious problem that fundamental reform of audit regulation and the audit market is required – in any professional endeavour there will always be some variation of performance quality, and just as corporate failure will never be eliminated, so there will always be some instances of poor audit quality. Indeed, a closer examination of the evidence regarding audit quality cited by the CMA does not in fact indicate that there is a systemic audit quality problem.

1.3 The CMA says that it has come to its conclusion based on:
(a) evidence of recent audit failures and FRC enforcement actions;
(b) audit quality inspections;
(c) international concerns over audit quality; and
(d) stakeholder views[3].

- *CMA's consideration of "evidence of recent audit failures and FRC enforcement actions"*

1.4 Figure 2.16 in the CMA Update paper shows that in the past 11 years the FRC has initiated a total of 26 enforcement cases. Of these, only 12 have been concluded. Of the 12 concluded cases, three relate to a specific breach of ethical rules. It would be a gross exaggeration to describe these cases as "audit failures" (the audits concerned in these cases were not reviewed as part of the enforcement case) while in only five of the 12 cases did the companies concerned fail.

1.5 Some of the 14 open cases, for example Sports Direct and Rolls Royce, appear to relate to the accounting treatment or disclosure of specific transactions or groups of transactions that are material but not of fundamental significance to the financial statements as a whole, while one (BNY Mellon) does not relate to the audit of financial statements at all. Only two of the companies concerned, one of which was Carillion and the other a small, AIM-listed company, have gone out of business and only in one or two other cases have the accounting breakdowns or misstatements involved been anything like life-threatening for the companies concerned.

1.6 During the 11 years covered by Figure 2.16, the average number of listed companies in the UK has been around 2,000. The number of audits of listed companies during that period is therefore well over 20,000. At least five of the 26 companies subject to enforcement cases are unlisted. Allowing for multi-year issues in some of the cases, the enforcement cases therefore represent no more than 0.02% of the audits of listed companies performed in the 11 years.

[1] CMA Update paper para 2.37
[2] ibid para 2.41
[3] ibid para 2.41

1.7 The statement by the CMA immediately beneath Figure 2.16 that "these failures appear not to be isolated instances and have had significant wider impacts"[4] is therefore clearly not justified based on any analysis of the FRC enforcement cases. Further, in view of the infinitesimally small proportion of audits that have been the subject of enforcement action and the diverse nature and scale of the issues involved, the CMA's statement "that the enforcement cases reflect underlying quality concerns"[5] is clearly not justified and borders on the irresponsible.

1.8 The CMA then quotes from the submission by the United Kingdom Shareholders Association (UKSA) as follows: "shareholders can no longer rely on the audit and it is a matter of luck that there have not been more major audit failures recently"[6]. The UKSA provides not a shred of factual evidence to support its opinions. A truly objective and impartial investigator would not give credence to such unsupported assertions.

1.9 The CMA then quotes from submissions by the Pensions and Lifetime Savings Association and others to the effect that high profile failures or even the perception of failure can be extremely damaging to investor (and public) confidence. There is no doubt that this is indeed the case, but among the 11 years of FRC enforcement cases shown in the table (Figure 2.16) immediately preceding these statements there are just two or perhaps three high profile failures or near-failures: Carillion, BHS and Patisserie Holdings.

- *CMA's consideration of FRC audit quality reviews*

1.10 As the CMA points out, the FRC grades the audits it reviews as either "good", "limited improvements required", "improvements required", or "significant improvements required" and the FRC has a target of 90% of FTSE audits requiring no more than limited improvements. It is not possible for third parties to assess how these classifications are applied by the FRC. The distinction between "limited improvements required" and "improvements required", which must be a matter of judgement, is critical since in 2017/18 73% of FTSE 350 audits reviewed by the FRC were assessed as "good or requiring limited improvement" but this percentage increases to 97% if audits classified as "improvements required" are included[7].

1.11 The FRC itself states (emphasis added) that "where an audit requires significant improvement, we have significant concerns in relation to the sufficiency or quality of audit evidence, the appropriateness of key audit judgements or other matters identified. *However, this does not automatically mean that the audit opinion is or was at risk*. In such circumstances we require remedial action by the firm to address our concerns and to confirm that the audit opinion remains appropriate….. Audits which receive a grading of [improvements required] or [significant improvements required] may be referred to our Enforcement Team for investigation"[8].

1.12 It is likely that any audit regulator will conclude, as does the FRC in its *Developments in Audit 2018*, that "high quality audit is not being delivered consistently"[9], as there will always be some degree of inconsistency of practice in any professional service that is performed many thousands of times each year by thousands of people. The term "audit failure" which is used repeatedly but not defined by the CMA must denote an audit which resulted in an inappropriate audit report on the financial statements concerned. It is very unlikely that an audit graded "improvements required" – where by definition the improvements required are not "significant" – would call into question the appropriateness of the audit opinion given on the financial statements concerned. This suggests that

[4] CMA Update paper para 2.43
[5] Ibid para 2.47
[6] Ibid para 2.43
[7] Ibid figure 2.18
[8] FRC 'Developments in audit 2018' page 8
[9] Ibid page 4

the maximum number of instances of what may properly be described as "audit failures" that are identified by the FRC in its audit quality reviews is likely to be the number of audits that the FRC finds require "significant improvements". There were just two such audits identified by the FRC in 2017/18. Further, it would appear from the enforcement actions taken by the FRC in the past 11 years that very few of these actions were triggered by FRC audit quality reviews. This suggests that FRC audit quality reviews have identified very few cases that can fairly be described as "audit failures".

- *The CMA's consideration of "international concerns over audit quality"*

1.13 The CMA identifies 16 cases that it describes as "some recent international examples of audit problems"[10]. The words "some" and "examples" suggest that the 16 cases are merely a small sample of a much larger population but the CMA makes no attempt to assess the overall scale of such "audit problems" or to place them in the context of the worldwide audit market over the 14 year period in which the 16 cases occurred. Also, one might have thought that the CMA would seek better quality information than brief press articles about the actual audit quality issues raised by these cases[11].

1.14 These cases clearly do include significant audit failings by any definition, although among the cases are companies in which management perpetrated and covered up sophisticated fraud, which raise some fundamental questions about the extent of auditors' responsibilities in relation to the discovery of fraud (generally not clarified in these cases as most were settled out of court). It would be naïve to believe that allegations of negligence by auditors could ever be eliminated, especially – as reflected in the list of cases presented by the CMA in its Update paper[12] – where there is sophisticated fraud and management cover-up. However, once again the relevant question is what the 16 cases cited by the CMA say about audit quality issues in the international audit market as a whole when there are more than 40,000 listed companies in the world whose financial statements are audited each year, and around 350,000 people are employed by the Big Four audit firms in their audit and assurance practices worldwide. The CMA states on the basis of the 16 press articles it refers to "this evidence suggests that some of the same market issues present in the UK are likely to apply to auditors overseas"[13]. One would expect a body like the CMA to understand the need to base its findings regarding "market issues" on representative samples. Once again, however, the CMA descends to innuendo in the absence of a proper consideration of the facts.

- *The CMA's consideration of stakeholder views*

1.15 It is telling that the CMA begins its consideration of the views of stakeholders on audit quality with the statement "overall, the balance of views from audit committees and investors was that audit in the UK is generally of a high quality"[14] and devotes one paragraph to such positive views, but then goes on to devote no less than four paragraphs to the – minority - views of investors who "expressed a view that there were significant [audit] quality problems"[15].

1.16 The CMA states that "Hermes expressed concerns in relation to auditor independence and integrity and their ability to challenge management"[16]. However, the CMA does not mention that Hermes stated that these concerns arise due to the audit being "cross-subsidised by the more lucrative consulting arms of the business"[17] that undertake consultancy work for the firm's audit

[10] CMA Update paper para 2.60
[11] Ibid figure 2.60 and related footnote references
[12] Ibid figure 2.60
[13] Ibid para 2.61
[14] Ibid para 2.62
[15] CMA Update paper paras 263-265
[16] Ibid para 2.64
[17] Hermes submission to CMA page 2

clients. As the CMA observes[18] , the proportion of non-audit fees received by audit firms from their audit clients in the FTSE 350 was only 16%, and also points out that the rules on conflicts and on the amount of non-audit work that can be provided to an audit client "significantly reduce any incentive that auditors might have to use audit as a loss leader at the client level"[19]. The premise that auditor independence, integrity and scepticism issues are attributable to non-audit services is therefore highly questionable. It is therefore surprising that despite the questionable foundation for the concerns expressed by Hermes, the CMA nevertheless chose to cite Hermes' concerns.

1.17 The CMA reports the Investment Association's comment that "'too often audit firms consider the audited entity to be their clients. It is a company's shareholders that rely on the auditor's work and to whom the auditor reports"[20]. In the same paragraph of the Investment Association's submission is the statement "in this context, certain major investors would welcome audit firms discussing the planning process with them so that any significant concerns they have can be addressed"[21]. It would have been very helpful for the CMA to report this statement as direct communication between investors and auditors would have the potential to be an effective incentive mechanism for high quality audit (although it has to be recognised that major investors have to date made no attempt to initiate such discussions with the audit firms). And despite its comment that too often audit firms consider the audited entity to be their clients (which in law they indeed are), the Investment Association states that "On the whole, IA members consider that historically the audit sector has served stakeholders well in that instances of audit failure have been relatively isolated"[22].

1.18 The CMA quotes from the Schroders submission that "audit firms can and should do more to ensure that companies clearly and unambiguously report the underlying business and financial risks that they face along with the significant estimates and judgements that have been made in preparing the financial results. Where the auditors believe that this is not the case, the auditors must be robust in fulfilling their existing responsibilities to report these matters to shareholders"[23]. A reading of the entire Schroders' submission does not, however, suggest that Schroders have significant concerns about audit quality or, contrary to what is implied by the CMA, that they do not have confidence in UK audit overall.

1.19 It is clearly the case that, whilst the collapse of Carillion has given rise to some concerns among stakeholders about audit quality, shareholders overall do not advocate significant reform of the audit market on grounds of audit quality alone.

- *The CMA's* "*Conclusion on audit quality"*

1.20 The CMA's stated conclusion on audit quality is highly tendentious. It consists of a combination of highly selective quotations, exaggerated claims, and pure speculation.

1.21 The first paragraph of the CMA's conclusion states "shareholders and other users are reliant on the oversight provided by audit committees and regulators. Audit committee chairs have themselves told us that it is difficult to judge quality"[24]. That something is difficult does not mean that it is impossible or that it is either not done at all or not done effectively and the Audit Committee Chairs referred to by the CMA told the CMA "that they felt confident in their ability to assess the quality of the key aspects of the audit of their companies, in particular by discussing with the auditors the audit work performed on areas of higher audit risk and the basis for the auditors'

---

[18] CMA Update paper para 2.27
[19] Ibid para 3.167
[20] Ibid para 2.64
[21] The Investment Association submission to CMA page 5
[22] Ibid page 2
[23] CMA Update paper para 2.65
[24] CMA Update paper para 2.73

conclusions on those areas, supplemented by their other interactions with the auditors that enable them, for example, to gauge the depth of the auditors' understanding of the company's business"[25]. Although most of this statement is reproduced in the CMA report, the impression given by the statement "Audit committee chairs have themselves told us that it is difficult to judge quality" that Audit Committees either do not assess audit quality at all or that they cannot assess audit quality effectively – precisely the opposite of what the Audit Committee Chairs actually said to the CMA.

1.22 The CMA continues "in recent years a number of high profile cases of audit failures have been exposed by corporate failures and fraud"[26]. It is unclear whether such "high profile cases of audit failures" relates to the UK or to the world as a whole. As regards the UK, in recent years (say in the past 10 years) there have been very few "high profile corporate failures and fraud" and, as the FRC enforcement cases show, very few indeed of such high profile failures and fraud that have exposed "audit failures". If the statement refers to the world as a whole, the 16 international cases adduced by the CMA need to be compared with an audit population of more than 40,000 listed companies and the audit and assurance workforce in the Big Four audit firms of some 350,000 people. The CMA's statement is therefore a gross exaggeration.

1.23 This exaggeration is immediately followed by the statement "Poor quality is likely to be more widespread (but not exposed by other events)"[27]. In one sense this is a truism – of course there will be some poor quality audits that are not revealed by corporate collapses or regulatory reviews. However, this is said by the CMA immediately following an assertion that the incidence of audit failures that have been exposed is high and therefore implies that the underlying position is even worse. This, once again, is speculation and innuendo.

1.24 The CMA's next paragraph starts with the extraordinary statement "while audit failures were not solely responsible for corporate failure…"[28]. The implication of "not solely responsible" is that corporate failure has *in large part* been brought about by audit failures. There are many different reasons why companies fail. They include a flawed business model, poor quality products or services, powerful competition, overtrading, lack of finance, misappropriation of assets and poor management. They do not include poor quality audits of their financial statements.

1.25 The sentence continues "had auditors carried out their work to a higher standard it is possible that the commercial or other problems could have been identified earlier"[29]. It is not clear what the CMA means by "commercial or other problems". The role of the auditor is to audit the financial statements. Is the CMA accusing auditors of failing to identify errors in the financial statements and have them corrected by the directors, or is it accusing them of failing to identify material uncertainties that could affect the continued use of the going concern basis of accounting? It cannot be anything other than these two alternatives.

1.26 It is most likely that the CMA has in mind Carillion and BHS as these are the only two "high profile" corporate failures in recent years, and the CMA's study of the audit market was precipitated by Carillion. This is reinforced by the reference to Carillion in the next paragraph of the CMA report[30]. As the enforcement case against Carillion's auditors remains open, no reliable information about the audit of Carillion's 2016 accounts has been published. It is therefore surprising that the CMA feels able to imply so strongly that there was "audit failure" in the case of Carillion. However, there is little doubt that one of the key issues in the FRC enforcement case is whether reference

[25] Ibid para 3.36 (extracted by CMA from written statement submitted by Audit Committee Chairs Independent Forum)
[26] Ibid para 2.74
[27] Ibid para 2.74
[28] Ibid para 2.75
[29] CMA Update paper para 2.75
[30] Ibid para 2.76

should have been in the going concern statement to any material uncertainties that could affect the continued use of the gong concern basis of accounting.

1.27 If it were shown to be the case that, at the time Carillion's 2016 financial statements were approved, such a material uncertainty or uncertainties existed, the immediate result would almost certainly have been a delay in the results announcement while the board considered and pursued possible courses of action. Such a delay would in itself have begun to undermine confidence in the company and the share price would have fallen significantly. Unless the company had been able to arrange additional borrowing facilities the effect of which would have been to eliminate the material going concern uncertainty, the going concern statement referring to the material uncertainty would have had to be published. It is impossible to know what effect this would have had on the company.

1.28 The CMA says that had the commercial or other problems been identified earlier "this would have allowed those affected to have made better informed decisions"[31]. Quite what the CMA thinks this would have meant in practice is impossible to know but based on events in other cases where such material going concern uncertainties are exposed, the principal immediate consequences would have been a collapse in the share price and the withdrawal or reduction of credit lines with finance houses and also suppliers. On this basis, the realistic view is that earlier identification of such problems would simply accelerate the timing of corporate failure.

1.29 It is certainly true that, as the CMA says, corporate failures cause financial harm and distress to many stakeholders. But to say that this illustrates "the potential impact of audit failures"[32] is a fallacy.

1.30 Having held the auditors responsible for information that does not identify "the commercial or other problems" and is therefore not reliable, the CMA then goes so far as to hold auditors effectively responsible for ineffective corporate governance too when it says "reliable financial information is essential to effective corporate governance"[33].

1.31 The CMA the concludes finally that "all this means that the number of recent events combined with the size of these companies and their importance to the UK economy, cannot be dismissed as 'isolated events'"[34]. This is a pure non sequitur. For events not to be "isolated" they must have a common cause and must be fairly common. As elsewhere in the CMA report it is not clear what the CMA is referring to when it says "the number of recent events" as the CMA discusses only the FRC enforcement cases over the past 11 years, where the only common feature is that they raise questions regarding the auditors' compliance with auditing standards. As regards the reference to "their importance to the UK economy", since the CMA's concluding comments discuss corporate failure, this comment can only refer to Carillion and BHS as these are the only recent corporate failures of any importance to the UK economy. Carillion was a listed company and BHS was a member of a privately-owned group. The reasons they collapsed were quite different. There are more than 2,000 listed companies and one million companies with employees in the UK. In this context, there can be no doubt that, contrary to what the CMA says, they were indeed "isolated events".

[31] Ibid para 2.75
[32] Ibid para 2.76
[33] CMA Update paper para 2.77
[34] Ibid para 2.78

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.

a. Issues relating to the role of Audit Committees and investors in the process of appointing and monitoring auditors

2.1 The CMA introduces its discussion of the selection and oversight of auditors by referring to the "principal-agent problem" created by the separation of ownership and control within a public limited company[35]. It presents this as a dichotomy and says that "a key challenge is how to ensure that the auditors are acting in the interests of the company's owners rather than in the interests of the company's managers"[36]. The analysis that follows this statement is based on the premise that in the absence of extremely active and close independent oversight of auditors, auditors would not act in the interests of the company's owners: the CMA makes no reference whatever to the principal factors that drive and underpin quality in the auditing profession, namely the professional standards, values and cultures of the audit firms and the audit staff they employ, underpinned by increasingly demanding auditing standards and backed up by the need to avoid reputation or financial loss from litigation or criticism by audit regulators. As is made clear by the remedies it proposes, the CMA appears to believe that drivers such as these are no consequence and that auditors will discharge their duties properly if their work is continuously and directly observed by an appropriately incentivised third party.

2.2 The CMA frequently refers to the need for auditors to exercise professional scepticism. This is clearly also a necessary attribute for investigators like the CMA but its view of auditors borders on the cynical as it completely discounts any professional ethos and instead views auditors as fundamentally untrustworthy.

2.3 The CMA asks the question "Since auditors need to work closely with a company's managers on a day-to-day basis in order to carry out an audit, how can owners know whether the auditors are challenging the managers sufficiently?"[37]. This is a fair question but what is not fair is that to support this question the CMA cross refers at this point to the statement in a report on the UK auditing profession entitled *Reforming the audit industry* by a group of academics that "ever since the inception of modern audits there have been concerns about company directors selecting and remunerating auditors and thereby defeating the very concept of an independent audit"[38].

[35] Ibid para 3.5
[36] Ibid para 3.6
[37] CMA Update paper para 3.6
[38] Prof Prem Sikka et al 'Reforming the auditing industry', December 2018

2.4 The academics' report offers no information whatever about the sources or extent of such concerns. The report describes the UK auditing profession disparagingly as "the UK auditing industry". It is littered with such extreme, pejorative statements as "the big four firms who are routinely implicated in scandals and seem incapable of delivering high quality audits"[39], "the big companies and the audit industry collude to manufacture accounting standards"[40] and "the feather-duster standards of the FRC"[41]. The report is the very opposite of the objective, dispassionate analysis that characterises quality research and is essentially a campaign treatise – the academic who led the project has a visceral antipathy to the auditing profession and has largely made a living from such studies and reports for at least the last 30 years. Annual reports of companies are required to be "fair, balanced and understandable". The academics' report may be understandable but a report that is littered throughout with such intemperate and acrimonious language is as lacking in fairness and balance as the authors of the report claim were the annual reports of the companies they refer to in their report. It is shameful that the CMA cites such an unfair and unbalanced report as authoritative, particularly as it cites the report no less than three times.

2.5 Based as it is on what it describes as the "principal-agent problem", the CMA's analysis assumes or at least implies that the interests of a company's owners differ fundamentally from the interests of its managers. It is true that, although directors are required by law to promote the success of the company for the benefit of its shareholders as a whole, their interests may differ from those of the shareholders as a whole, particularly in the short term. For the purpose of the CMA study of the audit market, however, it is not helpful for the CMA to present the "principal-agent problem" as a major dichotomy - which almost inevitably leads to the conclusion that very close oversight of both auditors and management is required – particularly as the only aspect of the issue that is relevant to the CMA's study is how the "problem" might manifest itself in annual reports and financial statements prepared by directors. Rather than making generalised statements about the ability or lack of ability of audit committees "acting independently from the executive, to ensure that the interests of shareholders are properly protected in relation to financial reporting and internal control"[42], the CMA should have addressed the specific risks that arise in practice and the adequacy or otherwise of the processes and procedures that audit committees follow to address them.

2.6 Executive directors will always be tempted to present the company's performance in the best possible light. In the vast majority of cases, this will amount to no more than a slightly selective approach to information disclosure and a greater emphasis on "good" news than on "bad" news. In some cases, the directors might be tempted to make assumptions about the outcome of events that are relatively optimistic and this might affect the measurement of items in the company's financial statements and therefore reported performance. Very occasionally, directors might seek to apply assumptions that are outside the reasonable range of possible outcomes or may propose other aggressive accounting practices. These are normally the key issues that arise in connection with the preparation and audit of financial statements and are typically the focus of attention by both auditors and audit committees and the subject of considerable discussion by both of them with the executive.

2.7 The CMA correctly reports that "there is little direct investor engagement in audit issues"[43]. The CMA states "investors argued that this was partly a function of lack of transparency about the detail of the audit – they argued that if there was more information available about e.g. key audit

[39] Ibid page 3
[40] Ibid page 14
[41] Ibid page 15
[42] CMA Update paper para 3.7
[43] CMA Update paper para 3.8

issues then they would have an incentive to be more engaged"[44]. Since 2015, auditors' reports have been required inter alia to: "describe those assessed risks of material misstatement that were identified by the auditor and which had the greatest effect on: the overall audit strategy, the allocation of resources in the audit and directing the efforts of the engagement team"[45] and to "provide an overview of the scope of the audit, including an explanation of how such scope addressed the assessed risks of material misstatement"[46]. These disclosures would seem to provide precisely the type "information about e.g. key audit issues" that investors say are required to provide them with "an incentive to be more engaged" in audit issues. The fact that investors have not been prompted by the extended audit report to engage in audit issues suggests that they in fact have little desire to be more engaged.

2.8 The CMA then states that "this means that the system is very reliant on audit committees, and ACCs [audit committee chairs] in particular, in driving audit quality"[47]. This statement of course ignores completely the principal drivers of audit quality that are within the audit firms and the professionals they employ. Audit committee s told the CMA that "they felt confident in their ability to assess the quality of the key aspects of the audit of their companies in particular by discussing with the auditors the audit work performed on areas of higher audit risk and the basis for the auditors' conclusions on those areas, supplemented by their other interactions with the auditors that enabled them, for example, to gauge the depth of the auditors' understanding of the company's business"[48]. Despite this evidence, the CMA concluded that "the whole system" is "fragile, by diluting the incentives on auditors to focus on providing high quality audit based on professional scepticism and challenge"[49]. It is not clear how there has been "dilution" of incentives when, for example, the responsibilities placed by the UK Corporate Governance Code on audit committees relating to the appointment of auditors and the assessment of audit effectiveness have increased significantly in recent years.

2.9 In any event, it appears that despite what it was told by audit committee chairs, the CMA believes that audit committees cannot provide effective oversight of audit quality – in relation to which the CMA repeatedly emphasises "professional scepticism and challenge" by the auditors - as "audit committees cannot observe directly the quality of the audit work undertaken. Rather, audit committees will discuss with the auditors the work performed on areas of higher risk and the basis for the auditors' conclusions on those areas, supplemented by their other interactions with the auditors"[50]. On the face of it, therefore, the CMA is saying that only by direct observation of a professional service as it is being performed can its quality be properly assessed. The implications of this statement are wide-ranging. For example, FRC audit quality reviews, which are carried out well after the completion of the audits concerned, do not "observe directly the quality of the work undertaken". Of more direct relevance, as the CMA says, "the audit committee has a particular role, acting independently from the executive, to ensure the interests of shareholders are properly protected in relation to financial reporting and internal control"[51]. In relation to internal control, audit committees are usually charged with carrying out the review of the effectiveness of internal control and risk management systems required by the UK Corporate Governance Code. For this purpose, the audit committee unavoidably relies on the quality of the work of internal auditors supplemented, in many cases, by management self-certification. Unlike external auditors they are

[44] Ibid para 3.8
[45] International Standard on Auditing (UK) 701 para 11
[46] Ibid para 13R-1
[47] CMA Update paper para 3.9
[48] Ibid para 3.36
[49] Ibid para 3.11
[50] CMA Update paper para 3.10
[51] Ibid para 3.7

employees of the company and therefore more likely than external auditors to act in the interests of the company's managers. Yet although the CMA refers to the audit committee's role in relation to internal control it does not question the ability of the audit committee to exercise adequate monitoring of internal audit. And just as audit committees cannot "observe directly the quality of the audit work undertaken" by external or internal auditors, so independent directors cannot observe directly the operation of management processes for gathering, analysing and reporting information to the board of the company.

2.10 In all their dealings with the executive, independent directors must apply their experience and expertise and employ professional scepticism in challenging the judgements and recommendations of the executive. At the end of the day, however, they must either be satisfied with the responses they receive to their enquiries or reject the executive's recommendations, because they cannot observe directly or re-perform all the management processes involved. As regards the audit of companies' financial statements, the CMA concludes that as audit committees "cannot observe directly the quality of the audit work undertaken", "this makes the whole system is fragile by diluting the incentives on auditors to focus on providing high quality audit based on professional scepticism and challenge"[52]. Entirely on the basis of this conclusion, the CMA proposes a fundamental change in regulation under which audit committees would be required to report to the regulator "throughout the audit engagement"[53] in order to demonstrate how they are monitoring audit quality. However, independent directors cannot observe directly the quality of management processes any more than they can observe directly the quality of audit work. If, therefore, the CMA's remedy is appropriate in relation to audit, it is impossible to understand why independent directors should not be required to report to the regulator in order to demonstrate how effectively they are monitoring management in all their activities (thereby, using the CMA's terminology, addressing the principal-agent problem).

2.11 Having effectively dismissed the value of audit committee reviews of audit effectiveness on the grounds that the audit committee is not an eye-witness to the audit as it is being performed, the CMA then identifies some aspects of the current auditor appointment and oversight framework that "could work better"[54], although none of the aspects considered by the CMA would have any effect on the its view that Audit Committees are procedurally unable to assess audit effectiveness.

- *The CMA's consideration of selection processes for audit tenders*

2.12 The first aspect considered by the CMA is the criteria applied by companies in selecting their auditors. Under the very tendentious heading "'Cultural fit' vs audit quality"[55] (because it presumes that the two are in conflict with each other) the CMA expresses the view that in some tenders "factors such as 'cultural fit' are considered to a greater extent than factors such as the degree of challenge and scrutiny that the auditor is expected to demonstrate"[56]. "This", the CMA says, "calls into question the weight given in auditor selection to independence, scepticism and ability to challenge, the main attributes audit committees should be demanding of them"[57] and "could result in the selection of auditors with the interests of the company and its management rather than those of the shareholders, in mind".

[52] Ibid paras 3.10 and 3.11
[53] ibid para 4.16
[54] CMA Update paper para 3.12
[55] Ibid para 3.22
[56] Ibid para 3.15
[57] Ibid para 3.15

2.13 In this regard, the CMA analyses at some length the selection criteria applied by companies in audit tenders, in particular criteria such as 'easy to work with', 'cultural fit' and 'chemistry' which, it says, "raise concerns around independence of the auditor"[58]. The CMA found that the use of such criteria was quite common and concludes that "the weight attributed to factors like 'cultural fit' and 'chemistry' calls into question whether the current tendering approach rewards auditors for being close to management, rather than providing independent challenge"[59]. Not only does the CMA reach this conclusion based on its interpretation of a small number of specific cases but its interpretation is just that and is open to question. Further, in support of its conclusion it quotes from the submission of the UK Shareholders Association, which stated that as regards auditor appointment, large companies and public interest entities appear to take the position that "the only real requirement for selection is that they get on well with the audit partner(s)"[60]. The UKSA provides no evidence at all to support this assertion. It is surprising that the CMA appears to give greater credence to the views of a group of no more than 500 small shareholders than to the collective views of FTSE 100 finance directors who told the CMA that audit committees are focussed "on the quality and challenge provided by the audit firm"[61].

2.14 Of more direct relevance to the CMA's view of selection criteria are the views expressed to it by audit committee chairs on criteria such as 'cultural fit': "ACCs pointed out that the audit cannot be seen as an adversarial process as auditors are ultimately reliant on explanations as well as data they obtain and review, and this requires open and trustful working relationships between the auditor and management. Auditors need not only to ask the right questions but to ask them in the right way so as to elicit the most truthful, comprehensive and balanced response. Ultimately, an effective audit depends on how well the lead partner and the senior members of the audit team work with company executives. Industry experience may underpin the team but teams on the ground with the right relationships, asking the right people the right questions in the right way are essential"[62]. Again, the CMA appear to have dismissed or given little weight to evidence from those with the greatest first-hand knowledge of the issues it is addressing.

2.15 The CMA says it "observed that management still plays a significant role in the [audit] tender process and advising the Audit Committee"[63]. The CMA seems to have little factual evidence that this is the case, which appears to be based largely on its concern about "the importance attached to factors like 'cultural fit' and 'chemistry'. As in its consideration of other aspects of the current framework, in the absence of firm evidence to the contrary the CMA assumes the worst. In a tender process audit firms will inevitably see more of management than of the Audit Committee in order to acquire sufficient understanding of the company and its business to be able to develop a proposal (which will set out their initial thoughts on an audit strategy, their team and indicative fee) to submit to the audit committee. It would be negligent of the audit committee not to seek feedback from management on the quality of their interactions with the personnel from the audit firm. Further, as stated above, the audit committee will wish to assure itself that the audit teams proposed by the audit firms would, if appointed, develop a positive working relationship with management (whilst of course maintaining their professional scepticism and providing independent challenge).

- *The CMA's consideration of the effectiveness of audit committees in overseeing auditors*

2.16 According to the CMA, several submissions by investors expressed concern that "audit committees do not sufficiently challenge management on their judgements or auditors on the depth

[58] Ibid para 3.22
[59] Ibid para 3.28
[60] Ibid para 3.22
[61] Ibid para 3.19
[62] Extracted from unpublished contemporary note of meeting between certain audit committee chairs and CMA.
[63] CMA Update paper para 3.30

of work or analysis they have undertaken"[64] and that some audit committees "appear to rely on executive feedback on the auditor as the main input into their annual reviews of performance"[65]. Given the lack of engagement by investors with audit committees, it is not clear how these investors have sufficient knowledge of the facts to enable them make such statements and in fact some of the submissions which, according to the CMA, expressed such concerns in fact did not. For example, although Sarasin expressed concern that whereas executive feedback by BP was sought, no feedback was sought from shareholders[66]. This does not support the CMA's statement that executive feedback was "the main input" into the performance review, as BP stated that "The effectiveness, performance and integrity of the external audit process was evaluated through separate surveys for committee members and those BP personnel impacted by the audit"[67].

2.17 The CMA then turns to consider the amount of time spent by audit committees on external audit-related matters. It concludes that "for some, the hours suggest that audit committees cannot be taking as proactive a role as envisaged by the FRC"[68]. It is possible that audit committee members of a company with operations that are largely confined to the UK, a fairly straightforward business model that has not been subject to any significant change (eg corporate acquisitions), strong internal controls and financial reporting that involves no complex judgemental issues, may be able to spend less than 20 hours in a year and comply with the FRC guidance. It is certainly not fair to "suggest" that such a time commitment is necessarily too little to meet that guidance without having considered the particular circumstances concerned.

- *The CMA's consideration of the degree of engagement by shareholders*

2.18 The CMA repeats its observations in section 2 of its report regarding the lack of engagement by investors with audit matters. It acknowledges that there are constraints on additional disclosures in audit reports, such as confidentiality, and that some investors have limited capacity or willingness to engage. However, the CMA says that it has "received submissions from a range of investors on the case for greater transparency"[69]. It therefore does no more than call for "greater disclosure"[70]. Both the extended auditors' report and audit committee reports within annual reports now discuss accounting judgements and other aspects of financial statements that give rise to risks of misstatement. However, these developments have not prompted shareholders to engage with audit matters and whilst the CMA says, somewhat tentatively "more disclosure could make it easier for investors to engage"[71], this may well heap Pelion on Ossa: greater shareholder engagement is likely to remain a pious hope.

- *The CMA's consideration of shareholder interest vs wider public interest*

2.19 The CMA refers to the large pension deficit in the pension scheme of BHS at the time the company failed and the fact that it had made lower contributions to the scheme than recommended by the pension trustee, its advisors and the Pension Regulator. The CMA describes this as "potential for divergence between the interests of shareholders in audit and the interests of a company's pension holders and the wider public", which "suggests that even if all of the principal-agent issues in relation to the role of audit committees were addressed, concerns might remain"[72]. This may well be so but unless either the pension scheme deficit or contributions to the scheme were misstated in

[64] Ibid para 3.35
[65] Ibid para 3.35
[66] Sarasin submission to CMA page 8
[67] BP plc Annual Report and Form 20-F 2017 page 82
[68] CMA Update paper para 3.41
[69] CMA Update paper para 3.54
[70] Ibid para 3.55
[71] Ibid para 3.54
[72] Ibid para 3.61

BHS's financial statements it has nothing to do with either the audit of the financial statements or the oversight of audits by audit committees. It has never been suggested by anyone that audit committees could or should resolve all principal-agent issues and certainly not that it is the role of audit committees to arbitrate between management and the pension regulator as regards the level of pension fund contributions. If they are of material importance, as in the case of a large pension deficit, decisions regarding pension fund contributions are a matter for the board.

b. Limitations on choice leading to weaker competition

2.20 The CMA states that "competition … if focused on matters important to investors, can sharpen the incentives for auditors to deliver a consistently high standard"[73]. This is clearly correct. However, as regards evidence on competition as a driver of audit quality, the CMA merely points out that that "academic research evidence on the link between competition and audit quality is relatively limited and inconclusive"[74]. This hardly provides a basis for imposing fundamental change on the audit market with the sole object of increasing competition.

2.21 Further, the key question the CMA does not ask is *how* important competition is in relation to other drivers of audit quality. The CMA recognises that regulation "also plays a key role alongside competition" and whilst it refers to the importance of regulation in setting and maintaining *minimum* standards for audit" (emphasis added) it also says "given the difficulty in observing audit quality, regulation plays a key role alongside competition"[75] and indeed the remedies it proposes that relate primarily to regulation appear to be attributable to what it sees as and to its view that audit committees do not "consistently prioritise quality"[76].

2.22 The CMA's analysis ignores the other key drivers of audit quality, such as the professional standards, values and quality control processes of the audit firms - and the mindset of their audit staff - backed up by the threat of reputation or financial loss from litigation or sanctions by audit regulators. Another powerful incentive that the CMA does not refer to at all is the risk for an incumbent auditor that a poor quality audit will result in the audit committee not recommending the auditor's re-appointment.

2.23 Accordingly, whilst competition between audit firms is a necessary factor in driving audit quality, competition and regulation are not the only essential factors that incentivise auditors to deliver high quality audits. Further, the CMA comments that stakeholders it spoke to referred to the importance of the interaction of competition and regulation. To the extent that the auditing profession and audit firms were to be made subject to greater regulation, the importance of competition as an incentive for high quality audit would, logically, reduce. But even as audit regulation stands today, the importance of the other factors that drive high quality audits is such that sufficient competition can be provided by a small number of firms so long as all those firms are capable of providing a high quality audit to the company concerned.

2.23 The CMA states that where there are less than three credible bidders for an audit tender, "if one of the bidders fails to impress, the company is left, in effect, with no choice at all"[77]. This statement reflects the CMA's bias since, logically, if in these circumstances the other firm does impress, there would not seem to be a problem. If, in extremis, both bidders failed to impress then, so long as the audit firms concerned were able to offer an audit team that was capable of delivering a high quality audit (which will almost certainly be the case at least with all the Big Four firms), the

[73] Ibid para 3.62
[74] Ibid para 3.67
[75] Ibid para 3.62
[76] Ibid para 4.8
[77] CMA Update paper para 3.65

company concerned would be able to request the audit firms to make changes in the audit teams proposed by the firms and re-run the tender.

2.24 Unfortunately, and very surprisingly given its remit, the CMA appears to have obtained no evidence about the incidence of audit tenders in which there have been only two "credible bidders". Whilst it would clearly be preferable for companies, other than in exceptional circumstances, to be able to obtain at least three credible bidders for an audit tender, proposals to impose fundamental changes in the statutory audit regime, such as joint or shared audits, simply in order to ensure that this would always be the case would require proper evidential support which the CMA does not provide. And just as audit regulation over the past 20 to 30 years has increased at least partly in response to the reduction through merger in the number of large audit firms, the impact of any proposals to further strengthen audit regulation and the role of the audit regulator would need to be taken into consideration in assessing the need for intervention in the audit market solely with the purpose of increasing competition in that market.

2.25 In view of the parallel Kingman review of the FRC it is understandable that the CMA has not looked in detail at the regulatory framework. However, given the views of stakeholders about the importance of the interaction of competition and regulation, which the CMA appears to accept without demur, it makes no sense to propose remedies relating to competition in isolation from proposals to change the regulatory regime. Indeed, doing so must call into question the appropriateness of the remedies the CMA proposes. The CMA appears to downplay the importance of regulation as compared with competition when it says "regulation is important in setting minimum standards for audit" whereas "competition…..can sharpen the incentives for auditors to deliver a consistently high standard"[78]. This does not square at all, for example, with the FRC's statement that it is "responsible for promoting high quality corporate reporting and governance" and the fact that it grades the audits it reviews based on its view of their quality.

c. Barriers to "challenger firms" for FTSE 350 audits

2.26 The CMA identifies concerns about the capability of firms outside the Big Four as a key reason for what it describes somewhat exaggeratedly as "lack of choice in some tenders"[79] (when it should say "limited choice" rather than "lack of choice" – another example of biased CMA language). It reports that the reasons given by companies as to why non-Big Four firms were eliminated from FTSE 350 tenders at an early stage include lack of sufficient scale, international presence and experience with large companies, and lower perceived quality. A further important factor, which relates to scale but is not mentioned by the CMA, is audit experience relevant to the sector in which the company concerns operates (which, it is worth noting in this context, is now also a required attribute of members of audit committees under the UK Corporate Governance Code). This is of particular relevance in regulated sectors and sectors in which significant accounting assumptions and judgements are required in preparing financial statements.

2.27 In considering the barriers to expansion facing non-Big Four firms the CMA points out that they face a 'chicken and egg' problem whereby "they are frequently ruled out of tenders on the basis of lack of experience but would only be able to build that experience by gaining a substantial foothold in the market". However, the CMA states that the capability issue does not explain why non-Big Four firms have not been successful in establishing a presence in the smaller end of the market (e.g, in the FTSE 250). The CMA cites the examples of JD Wetherspoon and Mitie as showing that "when challenger firms are given serious consideration and the opportunity to demonstrate their capability, they can win"[80]. It has to recognised, however, that JD Wetherspoon's business is entirely in the UK and its business model is fairly straightforward, while competition for appointment

[78] Ibid para 3.62
[79] CMA Update paper para 3.80
[80] Ibid para 3.109

was limited in the case of Mitie as only one of the Big Four firms was in a position to tender for the audit.

2.28 Based on views expressed to the CMA by audit committee chairs, smaller and less complex companies in the FTSE 350 have similar concerns about the capability of non-Big Four firms to those of larger and more complex FTSE 350 companies. The CMA also mentions that some academic literature suggests that smaller audit firms may be expected to provide, on average, lower quality audits[81].

2.29 At this point in its analysis, the CMA points to "a lack of objective information available to Audit Committees to validate their judgements on quality of the challenger firms, which makes it harder for them to justify appointing a challenger firm"[82]. It does not support this statement based on anything it has been told by audit committees. Rather, it quotes the view of one firm that "false proxies" such as "the size of the audit firm or a firm's current roster of clients in the sector….explain why challenger firms with better records on audit quality are consistently being unsuccessful in tenders"[83]. However, in view of the signal importance of audit experience relevant to the sector in which a company operates, it is clearly incorrect to assert that "a firm's current roster of clients in the sector" is a false proxy. Also, it is not clear what is meant by "better records on audit quality" – better than what or whom, for example? And a "better" record in relation to the audit of smaller, less complex companies' financial statements is not a sound proxy for audit quality on large, complex companies.

2.30 The CMA refers to the high proportion of FTSE 100 audit committee chairs who have previously worked for a Big Four firm[84]. It says this is not surprising given the size of the Big Four firms. However, this is not the key reason, which is that to be an effective audit committee chair of a FTSE 100 company, experience of working with very large, complex companies in a sector that is relevant to the company, and knowledge of internal control and risk management systems in and financial reporting by such large, complex companies is essential.

2.31 The CMA then states that the presence of ex-Big Four employees on audit committees "raises questions about whether audit committee members' greater familiarity with the Big Four might lead them to favour Big Four firms when assessing audit tenders"[85]. The CMA makes no attempt to address such questions, and therefore leaves them hanging by way of innuendo. If, however, as the CMA appears to accept, the reasons given by companies as to why non-Big Four firms are eliminated at an early stage are valid, it is clear that these reasons, rather than any favouritism, explain why Big Four firms win audit tenders.

2.32 With regard to supply-side barriers for non-Big Four firms, the CMA draws attention to various factors including high tender costs, greater regulatory, the financial and reputational risk involved in conducting audits for FTSE 350 companies, the challenge of recruiting staff with relevant experience, and the cost of developing IT systems to carry out complex audit processes. However, the CMA concludes, somewhat simplistically, that "supply-side barriers are significant, but many of them relate strongly to the demand-side constraint. In other words, if the challenger firms had a higher chance of winning FTSE350 audit contracts then they would be able to invest to overcome the supply-side barriers"[86]. This might prove to be true over the long term, but as in most commercial activity, the investment has to be made up front and this would be especially true for challenger firms to enable them to deliver audits of FTSE 350 companies to a quality that matched audits

[81] Ibid para 3.112
[82] Ibid para 3.115
[83] Ibid para 3.116
[84] CMA Update paper para 3.119
[85] Ibid para 3.120
[86] Ibid para 3.130

carried out by the Big Four firms. Further, the extent of organisational change – changes in infrastructure, people, IT systems and so forth - that would be required for non-Big Four firms to perform high quality audits of multiple FTSE350 companies - would undoubtedly expose such firms to significant regulatory, financial and regulatory risk during a transition period that would extend over a number of years during which there would be a greater likelihood of poor quality audits.

c. Resilience concerns

2.33 The CMA states that "given the already limited choice in the market, we would be very concerned about the failure or withdrawal of one of the Big Four auditors if this led to the creation of a more consolidated 'Big Three'"[87], and discusses the implications of such a failure or withdrawal. It then considers how likely it is that an audit firm might fail.

2.34 Although the CMA states that "recent experience suggests that the Big Four firms appear to be resilient", it acknowledges that "they have withstood the reputational harm caused by a number of high profile cases of audit failure in the UK and elsewhere"[88] but says that "the risk may be small, but it cannot be dismissed as a possibility. This could be triggered by audit failure(s) in the UK or another major firm in the global network"[89].

2.35 Ultimately, of course, anything is possible; the issue is whether the risk is sufficiently great that steps need to be taken to mitigate the risk.

2.36 All the Big Four firms are broadly similar in size and overall structure globally. Taking PwC as an example, for the year ended 30 June 2018 its global revenues were $41bn of which $17bn was contributed by audit and assurance services, and its Americas region earned revenues of more than $17bn, i.e. more than 40% of the organisation's global revenues. The UK firm of PwC earned revenues totalling £3.1bn of which £673m was contributed by audit services. The UK arms of the Big Four have substantial professional indemnity cover as part of the firms' global insurance arrangements and the UK Big Four are strategically important to their global organisations. Other than a catastrophically large liability for professional negligence (way in excess of the international insurance cover and beyond the means or willingness of the global organisation to cover), it is difficult to understand circumstances that would result in the collapse of the UK arm of any of the Big Four. As can be seen from the example of PwC above, the Americas arms are by far the largest component of the Big Four firms and would be able to rescue another arm of the global organisation if necessary. Indeed, this has happened in the past. The greatest risk of a Big Four firm failing probably lies in the US, as was the case with Arthur Andersen, to which the CMA refers. However, the failure of Andersen was caused not by litigation resulting in a massive financial liability but by reputation damage arising from its work for Enron and following accusations that it destroyed documents relating to that work. The likelihood of such an event occurring again is very low and if it were seen to be likely, there is a good chance that US regulators would seek to avert it.

d. Wider incentive issues raised by the multi-disciplinary nature of the large audit firms.

2.37 The CMA states that it has considered "whether the structure of audit firms currently creates the right incentives to deliver high audit quality"[90]. In view of the key drivers of high audit quality such as professional standards of the audit firms and their people, competition and the deterrent effect of regulation, it would have been more appropriate for the CMA to consider whether the structure of the firms *reduces* the incentives for auditors to deliver high audit quality. The CMA correctly concludes that there is little evidence of conflicts between audit and non-audit

[87] Ibid para 3.131
[88] Ibid para 3.136
[89] CMA Update paper para 3.141
[90] Ibid para 3.153

work at the client level, primarily because of the restrictions in place on cross-selling[91], and it found no evidence that non-audit work was subsidising unprofitable audit work[92] or that the Big Four are systematically under-bidding non-Big Four firms so as to make it more difficult for them to gain a foothold in the market[93].

2.38 The CMA then falls back on much less tangible factors based largely on the fact that the proportion of the UK Big Four firms' revenues derived from non-audit services, which already exceed 75%, continues to increase[94]. The CMA concludes, based on findings from academic literature, recent FRC findings from its Thematic Review of Audit Culture and other sources[95], that the different objectives of audit and non-audit work, and the increasing proportion of the firms' revenues that are generated by non-audit services, reduce the incentives to focus on independent, high-quality audit. There is no doubt that audit has in recent years become less influential in determining the strategy and governance of the Big Four in particular. One reflection of this is that three of the current chairs/chief executives of the Big Four UK firms are not an auditors by background.

2.39 However, the CMA's conclusion that the incentives to focus on independent, high-quality audit have been weakened by the growing multidisciplinary nature of the firms is not only highly judgemental; it is also not in fact fully supported by the evidence it cites. For example, the first finding of its FRC Thematic Review of Audit Culture states "we found evidence that the firms are investing considerable time and effort on their firm-wide culture. There are examples in this report for other firms to consider adopting, including how firms relate their purpose, values and encouraged behaviours to day-to-day activities. We also identified areas of common strength, such as firms having well established accountability frameworks and robust processes to sanction poor quality work or behaviour"[96]. The findings that follow identify "a number of key areas where more should be done by the firms to establish, promote and embed an appropriate audit culture"[97]. However, there is no suggestion whatever in the FRC's report that the need to do more is a result of incentives to deliver high quality audit somehow being reduced or otherwise downplayed as a result of any influence exercised over the audit practice by the multidisciplinary firm as a whole.

---

[91] Ibid para 3.155
[92] Ibid para 3.166
[93] Ibid para 3.170
[94] Ibid para 3.173
[95] Ibid para 3.174
[96] FRC Audit culture thematic review May 2018 page 5
[97] Ibid page 5

3. The "remedies" proposed by the CMA

Remedy 1: Regulatory scrutiny of Audit Committees

3.1 The CMA concludes that "the evidence does not inspire confidence that Audit Committees consistently prioritise [audit] quality"[98]. It appears that if stakeholders were not opposed to it and if the current EU legislative framework did not prevent it, the CMA would propose that the responsibility for the audit selection process and audit engagement monitoring from companies altogether and be handed to an "independent appointment and monitoring body"[99]. The stakeholders consulted by the CMA in this regard do not appear to have included audit committee chairs. Had audit committee chairs been consulted it is probable that most of them would have told the CMA if such a regime were to be introduced, they would stand down immediately as audit committee chairs.

3.2 One of the objections expressed to the CMA regarding the transfer of audit committee responsibilities to an independent appointment and monitoring body is that an independent body would be incapable of replicating the functions of audit committees[100]. The CMA rejects this on the basis that "audit committee members on average spent less than 35 hours on matters relating to the statutory audit in the last financial year". This is an extremely simplistic view. The CMA seems to assume that audit committees are a tabula rasa when it comes to monitoring the statutory audit. In fact, however, through their membership of the board and their audit committee work other than their monitoring of the effectiveness of the statutory audit, audit committee members bring with them to the audit committee an intimate understanding of the company's business and financial position, its internal control and risk management systems, and of the accounting judgements and other areas of accounting complexity that are involved in preparing the company's financial statements.

3.3 In most companies, audit committee members at any one time will have spent an average of three to four years as members of the committee and built up their knowledge of the company, its financial reporting and the essential aspects of the external audit (which usually do not change radically from one year to the next) over that time.

3.4 It is woeful that the CMA feels able to justify its support for radical changes to the governance regime of companies based on such superficial evidence as a number of hours.

3.5 Constrained by the views of stakeholders from proposing an independent appointment and monitoring body, the CMA instead proposes what it describes as "strong regulation of audit committees" through oversight mechanisms which would require audit committees to "report directly to the regulator before, during and after a tender selection process and "throughout the audit process", with the regulator having the "ability….to issue reprimands, or direct statements to shareholders"[101]. A new prudential regulatory regime that singles out the audit committee, which is a committee of the board whose terms of reference are determined entirely by the board, from the company board as a whole, all of whose members are responsible for the company's annual report and financial statements, would represent a fundamental change in approach to the regulation of companies.

3.6 As explained in sections 1 and 2 of this response, the CMA has not made a case either that concerns regarding the quality of audits of financial statements in the UK or that the quality of the

[98] CMA Update paper para 4.8
[99] Ibid para 4.9
[100] Ibid para 4.10
[101] Ibid para 4.16

oversight of auditors by audit committees are sufficiently widespread or well-founded to justify such radical changes to the scope of regulation and the principles on which it is based.

3.6 The CMA states that "there was widespread support for strengthening oversight of the existing audit committee framework"[102] and refers specifically to submissions from three of the Big Four audit firms in this regard. The CMA's proposals, however, go much further than the suggestions made by the firms, which largely relate to the oversight of audit tenders and do not extend to direct regulatory monitoring of the audit committee's own monitoring of the audit (the purpose of which is effectively to monitor management's portrayal of performance in company financial statements).

3.7 Even with audit tenders, a key practical issue would be the ability of the regulator to assess the quality of the tender process within the audit tender timetable. However, as regards regulatory monitoring of audit committee oversight of the audit, it is difficult to see how this could be done effectively within the current reporting timetable of most FTSE 350 companies, especially given the bunching of audits due to calendar year-based financial reporting.

3.8 In addition, the CMA refers only to audit and not to other financial reports that are monitored by audit committees, in particular interim reports, which are almost invariably subject to limited review by the company's auditors and are in many respects as important as annual reports in reporting the performance and financial position of companies. Since the premise for the CMA's proposal is that audit committees need to be actively monitored by the regulator because they cannot be trusted "to ensure that the interests of shareholders are properly protected in relation to financial reporting"[103], it follows that the monitoring regime proposed by the CMA should extend to interim reports as well as annual reports. The FRC finds it very difficult to attract staff of the calibre necessary to carry out audit reviews of the highest quality. It therefore seems highly unlikely that the FRC or its successor would be able to recruit staff with appropriate experience and in sufficient numbers to monitor effectively the performance of audit committees in monitoring all relevant published reports and associated audits and limited reviews by auditors.

3.9 Not only, therefore, has the CMA failed to make a case based on evidence concerning shortcomings in the quality of audits and of audit committee monitoring of auditors that would justify the introduction of such direct and pervasive oversight of audit committees but it is also very doubtful whether the regulatory regime it proposes would be truly effective. It is relevant to note in this regard that the responsibilities of the Prudential Regulation Authority under the Financial Services and Markets Act do not require it to monitor the performance of audit committees as such and all directors, as opposed to audit committee members only, are the focus of accountability under the Senior Management Regime.

Remedy 2: Mandatory Joint Audit

3.10 In describing the aim of its proposal for mandatory joint audits, the CMA chooses its words carefully. Its first statement, that mandatory audits would "reduce the barriers to auditing large companies faced by the challenger firms"[104], is certainly correct to some extent. However, the CMA's own analysis of the reasons why non-Big Four firms are not selected as sole auditors of FTSE 350 companies strongly suggests that it is doubtful whether the barriers would be reduced significantly in the absence of a requirement that one of the two joint auditors in every case was a non-Big Four audit firm. In its summary of the remedy the CMA states "our preferred way of achieving this would be by mandating that at least one of the audit pair is a challenger firm"[105]. The CMA then says it

[102] CMA Update paper para 4.21
[103] Ibid para 3.7
[104] Ibid para 4.29
[105] CMA Update paper following para 4.60

would welcome views on any alternative ways of delivering this outcome and ensuring the remedy is effective in reducing concentration”[106].

3.11 It is clear from this that the CMA’s stated justification for proposing mandatory joint audit is that it would increase competition, and not that it would overcome any concerns about audit quality. This is fundamentally inconsistent with the issue that is at the heart of the CMA’s Update paper, as evidenced by its discussion and analysis in sections 2 and 3 of the Update paper, which is audit quality. With regard to mandatory joint audits, the CMA states that they “would lead, in the medium term, to improvements in the quality and capability of the challenger firms”[107]. This is probably correct, though more likely to happen in the long term than in the medium term, but is not the issue. The issue is whether mandatory joint audits would result in improvements in the overall quality of audits of listed companies. In this regard, the most the CMA feels able to say is that “joint audit has the potential to improve audit quality”[108].

3.12 In fact, of course, joint audit also has the potential to reduce audit quality, particularly if it were mandated, as the CMA would wish, that at least one of the audit pair is a non-Big Four firm. If it were the case that, as the CMA report suggests, audit quality is the fundamental issue that needs to be addressed, joint audits involving non-Big Four firms are clearly not an immediate solution. In fact, they could not be a solution for many years, until such time as the non-Big Four firms had built the expertise, human and digital, necessary in sufficient volume, and raised the finance necessary to fund the significant up-front investment required, to be able to perform audits of large, complex and often international businesses of a consistently high quality.

3.13 Although, as explained in this response, audit quality is currently not a systemic issue, the likelihood that it might become a major problem would be greatly increased were non-Big Four firms to be appointed whether as sole or as joint auditors of many FTSE 350 companies, until such time as they could demonstrate that they had built the resources and infrastructure as described in the paragraph 3.12.

3.14 The CMA acknowledges that “challenger firms, at least initially, would not have sufficient capacity to undertake a large proportion of the audit work for very large clients”[109]. In saying this, the CMA is considering only size, in the case of the challenger firms and companies. However, of equal importance to outright size in the case of the audit of most large companies is the capability of the international network of the audit firm and the firm’s knowledge and experience of the industry sector concerned. The CMA acknowledges that “there are some types of companies, such as banks, where the challenger firms may currently not have the required skills to perform an audit”. This is in fact likely to be the case in multiple sectors, especially those in which companies are subject to regulation, industry-based taxation or industry-related accounting issues, such as extractive industries, energy, investment trusts, software development and telecommunications.

3.15 The likelihood of delivering a poor quality audit with an audit team that has no significant audit experience in such industry sectors is high. The CMA appears to recognise this difficulty when it says “challenger firms faced a ‘chicken and egg’ problem – they were frequently ruled out of tenders on the basis of lack of experience, but would only be able to build that experience by gaining a more substantial foothold in the market”[110]. Mandatory joint audits would certainly not address this unless experience-based criteria were to be imposed on members of audit teams put forward in audit tenders, but this would merely perpetuate the ‘chicken and egg’ problem. With regard to the international networks of non-Big Four firms, it is unlikely that mandatory joint audit of UK

[106] Ibid following para 4.60
[107] Ibid para 4.29
[108] Ibid para 4.29
[109] Ibid para 4.35
[110] CMA Update paper para 3.105

companies would of itself result in transformation of the international networks of non-Big Four firms.

3.16 The key issue as regards non-Big Four firms is how quickly they could build and develop the necessary resources, standards and processes to be able to generate confidence among audit committees and other stakeholders in their ability to provide high quality audits of FTSE 350 companies. Although size is not everything, as noted above the CMA does not give any attention to the extent of the difference in size between the Big Four firms and the so-called challenger firms. This is a key factor as the greater the size differential, the greater is the challenge facing the challenger firms in building sufficient specialist expertise and developing leading edge audit technology. More important According to the magazine *Accountancy*, the UK audit revenues of the Big Four audit firms in 2017 totalled £3,473 million, with the smallest of the four earning fees of £556 million. The five “challenger” firms as identified by the CMA earned total audit fees of £512 million, the largest of them earning audit fees of £155 million and the smallest £52 million[111]. The difference in size between the Big Four firms and the “challenger” firms in the UK is therefore huge, and the size difference between them globally is many times greater in financial terms than in the UK. In these circumstances, simply mandating joint audits of FTSE 350 companies would certainly not result in improved audit quality but would, rather, greatly increase the risk of poor quality audits.

3.17 Auditing is far from being a risk-free profession. A requirement for mandatory joint audits in which one of the joint auditors was a non-Big Four firm would in all probability result in the non-Big Four firms being assigned to audit the least complex parts of businesses and in the Big Four joint auditor exercising extremely close monitoring of the joint auditor. It is not clear in these circumstances how, except by osmosis, the non-Big Four firm would quickly generate the required experience to audit to a high standard the more complex areas of the business concerned or other similarly complex businesses. In any areas audited by the non-Big Four firm that were perceived by the Big Four firm to have any significant audit risk or complexity, it is quite possible that the Big Four firm would feel it necessary to re-audit the area concerned. The Big Four firm would be far more concerned to reduce the risk to itself from assuming responsibility for the other firm’s work than to assist the non-Big Four firm to develop its auditing expertise.

3.18 In its assessment of its proposed remedy the CMA states that “the lower concentration of the audit market in France, where joint audit is mandatory, suggests that the introduction of joint audit in the UK is likely to lead to a significant increase in the share of audit fees of challenger firms”[112]. This is a highly misleading statement. Firstly, the CMA’s statement that there is “lower concentration of the audit market in France” is based on the number of firms that audit public interest entities (PIEs). In the case of France, according to the European Commission document cited by the CMA, the number is 565, whereas in the case of the UK the number is 50. The CMA does not note that whereas the number of PIEs in France is more than 40% greater than the number of PIEs in the UK, the total statutory audit fees paid by PIEs in France is only around 50% of the fees paid by PIEs in the UK. This suggests merely that a large number of PIEs in France are small and are audited by small firms – or alternatively that insufficient audit work is performed in most cases. In any event this data is of no relevance to the audit of FTSE 350 companies.

3.19 Worse still, in the sentence quoted above the CMA is clearly implying that this data relates to joint audits, which is not the case as joint audits are required in France only in the case of companies required to publish consolidated accounts. Far more relevant to the discussion of joint audits and whether or not their introduction would be likely to lead to a “significant increase in the share of audit fees of challenger firms” is the situation with regard to the CAC 40, which is comprised

[111] https://www.accountancydaily.co/sites/default/files/accountancy_top_75_firms_survey_2018
[112] CMA Update paper para 4.45

of the largest companies listed on the French stock markets. Other than Mazars, in 2016 only one joint appointment among CAC 40 companies was held by a non-Big Four firm, and each of the Big Four had more joint audit appointments among the CAC 40 than Mazars. It is also the case that of the companies in the CAC 40 that are headquartered outside France and are free to follow the French practice of joint audits, none does so[113]. The joint audit regime in France therefore does not suggest that it is conducive to the growth and development of non-Big Four audit firms as competitors of the Big Four firms.

3.20 As regards the impact of joint audit on audit quality, the CMA notes that the conclusions of such empirical studies as have been conducted on the impact "are mixed" and that the literature has not established a clear link between mandatory joint audit and audit quality". The only study it cites in this regard, however, "shows that joint audits by one big firm and one small firm may impair audit quality, because, in that situation, joint audits induce a free-riding problem between audit firms and reduce audit evidence precision"[114]. The CMA nevertheless concludes that since "there is no clear evidence that audit quality is lower in a joint audit regime", "we therefore expect that the introduction of mandatory joint audit in the UK ….. may result in higher quality through creating incentives for greater professional scepticism"[115]. This is a non sequitur. Even more extraordinary given the evidence and the previous conclusions expressed in the Update paper, the CMA states in the summary of its proposed remedy "our provisional view is that joint audit would increase competition without risking audit quality". Nothing whatever in the CMA's paper supports this view.

3.21 Rather than focus on the monitoring of audit committees in order to provide assurance that high quality audits are being delivered by Big Four firms, it would be far more helpful if the regulator were to focus on monitoring and critiquing the strategies of the non-Big Four audit firms to build the necessary resources, standards and processes. The regulator is uniquely well placed to do this as it has access to and knowledge of all aspects of the audit practices of the Big Four audit firms. This might appear to be an unusually constructive application of regulation and would certainly require appropriately skilled regulators but could be seen as an extension to smaller firms of the FRC's enhanced programme of monitoring for the largest firms, which covers leadership and governance, values and behaviours, business models and financial soundness, risk management and control, and audit quality. The monitoring of these attributes in the Big Four would provide benchmarks to apply to non-Big Four firms. Most importantly, this approach would, depending on the results of the regulator's monitoring, help to increase the confidence of audit committees that the "challenger" firms have the capability to carry out a complex audit. This admittedly would not directly address concerns that the international networks of the non-Big Four firms do not have the same strength, reach or consistency as those of the Big Four firms, but as noted above it is unlikely that mandatory joint audits of UK companies would of itself result in transformation of the international networks of non-Big Four firms.

Remedy 2A: Market share cap

3.22 The essential justification for each of the remedies proposed by the CMA is that if implemented it would contribute directly and significantly to the resolution of major problems in the audit market. The principal audit market problem identified by the CMA is that of audit quality: the CMA states "there was unanimous agreement among stakeholders we spoke to that audit quality should be the key focus in assessing whether the market was producing good outcomes"[116]. As

---

[113] J Peterson 'Count Down: The Past, Present and Uncertain Future of the Big Four Accounting Firms' July 2017 page 41

[114] Deng M,. T.Lu, DA Simunic and M. Ye 'Do joint audits improve or impair audit quality?' Journal of Accounting Research (2014) 52(5), pp 1029-1060
[115] CMA Update paper para 4.55
[116] CMA Update paper para 2.37

discussed above, the CMA's analysis of audit quality in the UK is very superficial and its interpretation of such evidence as it has reviewed is misconceived. Further, some of the CMA's remedies are based on the premise that high quality is driven by market competition. However, even if it were the case that the quality of audit in the UK needed to be improved, then far from helping to improve audit quality, the imposition of a market share cap on the Big Four firms in order to shield non-Big Four firms from competition would actually increase the risk of poor audit quality. It Further, the CMA expresses the view that "competition can play a crucial role in driving higher quality only if the incentives in the market are structured in the right way so that firms compete on what matters to shareholders and wider stakeholders – i.e. high-quality audit"[117]. That, of course, would not be the case were a market share cap designed to shield certain firms from competition to be imposed.

3.23 As the CMA was told by those who expressed a view on the possible introduction of a market share cap, the cap could well leave audit committees with no option but to appoint an audit firm which the audit committee doubts has the ability to carry out a high quality audit. Elsewhere in its report the CMA focuses on the undesirability of audit tenders where only two of the Big Four are able to tender for the audit. This, however, is far less undesirable than a situation in which a company is unable, due to a market share cap, to appoint an auditor that it is confident will carry out a high quality audit.

3.24 The CMA recognises the risks to audit quality that would inevitably arise from the imposition of a market share cap but offers no solution and implies that this is only a "short-term impact of the remedy"[118]. Since audit quality is recognised by the CMA to be the pivotal issue, it is surprising that that the CMA feels able, without any evidence whatever, to assume that the massive transition required by challenger firms in order to become real market competitors of the Big Four could and would be achieved over a short period of time.

3.25 If a market cap were to be introduced, it is possible that after say ten years, one or more challenger firms would have developed the scale, range and depth of expertise and technology to be able to compete on equal terms with the Big Four. However, it is at least equally possible that they would be unable to do so as, despite the helping hand of mandatory joint audit, they would start from such a low base in terms of human and financial resources compared with the Big Four firms.

3.26 As regards the effect of a market share cap on audit quality, at least in the case of a joint audit where one of the joint auditors was a non-Big Four firm, the Big Four firm concerned would do what is necessary to ensure that audit work of a sufficiently high quality was performed in the parts of the company audited by the non-Big Four firm. No such safeguard would exist in a sole audit obtained by a non-Big Four firm as a consequence of a market share cap on the Big Four firms. This consideration by itself should be of sufficient concern to end any discussion of a possible market share cap.

Remedy 3: Additional measures to reduce barriers for challenger firms

3.27 The CMA argues that the provision of direct support to challenger firms would be "largely redundant if our proposed remedy package is implemented"[119]. As discussed above, however, by introducing a strong bias in favour of the appointment of challenger firms as auditors of FTSE 350 companies, the CMA's remedy package would weaken the influence of competition which the CMA says it believes should "play a crucial role in driving higher quality"[120] and would prevent audit committees from discharging their responsibility to appoint the firm or firms that in their view are

[117] Ibid para 3.62
[118] Ibid para 4.82
[119] CMA Update paper para 4.89
[120] Ibid para 3.62

best able and most likely to deliver a high quality audit. This would be the position until such time as one or more challenger firms had achieved sufficient scale, range and depth of expertise to be able to offer effective competition to the Big Four firms. Even with the assistance provided by the guarantee of joint audit appointments, the challenger firms could not realistically reach this position for a number of years.

3.28 The only way of minimising the period during which the risk of poor quality audit would be increased as a result of forcing companies to appoint challenger firms, either as sole or joint auditor, would be to provide direct support to the challenger firms. It is therefore cavalier of the CMA to claim that its proposed remedy package would make the provision of direct support to challenger firms "largely redundant".

3.29 The CMA refers to three potential measures that, it says, "could reduce the barriers to challenger firms"[121].

3.30 The first relates to the movement of senior staff into the non-Big Four firms. The CMA reports that many of those who made submissions to it stated that there are not currently significant barriers preventing senior staff from moving between firms, including at partner level[122]. Just one challenger firm argued, however, that some Big Four firms do effectively operate such barriers[123]. There are a number of examples of audit partners switching between firms, mostly from one Big Four firm to another Big Four firm. This suggests that the barriers to senior staff switching between firms are neither significant nor unreasonable and that the main barrier to non-Big Four firms recruiting high quality partners from the Big Four firms is likely to be that they are unable to offer sufficiently attractive levels of remuneration. However, the CMA will no doubt investigate this matter before issuing its final report.

3.31 One submission to the CMA proposed the creation of an audit tendering fund to assist challenger firms to mitigate the costs of tendering and incentivising them to compete with the Big Four for large audit work. The CMA concludes that its proposed remedies, in particular mandatory joint audit, would provide sufficient incentive for them to sustain the cost of participating in audit tenders[124]. This is clearly the case but does not address the fundamental problem that the human and technology resources of the non-Big Four audit firms are not adequate to enable consistent delivery of high quality audits of large, complex companies.

3.32 The CMA also discusses the possibility of proposing measure to give the non-Big Four firms greater access to technology to make them better able to compete for FTSE 350 audits, either by getting non-Big Four to pool their resources to develop a new system or by requiring one or more of the Big Four firms to share their technology with the non-Big Four firms or to fund the development of a new system on an open source platform. It is widely acknowledged that audit technology is transforming the way audits are carried out. For example, EY reported in its *Global review 2018* "in Audit, our own transformation and digitalization — through investing more than US$500m in technology in the past few years — has transformed the provision of EY services"[125].

3.33 The Big Four firms clearly see audit technology as a source of competitive advantage or at least essential to prevent competitive disadvantage. Although in their submissions to the CMA two of the Big Four firms indicated a willingness to consider offering on-Big Four firms better access to audit technology, very much would therefore depend on exactly what applications they would be prepared to share. To require them to share their most advanced audit technology with other firms

[121] Ibid para 4.89
[122] Ibid para 4.91
[123] Ibid para 4.92
[124] CMA Update paper para 4.96
[125] 'EY Global Review 2018' page 5

would, as one firm noted in its submission, reduce their incentives to deliver the highest quality and/or most efficient audits and have a negative impact on competitiveness[126]. The CMA concludes that "a number of other measures such as technology sharing warrant further consideration". However, it seems somewhat odd that a remedy which is justified on the basis that it should help to increase competition is based on what is fundamentally an anti-competitive measure.

Remedy 4: Market resilience

3.34 The CMA states that at its core, the aim of its proposed remedy is to "ensure that the audit clients of a failing Big Four firm are not transferred to another Big Four firm"[127].

3.35 A major difficulty to which this aim gives rise is the strong likelihood that the failure of a Big Four firm in the UK would merely be part of a global failure of the firm concerned, such as occurred with Arthur Andersen. In such circumstances it is most unlikely that a successful turnaround of the UK fir concerned would be successful. Also, it is necessary to recognise that a substantial proportion of the clients of the Big Four firms in the UK is represented by companies that are part of international groups that are headquartered in other countries. In the case of a global Big Four firm failure, the wisdom of preventing such a foreign-controlled client from moving to the audit firm selected by its parent company is questionable.

3.36 The CMA suggests that incentives or the requirement to move audit clients and staff to challenger firms "could work if significant member firms in another large market at risk"[128]. This statement does not make sense - the CMA presumably meant to say "other large markets". However, it is difficult to understand why such initiatives would work in the absence of parallel incentives or requirements in the other large markets concerned. In the case of Arthur Andersen, its national member firms made their own decisions regarding the audit firms with which to merge when the organisation failed. Not surprisingly given the experience and expertise of senior Arthur Andersen staff, substantially all the national firms merged with another Big Four firm in their countries. This would almost certainly be the outcome were a Big Four firm to fail, in the absence of international action by governments or regulators to bring about a different outcome.

3.37 As discussed in paragraph 2.36 above, it is most likely that a multinational Big Four firm failure would be triggered by the failure of its US arm, since between 40% and 50% of the global revenues of the Big Four firms are earned by their US arms. The US authorities would therefore need to play a pivotal role in any international attempt to prevent the collapse of the firm and it would seem more appropriate to focus on how to achieve a workable international approach than to develop what would be an extremely complex set of UK mechanisms requiring legal force with no guarantee that they would be successful.

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

3.38 The CMA says that despite the extensive restrictions on the nature and amount of non-audit services that audit firms are permitted to provide to their audit clients "we do not believe the current framework for managing non-audit conflicts is sufficient to focus auditors' incentives on high quality audits"[129]. However, the reasons it gives for holding this belief do not relate in any way to "the current framework for managing non-audit conflicts". Rather, the CMA's concerns arise from the scale of the firms' services other than audit relative to the scale of their audit services. In any event, it is these concerns that underlie the CMA's proposed remedy that the firms' audit practices be separated, either structurally/legally or operationally, from the rest of their practices.

---

[126] CMA Update paper para 4.99
[127] Ibid para 4.109
[128] Ibid para 4.110
[129] CMA Update paper para 4.113

3.39 The CMA refers to “important practical challenges in creating audit-only firms, notably related to the international networks [of] which these firms are a part, and the use of non-audit experts on audits”[130]. Despite these practical issues and, also despite what appears to be almost universal opposition by key stakeholders to the creation of audit-only firms, the CMA expresses a clear preference for “full separation”, which it says “would comprehensively address the issues”[131]. It considers most of the objections to full separation to be overstated and it appears willing to revise its view only if it can be shown “how an operational split could be equally effective in addressing our objectives”[132], those objectives being “to address the negative effects on the culture of the audit practice (at a firm level) that can result from being part of a multidisciplinary professional services firm with a non-audit practice” and “the lack of choice (at an engagement level) that can arise as a result from being conflicted from tendering because of the provision of non-audit services to potential audit clients”[133].

3.40 The CMA states that “a complete split would address real and perceived concerns relating to culture. It would also have a positive impact on choice as firms would no longer be conflicted due to the provision of non-audit services in the UK”[134]. If these are indeed the CMA’s objectives, then it is simply impossible for an operational split to be “equally effective” in addressing them since there will always be some residual perceived concerns relating to the appropriateness to the audit practice of the overall culture of a firm that earns more than 75% of its total revenues from services other than audit. However, the relevant question is not whether such perceptions will exist but whether they are sufficiently well founded to justify such extreme action as breaking up successful existing firms. In this regard, it would be appropriate to apply the same test to these perceptions as is required to be applied by auditors in evaluating their own independence, namely whether or not an objective, reasonable and informed third party would conclude, that despite an operational split of the firms’ audit practice from the rest of the firm, the culture of the audit practice continues to be dictated by the non-audit practice.

3.41 Similarly, if the CMA’s objectives can only be met if separation reduces the lack of choice in audit tenders as a result of the provision of non-audit services to potential audit clients, then operational separation cannot possibly meet the CMA’s objectives. However, as discussed above (see paragraphs 2.20-2.25) the CMA’s conclusions regarding lack of choice focus on cases in which there are only two bidders, the incidence of which the CMA appears not to know, and fail to consider the interaction of competition and regulation in assessing the need for remedies of the type it proposes.

3.42 In section 2 of its report the CMA concludes that there is little evidence of conflicts between audit and non-audit work at the client level, primarily because of the restrictions in place on cross-selling, and it found no evidence that non-audit work was subsidising unprofitable audit work or that the Big Four are systematically under-bidding non-Big Four firms so as to make it more difficult for them to gain a foothold in the market. Although the CMA reaches the highly judgemental conclusion that the multidisciplinary nature of the firms “reduces the incentives to focus on independent, high-quality audit”, the one specific piece of evidence that it claims supports its conclusion in fact does not (see para 2.39 above). It therefore appears that the CMA may well be grossly exaggerating the issue. In any event its conclusion is not sufficiently reliable and robust to justify the wholesale break-up of the Big Four firms in the UK.

3.43 It is also surprising in view of the CMA’s concerns about market resilience that it does not consider at all the very substantial reduction in market resilience that would arise were the audit

130 Ibid para 4.114
131 Ibid para 4.114
132 Ibid in Summary following para 4.137
133 Ibid para 4.116
134 Ibid para 4.126

practices of the firms to be separated structurally/legally from the rest of their practices which, as the CMA points out, generate at least 75% of the revenues of the Big Four firms and are growing significantly faster than audit revenues[135].

3.44 At the heart of its view that separation of the firms is required is the CMA's view that "there are underlying cultural concerns where audit and non-audit service are provided by the one firm, given the key objective of the former is to be sceptical, and the key objective of the latter is typically to be collaborative"[136]. This is another extraordinarily simplistic view. Firstly, 'sceptical' and 'collaborative' are not antonyms. The opposite of 'sceptical' include 'credulous' or perhaps 'excessively trustful. The opposite of 'collaborative' include 'unilateral' or 'uncooperative'. 'Sceptical' and 'collaborative' are not even mutually exclusive and in fact the highest quality auditors and audits are characterised by both professional scepticism with and collaboration.

3.45 Further, the CMA is clearly of the view that advisory services offered by Big Four and non-Big Four firms alike are merely exercises in telling management what they want to hear or otherwise simply endorsing the views of management. This is a fundamental misconception. Advisory services such as tax planning, valuations, restructuring services, and transaction services, all involve an expert who behaves with integrity, applies a methodology objectively and knowledgeably to relevant evidence and arrives at a conclusion. This will often involve judgement and where there is be a range of reasonable results the advisor will explain them to the client. There will be cases where the client had hoped for a different result than that arrived at independently by the advisor and no doubt there are some advisers who are too complaisant or are even lacking in integrity such that they might be unduly influenced by their client. However, the reason why firms with successful audit practices have also built substantial non-audit service practices is that those who provide non-audit services are experts in their chosen area, behave with integrity, which implies fair dealing and truthfulness as well as honesty/display, and demonstrate independence of mind. They are very aware that their standing and reputation depend on these attributes, and the quality control processes of the firms reinforce them. The CMA's simplistic and misleading view of the differences in approach and mindset required to deliver high quality audit services on the one hand and high quality advisory services on the other hand is a wholly inadequate basis for concluding that audit services should be either operationally or structurally split from non-audit services where both are currently provided by the same firm.

3.46 Particularly if the CMA's overstatements and misinterpretations are discounted, there are good reasons to believe that operational separation of the audit practices of the firms could address sufficiently any legitimate concerns that incentives for auditors in multidisciplinary firms to focus on independent, high-quality audit are somehow negatively affected by the structure of the firms.

3.47 Some aspects of operational separation have been introduced elsewhere, for example the audit practices in the Netherlands are required to have a supervisory board the duties of which include "mak[ing] sure the accountancy organisation pays enough attention to public interest and focuses its auditing activities on organisation-wide aspects that have an impact on audit quality, neutrality, integrity and the interests of external stakeholders of the audit. Its task includes making sure appropriate investments are made in the auditing division and that the interests of the auditing division and audit quality are safeguarded in (strategic) decision-making"[137].

3.48 Since the CMA makes no reference to the Dutch arrangements or any other similar regimes, it is relevant to quote further from the report, as follows: "the root cause analysis shows that the existing collaboration model for audits and advice within a single organisation does not reduce quality and that effective collaboration with specialists plays an important role in audit quality.

---

[135] CMA Update paper para 3.173
[136] Ibid para 4.113
[137] NBA Public Interest Steering Committee 'Structural models for the accountancy sector', December 2017

Scientific literature also fails to show that using the existing model has a negative impact on the quality of audits. Some scientific literature showed that collaboration can lead to high audit quality because complex audits require market-specific expertise. Nonetheless, certain risks were identified when this model was being evaluated, which included compromised neutrality and objectivity on the part of accountants. Existing laws and regulations have been used to take various measures to reduce these risks …., like the legal ban on offering advice to PIE audit clients, the restriction of advisory activities in all other statutory audits, rotation of auditing assignments and partners, a ban on commercial incentives, introduction of a supervisory board at holding level and the need for accountants to possess the majority of voting rights in accountancy organisations"[138].

3.49 As the CMA suggests, effective operational separation of the audit practices of the firms from their non-audit practices would require separate profit pools and governance arrangements. There would also need to be no financial inter-dependency of one practice on the other, such as borrowings by one from the other or the guarantee of one practice's borrowings by the other. Although falling short of structural/legal separation, by implementing completely arm's length terms for dealings between the audit and non-audit practice there would seem to be no rationale for preventing the audit practice from tendering for audits where the non-audit practice provides non-audit services to the company concerned (although the restrictions on non-audit services also apply to members of the UK firm's network). As the CMA notes, there would need to be stringent regulatory oversight of the operation of the separation requirements[139].

Remedy 6: Peer review

3.50 The rationale for the CMA's proposal for peer review of audits appears to be to cut across "the cosy relationship that we have been told can develop between the audit committee, executive management and the statutory auditors"[140]. Put another way, had the CMA believed that audit committees discharge successfully the responsibilities assigned to them by the UK Corporate Governance Code and applied effectively the FRC's *Guidance on audit committees,* it would not have had sufficient justification for imposing yet another layer of review and monitoring of the performance of auditors, in addition to the monitoring by the audit committee, the internal quality assurance reviews performed by the audit firms before audit reports are issued, and the FRC's audit quality review programme.

3.51 Never mind that almost all those who made allegations to the CMA about a "cosy relationship" have no first-hand knowledge of the relationship and, like audit committees, "cannot observe directly the quality of the audit work undertaken"[141], or that the CMA prefers to accept their views in preference to the views of those, in particular audit committee chairs, from whom the CMA could have obtained reliable evidence showing the nature of actual relationships had it chosen to do so.

3.52 The CMA asserts that "the levels of duplication" created by the system of peer reviews it is suggesting "would be minimal, as the focus of the peer review would only be on the key audit areas and, unlike AQR procedures, it would occur prior to the signing-off of the accounts"[142]. The CMA does not refer to any evidence in support of this statement which, like so many of the CMA's views, are simplistic and fail to recognise the practical implications of applying the processes it proposes.

3.53 In particular, the CMA's "assessment of the remedy" does not address several of the key practical issues identified in submissions to it that would arise from the implementation of its

[138] ibid
[139] CMA Update paper para 4.132
[140] Ibid para 4.152
[141] Ibid para 3.10
[142] Ibid para 4.154

remedy. These include the need for arrangements to be put in place for dealing with material disagreements between the auditor and the peer reviewer, and the potential independence issues for the reviewing firm that could reduce competition and choice in future tenders. However, the practical difficulties of the peer review approach described by the CMA run much deeper than these.

3.54 The CMA describes the peer reviews it proposes as “reviews of the overall financials (for example, the consolidated accounts) coupled with shadow audits of risky areas”[143]. With regard to the “overall financials”, however, a key part of the role of audit committees and, increasingly, of auditors is to review the front end of annual reports, to ensure that the overall picture of performance in the strategic and other reports is consistent with the financial statements and that taken as a whole, the annual report is fair, balanced and understandable. A review by a peer reviewer that did not encompass the annual report as a whole would be of relatively little benefit if the “cosy relationship” referred to by the CMA existed. However, an informed assessment of the fairness of the picture of performance painted in the annual report must be based on a good understanding of the company’s business model and its performance, its successes and its setbacks. To acquire such an understanding would require a significant investment of time by a peer reviewer.

3.55 Similarly, in large, complex businesses, what the CMA describes as “risky areas” are likely to be complex and accounting for them is likely to involve a number of assumptions and to require significant judgement. A “shadow audit” of such areas would require the peer reviewer to develop their own independent view of all the variables and assumptions involved in accounting for the relevant activities, assets and liabilities. This too will often require a significant investment of time by the peer reviewer, and would often require the use of experts. It would also require the peer reviewer to spend significant time with management to understand its perspective on all matters within the scope of the peer review. None of this appears to have been considered by the CMA, which blithely concludes that “a well-designed peer review system that focused on key audit areas could avoid significant inefficiencies”[144] and that “the levels of duplication would be minimal”[145].

3.56 It is critical to the aim of the peer review proposed by the CMA that the review is carried out “prior to the signing off of the accounts”[146]. Any realistic and informed consideration of the impact of the proposed peer review on the reporting timetable of companies would conclude that the review would cause significant delays in the reporting of company results, which in turn would not be helpful for investors or the capital markets. The CMA does not, however, consider this consequence at all.

3.57 The reasons why results reporting would be significantly delayed are easy to see. Firstly, the peer review could not be carried out before the auditors have concluded their audit of the key areas and their review of the annual report and financial statements. In the vast majority of cases currently, the auditors are able to reach this point only days before companies release their results to the market. It is not clear from the CMA’s report whether it envisages that the peer reviewer (which would be appointed by the regulator) would report its findings to the audit committee but it would be absurd for this not to occur. The peer review process proposed by the CMA would then need to be completed before the audit committee meeting at which it reviews the results of the audit, which are set out in a detailed written report by the auditors to the committee. The audit committee would require a similar detailed report from the peer reviewer who could only prepare the report after the auditors had prepared theirs. Given the considerable responsibility, and potential risk, taken on by the peer reviewer, it would wish to take as much care as do the auditors (whose work is carried out over a relatively long period) in arriving at its findings and conclusions.

[143] Ibid para 4.152
[144] CMA Update paper para 4.153
[145] Ibid para 4.154
[146] Ibid para 4.154

3.58 Finally, in order to justify the requirement a “hot” review of the audit before the audit report is signed, as opposed to a “cold” review after the audit, such as the FRC’s audit quality reviews, it is necessary to produce relevant and reliable evidence that poor quality audits, or financial statements that are not fair or balanced, are sufficiently common to justify the imposition of a process that would be costly to companies and could well delay the reporting of results (which would trigger rumours and probably a fall in the share price). However, the findings of FRC audit quality reviews do not suggest that the incidence of poor quality audits or financial statements that are not fair or balanced is sufficiently great to justify adding yet another, and very expensive, layer of review.

3.59 As with all the CMA’s proposed remedies, the justification for the peer review remedy should be based on an informed analysis of the extent of the problem to which it is seen to be a solution, and an informed analysis of the value of the likely benefit of the remedy as compared with its cost, both direct and indirect. And as with all the CMA’s remedies, its justification for its peer review proposal does not meet either of these tests.