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By email: statutoryauditmarket@cma.gov.uk

Dear Sir/Madam

Update paper: Statutory audit market

EY welcomes the opportunity to respond to the CMA's Update Paper on the Statutory Audit Market, issued on 18th December 2018 (the "Update Paper").

The reform process that is currently underway provides a once in a generation opportunity for the United Kingdom to improve corporate governance, reporting and the audit ecosystem as a whole and for the long term. If implemented successfully, these reforms would make the UK the best place for investors, employees, pensioners and other stakeholders based on a robust overall system of corporate reporting, high quality auditing and effective regulation of both companies and their auditors. As described in our response to your Invitation to Comment (the "ITC"), dated 30th October 2018, we believe reform should be anchored around the following key objectives:

1. **Corporate reporting needs to evolve.** Corporate reporting needs to evolve to meet society's needs, particularly regarding the going concern and viability of companies, the measurement of long-term value creation for stakeholders and other risks. In this regard, we welcome the FRC review led by Paul Druckman into the Future of Corporate Reporting.
2. **Audit must be reformed.** Audit itself must be brought up to date by taking advantage of technology to enhance reliability and focusing assurance on both the financial statements and other key indicators. Audit firms must also have a revitalised purpose clearly focusing on the public interest. The Brydon Review into UK Audit Standards provides the opportunity to ensure audit meets the needs of stakeholders in the 21st century.
3. **Regulatory reform for auditors.** All audit firms need to focus on better quality audits. There should be accountability at senior levels in audit firms where audit quality systematically falls short. We believe the focus on audit quality is key and any changes to promote greater choice should not be at the expense of audit quality.
4. **Regulatory reform for management and directors.** Management and directors (including audit committees) are primarily responsible for the accuracy of corporate information, upon which shareholders and stakeholders rely. They should be held accountable through a framework of enhanced regulatory oversight. Management accountability could be increased through reforms, adapted to the UK market, based on the Sarbanes-Oxley reforms for investor protection in the US where, among other things, management of public companies were required to certify the material accuracy of the financial statements.
5. **Strengthened regulator.** The UK needs an enhanced regulatory framework that ensures there is appropriate scrutiny of companies, directors and auditors. In this regard, we welcome the direction set by the proposals in the Kingman Review, including the creation of Audit, Reporting and Governance Authority ("ARGA"), and its proposed role in ensuring resilience of the audit market.

We were pleased to note that the CMA has recognised, in Appendix C to the Update Paper, that *"there is a large range of important issues about the purpose and scope of whether the existing framework is able to deliver the audit outcomes stakeholders expect. We are supportive of a review which carefully considers these issues and finds a solution to ensure confidence and clear lines of responsibility for the future of the audit industry."* Any proposals by the CMA must take into account all the other reforms that could have a profound effect on audit and its regulatory framework given their interrelated nature. The aggregate impact of the various studies should be carefully considered to ensure the sequencing of the implementation of any remedies does not impact negatively upon audit quality and the competitiveness of the UK.

Principles for reform

We believe all reforms should be guided by the following principles:

1. Reforms should enhance, or at least not create risks to, audit quality.
2. To be effective and sustainable, reforms need to focus on improving the audit ecosystem as a whole, including corporate reporting, corporate governance, regulation in addition to the audit product. The regulator should have the legal authority and mandate to oversee the entire corporate reporting and governance system, taking enforcement action where necessary, including imposing significant fines and penalties against both directors and auditors.
3. Multi-disciplinary firms with global reach are needed to allow seamless access to non-audit specialists, investment and capital for long-term resilience. Global integration is required to serve the needs of UK multinational businesses.
4. Audit committees need a greater choice of audit firms.
5. Reforms should not harm the competitiveness of the UK in a post-Brexit world.

Response to proposed remedies

In Appendix A Parts 1-6 of this letter, we have set out our considered assessment. Each remedy has been assessed against the principles set out above. In summary, our views are:

- **Remedy 1 (Regulatory scrutiny of audit committees)** – We agree that there should be greater accountability of audit committees for their oversight of audit and tendering. Any changes should provide the right balance between regulatory oversight and personal responsibility to ensure the audit committee retains its primary oversight role on behalf of shareholders. We proposed in our ITC response transparency of tendering and enhanced disclosure of the audit committee's oversight of corporate reporting and audit. This, together with a new regulator, will help strengthen the accountability of the audit committee to shareholders. Enhanced audit committee reporting should also facilitate improved investor engagement.

- **Remedy 2 (Mandatory joint audit)** – We support the reduction of barriers to entry for challenger firms, but we do not believe this remedy is the right approach. We oppose the introduction of mandatory joint audits, as there is no evidence from the very few countries that still have joint audit regimes to indicate that they improve audit quality. Indeed, we believe they will create risks to, audit quality, such as management seeking to leverage one firm against the other. Joint audits reduce choice particularly when coupled with mandatory firm rotation. As proposed, the requirement for a challenger firm always to be one of the joint auditors would in many cases be impractical. For example, it is not clear that challenger firms would always have the capacity to take up the joint audits on offer. Additionally, joint unlimited liability for joint audits of larger and more complex companies creates a risk of firm resilience, making them highly unattractive. Mandatory joint audit would also substantially increase costs without a clear benefit. We also note that many countries have moved away from joint audits, including the UK where they have not been commonplace since the 1990s. Furthermore, the CMA acknowledges that complex audits may require two of the Big Four to perform a joint audit, which will reduce choice further. For these reasons, we do not believe mandatory joint audits will reduce barriers to entry.

- **Remedy 2A (Temporary market share caps)** – We agree with the goal of increasing auditor choice and building capacity in the challenger firms. The introduction of market share caps is a novel remedy and if the CMA is minded to explore this further, this should include deeper analysis of the effects of market segmentation, how long it would need to be in place and how to take account of systemically important institutions and the most complex listed companies to ensure audit quality. A cap could leave these companies without the experienced auditors and specialist expertise they need. Other economic issues that would need to be addressed include the risk of "cherry-picking" clients, possibly distorted pricing and incentives, capacity uncertainties and reduced choice. In addition, a prohibition on firms resigning from an audit may affect audit quality, could be difficult to design and implement, and would need to be carefully thought through. The interplay of temporary market share caps with existing competition law must also be reviewed thoroughly.

- **Remedy 3 (Support for challenger firms)** – We believe it is important to address barriers to entry for challenger firms to facilitate greater choice. Audit tendering and transition costs are not currently recovered from companies and so are a significant deterrent for challenger firms entering the market. To best address this, companies should bear the costs of both tendering and transition. This would be far preferable to a tendering fund. Whilst we note the CMA has not yet considered the impact of transition costs, in our experience these can range from 30% to 100% of the first-year audit fee. As an audit is only a one-year contract (auditors are reappointed annually at the AGM), all such costs must be borne as incurred and so this exposes firms to volatility in financial results. Remedies over staff movement create a number of issues that would need to be addressed to make that aspect of the remedy work. We are also concerned that some of the other remedies proposed could put firms' resilience at risk and make the market less attractive to challenger firms and new entrants. Additionally, we note that several firms proposed alternative measures in discussions with the CMA in August 2018 that could assist challenger firms in reducing barriers to entry; we recommend these now be re-examined to make the market attractive to new entrants.

- **Remedy 4 (Market resilience)** – We believe resilience is very important in maintaining a healthy audit market. Although we support measures that will address this, many of the other remedies proposed, such as operational separation, joint audits with a challenger firm (with resulting liability risks) and peer reviews (again with liability risks), could weaken the resilience of firms. Any resilience regime would need to take account of the full package of remedies before it could be properly designed. Safeguards would also need to be put in place when proposing powers to support any scheme to deal with a firm leaving the market. We note that the Financial Reporting Council ("FRC") is currently developing resilience measures for the audit market and this work should be examined before recommending further or different measures.

- **Remedy 5 (Separation)** – We strongly oppose measures that would impose either a full structural or operational split of audit firms, as any split could create a serious risk to audit quality. The CMA should ensure it has clear evidence that this remedy would be effective and not undermine firms in providing quality audits. Seamless access to non-audit skills is a requirement on every audit; the most complex audit engagements may use up to 15 different non-audit specialist teams. The ability of firms to remain resilient would be seriously curtailed by substantially reducing the capital strength provide by the larger multidisciplinary firms. Additionally, audit-only firms with a reduced profit pool would have increased reliance on their largest audit engagements. The audit business at EY already has certain features of operational separation including an Audit Quality Board and a performance management and remuneration system, where audit quality is the most important performance indicator. It is not clear that separation will produce a positive, material impact on audit culture as compared with the risk it poses to audit quality. In addition, it is unclear how independence restrictions can be alleviated to improve choice.

- **Remedy 6 (Peer review)** – We support the spirit and intent of this remedy. However, it raises several issues requiring further analysis, particularly regarding liability, cost and the effect on choice, whereby a firm may be prohibited from tendering due to having undertaken such a review. We believe the desired goals of this proposed remedy would be more readily achieved through a strengthened regulator, a conclusion reached in the US, and reflected in legislation. It is also unclear how peer review would fit with the proposal for mandatory joint audits, as this appears to be another review layer upon that which would be added by joint audits.

We have also provided, in Appendix B to this letter, answers to the 27 Consultation Questions posed at Box 6.1 of the Update Paper.

Summary

The proposed remedies are significant and any resultant reforms would be far-reaching. Many are novel and not used in other audit markets. Accordingly, the CMA should conduct significant further economic analysis of the impact of all the proposed remedies and reforms. We recognise that this investigation must be completed at speed to ensure that reforms can be introduced as quickly as possible.

Moreover, the Kingman and Brydon reviews, and the FRC's review of Corporate Reporting, will all impact the UK audit market and it is vital that all reforms are coordinated to achieve the best result possible for the UK. We believe that there is a grave danger of unintended consequences if the package of reforms from the various reviews is not considered as a whole, and is not proportionate to the issues it is intended to address.

In summary, it is vital that, taken together, the reforms provide a cohesive way forward, protecting and enhancing audit quality while also restoring trust in business and maintaining the attractiveness of the UK as a place to do business.

Yours faithfully

Hywel Ball

UK Head of Audit

Appendix A, Part 1

Remedy 1: Regulatory scrutiny of audit committees

The CMA has proposed subjecting audit committees to a requirement that they report directly to the regulator before, during and after a tender selection process, and a requirement that they report directly to the regulator throughout the audit engagement. The CMA has further proposed that the regulator be provided the ability to issue public reprimands or direct statements to shareholders. The aim of this remedy is to ensure audit committees "fully protect the interests of shareholders when making decisions about auditor selection and monitoring the audit engagement," which should "improve incentives for high quality audits" and ensure that challenger firms are not "unfairly disadvantaged due to biases during audit selection procedures."

EY's position

We strongly believe that audit committees need to be independent, empowered and accountable for overseeing management and the auditor. This will enable them to better achieve the aims of this remedy. We further believe that enhanced audit committee reporting will help investor engagement. We support greater regulatory scrutiny of audit committees to achieve these aims, and set out below our views on specific features we believe would be most effective. We also set out our views as to features of the CMA proposal that we believe would not be effective.

Tender selection process

It is essential the tender selection process is updated in a way that empowers the audit committee, helps emphasise quality over price and provides the regulator and the public with more information on how the market works. In view of these objectives, we recommend:

- The current best practice notes on running an audit tender issued by the FRC (updated in 2017) should be further updated by a regulator to reflect the conclusions/consensus from this consultation and other related reviews e.g., the Kingman Review. This guidance should have more persuasive authority than it currently has, e.g. being endorsed as an operating procedure rather than just best practice guidance. It should become the benchmark against which audit committees would be assessed by the regulator for running an external audit tender process ("the tender operating procedures")
- As well as tenders being run 'price blind,' the audit committee should have sole responsibility for the negotiation of fees. This should be a criterion stipulated in the tender operating procedures.
- The audit committee should be required to provide a report to investors and an independent regulator on selection criteria and the process pursued (both benchmarked against the tender operating procedures), the outcome and the rationale for the audit committee's final recommendation to the board. This report ('the audit committee tender selection report') should be made available to investors ahead of the AGM vote on auditor selection to inform their voting decisions.
- It should be mandatory for audit committees to articulate in their tender selection reports how audit quality has been considered and the factors detailed in Appendix 1A of our CMA response of 30 October 2018. The audit committee tender selection report should follow a standard format (e.g. as with the extended external audit opinions) so that reporting by audit committees is consistent and comparable. It should also be publicly available.

- On an annual basis an independent regulator should review a sample of the audit committee tender selection reports and form a view on audit committee's involvement in the tender selection process, the emphasis placed by the audit committees on quality and the overall rigour and robustness of tender selection processes (benchmarked against the tender selection operating procedures). Annually, a public report should be published on the overall audit market and the role of audit committees in the auditor selection process.
  - Mirroring the public reporting of external audit inspections (as currently undertaken by the FRC's Audit Quality Review Team), the regulator should publish on an annual basis the names of companies whose audit committees tender selection reports were reviewed.

Reporting throughout the course of the audit engagement

- In our view, the second part of this remedy, i.e., a requirement that audit committees report directly to the regulator throughout the audit engagement (Update Paper para 4.16b) is not practicable. It is not clear what 'throughout the audit engagement' would mean in practice and it would place undue burden both on audit committees and the regulator (which would receive regular reports throughout the year from 350 audit committees). Additionally, it is unclear what a material disagreement constitutes versus challenge and debate.

Public reprimands

- We agree with the third part of this remedy on the ability of the regulator to issue public reprimands or direct statements to shareholders in certain circumstances – although we would expect this power to be used as a last resort. These could be issued if there are persistent shortcomings by an audit committee, e.g. an audit committee fails to take the actions it submitted to the regulator identified through its independent inspection of the audit committee's interaction on the external audit as referred to above.

Practice Aid update

- While we note that the CMA says "no statement of what constitutes best practice in the area of auditor monitoring" exists (Update Paper para 3.35), we bring the CMA's attention to the FRC's Practice Aid for Audit Committees on Audit Quality issued in May 2015. This should now be updated in light of the consensus reached by the CMA review and other related reviews, such that audit committees have a consistent and recognised framework for assessing the external audit process (which should include how management and the audit committee itself contribute to the effectiveness of the overall process). The Practice Aid update could address the concerns expressed in para 3.35, e.g., around the independence of the assessment process and excessive reliance on management feedback.

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Appendix A, Part 2

Remedy 2: Mandatory joint audit

The CMA has proposed the introduction of mandatory joint audit with the aim to increase competition in the audit market by 'reducing the barriers to auditing large companies faced by the challenger firms'[1].

EY's position

Despite the aim of increasing competition, we have serious concerns that this remedy will not increase choice in the FTSE 350 audit market. Instead, it will significantly increase the costs and operational complexity of delivering an audit, and will introduce significant risks to audit quality.

Our review of recently published academic papers on the impact of joint audit, show that there is limited empirical evidence that joint audits result in an increase in audit quality and a lower market concentration. There is, however, more evidence that joint audits will lead to an increase in costs.

Furthermore, it should be noted that a majority of the respondents to the CMA's ITC opposed the proposal to introduce joint audits. Those who opposed the idea provided empirical support, whereas those who were in favour relied on their assumptions and belief or fairly limited empirical evidence.

We outline the reasons for our concerns and references to relevant academic studies below:

Impact on choice and competition

The Update Paper refers to a report from The Commission To The Council, The European Central Bank, The European Systemic Risk Board And The European Parliament[2] and a study carried out by a group of academics[3] to provide evidence that the introduction of joints audits led to lower concentration in the French market and increased the capability of challenger firms to compete for larger audits. However, those reports are potentially misleading for the following reasons:

- <u>The Commission To The Council, The European Central Bank, The European Systemic Risk Board And The European Parliament</u>
    - This report does not explain the reasons for the lower concentration in the French audit market.
    - It provides a single snapshot of the level of market concentration in 2015. Trending data, rather than a snapshot, is required to establish whether the introduction of joint audits in France has had an impact on Big Four concentration in that jurisdiction.
    - The lower concentration in France may not necessarily be a direct result of the joint audit requirement. The report also highlights that no fewer than 17 other EU member states have levels of Big Four concentration that are lower than in the UK, 16 having achieved this result without the introduction of mandatory joint audit.

- <u>Guo et al. (2017)</u>
    - The Update Paper states that 'a significant minority of large firms have chosen audit pairs with one Big Four and one challenger firm, and the workload in these cases is

1 Update Paper, para 4.29

2 Report from The Commission To The Council, The European Central Bank, The European Systemic Risk Board And The European Parliament on monitoring developments in the EU market for providing statutory audit services to public-interest entities pursuant to Article 27 of Regulation (EU) 537/2014 (https://eur-lex.europa.eu/legalcontent/EN/TXT/?uri=CELEX:52017DC0464)

3 Guo, Q., C. Koch, and A. Zhu (2017) Joint audit, audit market structure, and consumer surplus, Review of Accounting Studies, 22(4), 1595-1627

shared between the joint auditors in a fairly balanced way, with the challenger firm often receiving more than 40% of the audit fee'.
    - This conclusion is based on a study carried out on 1,121 listed companies in France, excluding financial institutions. The scope of study, which includes a significant number of smaller listed companies, has a higher likelihood of heavier involvement of the challenger firms – it is therefore likely to be misrepresentative of the true position.

We have carried out a separate analysis of companies listed on the SBF 120 in France, which is the most comparable index to the FTSE 350 in the UK. Our analysis shows that joint audits would not significantly increase choice and competition in the market; close to half of SBF 120 companies remain audited by two Big Four firms (2017: 44%; 2016: 44%).

Although the CMA proposal is different to the French model in that one of the joint auditors has to be a challenger firm, this proposed model nonetheless poses risks and challenges to both the Big Four and challenger firms as described below:

- The proposed joint liability framework for joint audit, where both auditors are jointly and severally liable, may be seen as a significant barrier to entry for challenger firms as it increases their financial risk, this is particularly the case on joint audits where they would assume a smaller role than the other joint auditor.
- This model also risks perpetuating the difference between a Big Four and a challenger firm. The market will continue to perceive the challenger firms as understudies and shadows of the Big Four. It may therefore discourage challenger firms from investing and moving towards being more equal competitors of the Big Four.

We also make the following points:

- Where joint audits are carried out in France between a challenger firm and a Big Four, we found unequal sharing of responsibility between the two auditors, despite having a joint audit regime in place for more than 50 years. This is evidenced by the fact that the weighted average fee earned by challenger firms paired with the Big Four on joint audits of SBF 120 companies was only around 35% of the total audit fee in 2017 and 37% in 2016.
- Furthermore, the instances of an SBF120 company appointing two challenger firms as their joint auditors were very low (2017: 3%; 2016: 3%), which suggests that companies still have less confidence in challenger firms' ability to deliver larger audits.
- The empirical evidence listed below shows that although joint audit is effective in maintaining market openness, it does not have an impact on the market shares of the Big Four in the long term. Even with a joint audit regime, the Big Four still held significant shares of the market for large, listed companies in France.
    - A 2007 academic study[4] highlights that, even in the context of France, the Big Four firms continue to hold significant shares of the market for large, listed companies, whereas there has been a significant reduction in audit market concentration for small and medium sized companies.
    - Another academic study in 2008[5] reported that audit market concentration in France is high for certain industries, such as the construction, energy and financial sectors.

4 Broye, G. (2007). Concentration du marché de l'audit: Un état des lieux.. Revue Française de Comptabilité, 399: 34-37.

5 Piot, C. (2008). Concentration et compétitivité du marché de l'audit en France: Une étude longitudinale 1997-2003 [Concentration and competitiveness of the French audit market: A longitudinal study 1997-2003]. Finance Contrôle Stratégie, 11(4), 31-63.

    - A report by London Economics in 2012[6] found that none of the large medium-sized firms, except Mazars, gained market share in France during 2003 to 2010. Rather, the collective market share of the large medium-sized audit firms actually diminished over this period.
- Commentary in 2019[7] also points out that challenger firms would be required to make heavy investments over the next few years in order to undertake joint audits of larger companies. Challenger firms have to invest in the recruitment of skilled personnel to carry out audit work of a more complex nature, as well as to deploy the personnel and expertise to participate in competitive tenders. Such an initiative is very likely to 'challenge the challengers' because of the level of investments required – from the costs of tendering for a joint audit to the resources required to deliver more complex audits and cross-review the other auditor's work.
- If companies continue to favour the Big Four in a joint audit regime (as currently observed in France), this would further reduce choice in the market. This impact on choice could be exacerbated given the mandatory firm rotation requirements – the extent of the impact is yet to be seen, given that rotation is still in its infancy in France. The effects of the interplay between joint audits and rotation need to therefore be assessed and carefully considered.
- The evidence above shows that joint audit is not an effective measure to address a number of barriers to entry to the FTSE 350 audit market, such as the need for geographical coverage across the global network and greater access to specialists.

Impact on quality

- We are concerned that the potential negative impact of joint audits on audit quality has been understated, particularly if choice is further restricted by the introduction of this requirement.
- Contrary to the suggestions contained in the Update Paper that joint audits will lead to increase in audit quality, a number of academic studies (listed below) point out that there is very little empirical support for the argument that joint audits lead to better audit quality. Rather, these studies found no statistically significant difference in audit quality between companies that used one or two audit firms or between companies that switched from joint to single audits rather than continuing with two, irrespective of the joint audit combination.
    - In 2012, Lesage and Ratzinger-Sakel[8] reported no significant difference in audit quality between France and Germany, suggesting that joint audits do not necessarily result in higher audit quality.
    - Lesage et al[9] in 2017 reported an insignificant association between Danish joint audits and audit quality.
    - Holm and Thinggard[10] in 2011 concluded that joint audits do not have any impact on audit quality, as measured by abnormal accruals. Abnormal accruals are used widely as a proxy for audit quality. Abnormal accruals imply that managerial discretion over accounting is used to distort reported earnings for private benefit, and that managed earnings are different from the outcome of a 'neutral' application of generally accepted accounting principles.

6 London Economics (2012). Study on joint audits: study commissioned by Deloitte, Ernst and Young, KPMG and PWC. London Economics, London.
7 Peterson, J., (2019). Joint audit for larger companies? The UK might wish it so. Available at: https://www.jamesrpeterson.com/home/2019/01/joint-audits-for-large-companies-the-uk-seems-to-think-so.html
8 Lesage, C. and Ratzinger-Sakel, N. (2012). Are the findings of international studies reliable? The joint audit example. Working paper (Germany: HEC Paris, France and Ulm University)
9 Lesage, C,M., Ratzinger-Sakel, N.V.S., and Kettunen, J. (2017) Consequences of the Abandonment of Mandatory Joint Audit: An Empirical Study of Audit Costs and Audit Quality Effects. European Accounting Review, 26:2, 311-339.
10 Holm, C. and Thinggaard, F. (2011), 'Joint audits – benefit or burden?'

    - Holm and Thinggard[11] in 2018 investigated audit quality differences between joint audits and single audits in Denmark. Their study indicated that a switch from joint audit to single audit results in reduced audit costs without any corresponding impact on audit
- The Update Paper does not address the following factors that may impact the quality of an audit:
    - The potential for disconnect between joint auditors as opposed to a single auditor with a holistic view of the company.
    - Differences in firms' audit methodologies and policies (e.g., determination of materiality levels of the audit, testing thresholds, sampling methods) which may lead to different conclusions.
    - Different views on key audit judgments and technical interpretations of the accounting standards by different audit firms.
    - The opportunity and incentive for management to leverage differences in views between the firms.
    - Added operational complexity (e.g., significant co-ordination efforts between two firms, two points of contact for audit committees) creates more time pressure to complete the audit.
    - The risk that challenger firms may not have the necessary experience, competence and resources to challenge a Big Four joint auditor.
- In Canada, the transition from joint auditors to a single auditor was prompted by the failure of joint audits to prevent the collapse of the Canadian Commercial Bank[12].
- The removal of joint audits in Denmark was driven by the view that a single auditor can provide a more holistic approach and joint audits were resulting in 'unnecessary high audit costs'[13].
- The CMA asked whether, if joint audits were introduced, a minimum amount of work (and fee) allocated to each joint auditor should be set by a regulator – and whether the same splits should apply across the FTSE 350. We do not support such an approach. In particular, we do not consider a 'one size fits all' approach to the split to be appropriate. This would not give companies the flexibility to decide the most appropriate allocation of work between the auditors based on their own assessment of each auditor's capability and credentials.
- Furthermore, companies may be forced to allocate more work to one auditor in order to meet the minimum requirement. This could have a negative impact on audit quality if the auditor does not have ability to deliver the allocated portion.

Impact on costs

- Implementation of this remedy would also increase costs, as recognised by the CMA in the Update Paper. However, the expected level of cost increase of 20% based on bottom-up estimates received by the CMA appears to be overly optimistic.
- The impact of a joint audit arrangement on the costs of the audit is more widely documented. A number of recent academic papers[14], which look into the cost impact of joint audits, provide evidence that companies with joint auditors pay significantly higher audit fees – ranging from 10% to as high as 70% - than companies with a single auditor.

11 Holm, C. and Thinggaard, F, (2018). From joint to single audits – audit quality differences and auditor pairings. Accounting and Business Research, 48:3, 321-344.

12 Lew, B. and Richardson, A. J. (1992), 'Institutional responses to bank failure: A comparative case study of the home bank (1923) and canadian commercial bank (1985) failures', Critical Perspectives on Accounting, 3(2), pp. 163-183.

13 Holm, C. and Warming-Rasmussen, B. (2008), 'An account of accountants. Audit regulation and the audit profession in Denmark', In Auditing, trust and governance – regulation in Europe (Eds, Quick, R., Turley, S. and Willekens, M.) Routledge, London.

14 Holm, C. and Thinggaard, F., (2016). Paying for joint or single audits? The importance of auditor pairings and differences in technology efficiency. International Journal of Auditing, 20, 1–16. Audousset-Coulier, S. (2015). Audit fees in a joint-audit setting. European Accounting Review, 24(2), pp. 347-377. Andre, P., Broye, J., Pong, C. and Schatt, A., (2016). Are joint audits associated with higher audit fees? European Accounting Review 25 (2): 245-274. Lesage, C,M., Ratzinger-Sakel, N.V.S., and Kettunen, J. (2017) Consequences of the Abandonment of Mandatory Joint Audit: An Empirical Study of Audit Costs and Audit Quality Effects. European Accounting Review, 26:2, 311-339.

- A high-quality audit can only be truly achieved if the auditor effectively duplicates the work of the other on the audit of material balances and high-risk areas. Joint audits would, therefore, drive up costs and lead to delays.
- Experience in Denmark also shows that it is more expensive for companies to meet the joint audit requirement with no countervailing benefit on audit quality.
- Higher costs are not only confined to the cost of delivering the audit. Joint audits would also create greater challenges for regulatory oversight, additional operation costs for companies due to added burden on finance functions, as well as higher insurance premiums borne by challenger firms as a result of being jointly and severally liable with another firm.

Our overall assessment of the remedy

- There is no clear evidence that the potential negative effects of joint audits would be outweighed by any improvements in audit quality due to stronger competition.
- We also recommend that the CMA should look carefully at the experiences of countries that have adopted joint audits in the past and subsequently abolished the requirement, including Canada, Sweden, South Africa and Denmark.

We strongly urge the CMA to carry out further research on the impact of joint audits, taking into full consideration the uniqueness of the market landscape in the UK and the reasons we have outlined above.

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Appendix A, Part 2a

Remedy 2a: Temporary market share cap

As a potential alternative to mandatory joint audit, the CMA has proposed the imposition of a temporary market share cap on the Big Four firms. The intention is that by 'temporarily shielding challenger firms from competition with the Big Four,' a portion of the market would be reserved for challenger firms so that they can 'achieve greater scale and experience' and, in the long term, 'become more effective competitors for the audit of large companies.'[1]

EY's position

We fully recognise and support efforts to address the need to increase choice for audit committees and reduced barriers to entry, including capacity in the challenger firms. Conceptually, imposing a market share cap presents a straightforward way of achieving this goal. However, we are concerned that a market share cap may result in unintended consequences, and consider that reducing barriers to entry and increasing audit committee choice can be achieved more effectively through Remedy 1, (regulatory scrutiny of audit committees), and 3, (support for challenger firms), both modified as we have suggested. In our experience, audit committees play a key role in ensuring audit quality when they are empowered, independent and accountable. We are therefore deeply concerned that by limiting choice, the imposition of a market share cap risks disempowering audit committees and leading to unintended consequences that may harm audit quality. We believe that the CMA needs to be satisfied pursuing greater choice at the expense of audit quality is an acceptable trade-off.

For the reasons we provide in this appendix, we do not believe this is a remedy that should be pursued.

This remedy is untested and unproven

Importantly, we have identified no evidence of this or a similar remedy having been introduced in any audit market elsewhere globally. [2] As an untested remedy, the outcomes are uncertain, and risk undermining the valuable objectives that the CMA and several other reviews related to audit and the audit market, seek to achieve.

By contrast, the use of market share caps was previously considered by the European Commission to address audit firm concentration within the EU, but ultimately not progressed as a preferred option. This was based on the determination that it would fail to achieve the overarching objective of strengthening competition and improving choice:

> 'Imposing a market share ceiling for audit services providers would immediately reduce the market share of large audit providers. Over a period of time, however, this option is likely to lead to less competition since those who reach the limit would be banned from competing for other available audit engagements. Companies might be faced with further limitation of choice.'[3]

[1] Update Paper, para 4.64.
[2] The highly unique public interest role of audit firms in fulfilment of statutory obligations and the direct effect of the quality of their work in instilling public confidence in capital markets renders comparisons to market share caps imposed in other markets exceedingly challenging.
[3] European Commission (2011) *Commission Staff Working Paper - Impact Assessment Accompanying the document Proposal for a Directive of the European Parliament and of the Council amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts and a Proposal for a Regulation of the European Parliament and of the Council on specific requirements regarding statutory audit of public-interest entities.* Belgium.

As the European Commission assessed, even if imposing a market share cap temporarily increased choice, that outcome was viewed as not likely to be sustainable. Importantly, for the reasons we cite, below, this unsuccessful result would also be coupled with the potential risks to audit quality.

The potential to harm audit quality

As the CMA recognises, implementing a market share cap poses a risk to audit quality.[4] Although the CMA qualifies this as being a part of the potential 'short-term impact' of the remedy, the Update Paper provides no evidence as to the anticipated scale of the risk, the severity of the risk, how it will be managed or the projected timescale for it to be diminished. Given the novelty of this proposal and the risk of an impact that is greater than anticipated, it is imperative that more work is undertaken to understand these potential risks to avoid a significant adverse impact that further undermines public trust. This risk cannot be taken lightly. We highlight below several ways in which quality would be threatened by this proposal.

a. Challenger firm capability and capacity

We support efforts to enhance challenger firms' capability and capacity. We believe their present levels of capability and capacity need to be fully considered in connection with any remedy designed to restrict larger and potentially more experienced firms from tendering for audits. This would not only lead to a better understanding of potential gaps that could inform efforts to assist the development of challenger firms, but also highlight where those gaps may pose a genuine risk to audit quality.

The CMA has repeatedly acknowledged concerns around challenger firm capability and capacity to perform complex audits.[5] These concerns were echoed by Ilias Basioudis, one of the academic witnesses during a BEIS oral evidence hearing on the Future of Audit on 15 January 2019, who asserted:

> 'Creating a market cap means that a share of that market will be offered to the non-Big Four firms, but we know that the non-Big Four firms do not have the experience, the staff, the expertise or the ability to audit such large and complex companies in the FTSE 350.'[6]

Our views are underscored by an analysis of FTSE 350 audits inspected by the FRC over the past five years, contained within the Update Paper. [7] The analysis highlights that, with the exception of one year, the challenger firms consistently had a greater percentage of audits requiring significant improvements annually than did the Big Four.

Insofar as the CMA has queried the population of companies on which its proposed market share cap should apply, we urge that present levels of capability and capacity need to be fully considered before an informed determination can be made.

[4] Update Paper, para 4.81, stating '[The short-term impact of the remedy] would be expected to weaken competition to some extent, potentially resulting in higher fees and/or a reduction in quality.' Update Paper, para 4.82, stating 'Without other measures in place, weaker competition between the Big Four could lead in the short term to a reduction in the quality they provide. In addition, the reduction in choice might also result in a worse matching between companies' requirements and auditors' expertise, with a potential negative impact on audit accuracy.' Update Paper, para. 4.83, stating 'The introduction of a market share cap might therefore reduce average audit quality to some extent in the short term as more companies would be audited by smaller firms.'
[5] Update Paper, paras. 3.65b, 3.105, 3.108, 3.110, 4.37 and 4.83.
[6] House of Commons, Business, Energy and Industrial Strategy Committee, Oral Evidence: Future of Audit, HC1718, 15 January 2019, Ilias Basioudis, Senior Lecturer in Financial Accounting and Auditing, Aston University School of Business, response to Q18.
[7] Update Paper, figure 2.18.

b. Limitations to choice

By prohibiting the Big Four from tendering for certain audits, the implementation of a market share cap would naturally reduce choice. This would result in companies being less able to select the auditor they consider best suited for their specific needs. This raises the potential for several outcomes that are harmful to audit quality, including, but not limited to:

- constraints on the availability of experienced auditors for complex audits;
- reduced access to specialists
- the potential for higher risk audits to face greater difficulty in securing appropriate auditors

The CMA has acknowledged the potential harm to audit quality resulting from a reduced choice, stating 'the reduction in choice might also result in a worse matching between companies' requirements and auditors' expertise, with a potential negative impact on audit accuracy.'[8] Again, although the CMA qualifies this as being a part of the potential 'short-term impact' of the remedy, we suggest that this is an unacceptable trade-off. Audit quality should not be put at risk, even if only in the short term.

c. The risk to rivalry across the Big Four

In the event that a market share cap is ultimately applied, the CMA has expressed a preference for separate market share caps for each of the Big Four. In support of this, the CMA cites the relative ease of implementation and monitoring for individual caps as compared with a system based on a collective cap across the Big Four.[9] We strongly believe that the drawbacks of any regulatory burden are greatly outweighed by the need to avoid a system that risks adversely impacting rivalry across the Big Four. Implementing individual caps risks distorting competition by limiting the number of Big Four firms that tender as their individual caps are reached. This would also significantly diminish incentives to pursue investments that help further audit quality and increase the risk that specialist partners at firms that have reached their caps would then be unable to serve the companies that need them.

d. The effect of prohibiting auditor resignation without consent

As a possible feature of the proposed market share cap, the CMA has suggested imposing a prohibition on the Big Four resigning from an audit without the audited company's approval. The prohibition is intended to prevent 'cherry picking' of companies to audit by the Big Four. However, unless this remedy allows for specific circumstances where an auditor can resign, this prohibition would naturally raise concerns as to audit quality: it would constrain auditors from standing down when they perceive that audit effectiveness is impaired by an audit committee's, or management's, lack of openness to an auditor's view that issues require remediation. In such a case, if the company were unwilling to consent to the auditor's resignation, both the company's shareholders and wider stakeholder group would clearly be disadvantaged by the continued service of an auditor lacking necessary influence.

We also emphasise that an auditor's ability to resign is a powerful tool in ensuring high audit quality. We worry that placing constraints around auditor resignation would increase the potential for audit quality to diminish.

[8] Update Paper, figure 4.82.
[9] Update Paper, para 4.68.

The prohibition would also create situations where an auditor would be disadvantaged if, for example, the company had ceased making payments toward the audit fee. In those circumstances, the auditor would be unfairly compelled to continue provide services in fulfilment of its statutory obligation and the absence of payment may itself create a threat to independence.

We note that the prohibition also raises other unanswered questions, such as the appropriate outcome if for example the company's directors refused to consent to the auditor's resignation, but the company's shareholders did consent.

The potential to increase audit fees

As the CMA has acknowledged, the inevitable limitation of choice caused by this remedy in the short term has the potential to result in higher audit fees.[10] In the event that market share caps were assigned to each of the Big Four individually, this would also increase the risk that firms would price audits at a premium as they reach their individual caps, given that it diminishes the incentive for competitive pricing by adversely impacting rivalry across the Big Four.

This potential outcome would appear to undermine one of the chief objectives for which greater competition is traditionally encouraged, and as previously noted would potentially be accompanied with a reduction in audit quality.

The prioritisation of companies by the Big Four

The CMA has expressed concern that the imposition of a market share cap may incentivise the Big Four to prioritise competing for the largest, most profitable and least risky companies ('cherry picking'). This could have the adverse result that a 'higher risk' company might be unattractive and find it hard to find a suitable auditor. We raised this as one of several inherent risks associated with market share caps in our response to the CMA's Invitation to Comment.[11]

We consider the risk of 'cherry picking' to be an unavoidable consequence of the CMA's proposal to impose a market share cap. The CMA has proposed that this could be addressed by identifying groups of companies for which the Big Four would be precluded from bidding. We disagree that this would be effective, and believe it would require significant regulatory intervention.

Potential legal issues

The CMA has also suggested possible features of the proposed market share cap that would raise significant legal issues.

a. Prohibition on auditor resignation without consent

As noted above, the CMA has proposed imposing a prohibition on a Big Four firm resigning from an audit without the audited company's approval. In the absence of reforms to the Companies Act 2006 and other relevant legislation that set out the conditions under which an auditor may resign, it is unclear from the Update Paper how the CMA proposes the prohibition can be achieved.

b. Regulatory power over tendering

[10] Update Paper, para 4.82.
[11] EY response to CMA invitation to comment: statutory audit market, October 2018, response to q.19.

In order to avoid companies delaying tendering or tendering immediately before the cap comes into force, the CMA has proposed that the regulator should be empowered to require certain firms to re-tender before the expiry of the ten-year period or to require all firms to re-tender more frequently.[12] This could become quite a burden for some companies, particularly smaller companies in the FTSE350 and any such power would need to be very carefully crafted.

c. Competition law

Interplay of temporary market share caps with existing competition law must also be reviewed thoroughly.

Additional legislation required

The legal and regulatory framework both at local an EU level would require careful consideration and amendment to govern the criteria for tendering for example would a Big 4 firm be expected to bid for an entity where all other Big 4 firms had already reached their cap?

The level of regulatory resource required

The complexity of this remedy renders it difficult to administer effectively. A significant level of regulatory resource would be required. As envisioned, the regulator (and an independent body) would be responsible for:

- Monitoring audit firm tender outcomes and compliance with the caps
- Assessing the relative capability of auditors over time
- Adjusting the caps as auditor capability changes
- Reviewing companies' size and industries to enable the introduction of multiple caps over subsets of the FTSE 350 in stages
- Requiring certain firms to re-tender before the expiry of the 10-year period or requiring all firms to re-tender more frequently[13]

The regulator would also presumably be required to monitor and communicate the impact of FTSE 350 membership changes on the market share cap scheme.

We consider that this reflects a significant increase in regulatory responsibility and required resource, and therefore that it should be considered in connection with the proposals made as part of the Kingman Review. We further suggest that the additional demands on the regulator should only be imposed if there is persuasive evidence base as to the effectiveness and sustainability of this proposed remedy.

[12] Update Paper, para 4.73.
[13] Update Paper, paras 4.71, 4.73, 4.75.

Appendix A, Part 3

Remedy 3: Additional measures to support challenger firms that the CMA proposes to consider further

The CMA has proposed introducing measures directed at easing the movement of staff between audit firms and helping challenger firms to mitigate the cost of tendering. The intended result of these measures is to reduce barriers to entry for challenger firms, enabling them to compete more effectively with the Big Four.

EY's position

We believe it is important to address barriers to entry for challenger firms to facilitate greater choice. We believe tendering and transition costs are the most significant deterrent for challenger firms and, in order to address this, companies should bear the costs of both tendering and transition. We also support efforts to ease movement of staff, and note that there are several issues associated with that aspect of the CMA's proposal which require close consideration.

Ease of movement of staff

The CMA has expressed its preference for a "prohibition or limits on the length on non-compete clauses," which have the effect of making it "harder for audit partners and staff to switch firms." It considers that "partner switching is necessary for challenger firms to build their capacity."

EY supports this proposal in principle, and agrees it would represent an important step in enabling challenger firms to build up both their capability and capacity. We believe there are several factors to consider in designing and implementing this proposal, including:

- The FRC's Ethical Standard requirements on audit partner rotation, which have certain 'time-out' periods (up to five years) that an individual (having served the maximum period on the audit engagement) needs to observe before he or she can participate again on the audit engagement. The purpose of this requirement is to address any familiarity threat to independence between the individual and the company being audited. These 'time-out' periods are applied on an individual basis, rather than at a firm level, and therefore need to be complied with even if the partner moves to another firm.
- The lawful imposition of reasonable notice periods and post-termination restrictive covenants is necessary to protect a firm's legitimate proprietary interests (for example, relationships with the companies it provides services to, confidential information and maintaining the stability of its staff). Such restrictions allow firms a reasonable period of time to identify and recruit a suitable replacement or to implement a continuity plan, which is critical to maintaining consistency and audit quality.

Departing employees and partners could take advantage of confidential information and, strategic plans, as well as the influence gained over clients the companies they provided services to and colleagues secured in their roles. Unless restricted, they can use this information for the benefit of their new firm, which could harm the interests of the former firm and the companies for which it provides services.

Audit partners and staff are free to change firms. However, in our experience, a significant reason why audit partners often choose not to move is that they find it challenging to identify an appropriate time to do so. This is because, having committed to a five-year term for overseeing an audit, the impact of these could be significant (particularly if they are large and complex audits). Moreover, most audit partners will be simultaneously overseeing a number of audits, each of which is often at different stages of their five-year cycles. Given their general oversight role, a partner considering a move at senior level will also be very concerned about the impact on their audit engagements in terms of quality, consistency and availability of technical expertise. The latter may also have been a significant factor in the firm winning the work in the first place.

Tendering fund

The CMA has also indicated that it is considering the creation of a tendering fund.[1] We support the spirit and intent of this remedy, as in our experience tendering and transition costs represent significant barriers to entry for challenger firms. However, we do not believe the creation of a tendering fund will provide an effective and sustainable solution. Rather, we firmly believe that tender and transition costs should be borne by the companies that have gone out to tender, with a cap on the maximum spend that can be incurred by each tendering firm and transition costs disclosed separately. In this way, the true cost of the audit (tendering fees, transition costs and fees for audit services) would be accurately captured and paid for by the company benefiting from those services. The result would lower the barriers to entry and create a level playing field for all participating firms.

In our experience, the transition costs for a new auditor can range from 30% to 100% of the first-year audit fee. These costs adversely affect market attractiveness given that even audit services with an anticipated long term are delivered through a series of one-year contracts, each of which is followed by the audit firm being re-appointed for a subsequent year. These costs are required to be absorbed by the audit firms within the first year, which necessarily impacts audit firms' profit and loss statements in ways that is likely easier for Big Four firms to sustain.

As to a tender fund, we consider that the associated costs would be exceedingly difficult to gauge, rendering the administration of such a fund highly complex. Reasons for this include:

- Tender costs vary significantly from one company to another. They are heavily dependent on a companies' geographical footprint, size and complexity, and the length of tender.
- Each audit firm has a different level of investment towards each tender. To produce an estimate of a tender fund, it is important to have a holistic view of the tender costs that have been incurred by all firms on the past tenders and this depends on the accuracy and completeness of the tender costs data maintained by the firms.

Access to technology

We note that the CMA is encouraging the industry to consider technology sharing, and has requested views on this. As recommended in our response to the CMA's earlier ITC, examining open sourcing to assist firms in enhancing their technological capabilities could facilitate new entrants into the UK audit market, without the need for mandatory licensing. Accordingly, we do not believe the Big Four need to be compelled to licence their technology to challenger firms.

We would add that any mandatory licensing regime would need to take account of a number of factors (e.g., legal, operational and costs), which would impact on the viability and success of any proposed licensing arrangement. For example, what would constitute a "reasonable" cost and an "affordable"

[1] However, the CMA indicates that some of the other remedies proposed may reduce the necessity of this fund; CMA Update Paper, para 4.96.

licence for Big Four firms and challengers, respectively, will depend on factors such as the scope of the licences and/or risk of independence issues, data storage and protection requirements, the integration and compatibility with the systems of participating firms, the mechanisms for updating tools or withdrawing them, and so on. Consideration will also need to be given as to how the appropriate tools or technologies would be identified and the terms of the licences themselves.

Appendix A, Part 4

Remedy 4: Market Resilience

The CMA has proposed the creation of a market oversight and resilience regime in the event of a likely or actual failure of a large audit firm in the UK. The remedy is proposed in recognition of the role audit continues to play in the functioning of capital markets and other areas of the modern economy. Its purpose is to protect against the negative effects of further concentration in the audit market by ensuring there remains an adequate choice of auditors and by preventing companies audited by a failing Big Four firm from transferring to another Big Four firm.[1]

EY's position

EY recognises the important public interest role played by audit firms, and generally supports the introduction of market resilience measures as a concept. The failure of one of the Big Four in the UK would likely have significant adverse economic and social implications. Therefore, we embrace the opportunity to put appropriate and effective safeguards in place.

However, we consider that extensive analysis is required to ensure that the design and implementation of any resilience scheme is effective, has a sound legal basis and poses no risk to audit quality. We are concerned that the existing proposal, as presented in the CMA's Update Paper, will fail to achieve these critical objectives.

The level of uncertainty as to the fundamentals for the UK audit market

At the outset, it is critical to recognise that a crisis in a UK audit firm may result from actions and events outside of the UK or have implications outside of the UK, just as Arthur Andersen's failure in the US was experienced outside of the US. This speaks to the complexity of resilience measures for large corporations generally, but particularly for large audit firms whose primary assets are their people. This presents significantly different challenges and risks in terms of resilience than, for example, a standard manufacturing company would present. Adding to the complexity, the regulator will require the authority to share information and cooperate with regulators across borders in such situations.

Clarity over the operational structures of the Big Four and the nature and extent of the audit services they provide is a prerequisite to the effective design of a resilience scheme. To be effective, resilience schemes must take into consideration the numerous feasible scenarios that could prompt firm failure. There is no 'one size fits all' resilience solution. We perceive the CMA recognises this, given the range of options within its market resilience proposal.

However, multiple remedies suggested by the CMA propose to alter radically the ways in which UK audit firms operate (e.g., mandatory joint audit, market share caps, structural split of audit and non-audit businesses, operational split of audit and non-audit services). If implemented, these proposals will necessarily also alter the scenarios that might prompt firm failure. Moreover, the proposals are likely to alter them in highly uncertain ways given that so many of the approaches proposed by the CMA, and the interconnection of the CMA's proposals with each other, are untested in audit markets

[1] CMA Update Paper, para 4.103, 4.107, 4.108, 4.109.

anywhere else in the world. This uncertainty is likely to have an impact on the attractiveness of the UK audit market generally.

Furthermore, and as we set out in detail throughout this response, many of the CMA's proposals pose direct threats to the resilience of UK audit firms, introducing yet further unknowns as to the future of the market. Designing and implementing a resilience scheme in the absence of knowing the scenarios that might prompt a firm to fail will almost certainly result in significant gaps and in measures that are not fit for the new audit market environment.

Similarly, clarity over how the Big Four firms are structured and the nature and extent of the audit services they provide is also required to assess what resilience measures are necessary. By way of example, the service continuity plan for the provision of audits necessarily depends upon whether mandatory joint audits are introduced. This is because mandatory joint audits would require new ways of working, including, but not limited to, new applications of technology, the development of information sharing frameworks and, critically, a new approach to managing joint and several liability.

As another example, whether audit firms are structurally split, operationally split or not split at all has a direct bearing on what their continuity entails. It impacts the extent and nature of their reliance on third parties, their financial requirements and their human capital needs — to highlight just some of the many issues that would require consideration.

Through its other proposals, the CMA has introduced potential remedies that would radically alter the future state of UK audit firms. We stress that this must be resolved before meaningful work on the design of a resilience scheme can proceed. We further stress the importance of the regulator's involvement in the design and implementation of any resilience regime, and therefore urge that this work should take place following the implementation of any other CMA remedies and any proposals introduced by the Kingman Review.

The extent of new powers

At a high level, we consider that it would be possible to achieve the same intended objectives through a more narrowly tailored set of regulatory powers than those proposed. As an example, the CMA's proposal as currently described would afford the regulator not only the power to incentivise or mandate the movement of audited companies and staff to challenger firms, but also to appoint a special administrator to take executive control over failing firms. Robust safeguards would need to be simultaneously implemented with any expanded regulatory powers to ensure that the powers are used strictly for the purpose for which they are intended, and to enable intervention in the event of misuse.

Legal issues to consider

The proposed remedy suggests mandating that staff of a distressed firm either remain at a distressed audit firm while a special administrator attempts a turnaround of the firm or that they be required to move to a challenger firm. We question whether broadly restricting where staff can work can be lawfully accomplished, as it would fetter individuals' ability to participate freely in the market

The proposed remedy similarly suggests mandating that audited companies either remain at a distressed audit firm while a special administrator attempts a turnaround of the firm or that they be required to move to a challenger firm. We note that this would require legislation and has the potential to harm audit quality, either by constraining a company to continue its audit contract with a firm that may well have become distressed because of audit quality issues, or by impelling that company to contract with a challenger firm that may lack the requisite capability or capacity. Both outcomes reflect a potentially severe limitation to choice.

Other issues to consider The CMA's proposal suggests several additional potential measures, including:

- appointing a special administrator to take executive control of failing firm
- ringfencing firm equity relating to both audit and non-audit partners
- using that equity to pay the fees of the regulator and/or a special administrator
- using that equity to incentivise staff and partners to remain at the distressed firm or to transfer to a challenger firm
- prohibiting equity distributions to partners of a distressed firm unless a successful turnaround is achieved

We believe it is critical that the legal implications and potential for unintended adverse consequences be thoroughly examined before any of these measures are implemented. As we have stressed, this should occur with the heavy involvement of the regulator and following the implementation of any other measures that may have an impact on audit and the audit market.

Additional considerations for the CMA include:

- the impact of a special administrator on a 'people business' with long-term contracts
- the impact of the Transfer of Undertakings (Protection of Employment) Regulations 2006 on the transfer of audited companies and staff
- how trading losses would be funded
- how liabilities such as litigation, fines and sanctions arising from previous audits will be handled
- the likely impact to challenger firms of aspects of this remedy

Ongoing work by the FRC

We are actively engaged with a programme of audit firm contingency and resolution planning work currently being led by the FRC. Although that programme is presently in its early stages, we are hopeful that as it progresses it will help to achieve several of the aims of this remedy, while avoiding many of the issues noted above.

Building a better working world

Appendix A, Part 5

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

Separation, whether structural or operational, is a radical proposal.

We agree that mitigating conflicts in order to deliver an objective, high quality audit is critical. The key to managing conflicts is a strong governance framework with supporting controls and incentives, overseen by an appropriately empowered regulator. The FRC's oversight was starting to be enhanced through, for example, the revised Audit Firm Governance Code, cultural thematic reviews, the Audit Firm Monitoring Approach and ISQM1 (International Standard on Quality Management) implementation which addresses quality management at the firm level. If the UK had a sufficiently strong regulator and governance frameworks in place for audit firms, then it is unclear what additional benefit separation would deliver.

Instead, we suggest a broader review of all measures available to tackle conflicts and their consequences for culture, quality, choice and cost.

EY's position

Neither a structural nor an operational separation is an improvement over the status quo in addressing concerns over audit quality, choice or competition. Neither proposal will reduce the risk of corporate failure. The consequences of increased cost and increased risk to audit quality will be undesirable to organisations, their shareholders, and wider stakeholders.

Full structural split would create an audit business that would be less resilient, with reduced capacity for investment, and which, consequently, would be less able to withstand exceptional costs.

Audit quality would be negatively affected by the loss of the existing multi-disciplinary model and the loss of seamless access to non-audit skills and expertise. This is relevant for all audits, but particularly for complex companies. For example, a global mining audit uses up to 15 different non-audit specialist teams. It would also have severe consequences for multinational companies, which need ready access to their auditor's global network. Neither choice nor competition would not improve.

Further, the market would become less attractive to new entrants, who could be deterred by the challenging commercial model (discussed in greater detail below), a tougher regulatory and legal environment and resourcing difficulties.

The costs of implementation to existing firms would be substantial, and in respect of pensions, potentially prohibitive. We see no benefits. With multi-year implementation timescales, the distraction for firms would result in a reduced contribution to the UK economy, at a time when the economy is already challenged with Brexit and difficult global economic headwinds. It also threatens further progress on improvements to audit quality, which is our key focus.

The separation of audit and non-audit profit pools, as proposed in both the structural and operational split, risks lasting damage to the quality and resilience of the firms and the market as a whole. Tying the audit and non-audit businesses together economically, overseen by appropriate governance and controls, helps drive a uniform culture with audit at its centre. Given the significant support that multi-disciplinary specialists in the non-audit businesses provide to the delivery of the core audit, it is very much in the entire UK firm's interest to adhere to the audit-led governance and policies.

Audit is the *raison d'etre* of the firm, but it is not as profitable as other parts of the firm. This is not, as often described in the press, because audit is a loss leader used as a platform to cross-sell lucrative consulting contracts. Rather, it is a reflection of the current market price for audit and the rising costs of undertaking audits, particularly given increasing regulation, rotation requirements, and the increasing number of diverse specialists necessary to support the audit. The inefficiencies introduced by the separation will increase the cost base and drive higher fees.

In section 1 below, we set out the challenges we see with the separation proposals; in section 2 we identify elements of the proposals that could result in enhancements to the existing model, and finally in section 3, we set out some alternative mitigating strategies. All proposed changes need further evaluation in order to establish benefits, avoid unintended consequences as far as possible, and ensure that in implementing change we do not sacrifice the strengths of the current model and the ability to invest in quality, innovation and talent retention.

1. Challenges with the separation proposals

Financial consequences of the proposal

People costs makes up the bulk of an audit firm's expenses. The partners and staff in the audit practice benefit from the higher overall profit pool of the UK firm (to help manage any volatility in audit profit). We set out how any potential conflict is managed in section 3 under 'Performance and Incentives'.

Under either separation model, unless audit could draw on the firm's larger profit pool as needed, audit compensation would be volatile and lead to a talent drain from the audit practice. This would present a clear and significant risk to audit quality.

Any proposed audit-only business would be smaller and less resilient. For example, the audit of a large company would be proportionately more important to an audit-only firm, than to the combined UK audit and non-audit businesses. This could impact decision making in ways that undermine the aims of this proposal (Article 4.3 of EU audit regulation highlights this risk). Some consider that amongst the contributing factors in the downfall of Andersen was the incentive to achieve a certain financial return after separation, resulting in the practice taking on riskier companies. Consider also, in that example, the scale of an individual company's audit (e.g., Enron) as a proportion of an audit practice's business. A number of substantial one-off costs of doing business - such as the loss of large audits and the take-on costs of new ones (driven by EU audit rotation requirements), and increases in business costs, fines and other sanctions, would be difficult - and in some cases prohibitive - to absorb. The firm would also be less able to withstand significant shocks, for instance as a result of damage to its audit reputation, or as a consequence of a destructive cyber-attack. As a result, the risk that one of the larger firms could be forced to exit the UK audit market would increase, effectively putting current choice at risk. This, in turn, could damage the reputation of the UK from a corporate governance perspective, impacting continuity of audit service and coverage of the FTSE, and decreasing competition.

Separation could also require a reshaping of current audit practices, potentially necessitating consolidation of offices and the reduction of employment outside London, a result which would be harmful to the broader UK economy.

Capacity for capital investment and innovation would also be likely to reduce. The audit firm would probably have to bear a greater share of some existing costs, e.g., funding of the defined benefit pension scheme, as well as the cost of increased professional indemnity insurance due to the unlimited liability nature of the work. These consequences, again, would pose risks to audit quality and firm resilience.

Continued investment in new technology, methodologies, staff training and development, and quality assurance is critical for supporting continuous improvement in audit quality and advancement in audit delivery. Audit must keep pace with the increased sophistication of organisations being audited, new and evolving regulations and the subsequent needs of stakeholders. Less investment capacity in the UK would lead to a decline in the pace of advancement, putting the profession at odds with the companies it audits and potentially increasing the expectation gap.

The effect of separation on cost and audit pricing should be assessed by the CMA, as these could be significant. Due to the timeline, the high-level nature of the proposals and wide number of possible assumptions, we are not yet in a position to quantify the impact.

Consequences of separation for the existing operational model

The importance of the multidisciplinary firm in delivering an audit

Essential to the delivery of high quality audit is seamless and continual access to a variety of specialist disciplines. This need increases with the complexity of technology and as audit automation improves. The expectations of a statutory audit amongst regulators, companies and other stakeholders will only continue to increase. The scale and multidisciplinary nature of the current operating model means that auditors can find the specialist skills they need in-house, and easily and efficiently integrate them into the core audit team. Specialists used in an audit include, for example, actuarial, valuation and business modelling, risk management, real estate, conduct and compliance experts. A series of benefits is gained from in-house resources, including:

- Specialists work on both audits and non-audit engagements, which hones their skills and knowledge and improves their ability to provide services that reflect the context of the broader market. This breadth of experience adds tangible value to audits and is directly related to improving audit quality standards.
- The present model is cost-effective for audit: the audit recipient only pays for the specialists' time that it uses. Under full separation, the audit practice would bear the full year-round employment cost of the in-house specialists, but it may be unable to use the specialists' services throughout the year, given the seasonal nature of audit commitments. The limitations of the contractor model are set out further below.

By removing easy access to specialists and necessitating new recruitment of high-value skills, full structural separation presents a distinct threat to audit quality both at the point of implementation and on an ongoing basis.

The alternative operating model - obtaining specialists from third parties - raises many issues. For instance:

- The need for extensive use of third-party providers may present additional risks to the control of the audit partners over critical resources, and increases the complexity of delivering a high quality audit;

- Management of conflicts and independence would become more challenging as specialists would not necessarily want to comply with these restrictions, and monitoring becomes more difficult without common systems and regular reviews;
- The level of challenge in higher-risk areas may be lower if third party specialist resources are used rather than in-house resources due to time commitments and continuity issues driven by the commercial basis of the arrangement and more limited opportunity to observe and raise challenges;
- Specialists currently help to upskill and continuously improve the audit team and the work product in their area of expertise; it is not clear that this would happen if the specialists were third parties;
- The audit firm would move from paying a cost rate to a market rate for specialists, which would increase the overall cost of the audit;
- New challenges over data sharing and liability would arise (see points made in Appendix A, Part 2 on joint audits for further explanation); and
- In-house specialists accompany the audit teams to sensitive meetings and governance forums including with the Audit Committee. If these specialists are third parties this is less likely to happen.

Impact on the ability of the firms to deliver a consistent, high-quality audit internationally

A further consideration is the international nature of the firms' audit portfolio. Over 80% of the FTSE100 have significant overseas operations. This has two implications for present purposes:

- Significant amounts of audit work would occur outside of the UK and be performed by network affiliates that would not be subject to the proposed UK requirements around separation and that may still have fully-integrated multidisciplinary practices. This will impact any attempts to achieve an "independence separation".
- In many large audit firms, including EY, audit is run as a global service line, with consistency of approach, methodology and technology based around high quality standards. This allows the efficient management of complex multi-jurisdiction audits. In this closely integrated model, one firm takes on unlimited liability for the audit on behalf of the other firms in the network. Dislocation of the UK audit business will challenge the integrated model, and so increase risks to audit quality.

Impact on the retention of talent

The quality of audits is highly dependent on the quality of the people delivering those audits. Separation would pose significant risk to retention, particularly of the most talented members of the practice:

- We pride ourselves on the quality, intellect, skills and integrity of our audit teams. To maintain this workforce at scale, our people proposition needs to remain highly attractive. Although we do not anticipate challenges in attracting new joiners at graduate level, the proposition to retain talent within the audit firm post training contract and up to partner level would be at risk. The comments above on resilience are also relevant, as the financial strength of the existing business provides a level of job security to our people which is essential in retaining talent and therefore delivering the best quality audits.
- It is unlikely that an audit-only portfolio will be attractive to specialists, given restrictions it will place on their career development, and the likelihood that the audit business would pay lower compensation. Consequently, the availability and quality of hires would suffer and coupled with

the reduced capacity for investment in technology and skill development, there would be associated risks for audit quality.
- The partners currently leading audits have skillsets that are valuable outside of the profession. Reward, particularly compensation and career progression, needs to be sufficiently appealing, and to compensate for risk and the significant personal liability that signing audit reports carries. If the balance alters as a result of separation, then many more attractive career options may be available to them, risking a step change in attrition ultimately leading to audit quality risk on our most complex audits and viability challenges to the firm

Other considerations

By implication, the full structural separation proposal suggests that:

- All support functions would need to exist within each of the two separated entities (the audit and non-audit businesses) and this would be disproportionately expensive and inefficient for the size of the UK audit revenue base.
- Anything provided by the international network would be priced on an arm's length basis. Determining whether there was an implicit subsidy in services provided by the global firm, e.g., payment for technology services provided, would be complex.

We ask that further analysis is performed to understand whether and the extent that this proposal would increase choice and to properly assess what is lost through a separation of the audit firm from the rest of the firm, as well as the impact on quality.

Consequences for choice

The audit and non-audit services businesses of EY in the UK would both remain part of the global network, using the common EY brand. Consequently, the existing independence rules would remain in force for both entities, as they would do for the rest of the global network. This would result in the continued assessment by the audit firms and the public interest entities (PIEs) as to whether the firms were better placed to provide audit or non-audit services. If they came down on the side of non-audit services, their pool of potential auditors would be reduced. We believe that having seamless access to specialists through an international, multidisciplinary model is critical for audit quality and therefore we are unclear as to how this remedy would increase choice.

Increased operating costs, as well as a reduced potential to grow, as part of a global multi-disciplinary firm, would reduce the attractiveness of the audit market for new or growing players. As observed in many other markets, higher barriers to entry prohibit competitive forces, and indeed frequently stifle existing levels of competition.

Implementation costs

Significant cost and management time would be required to design and implement full structural separation, over a minimum period of at least two years. This time could be better spent investing in quality initiatives, technology and training to further enhance the firm's audit capability.

Implementation of a full structural separation would be highly complex and difficult to deliver without impacting companies being audited (as well as those receiving non-audit services). Depending upon the detailed requirements, this could lead to substantial re-tendering of audit contracts (including PIEs), re-papering of contracts, staff / TUPE consultations, establishment of new service frameworks, new employee propositions, sourcing third party supply chains and negotiation with internal and external counterparties.

The impact of any separation on the funding for the legacy defined benefit plan is likely to be significant in the context of the UK business. We have considered whether the defined benefit plan could be split or sectionalised as part of any separation in order that each business could manage its liability exposure appropriately going forward. Further analysis is required, but our initial observations are as follows:

- The vast majority of the liabilities relate to deferred and pensioner members who were former (and legacy employer) employees spanning many decades in the past.
- It will be extremely challenging, if not impossible, to split the liabilities fairly using a pragmatic approach given the historical evolution of the businesses.
- Building on this point, any split in the business is also likely to be perceived by the pension scheme trustee (the Trustee) as having a detrimental impact on the employer covenant. Considerations for the Trustee will include challenges in evaluating the risk profiles, with a focus on the revenues and profitability of the newly created businesses, and losing the benefit of having a diversified assurance and non-assurance business supporting the scheme.
- Given the emergent risks, and the complex nature of the decisions to be made, the Trustee (and the Pensions Regulator) is likely to approach any split or sectionalisation of the scheme and future funding on a cautious basis to ensure that no members incur an impairment of the security of their benefits.
- In particular, the Trustee is likely to move to a more cautious investment strategy and look to recover the current sizeable deficit over a shorter period, which could lead to a significantly higher funding burden being placed on the business and the current generation of partners. Further modelling needs to be performed to understand whether this would be prohibitive.
- This would negatively impact the ability to attract and retain talent in the business and reduce scope for investment in quality-enhancing initiatives, all of which are considered paramount to deliver a high quality audit.

Considering the changed operating model, reduced financial viability and significant implementation impacts, it is likely that the PIEs would see sizeable increases in audit fees, and suffer potential disruption and inconvenience.

Difficulty of implementation risk given the scale of change

Audit firms are still adjusting to the impact of the EU Audit regulation, particularly concerning mandatory audit rotation. This required significant resources and expense and has seen substantial changes in portfolios amongst the Big Four firms. The firms are also continuing to invest heavily in increasing quality. The measures proposed under the CMA consultation, such as joint audit and operational separation, are individually substantial - and significantly more so as a package. There are also further significant changes anticipated in the upcoming reviews on audit scope and corporate reporting that will impact the audit firms. Recommendations made by the Kingman review are also expected to require additional actions to be taken and the associated costs absorbed by the audit firms. The combined scale of such change will stretch the firms and test their resilience. These changes need to be viewed holistically and consideration given as to whether they are achievable and sustainable. Dependencies, such as the review of the PIE definition, will need to be recognised and any final measures resulting from the CMA's market study will all need to be implemented over a reasonable timeframe. Any failure to consider the proposed changes in the round will risk adverse outcomes including reduced audit quality, lack of capacity, lack of continuity of service, and issues from failure to sufficiently comply with the substantial list of new requirements.

2. Elements of the proposal that could result in improvements to our existing model

An important element of the proposed separation is the establishment of audit with its own governance arrangements. The audit practice would be responsible for oversight and management of all aspects of the business, including investment. Certain features of the proposed remedy are already in place at EY. For example, audit has its own Audit Quality Board overseeing investment and audit quality. Audit partners are subject to specific performance management and remuneration processes based primarily on audit quality.

We would welcome a review of best practice for the firms if this helps to further enhance governance and oversight, our culture and the delivery of high quality audits on a sustainable basis.

Any moves to enhance governance of audit firms needs to be properly investigated and understood given the potential effect on audit quality. The best entity to perform this investigation would be the new Audit, Reporting and Governance Authority when it is constituted. Audit quality is protected within the multi-disciplinary model through strong governance, a consistent tone from the top, policies, incentives, reward and internal oversight of non-auditors working on audits. We set out further detail on these aspects below.

We have had a strong and continuous focus on improving our governance for many years. We set out our governance structure at Table 1 below. This structure supports the principles of the FRC's 2016 revised Audit Firm Governance Code (AFGC) as well as Article 13 of the EU Audit Regulation (537/2014). (further detail can be found in our Transparency Report - link). We have recently made the following enhancements to reinforce the protection of audit quality within the multi-disciplinary model:

- In 2017 EY UK established an Independent Oversight Committee (IOC) comprised of three Independent non-executives (INEs), a year ahead of the timeline required by the AFGC. The IOC's role is collectively to enhance EY UK's performance in meeting the purpose of the AFGC which provides a benchmark of good governance practice against which audit firms, that audit listed companies, can report. It is also important to note that one of the AFGC's principal objectives for the regulation is to ensure that appropriate measures are in place to reduce the risk of firm failure (page 5)[1]. The AFGC has also placed a greater onus on the firm's INEs, by substantially expanding their responsibilities in assessing the firm's culture, supporting the firm's public interest role and ensuring the long-term sustainability of the wider business. These new responsibilities require the INEs to have full visibility of the entirety of the business. Given the global nature of the business, one of the UK firm's INEs, David Thorburn, is also a member of the Global Governance Council (GGC) and chairs the EY global Public Interest Committee (PIC).

- In response to the changing environment, and to ensure that we uphold our obligation to protect and serve the public interest, we have enhanced our robust conflicts procedures by establishing a new Conflicts Panel. This panel was established in June 2018 and was formed to consider both high-profile reputational matters and to challenge engagement acceptance, taking into account

[1] https://www.frc.org.uk/getattachment/8e2026c0-cac0-4faa-8326-4713511f139a/Audit-Firm-Governance-Code-July-2016.pdf

the Objective, Reasonable and Informed Third Party test. The panel is chaired by the Regional Conflicts Leader and the EY UK Ethics Partner and is comprised of senior partners from across the firm.

In our response to the ITC we proposed giving specific responsibility and accountability for audit quality to senior executives of the firm. We believe that a formal recognition of senior management responsibility would strengthen the focus from the top of an organisation and further highlight the importance of audit quality across the firm, and not just to the audit practice.

Both the IOC and Conflicts Panel have a remit that extends across all EY's business lines in the UK. This is important to ensure that the tone from the top and requirements from a conduct and conflicts perspective are consistent for everyone providing audit services – whether from within the audit or non-audit part of the business. This is supported by a global code of conduct and firm-wide systems, policies and training on conflicts and risk management.

As you will see from Table 1, which identifies all our governance committees, the tone from the top places a heavy emphasis on audit and risk.

In addition, a more powerful, better-resourced and independent regulator - in line with the proposals of the Kingman review - will be more effective than a split of the firms in protecting audit quality and culture.

3. <u>Alternative strategies to mitigate conflicts</u>

The elements of operational separation which we view as counterproductive to the improvement of quality and choice are the proposals to separate the audit entity's profits and pension pool as we set out in section 1 above. The driver for separating audit profits appears to derive from a perception that, if audit partners are compensated from the UK firm profits, they will be incentivised to operate differently and in ways that detract from their duty as auditors. Coupled with this is a perception that the culture in the audit practice is influenced by the firm's advisory businesses, and that together these two things may weaken independence and professional scepticism. We consider these issues below:

Profit Pools

We have already set out our views on the likely negative impacts of separating audit profits. The stipulation that transfers between the two entities could only be in respect of the hiring of specialists for audits ignores other valid categories of transfer of value between the two entities. Valid financial transfers between the two sides of the business should be permissible. For instance, the audit practice makes an important contribution to brand and reputation, and to the firm's risk management and compliance frameworks, for which it should be compensated.

The risk of incentives adversely impacting partner behaviour is already mitigated as set out below under 'Performance and Incentives'. If a part of the intent behind the stipulation on separate profit pools is to be able to measure financial performance, resilience and investment in the audit business, this can be achieved more simply by enhancing the firm's existing internal financial reporting. The influence of the wider firm could be limited to agreement of a high-level budget, with audit management taking responsibility for detailed budgeting and performance management. This would create an effective ringfence and greater transparency to the regulator responsible for supervising the firm's audit business.

We are open to assessing the relative effectiveness of incorporating a board for audit into our corporate governance structure to formalise the alternative strategies for mitigating conflicts set out above. The primary remit of the board would be to protect the integrity of the audit practice. The board would be accountable for overseeing the financials of the audit practice, approving and monitoring investments, monitoring audit quality and improvement initiatives, culture and culture change, resilience, risks and risk management. The board would also have the power to veto or sanction investments by the whole firm that could impact audit quality

Culture

The firm's culture developed in the heavily audit-dominated business of the 1980s. Many key cultural traits from this era, including risk perception, professionalism and ethics, remain at the cultural core of all areas of the firm today. The audit and non-audit businesses share a common code of conduct, training, risk management and independence requirements. As seen from the governance arrangements as described above and as set out in Table 1, the tone from the top is set through the prism of audit and risk.

We welcome the challenge provided by the FRC in its cultural review issued in May 2018, which will drive greater transparency over the culture in the firms. The review has triggered a programme of work to better promote and embed an appropriate audit culture and to emphasise the purpose of the audit and its value in society. All partners suffer financial penalties for non-compliance with risk management policies. In addition, quality is the dominant measure in partners' performance and profit share evaluation.

Performance and Incentives

One aspect of incentivisation is compensation. Audit partners' compensation is based upon their performance, which is measured against a set of metrics focused on audit delivery and audit quality. The quantum of reward may be affected by being derived from a UK firm as opposed to a UK audit practice profit pool, but the allocation method is solely focused on performance as an auditor.

An independent assessment of an individual partner's quality and risk management approach is made by an independent panel comprising quality leaders, the risk management team, the audit practice Managing Partner and a representative from the partner forum. The quality assessment covers all partners and associate partners who have a meaningful role in the delivery of an audit and so will include the IT and other specialists who may sit in the non-audit part of the business. The quality rating will reflect a range of partner performance - recognising best practice by some and identifying areas for improvement in others. This assessment is based on a combination of factors including attitude, commitment, outcome of independent audit quality reviews (Audit Quality Review and the FRC's Audit Quality Review Team results), satisfactory completion of mandatory learning, adherence to internal policies and other metrics which measure quality matters. Any quality concerns will result in, at a minimum, a cap on the profit share that partners can receive. The quality assessment has the single greatest impact on the overall rating. This is an area that the regulator reviews as part of its inspection to check that the incentives are aligned to the objective of delivering a high quality audit and that any audit quality concerns are reflected in the relevant partner's pay.

In addition to being measured on audit quality for their own audits, partners are also judged on whether they have contributed to the overall improvement of the audit practice.

Separately, all partners in the firm are subject to a sanctions regime, which is designed to address conflicts and other aspects of compliance with regulation and the firm's policies and code of conduct.

At an individual level the audit staff are measured on criteria designed to promote high quality and avoid conflicts of interest. All audit staff are assessed on quality at year end.

In terms of incentives aligning to our culture, we have recently launched our "Fulfilling Careers" programme. This links the role of the auditor to the societal purpose of an audit. We have also introduced Purpose Led Outcome Testing (PLOT) on individual engagements to help the auditor and specialists focus on what they are trying to achieve with their testing, and encourage scepticism. We have already seen a consequent positive shift in the mindset of individuals delivering audits.

We assess our audit culture through a specific culture assessment tool and through our global people survey. The UK culture assessment tool is now being adopted on a global basis.

We would be prepared to review this area in the light of any emerging best practice.

Conclusion

In summary we do not see how either type of split addresses concerns over conflicts impacting culture and choice. Audit quality is better protected through other measures focused on governance and incentives as set out above, overseen by an appropriately empowered regulator. Post separation, the operational complexity of delivering a high quality audit would be significantly increased. Any changes must not sacrifice the strengths of the current model and the ability to invest in quality, innovation and talent retention.

The safeguards against conflicts already in place should be reviewed for their design and effectiveness. We are open to adopting targeted enhancements and complementary measures, but only after these have been thoroughly analysed. This is essential to avoid any unintended consequences of the models, which would likely be adverse for stakeholders.

Table 1: Governance structure and applicability

Note that all of these boards and committees have authority over both the audit and non-audit businesses in the UK.

Board/Committee Name	**Remit**
The Board of EY UK (The Board) Chaired by UK Chairman and CEO	The Board is responsible for overseeing the conduct of the UK firm's business units and compliance with all applicable professional, regulatory and legal requirements.
Independent Non-Executive (INE) Oversight Committee (IOC)	The IOC's role is collectively to enhance EY UK's performance in meeting the purpose of the Audit Firm Governance Code (AFGC). The AFGC provides a benchmark of good governance practice against which audit firms, that audit listed companies, can report.

Chaired by an INE	
Conflicts Panel (CP) Established June 2018 Chaired by Regional Conflicts Leader and EY UK Ethics partner	In situations that have potential for a conflict or damage to the reputation of the firm, we now have the ability to escalate to a Conflicts Panel. This panel consists of senior leaders who add further challenge to engagement acceptance and provide informed views.
Risk Oversight Committee (ROC) Chaired by EY's General Counsel and Managing Partner for Risk and Legal	The ROC is the senior risk management committee for EY LLP. Its primary mandate is to support the Board of EY UK in its assessment and management of risk across the UK firm.
Audit Quality Board (AQB) Chaired by UK Head of Audit	The AQB meets monthly and covers all parts of the practice that operate under the UK audit license. The IOC has oversight over the AQB's work and INEs are invited to AQB meetings.
Code of Conduct Committee (CCC) Chaired by a Senior audit partner	EY also has a Code of Conduct Committee, which covers all partners in EY LLP in all parts and business units of the practice. The EY Global Code of Conduct ('the Code') provides the ethical framework on which we base our decisions – as individuals and as members of our global organisation. The Code provides a clear set of standards for our business conduct.

Appendix A, Part 6

Remedy 6: Peer reviews

The CMA has proposed implementing a system of third party peer reviews as part of the regulator's tool kit. The intention is to provide an additional, independent check to identify and deter underperformance, thereby improving audit quality.[1]

EY's position

We support the spirit and intent of this remedy. However, it raises several issues requiring comprehensive analysis, particularly regarding liability, cost and the effect on choice whereby a firm may be prohibited from tendering due to having undertaken such a review. We believe the desired goals of this proposed remedy would be more readily achieved through a strengthened regulator. It is also unclear how peer review would fit with the proposal for mandatory joint audits, as the suggestion appears to be to add an additional layer on top of joint audits.

Peer reviews as part of the oversight regime

The concept of peer reviews was tainted in the US following the collapse of WorldCom and Enron, at a time when peer reviews were mandatory. This led to the 2002 enactment of the Public Company Accounting Reform and Investor Protection Act and the Corporate and Auditing Accountability, Responsibility, and Transparency Act, collectively and colloquially known as the Sarbanes-Oxley Act (SOX). This replaced mandatory peer reviews in the US with a system of independent inspections of audits by the Public Company Accounting Oversight Board (PCAOB). Academic research indicates that public inspectors are regarded as more independent than reviewers, and that, by comparison, the validity of peer reviews is impaired.[2]

The topic of audit reviews was addressed in the EU with the 8th Company Law Directive, commonly referred to as the Statutory Audit Directive 2006. This legislated for audit oversight regimes in all EU member states.[3] It requires, amongst other things, that such regimes shall:

- be independent from the profession: '*quality assurance system shall be organised in such a manner that it is independent of the reviewed statutory auditors and audit firms and is subject to public oversight';*

- apply a minimum scope of review, supported by an adequate testing of audit files: '*an assessment of compliance with applicable auditing standards and independence requirements, of the quantity and quality of resources spent, of the audit fees charged and of the internal quality control system of the audit firm*'; and

- be adequately resource: 'the quality assurance system shall have adequate resources.'

Each of these requirements should be fully considered in connection with the design of the peer review regime, although we would expect the regulator to determine the scope and frequency of their review.

[1] Update Paper, Paras. 4.139, 4.140.
[2] From peer review to PCAOB inspections: regulating for audit quality in the US. Lukas Lohlein, London School of Economics and Political Science, July 2016.
[3] Article 29, Statutory Audit Directive (Directive 2006/43/EC of the European Parliament and of the Council, 17 May 2006). Transposed into the UK Companies Act 2006.

Other considerations

Peer reviews would give rise to new risks and potential liabilities for the firm conducting the review. The regulator would therefore also need to determine whether the individual and audit firm would need to be independent of the corporate entity whose financial statements were being reviewed. This may depend on the scope of the review. It would also have a direct impact on whether a firm is able to take part in a company's audit tendering activity, or whether its participation in a peer review will cause it to be conflicted, thereby reducing choice for the company tendering.

Other considerations raised by a system of peer reviews include the following:

- the potential for it to delay the length and also increase the overall cost of the audit;
- how liability would be shared between the auditor and reviewer; and
- determining the process by which a disagreement between the audit firm and reviewer might be resolved and the impact for the company concerned, both commercially and in terms of its market value.

Building a better working world

Appendix B

Responses to the 27 Consultation Questions posed at Box 6.1 of the Update Paper

	Question	Response
	(A) Issues	
	Overall	
1	Do you agree with our analysis in section two of the concerns about audit quality?	We recognise the importance of re-establishing the highest levels of trust in the UK business environment, including, but not limited to, improving audit quality. Any reforms proposed must not come at the expense of audit quality. We were pleased to note that the CMA recognised that audit failure is not solely responsible for corporate failure and that the expectation gap must be addressed.
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.	In Appendix C to the Update Paper the CMA comments on the "expectation gap" – what audit is and could be vs the public expectation of what it is should be. We believe this is the fundamental cause of public concern around audit quality. The Brydon Review will consider this, and so will be fundamental to making sure that reforms drive audit quality.
	(B) Remedies	
	All remedies	
3	What should the scope of each remedy be? Please explain your reasoning. For example, should each remedy apply to all FTSE 350 companies, or be expanded to include PIEs or large privately-owned companies that could be deemed to be in the public interest?	Remedies related to market structure should focus on the FTSE350 market, as this is where the greatest impact of deficient audit quality can be felt and where most of the concerns regarding competition issues lie. Remedies related to audit firms must apply to all audit firms who audit these companies, to address the CMA's concerns about culture.
	Remedy 1: Regulatory scrutiny of Audit Committees	
4	How could the regulatory scrutiny remedy be best designed to ensure that the requirements	Please see our response at Appendix A, Part 1

	placed on Audit Committees by a regulator are concrete, measurable and able to hold Audit Committees to account? Please respond in relation to requirements both during the tender selection process and during the audit engagement.	
	Remedy 2: Mandatory joint audit	
5	What should the scope of this remedy be? Please explain your reasoning. a) Should the requirement to have a joint audit apply to all FTSE 350 companies or potentially go wider by including large private companies? b) What types of companies (if any) should be excluded from a requirement for joint audit?	Please see our response at Appendix A, Part 2
6	Should one of the joint auditors be required to be a challenger firm? If so, should this be required for all companies subject to joint audit? Are there any categories of companies to which this requirement should not apply? Please explain your reasoning for each of the answers.	Please see our response at Appendix A, Part 2
7	Should a minimum amount of work (and fee) allocated to each joint auditor be set by a regulator? If so, should the same splits apply across the FTSE 350? (please comment on the illustrative examples in section four). Please explain your reasoning.	Please see our response at Appendix A, Part 2
8	Our provisional view is that there would be merit in the joint auditors being appointed at different times. Should this be mandated, or left to the choice of individual companies? How should companies manage (or be mandated to manage) the transition from a single auditor to joint auditors?	Please see our response at Appendix A, Part 2

9	Should a joint liability framework be introduced to encourage active participation in the market by the Big Four and challenger firms? Please explain your reasoning. In the context of joint audits, what are the advantages or disadvantages of auditor liability being proportionate to the audit fee of the joint auditors, compared to the auditors being jointly and severally liable?	Please see our response at Appendix A, Part 2
	Remedy 2A: Market share cap	
10	How could the risks associated with a market share cap, such as cherrypicking, be addressed?	Please see our response at Appendix A, Part 2A
11	Would it need to apply only to FTSE 350 companies, or also to other large companies, and if so, which?	Please see our responses at Appendix A, Part 2A and Question 3 above
	Remedy 3: Additional measures to reduce barriers for challenger firms	
12	We welcome evidence from stakeholders on the existence of barriers to senior staff (including partners) switching quickly and smoothly between firms. We also welcome views on how justified such barriers are, bearing in mind commercial considerations that audit firms have.	Please see our response at Appendix A, Part 3
13	We welcome estimates on the costs of setting up and running a tendering fund or equivalent subsidy scheme, and views as to how this should be designed.	Please see our response at Appendix A, Part 3
14	We welcome comments as to whether the Big Four should be compelled to license their technology platforms at a reasonable cost to the challenger firms, and/or contribute resources (financial, technical, algorithms and data to enable machine learning) towards developing an open-source platform. In the first scenario, we also welcome comments on how such a 'reasonable cost' might be determined in such a way that it is affordable for challenger firms but	Please see our response at Appendix A, Part 3

	does not disincentivise Big Four firms from innovating and developing new platforms.	
	Remedy 4: Market resilience	
15	How could a resilience system be designed to prevent the Big Four becoming the Big Three, not just in the case of a sudden event, but also in the case of a gradual decline? Please also comment on our initial views to disincentivise and/or prohibit the movement of audit clients (and staff) to another Big Four firm.	Please see our response at Appendix A, Part 4
16	How could such a system prevent moral hazard? Please comment on our initial view.	Please see our response at Appendix A, Part 4
17	What powers would a regulator and a special administrator require, and how would their roles be divided? At what point should a regulator or a special administrator be able to exercise executive control over a distressed firm? Please comment on our initial view.	Please see our response at Appendix A, Part 4
18	What could be done regarding the challenges relating to the fact that an audit firm's value lies in its people and clients – which would be complicated to restrict? Please comment on our initial view.	Please see our response at Appendix A, Part 4
	Remedy 5: Full structural or operational split	
19	Do you agree with the view that the challenges to implement a full structural split are surmountable (especially relating to the international networks)? If not, please explain why it would be unachievable, i.e. that the barriers to implement this remedy could never be overcome, including through a legislative process.	Please see our response at Appendix A, Part 5
20	How could an operational split be designed so that it would be as effective as the full structural split in achieving its aims, without	Please see our response at Appendix A, Part 5

	imposing the costs of a full structural split? In your responses, please also compare and contrast the full structural split to the operational split.	
21	With regards to the operational split, please provide comments on: a) implementation risks and whether they are surmountable: e.g. how any defined benefit pension schemes could be separated between audit and non-audit services; b) risks of circumvention and how they could be addressed e.g. how audit firms could circumvent the remedy through non-arm's-length transfer pricing and cost allocations; c) implementation timescales to separate the audit firms and how soon the remedy could be brought into effect; d) ongoing monitoring costs for the audit firms and a regulator; e) role and competencies of a regulator in overseeing ongoing adherence to the operational split.	Please see our response at Appendix A, Part 5
22	Under an operational split, how far, if at all, should it be possible to relax the current restrictions on non-audit services to audit clients? For example through changes to the blacklist or to the current 70% limit.	An operational split is unlikely, based on current standards, to result in any relaxation of the current restrictions on non-audit services to organisations they audit as the audit firm would remain a member of the international network. This seems perverse and will do nothing to address choice in the market. Under most independence standards NAS restrictions generally extend to the audit firm and any firms that fall within the definition of a "network". A network is defined by FRC, EU and IESBA as the following: network means the larger structure: – which is aimed at cooperation and to which a statutory auditor or an audit firm belongs, and

		– which is clearly aimed at profit- or cost-sharing or shares common ownership, control or management, common quality-control policies and procedures, a common business strategy, the use of a common brand-name or a significant part of professional resources Under an operational split (and indeed under a full structural split) as described in the audit market update paper the non-audit business would continue to be a member of the international network firm and therefore will be required to comply with the NAS restrictions. The 70% fee cap under the EU Audit Regulation does not apply to the network. However, the FRC's Ethical Standard has extended this to the network. A revision to the Ethical Standard could in theory limit this to the audit-only firm.
23	Should challenger firms be included within the scope of the structural and operational split remedies?	The rationale for the structural or operational split is conflicts of interest and knock on impact on culture, particularly as it relates to quality and competition. Conflicts and culture are not specific to the size of a firm and therefore the challenger firms should not be excluded from any remedies. The challenger firms typically have a higher percentage of NAS delivered to organisations they audit therefore any exclusion would be to prioritise increased competition over quality and would not address the primary aim of the remedy around the negative effect on the culture of the audit practice that can result from being part of the multidisciplinary firm A consequence of the remedy is likely to be that the scale of the Challenger firm may be reduced in the short term, as they may find it more difficult to get the additional staff and specialists that they need. They are also likely to suffer more from seasonality in their portfolio and the corresponding funding challenges. New market entrants are also less likely to be attracted to providing audit services as the financial and operational barriers to entry would be seen to have been raised. Separation is even more difficult and impactful on business models in small offices of Challenger Firms and Regional Offices of Big Four Firms, where size may mean a separated audit business is untenable.

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24	Which non-audit services (services other than statutory audits) should the audit practices be permitted to provide under a full structural split and operational split? Please explain your reasoning.	The Ethical Standard lists a number of audit related services that present no independence threat and are usually undertaken by the audit engagement team including interim reviews, reporting on regulatory returns, extended audit work etc. In addition, there are a number of non-audit services that the FRC consider to be generally acceptable for the auditor to perform and present a low independence threat where safeguards can be applied e.g., s166 reports, reporting accountant work, other assurance engagements. For these types of engagements, it would be challenging to find a separate, independent firm to carry out this work in the necessary time frame and there may be duplication of effort and cost. Ideally the nature of permissible non-audit services would also consider the viability of the audit practice and the seasonality of the traditional statutory audit work. Without the ability to provide services to non-audit clients during the "low season" for audit, the economics of audit will be further deteriorated making it less attractive to new entrants. The Brydon review may address some of these points. More details will be provided in the Call for Feedback request from the FRC on the 2016 Ethical and Auditing and Auditing Standards response. Changes to the scope of the audit under the Brydon review will also need to be factored into this review.
Remedy 6: Peer reviews		
25	What should be the scope (ie which companies) and frequency of peer reviews, if used as a regulatory tool?	Please see our response at Appendix A, Part 6
26	How could peer reviews be designed to best incentivise auditors to retain a high level of scepticism, and thus improve audit quality?	Please see our response at Appendix A, Part 6
(C) Next Steps		
27	What are your views, if any, on our proposal not to make a market investigation reference?	The proposed remedies are significant and far-reaching reforms, many of which are novel and not used in other audit markets. Therefore, it is vital that the CMA conducts significant further economic

		analysis of the impact of the proposed remedies and how they will succeed in addressing the stated aims. The Kingman and Brydon reviews and the FRC's review of Corporate Reporting will also impact the UK audit market and it is vital that all these reforms are coordinated to achieve the best result possible for the UK. We believe that there is a grave danger of unintended consequences if the package of reforms from the various reviews are not considered together.