THE INVESTMENT ASSOCIATION

Competition and Markets Authority

Statutory Audit Market Study
Update Paper

Response from the Investment Association

18 January 2019

EXECUTIVE SUMMARY

The Investment Association[1] (IA) welcomes the CMA undertaking this review of the Statutory Audit Market and the opportunity to respond to the Update Paper. In preparing this submission, feedback was sought from the IA's members and also from members of the Company Reporting and Auditing Group (CRAG). CRAG is the main UK grouping of institutional investors that specifically focuses on accounting and auditing issues. It provides input to the IA's responses.

In managing assets for both retail and institutional investors, the IA's members are major investors in listed companies. They rely on the quality and robustness of the audited information those companies report to the market when making investment decisions and holding company management and boards to account. High quality audits are vital to ensure the markets trust and have confidence in the information companies report.

For investors audit quality is key but their views vary on whether and how it needs to be improved. Whilst for many investors recent high profile failures and declining audit inspection scores have undermined trust in audit such that they consider measures are needed, others consider that on the whole in the UK audit quality is satisfactory and that recently introduced mechanisms should be given more time to take effect. This is not helped by a lack of transparency as to whether a company has had a quality audit which makes it difficult for investors to make informed judgments.

There are concerns that the dominance of the Big Four as auditors of FTSE 350 companies and the lack of choice an entity can have when it tenders its audit (audit firms can be precluded from participating if they provide prohibited non-audit services) can impact audit quality. With such limited choice, investors question whether audit firms are really competing on quality issues and innovating sufficiently to improve quality.

The IA thus welcomes the CMA looking at the statutory audit market and audit quality. However, investors do not have a clear consensus around the CMA's Remedies and do not consider there is necessarily a single silver bullet that will address the problems identified. Whilst each Remedy would bring certain benefits there are issues with a number that need to be considered before they could be taken forward. We also believe it would be helpful for the CMA to establish criteria to measure the success, or otherwise, of any of the Remedies that are ultimately implemented.

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[1] The IA champions UK investment management, a world leading industry which helps millions of households save for the future while supporting businesses and economic growth in the UK and abroad. Our 250 members range from smaller, specialist UK firms to European and global investment managers with a UK base. Collectively they manage £7.7 trillion for savers and institutions, such as pension schemes and insurance companies, in the UK and beyond. Forty per cent of this is for overseas customers. The UK asset management industry is the largest in Europe and the second largest globally.

Set out below are the IA's key observations on the Remedies in the Update Paper, and in the attached Annex its answers to the particular questions raised.

- *Regulatory scrutiny of auditor appointment and management (Remedy 1).* It is important that the audit committee oversees auditor appointments and monitors the relationship with the auditor to ensure the auditor is independent and objective, and safeguards the interests of a company's shareholders. Whilst the best audit committees are very good and genuinely independent of company management, not all are and do not necessarily appoint the auditor that will deliver the best audit, improve reporting and challenge company management. The audit committee of a FTSE 350 company can also often be reluctant to appoint a non-Big Four or challenger firm on the basis they do not consider they are credible for the scale and complexity of their business. This has led to a more concentrated market-place. Some committees also still consider that reducing the audit fee is in the interests of shareholders when the opposite is true. Nor do all committees sufficiently challenge auditors on the depth of their work.

  Requiring audit committees to report to the regulator on any audit tenders and throughout the audit engagement will help ensure they carry out their role more effectively. In addition to this, investors would like more insight into how an audit committee has ensured there has been a quality audit. The committee should report in its audit committee report why it had recommended a particular auditor following a tender. It should assert annually why it believes the auditor has been challenging and exercised professional scepticism. This improved transparency will enable investors to hold auditor committees and auditors to account better for the judgements and scrutiny exercised.

- *Breaking down barriers to challenger firms - mandatory joint audit (Remedy 2)*. To address the lack of competition and choice in the audit market, it is vital that the non-Big Four or challenger firms scale up their operations so that they can compete for the audit of large, complex entities in the FTSE 350. One of Remedies favoured by the CMA is to require joint or shared audits on the basis this could lead to an improvement in the quality and capability of the challenger firms. This Remedy brings the benefit of additional scrutiny and challenge. However, if it is to be explored further then investors would need to be persuaded that it would work in practice in that: there is no evidence that joint or shared audits increase audit quality, independence and choice; there would be practical issues with two audit firms signing off the accounts, including lack of consistency in approach and increased costs; with joint audit lines of accountability are not necessarily clear and liability is jointly held even if a particular party performed a weak audit which may affect incentives to carry out quality work; and with a shared audit, one party would always be likely to be the junior party and would not increase its market share as a result.

Alternatively, we consider *a market share cap* (*Remedy 2A)* and a limit on the proportion of large companies and PIEs the Big Four can audit could be a direct way of increasing the number of audit firms in the market. However, work is needed on the construct of the cap, and how it is monitored and reviewed before this could be taken forward. The issues to be addressed include: ensuring enough firms have sufficient sector expertise and global reach; the fact a cap could blunt competition and reduce the choice of audit candidates if firms are at their cap; and the need for safeguards so that the Big Four do not cherry pick the less risky audits.

We welcome the development of a *market resilience system (Remedy 4)* to prevent the Big Four becoming the Big Three. This could incentivise/mandate the movement of clients and staff either to remain with the firm whilst a special administrator attempts a turnaround or to challenger firms. (Although we question whether the regulator would be able to do this internationally.) We also support equity being ring fenced and a distribution only being made to partners if the turnaround is successful or staff transfer to a challenger firm.

- *A split between audit and advisory business.* A factor that impacts audit quality is the conflicts that arise when the auditor provides non-audit services. This can impair the perception of auditor independence and objectivity in that the significant revenues generated and the nature of the services can lead the auditor to identify themselves with the interests of company management rather than investors. It is the latter that rely on the auditor's work and to whom the auditor reports. Auditors need to start to consider investors as their clients and not the audited company.

  The EU Audit Regulation went some way to address conflicts in prohibiting a wider range of services and limiting others. Nevertheless there are still concerns. Independence is important for quality and the IA supports a wider ban on non-audit services such that the provision of non-audit services to audit clients in the FTSE 350 and/or large PIEs is prohibited.

  Many investors are concerned about going further than this and requiring a full structural split and "audit-only" firms. The Big Four are international and often responsible for the audit of global companies. They need to remain connected to their international network to service global clients leaving questions over the non-audit services provided by that network. A quality audit also requires quality staff who can challenge and apply economic rationale. The seasonality of audits (the majority of companies have 31 December year ends) could impact the ability of an audit only firm to retain such staff. Investors' are more supportive of an operational separation as this is simpler and does not give rise to these same issues. However, it would require detailed regulatory oversight to ensure it is effective in delivering the anticipated benefits for audit without the issues that arise with a structural split.

  That said, certain investors consider the actual and/or perceived conflicts and lack of independence that arise through audit firms providing non-audit services merit consideration being given to the creation of audit only firms. In particular, the complex structures and range of non-audit services provided by the Big Four can be a substantial barrier for entry for the non-Big Four or challenger firms. An audit-only firm environment could encourage new entrants.

- *Peer review (Remedy 6).* The introduction of peer reviews should be explored in that they could benefit audit quality by providing an additional, independent quality check.

THE IA'S ANSWERS TO THE DETAILED QUESTIONS RAISED

The IA's answers to the detailed questions raised are set out below.

A) ISSUES

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

The IA's members are major investors in listed companies. They are key users of the information in a company's annual report and accounts which provides them with the information they need to make investment decisions and fulfil their responsibilities as owners in holding company management and boards to account. The fact the annual report and accounts is subject to an audit is vital to investors' confidence in these companies and the information reported.

For investors it is vital that audits are high quality, trusted and that there is a well-functioning market for audit services. However, their views vary on whether and how these matters should be addressed. We agree with the CMA's view that audit quality is difficult to observe. To an extent, users of audited company information have to trust that auditors have demonstrated the required levels of professional scepticism and independence in carrying out their work.

Recently there have been some high profile failures which have had serious implications for companies, the people they employ, their suppliers and shareholders. As the CMA notes, similar failures have been observed internationally. We note the CMA's view that poor quality audits may be more widespread, but as not all cases result in failure, they may be underreported.

Also, whilst in the past the FRC's AQR noted that its audit inspection results were improving, in June 2018 it indicated that "the Big Four audit practices must act swiftly to reverse the decline in this year's audit inspection results if they are to achieve the targets for audit quality set by the Financial Reporting Council[2]".

For many investors these trends have undermined trust in audit and they consider measures are needed to re-establish it. Others, on the other hand, consider that on the whole in the UK audit quality is satisfactory and that recently introduced mechanisms should be given more time to take effect.

Audit quality can be particularly impacted by a lack of independence and objectivity which can arise from:

- The way auditors are appointed and monitored.
- The limited competition and choice in the market.
- Non-audit services and the conflicts that result.

[2] The FRC highlighted that 73% of FTSE 350 audits reviewed in 2017/18 were categorised as requiring "no more than limited improvements" as compared to 81% in 2016/17.

THE IA'S ANSWERS TO THE DETAILED QUESTIONS RAISED

We comment on these issues in question 2 below.

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;

Audit committees have an important role to play in ensuring oversight of the audit tendering and monitoring processes. In the past auditors appeared to be too close to company management in that they were appointed largely by the finance function. This was a concern and we welcomed the measures introduced by the Competition Commission in 2013 which included requiring the auditor to be accountable to the audit committee and implementation of the EU Audit Regulation from June 2016 which required audit committees to be responsible for the audit tender process and the final recommendation to the board. We agree with the CMA's view that these measures brought about positive changes. Whilst the tender process may still involve operations and finance functions, oversight by the audit committee is important to ensure the tender is managed and directed in the interests of a company's shareholders.

The audit committee should direct the planning and oversee the process, including identifying candidates, setting the audit quality criteria for selection and conducting the interviews. This should involve the whole committee in that the tender should not just be the responsibility of the audit committee chair. See the IA's Audit Tender Guidelines, developed in consultation with the IA's members.

There are still concerns. We set out in 2b. below the importance to investors of more competition and choice in the audit market in interests of ensuring high quality audits. In overseeing the tender process audit committees have an important role to play and investors would like them to ensure a wide range of firms are invited to participate. We set out in 2c. what we see as the barriers to more challenger firms participating in tenders.

We note the CMA's view that during the tender, many audit committees focus on quality rather than price. That said, investors still hear that certain committees consider reducing the audit fee is in the interests of shareholders when the opposite is true. As set out in the IA's Tender Guidelines, the audit committee should consider audit fees in that they should be neither too low to suggest audit quality could be impaired nor too high as to be excessive. However, fees should not be the main factor under consideration, particularly in the early stages of the tender process. If the audit firms invest in more and better technology then this should ultimately result in a reduction in the cost of audits and associated fees.

When the committee recommends the appointment of a particular auditor to the board, investors want the auditor that will provide the highest quality audit appointed. We are concerned with the CMA's finding that selection criteria can include matters such as "easy to work with", "cultural fit" and "chemistry". The CMA notes that some executive directors are still overly involved in committee activities such as the tender. Certain investors consider that company management should be prohibited from being involved in any decisions related to audit tenders. It is a company's shareholders that rely on the auditor's work and to whom the auditor reports. Audit committees and auditors should consider the investor community to be the auditors' true clients and ensure their needs for a quality audit are met. Prospective auditors should demonstrate clearly that they can provide a quality service, compete on quality issues and challenge management. This should help drive innovation in the market place and achieve consistently higher quality audits over time.

The audit committee also has an ongoing role in ensuring the appointed auditor delivers a quality audit. We agree with the CMA's finding that many audit committees are not adequately monitoring the audit process or devoting sufficient time to their duties. In particular, during the audit, the auditor will understandably develop a close relationship with the audited entity's management. This can result in auditors not always questioning management sufficiently on their judgements.

Audit committees have an important role in ensuring that auditors challenge managements' assumptions and judgements, deliver high quality audits that are undertaken with the appropriate standards of scepticism. Professional scepticism is vital when key areas of accounting and disclosure depend on management's judgement. The committee should monitor the planning of, execution of and findings from the audit. We note the CMA's view that as audit committees cannot observe the quality of the audit directly, this will lead to a fragile system. The IA considers that the measures such as those outlined in question 4 (Remedy 1) will help strengthen this.

We recognise that investors have an important role to play in ensuring quality audits. But there is largely a lack of transparency and information to enable them to do so, particularly about audit tenders and the audit process. Both the audit committee and the auditor provide an important independent check for shareholders and yet certain investors have highlighted concerns that auditors and audit committee chairs often want their respective reports to be as aligned as much as possible before they are published.

Under question 4 we set out how investors would like audit committees to give more insight into how they have ensured a quality audit in their audit committee reports. This should include how the committee assessed the quality of the audit, and ensured it was challenging and scepticism exercised. Some major investors would welcome auditors at the outset discussing the planning process with them so that any significant concerns they have can be addressed. Investors welcomed one of the Big Four firms reaching out to the top ten shareholders of the major companies they audit to see if they had concerns.

The IA Audit Tender Guidelines state that when a company plans to enter into a tender it should issue an RNS announcement so that investors can, if they wish, engage with it on the tender. It should also contact its major shareholders and engage with them on the process. For example: on the timetable; how the audit committee intends to assess audit quality; the selection criteria and assessment mechanism that will be applied; and the conclusion reached.

THE IA'S ANSWERS TO THE DETAILED QUESTIONS RAISED

In terms of the audit tender candidates, the Guidelines clarify that investors would like disclosure of:

- Any restrictions on a firm being able to tender.
- Whether any mid-sized firms will be invited to tender and an explanation where this is not the case.
- How any conflicts between audit committee members and tender candidates will be managed and mitigated.
- Whether the incumbent will be invited to re-tender.

Following the tender, the audit committee should consider reporting on the following:

- The various stages in the tender process and the timetable.
- How firms were assessed and the issue of fees addressed.
- Details as to why the firm concerned was chosen.
- A summary of the handover process.

The audit committee should also ensure there is an RNS announcement when the decision is made.

We note the CMA's view that some investors do not engage sufficiently in audit matters. We also agree that there is limit to the extent to which shareholders can oversee the audit committee's work, or the audit itself. Investors periodically engage with certain audit committees when there are reporting and accounting issues with a company. They engage with individual audit firms, both the Executive and Independent Non-Executives, on governance and audit quality issues. They also vote on the incumbent auditor's and audit committee members' re-appointments annually.

As many tenders are completed significantly before the new auditor takes office due to the need to 'cleanse' of threats to independence, such as when an auditor provides non-audit services, consideration could be given to giving shareholders the opportunity to approve the appointment of the new provider. This would provide a focus for the audit committee to set out the process, and why it chose that particular auditor and considered the fee to be at the right level. This vote to approve the new auditor would be a significant new power for shareholders at a time when there is more scope for influence, and ought to add an important new dynamic to the appointment process.

Investors would also welcome a register being established of audit partners which includes a list of the companies where they have been the lead partner–along the lines of the US model. This would enable them to identify if a partner had been responsible for the audit of a company where investors are aware there had been issues.

In conclusion, the improved transparency we are asking for would enable investors to hold auditors and audit committees to account better for the judgements and scrutiny exercised.

b. Limitations on choice leading to weaker competition.

The IA agrees with the CMA that competition can play a crucial role in driving quality. Effective competition requires audits to be tendered sufficiently frequently and adequate choice when the audit is tendered. Prior to the Competition Commission's and EU Audit Regulation's measures for mandatory tendering and rotation, audit firms tended to hold office for long periods. This concerned investors in that it can impact the firms' integrity, independence and objectivity, each of which is important in ensuring audit quality.

These measures largely addressed this – over 50% of companies in the FTSE 350 have tendered their audit since 2013 and the overall switching rate peaked at 14% in 2015. However, whilst the long terms auditors held office has been addressed, it is clear it is still a concentrated market. The Big Four firms maintain a dominant position as auditors of companies in the FTSE 350: indeed the proportion of FTSE 350 audits carried out by the Big Four has only increased[3].

We agree with the CMA in that there is limited choice when an entity tenders its audit, which can be further impacted when audit firms provide certain prohibited non-audit services which prevent them from participating in a tender. Thus the incumbent may be time barred and unable to participate in the tender process; other audit firms could be precluded as they provide prohibited non–audit services to the entity; and others could audit competitors of the entity. As acknowledged in the Update, an entity may be faced with only two viable "choices".

For investors audit quality is key and there are concerns that this lack of choice can impact it. Investors want the auditor that will provide the highest quality service appointed. But with so few players, investors question whether auditors are really competing on quality issues. Even between the Big Four, investors are concerned that they are largely "cosily competitive" with each other in that there is little evidence of the development that a fully competitive market can bring to meet the market's needs for quality audits. The absence of real competition has led to a lack of innovation which could impact quality.

To ensure confidence in corporate reporting and quality audits, it is essential to have a well-functioning market for audit services and more competition and choice. The non-Big Four or challenger firms need to scale up their operations so that they can compete for the audit of large, complex entities in the FTSE 350. This should help drive quality. However, we do not believe it likely that there will be an organically developed competitor to the Big Four in the medium term.

c. Barriers to challenger firms for FTSE 350 audits.

The IA agrees with the CMA that there are both demand side and supply side barriers to the challenger firms building a presence in the audit market.

On the demand side the audit committee of a FTSE 350 company can be reticent to appoint an auditor that is not from the Big Four on the basis they do not consider they are credible for the scale and complexity of their business. An audit committee may also be concerned that challenger firms have smaller international networks; a lack of

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[3] Page 22 of the CMA's Statutory Audit Services Market Study update paper: "the overall share of the Big Four by number of audit clients [in the FTSE 350]has remained stable since 2011 – increasing slightly from 95% to 97% in 2017".

experience conducting FTSE 350 audits; and may not be able to deliver a quality audit. This can mean that challenger firms are not invited to tender.

As regards some investors encouraging audit committees to appoint Big Four firms at the expense of others, the IA's Tender Guidelines are clear that investors expect the committee to ensure a wide range of firms are invited to participate in a tender and, where practical, firms other than the Big Four should be included. Each candidate should have a genuine prospect of being successful. Investors consider that, depending on each group's circumstances, only the larger multinational groups should have to restrict their choice to the Big Four audit firms.

On the supply side, challenger firms may avoid bidding for audit tenders due to factors such as high tender costs (which can be more easily absorbed by large firms); the lower likelihood of winning; and the greater potential risk should they be appointed to audit a large group. This can mean that non Big-Four or challenger firms are reticent to participate in a tender.

We agree with the other potential barriers noted by the CMA: that some audit committees composed of Big Four alumni may favour their old firms in tenders; and that challenger firms might be reluctant to take on FTSE 350 audits because of the increased regulation involved (which could have a disproportionate effect on these firms).

d. Resilience concerns.

Given the limited choice in the market, investors would be very concerned should one of the Big Four fail or withdraw from the market. This would give rise to even less choice and further weaken competition.

Investors are concerned that the present level of concentration also compromises regulatory oversight in that the regulator might not be willing to impose significant sanctions for fear of driving one of the major players out of the market - they are 'too big to fail'. Also should one of the Big Four fail and its staff and clients transfer to another Big Four, as happened with the demise of Anderson where staff transferred to Deloitte, this would exacerbate the choice issues and result in the Big Three as opposed to the Big Four. Should one of the Big Four fail, it is unlikely that the challenger firms would be able to provide the necessary capacity.

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

The IA agrees with the CMA that the current multi-disciplinary nature of the firms can influence the way they undertake audits. The provision of non-audit services, particularly those of an advisory nature, can introduce a potential conflict of interest and impact an auditor's independence in that the auditor may identify himself with the interests of management rather than those of investors. We discuss this further under question 19 below.

More widely, the cultures of the Big Four can be influenced by non-audit work. The underlying tension between audit work (which relies the auditor distancing itself from management to maintain professional objectivity) and non-audit work (which involves working closely and identifying with management) is a concern and will only grow as firms take on more non-audit work.

In addition, most players in the capital market operate under long term incentive plans that include malus and claw-back provisions that can be triggered by poor performance or personal misconduct. Audit firms are constituted under partnership law where profits are paid out annually. Given the systemic importance of the firms and the need to develop and innovate over the long term, in the interests of ensuring audit quality, consideration should be given to addressing any constraints in partnership law that may prevent the operation of long term incentive plans.

B) 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?

Except for a market share cap (see question 11), we consider the remedies should be applied to larger PIEs[4]. This means they will not just apply to the listed sector but also to entities that are of systemic importance. We also consider it would be helpful for the CMA to establish criteria to measure the success, or otherwise, of any of the Remedies that are ultimately implemented. The CMA should seek to determine whether those Remedies that are taken forward improve competition, choice, and audit quality or whether other measures need to be considered.

Remedy 1: Regulatory scrutiny of Audit Committees

4. How could the regulatory scrutiny remedy be best designed to ensure that the requirements placed on Audit Committees by a regulator are concrete, measurable and able to hold Audit Committees to account? Please respond in relation to requirements both during the tender selection process and during the audit engagement.

As noted in question 2 a) above, audit committees have an important role to play in overseeing any audit tender and, on an ongoing basis, monitoring the audit. In practice, however, investors are concerned in that while the best audit committees are very good and genuinely act independently of company management, not all are and do not necessarily use the relationship with the auditor to improve reporting and add challenge to the boardroom. Nor do all committees sufficiently challenge management on their judgements or auditors on the depth of their work and analysis. They are not necessarily carrying out their role effectively. We thus support more scrutiny of their work and the CMA requiring audit committees to report direct to the regulator:

[4] A PIE, as defined, is an entity incorporated in an EU Member State with equity or debt listed on an EU regulated market; or a credit institution or insurance undertaking.

THE IA'S ANSWERS TO THE DETAILED QUESTIONS RAISED

- Before, during and after a tender selection process. The Committee would be required to demonstrate that: it prioritised independence and challenge in its tender assessment; made its decisions independently of management; managed conflicts of interest; and gave fair consideration to challenger firms.
- Throughout the audit engagement. The Committee would be required to demonstrate that they had intervened meaningfully and provide an account of material disagreements between the audit firm and company management.

This scrutiny will help ensure that audit committees fulfil their function properly. However, we have a concern about including an observer from the regulator in all or a sample of audit committee meetings. The discussions at an audit committee can be confidential and the committee needs to challenge management's judgements. The presence of a regulator could impact on the discussion at and dynamics of the meeting.

The Update Paper does not address the information that will be given to investors. Whilst the Paper states that the regulator will be able to issue public reprimands or direct statements to shareholders, this is only likely to be exercised in extremis when the regulator considers the committee has not followed proper procedures.

Investors welcomed the increased transparency by audit committees following successive revisions of the UK's Corporate Governance Code. Audit committees are required to report on how they assessed the independence and effectiveness of the external audit. Nevertheless, investors have been disappointed that in practice often the description is generic and based on the answers to questionnaires which in the main have been drafted by audit firms. The regulator should consider such "boilerplate" reporting and stress the importance of audit committees providing company specific reporting that is informative to investors.

The real issue for investors is whether the company in which they have an interest has appointed an auditor that can deliver, and has delivered, a quality audit. This goes beyond checking compliance with accounting standards and gives assurance to investors that the accounts can be relied on to provide a true and fair view of performance and ultimately that capital is maintained.

Investors would like audit committees to give more insight into the steps they have taken to ensure a quality in their audit committee reports. If there has been a tender then the committee should be transparent as to why it recommended a particular auditor and considered that firm would provide a quality audit. Annually it should assert whether it believes and how it determined that the auditor has provided a quality audit, been challenging, the granularity of key accounting issues and how the auditor challenged management's judgement and assertions, and exercised professional scepticism. The committee should report on what it itself challenged and the specific areas it asked the auditor to look at and why. At present these matters are rarely transparent. Increased transparency would help facilitate more and better investor engagement with both auditors and audit committees on these issues.

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?

This Remedy brings the benefit of additional scrutiny and challenge. However, if it is to be explored further then investors would need to be persuaded that it would work in practice in that:

- There is little evidence to suggest that joint or shared audits increase audit quality, independence and choice. Joint audits are mandated in France. As investors in French companies, the IA's members have not seen an improvement in audit quality as a result.
- Indeed joint or shared audits could reduce choice in the number of firms that could be invited to tender in that there would be two incumbents as opposed to one. They would also reduce the number of providers for other services that an auditor is prohibited from providing to the audited entity.
- There would be practical issues with two audit firms signing off the accounts of the client, including lack of consistency in audit approach and increased costs.
- With a joint aduit, there is not necessarily a clear line of accountability.
- We note that audit regulators have noted examples of poor co-ordination and oversight of component auditors' work. Joint or shared audits may only serve to exacerbate this.
- As noted in the Update Paper, both joint auditors sign off the same audit and liability for any issues is jointly held regardless of whether a particular party delivered a weak audit. This could act as a disincentive to carry out quality work.
- All of the large audit firms have undergone a series of mergers resulting in the Big Five, and following the collapse of Andersons, the Big Four today. These mergers were a response to the increasing globalisation of companies and sought to minimise risks and costs of using firms from one network to audit a large multinational company. Therefore, to require companies to use firms from more than one audit network could be a retrograde step.
- With a shared audit we would be concerned that one party would always be the junior party and unlikely to increase their market share as a result.

If this Remedy is taken forward then we would propose that a pilot study is conducted first to determine its impact.

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.

If joint audits are adopted, then the IA considers it important that at least one of the audit firms is a challenger firm in order to help improve the quality and capabilities of these firms. As noted in the Update Paper, there may be certain types of companies, such as banks, insurers and large multinationals, where challengers may not have the skills or geographical reach to perform an audit such that there would need to be some flexibility in this. This should be agreed with the regulator.

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.

In the event that joint audits are taken forward then as opposed to the allocation of work being set by a regulator, the IA suggests that the model adopted in France is followed where joint audits have been required for over 50 years. In France a professional standard, NEP-100, sets requirements in this area. NEP 100 stipulates that the audit work should be split on a balanced basis reflecting criteria which may be quantitative or qualitative in nature. If a quantitative basis is used, the split may be by reference to the estimated number of hours of work required to undertake the audit. If a qualitative basis is adopted then the analysis may be the qualifications and experience of the members of the audit teams. Where a group entity is audited by a firm that is not one of the joint audit firms, the third party auditor's work is supervised by one of the joint audit firms.

The overall balance sought is reflected in the split of the audit fees. The objective will normally be for each joint auditor to receive between 40% and 60% of the total fees. A split of up to 70%/30% may be accepted. Splits of less than 30% for one of the joint auditors, and greater than 70% for the other, may be tolerated but are monitored by the regulator with a view to progressively readjusting them.

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?

There would be merit in each of the joint auditors being appointed at different times to ensure that their terms do not end at the same time. This would ensure that the one auditor retained can share its knowledge of the company with the incoming auditor. This will help ensure a smooth transition between auditors in that it can take some time for an incoming auditor to get up to speed with a new audit client. That said, an investor believes that joint auditors should be appointed at the same time to ensure that there is fresh challenge. They consider it may otherwise be difficult for a newly appointed auditor to question the judgments of the existing auditor if the appointments are staggered.

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?

We note that France follows a joint and several liability regime. Thus we understand each joint auditor performs a review of the work performed by the other. In addition, the audit summary memoranda and working paper files for the engagement are subject to reciprocal peer review. This review, which leads to the joint audit opinion being issued, has to be documented for each engagement. If effective this should improve audit quality but we question whether challenger firms would have the skills and capacity to review the files of a Big Four firm. We also question whether a challenger firm would have the same level of professional indemnity insurance as a Big Four firm in the event there is a failure.

Remedy 2A: Market share cap

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

Investors support a market share cap as a means of reducing the barriers to challenger firms expanding the number of large companies they audit. A limit on the proportion of large companies the Big Four could audit would increase the number of large company audits available to challenger firms, and would allow these firms to achieve greater scale and experience. It could also trigger more mobility of ambitious audit staff conscious of the limits to opportunity within the Big Four. Nevertheless, there are a number of complex factors that need to be addressed:

- Ensuring there is sufficient sector expertise and global reach in the market. The appointment of firms that do not possess the necessary capabilities would lead to a decline in audit quality.
- Whilst a market share cap may open the market to new entrants, it could blunt incentives for audit firms to compete, reducing competition and resulting in audit fees increasing or quality falling.
- Companies would have less choice in carrying out tenders if one or more of the Big Four is at its capped limit. This could also impact the attractiveness of the UK for international companies to list.
- As acknowledged in the Update Paper, it is important that safeguards are introduced so that the Big Four do not cherry pick the less risky audits. For example, say a cap was imposed of 20% of the audit market for any one auditor. Due to their dominance, the Big Four would thus take the "best" 80% with the remaining 20% likely to be particularly risky, costly in terms of geographic distribution, complex and have reputational issues. As the audit fees from the top 71 FTSE 350 companies make up 80% of the total whereas the bottom 80 amount to only 1%, this could result in a disparity in fees collected. Prohibiting the Big Four from resigning without the audited company's approval and limiting the Big Four's choice as to which company they can bid for, as proposed in Option 2, would each have unintended consequences.

In conclusion, more work is needed to determine how the cap should be constructed, monitored and reviewed before this Remedy could be taken forward.

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

Due to the complexities in introducing a market share cap, we agree that initially it should only apply to the FTSE 350.

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.

Senior staff switching. The Update Paper states that if senior staff could switch easily between firms it would allow challenger firms to hire experienced staff from the Big Four, and thus help build their capacity. It asks about the barriers to this. We consider these are:

- The risk that the Big Four staff switch only among the Big Four, and not to the challenger audit firms. As we note under Remedy 2, a market share cap could trigger more mobility of ambitious audit staff conscious of the limits to opportunity within the Big Four.
- It is likely that only those staff that have little chance of future promotion would move from the Big Four.
- Each firm has its own audit processes/ software giving rise to a huge learning curve.

The CMA favours helping challenger firms build their capacity through prohibiting, or limiting the length, of non-compete clauses on the basis such clauses can make it harder for audit partners and staff to switch firms. This may not necessarily be effective in that it assumes that partners and staff switch from the Big Four to the challenger firms when the reverse may be the case. Also we are aware that the recent publicity surrounding audit failures are making it increasingly difficult for all firms to attract and retain staff.

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.

This question is beyond the IA's remit.

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

The IA has reservations about such a measure. First, each of the firms has its own audit processes/ software giving rise to a huge learning curve. Secondly, it is highly likely that the Big Four would only put their worst resource into the open source pool available for all. There is also the possibility that innovation could stall if a firm no longer had exclusive access to the systems it had developed. Lastly, the international ramifications would be likely to be complex to resolve.

Remedy 4: Market resilience

15. How could a resilience system be designed to prevent the Big Four becoming the Big Three, not just in the case of a sudden event, but also in the case of a gradual decline? Please also comment on our initial views to disincentivise and/or prohibit the movement of audit clients (and staff) to another Big Four firm.

The IA is concerned that the present level of market concentration compromises regulatory oversight in that the regulator might not be willing to impose significant sanctions for fear of driving one of the major players out of the market - they are 'too big to fail'. Also should one of the Big Four fail and its staff and clients transfer to another Big Four, as happened with the demise of Anderson where staff transferred to Deloitte, this would exacerbate the choice issues and result in the Big Three as opposed to the Big Four. We thus welcome the CMA looking at designing a resilience system where:

- If audit firms in same network in another large market are at risk, it incentivises and/or mandates the movement of clients and staff to challenger firms. (Although we question whether the regulator would be able to do this internationally.)
- If the problem is limited to the UK network firm, it incentivises and/or mandates that clients and staff of the failing firm remain with the firm while a special administrator attempts a turnaround.

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

The IA supports the CMA's initial view that moral hazard could be addressed by ring fencing the equity within the firm relating to all audit and non-audit partners with partner drawings coming under regulatory review. A distribution to the partners should only be made if the turnaround is successful or if staff transfer to a challenger firm.

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.**
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.**

We consider that the regulator's role should be to keep the market under review and take steps to incentivise and/or mandate that staff and clients do not transfer to another Big Four or remain with the same firm. If the firm does not respond to these measures and is heading towards a failure in the short to medium term, then the regulator should appoint a special administrator to take over executive control of the failing firm.

Whilst initially such a regime should apply to the Big Four, as the challenger firms grow in size it may be appropriate to bring them within its scope.

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.

To produce a quality audit, auditors need to be independent, objective and free from conflicts. Investors support a wider ban on non-audit services such that the provision of non-audit services to audit clients in the FTSE 350 and/or large PIEs is prohibited. Once the firm has stopped providing non-audit services there should be a cooling off period before it can be appointed as an auditor. Any restriction should be applied consistently across audit firms irrespective of whether they are Big Four or challenger firms. In addition, in the interests of efficiencies the auditor should still be allowed to provide certain audit-related services, such as reviewing preliminary announcements or auditing regulatory returns.

Many investors do not support a full structural split and "audit-only" firms where the ownership of the audit and non-audit services practices of UK firms are separated. First, such a remedy cannot be viewed in isolation but needs to have international reach to be effective. The Big Four audit firms are international and often responsible for the audit of global companies. The UK audit-only firm would need to remain connected to the international network to ensure they can deliver a quality audit to multinational clients leaving questions over the non-audit services provided by that network. There is also a risk that the international networks break away from the UK audit–only firms again impacting the firms' global reach and the attractiveness of the UK market.

Secondly, a quality audit requires quality staff who can challenge and apply economic rationale (not simply box tick). If firms were restricted to providing only audit services, particularly due to the seasonality of audits (the majority of companies have 31 December year ends), it could impact their ability to retain such staff. Moreover, due to the level of complexity and judgement required in undertaking a major audit, specialist non-audit staff are often needed to help and advise. Investors want auditors to exercise professional scepticism which necessitates firms having access to the widest possible experience so that their staff can see economic substance over form and are up to date with accounting requirements. If this resource is not available to audit-only firms this is likely to reduce rather than enhance audit quality.

Lastly, smaller firms may not have the necessary economies of scale to recruit and fund such resource in an audit-only environment. Moreover, a structural spilt may only serve to exacerbate the dominance of the Big Four in that they would no longer be precluded from participating in audit tenders on the basis of the non-audit services they provide.

That said, certain investors consider the actual and/or perceived conflicts and lack of independence that exist by allowing audit firms to provide non-audit services merit the creation of audit-only firms. In particular, the complex structures and range of non-audit services provided by the Big Four can be a substantial barrier for entry for the challenger firms. An audit-only firm environment could encourage new entrants. They also consider that an audit-only firm would be able to procure the specialist knowledge required in the market or if there is sufficient demand retain it in-house.

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

The IA's members are more supportive of an operational split in that it does not give rise to the same issues as a structural split. It also has the merits of:

- Separate profit pools and governance arrangement to address independence concerns.
- Firms being able to continue to access non-audit expertise from the non-audit arms and international networks would not be impacted.

However, there are still issues that would need to be addressed in that it would be complex to implement and would require detailed regulatory oversight to ensure it is effective in delivering the anticipated benefits for audit without the downsides of a structural 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.

This question is outside the IA's remit.

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

The Update Paper cites one of the advantages of the operational split is that the restrictions on non-audit services could be relaxed such that companies could have more choice when they tender an audit. For investors audit quality is key but can be impacted by a lack of independence and objectivity which can arise from the provision of non-audit services and the conflicts that result. We thus would not support the relaxation of current restrictions on non-audit services.

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

On the basis the challenger firms may not have the necessary economies of scale to recruit and fund such resource in an audit only environment, we do not consider they should be in the scope of a structural split. The arguments are, however, less convincing when it comes to bringing them in the scope of an operational split.

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 IA supported the EU Audit Regulation which extended the list of prohibited non-audit services for PIEs such as tax advice, book keeping and internal audit, and permitted non-audit services up to a cap of 70 per cent of the average audit fee paid in the last three consecutive years. Whilst this largely addressed many investor concerns about the provision of non-audit services we support a wider ban on non-audit services such that their provision to audit clients in the FTSE 350 and/or large PIEs is prohibited. If this were to happen we recognise that there are certain non-audit series that are clearly related to the statutory audit and where it would be more efficient and cost effective for these to remain with the statutory auditor. These include matters such as reviewing regulatory returns for financial institutions; reviewing preliminary announcements etc. We would anticipate that there would be a full consultation on these in the event the ban is widened.

Remedy 6: Peer review

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

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

We consider there is merit in exploring the introduction of peer reviews in that they could benefit audit quality by providing an additional, independent quality check. We note under question 1 that the FRC's AQR noted in June 2018 that there had been a decline in this year's audit inspection results. This trend is concerning and undermines investor confidence in audit which is vital to the effective operation of the capital markets. Peer reviews could help in addressing this. However, the Update Paper does not mention how and whether any of this would be transparent to investors. Investors would welcome the key conclusions being disclosed.

C) NEXT STEPS

THE IA'S ANSWERS TO THE DETAILED QUESTIONS RAISED

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

We agree with the Update's conclusion that given the scrutiny being afforded to the audit sector at present, recommendations to the Government are a more effective route to implementation than a market investigation reference.