KPMG LLP
15 Canada Square
London E14 5GL
United Kingdom

Bill Michael
UK Chairman and Senior Partner

Statutory Audit Market Study
Competition and Markets Authority
7th floor
Victoria House
37 Southampton Row
London, WC1B 4AD

25 January 2019

Dear Mr Hayter,

Statutory Audit Services Market Study Update paper

I am writing in response to the questions posed in the Competition & Markets Authority's (CMA) Statutory Audit Services Market Study Update paper dated 18 December 2018 (Update Paper).

The UK has one of the largest and most internationally diverse capital markets in the world, which depends and thrives on a high level of global connectivity. This strong position has not arisen by good fortune, but as a consequence of political and economic stability and a highly respected track record in corporate governance, corporate reporting and auditing. In order to remain attractive as an international capital market, it is important that the UK's standing as a secure and predictable environment for international business is preserved, which means that any unintended consequences of changes must be monitored closely.

Recognising the need for change

It has been a challenging year for the audit profession with much criticism and, for us, much reflection. As I indicated in KPMG's response to the CMA's Invitation to Comment (dated 30 October 2018), audit is core to our business and critical to our brand.

The concerns in relation to audit and the audit profession (whilst part of the issue of trust in business more generally) are wide and varied, and we recognise that these need to be addressed. It is vital that confidence in audits is upheld.

We understand the desire for a market that supports more than four firms to audit the larger companies. We also understand the scepticism as to whether large multi-disciplinary firms can be sufficiently focused on audit. Above all, we recognise the need for audits to be of consistently high quality.

We have been taking steps to address these concerns, including significant new investment to enhance audit quality; strengthening governance and performance management of our audit business; committing to cease non-audit services for FTSE 350 audited companies; and being the first firm to offer enhanced audit opinions with "graduated findings".

Our views of the CMA's proposed remedies

Notwithstanding the initiatives we have already taken, we also appreciate that fundamental industry-wide change is necessary. This is why we agree with the broad direction of the CMA Market Study and many of the CMA's aims. However, we consider that some of the suggested remedies currently lack the analysis and evidence that is typical of such reviews. For this reason, whilst we are eager to achieve expeditious solutions, we consider that deeper analysis and further consideration of specific proposals is essential. We comment on the CMA's specific proposals below.

Responsibilities and accountability of Audit Committees

Our experience is that audit committees (ACs) are becoming ever more sophisticated purchasers of audit services as their responsibilities for the appointment and oversight of the auditor increase. The regulatory changes which have driven this trend are relatively recent and have not yet had time to take full effect, but we have already seen a significant shift from executive management to the AC on audit related matters. We welcome steps to reinforce this trend and the focus now should be on enhancing the capabilities of ACs to achieve more uniform quality and providing greater regulatory oversight. In certain circumstances, regulatory intervention may be required, but such instances should be exceptions and should complement, rather than undermine, the responsibilities of ACs (and shareholders) in the appointment of auditors and oversight of audit quality.

Mandated joint audits (or market share caps as a possible alternative)

We agree that for the long term health and stability of our capital markets, the UK needs more firms capable of auditing FTSE 350 and other public interest entities. Joint audits and market share caps have the potential to achieve greater participation, but neither are easy to implement. We consider that a market share cap for a finite period is the better option, although the implementation details are complex.

On joint audit, while we are not opposed in principle, joint audits in our view would need to involve equal, or at least reasonably equal, input from each joint auditor, and would, at least in the short to medium term, involve significant implementation and capability challenges.

Any model for joint audit or market share caps: (i) needs to recognise that, at least at the outset of implementation, it may not be appropriate to have smaller firms involved in the audits of particular FTSE 350 companies; and (ii) should have sufficient flexibility to address the challenges that smaller firms would face in taking on large numbers of audits in a short timeframe. Whatever solution is considered, a model which seeks to provide smaller firms with suitable access to audits for FTSE 350 companies should not compromise on quality. That, in turn means that smaller firms must have the incentives, the means and the willingness to invest sufficiently.

Other measures to break down barriers to smaller firms

We have previously indicated our willingness to consider removing the existing restrictions we have in place for audit partners leaving to join non-Big Four networks. In relation to technology licensing, the nature of any demand for access to technology resources from smaller firms is unclear and would need to be better defined before mandating a solution.

Resilience regime

We consider that success in increasing the participation of smaller firms in the market for large audits will reduce the concern of "Four to Three" Big firms. In practice, we believe the moral hazard articulated by the CMA to have limited practical impact. We accept that more could be done in relation to resilience, but note that without international regulatory co-ordination, there are limits on what is realistic.

Full structural or operational split between audit and non-audit services

We recognise the criticism that the profession's current operating model has become too opaque and brings with it the potential to impair market confidence in our ability to deliver high quality audits.

We consider that there is scope for further enhancing the governance and performance management of audit businesses and to improve the transparency thereof. As explained in our response, KPMG is already introducing reforms in this regard. We consider that separate profit pools and legal entity separation would bring disproportionate risks and costs. We consider that narrowing the services that auditors provide to FTSE 350 audited companies, along the lines of our voluntary restriction not to provide non-audit services (except those closely related to the audit) for the FTSE 350 companies we audit, would be an effective way to significantly decrease investors' concerns regarding conflicts of interests.

In our view, the need for multi-disciplinary firms with the scale to invest and operate at a global level remains critical and a "full structural" split would lead to significant and unmanageable negative implications for audit quality for reasons which we have set out in our response to the CMA's Invitation to Comment, and which are further explained in our response to the Update Paper. We disagree with the CMA's suggestion that these issues are surmountable and therefore remain strongly against this option.

Again, whatever solution is adopted, there will be significant implementation challenges, recognising the complexity of moving to any new arrangements, the potential for additional costs and / or unintended consequences. Any operational segregation needs to ensure that the audit business remains attractive in terms of risk and reward so as to maintain the high levels of investment and recruitment needed. The extent of separation of economic interest currently envisaged by the CMA would potentially undermine these objectives, with detriment to audit quality.

Peer review

We consider that this would have a valid role in certain circumstances but would be less necessary where there is a requirement for joint audit.

We have set out in the attached appendix more detail on our views of the CMA's proposals and our responses to the questions posed by the CMA, which we look forward to discussing further.

Changes need to support audit quality and be integrated / sequenced with other reforms

Since KPMG's response to the Invitation to Comment, there have been further developments. Sir John Kingman has made recommendations in relation to the FRC and corporate regulation; BEIS has announced a review of UK audit standards to be undertaken by Sir Donald Brydon; and the BEIS parliamentary committee has announced its own inquiry into the future of audit.

These are all important initiatives and need to be considered together. As many commentators have observed, there is no "silver bullet" to address concerns but there is a real potential for unintended consequences as a result of the CMA's proposed remedies, particularly where reforms with potential global implications have no precedent elsewhere.

There is little point in designing a regulatory framework and market structure if the audit that is delivered is not what stakeholders want. The Brydon Review is, in our view, essential and will provide much needed context to many of the Kingman and CMA recommendations. It will be critical to the successful sequencing, timing, implementation and, ultimately, evaluation of the many changes. We are very keen that this work should be completed comprehensively and as swiftly as possible as we share the CMA's desire for prompt resolution of the concerns identified but believe that the final recommendations of the CMA need to be appropriately sequenced and integrated with those of other reviews and appropriately balance the responsibilities of participants in the corporate governance and reporting process. Without the necessary sequencing and co-ordination, the result will be a patchwork series of initiatives with the potential for duplication, overlap and gaps, unnecessary cost, disruption and unintended adverse consequences.

Achieving this will only be possible if the need for, and details of, proposed remedies are examined in sufficient depth either by the CMA or, if examined to an equivalent standard, by another body. We consider that the CMA would be well placed to complete this through a market investigation.

The way forward

There is a need for change and I have been supportive of that.

I want KPMG in the UK to play our full part in helping to restore trust in audit, in our profession and in corporate Britain more widely. The benefits of change will not happen overnight and there will be no single change in the audit market that will meet all expectations. Changes must be beneficial, practical and capable of implementation for the long term sustainability of trust in audit and the audit profession.

We will work with the various reviews on implementation plans to help develop clear short to medium term road maps to deliver pragmatic and practical solutions.

Yours sincerely,

Bill Michael
UK Chairman and Senior Partner

Statutory audit market study

Response to the Competition and Markets Authority Update Paper

KPMG LLP

25 January 2019

This report contains 66 pages

KPMG

PART A: Issues

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

1.1. We recognise that the audit profession is rightly under scrutiny, in particular as regards audit quality, and consider that the challenges facing the profession need to be addressed because it is vital that confidence in audits is upheld. Audit is the bedrock of our business; it is critical to the KPMG brand and, ultimately, to the success of the business. However, it is clear that there is a public concern about audit quality – and indeed about aspects of corporate Britain more widely – at present. These concerns are wide and varied, and they relate not only to audit quality but to objectivity and independence of auditors and concentration in the market for large audits. Related to this, we understand the desire for a market that supports more than four firms to audit the largest companies and the scepticism that large multi-disciplinary firms can be sufficiently focused on audit. Above all, we recognise the need for consistent high-quality audits.

1.2. While we believe that the quality of audit in the UK does generally meets a high standard, the particular challenge is one of consistency to ensure that this is always achieved. KPMG recognises and is focused on achieving this and is making substantial new investment in audit quality; and strengthening governance and performance management of our audit business. However, we appreciate that there is always more that can be done in the form of continuous improvement.

1.3. Indeed, we believe that the UK audit profession and the qualifications which underpin it (principally the ICAEW's ACA and ICAS's CA qualifications) are highly respected across the world, and that a key reason for this is the culture of openness and continuous improvement that both the FRC and audit firms embrace. However, an assessment of quality depends to an extent on the underlying purpose and scope of the activity (i.e. audit). There is at present concern as to whether the current purpose and scope of audit meets the current needs of shareholders and other stakeholders. The Brydon review, together with Sir John Kingman's review, will provide essential context for any future reform and we urge the CMA to take this wider context fully into account.

1.4. That said, we welcome the CMA's broad direction as set out in its Update Paper and acknowledge concerns about audit quality. However, we do not consider that the evidence demonstrates systematic, market-wide failings in audit quality as the CMA suggests. As the CMA acknowledges, audit quality is hard to measure, and this suggests the need for caution in making over-wide statements about market-wide quality.[1] The FRC itself, whose function expressly includes the systematic assessment of audit quality and upon whose findings the CMA relies, warns about the need for caution in drawing definitive conclusions about overall audit quality

[1] Update Paper, para 2.39.

from its findings,[2] notably in light of the "not statistical" sampling methods it uses. Our more detailed views are set out in the rest of the response to this Question 1.

Overall views on the analysis in Section 2 of the Update Paper

1.5. There is no single agreed definition of audit quality (as is acknowledged by the CMA). Moreover, one of the key challenges of audit is that aspects of quality are very difficult to observe. While it may be possible to observe whether suitable audit processes are in place and whether the audit report is properly evidenced, it is much harder to assess whether an auditor is demonstrating professional scepticism and objectivity.

1.6. The FRC's AQR inspection results provide one possible measure of audit quality. We acknowledge the challenge for all market participants to reach the FRC's target for 90% of FTSE 350 audits requiring no more than limited improvements, and, indeed, we note that KPMG faced a disappointing drop in our own AQR inspection results for 2017/2018 and that further work needs to be undertaken to improve the position. However, given the difficulty of assessing audit quality, one measure cannot be taken to infer an overall failing of either competition or quality. Moreover, the existence of the FRC's 90% target evidences the high-quality standards to which auditors are held to account and the climate of continuous improvement required of audit firms. Further detail on the FRC's AQR inspection results as a measure of audit quality is set out in Paragraph 1.12 below.

1.7. We also do not consider that individual instances of corporate failure can be used as evidence of audit failings. We note the findings of Sir John Kingman's review that it is important to be realistic about the likelihood of corporate failure, which he suggests is inevitable in a vibrant and competitive economy.[3] Throughout the Update Paper, the CMA conflates individual failings with systemic failings[4] and corporate failure with audit failure.[5]

1.8. Further, the evidence does not show that stakeholders such as investors and analysts perceive there to be a systemic quality problem with statutory audit services for FTSE 350 companies. In fact, the UK is widely respected internationally for the quality of its financial reporting and corporate governance, as noted by the Competition Commission ("**CC**") in its 2013 inquiry,[6] and the recent Kingman review notes that the quality, accuracy and reliability of corporate

[2] Financial Reporting Council, Developments in Audit 2018 at page.6, which notes that the FRC's assessment sample "*is not statistical, (so that) we have to be careful in drawing definitive conclusions.*"
[3] Independent Review of the Financial Reporting Council, December 2018, para 16.
[4] See for example Update Paper, para 2.63.
[5] See for example, Update Paper, para 2.75 which speculates that audit may have prevented major corporate failures such as Carillion.
[6] CC Final Report, paras 12.10 – 12.13.

reporting, governance and audit in the UK contribute to the UK's standing as a pre-eminent international financial centre.[7]

1.9. We note that the CMA has found that some academic research suggests smaller audit firms may be expected to provide, on average, lower quality audits.[8] The CMA suggests that this may be because larger firms have more reputational capital to protect, higher litigation risk and greater regulatory scrutiny; they are less financially dependent on any given client, which reduces their incentives to compromise their independence; and they are able to attract and retain higher-quality human resources and expertise, therefore increasing their competence. Empirical evidence from recent studies (based on US data) supports this argument,[9] although it is unclear how far these findings might read across to the UK. However, if true, this research would suggest that measures to increase the proportion of audits provided by smaller firms may risk a reduction in audit quality.

1.10. Finally, whilst we agree that reforms are needed, and we are determined to improve the consistency of quality of the audits we perform, we do not believe that the CMA has shown evidence that key stakeholders consider there is a systemic problem with the quality of audits. More specifically:

1.10.1. overall, the balance of views from audit committees ("**ACs**") and investors was that audit in the UK is generally of a high quality.[10] This positive overall view of quality is also reflected in the recent FRC survey of Audit Committee Chairs ("**ACCs**"), which suggested that 86% of respondents rated their external auditor as either 'excellent' or 'above average'.[11] ACs do not hold the view that there is a systemic and significant quality problem (as the CMA acknowledges). Members of the Audit Committee Chairs Independent Forum (ACCIF) told the CMA that they felt confident in their ability to assess the quality of the key aspects of the audit of their companies.[12] Moreover, the documentary evidence the CMA gathered from companies and auditors suggests that tenders usually involve detailed and comprehensive selection processes;[13]

---

[7] Independent Review of the Financial Reporting Council, December 2018, at para 1.
[8] Update Paper, para 3.112 and the citations provided in that paragraph. This view seems to be supported by Figure 2.18 of the Update Paper, which shows a clear quality difference between the big Four and smaller audit firms: see paragraph 1.12 below.
[9] Update Paper, para 3.112, citing Berglund, N. R., J. D. Eshleman, and P. Guo (2018). Auditor Size and Going Concern Reporting. Auditing: A Journal of Practice & Theory, 37(2), 1-25; (ii) DeFond, M., D. H. Erkens, and J. Zhang (2017). Do Client Characteristics Really Drive the Big N Audit Quality Effect? New Evidence from Propensity Score Matching. Management Science, 63(11), 3628-49
[10] Update Paper, para 2.62.
[11] Update Paper, para 2.62.
[12] Update Paper, para 3.36.
[13] Update Paper, para 3.72.

1.10.2. the 100 Group, which represents the views of FTSE 100 finance directors and several large UK private companies, stated that, in its experience, ACs are focused 'on the quality and challenge provided by the audit firm';[14]

1.10.3. it is not the view amongst shareholders – who are the ultimate customers for statutory audit – that there is a problem with the quality of FTSE 350 audits;[15]

1.10.4. overall, the evidence from recent tenders suggests that quality is typically viewed as more important than price, which matches the preferences of most shareholders and other stakeholders.[16] The CMA found little evidence to support a claim that ACs overly focus on price in the selection of auditors.[17]

1.11. In addition, the CMA acknowledges that (to the extent they exist) public concerns may arise in part from an expectation gap about the role of audit,[18] and it heard various views about how the role of audit should change in the future. The recently announced review into UK audit standards by Sir Donald Brydon will expressly consider how far audit can, and should, evolve to meet the needs of investors and other stakeholders. As already stated, this review will provide much needed context to many of Sir John Kingman's recommendations and will be critical to the successful sequencing, timing, implementation and, ultimately, evaluation of possible changes.

Comments on specific parts of Section 2 of the Update Paper

1.12. Figure 2.18:[19] The CMA, in its Update Paper, refers to the FRC's AQR inspection results as evidence that audit quality, especially amongst the Big Four and in relation to FTSE 350 audits, is not satisfactory. The CMA attributes this to a lack of competition,[20] but the evidence provided does not support the conclusion that there is a lack of competition in this area, or that a lack of competition is driving poor audit quality outcomes. In particular:

1.12.1. the FRC's AQR inspection results are one measure of audit quality, and even the FRC itself cautions that the sampling methods it uses are not statistical, so caution must be exercised in attempting to draw definitive

[14] Update Paper, para 3.19.
[15] Update Paper, paras 2.5 and 2.63.
[16] Update Paper, para 3.15.
[17] Update Paper, para 3.17.
[18] Update Paper, paras 2.66 - 2.71.
[19] Analysis of FTSE 350 audits inspected by the FRC for Big Four (FTSE 350 audits) and challenger firms (all audits).
[20] KPMG notes that the CMA acknowledges that academic literature is unclear as to the relationship between competition and audit quality: see Update Paper, para 3.67.

conclusions,[21] particularly in an environment where firms market-wide are striving for continuous improvement and to progressively raise the bar of audit quality over time;

1.12.2. although KPMG notes that its AQR inspection results in 2017/2018 indicate some short-fallings in audit quality for our own firm, 2016/2017 was the fifth consecutive year of increased overall FRC measured quality, which the FRC itself noted showed an "*improving picture in recent years.*"[22] In absolute terms, the FRC measured quality result for 2017/2018 was still over 30% higher than the equivalent result in 2011/2012, which shows an overall picture of progressively increasing audit quality prior to the 2017/2018 AQR inspection results;

1.12.3. if the AQR inspection results are used to assess quality, based on the chart the CMA has included at Figure 2.18, in all years surveyed other than 2017/2018, the proportion of "*good or limited improvement*" audits by the Big Four is significantly higher than for the smaller audit firms;

1.12.4. in addition, the proportion of Big Four audits that require "*significant improvements*" (which is a key statistic in assessing those audits that are likely to be of such poor quality as to significantly erode public trust and confidence), is less than half that of the smaller audit firms in both 2013/2015 and 2016/2017, and it also represents a much smaller percentage in 2017/2018. This implies again that the Big Four firms are providing a higher and more consistent quality audit product than smaller audit firms.

1.13. Figure 2.17:[23] FTSE 350 audits (which are generally performed by the Big Four) have received higher AQR results from the FRC than non-FTSE 350 audits (in which smaller audit firms are represented to a greater extent) across all years surveyed (2011-2018), notwithstanding the apparent lack of choice the CMA claims exists for these companies. The CMA notes that 73% of FTSE 350 audits were assessed as good or requiring limited improvement, which is "*well short of the FRC's target*" but, in fact, this graph indicates that the quality of audits carried out for FTSE 350 companies is consistently higher than the quality of audits carried out for non-FTSE 350 companies, a large proportion of which are carried out by smaller audit firms. As such, the CMA's suggestion that a lack of choice for FTSE 350 companies has led to a lower quality of audit is not supported by the evidence, which instead shows lower quality of audit for companies which have a greater choice of auditor.

---

[21] Financial Reporting Council, Developments in Audit 2018 at page 6. which notes that the FRC's assessment sample "*is not* statistical, *(so that) we have to be careful in drawing definitive conclusions*."
[22] Financial Reporting Council, Developments in Audit 2018 at page 6.
[23] Percentage of audits inspected by the FRC rated as 'good' or 'required limited improvement'.

1.14. Paragraph 2.44 (earlier identification of issues in problematic audits would have provided shareholders and other stakeholders the opportunity to make more informed decisions): We do not believe that the conclusions in this paragraph are realistic in light of current accounting standards or that the CMA is sufficiently well placed in the context of a rapid market study into the degree of competition within the audit market to assess the reasons for recent UK corporate failures. The wider question of whether the current audit framework is consistent with public expectations and more broadly fit for purpose is one which the Brydon review will soon expressly consider. Moreover, we note the findings of the Kingman review (the mandate of which was to provide a root and branch review of the overarching regulatory body responsible for audit) that it is important to be realistic about the likelihood of corporate failure and that it is inevitable in a vibrant and competitive economy.[24] We further note that Kingman also suggests changes to the FRC's powers to act on intelligence and identify problems earlier[25] and we are supportive of these changes.

1.15. Figure 2.19:[26] We query the CMA's use of international cases which the CMA implies reflect both widespread and longstanding concerns about quality. Ad hoc international examples of audit failure are of negligible probative value given that no context is given as to the examples or relative frequency with which they occur or the relevant regulatory scheme of the country concerned. As with any service industry, whilst examples of individual failings exist, the key metric is the rate of those failings, their severity and the underlying root cause of the failing. These failures provide important learning opportunities for us in line with our culture of continuous improvement, which is necessary in the constantly evolving market.

2. Do you agree with our analysis of the issues that are driving quality concerns?

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

2.1. As the CMA notes in its Invitation to Comment ("**ITC**"), audit is a service for shareholders, but is commissioned by the company (following both AC recommendation and shareholder approval), as has always been the case under company law. We do not, however, believe that what the CMA describes as a "principal-agent" problem adversely affects audit quality. In particular, the very reason audit has evolved has been to reduce the principal-agent problem by providing an independent check on management behaviour by ensuring that the financial reporting of companies to shareholders (the principal) is accurate and gives a true and fair view of the company concerned.[27] In addition, the AC is a

---

[24] Independent Review of the Financial Reporting Council, December 2018, para 16.
[25] Independent Review of the Financial Reporting Council, December 2018, para 18.
[26] International examples of audit problems.
[27] See for example, ICAEW, "Agency Theory and the Role of Audit", available at https://www.icaew.com/-/media/corporate/files/technical/audit-and-assurance/audit-quality/audit-quality-forum/agency-theory-and-the-role-of-audit.ashx at page 4.

critical safeguard in aligning incentives and preserving audit quality. We strongly believe that the current framework for ACs supports (and indeed requires) the provision of high quality audits.

2.2. Our experience is that ACs are sophisticated purchasers of audit services – but this may not uniformly be the case and we welcome initiatives to make quality more consistent. They closely scrutinise and challenge auditors' work, including consideration of any potential conflicts of interest. ACs pay close attention to audit firms' AQR results and ask questions around firms' quality processes – particularly since the introduction of requirements for additional tendering. ACs' focus on quality is driven in part by the need for members of ACs to protect their personal and professional reputation, which relies on the robustness of the auditing and financial reporting carried out. The CC's 2013 interventions have driven an overall paradigm shift in the way audit decisions are made; whereas historically this used to be a relationship decision, with a high degree of continuity and low switching, companies, led by their ACs, are now much more analytical about trying to find technical differentiation.

2.3. The CMA argues that factors such as "cultural fit" are given a disproportionate weight in audit appointment criteria, and that this reflects a tendency for ACs to select external auditors who are least likely to provide independence, scepticism and challenge of management practices, which is contrary to the delivery of high quality audits. While we note that the Kingman review proposes a number of regulatory changes to strengthen the role and regulatory accountability of ACs,[28] which we support, we do not agree with the CMA's criticisms of the way that ACs currently make appointment decisions. At a conceptual level, given that auditors' primary role is to provide independent scrutiny of the actions of *management* not ACs themselves, the use of criteria like "cultural fit" in selection decisions by ACs should not be of concern; unlike auditors and management, the incentives of auditors and the AC in a thorough and independent audit are closely aligned. As a result, it cannot be inferred that such criteria suggest selection based on absence of independent challenge.

2.4. In any case, the CMA offers little objective evidence in support of its conclusion that such criteria have a disproportionate weight in auditor selection decisions. In particular:

2.4.1. the CMA draws on a sample of only 24 FTSE 350 companies in its analysis of evaluation criteria for auditor appointments – i.e. less than 7% of the overall pool of companies[29] and only around one tenth of the number of FTSE 350 firms for whom the CMA obtained tender data.[30]

---

[28] Independent Review of the Financial Reporting Council, December 2018, summarised on page 14.
[29] Update Paper, Figure 2.20.
[30] Update Paper, para 3.20.

2.4.2. even if the appointment criteria identified by the CMA in this small sample were reflective of the criteria used by companies to select auditors, terms such as “cultural fit”, “chemistry” etc. are not well-defined (as is acknowledged by the CMA[31]) and therefore cannot be inferred as implying the lack of independence which the CMA suggests.

2.4.3. more broadly, we dispute that criteria such as “cultural” fit necessarily contradict with effective auditor challenge. Our experience is that effective challenge relies upon developing appropriate relationships with management, so as to obtain the information necessary to provide a well-informed critique of management practices. It is true that some elements of an audit can be conducted effectively regardless of the quality of relationship – detailed verification of individual transactions for example. However, in other areas, the quality of the relationship is very important. For example, the auditor’s understanding of the business depends to a considerable extent on management and staff at the audited entity explaining the business and “how things work in practice”. Here, the depth and quality of responses to questions, and descriptions, for example, will be better where there is a co-operative relationship. Where the relationship is poorer, management and staff may be less inclined to spend quality time with the auditor and/or limit responses / explanations to the specific question or request, rather than seeking to understand the intention behind the question / request and responding accordingly. In extremis, this can lead to obfuscation and a lack of care in responding to queries.

2.4.4. similarly, when there are more contentious issues to be addressed, the ability to have open discussions about the issue and its resolution is likely to be easier where there is a good relationship allowing an open discussion, on a timely basis, with sufficiently senior management. Without such a relationship, management instead may simply not engage with the issue, resulting in the matter becoming a point of disagreement which only gets resolved, possibly with a worse solution, late in the audit process.

2.4.5. whilst the overt outcome of an audit is the auditor’s report, the auditor’s impact on the quality of annual reports is often achieved through influencing the management and Board of audited companies to make changes that improve the balance and clarity of the disclosures, as well as to make important changes to the financial figures. The ability to influence in this way is enhanced by the management’s and Board’s trust of the auditor and can be destroyed by a lack of trust. Similarly, providing tough feedback that results in the right actions being taken by management and the Board on, for example, governance processes or the quality of management also requires a high level of trust. Indeed, the

[31] Update Paper, para 3.25.

need for an appropriate relationship with the company is reflected in the requirements for the tenders we participate in, where some clients have expressly stated in their tender documents that they are looking for criteria such as "*good relationships […] coupled with honest feedback*"[32] or "*gravitas from the lead partner […] including ability to interact with the Board Audit Committee*".[33] Criteria such as these indicate that, rather than applying a lack of independence, a good relationship with the company and a strong audit partner can in fact increase audit quality where the auditor feels comfortable being open and honest with the Board, and in influencing them to make improvements.

2.4.6. in addition, we note that several of the definitions the CMA notes for "cultural fit" include factors that do relate to providing challenge (for example, the example cited in paragraph 3.27, where the definition of "cultural fit" explicitly included the audit partner and team bringing adequate challenge). Similarly, we would expect "technical capabilities" – which is evaluated in all tenders the CMA reviewed – to include challenge, so the figures presented comparing the prevalence of these different evaluation criteria are not significant.

2.4.7. the CMA indicates that the auditor used in the example at paragraph 3.26 was chosen mainly on cultural fit and showed "*not much challenge during the process*". While there is little that can be deduced about overall market practices and standards from single anecdotal examples, the example is in any case inconsistent with footnote 121, where it is noted that the auditor did indeed resist challenge from the Finance Director.

2.4.8. finally, we believe that the use of terms like "chemistry" and "cultural fit" in tender criteria simply reflect the role of important service quality factors which are key parameters of competition in an industry like auditing. We are proud of our ability to offer high levels of client service to a range of different clients, both through the industry and sector knowledge of our staff and their professional manner whilst nevertheless providing robust and independent challenge, which allows us to succeed in a highly competitive market.

2.5. The CMA also argues that senior management involvement in the selection process provides an opportunity for them to influence auditor appointment, particularly given the importance attached to factors like "cultural fit" and "chemistry", and that this is to the detriment of audit quality. As stated above, we consider that factors such as cultural fit reflect service factors upon which audit firms compete and that this does not conflict with the delivery of high-quality audits as the CMA suggests – instead in many cases it will enhance audit quality. In addition, whilst the independence of the AC and auditors from senior management

32 [✂]
33 [✂]

must be preserved, senior management necessarily have a closer knowledge of the business to be audited than the AC. As such, their input into the audit tendering decision can assist the AC in ensuring that they have sufficient information to be able to determine the best qualified auditor for the business in question. It is for ACs to make sure that the role of management in tenders is appropriate and in general we see this happening in practice.

2.6. The CMA generally questions the effectiveness of ACs in overseeing auditors. However:

2.6.1. members of the Audit Committee Chairs Independent Forum (ACCIF) told the CMA that they felt confident in their ability to assess the quality of the key aspects of the audit of their companies, in particular by discussing with the auditors the work performed on areas of higher audit risk and the basis for the auditors' conclusions on those areas, supplemented by their other interactions with the auditors.[34] That enabled them, for example, to gauge the depth of the auditors' understanding of the company's business.

2.6.2. the CMA notes that the amount of time spent by ACs overseeing audits varies significantly across companies (which it appears to infer as showing an inconsistent degree of scrutiny of external auditors). We do not believe that this fact alone suggests a lack of scrutiny by ACs. We would expect the time spent to vary considerably depending on the scale of the company's operations and the nature and complexity of its operations (with obvious implications for the audit). Whilst we note that the CMA states that the time spent varies even for 'similar companies', given that the CMA relies on a sample of only 18 companies from the FTSE 350, it is unclear how the CMA could have properly taken into account the complexity of different audits and compared companies on a like-for-like basis.

b) Limitations on choice leading to weaker competition

2.7. As mentioned in our response to the CMA's ITC, we are open to, and supportive of, measures to improve choice in the market, provided that the ultimate solutions do not jeopardise audit quality now or in the future. However, we do not consider that audit consumers, as a whole, suffer from a lack of choice between high-quality providers.

2.8. We note that during the CC inquiry, the CC stated that competition during tenders was strong – yet in the Update Paper, the CMA is stating that competition and choice is not sufficient (without justifying its reasoning). Paragraph 9.309 in the CC's final market investigation report states that: "*Our view is that competition in tender processes for FTSE 350 engagements is strong in relation to the factors on*

[34] Update Paper, para 3.36.

which selection is based, namely the capabilities and experience of the firms and the audit team, the reputation of the firm and the audit fee".

2.9. The majority of companies tendering for an audit have at least three bidders. This rivalry drives audit quality and the incentive to invest in service quality. In this sense, it can clearly be said that large companies as a group have sufficient choice to drive very strong competition in audit services. The CMA's small sample of FTSE 350 companies (only 24 cases) does not permit meaningful conclusions to be drawn for the whole market, and even less so when narrowed further to the five cases the CMA identifies of FTSE 350 companies sampled that had only two bidders for their audit tender (although we note that at least three out of five of these companies did in fact appear happy with the level of choice they had even in this scenario, and that very strong competition can in any case result between two firms who can both offer a high-quality offering).

2.10. We believe that the vast majority of public interest entities ("**PIEs**") and other large companies do currently have the choice of multiple high-quality offerings. However, the nature of the demand means that for many companies only the Big Four are considered as being able to offer the quality, resources and investment necessary to compete effectively. This is a direct result of the fact that audit firms compete aggressively to develop better quality audit offerings. Our observations are that ACs, particularly of FTSE 350 companies, continue to prefer Big Four audit firms over others based on a perceived higher quality of service provision and the statistics cited by the CMA's ITC appear to confirm this. This does not reflect a reduction in choice – quite the opposite, it reflects the deliberate decision by the procuring companies to exercise their ability to choose in a discriminating way.

2.11. More broadly, we note the following relevant conclusions from the CMA's Update Paper about the extent of choice in the market:[35]

- tenders occur much more frequently than in the past;
- in most cases tenders involve detailed and comprehensive processes that should allow the company to make well-informed decisions;
- although there are costs of tendering and switching, the switching process has generally gone smoothly; and
- the majority of companies believe they have sufficient choice.

2.12. We agree with the CMA's statement that "*All things being equal, the more choice that Audit Committees have in selecting their auditor, the stronger competition will be*".[36] However, this statement would apply to any market irrespective of the extent of competition within it. In a real-world context all else is not equal and the current structure of the UK statutory audit market has been shaped by competitive market

[35] Update Paper, paras 3.64 - 3.65 and 3.75.
[36] Update Paper, para 3.63.

forces. In particular, audit firms, especially the Big Four, have invested very considerably in the scale and techniques that are necessary to keep pace with the global reach of many companies and the sheer complexity of many modern businesses. In audit, competition drives concentration due to the need for investment in technology and skills, and firms must compete to employ the highest quality staff. There is therefore an inherent trade-off between audit quality and consumer choice, at least as the market currently operates, and any initiative to alter this would need to be very carefully designed and progressively implemented in a market and industry driven way.

c) Barriers to smaller audit firms for FTSE 350 audits

2.13. While smaller audit firms have more opportunity to tender than previously, we acknowledge that these firms may face experience and reputational hurdles. However, as set out above, this largely reflects the operation of market forces, which drives concentration due to the need for investment in technology and skills, and the need for firms to compete to employ the highest quality staff. These are not 'barriers' to smaller audit firms, in the sense set out in the CMA's market investigation guidelines (such as natural or intrinsic barriers, strategic barriers, or regulatory barriers);[37] rather the smaller audit firm's position has resulted from competitive and quality enhancing market forces.

2.14. Similarly, what should not be mistaken for a barrier to entry is smaller audit firms not being appointed because of quality differentials compared to larger firms. We note that the CMA's Update Paper outlines several key respects in which the quality of the service offered by smaller audit firms falls below that of the Big Four, even outside the FTSE 350 context which the CMA focuses upon. Smaller audits provide a path to progression towards more complex FTSE 350 audits if the firm performing them can establish a high-quality record in doing so, which would enable further upskilling on larger and larger audits. However, the smaller audit firms do not appear to have achieved this. This is evident in the FRC's AQR inspection results, which the CMA analyses in Figure 2.17 and Figure 2.18 of the Update Paper. While AQR results are not statistically robust for year-on-year comparisons to allow significant weight to be placed on findings in an individual year, the overall consistent picture over time is of the difference between Big Four and smaller firms.

2.15. As the CMA itself notes in its Update Paper, a well-functioning market should ensure that firms and individuals succeed financially and reputationally if they produce the highest quality over and above the minimum standards.[38] We consider that this is indeed what is happening in the statutory audit market, with the Big Four benefitting from, and further investing in, the quality advantage they offer to audited firms.

[37] CC3, Competition Commission, Guidelines for market investigation: Their role, procedures, assessment and remedies, para 210, April 2013.
[38] Update Paper, para 5.

2.16. The CC in 2013 considered that, given strategic investments to build reputation and to target appropriate FTSE 350 companies, there was no reason why mid-tier firms could not expand their provision of audit services on an incremental basis. We believe this is still the case. Many more tendering opportunities are now available in the audit market and increased levels of switching are occurring. This should remove one of the barriers to expansion cited by the CC in the last review and strengthen its view that incremental expansion by mid-tier firms could occur, particularly in the FTSE 250. Moreover, the smaller audit firms are able to build their scale, networks and breadth of expertise in other ways, with the recently announced merger between BDO and Moore Stephens[39], which The Guardian described as "*piling the pressure on the Big Four*",[40] being one such example.

2.17. It cannot be ignored that the Big Four firms have made and implemented significant decisions that the smaller firms have (at least until this point) seemingly chosen not to. To service an increasingly complex and globalised market, each of the large firms undertook at least one major merger. Such mergers have allowed the Big Four to gain critical mass, breadth and depth of expertise, deep international capability and foundations for investment. None of these mergers were without risk from commercial, operational and strategic perspectives. In addition to these merger risks, the Big Four firms inevitably had to accept trade-offs; for example, the greatly improved international strength comes at the cost of reduced local country flexibility. Other firms may have largely chosen not to take the significant risk inherent in mergers or the trade-offs and sustained efforts that are required to make them succeed.

d) Resilience concerns

2.18. The CMA expresses a concern that resilience issues might create an incentive for the regulator not to take appropriate action against a large audit firm that was performing poorly because of the fear that this might drive the firm out of business. One group of academics told the CMA that despite regulators holding concerns about the market structure and the impact on choice, "*the profession is likely to escape censure from either the government or regulators who fear that any crackdown will only force one or more of the firms out of business and make the situation worse*".[41]

2.19. As noted above, the Brydon review, together with Sir John Kingman's review, will provide essential context for any future reform and we urge the CMA to take this wider context fully into account in assessing this potential issue. In any case, we note that the CMA has not found any evidence that any such "too big to fail" considerations are currently affecting the approach of the FRC. As the Kingman

[39] https://www.accountancyage.com/2018/12/20/bdo-and-moore-stephens-exchange-contracts-on-merger-agreement/
[40] https://www.theguardian.com/business/2018/nov/25/moore-stephens-and-bdo-merger-could-pile-pressure-on-big-four
[41] Update Paper, para 3.148, citing Professor Atul Shah, Mr Brian Little, Mr Paul Moore and Professor Richard Murphy Response to CMA Invitation to Comment, 30 October 2018, page 3.

review highlights, compared to the Public Company Accounting Oversight Board ("**PCAOB**") in the USA, the levels of fines imposed on both companies and individuals by the FRC are significantly higher, with the largest individual fine levied by the FRC over four times as high as the largest individual fine levied by the PCAOB.[42] This suggests that audit firms in the UK already face the prospect of penalties which are very significant by international standards, which strongly refutes the CMA's concern about the lack of effective regulatory action against audit firms that do not meet quality standards.

2.20. In any case, the failure of an audit firm is not the most direct way in which the threat of "failure" drives incentives to maintain audit quality. As we previously explained in our response to the CMA's ITC, audit is a service performed by individuals within firms, rather than firms as monoliths. Audits are led by individual partners, and those partners can "fail" if they are seen not to have demonstrated the right degree of professional scepticism or judgement, or executed their responsibilities as required by professional standards. During a tender process, companies will almost always require information on the record of the proposed senior team in relation to KPMG's quality review process. This leads to any partner with a poor inspection result not being included in tender documents and, as a result, to significant damage to their career.

2.21. Similarly, these results are shared with clients during the course of an audit and, again, any poor inspection result (unless adequately explained and remediated) would most likely lead to a client demanding that the partner no longer work on their audit. As well as an individual's professional reputation, sanctions of UK audit partners can be applied by the FRC and ICAEW. These individuals therefore have very powerful personal incentives to provide a high-quality product and effectively compete against each other even within firms to develop reputations for quality which, as the CMA itself notes, leads to commercial success.[43]

2.22. At an inter-firm level, as the CMA notes in its Update Paper, switching levels within FTSE 350 firms are very high and have markedly increased following the introduction of the CC and European Commission remedies.[44] This reflects the intensity of competition in the market, and given the highly transparent nature of FRC reviews and AQR inspection results, any firm that consistently had worse inspection results or has suffered more generally from a perception of a decline in quality would be highly vulnerable to commercial pressure from competing firms who are able to seize upon any opportunities in marketing and tender situations to win market share. We are acutely aware of this risk in relation to our own most recent AQR inspection results and it is for this reason that we have taken immediate and significant action to implement a range of measures to remedy the reduction in FRC inspection results we experienced in 2017/2018. As is set out above, the fact the Big Four accounting firms have consistently outperformed the

[42] Independent Review of the Financial Reporting Council, December 2018 at page 42
[43] Update Paper, para 5.
[44] Update Paper, para 2.2.

smaller audit firms in AQR assessments is a major part of their greater commercial success.

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

2.23. Auditors need to be objective in carrying out their work and independent of the companies they audit. We believe that in practice this is the case. The professionalism of our partners and staff, the qualifications required to practice as an auditor, the ongoing training that they receive, as well as the standards with which they have to comply are drivers of this objectivity and independence which enable high quality audits to be delivered. Moreover, there are strong disincentives to the delivery of audits which are not of the quality required – most notably the serious financial and reputational consequences for individuals and firms alike.

2.24. Regardless of whether this is the case in practice, it is clear that perceived conflicts of interest are at the centre of much of the current criticism of the audit profession and that the potential for conflicts needs to be managed more effectively and transparently by audit firms to improve public confidence and trust in the profession (and capital markets more broadly). We have already taken a number of steps to strengthen the governance and performance management of our audit business (and the transparency thereof), including the establishment of a Board sub-committee focused on audit quality and the primacy of audit quality goals for all audit partners.

2.25. However, while further enhanced governance is likely to address this perception to a degree, we recognise that restricting the provision of non-audit services may also be desirable. We are already working towards the discontinuance of non-audit services (other than those closely related to the audit) for the FTSE 350 companies that we audit. We believe that if a similar restriction was implemented market-wide within a regulatory framework, this would be an effective way of mitigating actual or potential conflicts and increasing trust in audit.

2.26. The direction of travel with regards to non-audit services to audited companies across the profession has been clear for a number of years. The proportion of non-audit fees to audit fees provided by companies' statutory audit firm has fallen significantly in the last seven years (also bearing in mind that non-audit fees include audit related services[45]). As such, we are overall supportive of greater operational separation. Nevertheless, we note that there are significant implementation challenges in realising this split and the detail of how it could work in practice will need to be very carefully considered.

2.27. Having said this, we do not consider that the CMA uses credible evidence in the Update Paper to demonstrate that:

---

[45] As set out in paragraph 5.41 of the FRC's Ethical Standard.

- auditors have weak incentives to challenge a company's management or exercise scepticism about the company's accounts if they are also selling substantial non-audit services (by virtue of being part of a multi-disciplinary firm); or

- auditors are adversely influenced by the cross-pollination of the culture of and diversion of focus to the non-audit practice particularly with regard to the audit of FTSE 350 companies by Big Four firms.

2.28. This lack of evidence is consistent with the findings of the CC in 2013, who found no link between audit profitability and the level of non-audit services provided.[46] Since then, as the CMA notes, the effect of both CC and EU interventions has been to further restrict the overall amount of non-audit services that can be provided and prohibit entirely certain types of services to listed audit clients.[47] Indeed, the data presented by the CMA shows that the amount of non-audit services to audit clients (which is the more direct of the two theories of harm the CMA posits about adverse incentives on audit quality) by smaller audit firms is more than double that of the Big Four to FTSE 350 clients.[48]

2.29. Overall, the CMA's Update Paper describes finding limited evidence of conflicts between audit and non-audit work at the client level, primarily because of the restrictions in place on cross-selling.[49] As the CMA notes, the rules on conflicts and on the amount of non-audit work that can be provided to an audit client significantly reduce any incentive that the auditors might have to use audit as a loss leader at the client level. Where the Big Four win tenders for large company audits, they frequently have to reduce rather than increase their non-audit work to that client, so it is not clear why they would have an incentive to 'under-bid'.[50] This is borne out in the significant reduction the CMA notes in the average value of non-audit services provided by the Big Four firms to their audit clients from around 55% of audit fees in 2011 to 38% of audit fees in 2018.[51] While revenues from non-audit services have also increased faster than those from audit, the bulk of these non-audit services are provided to companies that are not audit clients.[52]

2.30. Providing non-audit services to audit clients is therefore much less common now than at the time of the CC's comprehensive market investigation, which even then rejected the need for any further restrictions on the provision of non-audit services by audit firms,[53] concluding that the role of ACs in appointment decisions was

---

[46] CC Final Report, paras 7.93 and 17.74.
[47] Update Paper, para 3.160.
[48] In 2018 the average value of non-audit services to their audit clients was around 42% of audit fees for the smaller audit firms (Update Paper, para 3.159). By contrast, the CMA estimated that, in 2017/18, revenues earned from non-audit services provided by the Big Four to their FTSE 350 audit clients were, on average, around 20% of their FTSE 350 audit fees (Update Paper, para 3.161).
[49] Update Paper, para 3.155.
[50] Update Paper, para 3.167.
[51] Update Paper, para 3.157.
[52] Update Paper, para 3.158.
[53] CC Final Report, paras 17.64 - 17.79.

sufficient to reduce the risk of any adverse incentives to audit quality arising from the provision of non-audit services.

2.31. The CMA's second, and more speculative,[54] concern relating to the provision of non-audit services is that the provision of these services may be detrimental to audit quality because:

- the client service driven firm culture that develops through the provision of consultancy services may spill over into the culture of the audit practice and undermine the culture of independence and challenge necessary for high-quality audit ("**cultural pressures**");
- the higher profitability of consultancy services relative to audit may create internal competition for resources meaning that less firm resources and attention are provided to the audit practice which progressively declines in relative importance ("**differential growth**"); and
- audit partner remuneration is driven by the overall profitability of the firm, and given that consultancy services are more profitable than audit, even audit partners themselves would have an economic incentive to promote the development of this area of the practice to the expense of the audit practice ("**audit partner remuneration**").

2.32. Each of these potential issues is considered in turn below.

CULTURAL PRESSURES

2.33. The CMA's concerns about cultural pressures from consultancy services, if true, would apply equally to all multi-disciplinary audit firms (not just the Big Four), and potentially also to many other professional service institutions with both regulated and non-regulated functions, or indeed any service institution where different skills are required for different practice areas. However, the CMA acknowledges itself that the academic literature upon which its concern is primarily based is unsettled,[55] and does not offer any UK specific empirical evidence to show an adverse effect on audit quality from the cross-pollination of the culture of non-audit services.

2.34. We strongly believe, contrary to being an adverse influence, that the quality of our audit practice benefits from being part of a multi-disciplinary firm, which is reflected in this model being the norm across the market, not only in the UK, but globally. Contrary to the CMA's suggestions, and beyond the direct importance of audit to the overall KPMG brand, many of the skills needed for effective and high-quality audit are also required in other areas of the KPMG business. At a conceptual level these include the need for objectivity, analytical rigour, attention to detail and constructive criticism and at a specific level include understanding of effective

---

[54] The CMA cites only a "debate" in the academic literature which has "intensified" in recent years: see the Update Paper, para 3.175.
[55] Update Paper, para 3.175.

governance structures and controls, due diligence, forensic investigations, and regulatory reporting. Obligations arising from audit and accountancy directly bind other parts of the KPMG business who practice outside these areas, such as in the requirement for all partners and staff in the firm to abide by the ICAEW Code of Ethics irrespective of their business division.

2.35. Moreover, audits are complex and require both specialist skills and significant technology which only the scale and scope associated with a multi-disciplinary firm can provide, particularly internationally. The provision of non-audit services to audited companies can lead to important efficiencies, thanks to economies of scope and direct savings for the audited entity which benefits from continuity and consistency. There may be further efficiencies that are enjoyed by audited companies from the provision of non-audit services by their auditor, which is likely to vary across companies. Any consideration of whether it is appropriate for an auditor to be part of a firm also providing non-audit services needs to recognise these potential benefits to those companies and take into account relevant views.

2.36. The CMA's discussion also does not take into account the commercial and regulatory context in which audits are performed and the personal incentives of the individuals who perform them, which mitigate against the potential adverse influences the CMA suggests exist. As the CMA notes, qualified auditors will have undertaken years of training, tested by rigorous examination. They will be members of a professional body and are subject to highly transparent independent quality assessments by the FRC, on both tangible service parameters and even, as the CMA itself quotes, on intangible factors like overall audit "culture". The scope of this regulation reflects the fact that the practices and values of the profession are fundamental to audit work, and the way that external regulation and internal controls exist to protect the professionalism of the audit function within firms.[56]

2.37. While, as the CMA notes, these regulations and controls rely on a commitment to professional standards that is embedded in the culture, the training, and the identity of professionals, auditors practice in firms which rely heavily on trust in their audit service in order to build the reputation of their brand. Given the high switching rates that the CMA has observed, failure to deliver high quality audits is likely to be punished by audit clients. Individual auditors compete both with other firms and with other individuals within their own firm for career progression and financial success, which provides a very strong incentive to offer a high-quality service and act with integrity. While it is indeed true that audit practices compete with other areas of practice to attract and retain quality talent, this would remain the case irrespective of whether audit was provided independently, or within a multi-disciplinary firm, and indeed retaining and attracting talent to the audit profession is easier within a multi-disciplinary firm.

[56] Update Paper, para 3.188.

DIFFERENTIAL GROWTH

2.38. As noted above, audit is the bedrock of our business. It is critical to the KPMG brand and, ultimately, to the success of the wider business. The CMA recognises the importance of audit to the wider reputation of a multi-disciplinary firm.[57] However the CMA considers that, despite this, audit investment is not as high as it could be and/or audit is not given appropriate weight in determining the strategy of the firm. These conclusions seem inconsistent with the importance of the audit brand to the broader business and in fact do not seem to be supported by evidence.

2.39. In our view, our overall brand is enhanced by our position in the audit market and the attributes of trust and quality that flow from this. By the same measure, when our audit quality is called into question these positive attributes are put at risk. For us, therefore, there is a strong incentive to invest in audit quality for the benefit of the whole firm. Contrary to the CMA's contention, a growing non-audit practice can facilitate the ability to invest in the audit practice. Given the importance of audit to the overall brand of our firm, investing in the quality and reputation of our audit practice confers a benefit not only on the audit practice itself but also on the non-audit practice. In this context, as the size of the non-audit practice grows, the proportionate cost to the non-audit parts of the business of investment in audit quality declines – thereby facilitating greater levels of investment.

2.40. Significant investment, resources and strategic direction are focused on audit quality in KPMG. This includes the audit transformation programme outlined at Annex 1 of KPMG's Response to the CMA's ITC which requires significant amounts of resource – including from senior leadership. More broadly, as the CMA notes, accounting firms have put in place a range of measures to ensure that their audit partners focus on audit quality within the multi-disciplinary firm structure.[58]

2.41. We have also provided, in our response to the CMA's ITC, extensive evidence of the investment that the KPMG international network (to which the KPMG UK member firm contributes) has made into audit technology – totalling [✂] over five years. The CMA has not provided any evidence to demonstrate why these levels of investment or the importance of such programmes to the strategy of the firm, are somehow marginalised due to being part of a multi-disciplined firm.

2.42. Furthermore, and again contrary to the CMA's suggestions, we strongly believe that there are a range of other benefits to our diversified business model, including:

- increasing the resilience of the business overall by reducing its financial and reputational reliance on each individual business area, and therefore its susceptibility to individual shocks within any given business area;

[57] Update Paper, para 3.188.
[58] Update Paper, para 3.188.

- providing economies of scope, which spread fixed costs and allow investment in firm level technologies that increase levels of client service to be spread more widely; and
- allowing the development of cross-practice sector specific expertise, which as set out in our response to the CMA's ITC includes, for example, financial services, pharmaceuticals, telecoms and energy.

AUDIT PARTNER REMUNERATION

2.43. The CMA suggest that "*audit partners are incentivised to care about the overall performance of the firm (the majority of which relates to non-audit services)*"[59]. We acknowledge that there remains a perception of over-reliance on non-audit business profitability and shared profits and that transparency of the financial performance of each business is required. Firms should ensure that financial information is produced for the two parts of the business in a way that achieves the required level of transparency to enable public and regulatory scrutiny of key aspects of the businesses. We believe this transparency can be achieved through annualised budgets for shared operations and formalised transfer pricing arrangements, and have already taken steps towards this. From the beginning of our current Financial Year (commencing 1 October 2018) we have changed the method of allocating costs in order to provide greater transparency of the profitability of audit and to enhance decision making.

2.44. However, at the same time, while it is true that all KPMG partners are affected by the overall performance of the firm, in our view what matters is the extent to which incentive and performance management structures are such that audit partners would have any incentive or ability to influence the profit of the non-audit practice at the expense of audit quality or performance. In this regard, we strongly believe that there is no evidence to support the CMA's concern.

2.45. As the CMA recognises, audit partner remuneration is linked to measures of audit quality.[60] The CMA describes a system whereby audit partners' end of year performance is determined by audit performance, in which measures of audit quality play an important part. As the CMA notes, this end of year performance then determines the share of the overall profit of the firm (including non-audit services) that each audit partner is allocated. This system implies that there is no incentive for audit partners to sacrifice audit quality in order to somehow improve the profitability of the non-audit practice. The difference an individual audit partner can make to the profitability of non-audit services is marginal, and any increase in non-audit service profit that would be achieved would be spread over all 603

[59] Update Paper, para 3.187.
[60] Update Paper, para 3.188.

partners in the whole of KPMG,[61] such that the impact on any individual audit partner's remuneration would be marginal at best.

2.46. By contrast, any actions taken by an audit partner that risk sacrificing audit quality have a direct and substantial impact on their remuneration – directly impacting their rating, and therefore the share of the overall profit that they are allocated. They are also likely to damage the overall KPMG brand, which is critical to the financial success of all parts of the KPMG business. There is therefore no financial incentive for audit partners to somehow put non-audit profit ahead of audit quality. This is quite apart from the personal reputational risk that any audit partner would subject themselves to if they let audit quality suffer in order to facilitate non-audit service growth and profitability.

2.47. In addition, even if they had the incentive to promote the profitability of the non-audit practice at the expense of audit quality, individual audit partners are accountable to their colleagues within the practice and an Audit Leadership team. This limits their ability to sacrifice audit quality given the immediate prospect of sanctions and remedial action, which would jeopardise their standing within the firm and prospects of further progression in future.

2.48. Overall, therefore, we consider that the CMA does not have evidence to support a provisional view that the measures put in place by audit firms (to manage conflicts and ensure a focus on audit quality) are insufficient to resolve any underlying tension between audit and non-audit work, nor that the incentive to focus on independent, high quality audit will decline in future.[62]

---

[61] Average numbers of KPMG LLP partners in FY2018, KPMG UK 2018 Transparency report, page 30.
[62] Update paper, para 3.189.

Part 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?

3.1. The answer to this will differ depending on the issue which the remedy is intended to address and / or the specific solution. We therefore address the question of scope, where relevant in the context of the specific remedy, in the responses relating to each remedy below.

3.2. However, as a general point, whilst we acknowledge the concerns that have been identified and are open to engaging with the CMA about the scope of the proposed remedies, we consider that more detailed work needs to be undertaken to determine the scope of particular remedies given the complexity of the proposals and the significant impact they are likely to have on investors, stakeholders and the market more widely.

3.3. We also note that, in so far as listed companies are concerned, a number of companies in the FTSE 350 (as well as at lower levels of the listed market) are not UK companies. To the extent that remedies are considered necessary to improve audit quality, those remedies applicable to individual companies or audit engagements should apply regardless of whether the company (or its auditor) is a UK registered company (or a UK audit firm).

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.

OUR VIEWS

4.1. As noted above, our experience is that ACs are sophisticated purchasers of audit services. They closely scrutinise and challenge auditors' work, including consideration of any potential conflicts of interest. However, oversight of the audit and the auditor are only elements of the AC's role, and the focus of any remedy should be on measures which strengthen the role, effectiveness and accountability of ACs (and independent non-executives ("**INEs**") more generally), rather than removing their authority in specific areas. Increased responsibilities on ACs in the appointment and oversight of the auditor are relatively new and have not yet had time to take full effect, albeit our own experience is that there has been a significant shift from executive management to the AC on audit related matters.

4.2. In our letter to Sir John Kingman dated 9 November 2018,[63] we proposed:

4.2.1. Enhanced disclosure, including a requirement for the Board to publish, as part of its recommendation to shareholders, more extensive details as to the execution of a tender, and the rationale behind its decision to propose the appointment for a specific firm and its remuneration.

4.2.2. Greater dialogue between ACs and institutional shareholders around the process of auditor selection. Larger companies might be encouraged or required to seek the views of the largest shareholders, and this process might form part of the enhanced disclosure referred to above.

4.2.3. Monitoring by a corporate regulator (as part of its "macro-prudential" responsibilities in overseeing corporate Britain) of the quality, consistency and transparency of how ACs appoint an auditor, including the quality and extent of engagement with shareholders.

THE CMA'S PROPOSALS

4.3. The CMA proposes that ACs should be required to report a number of matters to the regulator (a) before, during and after the tender selection process and (b) during the conduct of the audit (in each case a possible enhancement being with an observer sitting on the relevant AC), as well as providing the regulator with the ability to issue public reprimands or direct statements to shareholders.[64]

SIR JOHN KINGMAN'S VIEWS

4.4. For completeness, we note that Sir John Kingman has also written to the Secretary of State for Business, Energy and Industrial Strategy (BEIS) on the question of the approval of the appointment and remuneration of the auditor. In his response, Sir John expresses a personal view that the auditor of a PIE should, subject to approval as at present, be appointed by an independent body representing the public interest (specifically, the new corporate regulator), noting that the new regulator would need to build capability to do. However, Sir John also notes that his views do not appear to have support, including from the important constituency of investors. He therefore proposes an alternative way forward, namely that the regulator should have the right to appoint auditors in certain circumstances (where quality issues have been identified, or the auditor and the audited company part ways outside of a normal rotation cycle, or where there has been a significant shareholder vote against the appointment of the auditor) or approve audit fees where it sees a case for doing so in the interest of quality.

---

[63] KPMG letter to Sir John Kingman, 9 November 2018, page 2.
[64] Update Paper, para 4.16.

OUR COMMENTS ON THE CMA'S PROPOSALS AND SIR JOHN KINGMAN'S VIEWS

4.5. We agree with the CMA that the regulator should have the power to hold ACs to account where ACs have clearly failed to discharge their responsibilities (whether in relation to the auditor or to any other area). By extension, we believe the supervisory powers of the regulator should include the ability to challenge ACs as to how they have discharged their responsibilities and seek evidence of this. We also consider that greater transparency in relation to the audit tender process may reassure shareholders and other stakeholders that an effective tender process, with the emphasis on selecting the firm able to deliver the highest quality audit, has been run.

4.6. The CMA's suggestion that the regulator might nominate an observer to attend ACs may also have merit if shareholders had residual concerns which were not addressed by increased transparency and enhanced shareholder dialogue. In such circumstances, we suggested a similar approach in our letter to Sir John Kingman, namely:

4.6.1. A panel of "independent experts" would be established, for example by a nominating committee comprising investors or the regulator.

4.6.2. Panel members would need to be experienced professionals, most likely currently serving as non-executives (or recently retired from such roles) or recently retired senior auditors.

4.6.3. The "independent expert" would supplement the company's internal committee overseeing the tender process.

4.6.4. The Board of a company would continue to make a recommendation to shareholders, but the "independent expert" would report to the shareholders who would then be better placed to decide whether to endorse the Board's recommendation or adopt a different approach.

4.7. However, we believe the above model would be best applied only in the context of an audit tender process rather than in relation to the AC's oversight of audit quality more generally, since the primary area of shareholder concern appears to be over the auditor appointment decision. Beyond increased transparency, we are not convinced that further requirements of ACs in this area are necessary. The responsibilities of ACs pertaining to the audit and the auditor are already well defined,[65] and seeking greater specificity in this area carries the danger of a "checklist" approach to compliance. In addition, it is not clear that any reporting by ACs to the regulator, as envisaged by the CMA, would provide a sufficient basis for the regulator to "challenge" the effectiveness of an AC in this area and, indeed,

---

[65] UK Corporate Governance Code (July 2018), Chapter 4; FRC's Guidance on Audit Committees (April 2016).

it is in danger of creating a bureaucracy (the scale of which would depend on the scope of the remedy) for no real purpose.

4.8. We therefore remain of the view that increased transparency and enhanced shareholder dialogue, in conjunction with a regulatory framework which enables ACs to be held to account where they have failed in their duties, is sufficient.

SCOPE OF REMEDY AND INTERACTION WITH OTHER REMEDIES

4.9. In terms of the scope of any remedy in this area, this will depend to an extent on the remedy itself. For example, if the remedy is to provide for intervention by the regulator in certain specified circumstances, there is no reason as to why this should not be in relation to all PIEs. On the other hand, if a more interventionist approach were to be adopted - for example as envisaged by the CMA - in practical terms it is likely that this would need to be more limited, for example to FTSE 350 companies.

4.10. In addition, the interaction of this proposed remedy would need to be considered in conjunction with the other proposed remedies. For example, the need to report to the regulator "*…an objective justification for excluding any challenger firm*"[66] would be irrelevant if there was a requirement that one of the auditors in a joint audit arrangement needed to be a smaller firm.

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?

RATIONALE FOR MANDATORY JOINT AUDIT

5.1. We agree that for the long term health and stability of our capital markets, the UK needs more firms capable of auditing FTSE 350 and other public interest entities. Joint audits and market share caps have the potential to achieve greater participation and we are open to exploring these further. However, neither are easy to implement. As explained in response to Questions 10 and 11, we believe that a market share cap for a finite period is the better option of the two, although the implementation details are still complex.

5.2. In relation to joint audit, although in our view, there is little evidence that joint audits increase audit quality (and indeed there are some risks of a reduction in audit quality), we are not opposed in principle to joint audit and we recognise that it potentially has a role to play in addressing some of the capacity issues in the

[66] Update Paper, para 4.16(a)(iv).

market by providing an opportunity for smaller firms to gain experience of conducting larger, more complex audits. This should encourage smaller firms to expand their capability and capacity and, over time, build up their market share of audits for the FTSE 350 and PIE companies in the UK, which might benefit the long-term health and stability of the UK's capital markets. Judiciously implemented, mandatory joint audits, where at least one of the firms is required to be a smaller audit firm, could allow those smaller firms to invest, acquire experience and build expertise without a reduction in audit quality.

5.3. However, in our view, joint audit would need to involve both auditors on a more or less equal footing (i.e. with each of the two audit firms responsible for between 40% and 60% of the overall audit effort) and there would be significant challenges to designing an effective approach that works for all companies, for small and large audit firms alike, and for the market more generally. Therefore, the detail of how this remedy might work in practice and implementation of the remedy will be key. Risks to audit quality, which arise through the introduction of less experienced smaller audit firms and the partial oversight of each joint audit firm, communication hurdles, moral hazard, joint and several liability and a high degree of scepticism as to the benefits of joint audit amongst directors and investors, would need to be carefully managed. As the CMA acknowledges, cost increases from duplication of work will also be a significant adverse factor that must be considered. We note, in particular, that the long-established joint audit regime in Denmark was abandoned due to its unnecessary high costs, coupled with the lack of tangible benefits from an audit quality perspective.[67]

5.4. Overcoming these challenges would require careful institutional design, clear regulatory oversight and progressive implementation, which allows sufficient time for smaller audit firms to develop the resources and capabilities needed for a significant expansion in their work flow and the technical challenge of more complex audits than they currently perform. In France, where a joint audit model is used, practice has evolved over a period of over 50 years. A critical question for the remedy's design is how quickly smaller audit firms could build up the resources to take on the volume of complex, high risk audits that is implied and how they would manage joint and several liability of the scale to which they would be exposed in jointly auditing the UK's largest listed companies.

SCOPE OF THE REMEDY

5.5. There are arguments that any remedy to reduce concentration whilst ensuring audit quality is maintained might focus on companies most obviously within the capabilities of smaller firms, which would suggest the remedy might be applied (for example) to listed companies other than those in the FTSE 350. However, we acknowledge the particular concern relates to the level of concentration in the

[67] Danish Financial Statement Act 2001, Basis for Conclusions § 135, quoted in *"Struggle over joint audit: on behalf of public interest?"* Cédric Lesage, Sabine Ratzinger, Jaana Kettunen at page 36.

audits of the largest companies and therefore the FTSE 350, as a category, cannot be excluded.

5.6. This might suggest that the remedy should be applied to a wide range of companies - for example other listed companies (LSE and AIM), other EU PIEs, other significant entities – (such as large private companies), etc. However, we also note the potential challenges in terms of the ability (in terms of capacity and capabilities) of the smaller firms collectively to take on large numbers of larger audits in the short-term. We therefore believe that mandatory joint audit would be most effective as a remedy, and pose the least risk to audit quality, if the scope of the remedy is more limited, at least initially, and we would suggest that the remedy is focused on FTSE 350 companies where the public interest in audit outcomes is greatest (through dispersion of shareholdings and impact on the economy).

b) What types of companies (if any) should be excluded from a requirement for joint audit?

5.7. Whilst the focus of such a remedy should be on FTSE 350 companies, we believe that certain companies should be excluded from any such requirement. As we explain in our response to Question 7, we believe that for joint audits to operate effectively and in accordance with the rationale for the remedy, there needs to be equal, or at least reasonably equal, input from each joint auditor. On the implementation of joint audit, there would be companies within the FTSE 350 population where it would not be sensible, or potentially possible, for a smaller firm to achieve an appropriate level of contribution and in such cases we would not see any value in mandating joint audits where the scale (or nature) of the audited company is such that no smaller audit firm could participate in the audit of that company on a reasonably equal footing with its joint auditor.

5.8. It is not practicable for us to define which companies this would apply to, but we note that size and sector (or a combination of these) would be of relevance. In terms of size, smaller firms are unlikely to have the capacity and capability to take on the largest, most complex audits of companies, particularly those at the top end of the FTSE 100. However, this also might be the case for companies of a smaller size in certain sectors, for example financial services,[68] oil and gas, etc., where sectoral knowledge might be more limited due to the particular concentration of audits or the small number of companies in the sector.

5.9. In addition, many companies in the FTSE 350 have significant operations in many overseas locations, and this is even more the case for FTSE 100 companies. The more limited international networks of smaller audit firms (in terms of either geographic representation or scale in individual territories) may mean that certain

[68] As the CMA notes, there are some types of companies, such as banks, where the smaller firms may currently not have the required skills to perform an audit (Update Paper, para 4.36).

companies with particular geographic diversity may not be accessible to smaller firms at the outset.

5.10. Further, in relation to audits for the largest companies, the total liability may be prohibitively high for smaller audit firms to take on and they may have insufficient insurance cover to adequately de-risk themselves. Similarly, it would be challenging for the Big Four firms to take on the risk of conducting a joint audit with a smaller audit firm that does not have the requisite capabilities or insurance cover to participate in the audit in question. Moreover, an inequality of financial means could in fact weaken the resilience of the market, as while the Big Four audit firms may be able to bear the costs of a large liability claim, those costs may be irreparably detrimental to the joint smaller audit firm.

5.11. We would therefore suggest that the market would need to be segmented by size and/or complexity with mandatory joint audit being applied initially only to the segment(s) where the smaller audit firms are able to operate, for both individual audits and in aggregate. Under this framework, smaller audit firms would be taking on meaningful parts of FTSE 350 audits that they have the capability to do, on a reasonably equal footing with the Big Four partner.

5.12. By adopting this model, we envisage that once the joint audit programme is successfully implemented on the initial segment(s), it would (even without further intervention) ultimately lead to smaller audit firms developing the capacity and capability to audit even the largest FTSE companies and, ultimately, could achieve a market induced outcome of reduced concentration and more choice of auditor for the largest companies. If further intervention were needed to further stimulate the smaller firms to build capacity and capability, additional segment(s) of the market could be gradually added.

5.13. However, segmenting the market in this way would require regulatory intervention to ensure that the segmentation was undertaken on an informed basis, with a proper assessment made as to companies which might be mandated to have a joint audit, potentially against the wishes of ACs and shareholders, and those that might be excluded from such a requirement in the short term.

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.

6.1. Greater participation by smaller audit firms in the market for large audits would only be achieved to the extent that one (or both) of the joint auditors is a smaller firm in at least some cases. However, mandating that each FTSE 350 company was required to have at least one smaller firm as a joint auditor would require the transfer of 50% of the market to smaller firms which they would not, other than (possibly) in the longer term, have the capacity to meet. This would likely remain the case even if certain companies were to be excluded from the requirement by virtue of the reasons outlined in our response to Question 5(b) above (being too large, too complicated, or in sectors where smaller firms were not represented).

6.2. Given there is no evidence that joint audit improves audit quality, there is no justification for requiring mandatory joint audit for segments of the market where smaller firms would not have the capability or capacity to take on in the early stages of this remedy. A requirement covering the whole of the FTSE 350 would therefore have to be built up over time and could not be implemented in the short term.

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.

JOINT AUDITS SHOULD BE CONDUCTED EQUALLY BETWEEN THE JOINT AUDITORS

7.1. We believe that for joint audits to operate effectively and in accordance with the rationale for the remedy, there needs to be equal, or at least reasonably equal, input from each joint auditor, and that both firms must be reasonably equal in terms of their capability and capacity to carry out the audit. Only this level of participation would give the smaller firm a meaningful voice at the AC table and provide wide experience of the audit which could be a safe way to gain experience and provide AC members across the UK listed market with greater exposure to the smaller firms and their people. We could envision an implementation plan allowing smaller firms to take a smaller initial share in larger company audits (but no less than 20%) for a short period of time with a view to building this up to between 40-60% over, say, a three year period.

7.2. An unequal pairing of joint auditors, with the smaller audit firm only taking a low proportion of the work, would be less effective in achieving the CMA’s objectives of building up the smaller firms’ expertise, and indeed it is intrinsic in the concept of a joint audit that each of the two auditors share joint and several liability for the whole of the audit.

7.3. Finally, it is arguable that, where the contributions are asymmetrical, management would be more able to arbitrage between the two firms in seeking to support the validity of judgements it has made which would be detrimental to audit quality.

ALLOCATION OF WORK/FEES BETWEEN JOINT AUDITORS

7.4. On the basis of the scope outlined above, requiring joint audits for the smaller FTSE 350 companies in the first instance would allow the smaller audit firms to take on a large proportion (e.g. 40-60%) of the audit work on a reasonably equal basis to the Big Four partner. However, it would be critical for this remedy to be phased in over time to allow smaller audit firms to build up capacity, to ensure they have the expertise to take on a significant part of the available joint audits, and to participate in the tenders, which would entail a large increase in workload for them.

7.5. Concentrating on specific segments of the market initially, with a higher proportion of work allocated to the smaller audit firm (rather than applying it to all companies but only allocating smaller audit firms a small proportion, say 10%, of the work) would be a more effective deployment of capacity, would have a better risk profile for both firms and would allow the smaller audit firm to gradually scale up the size of company they are able to audit. In relation to the examples posed by the CMA in paragraph 4.35 of the Update Paper, we are therefore more supportive of option (b) - the minimum joint audit percentage.

JOINT AUDIT TO BE GOVERNED BY REGULATOR

7.6. At present, there are limited references to joint audits in ISAs and therefore the operation of a joint audit would need to be "inferred" from the more general principles in ISAs. For the remedy to be effective, it will be necessary for regulation to provide explicit guidance on how joint audits should be conducted (such as in France, which has developed a specific audit standard)[69] before the remedy takes effect.

7.7. We consider that a key role for the regulator would be in determining the companies to which joint audit should, or should not, apply in the context of both (a) the ability of smaller firms to take on audits of particular size and complexity (as explained in paragraphs 5.7 - 5.12 above) and (b) the capacity of smaller firms to take on large numbers of joint audits in the short term. In undertaking this role, we believe that the regulator should work with any sector regulator where such a regulator exists.

7.8. Finally, the framework and scope of the remedy should be kept under review by the regulator and adjusted periodically to respond to how effective it is at building the capabilities of smaller audit firms and ultimately increasing concentration in the market.

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?

8.1. Our view is that the timing for appointing joint auditors should be left to individual companies to decide. It may be more practical from a company's perspective for the joint auditors to be appointed at different times so that the new auditor can learn about the company from the incumbent auditor. However, the introduction of mandatory audit rotation requirements has not demonstrated that there is a drop in audit quality when auditors change, even for the largest companies.

---

[69] French Commercial Code, Article L225-228 and Code of conduct for statutory auditors, Article 17.

Consequently, we see no reason to require tendering at different times for joint auditors.

8.2. In practice, it may be more likely that the two auditors are appointed at different times even without any such requirement, i.e. if the incumbent auditor stays at least until the next required tender, and the smaller audit firm is brought in during the required implementation timeframe for the remedy which may be sooner. In this instance, the timeframes for future tenders for the incumbent and new audit firm would be out of sync from the outset and would remain staggered. Alternatively, some companies may choose to run a tender for both joint auditors (including the incumbent) at the same time, in order to minimise the (often significant) costs and time involved in conducting tenders.

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?

9.1. In principle, we consider that for joint audit to work effectively, with each auditor responsible for different parts of the audit work but both signing off on and being liable for the overall report, joint and several liability (where, in the absence of any agreement to the contrary, the joint auditors share any assessed liability equally) is the most appropriate framework. This is a key reason why we believe the joint auditors should be on as equal footing as possible, as they would share the liability of the work.

9.2. As regards some form of proportionate liability framework when the relative input of smaller audit firms is low (i.e. below 40%), this poses significant challenges. Any system of liability that provided for an asymmetric apportionment of liability for the audit findings, whether based on relative fees or otherwise, would reduce the economic incentives of the firm with the lesser liability to provide a high-quality audit, and transfer responsibility to the firm with the larger liability exposure for the overall quality of the audit.

9.3. The firm with the larger liability would in effect be forced to take an oversight role given its greater financial exposure. This would be inconsistent with the notion of a joint audit, and more in line with the shared model which we suggested as a possible remedy in our response to the CMA's ITC, but which the CMA has rejected as less likely to achieve the remedy's aims of reducing the barriers to auditing large companies faced by the smaller audit firms.

9.4. However, notwithstanding that joint and several liability might be the most appropriate basis, there are likely to be challenges for both large and smaller firms. Larger firms are likely to have greater financial resources (after taking account of available insurance) than smaller firms. Where a joint audit involves a smaller and a larger firm, claims against the auditors may be based on the financial resources of the larger firm (or, indeed, of the firms on a combined basis). The equal sharing of liability assessed on this basis may therefore be a deterrent to smaller firm participation in joint audits. Conversely, larger firms might be concerned about the ability of smaller firms to finance their share of any liability and the potential, therefore, that the larger firm remains liable for the liability of the smaller firm that it cannot meet.

9.5. A further alternative would be to change the current model of unlimited liability[70] to one where liability might be capped or assessed on a basis which is proportionate to the joint work undertaken by the auditors. At present, there is an asymmetry in liability between those with fiduciary responsibilities for running the company and preparing accurate financial statements (who are unlikely to have the resources to meet any claims) and the auditors, who face this unlimited liability. Therefore, the only party against whom a claim can be made is the auditor. Whilst significant claims in the UK are rare, the threat is very real and may act as a deterrent to smaller firms participating in larger audits. A move to a statutory capped or proportionate liability for the auditor would address this.

Remedy 2A: Market share cap

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

10.1. We believe that a market share cap may have the ability to achieve greater participation of smaller audit firms in large company audits without some of the challenges of joint audits. Having said that, some of the issues relating to the capability and capacity of smaller firms to take on: (a) audits of the largest companies; or (b) large numbers of audits in the short term that we describe for joint audits in response to Question 5(b) above are equally applicable (and possibly more so) for a market share cap remedy.

10.2. Whilst there are a number of ways in which a market share cap could be implemented, a decision would need to be made as to whether to introduce the remedy by "forcing" certain companies to tender their audits before the normal tender date or simply in relation to new tenders. The risk of cherry-picking would appear to be greater with the former.

10.3. For this reason, we would suggest a simple cap on the number of audited companies. We believe that number is more appropriate than other obvious metrics such as market capitalisation since it is simple and not subject to significant swings in relation to valuations. In addition, a cap by reference to numbers of audits rather than fees might ensure representation of smaller audit firms across a larger number of companies and therefore allow greater exposure of those firms to non-

[70] Audit clients currently can agree limits on the auditor's liability but this requires the agreement of shareholders and it is extremely rare for this to happen in practice.

executives constituting the ACs with the ability to more rapidly increase awareness of the capabilities of those firms. We acknowledge, however, that this would depend to an extent on the level at which any cap was set.

10.4. Any such cap should be set in aggregate for the four largest firms and might be implemented by prohibiting those firms from tendering for audits of FTSE 350 companies until the target market share for smaller firms had been reached. However, because of the fact that certain audits may not, in the short term, be suitable for smaller firms to audit (for the reasons set out in response to Question 5(b) above), companies would need to have the right to request that the larger firms are exempted from this requirement to enable participation by Big Four firms where a suitable number of smaller firms were not able to tender for the relevant audit to ensure that the AC had a reasonable choice and to maintain competitive tension.

10.5. In setting the level of any cap, and time period over which it should be achieved, there would need to be consideration given to the speed with which smaller firms might have the capacity to take on audits with sole responsibility. It would be to the detriment of the market if a cap was applied to the large audit firms and smaller firms with adequate capability and capacity were unable to take-on a sufficient number of audits, or if a sufficient number of smaller firms were not able to tender for any individual audit to ensure that ACs and shareholders had adequate choice in any individual case.

10.6. Any market share cap would need to have a finite period of operation.

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

11.1. As we explain above for joint audits, while it is the FTSE 350 companies where the public interest in audit outcomes is greatest (through dispersion of shareholdings and impact on the economy), in our view, there is no reason why the proposed remedy could not also apply to all other listed companies (LSE and AIM), other EU PIEs and other significant entities – such as large private companies – provided the smaller audit firms have the capabilities and capacity to take on the audits of these companies.

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.

12.1. As we outlined in our response to the CMA's ITC, it is not clear to us that there are barriers to senior staff switching between firms which would require any intervention.[71] However, in that response we also indicated our willingness to consider removing the existing restrictions we have in place for audit partners leaving to join non-Big Four networks, in order to address any perceived concerns. Our position on this remains unchanged.

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.

13.1. We consider that before costs of the establishment / maintenance of such a scheme might be estimated, key questions would need to be addressed, as set out in the following paragraphs:

13.1.1. *Determining the population of companies in respect of which eligible audit firms might be entitled to draw on any tendering fund* – since a key focus of the CMA is to achieve greater participation of smaller firms in the large audit market, we would suggest that eligible audit firms (see paragraph 13.1.2 below) should be able to draw on the fund when tendering for FTSE 350 company audits but that the scope of the fund should not go beyond FTSE 350 companies.

13.1.2. *Determining eligibility criteria for audit firms which might be able to draw on any tendering fund* - we consider that this could work in two ways - (i) either by identifying a small number of firms that would always be eligible to draw on the fund, or (ii) by identifying a larger number of audit firms that would be eligible to draw on the fund in certain circumstances, for example on being able to demonstrate that they had the capability to deliver an audit of the relevant company. The latter would be more complicated as it would require a case-by-case assessment of the capability of a firm to deliver a quality audit for the relevant company.

13.1.3. *Determining the amount of funding that would be available in any particular instance* - the cost of participating in an audit tender depends on a number of factors, most notably the size, scale and business of the audited company and the form of the tender process itself. It follows that a “fixed amount” in relation to each and every tender is unlikely to be an appropriate model to adopt, and that another mechanism for identifying the potential cost involved, and the extent to which this should be borne by an audit firm directly rather than from a tendering fund, would need to be considered. Criteria might also be used which limited the number of times any individual firm might draw on the fund or amounts that might be paid to any individual firm in aggregate over a specified time.

13.1.4. *Designing an appropriate administration and monitoring scheme* - a body (or resource within an existing body, such as the regulator) would need to

[71] See KPMG response to ITC, response to question 2.5.

be established to administer the scheme, potentially in order to determine the considerations noted above, but at the least to raise the levy, receive requests for funding, assess eligibility against pre-defined criteria and monitor usage by audit firms benefiting from funding (the latter being important to ensure that funding had been properly applied).

13.1.5. *Determining contributors to a tendering fund* - any fund should logically be funded by the population of those companies for which participants in a tender process might be eligible for funding. Funds could therefore be levied and collected alongside amounts levied for the funding of the audit regulator (regardless of whether or not the audit regulator had responsibility for administering the fund).

13.2. In addition to considering the above factors in relation to the implementation of any tendering fund, as the CMA notes, the need for a fund is likely to be significantly reduced if there is a higher probability of smaller firms being retained for large audits (as a result of the joint audit or market share cap remedy), thereby increasing the incentive for those firms to invest in the tender process. We agree with this, and also question the cost / benefit of any such fund if an underlying cause for the lack of success of smaller audit firms in tenders for the audits of large companies is driven by demand-side factors.

13.3. In the absence of any increased probability of such an outcome (i.e. an increased probability of success for the smaller firms to work on the larger, more complex audits), the benefits of any tendering fund are likely to be limited. Whilst access to funds may provide an incentive for smaller firms to participate in audit tenders, this would not necessarily have a positive impact on the instances of smaller firms being appointed for the larger audits (due to company preferences to have auditors with more experience and capacity doing their audits) and therefore the cost / benefit of such an arrangement would be questionable.

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.

ESTABLISHING THE NEED FOR THE TECHNOLOGY TO BE LICENSED

14.1. In our response to the CMA’s ITC, we expressed support for measures to address potential issues relating to the depth of skills and resources of smaller firms, provided that this could be achieved in a way that preserves the incentives on all audit firms to invest and compete on audit quality and innovation. This includes, to the extent to which it is within KPMG's control, making available technology on a reasonable commercial basis.

14.2. We note the CMA's finding that "*…some Challenger firms have indicated that they did not have an interest in these [technology sharing] measures and that their technology was state of the art*".[72] We are not in a position to agree or disagree with this view but note that it would not be efficient to create a solution for which there is no demand. A critical first step would therefore be to establish the precise nature of any needs of smaller firms in relation to technology.

14.3. Once the need is understood, potential users would need to be aware of technology solutions available to other firms to meet these needs which would require either bilateral engagement between individual buyers and sellers or the centralised offering of available resources, for example via a website.

Reasonable cost

14.4. Pricing would need to reflect (a) access to the technology itself (i.e. a licence fee) as well as (b) the provision of any training etc. required to understand and / or utilise the technology. On the latter, this would need to reflect the time costs of individuals involved in providing such training and support. In relation to any licence fee, depending on the nature of the technology solution, it may be possible to establish a market price for similar products.

14.5. In establishing any basis for pricing (other than on a normal process of price negotiation between a willing buyer and a willing seller), care will need to be taken to ensure that any restrictions do not undermine incentives to invest in innovation. Whilst this could be the case for the buyer, the risk may be more significant in respect of sellers if they were compelled to provide access to technology representing potential sources of competitive advantage without adequate return.

Other issues to be addressed

14.6. Clearly one of the challenges to sharing technology would be the contractual basis on which KPMG or another member of the Big Four have access to the technology, including the terms of any licence where the technology is not owned by the relevant firm in the UK (as is the case with KPMG UK's audit platform and certain other tools), or restrictions in licences underpinning the technology where the ownership does reside with the relevant member firm in the UK. Issues such as these would need to be resolved before any technology could be shared.

---

[72] Update Paper, para 4.100.

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 CMA'S CONCERNS

15.1. The CMA identifies two concerns, namely: (i) the failure of a Big Four firm, leading to the existence of only three remaining "Big Four" firms; and (ii) moral hazard arising from the regulator not taking appropriate action in order to prevent one of the Big Four firms failing. We refer to our comments on the CMA's concerns in our response to Question 2(d) above.

15.2. These concerns need to be considered in the context of other remedies being proposed by the CMA, a key thrust of which is to ensure a larger number of firms are capable of, and in practice do, deliver audits of large companies, and are recognised as a viable choice of auditor by companies and shareholders. The success of such other remedies would clearly reduce the significance of the CMA's concerns in relation to resilience. This would particularly be the case in terms of a "gradual decline" of one of the Big Four, where we believe it is likely that the eroding client base of an audit firm in gradual decline would be picked up proportionately by other audit firms, including those outside the Big Four.

CAUSES OF FIRM FAILURE

15.3. At the outset, it is worth focussing on the reasons as to why a firm may no longer undertake audits in an individual jurisdiction, which might be summarised as: (a) firm failure, for example as a result of major litigation; (b) loss of licence arising from regulatory action; and/or (c) market confidence.[73] In each case, the issue giving rise to the potential exit from the market might originate in the UK or in an overseas market - an important consideration in design and potential effectiveness of any resilience regime:

15.3.1. *Firm failure as a result of major litigation*

In practice, it is unlikely that major companies would continue to retain an auditor if there were significant doubts as to its ability to survive. Where such doubts exist, it is possible that the loss of clients as a result of a lack of market confidence would lead to an audit firm exiting the market in

[73] These all represent "involuntary" withdrawal. There is a fourth possibility ("voluntary" withdrawal), which is not dealt with here.

advance of any failure triggered by insolvency from legal claims/major litigation.

At the root of this risk is the unlimited liability regime which, in practice, exists in relation to the audit of listed (and most unlisted) companies at present,[74] notwithstanding that it is generally accepted that audit can never be the "cause" of company failure, and is unlikely to be the cause of material errors in an audited entity's financial statements. Whilst audit firms have access to insurance in relation to claims arising from professional services, for larger companies the amount of such insurance is likely to represent only a small proportion of the market capitalisation.[75] Audit is not an insurance product, and we are not aware of other markets where the provision of a service exposes the provider to such significant potential exposure. Potentially the issues arising from an unlimited liability regime would be exacerbated with the introduction of joint audit by virtue of exposing more than one firm to any single claim. Similarly, the separation of audit firms from the non-audit business, or transparency which would arise from the separate reporting of results and financial position of the audit business on a "stand alone" basis, would likely highlight the imbalance of risk from unlimited liability for audits compared with the potential rewards in the form of revenues and profits.

15.3.2. *Failure as a result of loss of licence*

Any resilience regime needs to be compatible with others in major jurisdictions. For example, there would be little benefit in the regulator allowing the continuation of a UK member firm which is part of a failing international network, if some or all of the other significant firms in the network had had their licences to operate removed (or such other member firms had failed due to client / partner and staff attrition or left the network to join another network). It follows that there is a need for close global co-operation between regulators in designing any resilience regime.

In addition, the largest UK audit firms operate under licence from the global networks of which they are part. If this licence is revoked, whilst it would be possible for the relevant firm to continue to operate in the UK (most likely under a different name) it would no longer have automatic access to the resources of other firms in the network necessary to deliver the audits of major global companies based in the UK.

---

[74] Whilst the potential to limit liability exists, with the consent of shareholders, in practice this limitation of liability is not obtained.
[75] KPMG notes that as of January 2019 the average market capitalisation for the FTSE 100 companies is £18.6 billion and £6.5 billion for the FTSE 350 companies.

15.3.3. _Market confidence_

Finally, any resilience regime needs to be able to address two scenarios, namely: (i) where the regulator has confidence in the ability of the affected firm (and, potentially, the wider network of which it is a part) to deliver quality audits; and (ii) where it does not. In the former case, the regime might be designed to enable the relevant network to continue to undertake audits (potentially subject to appropriate operating restrictions or sanctions), whereas in the latter case the only solution would be the transfer of business to other suppliers in an orderly manner over time. We address each of these in our responses to Questions 16 and 18 respectively below.

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

16.1. In our view, we do not believe that moral hazard (caused by a regulator not taking appropriate action to address quality concerns) is an issue in the market. However, notwithstanding this, we consider whether such concerns can be addressed.

16.2. The Audit Firm Monitoring and Supervisory Approach (AFMAS) introduced by the FRC in response to the EU Regulation[76] enables the regulator to have a much deeper understanding of the management of, and culture within, an audit firm (although given the relatively recent introduction of AFMAS, its benefits have yet to be experienced). The Kingman review included a recommendation for the regulator to be empowered by statute to carry out AFMAS on a mandatory basis, instead of voluntarily, as under the current regime.[77] Other reforms proposed by Sir John Kingman will also increase the range of options available to the regulator and strengthen its independence from the firms it regulates - for instance, for a new regime for the approval and registration of audit firms conducting PIE audits; incorporation of a range of sanctions for underperforming firms, e.g. requiring firms to implement actions, temporary bans on new audit clients, requiring firms to perform enhanced quality control reviews; and enhanced responsibilities in relation to monitoring audit market structure.[78]

16.3. These developments will further protect the FRC from the prospect of “regulatory capture” and enable the regulator to better assess whether or not the issue giving rise to the threat of firm failure is isolated or systemic. In the former case, it may be practicable to enable the affected firm to continue in operation within its existing legal entity structure or within a new structure.[79] This “continuation option” is less likely, albeit still possible, if any issues are systemic, in which case the only option

[76] Regulation (EU) No 537/2014 of the European Parliament and of the Council of 16 April 2014 on specific requirements regarding statutory audit of public-interest entities.
[77] Report on the Independent Review of the Financial Reporting Council, page 32, Recommendation 19.
[78] Report on the Independent Review of the Financial Reporting Council, page 29, Recommendation 16.
[79] Subject to the relevant entity having the benefit of a licence from the international network.

for a regulator might be to allow the failure of the firm (or remove its licence) and ensure an orderly transfer of its audit business.

16.4. In order to enable the continuation of an affected firm in some form, there would be a number of pre-requisites, including the regulator:

16.4.1. being able to take appropriate steps against any responsible individuals and the firm itself, including the removal of individuals from the existing firm or preventing them from joining any replacement firm;

16.4.2. satisfying itself that individuals in go-forward management roles had the appropriate skills and attributes to lead a public interest business;

16.4.3. having an ability to exercise sufficient oversight, either directly or through a third party, to ensure that any conditions that the regulator placed on a firm in return for granting a licence to undertake audits were being observed; and

16.4.4. having mechanisms it can use to ensure the ongoing economic viability of the firm (if needed), even if only in the medium term while a transition plan is implemented.

16.5. However, as indicated in the response to Question 15 above, if doubts exist as to the viability of an audit firm, it is likely that the loss of clients (or partners and staff) as a result of a lack of market confidence would result in an audit firm exiting the market in advance of any failure as a result of insolvency from legal claims or major litigation. The consequence of this is that a regulator would need to be in a position to stabilise the market - and therefore prevent these events - at an early stage, which might not be possible if the regulator considered that it did not have sufficient information to assess whether or not the underlying issues were systemic. At present, whilst the regulator might seek to stabilise the market and encourage companies to retain the impacted firm as its auditor, it has no power to mandate this. Notwithstanding the concerns regarding limiting companies' choice of audit firm, there may be merit in the regulator being granted statutory powers to ensure market stability in certain circumstances. The major challenge would, however, be how to control or limit the attrition of partners and staff where they have lost confidence in the firm. Any such proposal should therefore take the views of both groups into careful consideration and ensure that its impact on individuals and their choice to enter/remain in the audit profession is fully understood and managed. We comment on this in our response to Question 18 below.

16.6. In addition, even were the regulator to be satisfied that a firm should be allowed to continue to operate, if the network of which it is a part is failing internationally, the ultimate impact may in any case be that one or more other firms in the UK would need to take on the business or selected audit clients of the affected 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.

17.1. This complex question requires consideration of the potential strategies for intervention in the circumstances in order to meet the CMA's objective of ensuring that the audit clients of a failing Big Four firm are not transferred to another Big Four audit firm, for example either:

- retaining the firm in some guise via a 'Newco';
- transferring the business to one or more smaller firms to avoid concentration in the remaining Big Four firms;
- winding down the audit business until new auditors are appointed to each client through the market; or
- retaining confidence in the domestic and international audit regime to prevent contagion into the entire market and thus avoiding systemic collapse - not of a single provider but a wider group.

17.2. In any of these scenarios, the following key issues would need to be considered:

17.2.1. whether the firm and/or new owner has the funding to stabilise the business, retain partners and staff, avoid client "flight" and reassure external stakeholders;

17.2.2. partners would need to buy into the proposed strategy given the provisions of the partnership deed controlling any transfer of the business, their potential liabilities to the failing firm, and the fact that many (and often key) partners could rapidly leave if they saw better prospects and greater certainty elsewhere (notwithstanding non-compete restrictions in the partnership deed - although these may not apply following a transfer);

17.2.3. the proposed strategy would need to address both the audit and non-audit businesses of the firm, particularly given that the ability to sell non-audit business of the firm would likely be greater. Different strategies may also apply to different parts of the firm, given the distinct characteristics of aspects of the firm, e.g. regional differences and cross-border work / PIE clients vs. SME clients;

17.2.4. staff would also need to buy into the proposed strategy or many (and often key) staff would likely seek to leave;

17.2.5. whether a special administration would be feasible, given that the remaining Big Four audit firms (who would have the resources to meet this role), would be conflicted from accepting the special administrator role and that market confidence would evaporate rapidly following an appointment;

17.2.6. what the consideration for any transfer of the business to a Newco would be and how it would be funded. For example, the attractiveness of funding a tainted audit business with potential unlimited liability to clients for audit failings is likely to be limited.

17.3. A special administration could potentially achieve the CMA's stated objective if there has been time to develop and plan a pre-packaged transaction in private that could be announced in short order to provide clarity to partners, staff, clients and the capital markets, and seek to achieve market stability, with only a rump tainted business being retained and wound down in special administration.

17.4. However, a special administration is a formal insolvency process and seeking to turnaround a failing firm providing essential audit services within a special administration would be extremely challenging, particularly given that the Big Four are 'people businesses'. A turnaround is more likely to be achieved by early regulatory intervention in private to ensure that the firm has appropriate turnaround experience within the leadership team, rather than allowing the situation to deteriorate to the point when a formal insolvency process is required. However, early intervention may not be possible in the event of the firm's failure being caused by a sudden catastrophic event. In that circumstance, identification of special administrators to act may itself be hard to achieve.

17.5. Furthermore, special administration would require funding and a clear articulation of the objective of the proposals of the special administrator. It would need to be considered how the special administrator should balance the requirement to maximise recovery with the need to protect the wider audit market, especially given the special administrator's role is essentially short term.

17.6. Alternatively, the failing firm may seek to implement one of these strategies itself, outside of an insolvency process, with regulator support. However, this would only be feasible if the buyer was comfortable that the process would not subsequently be challenged by an insolvency officeholder, or if it was achieved through an alternative "lifeboat" arrangement, as explained below in paragraphs 17.7 - 17.9.

17.7. So called "lifeboat" arrangements derive from the 1974 secondary banking crisis, where, as is the case with statutory audit, the objective was a stabilisation plan to ensure that the risks to external confidence (a matter of concern to the banking institution, the regulators and the market) did not spread, potentially widening the cycle of collapse away from the initial entity and into the whole market. In the case of statutory audit, the stabilisation objective would be to ensure that clients in general and audit clients in particular still receive the services that they require to maintain the capital markets' integrity. Prompt and decisive action to prevent the loss of confidence would be essential. This could come from the actions of a central regulator, such as the Bank of England, the Treasury or the new body recommended by the Kingman review, who would act as a central controller, creating a "lifeboat", comprising members of the recognised professional bodies (such as the ICAEW or ICAS). The actions of this "lifeboat" would be coordinated by this central controller with a short term aim of an orderly rehabilitation or wind down of the business, including the necessary transfers of business and services.

17.8. If the central controller was an entity such as the Treasury or the Bank of England, the needs of the wider capital markets could be considered, as well as the broader economy. The lifeboat could oversee the distressed entity, either working with its management or replacing that management to give direction and appropriate control, as well as either determining whether the distressed entity can be rehabilitated or disposing of the viable business units. A body such as the Treasury or the Bank of England could also give more general guidance to the market to limit or prohibit the poaching of partners and staff away from the distressed entity to competitors. This would enable the services to be provided at a commercial rate and should alleviate both national and international concerns as to the quality of retained management in the transition period. It could manage the transfers, in an orderly fashion, not just of Registered Individuals but teams as well, to ensure viability within the market, as well as giving those partners and staff greater certainty and stability.

17.9. Furthermore, a lifeboat regime would allow audits to be continued and completed in the interim period, which a special administrator is unlikely to do because they will not wish to accept unlimited liability. The broader market could face a one-off levy to fund a 'lifeboat' regime. A lifeboat regime would be more robust than a special administrator, as based on existing models in analogous legislation the latter would be an individual whose actions would be driven by their ability to achieve their legislative objectives (i.e. maximise recoveries) with powers only over the distressed entity and not the general market.

Response to the CMA's initial views

17.10. We do not consider that staff will generally follow the companies they audit, unless all audits are being transferred to one new entity, or there are controls and limits placed on the transfers. Audit staff typically work on a variety of audits and they will also have different views and motivations. Even if staff do follow the destination of companies they audit, this may well only be temporary without some other form of incentive or a coercion to prevent poor behaviour. The creation of a clearing house through a lifeboat mechanism may be more effective at protecting the market, clients, employment and quality, as well as preventing contagion.

17.11. The transfer of a business outside of an understood framework would need to be done very quickly on a large scale as part of a single transaction, or, in order to maintain stakeholder confidence, on transparent terms - though commercially these are likely to be difficult to manage in the near term.

17.12. A regulator mandating, outside of an accepted and understood framework, that some audit clients remain with a distressed firm while a turnaround is sought is also likely to exacerbate problems for the distressed firm and reduce market stability, with greater risk of contagion. For example, non-audit partners, staff and clients are more likely to leave following this regulatory action becoming public, which would impact upon the receiving professional firm if there are no controls on the transfer or movement of staff.

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.

18.1. Our response to Question 16 comments on the challenges in controlling company and partner / staff decisions in an environment where the regulator is explicitly or implicitly supportive of the impacted firm continuing in some form.

18.2. Where this is not the case, i.e. where the regulator has determined that the firm or a replacement firm established by the same network should not be allowed to operate (or the network has failed internationally) there will be similar issues.

18.3. The specific nature of the issues may in part depend on whether there is a desire to keep the client base and partners / staff together, effectively taken over by another firm, or whether it would be acceptable for participants in the market - companies and partners / staff of the impacted firm to make their own individual decisions.

18.4. For example, if there were six firms actively involved in the market for large audits compared with the current four, the latter might be an appropriate and/or acceptable approach.

18.5. On the other hand, where there were only four such firms, if the CMA is concerned about choice as it has set out in its Update Paper, it would be essential that the audit clients and partners / staff of the impacted firm were distributed (largely) across the smaller firms.

18.6. Ultimately it is difficult to "tie the hands" of companies in their selection of auditor (at least in an environment where the appointment of the auditor is based on the recommendation of the board of a company) but, as highlighted above, in theory the regulator could be granted statutory powers to appoint the auditor in certain circumstances in order to ensure market stability in exceptional circumstances, such as the lifeboat regime referred to above. A key problem may be that the smaller firms that receive the clients of the failed firm might not have the resources to deliver the increased number of audits. This could be addressed by establishing a regulator-overseen mechanism to allow the smaller firms to contract for resource from the (remaining) Big Four firms in this type of exceptional circumstance (providing issues associated with (for example) independence could be addressed).

18.7. The position for partners and staff of an impacted audit firm would, however, be different. Even if parts of the impacted firm were transferred to one or more smaller firms, with staff transferred under TUPE provisions, it would be difficult to compel them to remain at the relevant firm if they wished to seek employment elsewhere. The ability to retain partners and staff during an attempt to build and execute a turnaround or transition plan can be easily frustrated by competitor activity and we therefore believe that any recovery/insolvency regime should have a mechanism to allow the regulator (or perhaps the Treasury) to intervene on a temporary basis by placing a restriction on other (presumably larger) firms from employing staff meeting particular criteria for a specified period. After the transitional period, the restriction would have to be lifted and normal market forces should resume. However, it is not clear that the regulator would have such powers under any proposals currently being made.

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.

19.1. While we are open to working with the CMA to consider the challenges involved in a full structural split, these discussions should be properly framed. The relevant questions for the CMA to consider in assessing a remedy are not whether the challenges of that remedy are surmountable or could never be overcome, but in accordance with CMA's own guidance, whether the proposed remedy would, as comprehensively as possible, address any adverse effect on competition identified and/or its detrimental effects, and whether the remedy is effective and proportionate.[80] Notwithstanding this, and the fact that the CMA has itself acknowledged widespread opposition to the prospect of full structural separation,[81] we have provided a response to the question as phrased.

FULL SEPARATION WOULD BE TO THE LONGER-TERM DETRIMENT OF AUDIT QUALITY AT INCREASED COST

19.2. We do not believe that the challenges of full separation are surmountable. As explained in our response to the CMA's ITC,[82] there would be foreseeable detriment as a result of full separation, primarily relating to access to specialists required to undertake a high-quality audit and scale to invest. The CMA states that it believes firms could mitigate the challenges in obtaining non-audit expertise through the use of retainer contracts with external providers of the relevant non-audit services.[83] The CMA has not, however, presented any analysis of the feasibility of such arrangements, which would be needed for a whole host of

---

[80] CC3, Competition Commission, Guidelines for market investigation: Their role, procedures, assessment and remedies, para 329, April 2013.
[81] Update Paper, para 4.122.
[82] KPMG Response to the CMA's Invitation to Comment, Section 2.1.2, pages 16 – 17.
[83] Update Paper, para 4.127 (b).

specialist non-audit skills depending on the nature and different needs of the audited company, including in tax, cyber security, risk and regulation, technology, actuarial valuation, cash flow and business model analysis and macroeconomics. These need to be available in varying quantities (with time sensitivity, to fit in with KPMG's audit processes), of verifiable high quality, and without conflicts (having particular regard to the potential impact of auditor independence requirements). They may also be difficult to specify in contractual detail in advance and must be able to respond to emerging issues. This requires investment in understanding KPMG's audit processes and trust in the governance of transactions between audit and non-audit providers.

19.3. It is well-established in the economic literature that under such conditions, the transaction cost of open market procurement is problematic.[84,85,86] The economic literature shows that the non-audit provider would have an incentive to under-invest in, for example, specific understanding of KPMG's audit needs, if ongoing provision of such services may be terminated at the point of external contract renewal. The literature also finds that the safeguards made possible by in-house provision provides better quality enforcement mechanisms; for example, it is easier to see and remedy lower quality work in-house through internal incentives and discipline, than to resort to the courts or to exit future contracts. In-house provision also achieves a more appropriate balance between profit incentives and professional controls to ensure a quality focus and facilitates cooperation and adaption to changing requirements at short notice and without costly renegotiation of terms.[87,88]

19.4. In the Update Paper, the CMA does not consider the issues set out in this economic literature in forming its view that specialist expertise could be replicated through external retainer contracts. Nor has the CMA explained how issues such as maintaining independence could be managed as easily through external procurement of these skills. A full separation of audit from the non-audit parts of the business would put the ability to include specialist expertise in the delivery of the audit at risk, and make it more difficult to ensure that the quality of that specialist expertise is at the highest level. The CMA therefore needs to fully take into account these sorts of unintended consequences in relation to specialist non-audit expertise in order to form a proper view on the effectiveness and proportionality of full separation.

[84] Oliver Williamson, "The Theory of the Firm as Governance Structure: From Choice to Contract", Journal of Economic Perspectives (vol. 16, no. 3, Summer 2002, pp. 171 – 195).
[85] Benjamin Klein, Robert G. Crawford and Armen A. Alchian, "Vertical Integration, Appropriable Rents, and the Competitive Contracting Process", The Journal of Law & Economics (vol. 21, no. 3, October 1978, pp. 297 – 326)
[86] Ronald Coase, "The nature of the firm", Economica (New Series, vol. 4, No. 16, November 1937, pp. 386 – 405)
[87] Oliver Williamson, "The Theory of the Firm as Governance Structure: From Choice to Contract", Journal of Economic Perspectives (vol. 16, no. 3, Summer 2002, pp. 171 – 195).
[88] Oliver Williamson, "Comparative Economic Organization: The Analysis of Discrete Structural Alternatives", Administrative Science Quarterly (vol. 36, no. 2, June 1991, pp. 269 – 296).

19.5. In addition, we strongly believe that it would be harder to recruit and retain talented staff in an audit only firm. Graduates join the audit divisions of multi-disciplinary firms for a number of reasons. These include the opportunity to qualify as an accountant and then seamlessly continue their career in another area of the firm. Moreover, they know that they will be able to 'sample' other disciplines through secondments to other parts of the firm during their training contract or through ad hoc engagement opportunities that typically arise for audit staff outside the busier audit season. More senior audit staff know that if they specialise in a particularly audit area (a technical competence or a market sector) they will have the opportunity to transfer their acquired skills to the consulting side of the business if they choose. An audit-only firm will not be able to offer these opportunities.

19.6. Another negative impact of full separation on audit firms, as well as the audit profession and corporate ecosystem more widely, is the loss of the benefits of innovation that come from the multi-disciplinary model. Under the current structure, innovative ideas and thinking that originate from other non-audit areas of the firm, such as potentially transformational technology and data solutions, may be shared or applied to the firm's audit services, to the benefit of the audit sector e.g. in terms of audit quality or efficiency. Such innovations are more likely to arise in a firm that has a wider pool of different skills, perspectives and approaches, and are more likely to be developed and to receive the necessary investment when a firm has more options to allow the innovation to be applied/monetised. The ability to invest in such innovations is also key, which is more likely to be possible for large multi-disciplinary firms rather than smaller, less profitable audit-only firms.

19.7. It is difficult to quantify the financial impacts of full structural separation, but we see this posing significant challenges to both the audit and non-audit businesses, as well as significant incremental costs which would need to be passed on to audited entities. For example, there could be potentially significant tax implications triggered as a result of the demerger of audit (or the non-audit) business into a separate legal entity (likely to be similar to the consequences of an operational separation envisaged by the CMA, as we set out in paragraph 21.11 below) as well as the costs of splitting numerous operational systems and the subsequent costs of developing and maintaining these separately.

19.8. Additionally, the impact of separating the balance sheet of the business would result in a disproportionate impact to the audit business. In relation to pensions, the proportion of liabilities attributable to the audit business would be significantly greater than the relative size of the current audit business to the non-audit business, and it follows that any future movements in the deficit could have significantly greater impact on the audit business than the non-audit business. The implementation risks for separation of these areas are addressed further in our response to Question 21.

19.9. In addition, we believe that it is difficult to foresee the full extent of the potential adverse impact on audit quality arising from a full separation of audit business from the non-audit businesses of the UK member firms of the large audit networks, and are concerned about the potential for unforeseen consequences.

RISKS RELATING TO REDUCED SIZE OF AUDIT-ONLY BUSINESS

19.10. Full separation would mean that the separate audit-only entities would be considerably smaller than when they were part of the multi-disciplinary firms, in terms of scale, resources and financials. With reduced revenues, the audit firms would be proportionately more dependent on revenues derived from larger audits and these audit engagements would take on more importance than they would under the current structure, as they would be more critical to the success of the firm. If the loss of a major audit client could place the whole firm in jeopardy, this could threaten the resilience of the market. In addition, this over-reliance could increase rather than decrease the perceived issue of auditor independence as the incentives of the auditor to challenge management or apply suitable levels of scepticism may be weakened due to the need to retain the client and would thus be detrimental to audit quality.

19.11. The significantly smaller balance sheets of the separated audit firms would restrict their ability to invest at scale in the transformational technology required to keep pace with the complexity of audited company's businesses.

19.12. Furthermore, there is a risk that reduced financial foundations and therefore ability of an audit-only firm to withstand fines and claims arising from a failed audit would reduce systemic resilience and may deter them from competing for the more risky / complex audits and thus undermine the aim to improve choice in the audit market. In other words, this remedy would likely defeat the very resilience which other CMA remedies seek to safeguard.

THE INTERNATIONAL DIMENSION

19.13. Further, as the CMA acknowledges, there would be challenges in implementing full separation in an effective manner only in the UK given that this may result in only one of those businesses remaining within the KPMG network. Most large listed companies have international operations and these are often significant to the group as a whole. It follows that in order for the UK audit firm to be able to undertake audits of such companies that are based in the UK, it would need to have an international network of member firms in other jurisdictions and, therefore, remain part of the KPMG network.

19.14. It would, therefore, be the non-audit business which would be separated from the KPMG network, with inevitable consequences for the ability of the UK non-audit business to be able to service its clients internationally. The implications of this go beyond that business alone and could also impact on audit quality and the audit business (even if audit was performed by a full separate company), because there is a significant risk that the multi-disciplinary skills which are important for providing the highest quality audits could be lost to the market, at least in the short term. These skills could only be replaced if the market, in the medium to long term, could replicate the kind of provision of skills that the advisory arms of the Big Four currently provide – which cannot necessarily be assumed.

IMPACT ON NON-AUDIT BUSINESS

19.15. Whilst the CMA's focus is on audit, we believe a full separation would result in adverse consequences for the non-audit businesses which are difficult to envisage in full.

19.16. Firstly, without similar action internationally to split the audit and non-audit businesses, the non-audit business operating independently from the KPMG network would not have access to resources of other member firms internationally and would therefore be restricted in its ability to advise companies with international operations. Ultimately this may undermine the viability of these as stand-alone businesses.

19.17. In addition, the large audit firms in the UK support a broad range of businesses in relation to internal effectiveness and efficiency and their UK and international growth. In FY2017 the largest six firms in the UK generated revenues of £12.4 billion and contributed £4 billion in taxes (excluding BDO). £1.4 billion of the total tax contribution was paid by the firms themselves, while £2.6 billion was tax collected on behalf of others. The capabilities and efficiency of these firms is enhanced by: (a) increased flexibility on resourcing from being able to draw on the resources from the audit side of the firm when capacity allows; and (b) the skills of audit staff which are relevant to a broad range of (non-audit) assurance, governance risk and controls, due diligence, forensic work and investigations. In addition, historically the non-audit business has hired staff from the audit business, often after a formal or informal secondment. Separation of the audit and non-audit businesses would most likely significantly curtail this sourcing of talent by the non-audit firm, with significant implications for cost and capability. Without access to these skills, the capability of the non-audit business to support British companies will undoubtedly be adversely impacted, although it is difficult to quantify the impact of this.

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.

20.1. As noted above, it is critical that these discussions are properly framed. The relevant question for the CMA to consider in assessing an operational split is not its efficacy and costs relative to a full structural split. Instead, it is whether the proposed remedy would, as comprehensively as possible, address any adverse effect on competition identified and/or its detrimental effects, and whether the remedy is effective and proportionate. Notwithstanding this, we have provided a response to the question as phrased in the paragraphs below.

20.2. The CMA's concerns are in relation to the conflicts and the culture within the structure of multi-disciplinary audit businesses (although we note that the CMA acknowledges there is limited evidence that such conflicts impact on audit quality). Conflicts are perceived to arise both at:

20.2.1. engagement level, from the delivery of non-audit services to audited entities; and

20.2.2. at entity level, since profitability and growth options are considered to be higher in the non-audit businesses than the audit businesses, with the inference that the firm's culture and management focus (and investment) is primarily driven by the non-audit business, with adverse consequences for innovation in audit and audit quality.

20.3. We do not share the CMA's view, given that we regard audit as fundamental to the success of our firm and poor audit quality as a critical driver of reputation and, ultimately, our ability to win new business and to be successful. As discussed above, we do not believe that the culture within a multi-disciplinary firm creates a tension that could undermine the incentives to focus on independent, high-quality audit. In any event, these incentives are protected by external regulation and internal controls. Instead, we firmly believe the multi-disciplinary model and the culture of such firms brings benefits to the audit practice and to audit quality.

20.4. Notwithstanding this, we acknowledge that the concerns articulated by the CMA are held by some others as well, but we also believe that these concerns, even if substantiated, can be addressed through a combination of: (i) enhanced governance and performance management of the audit business within the firm (and increased transparency thereof); and (ii) the cessation of the provision of non-audit services (other than those closely associated with the audit) to certain companies, without the additional complexity (and associated costs) of separate legal vehicles and the separation of economic interest as envisaged by the CMA. We believe that these requirements should apply to all firms that carry out audit services and should not be limited to applying to only the large audit firms.

20.5. We have already taken steps to enhance the governance and performance management of our audit business to increase transparency and ensure performance is measured solely on audit quality. Further, we have announced that we are working to discontinue the provision of non-audit services (other than those closely related to the audit) to companies within the FTSE 350 which we audit. We believe that if a similar restriction was implemented market-wide within a regulatory framework, this would be an effective way of mitigating actual or potential conflicts and increasing trust in audit.

21. With regard to the operational split, please provide comments on (a)-(e):

THE OPERATIONAL SPLIT AS ENVISAGED BY THE CMA

21.1. The CMA sets out the key features of an operational split[89] and we comment on each of these features in the following paragraphs:

(a) Separation of the audit and non-audit businesses with the audit business having a separate board, chief executive, staff and assets

We believe that the separation of businesses can exist within the current structure of the firms (rather than involving separate legal entities) and that separation of assets may be impractical, but otherwise agree with the CMA view that the board and staff can be separated so that senior audit staff (at least in so far as those who are involved in the audit of PIEs are concerned) are not involved in non-audit work or decisions, and vice versa.

Staff are allocated within the business to audit and non-audit business units, however in order to deliver quality and maintain capabilities and efficiencies of the business, access to specialist across the business will be required with transfer pricing arrangements in place (see (d) below).

In relation to "assets", few assets (other than audit specific technology, receivables arising from the provision of services to clients, etc) are directly attributable to audit / non-audit businesses. Given the ongoing need to access those assets which are not directly attributable to the audit business, it is critical both that there are procedures for continued and efficient access to these assets by the audit business and that the charges for the use of these assets between the different businesses is appropriate.

We have set out further under '*Enhanced governance and performance management'* below how we would envisage an operational separation working in practice.

(b) Separate profit and pension pools for the audit and non-audit entities

We acknowledge that there remains a perception of over-reliance on non-audit business profitability and shared profits, however we do not believe that the separation of profit and pension pools is necessary or desirable, and it has significant potential associated costs that would affect all audit firms.

[89] Update Paper, para 4.118.

We recognise that transparency of the financial performance of each business is required and can be achieved without the need for full separation. Given the relative predictability and stability of audit compared to the non-audit business, we believe this transparency can be achieved through annualised budgets for shared operations and formalised transfer pricing arrangements.

We comment further on this under '*Separation of economic interests and legal entity separation'* below.

(c) Restrictions on audit partners (but not staff) moving between audit and non-audit businesses of the same firm

It is not clear whether the CMA envisages partners moving on an engagement by engagement basis or whether the restriction would be wider.

In any event, we believe that all partners should be permitted to deliver non-audit services which are closely associated with the audit, but that a different approach could be adopted in relation to other non-audit services which are not closely related to audit services.

In relation to non-audit services which are not closely related to audit services, the restriction not to provide these services should apply to partners undertaking audits of FTSE 350 companies, since this tends to be the level where the public interest (through dispersion of shareholdings and impact on the economy) is greatest.

Audit partners and staff not involved in the audits of FTSE 350 companies should remain able to deliver non-audit services (albeit that, as at present, they should not be rewarded for the sale of such services to audited entities).

(d) Transfer pricing arrangements between the two entities, for example to support the use of non-audit staff on audits

In principle, we agree that transfer pricing can be used to support the use of non-audit staff on audits. Transfer pricing arrangements already exist for partners and staff from one business unit working for another business unit, but there is scope for greater formalisation of these arrangements. However, we consider that the details of any transfer pricing arrangements, and whether they can fully replicate the incentives to deliver high quality work, will need to be carefully worked out.

(e) Both the audit and non-audit businesses could share some central operations, systems, branding and know-how, and both would remain part of the same multi-disciplinary network

We agree that the audit and non-audit businesses could share some operations, systems and knowhow, and that they would remain part of the same multi-disciplinary network. From the beginning of our current Financial Year (commencing 1 October 2018) we have changed the method of allocating costs in order to provide greater transparency of the profitability of audit and to enhance decision making.

SEPARATION OF ECONOMIC INTERESTS AND LEGAL ENTITY SEPARATION

21.2. The CMA proposals for operational separation envisage separate profit pools and legal entity separation. In relation to separate profit pools, we note that the CMA itself has concluded that *"…it appears unlikely that the Big Four would have the ability and incentive to under-bid in order to exclude competitors"*[90] *and that the evidence "….does not suggest that the Big Four are systemically under-bidding the other challenger firms*"[91]. We agree and do not see under-bidding of smaller firms in relation to audit services that are offered.

21.3. Indeed, we believe that the CMA's concerns as to whether audit is appropriately priced could be monitored through transparency of the financial performance of the audit business, without the need for more radical forms of separation.

21.4. Similarly, in line with our response in paragraphs 2.33 – 2.37 above, we do not consider that separate legal entities are necessary to ensure an appropriate culture and focus on quality within the firms. The management of businesses can be segregated in a similar way regardless of whether these business units operate in separate legal entities or within a single entity. The principal difference is that the performance of a certain business unit within a single entity is not as visible as for a business unit in a standalone separate entity. However, this can be mitigated by transparency, with the added potential for regulatory oversight as to how the business has been managed in practice.

21.5. We recognise two key areas of perceived economic connectivity across the business, namely (i) lending and borrowing of staff between the business units (and the rates applied for these staff hours), and (ii) shared back-office services (and the basis of cost allocation). In order to provide greater transparency on the allocation of costs we have taken steps to reduce the hours lent/borrowed between business units, have in place transfer pricing arrangements and, as explained in paragraph 21.1 above, have recently undertaken an exercise to monitor each of our client facing businesses (audit, tax, etc.) with different bases for allocating the costs of "shared" activities.

[90] Update Paper, para 3.169.
[91] Update Paper, para 3.170.

21.6. Additionally, we believe it is possible to achieve further transparency through annualised budget processes in relation to shared cost allocations, ensuring the audit business maintains the ability to remunerate appropriately.

21.7. We have commented on the implementation challenges of separate profit pools and legal entity separation in our response to Question 21(a), at paragraphs 21.10 – 21.11 below.

ENHANCED GOVERNANCE AND PERFORMANCE MANAGEMENT

21.8. We believe that the following are important principles of enhanced governance and performance management of an audit business operating within a multi-disciplinary firm:

- Clarity of responsibilities of the wider firm (in terms of both the non-audit business and any group level leadership team / board) in supporting the audit business in the performance of quality audits and ensuring the long-term viability of the audit business.
- Executive leadership of the audit business with sufficient authority to direct the business and accountability for the delivery of high quality audits and ensuring the long term viability of the audit business.
- Oversight of executive leadership of the audit business, including independent participation from INEs, to hold executive leadership to account.
- A culture focused on audit quality, backed up by appropriate personal objectives and remuneration incentives.
- Transactions between the audit business and the non-audit business (and shared functions) based on pre-agreed protocols (as referred to in paragraphs 21.1 (d) and (e) above).
- Transparency as to the governance, management and performance (financial and non-financial) of the audit business.

21.9. In relation to the latter point, firms should ensure that financial information is produced for the two parts of the business in a way that achieves the required level of transparency to enable public and regulatory scrutiny of key aspects of the businesses. This will be an area that would require further consideration by the CMA.

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

21.10. As we have explained above, we do not believe that legal entity separation or the operation of separate profit pools envisaged by the CMA is necessary in the design of any operational objectives in order to achieve the objectives of the CMA.

21.11. In addition, these measures would come with significant implementation and cost challenges which would be similar in some regards to those of a full separation of the audit and non-audit businesses. These would include:

21.11.1. *Pensions:* any exercise to estimate the liabilities arising from years of service within the audit business and non-audit business would be time consuming and challenging given the time period over which records would need to be consulted and the movement of individuals between the audit and non-audit businesses during their time with KPMG. [✂] As a result, we believe that it would be more appropriate for the audit and non-audit businesses to continue to participate in the schemes as at present on a joint and several basis. This would also mean that, in the event of a failure of one of the businesses, the pension scheme would still have the benefit of funding from the surviving business.

21.11.2. [✂]

21.11.3. *People:* the current business offers varied opportunities in career development through secondments and transfers to difference business unit and these opportunities might be more limited (depending on what the CMA means by allowing staff to move across the two parts of the business). This could make the firm less attractive to potential employees, having a detrimental impact on recruitment and retention of talented individuals.

21.11.4. *Utilisation/operating efficiency:* implementing greater restrictions on lending/borrowing could impact the utilisation and operating efficiency of both the audit and non-audit businesses (depending on what the CMA means by allowing staff to move between the audit and non-audit parts of the firm).

21.11.5. *One-off costs*: a number of one-off costs would arise in implementation of operational separation, including the cost of implementation of the new proposed governance structure, transfer of staff into relevant entities, one-off training of staff, programme costs, and potential disruption of staff and commercially.

21.11.6. These difficulties are in addition to the issues already discussed in paragraphs 21.1 – 21.7 above.

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

21.12. We note that while the CMA asserts that this remedy carries circumvention risks, it does not provide a detailed explanation of what it considers these risks to be. It is therefore difficult to provide a constructive answer to this question. However, at a high level, we believe this could be managed by (i) detailed protocols setting out the basis of charging between audit / non-audit businesses and the allocation of share costs together with (ii) internal certifications that these protocols had been complied with.

21.13. These would be subject to monitoring by the regulator who could, to the extent considered necessary, commission a third party (potentially the external auditor) to audit compliance with the protocols.

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

21.14. We believe that arrangements to enhance the governance and performance management of audit businesses within firms, as well as move to a basis where the financial management of the audit business is managed and reported on an arms-length basis, could be implemented in a relatively short timeframe with the majority in place by the end of 2020.

21.15. Achieving separation of economic interests – which in any event would be counterproductive from the point of view of quality and efficiency, as shown above - would likely take considerably longer, particularly because audit partner remuneration could not be maintained at a sufficiently competitive level to continue to attract the requisite talent based on the current audit prices. As such, economic support from the non-audit business may be necessary while audit prices adjust to the new market structure during the first few years of implementation.

21.16. Similarly, our internal estimates are that it would likely take at least five years to create and bring into operation a separate legal entity for the audit only business. Full separation of operations would require a number of issues to be addressed across legal, HR, tax and pensions (in the case of HR assuming it was necessary for staff to be employed directly by the separate legal entity, rather than as at present by an employment company on behalf of the businesses delivering services to clients). Approval from the international network would be required along with clearance from tax authorities and alignment with other reporting bodies.

21.17. Furthermore, full separation would require the market to adjust to the new economics of the audit business in order for the separated businesses to be economically viable.

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

21.18. Enhanced governance and performance management of the audit business involves extra costs for the firms affected, for example through the duplication of oversight structures in both businesses.

21.19. However, we are not in a position to comment on the additional monitoring costs of the regulator, without more details on the specific approaches to be implemented, but note that under the AFMAS regime, it is already the intention of the FRC to extend the monitoring of audit firms into areas such as business model, management information, profitability, etc.

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

21.20. We believe that overseeing adherence to the operational split would not require specific skills which would not already be available within the regulator, provided that the operating model is adequately defined and it is clear what would be captured within the audit and non-audit businesses.

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 the blacklist or to the current 70% limit.

PROHIBITED SERVICES

22.1. Whilst we would welcome the possible benefit of the CMA's suggestion that "*an operational split has the potential to release audit firms from the application of certain conflict regulations*",[92] we think it highly unlikely that this would come to pass given other regulations applicable to UK audit firms.

22.2. To the extent that audit and non-audit businesses are within the same network, we would see limited opportunity for relaxing current restrictions on the provision of non-audit services to audited entities. This is because various other regulations applicable to UK audit firms, including the Code of Ethics issued by the International Ethics Standards Board for Accountants (IESBA), as implemented in the UK by the professional bodies (ICAEW/ICAS), restrict the provision of non-audit services by members of the same network[93] to the audited entity (and certain of its related entities). The extent of the restrictions depends on whether or not the audited entity has listed securities. In addition, other regulations are or may be applicable, including the independence requirements of the PCAOB (in respect of

[92] Update Paper paras 4.129(c) and 4.130.
[93] https://www.ethicsboard.org/; IESBA Code of Ethics 2016: Para 290.13; IESBA Code of Ethics 2018 (eff. June 2019): Para R400.51.

audits of entities which are SEC Registered Audit Clients (SECRACs))[94] and, to the extent the UK remains committed to the application of EU requirements post Brexit, the EU Audit Regulation[95].

22.3. In addition, if the regulatory constraints were to be removed, we question whether allowing the audit firm (albeit the operationally separate advisory business of that firm) to provide non-audit services to the firm's audit clients would, in the view of the market and the general public, be perceived as being sufficiently objective and independent.

22.4. It is for this reason that we believe that, for the largest public companies, further restrictions on the provision of non-audit services (other than those closely related to the audit) should be introduced.

70% CAP

22.5. Whether or not the 70% cap remained effective would depend on whether the UK remains committed to the application of EU requirements post Brexit. If the UK remains committed to the EU requirements post-Brexit, we consider that the 70% cap should remain in place as it is.

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

23.1. Given the nature of the CMA's concerns, we believe that any remedy in relation to the management of the audit business of a firm should apply to any firm auditing or aspiring to audit PIEs or, as a minimum FTSE 350 companies.

23.2. More specifically, we see no justification for the remedy to apply only to the Big Four and to exclude smaller audit firms, since the concerns around profit pooling, government and investment decisions being driven by non-audit considerations, underlying cultural concerns and independence and challenge would be applicable to all firms carrying out both audit and non-audit services for FTSE 350 companies and/or PIEs. If the CMA does really believe that these concerns impact audit quality or choice in the market, we do not see a reason for distinguishing between these concerns based on the size of the audit company. To only apply it to the Big Four would move beyond the CMA's objective of promoting competition and considering remedies to resolve specific issues, towards protecting specific competitors (i.e. the non-Big Four firms) without a rational explanation.

---

[94] https://www.ecfr.gov/cgi-bin/text-idx?SID=d6945d6b1a8dfbddb19c155fee2e20d6&mc=true&node=se17.3.210_12_601&rgn=div8; SEC Regulation S-X 210.2.01(c)(4)
[95] https://eur-lex.europa.eu/legal-content/en/TXT/?uri=CELEX:32014R0537; Regulation (EU) No 537/2014 of the European Parliament and Council

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.

24.1. We agree with the CMA that certain non-audit services might be provided by the audit firm even where the audit business is operationally separate from the non-audit business[96].

24.2. We believe that certain services are closely associated with the audit and are either best delivered by the statutory auditor or are demonstrably not in conflict with the role of the auditor. In brief, these include:

24.2.1. Audit related services (as set out in paragraph 5.41 of the FRC's Ethical Standard).

24.2.2. Other assurance services provided over information primarily derived from the financial information systems subject to audit or over the controls over those systems.

24.2.3. Certain public company transaction related reporting accountant work.

24.3. These services require a similar skill set and approach to audit work and are arguably more in line with the 'audit' culture of independence and challenge. The purpose of such work is more aligned with providing independent assurance upon which market participants may rely (i.e. investors) rather than just the audited company and thus it remains in the public interest for the auditor to perform this work.

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?

25.1. As indicated in our response to the CMA's ITC, we are not opposed, in principle, to peer review, notwithstanding that it would represent an incremental cost which would, ultimately, need to be borne by companies.

25.2. We note that the CMA suggests that the aim of a peer review should be *"….an additional, independent quality check*".[97] However, we believe that the aim of a peer review should be more focused and would suggest that it should be seeking to identify where the audit has not detected material errors or disclosure omissions in the financial statements of the audited entity, as any broader assessment of audit quality can be dealt with through routine monitoring on a non-timely basis. It follows

[96] Update Paper, para 4.119.
[97] Update Paper, para 4.1.

that the precise extent of work to be undertaken, and other aspects of the design of a peer review, would follow from clarity on this objective.

25.3. In terms of scope of this remedy, given that the incidence of material errors in financial statements appears to be low in proportionate terms, we suggest that a selective approach would be most appropriate. On this basis, we agree with the CMA that the peer reviewer should be appointed by, and accountable to, the regulator.

25.4. However, should a comprehensive application of peer review be implemented, for example to all FTSE 350 companies (this would not necessarily need to be on an annual basis but could, for example be once every three years), we would suggest that it might be more appropriate - and manageable - if the peer reviewer was appointed by and accountable to the company (controlled, as with the audit, by the AC).

25.5. In this latter case, consideration would need to be given to the interaction of this remedy with other remedies proposed by the CMA. For example, we do not believe that there would be benefit in having a peer review of a joint audit, with two firms already involved. Similarly, consideration should be given as to how peer reviews would interact with remedies proposed by the CMA to review the ACs' own assessment of the quality of the audit. The incremental benefits need to be defined in this context, given that there will clearly be incremental costs in the operation of such a regime.

25.6. In either case, we would suggest that rather than the cost of peer reviews being borne by the regulator, the cost should be borne by the relevant company.

25.7. In our view, there are two other important questions that would need to be addressed in relation to a peer review remedy – namely independence and liability:

25.7.1. in relation to independence, we believe that it would be necessary for the peer reviewer to be subject to the same independence standards as required for the auditor, regardless of whether the appointment is made by the regulator or the company; and

25.7.2. in relation to liability, we believe that the liability should be capped. Whilst we recognise the argument that capped liability might not provide the right incentives, we believe, firstly, that this ignores other incentives (in particular professionalism and reputation) and, secondly, that peer reviews are unlikely to represent an attractive risk relative to the reward if undertaken on an uncapped liability basis.

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

26.1. In order to be valuable, peer reviews would need to be conducted and concluded in advance of the statutory auditor expressing an audit opinion. In practice, this would mean that the appointment of the peer reviewer and scope of work to be undertaken (if this was other than a "standard" approach) would need to be finalised at an early stage in the audit cycle.

26.2. We believe that the value of the peer review is likely to be maximised if undertaken on a "real-time" basis. This is also likely to be least disruptive to existing reporting timescales for the release of audited information by a company. This would mean that the peer reviewer would, in so far as timing is concerned, be similar to that which would be undertaken in a joint audit but with the key difference being that, unlike in a joint audit, the peer reviewer would not undertake any audit work directly but would simply review the work undertaken by the statutory auditor. The peer reviewer would therefore review:

26.2.1. the auditors understanding of the entity and its assessment of risks of material misstatement in the financial statements;

26.2.2. the auditor's scoping and materiality assessments;

26.2.3. the audit work undertaken in relation to key risk areas;

26.2.4. the auditor's review of the work of component auditors;

26.2.5. the auditor's reporting to the AC; and

26.2.6. the accounting and disclosure relating to areas of significant risks / judgement in the audited entity's financial statements.

26.3. In addition to direct engagement with the auditor and reviewing its workpapers, the peer reviewer could also attend significant meetings with management and / or the AC, although this would clearly increase the extent of the work required.

26.4. One question would be whether the work of the peer reviewer would be limited to a review of the work undertaken by the group auditor or also of component auditors. We suggest that the scope should be confined only to the work of the group auditor, recognising the responsibilities of the group auditor (under ISA600) to plan and oversee the work of auditors of material components of the group.

Part C: Next steps

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

27.1. For the reasons given below, we think the need for, and the details of, proposed remedies can only be examined in sufficient depth in the context of a market investigation by the CMA, or, if examined to an equivalent standard, by another body.

27.2. As set out in our initial response to the CMA's ITC and further reiterated in this response to the CMA's Update Paper, we recognise that the audit profession is rightly under scrutiny, in particular as regards audit quality, actual or perceived conflicts, and choice and concentration. We believe that industry and market participants have a critical role to play in ensuring that any reforms are as effective as they possibly can be in improving audit market competition and quality outcomes. As such, we broadly support the CMA's review provided that careful consideration is given to the practical consequences on market outcomes of the CMA's proposals and how they can be most effectively implemented, including through obtaining the perspectives of key market players.

27.3. We noted in our ITC submissions, there are three particular factors that any further proposed reforms must consider:

27.3.1. first, the enhancement of audit quality should be the primary criterion; any reforms proposed from a competition perspective should be judged from their potential to protect and enhance audit quality and should not risk a deterioration in quality;

27.3.2. secondly, the risks of unintended consequences must be evaluated. For example, measures that prevented audit firms from accessing or attracting the best talent, or discouraged investment or innovation, would be clearly counterproductive. Similarly, measures that hampered ACs in driving competitive tension in the market (for example if mandatory joint audit in practice reduced the level of choice for companies), or undermined the role of the AC in its governance role on behalf of shareholders, would risk reducing quality in the future; and

27.3.3. thirdly, any reforms of the market need to consider the drivers of the present state. The current market structure has been shaped by competitive market forces, in particular audit firms investing very considerably in the scale and techniques that are necessary to keep pace with the global reach of many companies and the sheer complexity of many modern businesses. Scale and scope economies, the ability to attract and retain talented individuals and investment incentives – especially in audit quality – could easily be lost by ill-considered reform, especially if the result were to hamper UK based firms internationally.

Successful reforms to the statutory audit market are most likely to succeed, and be sustainable in the long term, if they properly consider, and indeed are driven by, these market forces and are implemented through careful and incremental change.

27.4. Against this background, we note the statutory context in which market studies such as this one occur under the Enterprise Act 2002, which provides for the CMA to consider at the end of a market study only whether there is a reasonable prospect of the existence of features of the market which prevent, restrict or distort competition, rather than to reach a final conclusion on this.

27.5. In the previous Statutory Audit Market Study conducted by the OFT in October 2011, the OFT (citing a Competition Appeal Tribunal case) noted that the purpose of the market study is to form a preliminary view of the market, and it is not intended to be a full, comprehensive investigation with definitive conclusions:

> "*...the (market study) stage, is not intended to be a deep and prolonged investigation in which every avenue is exhaustively looked at. That is for the (market investigation) stage…There is, if we may say so, some risk that one may mistake the height of the hurdle which s.131(1) presents. It is a 'reasonable ground to suspect' test. The scheme of the Act is that a full investigation is carried out at the stage of the (market investigation) not at the stage of the (market study).*"[98]

27.6. Given the inherent limitations of this context, it is critical that the CMA's proposals, although admirable in their desire for reform, do not exceed the scope of what can be fully tested and worked through in a market study context, which does not provide even for a firm conclusion about the state of competition in a market, let alone a full forum for analysing significant remedies like primary legislation.[99] These two issues are closely linked because without a clear and detailed understanding of the nature of any competition problems within the sector, neither the efficacy of the remedy in solving that problem or the proportionality of the proposed remedy relative to the competition problem to be solved can be properly considered, either by the CMA or market participants. It is for this reason that the sequencing of the CMA market investigation process involves first concluding there is an adverse effect on competition, and only then moving to a detailed consideration of potential remedies according to set criteria of effectiveness, reasonableness and proportionality.[100]

---

[98] Office of Fair Trading – Statutory Audit Market Investigation Reference (OFT1357MIR), para 5.3.
[99] While we note that the parties to a market study can offer undertakings in lieu of a reference to a market investigation, the onus of ensuring these remedies are workable and effective is with the parties offering them (who, as market participants are better placed to do so than the CMA), and is done without prejudice as to the CMA's final conclusion on the state of competition in the relevant market(s) should an MIR be conducted.
[100] CC3, Competition Commission, Guidelines for market investigation: Their role, procedures, assessment and remedies, para 210, April 2013 at pages 68-81.

27.7. Moreover, without the processual discipline imposed by the formal market investigation process where remedies are normally considered, there is a real risk that the approach to considering remedies strays from the specific inquiry contemplated by the Enterprise Act into a broader and less analytically coherent approach which may at times exceed the proper remit of the CMA. As outlined in response to a number of the specific questions the CMA has asked above, we believe there is already evidence of this occurring in the CMA's remedy questions, which are often framed in terms of the general workability of proposed remedies and, for example, whether the practical problems involved are "insurmountable" or justified only in relative terms to another proposed remedy (as opposed to a specifically identified competition problem).

27.8. We note in particular that the CMA's approach in its Update Paper contrasts starkly with that of the OFT in the previous audit market study conducted in 2011. Having noted the statutory question to be answered in a market study, the OFT then specifically considered the alternative powers open to it, including the potential to recommend primary legislation rather than make a market investigation reference. However, the OFT rejected this suggestion, on the basis that the preliminary nature of its own inquiry did not allow either a final diagnosis of any potential competition problems or a thorough analysis of how any legislation to be proposed would actually operate. It concluded that:

> "*First, as regards UK-specific audit legislation, the OFT notes that recommendations for national legislation might follow from, or be informed by, a Competition Commission inquiry, and that the CC itself has order-making powers. The benefit, in the case of legislation initiated by the CC is that it would be based on a thorough analysis of its impact on competition, as well as its ability to solve any competition problems identified in the market.*"[101]

27.9. The view of the OFT in 2011 was therefore that while recommending changes to primary legislation was an option available to it, the preliminary nature of the inquiry at market study stage posed a material risk to the likelihood of any such legislation achieving its goals. More generally with regard to remedies, the OFT noted that:

> "*It is not for the OFT to determine which remedies would and would not be appropriate. Rather its role is to assess whether there is a reasonable chance that appropriate remedies will be available to the CC in the event that it finds one or more adverse effects on competition in this market. In the event of a reference, it is for the CC to perform an independent investigation and to decide what remedy or remedies would be capable of achieving as comprehensive a solution as is reasonable and practicable to any adverse effects and any detrimental effects on customers.*"[102]

---

[101] Office of Fair Trading – Statutory Audit Market Investigation Reference (OFT1357MIR), para 5.3.
[102] Office of Fair Trading – Statutory Audit Market Investigation Reference (OFT1357MIR), para 6.29.

27.10. In particular, the OFT cautioned that:

> _"The choice of any remedies by the CC, would involve a detailed assessment of the benefits and costs (including the possibility for unintended consequences) of the potential remedies. We note that this detailed assessment would consider the full range of costs and benefits that may occur, including effects on quality, unintended consequences as well as the impact on the cost of audit services and benefits that may accrue to companies, auditors and the full range of customers."_[103]

27.11. The CMA's motivation for making such reforms at such an early stage in the present study appears to be its preliminary view that there are longstanding competition and quality problems in the audit market which merit additional and further reaching changes than those made pursuant to the CC investigation in 2013.[104] Even if this view as to the state of the statutory audit market was supported by the evidence (and for the reasons outlined above we do not consider this to be the case), this would suggest the need for more, rather than less caution in firstly diagnosing the factors contributing to any ongoing issues, and secondly in developing a package of reforms which are sufficiently robust and well tested as to ensure that they will, this time, provide a proper solution.

27.12. Moreover, the proposals for reform that the CMA has made in its Update Paper are significant in scope and in many cases are untested internationally, at least in capital markets of the scale and sophistication of those of the United Kingdom. While the CMA hopes that these proposals will improve the competitive landscape in the statutory audit market and increase audit quality, there is a very real risk that they will either not do this, or worse, that they will have unintended adverse consequences on both competitiveness and audit quality. Given this risk, there needs to be extensive analysis of both the likely effectiveness and proportionality of these proposed remedies, which as is clear from the OFT's comments in the last statutory audit market study, is normally conducted in the framework of a full market investigation reference, the process of which expressly provides for this.

27.13. We acknowledge that the CMA, in conducting its current market study, has the benefit of the full market investigation conducted by the CC in 2013, and hence the CMA desires to conduct its review more quickly than would ordinarily be the case. However, the Update Paper highlights some different issues from the CC investigation and it comes up with very different conclusions as to appropriate remedies. As a result, unless there is significant further analysis of the type that would normally be done in a market investigation, the current proposed approach risks the omission of the full analysis of the proportionality and effectiveness of these proposals and more detailed consideration and consultation on exactly how they will work in practice.

---

[103] Office of Fair Trading – Statutory Audit Market Investigation Reference (OFT1357MIR), para 6.41.
[104] Update Paper, para 7.

27.14. Therefore, we believe it is critical that the full analysis of the proposed remedies that would otherwise occur in that context is conducted, whether by the CMA (who we note would be well placed to conduct this) in the context of a market investigation, or another body. In particular, given the clear need to understand the benefits, costs and potential unintended consequences of any remedy, it is crucial that sufficient time and consideration is given to market participants' views of the proposed remedies and to the implementation challenges that will arise, and that market participants are able to help shape the detail of the remedies in order to create a stable profession that inspires confidence and trust.