Statutory audit market study
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NON CONFIDENTIAL VERSION

Dear Sir/Madam

Consultation: Statutory audit services market study update paper

We welcome this opportunity to respond to the proposed remedies set out within the CMA's market study update for the statutory audit market issued on 18 December 2018.

RBS is a UK-centric retail and commercial bank, and a constituent of the FTSE100. As a provider of finance, we are a stakeholder to large and small companies across the UK and beyond. We responded to the initial invitation to comment of 9 October, and note the widespread public interest in the matters set out by the CMA.

CMA paper
The update paper notes the complexity of the issues and the breadth of views and opinions offered. We note that there is not common consensus on which individual measures will best address the concerns raised.

Furthermore, we do not find the CMA's analysis points to a systemic failure in the audit market:

- Notwithstanding the work of the AQR, it has not resulted in the withdrawal of any audit opinions
- While there are a number of open enforcement cases, we do not believe it is possible or appropriate to draw a conclusion while these remain "live"
- Much of the CMA conclusion relies on investor comment – [✂]

Generally the UK audit and accounting market is a world-leader. As such, while debate as to measures that can maintain the UK's status is relevant, this should not be read as being a failing market. Outcomes that point to a failing market would damage the regard the UK is held in rather than protect it.

We believe there are two key areas of attention highlighted in the paper: effective audit quality and the lack of competition characterised by limited choice. We set out our primary observations below, which we expand in the questions included as an appendix.

Audit Quality and Choice
We agree that for a well-functioning corporate environment, it is essential that the UK has a high quality audit market. We also agree that there is an issue with choice when a company chooses to replace its auditor.

We believe that the CMA is right to focus on steps to enhance audit choice, recognising that promoting competition will lead to a better product. We are concerned that with some of the measures proposed, the costs that will be borne by preparers are not commensurate with the potential benefits available.

The CMA paper does not set out the characteristics of a high quality audit. We believe that the hallmarks of an effective audit are evidenced through:

(a) The audit experience and qualifications of an audit firm and staff in the critical geographic locations of the company
(b) The experience, skills and experience of the lead audit partner, and the wider group of partners and subject matter experts engaged in the audit
(c) A sound audit methodology and the internal quality assurance mechanisms within the firm
(d) The ability of the firm to secure the necessary resources and skills to support the audit
(e) The depth of audit partners in the firm to enable ongoing provision to the company beyond the five-year mandated tenor of individual key audit partners

This can make the appointment of a challenger organisation problematic where they cannot evidence the above attributes; they are more likely to have less equivalent audit experience, fewer partners of requisite experience restricting rotation and less developed international networks.

Stakeholder interest
In meetings with our shareholders, employees and other stakeholders we note that historic financial information is of reducing relevance and that there is increasing interest in a wider set of performance indicators and metrics. These include our forward looking statements, engagement with digital platforms, our customer service scores and our community and sustainability agendas. Audits are not designed to tackle these. Yet the primary benefit our stakeholders receive from an audit is the assurance that the information we present is accurate and appropriate. As the current basis only applies to the historical financial information we share, then we do not fully meet their needs.

Features of the audit market
The CMA paper notes the widespread concentration of audits in the hands of the Big Four. While this is to be expected for the very largest companies, such as constituents of the FTSE100, we agree that this outcome is not normal for smaller scale markets such as FTSE350 or AIM. These are markets where smaller accounting firms used to hold market share and have lost out to the Big Four over the last 10-15 years.

Equally, for challenger firms to become credible this will be built “bottom up” in terms of the size of individual clients, and therefore measures should primarily target correction in these small-cap and mid-cap markets. Over time, the correction of this market will flow into FTSE100.

Regulatory oversight
While we believe that our own audit committee performs the described functions appropriately, we note the CMA evidence shows that there is mixed practice. The use of a regulator is a remedy that would potentially mitigate the risk of committees using inappropriate tendering protocols.

As an alternative, a more comprehensive report from the audit committee to shareholders (and potentially other stakeholders) of the outcome of an audit tender might achieve the same outcome. We also note that it is unclear what would happen if the regulator disagreed with the conclusion of an audit committee in terms of tabling a vote to shareholders.

We believe the approach taken by the PRA in its oversight of auditors for financial services already covers the elements proposed for the new regulatory body.

We would also be concerned that there is a significant risk of duplication or conflicting approaches and demands arising from the work of different regulators. We would suggest that any lead audit regulator is able to delegate its work to other regulators.

Joint audits
We note that the CMA refers to evidence provided by Mazars in its support of joint audits. We equally note that other evidence indicates that joint audits lead to significantly higher costs without providing an enhancement of audit quality.

In France, where this practice is most common, there is no discernible difference in the size of competitors, with the Big Four holding similar market power to the UK. We separately note that the Italian report on the collapse of Parmalat pointed to the dual firm approach as one of the reasons that the fraud was not spotted through the audit.

In appointing each firm in a joint audit, the audit committee would still need to satisfy itself that each candidate had adequate audit and industry experience and geographic coverage and depth of personnel.

As an alternative to joint audits, the CMA paper suggests introducing a market share cap to firms. We note that responses from preparers consistently reject this as it reduces choice. It is therefore only appropriate where a "correction" of the market is needed. We believe that this should be targeted and smaller-scale listed markets – so recommend that this is considered for FTSE350 and AIM markets but not considered for FTSE100. We prefer this to mandatory joint audit.

Structural or operational split
Ring-fencing is familiar to our organisation. With the wider public concern on conflicts within accounting firms, we believe that there is an argument to support operational ring-fencing. This would permit the protection and clarify the independence of audit practices within wider practices. We would consider this to be appropriate for all firms, though there is a considerable cost attached.

As an alternative we question whether a limit on the number of audit-approved partners in a firm might more effectively achieve the stated goals.

Peer review
The proposed remedy envisages a peer review to be completed ahead of the signing of the accounts. We do not believe, operationally, it is possible to execute a concurrent peer review without delaying the completion of the reporting cycle. This is not beneficial. Further, this seems to be a remedy that would carry significant cost to us as preparer due to the need to pay for a second firm to undertake significant work on the audit.

As a Bank we (and our auditor) already have active engagement with our regulator, the PRA, on matters relating to the audit, which includes a report from our auditor to the PRA on its conclusions on specific matters.

As an added approach that could be considered, we would also propose periodic external evaluation of the work of the auditor. For internal audit functions, it is current practice to seek an external review of the quality of the function (EQA) on a triennial basis. In other years, this review is done internally. This process could be replicated for the statutory auditor. This would retain the peer review benefit but reduce the cost implication, provide a clear framework for improvements and not jeopardise the publication of results.

RBS as a stakeholder in the audit
RBS is the largest lender to the UK corporate market and as such has a strong interest in the effectiveness of audit for corporate entities in the UK. The audit report is a key piece of information in credit evaluation.

We have an important role to play in auditor selection for companies. The most significant concern we track is those companies that do not appear to have a statutory auditor of sufficient scale to be able to challenge company management. This issue can arise as companies grow and reach a scale where the original auditor no longer has the resources to execute effective challenge.

For smaller entities, we note that it is often more practical to give a wider range of non-audit services to the auditor, since other accounting firms do not have suitable knowledge of the organisation.

We believe that the approach to the audit of going concern is an area where improvement would represent an enhancement in audit quality. The common approach to going concern, using a 12-month horizon, can often falsely mask longer term issues that we believe would merit greater transparency and different approaches.

Our general view is that audit failures typically stem from corporate failure, which point to a question of when a company or entity moves from being a going concern to not being a going concern. Audits should address this question in a better way than they do currently. This improvement would provide all stakeholders with better information on the likelihood or risk of failure of individual companies.

Addressing concerns over transparency
We believe that there is, typically, nervousness about "saying too much" or "spooking the market". There is a need for a culture change that promotes greater transparency in the risks faced by companies and how well they are prepared for these. If companies believe that they will send false signals or inappropriately unnerve investors or finance providers they will be reluctant to provide this transparency.

The role of technology and innovation
There is no discussion on the effect of market disruption, which might arise from technological or digital advances or product innovation. We believe that the lack of sources of disruption is a constraint on audit

quality. As a retail and commercial bank we see first-hand the level of disruption arising from the move to a digital world and the need to change our products and services to better reflect how technology can lead to better outcomes for our customers. We would not want regulatory intervention to reduce the opportunity for new ideas and technology in this market.

In summary, we are supportive of those proportionate actions that will lead to the development of a deeper audit market, leading to greater choice and promoting higher audit quality. The separate steps to enhance regulation will address audit quality, but need to take account of the risk of duplication. We remain concerned that there are unintended consequences from taking forward a number of the proposals and would look to detailed investigation to be made to ensure the measures will indeed promote rather than damage the UK market and its global perception.

We would be happy to meet to discuss our comments in more detail if this would be helpful.

Yours faithfully

Matthew Waymark
Director of Finance (interim)

Responses to questions

Question 1 *Do you agree with our analysis…of the concerns about audit quality?*
Question 2 *Do you agree with our analysis of the issues that are driving audit quality concerns?*

We agree that a well-functioning audit market benefits the UK, and is an essential part of corporate stewardship.

The CMA report notes that many commentators consider that audit quality is of a good standard, but with a number of concerns being called out. We also agree with the conclusion that there is significant public interest in the effectiveness of auditor scrutiny and oversight. This heightened interest is, in part, a result of high public corporate failures. While it is all too easy to conclude that any corporate failure must involve an audit failure, it is valid to question whether the role of audit and the auditor could have helped mitigate or prevent the effects of those failures.

The CMA notes five issues affecting audit quality:

(a) The role of the audit committee and investors in the process of appointing and monitoring auditors

We agree that the role of the audit committee is critical in appointing and monitoring auditors. For an organisation like ours, the committee is solely formed of non-executive directors (NEDs). NEDs are appointed by shareholders and have legally defined roles to ensure the interests of those shareholders, and wider stakeholders are met. While the CMA notes examples it believes questions whether audit committees have adequate focus on audit quality, we do not support the CMA conclusion that the model fails in most cases to give due attention to audit quality.

The audit is a valuable tool for NEDs in supporting their oversight of executive management and receiving assurance on financial reporting. As such, it would be contrary to the NEDs' own self-interest to promote low quality audits. In our own 2014 tender process, audit quality was a primary focus. However, for the auditor to be effective they do need to be able to establish effective working relationships with management to be able to best achieve their goals, so it would be wrong to ignore altogether. Since financial reporting involves significant judgments, it is absolutely central to any appointment process that the NEDs trust the judgment of the audit partner.

We do recognise that the historic focus on shareholders may have created some distortion, but changes in company law and accounting in place are already pointing towards a need to consider all stakeholders.

We do agree that audit committees could do more in monitoring audit quality, and that in most cases there is limited public information that allows effective benchmarking. Therefore, most audit committees will assess by reference to prior performance and, where relevant, the NEDs experience from other appointments.

(b) Limitations of choice leading to weaker competition

We agree that limitation of choice is a critical issue in the functioning of the audit market. While it is not always the case that a small number of suppliers must mean lower quality, we do believe that there is not a deep enough pool of credible choices to ensure that strong competition exists. Strong competition is evident when there is genuine diversity in product and service offering.

However, because audit quality is so important in the appointment process, companies and NEDs must receive sufficient evidence that a proposed auditor can deliver. For a challenger firm, that cannot provide historic capability, it is difficult to see how an audit committee could recommend that firm over established players.

Even amongst the Big Four there are differences in depth of expertise within each industry which will lead to questions over their ability to take the role of auditor.

The recent move to mandatory rotation has further highlighted this issue, while also providing opportunities for change in audit relationships.

Non-audit services can create conflicts in appointment of new auditors, where the candidates are involved with other services to the company. However, for large organisations like ours, there is very limited conflict for the incumbent, and the auditor is generally highly limited in other work performed for the company.

(c) Barriers to challenger firms for FTSE 350 audits

We agree with much of the CMA analysis, especially on the demand-side about barriers to challenger firms. We note that a number of comments from smaller accounting firms pointed to conservatism about the appointment process. We do not fully agree with this aspect. As we note above, if an appointment is made based on audit quality, then this is demonstrated by prior experience.

The key issue is for challenger firms to develop this experience. Advisory work provides an opportunity to build experience of larger organisations. We note that EY built up its banking advisory practice as an investment in a period when it lacked large banking audit clients. This investment led to it being able to develop the experience necessary to gain appointments, and it has been successful in winning several banking audits subsequently.

We do appoint smaller firms to perform other advisory work within RBS. It is developing and investing in this capability that will allow these challenger firms to become credible audit alternatives.

As a banker to many UK organisations we also have an interest in their appointments of auditor. We come across cases where, in growing companies, the original auditor no longer has the resources to execute effective challenge. We also see other stakeholders, especially those supporting equity and debt raising, would raise similar challenges. These will typically lead to a more suitable firm appointment than previously, to better match the size of the company – this might be a step up from a small firm to a mid-size firm or to a Big Four. Especially when the move is into equity markets, there is larger preference for a Big Four appointment.

The other most critical aspect is international reach. For companies with international operations they need to observe that the auditor has appropriate audit capability in all significant overseas territories.

(d) Resilience concerns

We recognise the concern noted about the potential failure of one of the Big Four firms. However, we do not see this as limiting audit quality or choice.

Indeed, the current risks attached to firms and their partners creates a natural incentive to accounting firms to deliver a high quality audit and the potential costs attached to taking on larger company audits from this risk appears to reduce the appetite of some smaller firms to seek larger appointments.

Therefore, while we recognise that the risk of failure of a Big Four is a concern for a well-functioning market, we believe it is the legal framework that introduces a limit on competition.

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

We do not believe that the wider incentive issues are a primary cause of low audit quality or choice. As noted above, we do believe that the delivery of non-audit services can affect the ability of an individual firm to seek an audit appointment but is not an issue once appointed.

We do note, however, that the changing landscape of accounting firms has tended to put the audit practice in a minority position within these firms, with revenues from audit often accounting for only 20% of the overall business. This is leading to a reduced voice from the audit practice in the management and direction of the firms, and leading to a culture that gives less prominence to audit work.

Equally, we believe the value gained by accounting firms from their broader activities is important to the overall capability to deliver an effective audit.

The characteristics of audit quality
We note that the CMA paper does not define audit quality, nor the characteristics of a high quality audit.

We believe that companies would generally focus on the below matters as being of most critical in evaluating audit quality:

(a) The audit experience and qualifications of an audit firm and staff in the critical geographic locations of the company
(b) The experience, skills and experience of the lead audit partner
(c) The complementary skills and experiences of the wider group of partners and subject matter experts engaged in the audit
(d) A sound audit methodology and the internal quality assurance mechanisms within the firm
(e) The ability of the firm to secure the necessary resources and skills to support the audit
(f) The depth of audit partners in the firm to enable ongoing provision to the company beyond the five-year mandated tenor of individual key audit partners

In considering an appointment, firms would need to demonstrate these attributes. A firm that was unable to do so would normally be considered as not suitable for appointment. This is especially important for organisations in specialist sectors (like financial services) or with significant overseas operations. It is likely to make appointment of some firms impossible because they cannot demonstrate the relevant strength in depth in the needed specialist areas or the country coverage.

All remedies
Question 3 *What should the scope of each remedy be? Please explain your reasoning*

Any applied remedy should be designed and scoped in a manner that specifically promotes either choice and/or quality.

Audit quality
Actions relating to audit quality should apply to all firms. Where audit quality is a concern that it would not be appropriate to restrict a remedy to a subset of audit firms. Otherwise, the remedies become obsolescent and will create distortions in the supply of audit services.

Choice
Remedies targeting audit choice and competition should be concentrated on small and mid-cap markets. To successfully bring change in the audit market, challenger firms need to build their experience and capability with smaller size companies in the first instance. This will naturally evolve to larger markets both as the companies themselves grow in size and also as the challenger firms build their own scale.

Sector specialisms
The CMA has noted that in a number of cases the unique characteristics of individual industries (especially regulated industries) may reduce or remove the likely effectiveness of individual remedies. Since these generally apply to larger listed companies (often with international operations) we would question whether some of the options should be targeted at listed and private companies outside of the FTSE100. Especially in matters of choice and appointment, change will come through smaller companies first and then larger companies.

We have commented further as relevant below under each remedy option (and their related questions).

Regulatory scrutiny
Question 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? [both during the tender process and the audit engagement]*

Tender process
We believe that in many instances audit committees are effective both during the tender process and then in subsequent monitoring. It is therefore important to ensure that the role of a regulator is designed to focus attention on instances of poor performance and not to be too intrusive in well-functioning cases.

Given the concerns noted by the CMA, we believe that the role of the regulator should be established to:

(a) Review the selection criteria chosen by an audit committee in commencing an audit tender.
(b) Understanding the decisions made by accounting firms to participate or not in an audit tender.

(c) Reviewing the rationale of a company in recommending a particular accounting firm for appointment as auditor.

We are not convinced that it is necessary for the regulator to sit as an observer on audit committees. Other regulatory bodies do not typically observe company meetings, but have the right to the papers and minutes of those meetings. Similarly we do not believe there is a need for reporting to the regulator throughout the tender process – just at the start and prior to the conclusion. Additionally we also undertake our own external evaluation of our Board and sub-committees using third party governance specialists.

<u>Ongoing monitoring</u>
We believe that a regulator could provide greater value in supporting companies in their ongoing monitoring of audit quality. The key aspects of their role should be:

(a) Providing clear frameworks and guidelines on establishing, measuring audit quality and indicators of good and poor quality practice.
(b) Transparency over the work undertaken on audit quality reviews to allow audit committees to understand emerging issues and matters requiring further diligence.
(c) Establishing best practice in how organisations undertake quality inspections and publishing recommended suppliers for this activity.

We believe that the regulator should have the right to report to shareholders directly if they believe there is a specific concern, but do not believe that the regulator should have the right to override a shareholder approved choice.

<u>Example of the PRA</u>
Financial services companies already receive regulatory oversight on audit-related matters from the PRA. Our own experience would indicate that this already addresses those matters identified for regulation:.

- We inform the regulator about our planning and expectations on audit tendering.
- During a tender process, we provide regular updates to the regulator regarding our progress and to discuss issues we are considering as part of our assessment.
- We confirm with the PRA our proposed choice of auditor before we ratify our decision.
- We engage with the PRA on the audit cycle each year.
- The PRA receive direct reporting from our auditor, and hold bilateral meetings with our auditor on matters that concern them.
- The PRA holds a trilateral meeting each year involving ourselves and our auditor.

Joint audit
Question 5 *What should the scope of [the mandatory joint audit] remedy be?*
Question 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 a joint audit? Are there any categories of companies to which this requirement would not apply?*
Question 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?*
Question 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?*
Question 9 *Should a joint liability framework be introduced to encourage active participation in the market by the Big Four and challenger firms in the context of joint audits, what are the advantages or disadvantages of auditor liability being proportionate to the audit fee of the joint auditors, compared to the auditors being jointly and severally liable?*

We agree that joint audits do offer an opportunity for smaller firms to be involved in larger company audits and, in theory, to develop their expertise. However, we do not support joint audits as a universal remedy.

<u>Joint audits in practice</u>
We question whether this will translate to a change in the overall market. The CMA paper makes reference to the French market where joint audits are relatively common. We note that despite this, it has not changed the relative scale of the Big Four and other firms, which matches the UK market.

Equally, we believe that joint audits introduce drawbacks that detract from overall quality:

- There is a benefit from a single firm seeing all aspects of a company. This often allows the firm to highlight issues because the audit team see all sides of an issue. In a split audit this is lost.

- Audit planning is equally constrained because each firm receives more limited information, risking an incomplete assessment.

While we note that the Mazars response, referred to by the CMA, indicated that the cost did not significantly increase in a joint audit, we do not believe this is a commonly held view. Other research from European academics points to a much higher potential cost differential. In particular, we note a 2015 report, “An evaluation of the French experience with joint auditing” written by Jean Bédard (Laval University), Charles Piot (University of Grenoble) and Alain Schatt (University of Lausanne) which concluded that joint audit did not increase the quality of accounting information, while the cost of auditing service was significantly higher.

<u>Design of joint audit</u>
If a joint audit approach was pursued then the following features would be relevant:

(a) Appointments would need to be Big Four and a non-Big Four firm (or two non-Big Four). To design an approach that allowed two Big Four firms to act would negate the stated rationale for introducing joint audits.
(b) The allocation of work should be agreed by the Audit Committee rather than the regulator, who will be able to establish the relative strengths and offerings of each audit firm.
(c) For reasons noted by the CMA and also above, we believe that applying a proportionate liability approach would be preferable. Otherwise there is a high risk premium for the challenger firm from involvement.
(d) While we agree that there is a benefit to staggering appointments, there are practical challenges that could make this problematic such as acquisitions. We therefore believe that the choice should be left to individual companies, but with best practice pointing to a staggered appointment mechanism.
(e) It is important that both firms sign the audit opinion. Otherwise we are paying one firm to audit and the other firm to review the audit.

Market share cap
Question 10 *How could the risks associated with a market share cap, such as cherry-picking be addressed?*
Question 11 *Would it need to apply only to FTSE350 companies, or also to other large companies, and if so, which?*

We note that preparers did not generally support a universal market share cap. This is because this would artificially reduce choice for a company seeking a new appointment.

We believe, as we have indicated above, that this measure, which forces change, should be targeted at small and mid-cap companies and better targeted at say AIM or FTSE350 markets. This would allow challenger firms to build their presence in these markets. Over time this would lead to change in FTSE100 market as these companies grow.

We do not believe it is appropriate to apply a cap at this time to the FTSE100 market. Challenger firms would take on very significant financial risk in taking on large company audits through unlimited liability model. Equally, it would not be appropriate for large companies to seek an appointment of a firm that cannot otherwise demonstrate its ability to deliver an appropriate quality of audit. An audit committee would struggle to support an appointment based on a theoretical rather than an actual capability in audit.

Barriers to challenger firm development
Question 12 *We welcome evidence from stakeholders on the existence of barriers to senior staff switching quickly and smoothly between firms.*
Question 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.*
Question 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 towards developing an open-source platform.*

We are not in a position to comment on Q12. Similarly, we cannot gauge likely costs of a tendering fund, though we would be supportive of this or equivalent mechanisms that assisted smaller firms with bidding on audit tenders.

<u>Promoting technological innovation</u>

We believe technological innovation to be a primary driver of competition and therefore would agree with the concerns noted by the CMA about freely allowing smaller firms to use Big Four technology platforms since it may stifle innovation. However, we would be supportive of initiatives on open-source platforms and technology. We see a banking parallel in the Open Banking initiative – this is designed to give challenger organisations access to some of the data held by larger banks – but allowing those same challengers to then design their own products and services.

Partner numbers cap
The growth of the Big Four was initiated by the removal of a cap on the number of partners permitted within a partnership structure. Re-introducing a cap on the numbers of partners (maybe with the ability to sign off statutory audits) would be effective in tackling this issue. If limitations on moving between accounting firms was removed, this would also lead to an increase in individuals looking to move from larger firms (where the caps prevented career progression) to other organisations that had capacity to take on new partners.

Resilience
Question 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.*
Question 16 *How could such a system prevent moral hazard?*
Question 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?*
Question 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?*

Risk of failure of a Big Four firm
We believe the risks attached to audit failures for individual partners and firms are a strong incentive to promote audit quality. We would therefore have concerns in seeing this linkage broken.

Equally, we believe that steps to ensure continuance of the Big Four goes against the objective of increasing competition. We therefore see the proposal that, in the event of a failure of one of the Big Four, their work is given in preference to a challenger firm as being attractive. However, for the same reasons, we do not think that it would be viable to move the entire business to a new provider and a statutory ban on some clients being moved to a Big Four competitor holds the risk of unintended consequences. In such a scenario it may be necessary for other of the Big Four firms to be part of the solution.

However, we agree, that in this scenario the active involvement of a regulator would be important to maintaining the audit work for affected corporates.

Living wills
The CMA refers to the 'living wills' regime established for banks. Given that the design is intended to maintain competition rather than protect customers (ie the audit clients themselves) we doubt whether such a regime would work as well. Since audit team members will often service multiple clients it is not possible to achieve a simple break up of a firm by audit.

Structural/operational split
Question 19 *Do you agree with the view that the challenges to implement a full structural split are surmountable?*
Question 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? Please compare and contrast the full structural split to the operational split.*
Question 21 *With regards to the operational split, please provide comments on [implementation risks, risks of circumvention, implementation timescales, ongoing monitoring costs, role and competencies of a regulator]?*
Question 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?*
Question 23 *Should challenger firms be included within the scope of the structural and operational split remedies?*
Question 24 *Which non-audit services should the audit practices be permitted to provide under a full structural split and operational split?*

We would prefer, and support, an operational split.

Structural split

While it is possible to believe in theory that a full structural split could be achieved, this ignores practical realities:

- The intention of such a split is to separate audit and consultancy arms. Managing the split so as to preserve those linkages fails to deliver the stated objective, while incurring significant cost.
- In the event of such a split, it is unclear that international organisations would choose to maintain affiliation with the audit practice. In most cases inbound international audit efforts (ie where the UK entity is a subsidiary) would be possible through the non-audit practice in the UK (since affected clients would typically not be listed entities) and for UK international businesses, this is no different to establishing a joint audit, and companies may prefer this approach.
- It is not clear why experts/specialists would choose to work within an audit practice rather than the equivalent consultancy practice. This deprives the audit practice of this expertise and this is therefore likely to reduce audit quality.
- Unless this measure is mandated for all audit providers, it will become out of date as (if intended) challenger firms became larger – either replicating the original issue or creating a shelf life at which point structural separation should be reversed.

Operational split – comparison to banking

The alternative suggestion of ring-fencing again replicates the position faced by the large UK banks:

- We prefer this as a solution to a full operational split. It reflects the realities of the cross-dependencies the audit practices have on wider expertise but would address the perception of internal conflicts.
- However, we do note that this is a costly measure to implement, and increases complexity for the organisation. We are not convinced that the benefits gained merit this cost, and cannot be achieved by other measures.
- We note that the UK banking solution was considered by other jurisdictions, notably the EU, but not adopted elsewhere.

Benefits of an operational split

In recent years, accounting firms have seen significant growth in their advisory practices. This is leading to a reduced significance of the audit practice within these firms. Additionally, this is leading to a partner set within each firm that includes more individuals without audit knowledge and experience. It is therefore increasingly likely that strategic choices and attention will be drawn away from audit. We note that for some firms, the share of revenues from the audit practice is falling to 20% of total revenues.

An operational split would provide greater protection to the audit practice and give improved operational independence to the audit practice to maintain a focus on the audit service.

We also believe, in a mirror to standard corporate governance, that the boards of the operational ringfence entities should include a majority of non-executive members.

In terms of access to suitable expertise, an operational ring-fence also ensures that the audit practice and can benefit from the subject matter expertise and experience from colleagues in the advisory side of the practice. A full structural split would not provide the same ease of access to such expertise.

Alternative option – partner cap

If the goal is to break up the largest UK accounting firms, then limiting the number of partners, who are authorised to sign accounts would more effectively reach this objective.

Peer reviews

Question 25 *What should be the scope and frequency of peer reviews, if used as a regulatory tool?*

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

If coupled with a regulatory regime, as appears to be the intent, a change in how peer review is performed would be an appropriate and sensible mechanism that should enhance audit quality. The use of peer review cannot be allowed to interfere with corporate reporting cycles.

Logistics

We do not believe peer reviews can run concurrent with the audit effort. Audit procedures typically complete "just in time" for the signing of the accounts. Seeking to run a peer review process that reports to the Audit Committee would delay the publication of financial results and result in joint audit rather than peer review.

Incentives

International accounting standards have increased the use of judgment in financial reporting significantly over recent years, often including consideration of forward looking information. The role of the auditor is to ensure that management employs robust methodologies and mechanisms to analyse and inform its measurement and estimation. It is not the role of the auditor to seek disagreement simply because alternative (permitted) options are available. We would be concerned that incentives for reviewers to disagree would be counter-productive and not lead to higher quality audits. Instead it would create confusion.

Periodic review

Companies need to be encouraged to build robust frameworks and methodologies and to apply them consistently. In auditing these, consistency of approach is an important part of good audit evidence.

Peer review should operate as a tool employed by a regulator to support its oversight. Examples of how this can be delivered are set out below:

(a) External quality assurance (EQA)

It is already recognised practice that EQA is performed on internal audit functions on a triennial basis. Given the current rotation periods (ten/twenty years) plus audit partner tenure of five years, replicating this for external audit would be appropriate.

The CMA response notes the difficulty committees have in evaluating auditor performance against objective benchmarks, and an EQA approach would provide a better framework to support this.

We believe it would be appropriate that the audit committee appointed a firm to undertake the EQA rather than the regulator mandating such an appointment. However, as happens in other areas, we would be supportive of the regulator maintaining a longlist of suppliers or approved partners suitable for performing such work. This would allow the regulator to maintain its own monitoring programme on the quality of work provided by such individuals. While the EQA should be addressed first and foremost to the audit committee, it would be appropriate for reports to be provided to the regulator. We would also support the inclusion of outputs from the EQA within the annual report (currently external reports would note an external review but not normally cover detailed findings).

(b) Long form reporting

An alternative mechanism to a full review would be to again follow banking precedent and use long form reporting, such as now used by the PRA. This involves the auditor responding directly to the regulator on a set form of questions about certain key judgments and risk areas the PRA believes to be of interest. The auditor reports to the regulator on how they reached their conclusions in those areas. This has an annual reporting cycle. The potential advantage of such an approach is that it focuses on specific high risk issues that apply across the industry, though it is more costly to the preparer organisations than a periodic review. The drawback with such an approach is that it does not consider all aspects of the audit process.

Market investigation reference

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

Given the wider investigations currently underway through the Department of Business, Energy and Industry, we agree that recommendations to government are appropriate. As such we do not believe a market investigation reference is necessary.

Appendix

Areas of regulatory oversight covering audit matters

As a large UK bank, with a UK and US listing, we receive regulatory oversight on our audit from various bodies. We set out below the bodies that oversee our activity and the forms of this oversight:

1. PRA/FCA

As a credit institution we are regulated by both the PRA and the FCA. The PRA acts as lead regulator.

- Regulatory examination and approval of the Chair of our audit committee (including chairs of subsidiary bank audit committees)
- No objection on decisions regarding the appointment of a new auditor
- Long form report on specific matters they request directly from the auditor
- Trilateral meeting involving both the auditor and the audit committee chair to discuss each year's audit
- Requirement for the auditor to report directly to the regulator on supervisory matters

2. FRC

The FRC has responsibilities with respect to corporate governance, corporate financial reporting and audit quality.

- Right of review and (if necessary) instruction to change accounts, exercised through Financial Reporting Review Panel
- Review of audit files, undertaken by the Audit Quality Review Team
- Promulgation of rules regarding the standards required from audit work
- Promulgation of rules auditor ethical standards, which specifically places limits and restrictions on our use of the auditor for non-audit services

3. SEC/PCAOB

As a US listed entity, we also experience oversight from US authorities. Our auditor must register with the Public Company Accounting Oversight Board.

- The SEC has a right to review and demand changes to our US filings, including our annual report (filed as a 20-F). The SEC establishes itself as a competent authority to interpret International Accounting Standards, and will challenge the judgments and choices of its filers if it disagrees with their accounting interpretation. This is exercised through the office of the chief accountant for the SEC
- Accounting firms must register with the PCAOB if they issue audit reports on SEC-filings
- Review of the quality of audit files, undertaken by the PCAOB
- Promulgating ethical standards for registered auditors, including limits and restrictions on the provision of non-audit services

4. Regulators of banking branches

We operate branches of our banking entities in overseas jurisdictions. These are typically subject to local regulation, which can include the right to challenge audit outcomes.