MAZARS

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

Direct line +44 (0)7768 828189

Email

21 January 2019

Dear Study Team

Mazars' response to Statutory audit services market study, Update paper, 18 December 2018

1. Introduction a

Mazars, the international, integrated and independent organisation specialising in audit, accountancy and advisory services, welcomes the opportunity to provide our attached response to the consultation questions set out in the Statutory audit services market study, Update Paper, 18 December 2018. As of 1st January 2019, Mazars operates as a truly internationally integrated partnership in 89 countries and territories with correspondent offices in an additional 14 countries. Mazars draws upon the expertise of 23,000 women and men. In the UK Mazars currently has around 140 partners and over 1750 employees, and is ranked one of the top 10 accountancy firms nationally.

2. Substantial audit market reform focused on delivering higher quality audits is needed as a matter of urgency

We commend the work performed by the CMA in its review of the statutory audit services market. The analysis presented in the Update Paper is insightful, sound and fair. It is our view that the bold remedies recommended by the CMA have a very high chance of "focusing competition on quality and allowing a sufficient choice of viable competitors in order to create the strongest possible incentives for highly competent, professionally sceptical audits".

The Public Interest Entity (PIE) audit market is in need of substantial reform as a matter of urgency in order to meet the public interest as the current ossified market, with four longstanding dominant firms, is visibly not responding to users' needs. 'Tweaks' to the current system will not be enough. Lobbying should not be allowed to either water down the proposed reform package or slow down its implementation.

3. Remedies to be considered as an integrated package

The proposed remedies need to be considered as an integrated package as they will interact with each other. No single remedy should be expected – on its own – to deliver all the necessary improvements to audit quality. We strongly believe, however, that enabling more quality firms to participate in the PIE audit market, working together with the existing firms for the common good, would have a significant impact on the reliability of audit opinions in the short term and the development of innovations to address market needs in the medium term.

4. Mandatory joint audit in FTSE350 involving challenger firms should be at centre of the reform

Mandatory joint audit for FTSE350 companies with at least one challenger firm involved in each audit, the CMA's provisionally preferred Remedy 2, should be at the centre of the reform package.

Remedy 2 has substantial advantages over and carries none of the risks associated with the alternative market share cap approach of Remedy 2A which were clearly identified by the CMA. It is a tried and tested approach that would contribute, in partnership with the other remedies, to enhancing audit quality, improving market resilience and protecting the investors' choice of auditor.

All FTSE350 companies, apart from certain Investment Trusts, should appoint joint auditors. Joint audit should be introduced on a phased basis over 5 years across the FTSE350 and apart from the largest 40 or so audits, with fees above £5m, should be joint audits from when challenger firms are first appointed. Some of the largest audits may need to start as shared audits and become joint audits after a period of 2 to 3 years. The aim should be for at least 20% of aggregate FTSE350 audit fees to be those of challenger firms after 5 years and 30% after 7 years.

The required reallocation of audit work and corresponding fees from the Big 4 to challenger firms is manageable in a way which best protects against any risks to audit quality. It is also, in the scheme of things, relatively innocuous as a 20% transfer of capacity over 5 years would reduce Big 4 audit turnover by less than 1% per annum and increase challenger firms' turnover by an average of 3.5% per annum. Appointing joint auditors on a staggered basis would also have a positive impact on audit quality.

Those opposing joint audits should provide evidence to support their views and should not be allowed to rely on asserting long standing urban myths, including those relating to material increases in cost, greater complexity for companies and the risk of 'things falling between the cracks' which do not bear scrutiny.

The implementation of the proposed new joint audit approach should be overseen by a committee within the proposed new regulator, with strong investor participation, and with guidance issued on undertaking joint audits.

5. A market share cap approach would need to include mandatory joint audit

The market share cap approach on its own would have the weaknesses identified by the CMA of being prone to cherry-picking by the Big 4 as to which audits were given up with the clear risk of an overemphasis on the smallest and/or most risky audits. It would not provide the same opportunities to enhance audit quality as Remedy 2. It would also limit investors' choice of auditor and, critically, would not address the need for greater market resilience unless accompanied by mandatory joint audit at the upper end of the FTSE350 given the marked concentration of audit fees in this part of the market.

If there were mandatory joint audit for FTSE350 companies, it would be helpful to consider, on practical grounds, a market share cap approach based on challenger firms auditing at least a set number of audits relating to companies in other parts of the PIE audit market.

6. Support for other CMA remedies
We also support the other CMA remedies, including greater regulatory oversight of audit committees and the separation of the dominant firms' audit and non-audit practices. In particular, steps are needed to ensure there are no unreasonable limitations on the movement of partners and staff from the Big 4 to challenger firms in order to enable the latter to build on their existing capabilities and capacity which are often under-estimated by the market. We would also support, and be willing to contribute to, the sharing of audit technology and other appropriate expertise with challenger firms that wished to licence it. Regarding peer reviews, we consider that these would generally be redundant with the additional pair of eyes brought by joint audits but such peer reviews could potentially be helpful in certain circumstances to a regulator.

7. There should be a proportionate regulatory regime with proportionate liability
On grounds of fairness and in order not to create unreasonably barriers to entry to the FTSE350 audits by challenger firms, there should be a proportionate regulatory system with an emphasis on promoting improvement through the stakeholders in the PIE audit market working together constructively. A proportionate liability regime should be introduced on similar grounds.

8. Mazars, alongside a number of other quality challenger firms, will play our part in delivering the proposed changes
The challenger firms currently have much greater capability and capacity than most stakeholders recognise. They can further expand this in a controlled manner and have an interest in doing so. If significant reform is not introduced soon however, the opportunity for reform could be much diminished since challenger firms may as a consequence reduce their commitment to the PIE audit market, as was recently seen in the case of one large challenger firm. We are clear that without decisive action the gap between the Big 4 and the challenger firms, already very significant, will keep getting bigger.

9. All stakeholders in the PIE audit market have a responsibility to contribute to audit reform
All stakeholders in the PIE audit market - shareholders, audit committees, Big 4 and challenger firms, professional bodies, regulators and government - have a responsibility to help create a new ecosystem for the PIE audit market that would enhance trust in corporate reporting by supporting reform and actively contributing to its implementation in a spirit of co-operation with other stakeholders.

10 Future of auditing and future of reporting projects should not hold up audit market reform
The reforms in the CMA Update Paper and the Kingman Report need to be complemented by the work of Sir Donald Brydon's Future of Audit group which in turn needs to consider reporting

developments as well as auditing issues given they are inseparably linked. The projects on the future of auditing and reporting, however, need not, and should not, hold up audit market reform moving forward without delay.

11. Detailed responses and further discussion
Our detailed responses to your questions are contained in the attached Appendix.

Please do contact us if there are any issues you would like to clarify or on which you would value further discussion at this stage.

Yours sincerely

Mazars

Consultation questions

A) Issues

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

We agree that audit quality is difficult to observe and that a number of cases of high profile audit failure have, at the very least, raised concerns that it is more widespread but has not been identified and/or brought to public attention.

There are also concerns that auditors of leading listed companies have too many ‘commercial‘ conflicts of interest which threaten the perception of their being robustly independent even if there has been formal compliance with Ethical Standards. These concerns emanate from the provision of an extensive range of non-audit services over many years and from the pervasive nature of the Big 4 across the economy including through their alumni networks.

Other quality concerns arise from a feeling that auditing has not kept up to date with the enormous changes in business and wider society in recent years. The key drivers of business performance for most leading businesses are intangible in nature and include the entity’s people, brands, patents or other forms of intellectual capital. Very few of these are recorded as assets on the balance sheet and there is often only limited disclosure on them anywhere in the annual report with very little direct assurance provided on them. This indicates that the scope of auditing needs to be reviewed and that it needs to be considered in the context of changes to reporting requirements.

We are strongly supportive of issues related to the scope of audit being addressed by Sir Donald Brydon’s Group on the ‘Future of Audit’ in order to enhance its relevance. Needing to wait for the outcome of his review should not, however, be used as a justification for holding up audit market reform as there are many other issues related to audit quality that a reform programme of the type proposed by the CMA would help to address.

We finally note that there also does not seem to be a close alignment between recent audit appointments made in the FTSE350 and AQR audit quality reports for some of the firms involved.

2. Do you agree with our analysis of the issues that are driving quality concerns, as set out in section three? In particular:

a. Issues relating to the role of Audit Committees and investors in the process of appointing and monitoring auditors;
b. Limitations on choice leading to weaker competition;
c. Barriers to challenger firms for FTSE 350 audits;
d. Resilience concerns; and
e. Wider incentive issues raised by the multi-disciplinary nature of the large audit firms.

Yes, we agree with your thorough analysis of the issues that are driving quality concerns.

The Public Interest Entity (PIE) audit market, and especially that for FTSE350 companies, has with very few exceptions been very resistant to appointing challenger firms as their auditors. In addition, in a number of instances few challenger firms have even been invited to tender and, more generally, little effort seems to have been made to get to know challenger firms. This highlights that the Audit Committee and shareholders could do much more to involve challenger firms in the PIE audit market.

The lack of new entrants, and the resultant high levels of concentration, over a prolonged period has weakened competition and will have had a negative impact on innovation and adapting to the changing needs of users of financial information. Concentration has also had a severely negative impact on market resilience with there being a widespread perception that the dominant firms have become ‘too big to fail’. The FRC, as regulator, must take a share of the responsibility for this situation as they declined to adopt CMA’s proposal at the time of their last review that they include a competition objective in their articles of association.

As auditing becomes an ever smaller proportion of the total business of the dominant firms there are risks that decisions are taken which do not properly take the public interest dimension into account given that this is not present in the work of most other parts of the firm. It should be noted, however, that the London capital market is amongst the most international in the world and most of the FTSE350 are internationally orientated businesses requiring the firms to have international reach through their networks in order that they may work with auditors from other parts of the world. All challenger firms have developed this international reach over the last 10 years.

B) Remedies

For all remedies:

3. What should the scope of each remedy be? Please explain your reasoning. For example, should each remedy apply to all FTSE 350 companies, or be expanded to include PIEs or large privately-owned companies that could be deemed to be in the public interest?

The primary focus of the remedies that centre primarily on companies rather than audit firms, i.e. Remedies 1, 2, 2A (to some extent) and 6 should be on the FTSE350. The FTSE100 on its own accounts for around 80% of the total market capitalisation of companies listed on the London Stock Exchange and it is in the FTSE350 where systemic risk is greatest from the point of view of the economy and wider society. There is also a very substantial concentration of audit fees in the FTSE350, and thus of audit work, relative to the rest of the listed or the wider PIE market. The FTSE350 accounts for over 97% of the total listed audit market fees. Thus, on a cost/benefit basis, the greatest returns are likely to be in the FTSE350.

It can also be argued that if a genuinely competitive audit market is created in the FTSE350 this will have positive effects on other parts of the market; for example, the bias against challenger firms is likely to significantly lessen as their skills and capabilities for the audit of PIEs will have been demonstrated.

A case can, however, be made, by virtue of their designation, for extending the remedies to cover other PIEs. We are, on balance, sympathetic to this view and believe there should be a common boundary for the scope of all remedies which if going beyond the FTSE350 should logically extend to covering all PIEs. We consider though that on a cost/benefit basis the remedy for PIEs outside the FTSE350 should not necessarily be the same as in the FTSE350 and it would generally be more appropriate for it to be tailored to the overall needs of that part of the sector.

The Kingman Review has raised the possibility of widening the scope of PIEs, with the main argument seeming to be that it is wider in many other EU Member States. The UK approach has generally been to have a reasonably narrow focus to the definition of PIEs and we believe caution should be exercised in extending the definition in order that regulatory resources can be applied where they will have the greatest impact. If extending the definition candidates for inclusion would include large AIM companies, listed companies registered outside the EEA and private companies where there is a specific public interest dimension such as their having a large pension scheme. We would only extend the definition to large private companies where there is a specific public interest dimension.

To ensure the impact of the proposed remedies are not undermined, if introduced, it will be important for the CMA to make clear that challenger firms should not be allowed to 'merge' unconditionally with any of the Big 4 as such mergers could significantly reduce the number of large challenger firms in the market.

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.

There are a number of steps that should be taken to strengthen the effectiveness of audit committees:

- introduction of a requirement for them to publish requests for tenders, and advance notification of their intention to issue a tender, on a website maintained by the regulator with tenders open to all eligible firms. The website should also contain details of the shortlisted firms and of the firm selected;

- enhanced guidance in the UK Code of Corporate Governance covering the expectations of audit committees with regards to tendering and to overseeing the audit engagement. This should emphasise the importance of inviting all firm eligible to tender to participate in the tender process along with acceptable criteria for the selection of auditors. The guidance should include a need to consult with the company's leading shareholders ahead of starting the tender process to ascertain their desired qualities in the appointed auditor. There should be a matching expectation in the Stewardship Code for leading investors to engage much more with audit committees; on audit tenders and auditing matters generally;

- an expectation of a three-yearly review of audit committee effectiveness to be set out in the UK Code of Corporate Governance, to be separate from main board review, with it considering how effectively the committee has performed its role both with regards to any tenders that have taken place, audit oversight its other functions such as risk and internal audit unless there is a separate risk committee (and if preferred this could be a regulatory requirement); and

- review of each audit committee by the regulator, probably every 3 to 5 years, having regard to the most recent effectiveness reviews, with the reports published so that shareholders may have the chance to review them as well as the audit committee. The committee should be asked to indicate how it is responding to issues raised in the report received in its audit committee report contained in the annual report.

The regulator should have the right to observe audit committee meetings in exceptional cases where there are serious grounds for concern.

It is important that those responsible for the regulation of audit committees have strong experience of them working in practice.

We consider the regulatory approach outlined is balanced and preferable on grounds of proportionality to one involving significant attendance at audit committee meetings and 'live' oversight of tenders and audits.

If this requirement is to be applied beyond the FTSE350 we think it would should be applied in a proportionate fashion to other PIE entities.

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?

We strongly support this provisionally preferred remedy for mandatory joint audit to be introduced by company law for FTSE350 companies with at least one of the joint auditors being chosen from challenger firms. It has substantial merits in the FTSE350 compared with the alternative market cap approach.

The merits of mandatory joint audit include:

- **enhancing audit quality** by introducing the four eyes principle of each joint auditor reviewing the other's work and arriving at a joint audit opinion;
- **strengthening resilience** in the FTSE350 where corporate systemic risk is greatest by ensuring that even if one of the largest firms leaves the market each company would still have an auditor;
- **providing continuity combined with a periodic fresh pair of eyes** by appointing joint auditors on a staggered basis;
- **enabling challenger firms to participate in the upper end of the audit market in the near future** recognising the substantial concentration of PIE audit work in the FTSE350; providing for an appropriate **sharing of expertise** between the firms;
- **flexibility** as the regulator can increase steadily the minimum share of the audit the challenger firms should undertake;
- **protecting consumer choice and reducing disruption in the market** as investors will be able to retain their current auditors;
- **addressing resistance to appointing challenger firms or even inviting them to tender for the audit**;
- being the model most likely to secure the **maximum overall participation of challenger firms**; and
- having a **positive impact on other parts of the PIE market** by increasing recognition of challenger firms' skills.

Audit quality

On audit quality, we note in your report that the French public audit oversight body The Haut Conseil du Commissariat aux Comptes (H3C) expressed its strong belief regarding the positive impact of joint audit on audit quality and challenged the oft quoted view by those opposed to it that issues ‘might fall through the gaps’ pointing out that, subject to effective communication between the joint auditors, joint audit required an appropriate cross-review of audit work by the other auditor and would in fact increase the level of professional scepticism. We also refer to the South African audit regulator's view on the impact of joint audits on audit quality: "We like joint audits for big, systemically important banks. We think it gives us a higher level of quality assurance," Reserve Bank deputy governor Kuben Naidoo said in May 2018 at the release of the annual report of the bank supervision department.

Given that joint audit involves a ‘live’ review of audit work by the auditors who are familiar with the client and its current circumstances, it would seem likely to have a better chance of identifying issues that need to be taken into account in forming the audit opinion than would occur under the current system involving either ‘hot’ or ‘cold’ reviews just of the files, with no client interactions, whether within the firm or by the regulator. Moreover, compared to ‘cold’ reviews as currently undertaken by the regulator it has the merit of being focused on preventing an inappropriate audit opinion being offered rather than identifying one in retrospect. Joint audit also ensures more challenge at the planning stage, so issues are less likely to be missed on the audit and a more effective audit approach is likely to be adopted. It also makes it harder for the auditor to accept management’s assertions without challenge and, most importantly, provides additional comfort in complex and/or judgemental areas.

By firms working together much more than under the current system, joint audit would also increase the sharing of expertise and experience across the profession which would be expected to further increase audit quality. We have undertaken a review of past cases of alleged audit failures, some well publicised and others not, and it seems that internal “hot” quality reviews (ie taking place before the audit opinion is issued) have not always protected against poor quality. It is also interesting to note that even a ‘clean bill of health’ by the FRC on an audit is not necessarily synonymous with audit quality. We consider there is a significant chance that joint audit would have picked a number of the quality issues identified. Such issues include for example: failure to act with professional competence and care, failure to challenge significant estimates, failure to apply professional scepticism, insufficient knowledge of the industry sector. We recognise that an exception, in general terms, to our view might well occur where collusion at senior management levels takes place.

We strongly disagree with the point in paragraph 3.112 that larger firms have ‘more reputational capital to protect’ when undertaking audits. A negative public report on a matter related to audit quality can threaten the existence of a challenger firm while it does not generally seem to have the same market impact on the dominant firms.

Cost issues

It is asserted by opponents of joint audit that they cost much more than sole audits but our experience and independent evidence challenges this view. A study by Audit Analytics in January 2019, for example, showed that for the top 25 companies in their survey there was no difference in cost while across the three other quartiles in the sample, in terms of comparative costs, the differential was between 10 and 28%. Further analysis is required to understand these results as the lower quartiles do not seem to be entirely comparable in terms of sector or geographic spread.

Mazars analysis shows that:

- taking all companies between 10bn and 100bn euros turnover, the population of companies is relatively comparable between the UK and France and the audit cost is 468k euros per billion euros turnover in the UK compared to 466k euros in France.
- Looking at specific comparables also contradicts the statement that “joint audits cost more”. For example:
    - A leading global bank with joint audit has a cost per million of total assets (representative of the audit effort in banking) of €23. This ratio is respectively €34, €32, €27 and €35 for HSBC, Bank of America, Mitsubishi UFJ and Deutsche Bank which are all single audits.
    - A leading global advertising agency with joint audit as a cost per million of revenue (representative of the audit effort in advertising) of €1,050. This ratio is respectively €1,450, €1,450 and €3,370 for WPP, Omnicom and IPG. Since 2011 this ratio has reduced by 30% for the group with joint audit compared to only 13%, 7% and 24% for the other 3 direct competitors.

In terms of academic research on quality and costs, the available research in the area is limited and, where applicable, it is important to be conscious of the sources of funding for individual studies. An interesting independent article 'Do Joint Audits Improve Audit Quality? Evidence for Voluntary Joint Audits (Zerni and others), European Accounting Review' answered their question positively, with regards to the environment studied and estimated there was an additional cost of around 13% compared to single audits.

The CMA has independently, thoroughly and fairly considered joint audit. Those opposing it should provide objective evidence to support their views and demonstrate their proposed reforms will lead to the necessary level of change. While there may be a moderate initial increase in costs, from each firm reviewing the work of the other, this will be linked to quality enhancement and create a competitive market which would be expected to create future savings in fees. Furthermore, recent research reported in the FT highlighted the substantial increases in sole audit fees in the FTSE350 in recent years.

Other matters

Joint audit, as proposed in Remedy 2 would address issues relating to how tenders are currently undertaken in that the Update Paper highlights that in nearly 3 out of 4 cases challenger firms were not invited to tender: paragraph 3.85 reports that 'we estimate that one or more challenger firms were approached to participate in around 30% of tenders for FTSE350 audits between 2013 and 2018'. Without intervention, our recent experience suggests these figures are not likely to increase significantly for FTSE350 audit tenders due between 2019 and 2021.

The figures above highlight in a substantial majority of instances not even one challenger firm was invited to participate in tenders issued by FTSE350 companies sits uncomfortably with the statement in paragraph 3.65 that 'for a substantial minority of FTSE350 companies, Audit Committee are faced with fewer than three credible bidders for an audit tender'. It is further reported that there is a 'lack of confidence that the challenger firms would have the capability to carry out a complex audit'. We would strongly disagree with these views which would seem to be largely based on hearsay rather than direct discussion with the firms.

The implementation of the proposed new joint audit approach should be overseen by a committee within the proposed new regulator, with strong investor participation, and with guidance issued on undertaking joint audits. The regulator should have the authority to deal with exceptional situations on a case-by-case basis.

In addition to requiring mandatory joint audit in the manner set out in Remedy 2, it would also be possible to apply individual caps to Big 4 firms within the FTSE350 market to limit the maximum potential impact of any of them leaving the market. On balance, however, we would not apply such a cap as it may lead to firms withdrawing from particular audits. Moreover, market resilience would be increased through FTSE350 companies having joint auditors so they would not be without an auditor even if a large firm left the market.

As a practical measure, we would limit application of this remedy to the FTSE350. It contains an implicit market share cap measure within it as the minimum resultant market share of challenger firms can be estimated once their agreed minimum share of given audits in, say, the FTSE100 and FTSE250 respectively, are known. The target in applying Remedy 2 should be that at least 20% of total audit market fees in the FTSE350 should be those of challenger firms after 5 years and 30% after seven years. We set out how this can be achieved in our response to Question 7.

For PIE audits outside the FTSE350, we would on grounds of proportionality apply a market share cap based on the number of companies any firm may audit recognising that the aggregate fees for these companies are a much lower proportion of those across the PIE audit market than in the case of the FTSE350. This is discussed more fully below.

b) What types of companies (if any) should be excluded from a requirement for joint audit?
Within the FTSE350 we would support Investment Trusts with annual audit fees below £100,000 being exempt from the need to have a joint audit. This is based on their unique nature and relatively simple business model.

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.
We firmly believe that for all FTSE350 companies, other than those Investment Trusts which we would propose to exempt, that at least one of the joint auditors should be a challenger firms.

In addition to promoting audit quality, this remedy is needed to address the effects of market concentration on market resilience. This is especially true with regard to the largest listed companies which if they were left without an auditor would give rise to the greatest systemic risk to the economy and wider society. Leading banks and insurance companies are strongly represented at the top end of the market and so they should be included fully within the scope of the remedy and have joint auditors including at least one from a challenger firm. As in some cases the number of Big 4 firms available to audit leading financial institutions is limited it would not be helpful to appoint two Big 4 firms as auditors as this could present difficulties at the next occasion of mandatory rotation. Moreover, given its systemic nature, financial services is a sector in which challenger firms need to be encouraged to participate as auditors. As discussed below, we recognise that for the largest audits it may be appropriate for challenger firms to start as shared auditors and for their share to progressively increase until they become joint auditors.

We would allow for the regulator to make a determination on the best way forward where in a given year on a particular audit either no Big 4 firm or no challenger firm was interested in submitting a tender but we would expect such cases to be exceptional. It may, for example, be appropriate in these circumstances to appoint a peer reviewer to oversee the audit.

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.
It would be helpful for the regulator to indicate the minimum proportion of the combined fee on an audit that should be attributable to each auditor in a joint audit arrangement in particular parts of the FTSE350.

In addition, guidance should be issued by the regulator on joint audit which should indicate that it would normally be expected that the firm with the smaller share of the audit, which in the early years of the new arrangement will normally be the challenger firm, should have around at least 30% in order for it to be considered a joint audit. In the early years of implementing this new approach this would mean that, particularly at the upper end of the FTSE100 challenger firms may start as shared auditors, with a smaller proportion of the audit, but there should be a clear understanding from the outset that they are expected to become a joint auditor once their share has reached the appropriate level. The 30% minimum could be subject to modification in individual cases and where this happened the regulator would be expected to take extra care to ensure it was genuinely a joint audit with a reasonable balance of work between the firms. It would not normally be expected that the smaller firm would have less than 20% in these special cases.

With regard to the illustrative figures provided in Section 4.35 of the Update Paper, based on modelling we have undertaken we believe a combination of the two options might be appropriate in the early years of the provisionally proposed new joint audit arrangements.
A progressive way exists to deploy joint audit over the next 5 years to achieve 24% share of audit fees after 5 years could be as follows:

- for the 36 companies with audit fees of more than £5m, 20% minimum share of the audit for the challenger firm;
- for the 95 companies with audit fees of more than £1m but less than £5m, 30% minimum share of the audit for the challenger firm;
- for the 152 companies with fees of more than £100k but less than £1m, 40% minimum share of the audit for the challenger firm
- No joint audit where fees are less than £100k (representing 41 companies primarily investment funds)
- 26 companies would be out of scope as not UK registered

Our model has made an allowance for work performed on components outside the UK based on a representative sample of FTSE350 companies.
The key outputs from this model are:

- For the UK element of the work, there is an annual average incremental increase for challenger firms of £15m ie 3.5% of the audit turnover of the "next 5 firms" which have expressed an interest in FTSE350 audits. The annual average reduction for the big 4 is 0.7% of their UK audit turnover.
- This plan is deliverable, mitigates risks of "overtrading" for challenger firms, and offers opportunities, with competition based on audit quality.

Further details on the above calculations are provided at the end of this paper.

Assuming the necessary legislation is enacted in 2020 and comes into effect the following year, a reasonable way of phasing in joint audit as proposed in Remedy 2, would be:

- if the next audit tender is due under current arrangements between 2020 and 2022, a challenger firm should be appointed as joint auditor at the latest 3 years after the big 4 incumbent;
- if the next audit tender is due between 2023 and 2025, a challenger firm should be appointed as joint auditor at the latest 2 years before next tender under the present arrangements; and
- if the last audit tender was held between 2015 and 2020, a challenger firm should be appointed as joint auditor at the latest 6 years after last tender under the present arrangements took place.

The above approach to phasing in would ensure all FTSE350 firms have a joint auditor in place by 2026 ie within 5 years post implementation of requirement with a relatively even spread.
eg next audit tender for incumbent in 2023 - joint auditor appointed in 2021 at the latest
eg last audit tender for incumbent in 2018 - joint auditor appointed at the latest in 2024.

8. Our provisional view is that there would be merit in the joint auditors being appointed at different times. Should this be mandated, or left to the choice of individual companies? How should companies manage (or be mandated to manage) the transition from a single auditor to joint auditors?
There would generally be merit in the joint auditors being appointed at different times to allow the benefit of staggered appointments in terms of periodically balancing the merits of a fresh pair of eyes in terms of the newly appointed joint auditor with the continuity of the ongoing one.

On balance, the choice should be left to the shareholders in individual companies recognising that circumstances may arise where shareholders want to vote against the reappointment of both joint auditors, for example if a negative regulatory report were received on both of them.

Given that UK audit appointments are currently on a one-year basis it is hard to ensure they will always remain staggered but a move away from staggered appointment should only be allowed with the shareholders' approval in a vote. The alternative would be to move to a multi-year appointment for auditors and to mandate staggered appointment, which would have merit but is a change that would require legislation.

The approach to transitioning from a sole to a joint audit arrangement should be set out in guidance provided by the regulator and should involve consultation between the audit firms involved and the audit committee.

9. Should a joint liability framework be introduced to encourage active participation in the market by the Big Four and challenger firms? Please explain your reasoning. In the context of joint audits, what are the advantages or disadvantages of auditor liability being proportionate to the audit fee of the joint auditors, compared to the auditors being jointly and severally liable?
We would strongly support a proportionate liability system being introduced in the case of a move to joint audit where a challenger firm working alongside a Big 4 firm. It would be fair with each party to be liable in proportion to the losses incurred as a result of their actions or defaults and would avoid a barrier to challenger firms entering the market for fear of significant rises in insurance premiums and being held jointly and severally liable for the losses on major new audits even though they were only undertaking about a third of the total work on them. Such an arrangement would similarly provide the Big 4 firms with the necessary assurance that they would only be liable for losses for which they were responsible.

Remedy 2A: Market share cap

10. How could the risks associated with a market share cap, such as cherry-picking, be addressed?
The market cap approach on its own would have the fundamental weakness identified in the Update Paper of being prone to cherry-picking by the Big 4 as to which audits were given up with the clear risk of an overemphasis on the smallest and/or most risky audits.

The market share cap approach on its own would not provide the same opportunities to enhance audit quality as Remedy 2; would limit investor choice of auditor as some companies would not have a Big 4 firm willing to tender for their audit; and, if a Big 4 firm left the market, would result in a number of systemically important businesses being left without an auditor.

To seek to at least partially address the weaknesses of Remedy 2A, it would be essential for there to be mandatory joint audit at the upper end of the FTSE350 market given the marked concentration of fees there and recognition that challenger firms would not be able to be sole auditors of the very largest companies. It would also be essential for the cap to be set for individual firms setting out the maximum share of the combined audit fees in the FTSE350 that any Big 4 firm could earn. This would progressively decline such that the combined share of the Big 4 firms did not exceed 80% after 5 years and 70% after 7 years. A formula would probably be needed which could be by reference to the current share of fees the previous year: this would in the interests of competition, allow those Big 4 firms winning new audits to increase their market share. In addition, a second absolute cap on any firm's share may be needed to limit the disruption that would be experienced if one of the dominant firms were to leave the market. Claims that it would be hard to implement a cap based on fees, rather than number of companies are exaggerated. Issues around uncertainty as to fees to be earned and hence market share would disappear if the calculation were based on the fees billed to companies the previous year.

If the CMA's provisionally preferred Remedy 2 were implemented and there were mandatory joint audits for FTSE350 companies, we would, on practical grounds, support a market share cap approach based on challenger firms auditing at least a set number of companies in other parts of the PIE audit market, probably segmented into other listed and unlisted companies. The aim would be for challenger firms to have a minimum 20% of combined fees in each of these markets after 5 years and 30% after 7 years though it would be harder to guarantee if based on number of companies rather than a fee based model.

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

If there is mandatory joint audit for FTSE350 companies we have indicated there should be a market share cap approach for the rest of the PIE audit market.

If there were to be a market share cap approach we would extend that across the whole of the PIE audit market with the PIE audit market divided into appropriate segments for application of the cap.

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.

We have experienced a situation where a partner we wished to recruit advised us of the losses they would suffer, and hence need to be compensated for, if they left their current firm, in terms of a long notice period of 2 years and a substantial loss of normal remuneration during that time as they would only earn their guaranteed level of remuneration which was a fraction of their normal total remuneration. This made making the appointment uneconomical.

We do not believe barriers, such as those outlined above, can be justified either with regards to the length of notice period which is far in excess of that needed for an orderly handover or the approach to remuneration during the notice period.

We believe barriers to the reasonable movement of partners and staff from Big 4 to challenger firms should be removed as reasonable movement of partners and staff will be needed if the current excessive levels of concentration in the PIE audit market are to be addressed in the coming years.

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.

We do not support the setting up of a tendering fund or equivalent subsidy scheme. It is hard to estimate the monetary costs of submitting a tender as it depends on the opportunity costs of the time spent and firms' charge out rates allow for the fact that time will need to be spent on tenders. Moreover, even if a firm fails to be appointed as the auditor, our experience is that if you have made a good impression during the tender process it often provides opportunities to undertake work in future on non-audit issues providing an opportunity to recoup the tender costs.

If mandatory joint audit involving challenger firms is introduced in the FTSE350 the need for a tendering fund would diminish significantly as challenger firms, if they were averagely successful in tenders, could expect to win a number of audits and significant new audit fees taking away the need for subsidy through a tendering fund or similar scheme.

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.

We understand some challenger firms would like to licence a technology platform from a Big 4 or a challenger firms. We would be willing to share for example our audit software or our actuarial and quantitative capabilities developed to support the audits of our global clients.

We would hope agreement could be reached for licensing of technology probably facilitated through one or more of the professional accountancy bodies, the key issue as identified would probably be determining what was a reasonable cost which would probably need to have regard to costs incurred and a resultant reasonable licensing fee with the regulator making the final determination if agreement could not be reached between the different firms involved.

If a number of firms are willing to share their technology one would hope that a reasonable pricing model could emerge through negotiation between those wanting to access the technology with firms possessing it. Many firms are presumably using internal charge out schemes across their networks and this could be a starting point for working out fair charge out rates.

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.

Ensuring the effective governance and leadership of audit practices is the best way to guard against gradual decline and indeed market forces should rightly be expected to lead to some firms growing over time while others are not doing so.

As part of their regulatory role one would expect the regulator to discuss with the partners leading a given audit practice and separately with the Independent Non-Executives (INEs) if there were concerns about its future viability including from a gradual deterioration over a number of years.

The approach set out in paragraph 4.110 for developing a workable regime in the event of the imminent/expected collapse of a Big 4 firm seems reasonable and the regulator would clearly need powers in such circumstances to stop clients being transferred to another Big 4 firm.

On grounds of proportionality and fairness, we agree this remedy should apply initially just to the Big 4 firms with non-Big 4 firms coming within its scope once they have a significant share of the FTSE350 audit market or PIE market, depending on the scope of the remedies.

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

The proposal for the regulator to be able to ringfence the equity of a large firm in distress and to be able to limit partners' drawings seems reasonable.

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.

We strongly support the regulator keeping the market under review and where necessary having conversations with the executive leadership of a firm if it has concerns about its future. It should also where they feel it necessary have separate conversations with the independent non-executives of the firm involved.

The necessarily intrusive nature of the regime suggests it should only be implemented as a last resort when it is clear there is a significant risk of collapse.

Care should be taken not to put firms within the regulatory regime until it is clear there is such a significant risk of their collapse.

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.

There is a clear limitation on what can be done by an organisation when its value lies in its people and there is a loss of confidence in it as was experienced in the case of Arthur Andersen. If a Big 4 firm were to suffer an existential loss of confidence, the regulator could indicate to the remaining ones that they could not take on clients from a failing firm and if they could not grow their client base they would not be likely to take on additional staff but it would be difficult to stop clients or staff leaving the failing firm. It would probably be possible to impose financial penalties on partners leaving the firm through relevant provisions in the deed relating to what would happen to their capital and their remuneration in the event of their leaving the firm during the period it was in a distressed state.

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.

We believe it would be difficult for there to be a full structural split of the Big 4 into audit and non-audit practices in the UK and that it would be of limited value given the need for the firms to work with overseas offices, as nearly all audits of leading companies have a strong international dimension, and those offices would not be subject to the same requirements for a structural split.

In terms of avoiding conflicts of interest the key elements seem to be:

- at the firm-wide level, the separate governance of the audit firm to enable full account to be taken of the public interest dimension which will include a full oversight role for the Independent Non-Executives (INEs) as expected under the Audit Firm Governance Code. All the firms applying the Code - the Big 4, GT, BDO and Mazars- have INEs. The audit practices should clearly set out their desired culture, have thorough ways of assessing the actual culture and programmes for addressing any gaps between them;
- at the individual client level, far stricter requirements on the non-audit work firms can provide to PIEs they audit with permissible services limited to a short list of primarily audit-related services.

An issue for consideration is whether the costs of implementing and maintaining a full structural split justify the benefits when most can be achieved by a simpler operational split recognising that in the latter case work will need to be undertaken on allocating joint costs between the two parts of the firm. Clearly the more joint costs there are, for example the two practices sharing the same offices, the more work that will be needed to allocate joint costs. reliably

On grounds of proportionality and fairness, we believe a split, whether operational or structural should only apply to the Big 4 in the first instance and should only apply to challenger firms once they have a significant client base in the FTSE350 or wider PIE audit market as appropriate.

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.

To the extent that some of the key issues identified include transfer pricing and sharing of costs, guidance could be developed by the regulator on how this should be done in overall terms and the resultant allocation could be audited by the auditor of the firm.

The maintenance of effective operational independence could be subject to periodic review by the regulator, say every 3 to 5 years.

21. With regards to the operational split, please provide comments on:

a. implementation risks and whether they are surmountable: e.g. how any defined benefit pension schemes could be separated between audit and non-audit services;
b. risks of circumvention and how they could be addressed e.g. how audit firms could circumvent the remedy through non-arm's-length transfer pricing and cost allocations;
c. implementation timescales to separate the audit firms and how soon the remedy could be brought into effect;
d. ongoing monitoring costs for the audit firms and a regulator;
e. role and competencies of a regulator in overseeing ongoing adherence to the operational split.

We think issues related to implementing an operational split are surmountable with appropriate guidance and the figures, as discussed above, being subject to audit and to regulatory review and these factors will also guard against circumvention.

The audit practice should be required to have its own audited accounts as it presumably would need to have anyway if partner distributions were to be based on them.

In terms of implementation timetables, for an operational split one would assume it could be achieved in a matter of months and probably not more than a year.

As it would be a fairly small number of firms involved, and if there were separate audited accounts for the audit practice the regulatory costs needed to ensure the agreed arrangements were being followed need not be that great and could be satisfied by the regulator employing somebody say with experience as a finance director of a professional service firm.

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

We are not convinced that splitting the audit and non-audit practices of dominant firms and placing restrictions on the provision of non-audit services to PIE audit clients are substitutes for each other.

The benefits of separating the audit and non-audit practices are principally linked to ensuring an appropriate culture in the audit practice. Introducing much tighter restrictions on the provision of non-audit services to PIE audit clients is the principal means of reducing threats to independence on particular clients.

Introducing an audit/non-audit practice split to keep helping promote an appropriate culture in the audit practice but then allowing the audit practice to provide a greater range of non-audit services to PIE companies they audit than would otherwise be the case would seem to be counterproductive as the direct threat to audit independence would be potentially increased.

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

On the grounds of proportionality and fairness, challenger firms should not be included initially within the scope of the structural or operational split remedy but should be considered for inclusion once they have a significant share of the FTSE350 or wider PIE audit market depending on the boundary of the remedies.

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.

We believe that logically the same services should be permitted under a full structural or operational split as the auditor should be permitted to provide to PIEs they audit. These would principally comprise:

- half–yearly and quarterly reviews
- assurance services on non-financial reporting
- other services specifically required by law, regulation or listing rules to be provided by the auditor

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?

If mandatory joint audit is introduced in the manner proposed in Remedy 2, as we strongly support, the need for peer review is substantially reduced as each of the joint auditors would be actively reviewing the work of the other on a 'live' basis.

We would support the regulator having the right to undertake a review while the audit is in progress in circumstances where there are grounds for serious concern on PIE audits, whether directly identified by the regulator or referred to it by a stakeholder such as a shareholder or employee. We would recommend, however, that given the sensitivity of a review being undertaken while the audit is ongoing that it should be undertaken by members of the regulatory team, which may include senior advisers who may have previously held senior positions in an audit firm, rather than it being delegated to an independent firm to undertake, Care will need to be taken for the reviewer not to be seen as a 'shadow auditor' and for this reason also it will be better if they are directly linked to the regulator.

It is also not clear how the proposed peer reviews would link in with the presumably ongoing annual review of the major firms with each major PIE audit being reviewed approximately every 5 years. There would seem to be a risk of confusion on the respective role of each review.

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

As discussed above, if Remedy 2 were introduced, we consider the use of reviews should be limited principally to circumstances where there are serious concerns about the audit or the company being audited. We would adopt the same position even if the preferred remedy were to change. We believe keeping the use of peer reviews as a reserve power would highlight the seriousness of the situation when it was adopted.

C) Next steps

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

We strongly support your views on not making a market investigation reference.

A very thorough review has been undertaken by the CMA and you have had the benefit of the last investigation undertaken earlier in the decade and have updated the results of studies undertaken at that time as part of the updating process so your current review is based on a substantial dataset. You have also had the benefit of the very detailed Kingman Review on regulation relating to auditing matters as well as to the linked areas of corporate reporting and corporate governance.

Further delay to implementing the necessary reform would not be in the public interest. There is a risk of a review being sought as a means just to delay the long overdue reform of the audit market in the hope that changes in the external environment or in key personnel may lead to a weaker reform package.

Proposed model for initial deployment of joint audit

Today

	#companies	Fees total GBP
Above £5m fees	36	510,148,174
Between £5m and £1m	95	189,085,770
Between £1m and £100k	152	67,124,786
Less than £100k	41	1,547,162
	324	**767,881,868**

Target after 5 years joint audit challenger firms

	Share JA	#companies	Fees total GBP	Challenger firms	Share	Uk share of turnover	Estimated fees to UK firms
Above £5m fees	20%	36	510,148,174	102,029,635		20%	36,730,669
Between £5m and £1m	30%	95	189,085,770	56,725,731		30%	24,959,322
Between £1m and £100k	40%	152	67,124,786	26,849,914		40%	13,961,956
Less than £100k	out of scope	41	1,547,162	-			
		324	**767,905,891**	**185,605,280**	24%		**75,651,946**

Year 1 joint audit challenger firms - incremental change

	Share JA	#companies	Fees total GBP	Challenger firms	Share	Uk share of turnover	Estimated fees to UK firms
Above £5m fees	20%	5	70,853,913	14,170,783		20%	5,101,482
Between £5m and £1m	30%	10	19,903,765	5,971,130		30%	2,627,297
Between £1m and £100k	40%	21	9,273,819	3,709,528		40%	1,928,954
Less than £100k	out of scope	-		-			
		36	**100,031,497**	**23,851,440**	3%		**9,657,733**

Year 2 joint audit challenger firms - incremental change

	Share JA	#companies	Fees total GBP	Challenger firms	Share	Uk share of turnover	Estimated fees to UK firms
Above £5m fees	20%	6	85,024,696	17,004,939		20%	6,121,778
Between £5m and £1m	30%	14	27,865,271	8,359,581		30%	3,678,216
Between £1m and £100k	40%	25	11,040,261	4,416,104		40%	2,296,374
Less than £100k	out of scope	-		-			
		45	**123,930,228**	**29,780,625**	7%		**12,096,368**

Year 3 joint audit challenger firms - incremental change

	Share JA	#companies	Fees total GBP	Challenger firms	Share	Uk share of turnover	Estimated fees to UK firms
Above £5m fees	20%	7	99,195,478	19,839,096		20%	7,142,074
Between £5m and £1m	30%	19	37,817,154	11,345,146		30%	4,991,864
Between £1m and £100k	40%	30	13,248,313	5,299,325		40%	2,755,649
Less than £100k	out of scope	-		-			
		56	**150,260,945**	**36,483,567**	12%		**14,889,588**

Year 4 joint audit challenger firms - incremental change

	Share JA	#companies	Fees total GBP	Challenger firms	Share	Uk share of turnover	Estimated fees to UK firms
Above £5m fees	20%	8	113,366,261	22,673,252		20%	8,162,371
Between £5m and £1m	30%	24	47,769,037	14,330,711		30%	6,305,513
Between £1m and £100k	40%	34	15,014,755	6,005,902		40%	3,123,069
Less than £100k	out of scope	-		-			
		66	**176,150,052**	**43,009,865**	17%		**17,590,953**

Year 5 joint audit challenger firms - incremental change

	Share JA	#companies	Fees total GBP	Challenger firms	Share	Uk share of turnover	Estimated fees to UK firms
Above £5m fees	20%	10	141,707,826	28,341,565		20%	10,202,963
Between £5m and £1m	30%	29	57,720,919	17,316,276		30%	7,619,161
Between £1m and £100k	40%	41	18,106,028	7,242,411		40%	3,766,054
Less than £100k	out of scope	-		-			
		80	**217,534,773**	**52,900,252**	24%		**21,588,179**