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Our ref:
Your ref:

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

Grant Thornton UK LLP
110 Bishopsgate
London
EC2N 4AY

T +44 (0)20 7383 5100
F +44 (0)20 7383 4715

21 January 2019

Dear Sirs

Competition and Markets Authority Statutory Audit Services Market Study Update Paper – Consultation Response

Grant Thornton UK LLP ('Grant Thornton') welcomes the opportunity to respond to the Competition and Markets Authority (CMA) Statutory Audit Services Market update paper.

We have previously submitted our response to the CMA Invitation to Comment (ITC) document in November 2018 in which we set out in detail our views regarding competition in the audit market for large companies and public interest entities and our concerns over audit quality, as well as our preliminary views on specific reforms that could address the lack of competition in the audit market and the consequent benefits on audit quality.

We note that for various reasons, some of the remedies that were explored in the ITC document have not been taken forward in the update paper. These include remedies which Grant Thornton had supported in our response to the ITC document. For example, remedies which included an independent auditor appointment body and more regular audit tendering.

However, in principle we support most of the remedies that the CMA is proposing in the update paper subject to specific concerns and observations that we set out in our detailed response to the consultation questions. In summary:

Remedy 1: Regulatory scrutiny of Audit Committees

We are pleased to note that the CMA recognises that reform to reduce demand-side barriers to auditor appointment is necessary.

In the absence of an independent appointment and monitoring body we support other measures such as regulation and enhanced oversight of audit committees to ensure that they fully protect the interests of shareholders and are independent when making decisions about auditor selection. Measures to enhance the independence and effectiveness of audit committees are therefore key and should involve robust monitoring of their performance and proper accountability. This includes the sufficiency of audit committee reporting to shareholders on auditor performance. We therefore support a mechanism whereby the regulator has the ability to issue public reprimands, or direct statements to shareholders in circumstance where it is not satisfied that audit committees have followed proper procedures. We would go further and suggest that regulatory powers could include rights of veto over audit committee decisions if necessary.

We would also encourage any measures to include requirements regarding audit committee diversity, which would go some way to addressing buy-side bias. More focus on the independence of audit committees would help to eliminate actual or perceived conflicts between audit committee responsibilities and those of individuals who sit on other board committees.

However, constraints on resources available to a regulator will inevitably impact on its ability to be effective in its scrutiny of audit committees in which case the allocation of regulator resource is likely to require careful consideration.

Remedy 2: Mandatory joint audit

We support mandatory joint audit as described in the CMA update paper, requiring at least one of the audit pair to be a non Big 4 firm, as a remedy to reducing the barriers faced by non Big 4 audit firms to auditing large companies. Joint audits can be used to actively develop audit quality and independence through collaboration between firms and allow non Big 4 firms greater prominence and opportunity to demonstrate their capacity and credentials with major companies. We are not of the view that there is a risk of issues being missed or ‘falling through the gaps’ as a result of a joint audit approach.

However, given the scale of change required, we consider the FTSE 350 is the most appropriate way to introduce Big 4/non Big 4 joint audit arrangements. We do not support the extension of this remedy to the wider PIE population or indeed large private companies.

We also accept that there may at present be valid reasons for excluding joint audit arrangements in parts of the FTSE 350 population where the size and highly complex nature of these audits may genuinely require the extended global network and sector expertise of the Big 4 firms. Non Big 4 firms will need time to build their capacity, expertise and indeed resources. The financial services sector is one such example. However, exclusions to joint audit within the FTSE 350 should be limited and in the longer term we would expect joint audits to operate across the whole of the FTSE 350.

In our view proportionate liability is an essential feature of joint audit if the non Big 4 firms are to be encouraged to participate otherwise an unintended consequence could be a failure to attract and retain the numbers of firms required.

Remedy 2A: Market share cap

Our preferred remedy is for mandatory joint audit and not the application of a market share cap. However, if a market share cap approach were to be implemented as an alternative to mandatory joint audits, then it should be applied to ensure that audit work is allocated across a number of non Big 4 firms reflecting capacity and quality and does not destabilise audit quality. A market cap should not allow the risk of the Big 4 firms cherry picking audit clients, a concept which is of significant concern to us.

Remedy 3: Additional measures to reduce barriers for challenger firms

We note the additional remedies suggested to support challenger firms.

In respect of ease of movement of senior staff we welcome flexibility for staff at senior manager, director and partner level to move between firms.

We are sceptical as to the suggestion of the tendering fund as access to such a fund would achieve little difference to the market if the inherent predisposition towards the Big 4 in audit procurement, recognised by the CMA, was not addressed. Further a remedy of mandatory joint audit would make the costs of tendering much less of an issue for non Big 4 firms.

Finally whilst we do not consider that costs of technology are currently a major barrier to entry for this market, advancing technology does represent an opportunity to refocus the purpose of UK audit and this should therefore be a consideration for the forthcoming Brydon Review.

Remedy 4: Market resilience

We consider it unrealistic that any Big 4 firm would exit the market. We do, however, consider it more likely that non Big 4 firms will fail to enter the market or will not be able to build their capacity quickly enough.

The suggested remedy of prohibiting a failing firm's clients and staff from leaving to join another Big 4 competitor appears to be entering complex territory in terms of competition law and individuals' freedom of movement between employers and our initial view is that this remedy would be difficult to operate in practice.

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

We do not support a full structural or operational split. A full or operational split would require a separate economic entity big enough to be sustainable in the audit marketplace. High costs of regulation, quality and risk management would need to be factored into the sustainability of this entity, which would also need to be resilient to regulator sanctions and capable of insuring against the costs of potentially significant claims. The current audit practices of the Big 4 are significantly different to the non Big 4, especially in the PIE audit market place. The sustainable economic entity would, in our opinion, not be workable for firms outside the Big 4.

Remedy 6: Peer review

Our initial view is that this this proposal has some merit as the peer reviewer is independently appointed and paid for by the regulator. However, care should be taken to ensure that the reviewer’s work is fair and balanced. For example the peer reviewer should not be incentivised to find weaknesses in other auditor’s work.

However, this remedy should only be applied if joint or shared audit solutions are not taken forward, or as an option in the case of the limited exceptions to the FTSE 350 companies where the CMA considers a joint audit would not be appropriate.

If you have any questions on our response, or wish us to amplify our comments, please do not hesitate to contact me.

Yours faithfully

Jonathan Riley
Head of Quality and Reputation
For Grant Thornton UK LLP

Grant Thornton UK LLP response to Competition and Markets Authority Statutory Audit Services Market Study Update Paper

21 January 2019

A) Issues

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

In general we agree with the Competition and Markets Authority (CMA)'s analysis of the concerns about audit quality. We also agree that audit quality ought to be the key focus to determine if the statutory audit market is producing good outcomes.

In the minority of cases where audit quality has failed, the consequent publicity surrounding audit failure creates a poor impression of the audit profession as a whole. This negative publicity therefore overshadows the significant number of quality audits that are performed. As a percentage of all audit opinions signed, those relating to the audit of companies where issues have led to public scrutiny of the profession are likely to be low. In addition, the outcome of the Audit Quality Review (AQR) audit inspections, and subsequent public reporting, are based on a very small sample of audits. In summary, we believe that the industry, including Grant Thornton UK LLP, must continue to strive to improve the quality of audit, but that any remedy must be proportionate.

We also agree that corporate failure does not rest solely with the auditor. Auditors cannot be held accountable for poor management, fraud or collusion. Further, corporate failure does not automatically mean that an audit was inadequate. We note that the lack of management challenge has been a common feature of FRC criticisms of audits to the UKs public interest entities (PIEs) and that AQR reviews do repeatedly highlight failings with insufficient challenge of management being the key finding. However, the regulatory focus on audit issues means that the many instances of challenge which have led to changes and improved audit quality, are often overlooked and not reported. The positive examples of good audit quality may only become more apparent if there is a move for auditors to publish their AQR findings documents. The regulator can also have a role in sharing examples of good audit behaviour and challenge that it observes that may not be in the public domain. We agree with the Kingman Review recommendations in this area.

Deeper analysis of the role of the auditor in cases of corporate failure would be helpful to understanding the link between corporate failure and the role of the auditor. For example, a better understanding of what an auditor would have needed to do, or what an auditor should not have done, in order for an instance of corporate failure not to have arisen. We support the case for reviewing the purpose and scope of audit and will be seeking to engage with the Brydon Review. We also note that in terms of accountability for corporate failure, proposals set out in the Kingman Review include a regime whereby directors are held to account, and not just members of professional bodies. We support this proposal.

We note that stakeholders hold the view that audit in the UK is generally of high quality. However, the final remedies proposed as part of this market study must address the concerns of some investors around quality and in particular that too often audit firms lose sight of the need to always demonstrate professional 'independence'.

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

In general the issues noted all seem to be legitimate ones although to varying degrees. This includes concerns over resilience where in our invitation to comment (ITC) response we note that there is a significant risk that the audit market is not resilient.

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

We agree that issues exist relating to the role of audit committees (there is currently limited oversight of the audit committee's role) and investors in the process of appointing and monitoring, which is why we have previously advocated the creation of an independent auditor appointment body for UK PIEs and particularly the FTSE 350 as one way to address this. We have taken a public position that emphasises the fact that current appointment arrangements encourage selection criteria such as 'relationship', 'cultural fit' and 'chemistry' with the company over independence and challenge.

We would argue that cultural fit is irrelevant as a determinant of an appropriate auditor. This is not to say that the right culture and behaviours are not important, but that it should not be about whether there is a fit between the auditor's and the audit client's culture. Such terms ought not to be used either explicitly or implicitly in audit tenders, or if used it ought to be clear exactly what cultures and behaviours are considered to be appropriate.

As noted at 3.35 in terms of audit committee effectiveness, relying on feedback from executives is not an appropriate method of auditor assessment which is why in the absence of an independent appointment body, more focus should be on the regulatory scrutiny of audit committees to ensure, for example. that the auditor appointment process is more independent of management. We acknowledge however that there may be challenges in measuring the effectiveness of audit committees as judgement will be required. Ring-non fencing the audit committee from other board roles could go some way to enhancing a committee's independence.

Some of the buy-side issues that exist relating to the role of audit committees in auditor appointment, are driven by the fact that a large proportion of audit committee chairs of the biggest companies trained at Big Four audit firms. The bias towards the Big Four is therefore hard to overcome due to audit committee composition and lack of diversity. In our view previous measures put in place to strengthen the position of audit committees by the Competition Commission have not been as effective as they could have been in bringing about change.

In terms of investor engagement, we recognise the reasons given for lack of engagement and that there is general acceptance of these. This is an area that could therefore benefit from some regulatory outreach to better understand the issues preventing investor engagement and how they can be overcome. Another approach could be to put the responsibility of shareholders to engage with companies on a more formal basis.

b. Limitations on choice leading to weaker competition:

In our view lack of choice in the audit market is not the dominant driver of audit quality, although it is likely to be a factor.

Where there is a limit on the number of firms that can realistically compete for an audit appointment there may be no real market incentive on that firm to deliver the highest quality. Whilst there might be an incentive derived from the fear of audit inspection, for example, the market itself does not drive quality.

One of the drivers of lack of choice is lack of confidence that the 'challenger firms' have the capability to carry out a complex audit. This reflects a buy-side bias. We do not agree that challenger firms lack the capability to carry out complex audits. Grant Thornton, for example has the technical capability, scale and capacity to undertake and deliver high quality audits for many FTSE 350 companies and currently audits many of the largest local authorities in the UK which are comparable in complexity. Audit committees need to be encouraged to have a more open mindset to explore audit appointment options outside of the Big Four firms, who are seen as a safe option.

We are also not convinced that other factors limiting choice cited in the update paper are all genuine, although conflicts such as those arising due the provision of non-audit services can have an impact on choice and therefore competition.

c. Barriers to challenger firms for FTSE 350 audits:

We agree with the analysis of the barriers faced by challenger firms for FTSE 350 audits and in particular the 'chicken and egg' analogy whereby it is necessary to obtain audit experience in respect of the FTSE 350 audit market in order to prove capability. We also agree that buy-side behaviour is skewed towards the Big Four for reasons outlined in section 3 of the CMA update paper.

In our view the lack of capability as a barrier of challenger firms is exaggerated. We can point to the many entities we audit that are comparable in size and complexity to some of the FTSE 350. However, we acknowledge that challenger firms have the least capability in respect of certain parts of the FTSE, in particular the large banks and insurance companies. We also acknowledge that to undertake a greater quantity of audit work in the FTSE 350 we will need to invest in additional resources. This is where a remedy such as mandatory joint audit (to include a challenger firm) would afford time to Grant Thornton and other non-big Four firms to develop expertise and capability in these specialist areas.

A further concern around capability refers to challenger firms having smaller international networks. However international networks are generally proportionate in size to the UK firm, with similar geographic reach to large networks so we would challenge this argument.

Disproportionate costs of regulation are, however, a barrier to a non-big Four firm. Relative PIE audit practices by fee income show that the non-big Four firms are much less resilient to sanction. In our response to the ITC we note that potential sanctions imposed by the FRC are not proportionate to the size of the sanctioned firm. This is illustrated numerically in section 3.128 of the update paper.

Finally, we note that buy-side issues discussed in section 3.103 onwards references investor reluctance to support the appointment of auditors outside of the Big Four. Whilst section 3 (section 3.105, for example) suggests that there is little investor engagement in audit matters, one area where there does appear to be engagement is in relation to supporting the appointment of a Big Four audit firm and thus maintaining the status quo with regards to Big Four market concentration.

d. Resilience concerns:

We would advocate the adoption of a commercially suitable resilience regime.

In our experience, such a regime may include:

- Regular monitoring of financial performance. This could include a set of covenants (both financial and non-financial) akin to that which would ordinarily be agreed between a firm and its lenders
- The compulsory creation of a ‘living will’ for any firm involved in PIE audits

We do not advocate the adoption of a special administration regime as, in our opinion, the combination of the current administration regime and competition law are adequate. However, in order to give the regulator a stronger voice in a distressed scenario, we consider that an amendment to insolvency law to give the regulator the power to commence insolvency has merit.

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

We agree that wider incentive issues from non-audit sales play a big part in influencing the culture of a firm. Auditors are expected to win work/grow the business in the same way as their advisory colleagues (apart from cross selling of non-audit services to audit clients).

At the extreme one might argue that a ban on the provision of non-audit services to PIEs would therefore remove any incentives. However, a complete ban could mean that non-audit services that are complementary to the provision of a high-quality audit could impact on the effectiveness of the audit.

We note the concerns raised at 3.164 within the update paper and believe that a restriction should be considered whereby the exiting audit firm is precluded from providing non-audit services to their former audit client for a period post retirement as auditor. This will be a consideration for the new audit regulator but we would propose a period of not less than two years.

Section 2.23 in the update paper indicates that the average sales of non-audit services to audit clients appear to be slightly higher for the challenger firms. However this is likely to reflect the fact that the audit portfolio of a challenger firm will include a greater proportion of smaller non-PIE clients who look to one advisor.

Finally it is important to note that many non-audit partners will similarly be bound by common professional standards, including accountancy or another similar body.

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?

Our overriding observation is that a package of remedies to address the issues identified by the CMA will be required and that there is unlikely to be one complete solution.

The primary focus should be on the audits of FTSE 350 companies where the market is most concentrated and previous Competition Commission measures have not had the desired impact. Whilst in the longer term there may be some merit to extending the remedies (for example those in relation to regulatory scrutiny of audit committees) to a clearly defined PIE population, we would be concerned about intentional or unintentional ‘creep' to non-PIEs and the impact that restricting access to quality advice could have for those businesses.

Extension beyond the FTSE 350 to PIEs could also have significant consequences. For example, within Grant Thornton’s local authority audit portfolio, there are a number of councils with listed debt where applying some of the remedial measures could be problematic, if not impossible.

Given that there is frequent movement by companies in and out of the FTSE 350, and in and out of the FTSE 100 and 250, a strict ‘cut off’ in terms of company numbers may provide some challenge and therefore require consideration when devising any remedial measures.

In terms of mandated joint audits, as a first step this could be applied to those entities in the FTSE 350 where the challenger firms currently have expertise. This might provide the CMA with evidence of the workability of the solution. However, exclusion from certain joint audits for challenger firms should be limited (for example certain aspects within the financial services sector) so that the opportunities to compete for the audits of these companies in the long term remain an option.

We note that Remedies 3, 4 and 5 are more structural in nature and therefore do not lend themselves to be limited to a particular portion of the market.

If Remedy 6 were introduced a period of experimentation with peer review is sensible to see what benefits it might bring. Such peer reviews would not apply to audits undertaken on a joint basis. See our response to Remedy 6 below in this regard.

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.

Firstly, we are pleased that the CMA recognises that reform to reduce buy-side barriers to auditor appointment is necessary.

In our response to the ITC we supported measures to improve the independence of decision-making in relation to auditor appointments, in particular through the creation of an independent appointment body. However, we note that this proposal has not been taken forward in the CMA's update paper due to barriers which exist to creating an independent audit appointment body and monitoring body in the short term.

In the absence of an independent appointment and monitoring body we therefore support other measures (such as regulation and enhanced oversight of audit committees) to ensure that Audit Committees fully protect the interests of shareholders when making decisions about auditor selection. Regulatory scrutiny could help in achieving this objective. We therefore support the measures proposed in section 4.16 of the CMA update paper but believe that they could go further as explained below.

We would recommend that the make-up of the regulatory body, having oversight for both auditor appointment and the conduct of the audit, could include wider stakeholders independent of the company and be charged with monitoring appointment of auditors and ongoing relationship for signs of a lack of independence. Diversity is also an important element when determining the constitution of a regulator.

In terms of regulatory oversight, consideration will need to be given as to which aspects of an audit committee's responsibilities regulatory focus should be applied. Ideally it should include a review of the tender process and a review of the effectiveness of the audit committee. The FRC has published best practice on audit tendering which could be used for example as a checklist when assessing any auditor appointment process. A further step could be to mandate the form that a tender selection should take, including agreed upon criteria that audit committee chairs then have to score, provide commentary and submit to the regulator with their decision. Factors that have been cited in the context of auditor appointment such as 'cultural fit', 'chemistry' and 'easy to work with' should be given little or no weight in a selection process.

However, constraints on resources available to a regulator will inevitably impact on its effectiveness and extent of involvement in which case the allocation of regulator resource is likely to require careful consideration.

We also note that there may be challenges in the operation of a regulatory oversight mechanism in relation to those aspects of an audit committee's role that involves significant judgement. Measurement of audit committee effectiveness in some areas may therefore prove difficult. For example, what measures would a regulator use to conclude that an audit committee chair has sufficiently challenged the external auditor? This is more likely to be relevant in audits where there are a number of significant audit issues involving judgement where regulatory subjectivity would be greatest. However, on the other hand there is potential for the perceived or actual risk that regulator participation in audit committee decisions could lead them to making decisions that ought to be the responsibility of the audit committee or management that could give rise to issues at a later date should things go wrong.

A right of inspection basis would not be appropriate for FTSE 350 audit committees however such a random method of inspection could be used outside the FTSE 350 as suggested in section 4.18.

Any regulatory measures should involve the robust monitoring of audit committee performance and proper accountability. This includes the sufficiency of audit committee reporting to shareholders on auditor performance. We therefore support a mechanism whereby the regulator has the ability to issue public reprimands or direct statements to shareholders in circumstance where it is not satisfied that audit committees have followed proper procedures as outlined in section 416(c). We would go further and suggest that regulatory powers could include rights of veto over audit committee decisions if necessary.

The CMA will need to consider how such powers of oversight of audit committees might be vested in a regulator. This may require some form of legislation.

As was noted in the CMA ITC document there is significant presence of ex-Big Four employees on audit committees which raises concerns around bias towards the choice of auditor from Big Four firms due to the professional background of audit committee alumni. Measurements could go further to include requirements regarding audit committee diversity, which would go some way to addressing buy-side bias. Further, more of a focus is required on the independence of audit committees. Prohibition of audit committee members from acting in other committees of the board would ensure independent focus and avoid actual or perceived conflicts of interest. Once audit appointments have been made we would support a protected fixed term of appointment with the auditor needing to fulfil the whole of that term before retendering.

The AQR remit could also be expanded to include reflections on audit committee functioning. For example the AQR could consider the adequacy of board consideration, level of debate, response and documentation of significant audit issues.

We note that members of the Audit Committee Chairs Independent Forum have confidence in their ability to assess the key aspects of the audit. This is reassuring as we believe that audit committee members should have the requisite skills to deal with the role. The selection process for non-executive and audit committee membership should therefore be robust and fit for purpose, in order for successful compliance with increased reporting and regulator interaction. The quality of audit committee membership will have a direct impact on the successful implementation of any new regulatory measures.

Remedy 2: Mandatory joint audit

5. What should the scope of this remedy be? Please explain your reasoning.

In summary, we support mandatory joint audit, requiring at least one of the audit pair to be a non-big Four firm, as a remedy to reducing the barriers faced by non-big Four audit firms to auditing large companies. Joint audits can be used to actively develop audit quality and independence through collaboration between firms and allow non-big Four firms greater prominence and opportunity to demonstrate their capacity and credentials with major companies. We are not of the view that there is a substantial risk of issues being missed or 'falling through the gaps' and consider that modern audit technology should be able to mitigate this risk far better than in the past.

We note that there is opposition to this remedy. We are not convinced by many of the arguments cited against joint audit. We do however acknowledge that audit fees are likely to increase but have heard from investors that the additional cost could be considered preferable if audit quality is improved and the audit market functions better.

Finally we observe that it is not clear whether the remedy proposed is intended to be permanent or to operate until such time as non-big Four firms have built up their experience, capacity and expertise to audit the largest companies such that the ability to tender alongside Big Four firms for the audits of such companies with a realistic chance of success is reached. There is therefore a question as to whether a joint audit regime could be removed once greater competition amongst audit firms has been established. A market cap could then apply to ensure continuing competition, or no remedial measure would be necessary if a proper functioning market had been created.

a) **Should the requirement to have a joint audit apply to all FTSE 350 companies or potentially go wider by including large private companies?**

Firstly we note that the aim of the remedy is to reduce barriers faced by non-big Four firms from auditing large companies which in turn lead to improvements in quality. Our response therefore focuses on this aim. If joint audit is about improving quality, then arguably there are merits in applying the same requirements to a wider population outside of the FTSE 350. We do not consider these merits further here.

Given the scale of change required, we consider the FTSE 350 is the most appropriate way to introduce Big Four/non-big Four joint audit arrangements. We do not support the extension of this remedy to the wider PIE population or indeed large private companies.

We believe that non-big Four firms possess the requisite expertise, capacity and quality to deliver quality audit services to all but the largest companies as is borne out in the FRC's public reports. However, we accept that there may at present be valid reasons for excluding joint audit arrangements in parts of the FTSE 350 population, particularly within the FTSE 100 where the size and highly complex nature of these audits may genuinely require the extended global network and sector expertise of the Big Four firms. FTSE 350 companies within the financial services sector (banks are cited in the CMA update paper) is one such example. However, exclusions to joint audit within the FTSE 350 should be limited so as not to 'shut the door' to opportunities for non-big Four firms in the longer term. In other words, in the long-term joint audits would operate across the whole of the FTSE 350.

We agree that mandatory joint audit will require regulatory oversight with clear guidance as to how such a regime would operate, from a practical viewpoint such as in relation to the allocation of responsibility and roles within an audit, as well as the legal implications around auditor liability – whether that be joint liability or proportional liability and welcome the CMA's suggestion that this should be considered**.**

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

As noted above at present there are valid reasons for excluding certain companies from joint audit, in particular those in sectors that are highly complex and specialised such as banking and insurance. Joint audit allowing two Big Four audit firms to act as joint auditor in these circumstances could therefore be appropriate, although, as market concentration and quality issues are not a significant concern for this group of companies we question whether the application of Big Four to Big Four joint audits is justified.

However, in the longer term we would expect to see joint audits undertaken in these areas once the non-big Four firms are better established, provided that the transition was managed properly.

Further there may be certain multinational entities where there is insufficient capability for any of the non-big Four firms to be able to compete. However, we would expect these to be limited exceptions as typically non-big Four firms have access to international networks and are therefore perfectly capable of auditing companies with wide international operations.

At the other extreme, one could argue that for the simplest of companies within the FTSE 350, the requirement for joint audit is unnecessary.

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.

In our view one of the joint auditors should be a non-big Four firm, subject to the limited exceptions that we refer to above (for example banking and insurance companies). Furthermore, it is important to note that audit appointments are subject to a firm’s internal take on procedures in which case expertise and capability should be relevant criteria in all cases. However, in the longer term we would expect the number of exceptions to reduce such that all FTSE 350 joint audits require a non-big Four firm. In the absence of mandating that one of the joint auditors should be a non-big Four firm we are not convinced that there will truly be a change in behaviours regarding auditor appointment and therefore a genuine impact on competition in the audit market.

However, one observation we have is at what point a non-big Four firm ceases to fall into the non-big Four category of firm. As a firm increases its footprint within the FTSE 350 audit market and reaches a certain level of revenue in that market, presumably it is no longer considered a challenger firm which then has an impact on joint auditor choice.

We also note that the Big 4 audit firms have expressed opposition to this remedy (section 4.41). This opposition could therefore present initial challenges within a mandatory joint audit regime, for example if a Big Four firm had a concern about the capabilities or reputation of the other firm. We acknowledge however that concerns could also come from challenger firms in respect of their Big Four joint audit counterpart.

It would also be important to ensure that a joint audit approach is genuinely balanced between the parties, subject to allowing challenger firms time to build their capacity, as they will be taking on greater responsibilities for a larger number of significant companies. A joint audit model will also be unfamiliar at first to many UK auditors who may not have followed such an audit model before in recent years.

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.

We agree that the CMA's suggestions appear a sensible way of phasing the introduction of joint audits. We also agree that the regulator should be involved in overseeing the phasing and the areas of split for each party (as is the case in France), which would help to reduce any actual or perceived bias in the allocation process were the assignment of work and fee to be set by the audited entity. In some cases the split may need initially to be weighted towards one of the incumbents. However, save for certain parts of the financial services sector as referred to above, the same would not be true for other companies where challenger firms are already likely to have existing expertise. A simple sliding scale as described in section 4.35.a might be overly simplistic.

Option b of section 4.35 is therefore slightly more preferable although within that option the dividing line appears to focus on size of company, whereas the share of audit work might be better aligned to capability of challenger firms.

Whatever the method ultimately used for calculating a minimum share of work, involvement by both joint auditors needs to be meaningful with an even split of risk areas across both audit firms to ensure that the audit is in reality ‘joint’. The 10% minimum share suggested seems too low to represent 'responsibility for a material part of the audit (section 4.39)'.

However, even with a fairly modest share of audit work initially, the fact that joint audits will be applied to say all of FTSE 250 and possibly some of FTSE 100 would be a challenge for non-Big Four firms to respond to (particularly at more senior grades), so sufficient time would be needed to support its introduction. We also note that following the introduction of the proposals put forward in the Kingman Review which includes recruitment by the regulator of more partner-equivalent staff to allow it to grow its inspection arrangements, the capacity within the available pool of high calibre partners and managers will be stretched as challenger firms and the regulator compete for the same limited human resource.

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?

On balance we agree that different appointment timescales should be applied to ensure that both auditors were not new at the same time. An argument in support of this approach would be to ensure that audit quality is not compromised unnecessarily by changing both firms of auditors at the same time and could even have the effect of enhancing quality through the combination of auditor continuity and a fresh pair of eyes. Furthermore, such a staggered approach to appointment may provide a natural remedy for the challenge set out in section 3.164 regarding the provision of non-audit services.

We also consider that some form of market cap/market management would be of value in the initial move to this regime as the non-big Four firms will need to build capacity in order for there to be at least four non-big Four firms capable of taking joint appointments at large listed companies. Conflicts of interest could also be a factor and would require careful management. As noted above there may also be issues regarding the availability of auditors with the necessary expertise and seniority in the market

We acknowledge that appointing all audit firms at the same time may bring benefits, such as agreement of a collective audit approach from the outset. If audit firms leave/enter the joint audit arrangement at different dates this could impact on the working relationship and create some practical issues.

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?

In our view proportionate commercial liability is an essential feature of joint audit if the non-big Four firms are to be encouraged to participate, otherwise an unintended consequence could be a failure to attract and retain the numbers of firms required. At present proportionate liability is not written into company law. We believe that liability needs to be by reference to the work that each audit firm is responsible for, not on a joint and several basis otherwise this potential additional cost will impact those who want to enter this market in the short term over and above those they will need to invest in by way of technical and human capacity.

We have previously stated our concerns regarding the regulatory costs and risk of competing for larger audits and the proportionality of regulatory sanctions. A more proportionate regime in the short term in the approach to sanctions will also be important to incentivise non-big Four firms to compete for joint audits.

However, as well as some resistance to a proportionate liability regime we realise that there may be practical issues. For example, if one firm has concerns about another firm, it might not be prepared to allow itself to be potentially exposed to the work of that other firm and therefore refuse to enter into a joint audit arrangement. A ‘blame culture’ might therefore be an unintended consequence of a joint liability framework which could have an impact on the same two firms being appointed in the future.

On the other hand, if the approach to sharing audit work is such that a challenger firm is initially only awarded a small proportion of the audit fee there is little incentive for that auditor to take up the appointment and be exposed to the risk of joint liability for the whole risk.

If the default position was joint liability for the whole risk, this will be detrimental to competition and choice as it is likely to be a disincentive to challenger firms to invest in capability to service this part of the audit market and could ultimately lead to the failure of a smaller challenger firm.

Notwithstanding our preferred view, we agree with the CMA that the UK's liability framework requires further significant consideration.

Proposals by Sir John Kingman regarding directors to be held to account as well as members of professional bodies will also be relevant to these considerations as the scope of the liability framework is potentially extended.

Remedy 2A: Market share cap

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

As discussed above our preferred remedy is for mandatory joint audit.

However, if a market share cap approach were to be implemented as an alternative to mandatory joint audits, then it should be applied to ensure that audit work is allocated across a number of non-big Four firms reflecting capacity and quality and does not destabilise audit quality. A market cap should not allow the risk of the Big Four firms' cherry picking audit clients, a concept which is of significant concern to us. We note that there are various options regarding how such a cap might be determined. Clarity over methodology would therefore be needed were such a remedy to be introduced.

We disagree that the construction of a market share cap should be determined by the Big Four firms as suggested in section 4.70 and feel that setting multiple caps over subsets of the FTSE 350, suggested in section 4.71 would be workable, rather than applying to the FTSE 350 as a whole. Over time it might be possible to devise a cap scheme that applies to both the totality of the market and also to sectors which provides a natural counterbalance to cherry-picking.

If a market share cap were to be introduced, we consider that option two (sections 4.72 - 4.75) would be preferable, which appears to us to offer a practical and workable solution to the risks of 'cherry picking' but would, we agree, require a regulator to oversee companies' tendering decisions and timetables to address concerns such as those around 'gaming'.

Above all, the application of a market share cap that was fair to all parties would need independent oversight and arbitration.

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

A practical application of such a capped market would be within the FTSE 350, as this is where the issue of competition is most apparent, potentially in phases (maybe starting with the FTSE 250) so as to allow the non-big Four firms the time to build their capacity so as not to diminish audit quality during the period of transition.

In the longer term there may be merit in extending a market share cap approach beyond the FTSE 350, but this would require careful and separate consideration and any decision should take account of the impact of the changes made in the FTSE 350.

Remedy 3 Additional measures to support challenger firms that we propose to consider further

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.

In general we welcome greater flexibility for people at senior manager, director and partner level to move between firms. At present notice periods for partners can extend to two years and garden leave and restrictive covenants can mean that an individual can be out of the market for a long time. There is an argument that such a lengthy notice period has the benefit of maintaining audit quality. A counter argument however would be that the primary motive for such a notice period is to prevent successful partners from competing elsewhere in the market until a lengthy period has elapsed.

To make either joint audits or a market share cap work effectively, there will need to be some movement of skilled people currently undertaking this work. We recognise that it will be at senior levels initially where resources will need to move, for example at senior manager, director and partner level. This will be a key area where the Big Four will need to demonstrate a commitment to 'the good of the market' by ensuring their high quality professionals are able to transfer easily to non-big Four firms.

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 are sceptical as to the suggestion of the tendering fund. Access to such a fund would achieve little difference to the market if the inherent predisposition towards the Big Four in audit procurement, recognised by the CMA, was not addressed. We also agree that mandatory joint audit would make the costs of tendering much less of an issue for non-big Four firms. Indeed, we would anticipate resistance for the existence of a tendering fund for the benefit solely of non-big Four firms in addition to the remedy of mandatory joint audit.

We also consider that such a fund would be challenging to administer. For example in the case of fund allocation, how would the pricing and effort of the firms tendering be assessed and therefore the subsidy that would be payable to each of the tendering firms be determined? We also have reservations that even with the possibility of being able to recoup tendering costs, the opportunity cost of providing alternative advisory work would be greater than the potential recovery of audit tendering costs.

Furthermore the method of financing a tendering fund would need to be addressed. It is not clear how it would work and who would be responsible for its funding.

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 do not consider that the costs of technology are a major barrier to entry for this market. Furthermore, the implication in this question is that the technology of the Big Four is better than that of non-big Four firms and that only Big Four firms are capable of technological innovation. As a firm we continue to make significant investment in technology, however as new technology can and will support transforming improvement to audit quality in the future - building on such opportunities as block chain and machine learning, we recognise and support greater collaboration in this area. We therefore consider that the CMA's conclusions in section 4.102 are appropriate.

We would also add that from experience not all audit clients are concerned about the technology used by the audit firm and that they place more importance on other factors such as time invested in the audit process at a senior level.

We also see a potential risk in non-big Four firms relying on the technology of the Big Four firms. For example a Big Four technology platform may be not be well designed for non PIE audits which form a large part of the non-big Four audit market and which may therefore be difficult to adapt to those markets. This could result in the need to run two platforms thus duplicating cost and effort.

Finally, if costs are considered to be a barrier then there may be scope for the FRC or a successor body to allocate a proportion of the fines that they levy for reinvestment in required technology and support.

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.

We set our views on a potential resilience regime in questions 16-18.

In doing so we note that the fundamental aim of any regime needs to be to prevent the Big Four becoming the Big Three. As a result, any regime needs to consider a variety of scenarios including:

- a Big Four firm exiting the market.
- regulator exclusion of a firm in PIE audits as has been seen in India and Japan
- reputational damage such that PIE clients move away from the Big Four firm but where non PIE clients may remain loyal to the firm.
- a Big Four firm may even choose voluntarily to exit the PIE audit market.

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

We consider that the risk of creating an undue risk of moral hazard from the adoption of a commercially suitable resilience regime to be low.

Any such regime needs to encompass both prevention and enforcement. We consider preventive measures in question 17.

Fines form a key part of any enforcement regime. We are strong advocates that the level of fines should be proportionate to the profits earned from relevant audits. Currently we do not consider them to be so.

It would take a very significant increase in the fines regime as applied to the Big Four to have a proportional impact on their strategy and viability to audit, compared to the fines levied at the challenger firms.

We are concerned that the contrary is true. A fines regime which continues to be disproportionate could serve as a disincentive for non-big Four firms to invest in providing the capability to undertake a greater proportion of the audits of FTSE 350 companies.

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 do not advocate the creation of a special administration regime for audit firms (akin to other industries such as financial institutions and social housing). In our view, the current administration regime, combined with the current competition law, would be sufficient to deal with the failure of a Big Four firm.

There have been a number of failures in recent years in the legal sector. Whilst the market concentration for the provision of legal services is fundamentally different to the provision of audit services to the largest companies, we observe from the legal sector that the regulator (the SRA) has specific powers which it uses to influence outcomes in distressed scenarios. These powers include intervention and the ability to impact the ability of individual solicitors to practice in certain scenarios. Whilst these powers are not regularly used by the SRA, in our experience they serve as a tool for the SRA to influence outcomes and behaviors in a distressed scenario.

One way to replicate this in the auditing industry would be to amend the Insolvency Act 1986 to allow the regulator to petition for the administration or winding up of a firm. The criteria under which this power could be triggered need further consideration, but the potential ability to petition for insolvency could serve as the ultimate threat by an administrator to impact the influence of a failing firm.

In our experience, in any distressed scenario, early intervention generally leads to the better outcome for all stakeholders. Therefore, any resilience regime should contain preventive measures. Possible measures include:

- regular monitoring of financial performance. This could include a set of covenants (both financial and non-financial) akin to that which would ordinarily be agreed between a firm and its lenders
- the compulsory creation of a 'living will' for any firm involved in PIE audits

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.

The suggested remedy of prohibiting a failing firm's clients and staff from leaving to join another Big Four competitor appears to be entering complex territory in terms of competition law and individuals' freedom of movement between employers. We would find it difficult to imagine such a remedy working in practice. It would also place a highly judgemental responsibility on the regulator should they be charged with monitoring firms for signs of distress causing partners and employees to leave for alternative employment.

In the situation in which there is a 'resilience event' it might be appropriate for the regulator to be the one to determine the allocation of certain audit clients to the remaining firms, with a need to balance this across all of the firms and not just the Big 3. We note that, this may necessarily be the case for FTSE 350 clients if certain of the remedies regarding supervision of audit committees are adopted

Where the clients go will to some extent drive where the partners and employees go as well. However, in such a situation, financial stability and public interest would need to take priority in the short term over preference of the allocation of clients and human resource, for example making sure that audits were completed to an appropriate quality.

In the event of a failure or significant distress by one of the Big Four audit firms all stakeholders would be best served by a market solution which delivers continuity of service to both maximise value and minimise market disruption. In the event of failure, this would almost certainly involve the transfer of people and clients to a different vehicle.

A wider point that is not addressed in the paper, is whether partnerships remain the appropriate vehicle for audit firms in this changed environment. If audit firms incorporate they could raise finances as a separate legal entity - and for challenger firms that might offer then a wider source of finance such as Private Equity. 'Partners' would have limited liability.

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

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 do not support a full structural or operational split as:

- we do not consider that it would have any material impact on competition

- if the measure applied to the Big Four extended to the challenger firms (through regulation or market impact of the changes), firms such as ours would not be able to invest to build resources to increase capability to service the FTSE 350 audit market.

As stated in our response to the ITC we would see ring-fencing of the audit business as challenging to implement and monitor, as well as being a weak response to the concern around conflicts and one that is also unlikely to mitigate the perception of conflict.

We strongly believe that a full separation of the Big Four's audit and advisory practices (and challenger firms for that matter) is inappropriate, due to the complexities of individual audits and international network arrangements – also this is not desirable from a market concentration aspect either as it would still leave the market with Big Four audit-only firms. Even where there was a full structural split across the whole audit market, this could lead to more standalone audit firm consolidation, thus reducing choice.

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.

A full or operational split would require a separate economic entity big enough to be sustainable in the audit marketplace. High costs of regulation, insurance, quality and risk management would need to be factored in to the sustainability of this entity, which would also need to be resilient to regulator sanctions and capable of insuring against the costs of potentially significant claims. The current audit practices of the Big Four are significantly different to the non-big Four, especially in the PIE audit market place. The sustainable economic entity would, in our opinion, not be workable for firms outside of the Big Four.

Firm	PIE fee income £m
PWC	365
KPMG	137
Deloitte	126
EY	111
Grant Thornton	10
BDO	10

The prohibition on non-audit services that ourselves and other firms have proposed achieves the same objective of improving independence in a much more practical manner.

The independent appointment of auditors would also deal with some of the concerns that the operational split is trying to address but as noted above this remedy has not been taken forward in the update paper.

In terms of an operational split we believe that there would be challenges regarding perceived independence of the two elements of the firm. The partners would still presumably meet, either socially or formally, and there would be the perceived danger of one influencing the other, albeit the monetary incentive might no longer exist.

One consequence of an operational split is that it might be a precursor to a structural split as the benefit of the annuity stream that is audit would no longer be felt by the other partners in the firm. The key design element of an operational split would therefore need to be around the utilisation and pricing of resource across the boundary. This would need to flow both ways, as for example, accounting knowledge is often important in the provision of tax and advisory services.

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:

In summary whilst most of the implementation issues would be surmountable, it would need time and resource to identify and design appropriate remedies. Such a split would be challenging and costly to implement and monitor. For example although the separation of defined benefit pension schemes referred to above is likely to be possible, it would be costly to achieve. Further, arrangements would be needed to support the movement of people between service lines as their career paths develop but again, barriers to this should be surmountable.

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:

Any form of ring-fencing would need to be formal in nature. Where inter firm trading was applied, for example valuation services, the audit firm should be required to obtain external quotations against its 'in-house' capacity to ensure that prices are at arm's length.

Further processes around utilising internal resource and the pricing of that resource could be devised and monitored.

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

Whilst an operational split is likely to be facilitated more quickly than a full structural split it is unclear as to how difficult this would be for a major firm of the scale and complexity of the Big Four. It is therefore difficult to be able to estimate a time scale.

d) Ongoing monitoring costs for the audit firms and a regulator:

It is difficult to comment on the possible level of ongoing monitoring costs for the audit firm and a regulator. However, in practice audit support costs are separate to costs relating to other types of support function so they should be relatively easy to monitor. Further, at an operating level much internal regulation is already carried out by the firm's audit leadership and firm-wide leadership.

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

Other than the fact that such an oversight function would need to brought within the remit of a regulator and that senior business experience would be necessary, we have no further comments.

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.

Even when an operational split is in place, the full EU ethical standards for PIE audits would apply.

In addition, given the increasing trend for the proportion of non-audit fees to audit fees in the FTSE 350 to decrease, we consider that operational ring-fencing should not be used as a method for relaxing the current non-audit service restrictions.

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

For the reasons set out above, challenger firms, at least in the short term, would not have a sustainable PIE audit practice for full separation or ring-fence to function in the same way as it would for the Big Four.

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 maintain that audit practices should be permitted to provide the non-audit services set out in our initial CMA submission as a subset of the current audit related services defined under the EU Ethical Standards. Services currently defined as ‘non-audit’, but which it is in the interests of stakeholders for auditors to provide, are:

• reporting required by law or regulation to be provided by the auditor

• reviews of interim financial information

• reporting on regulatory returns

• reporting to a regulator on client assets

• reporting on government grants

• reporting on internal financial controls when required by law or regulation.

We have therefore defined acceptable NAS as those set out in the Ethical Standard ES5.41 as “audit related” but have gone further by suggesting that “extended audit work that is authorised by those charged with governance performed on financial information and/or financial controls where this work is integrated with the audit work and is performed on the same principal terms and conditions”, which is permitted under ES5.41 could also be prohibited.

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?

Our initial view is that this this proposal has some merit as the peer reviewer is independently appointed and paid for by the regulator. However, care should be taken to ensure that the reviewer’s work is fair and balanced. For example the peer reviewer should not be incentivised to find weaknesses in other auditor’s work, as their findings should be based on objective audit work only.

However, as a remedy it should only be used where joint audits are not proposed under the current remedies, i.e. for those companies recognised as inappropriate for a joint audit approach.

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

A peer review would need to be timely and focus on key risk areas where scepticism was identified as requiring attention. Care would need to be taken to ensure that conflicts of interest were not an issue, that liability was considered and that the use of such an arrangement did not encourage overly negative auditing or result in unacceptable delays to filing audited accounts.

C) Next steps

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

We agree with the CMA that a full market investigation should not be applied.

Given the current demands on parliamentary time it is important to be sensitive to priorities. As such many of the recommendations set out in the CMA paper could be progressed by other groups at a high level without legislative intervention if the principles are agreed.