Response to CMA audit services market study update
Baroness Bowles of Berkhamsted.

This is a personal response based on my policy and legislative involvement in competition, company law and International Financial Reporting Standards (IFRS), in particular as a Member of the European Parliament from 2005 to 2014, serving on both the Economic and Monetary Affairs (ECON) and Legal Affairs (JURI) committees, and chairing ECON from 2009-2014. I was a major contributor to the EU consultations and legislation concerning company law, audit and accounting. Since then I have continued to be engaged on these issues with regard to policy and legislation. I responded to the Kingman Inquiry and a copy of my submission is included for relevant reference.

I hold company directorships which are included in the House of Lords Register of Interests. I have no objection to the publication of my submission under my name.

General background

As referenced in the original invitation to comment there was a large overlap in the eventual EU legislation and CC remedies. [   ] The UK also put its resources behind limiting the EU legislative scope as far as possible to the CC outcome.

It is a welcome finding that businesses report change of auditor as a good experience, which concurs with my own experience, but that was not the view in 2010 when grumbles of loss of expertise and interference proliferated. I regret that lowering the frequency of tender and rotation has been dropped from consideration because the cycles are so long that it means individual non-executive directors will rarely or never be involved in that experience on a given company.

Looking back at the EU audit consultation of 2010, all the remedies discussed in the market update paper were raised then as matters for possible action. The submissions for and against those issues remains much the same. As before the Big 4 tentatively concede minimal steps and naturally make the case against more substantive measures such as structural separation which would be a significant change to their business model.

Unfortunately it is their business model which has become part of the problem and its effects extend beyond oligopoly in competitive and market access terms into the 'omnipresence' of advisors and alumni throughout business, regulators and government, among other things putting them in control of the standards by which they operate and with the pervasive effects of unconscious bias.

Networks

A significant factor that distorts competition is the 'network effect'. This was discussed by the Commission and analysed in the CC 'Barriers to entry: international networks' working paper. As described then it is a virtuous/vicious cycle. A virtuous part is the stability of ring fencing of liability, insofar as that is not lifted by a court, which would depend on the particular circumstances and interactions - for example it was lifted in the Southern District of New York Court in Hermes v Deloitte and Grant Thornton International re Parmelat. The vicious part is the market barrier to those with less extensive networks or the perception of that being the case.

A further vicious aspect is how it makes the direct intervention of breaking up the UK entities of the Big 4 into smaller entities problematic, unless for example the UK prohibited use of exclusive networks or forbad limits on the percentage use of outside network firms. This would then require more partner presence for the overseas audits, as is the US model, and given that problems are seen or said to largely arise in the overseas networks this might mean UK companies were less exposed to those risks. However for now that remedy has not been suggested which means that a strong range of other measures have to be taken together to redress balance in other ways. Joint audit and structural separation would be powerful in combination for that purpose and also fit well as a package with other audit quality measures.

Response to consultation questions

Part A - Analysis

Q1. Do you agree with our analysis in section two of the concerns about audit quality?

I agree with the analysis and the conclusions, in particular that in paragraph 2.75 about earlier identification of problems and 2.76 about the impact of audit failure which go a long way to explain disillusionment and why expectations are for something better.

Public concern about failures is rooted in lack of warning rather than expecting that nothing ever fails. For example accounting standards have allowed unrealized profits to appear as profit and do not include the prudence level of company law. Yet, as stated in paragraph 11 of annex C, 'the auditor uses these standards to assess the truth and fairness of the financial statements'.

In both this market study update and the report of Sir John Kingman it is stated that audit serves the wider public interest – the public are stakeholders though jobs, suppliers, pensions, investments and taxpayers picking up costs of failure. However Annex C paragraph 12 states that it would be 'unusual for auditors to owe any duties to a wider stakeholder group such as future investors, or to the wider public.'

I have heard the aversion to public interest many times myself, on one notable occasion one of my assistants was told by a delegation of auditors, accountants and regulators to the European Parliament that a public interest role was a 'disgusting' proposition with more polite versions dressed up as 'conflict of interest' or 'not what legislation says' expressed to me.

Such expressions are part of a concerted process of systematic subordination of stronger company law tests to the 'right by process' following of standards.

Evidence concerning the FRC and IFRS abandoning Company Law appears in detail in my submission to the Kingman Inquiry. A copy of that response is attached for reference. An example is in a letter from the FRC of 8 April 2005 which states:

'Current restrictions on distributions create a rigid link between the amount that may legally be distributed and a company's statutory accounts. <u>This creates an unnecessary obstacle to the development of financial reporting . . .</u>'

'In short, the Board is firmly of the view that <u>outmoded and costly company law rules</u> must swiftly be brought up to date'.

This was part of the FRC (and others including the Big 4) attempt to remove true and fair requirements from EU and UK Company Law. It failed but the FRC still recommends wording for signing off accounts as 'true and fair <u>according to</u> accounting standards' although the admission of a Company Law true and fair override has more recently been forced from the FRC and acknowledged in response to my Parliamentary Question HL5280.

[ ]

Q2. Do you agree with our analysis of the issues that are driving quality concerns, as set out in section three?

Yes, but see also comments under Q1 concerning the public interest.

As pointed out in paragraph 3.57 the question is whether in audit the public interest is served by financial statements and accounts in which there is confidence. I fall into the camp that considers Company Law requires this but that accounting standards alone do not deliver it.

Paragraph 3.59 is worrying because although this may happen, and is a reason for favouring joint audit, it seems to concede that it can be more acceptable for private owners to influence auditors. The law is the same, the law requires prudence and capital preservation - that is not in the owner's say it is part of the limited liability 'bargain' with society and is a direct matter of public interest and stakeholders concerning liabilities that the owner can walk away from. Company Law says the accounts must be true and fair – and that includes from a stand back assessment not just from a righteous by process standard turned up to maximum aggression.

Therefore the statement at the end of paragraph 3.61 about regulation to protect wider public interests is important. Specific clarification of this would sit well alongside the clarification that has already been given about the duties owed by companies to other than their owners in the new CA06 s172 reporting[1].

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

I agree with the analysis, concerns and the specific points listed in 3.12. The appointment process only comes around rarely so independent non-executives will tend to rely on those who have seen it before, which means management and the Audit Committee chair. In terms of ongoing monitoring it is hard to see how a single relatively short annual meeting between non-executives and auditors is capable of giving oversight of any depth and reliance on the audit committee is almost total.

There is not a culture of external transparency around the appointment or monitoring of auditors. This makes it difficult for outsiders, which includes investors, to discern where there is good or bad practice in audited companies and that results in lack of early warnings, which surely is one if not the most important protective aspects of auditors. Far greater transparency has to be part of the remedy.

Audit committees have become stronger but there is no way even for them, and still less investors, to measure or compare the quality of audits. It can be difficult to obtain a true appreciation of the company accounting, how extensively judgement was needed, how close it was or how aggressive the accounting has been especially if auditors are not sceptical.

The taboo on qualifying audits has rendered explanation something to be avoided or buried by both companies and auditors. Regulator's efforts to get clear and concise reporting seems to convert into formalised statements and 'least said less liable'. Attempts to provide even yardstick information such as through viability statements have also been neutered away.

[1] The Competition (Miscellaneous Reporting) Regulations 2018

b. Limitations on choice leading to weaker competition

Agree. The intent of audit rotation, limiting non-audit business and (though not implemented) dual or consortium audit were attempts to involve and increase capacity of more second-tier firms. It was hugely lobbied against, to unprecedented levels in my personal experience. It is unfortunate that because the Big 4 have continued to dominate perceptions, neither the bringing-on of more use of challenger firms in audit nor significantly greater flow of non-audit work to them has materialized. As the market study update explains, a side effect is that there are now more conflicts to juggle with when considering a tender.

Nevertheless the limit on auditor's quantity of non-audit work and the blacklist had important cultural and independence considerations so their maintenance is still justified although it is also the case that cultural and independence issues can only really be resolved by full structural separation of non-audit work.

c. Barriers to challenger firms for FTSE 350 audits

Agree in general. The perception that only the Big 4 have the networks is a significant perceived issue, although challenger firms have made progress in building theirs. The perception barrier and historic lack of relationships with potential client companies seems to lie at the heart of many auditor selections yet in terms of having independence a prior relationship should be a reason to look elsewhere not a reason to select.

Some of the concerns about capability of challenger firms to put together audit teams seem overstated. Some challenger firms have demonstrable experience of large companies, including global banks in France where dual audits are required and they use their own systems. It is unfortunate that 'challengers' are all lumped together as lacking this or that experience and especially pointing to lack of tendering, although the lower nimber of tenders has an influence on perception. It is the uphill struggle against perception (and the constantly restated commentary of that) which makes tendering for what you will never get an uneconomic exercise, and it is welcome that the market update has recognised this.

It also seems that some confuse capacity with capability. There may be a lack of capacity of a challenger to take on many new clients compared with a Big 4 firm but this does not mean they do not have both the capacity and capability to service perfectly well a smaller number of clients. There is also insufficient recognition of the value of escaping from the 'group think' of the Big 4 and their omnipresence.

d. Resilience concerns

Agree with the concerns raised. There seems to be an admission that the Big 4 are too big to fail, too big to regulate or severely discipline, with a resulting moral hazard as a minimum.

A hit to the overall reputation of a brand would probably be needed to bring down a Big 4 firm, as happened with Arthur Andersen. The ring fencing of the network entities may help to prevent total collapse of the global network but that does not mean that the UK entity is free of risk from the group audits it does or from the individual subsidiary audits it does.

Furthermore, with regard to group audits the division into legal entities may not always prevent action against the UK entity for failures in the network, given the presumption that the group auditor must ensure understanding of subsidiaries individually and in aggregate. With common software so that the group auditor can see what is going on in the subsidiary audit how can involvement be denied? With a seemingly increasing stream of events in various countries, is it impossible to imagine the issue being pursued successfully of how well understood was the subsidiary and what was done for that purpose? As mentioned in the introduction the Judge in the US Parmelat case broke the ring fence.

Fines appear small in percentage terms for the Big 4 and bear more heavily on the challenger firms. There is a case to say that fines should be proportional to the size of the business.

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

Broadly agree. Non-audit work is the bigger earner and culture will settle to where principles are lowest. [ ]

With regard to below market rates for non-audit work I contest the suggestion in section 3.171 that because challenger firms can do it as well that makes it right. It is a form of mixed bundling if non-audit work is provided at below-market rates and is all the more objectionable when done by dominant companies. Even though all main firms have non-audit sides, combined firms, mixed bundling, or just the perception of better value, do provide a barrier to audit-only business as acknowledged at the end of the paragraph. Therefore pricing should be made fully transparent and action taken against any mixed bundling.

There is also the issue of culture, which is further discussed in section 3.175 concerning the social norms of the whole firm and collaboration versus challenge. If advice is internal then whatever its level of culture vis-a-vis audit and any public interest, it will likely be automatically accepted especially as part of a cut price associated deal. Advice is a matter for concern where potentially unregulated advice is given into a regulated sector. This appeared to be found in the FRC review as mentioned in 3.180 and also highlighted in 3.183.

Part B - Remedies

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

In general the remedies should be applied on a wide basis to all FTSE 350 and PIEs and large private entities. All large companies have a public interest element where there are employees and pension funds and potential repercussions on to the taxpayer. The fact that there may not be external investors can make a company more vulnerable to over-cosy relationships putting the other stakeholders and public interest more at risk.

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.

Regulatory scrutiny during the appointment of auditor and audit process may eliminate some of the concerns and provide valuable input and challenge from an experienced source. However it is a large use of regulatory resource, regulators can't be everywhere for everything, and shifting too much responsibility on to regulators might create conflict for disciplining what they had approved or seemingly approved.

In order to hold the Audit Committee to account on any issues that the Regulator identifies, there could be more use of disclosures to the public about the requests made or findings of the Regulator, for example about additional requirements that it has sought. A further stage would be censure but all disclosure should not be taken as a censure, it should be possible to see something in between nothing and 'nuclear'. Disclosures could then give rise to discussion in the annual report and questions at the AGM.

On audit appointment there can be greater transparency. There seems no reason why the audit tender documents should not be public. There should be wider consultation on the preparation of the tender documentation and short list, this could include Regulators and investors, followed by publication and approval of tender documents at the AGM, or some other arrangement if approval is required earlier.

The discussions about selection of the auditor should be open to non-executive directors not on the audit committee as it is a good way for them to see how that committee is operating and the opportunity does not come round often. There is a danger that by regulators increasingly speaking only to audit committees, there is an increase in inequality of information between directors.

There could be more narrative and grading in annual reports about how aggressive the accounting is, why that is condoned by the directors and any change in strategy. Analyst and investor discussions about results could then also include accounting issues.

It is observed again that under the present recommended maximum terms of 9 years for independent non-executive directors, they are likely to have one or no experience of retendering or rotation. It is not sufficient to rely for experience on the recirculation of the same old hands between organisations: that prejudices against diversity.

Remedy 2: Mandatory joint audit

5. What should the scope of this remedy be? Please explain your reasoning.
This is a very powerful remedy as it covers aspects of audit quality as well as being the best way in which challenger firms will acquire a significant share of audits, which in turn has bearing on resilience concerns about the Big 4.

It should apply to all group companies that prepare consolidated accounts, whether listed or not. Once a company prepares consolidated accounts it introduces a level of complexity and opacity that requires more challenge. The requirement could be phased in but there is no reason to delay it for any particular sector. It should also be noted that more than two auditors could be appointed for very large companies or to cater for a speciality, there are instances of this in France in particular for banks.

The improved quality aspect of joint audit is that during audit engagement there may be points of contention between company and auditor or an overly collaborative relationship may exist or develop between auditor and company for a variety of reasons. There are few ways to check on this as it can be a matter of cumulative nitty gritty matters rather than an overview that might be picked up in audit committee or meetings with a regulator. The dynamic is different when there is joint audit - the auditors then have the balance of power and it is harder for cosy relationships to rule the day. The auditors will have debates with each other when they have differences. That is healthy and each having liability is the guarantor against bullying and for a cautious approach.

It is hard to assess exactly how joint audit would pan out in the UK. France has the model, but I am informed that France has audit fees that are lower than in the UK, so there may not be a like for like comparison on either cost or quality.

In some commentary there seems to be confusion between joint audit and shared audit. This seems to completely misrepresent how a joint audit should work. It is an important feature of joint audit that there can be different approaches and different checking systems on the same items. That is where an increase in quality can arise. Taking short cuts to make the checking similar for cost purposes is the wrong approach.

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

It should be wider, and for all consolidated accounts whether listed or private.

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

None as a generality

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.

Given that previous measures intended to help break the big 4 dominance have failed to widen the use of challenger firms, then for progress one of the firms needs to be a challenger. Mandating joint audit is a potential game changer because no longer would tendering be a wasted effort for challengers.

It would require further capacity building because the challengers would be taking on extra work created by joint audit even if the work done by the Big 4 remained steady state. However the challenger firms would also be seen as a more attractive destination for audit partners wanting to be involved in big audits, helping to drive that growth. It should be appreciated that joint audit would not happen everywhere overnight, there would be phasing of some kind as answered under question 8.

Further, it does not make sense to 'use up' two of the big 4 simultaneously and then find the subsequent choice for rotation is much more confined, essentially being a progressive rotation to the other two of the Big 4.

There should not be any general exemption because checking on the balance of power, audit quality and judgement is still valid. It might be possible to give the regulator a mechanism to allow a dispensation but it would need extremely good reasons including particular circumstances rather than generalities. It should not be just to avoid cost.

It would be counterproductive to have any ruling that certain entities, such as banks, are no-go for challenger firms as that embeds and perpetuates prejudices in favour of the Big 4. Switching to joint audit (Q8) will need planning both within and across sectors.

It is hard to give any credence to the notion of gaps caused by joint audit when what happens is to add independent analysis of everything important and nothing is taken away.

7. Should a minimum amount of work (and fee) allocated to each joint auditor be set by a regulator? If so, should the same splits apply across the FTSE 350? (please comment on the illustrative examples in section four). Please explain your reasoning.

In general joint auditors should be seen as equal, and certain matters always require the independent analysis of each auditor. If there is a general capacity issue in the challenger firms in terms of number of audits that can be done, then it is better to have fewer equal partnership joint audits with the system working as it is intended to, rather than a larger number with unbalanced arrangements that might lead to a prejudiced view of joint audit. If time is needed for capacity building this should be done through phasing of the joint requirement rather than reduced involvement in the individual audits.

The cost of the 'duplication' in joint audit is put at a maximum of 40% (25% to 40% is indicated in the update) and that increase is largely down to the doubling up on the consolidated level and critical issues. Both auditors independently performing the consolidated level audit and any other critical issues is the basic premise of a joint audit and is therefore the minimum level of involvement of a joint auditor. On this basis the work share differential would be no greater than 40% to 60%, which can be perceived as 'equal'. Ideally there should be sharing out of the subsidiaries, but one auditor could take fewer at least initially or indeed specialist auditors can be used – constraint to networks is not essential. In a fully settled joint audit system rotation of which auditor does particular subsidiaries is also to be expected barring special circumstances.

10% involvement would not seem to constitute a joint audit as it could not even cover the basic joint audit premise; it looks rather more like sampling. Nor would simply allocating a few subsidiaries and not substantial work at the consolidated level constitute a joint audit although as an independent measure directed at movement away from exclusive networks it may have merit. In either scenario it looks more like a minimally shared audit which does not offer sufficient remedy to dominance and perception prejudices nor sufficient overlap for the prospect of enhanced audit quality.

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?

Having a staggered arrangement can be a continuity benefit of joint audit but that does not fit all circumstances and it can be argued that it might tend to mean you never get that complete 'new eyes' experience that a complete turnaround can give. I'm less inclined to the latter concern if joint audit is done properly with two independent views as described earlier. Mandating staggered appointment during the initial changeover period especially where rotation or change of auditor is imminent would be problematic, assuming it should not be an excuse for extending the auditor's term. While the transition to joint audit could be phased depending on where firms are in their cycle and/or with a 5 year or other deadline, it may be helpful for regulators to be able to give companies a landing slot for conversion within some general guidelines and a maximum timeframe. This would be able to take account of the range of variables and sectoral regulators could also be involved in the planning.

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?

I do not favour a change to the system of liability. That the firms have to check independently, agree and build trust is part of the strength of the joint audit system and the way that audit quality can be improved. It is what makes 'no mean no' if one of the auditors does not want to agree something and builds in a cautious approach which should be encouraged rather than fluid interpretation. In the event of ongoing disagreement s498(6) of CA06 would apply requiring explanation of the disagreement.

The liability issue may be overstated if the explanations of how networks operate to contain liability work as stated. The network approach is to pin blame on the local network firm wherever possible. Presumably that would continue for the relevant subsidiary auditor. If courts broke through the ring fencing they would no doubt also have a view as to where the culpability and liability lay. For the consolidated level, both are signing off so both are liable. Damages would presumably be shared.

<u>Remedy 2A: Market share cap</u>

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

I am not convinced of the workability of a market share cap, certainly not as an alternative to the far stronger joint audit remedy. It does not have the capacity to address issues beyond concentration and introduces requirement for a great deal of regulatory intervention and direction, which may not be the best use of regulatory resources.

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

If it were applied then it should apply widely to all kinds of larger companies where audit quality is also of enhanced importance for the public interest.

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.

I have no evidence to submit but as a general comment non-compete clauses within employment contracts in many businesses are tending to be too onerous and drawn too wide at all levels. If as described in the update there are periods of two years notice that seems unacceptable especially when there are financial penalties. Where businesses seek to restrict movement the costs should lie on them. For jobs where bonus is a substantial element, reversion to basic pay for as long as two years would appear to be a significant deterrent to movement and building in a run off time from audit engagement that is too long. Lesser time, say a maximum of one year, could be considered with waivers for transfer to challenger 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.

The idea is attractive. The funding could come via the regulator, using the same levy procedure and possibly a payback scheme when a tender is successful and once audit income has commenced. Other measures could be used to help coordinate and advertise where and when subsidies might be available, such as via a central register of upcoming audit tenders and also if the regulator establishes landing slots for firms to transfer to dual audit. A fund may not be so needed if there is joint audit requiring a challenger firm, however it may still be useful for the general purpose of building greater depth of challenger firms.

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

The technology issue raises interesting questions with both data analytics and AI as a fast moving field but also whether analytics packages should stand alone. Platforms are being created such as KPMG's 'Clara' that combine data analytics, communications and audit progress. The platforms are not for the exclusive use of the auditor but also used in real time by the client. How much the client can then see of the audit methodology may need to be checked. My understanding is also that as part of the resilience structuring the software/technology company is usually a separate entity.

This raises some question as to whether there is in fact tying and bundling of data analytics with audit to the detriment of not just other auditors but data analytics providers. The study update says that data analytics is becoming an important part of the tender process, whereas there is a case that data analytics is, or should be, separately commissioned. One solution might be that when a client acquires/chooses the analytics, the licence for access must cover use by statutory auditors whoever they may be for the purposes of interrogating the systems of the client. It should not require a separate licence.

Thought processes along that line can lead to an open source solution for data analytics and databases which is another way to address the situation more generally.

When it comes to the procedures for interrogating the client accounting systems there is value in having different approaches but that should not be forestalled by the choice of a given data analytics package.

Remedy 4: Market resilience

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

The main resilience plan of the Big 4 is the network, to isolate and cut off risk from a failing part. From a UK perspective there are threats if the whole goes down through reputational disaster and threats from the UK entity going down.

There should be resolution and recovery plans. The experience with banks was that the 'what if' questions had not been asked and a great deal was learned in requiring the making of recovery and resolution plans. The 'what if' questions should be posed, not avoided as unlikely or unthinkable and the firms should be required to make plans and regulators to assess them.

Requiring businesses to come up with a plan fulfilling basic requirements within 18 months has been proposed in other sectors, that could be implemented for the Big 4. Regulators should list a set of basic requirements that have to be covered, such as continuity of audit, access to software and services, divisibility of capital, identification of units that could migrate together including premises and management of migration.

Alongside those kinds of plans there should be stress tests to identify potential causes and risk of failure and to test whether there is sufficient operational capital. Once done the plans have to be maintained and kept live, not put on a shelf and forgotten about. The situation has to be avoided that it all happens suddenly and because nothing has been planned only one of the other big firms can step in quickly enough. The presumption must be that is forbidden.

Challenger firms should be consulted about how they could incorporate migrating audit groups.

Resolution planning and the administrative procedures will be a simpler operation if there is already structural separation. If there is not structural separation then the advisory arm would need to be included as would the control over all partner capital. The suggestion that the audit side is supported by the advisory side sounds redolent of retail banks being supported by the investment banking side and a mentality that puts audit in the hands of/in hock to the culture of the advisory side. It seems to be an extra argument for why they must be separated.

Control of capital is an important tool as part of resolution. It may need to be decided for what purpose capital is held, how much is needed to withstand stress and enable recovery and can it be ring fenced and used as incentive so that there is an orderly migration of audit groups with the attached share of capital to new destinations. There may need to be adjustment to the ranking of shareholder/partner capital below that of funding the movement of audit clients and staff to challenger firms, with similar changes in the ranking in insolvency proceedings.

In certain circumstances regulatory approval could be required for senior staff movements to other Big 4 firms and certainly notifications to regulators. Incentives rather than prohibitions are preferable if they can be found and sharing of plans with those affected so that there is not a rush to jump first because you don't know what is going to happen may help.

While the notion of building an audit firm within the NAO has been dropped, there might be a role for it to play in terms of assisting with resolution planning, migration and maybe as a special administrator. Decisions also need to be made about when to switch from the FRC/replacement Regulator to the resolution authority. It seems logical to avoid resolution being placed in the hands of the remaining Big 3.

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

Moral hazard has several aspects. Reward for too much risk taking is one, which in the audit context transfers to lower quality audit and maybe issues such as having one partner overseeing too many audits. Some of the audit quality issues help to address these.

Agree that in resolution control of equity and distributions is a disincentive to risk taking. Retention and clawback arrangements on distributions similar to those on bonuses in the financial services sector could also apply.

With regard to regulatory forbearance the actions of the FRC are hard to use as a means of analysis as they have seemed to forbear on many things, or not to perk up until there has been public or parliamentary outrage. This will presumably improve when the Kingman proposals are implemented and regulators given more powers.

New powers for the regulator could well be targeted more at the responsible individuals, as has started, to help overcome fines being the 'cost of doing business' which the relatively lower impact of the fines on the Big 4 plays into. Personal responsibility in terms of suspensions, introduction of a senior manager's regime and checks on whether audit partners spend sufficient time on each audit when they are running numerous audits could all come into play.

The only true way to prevent moral hazard of too big to fail is to split the Big 4 into smaller audit units, which is discounted due to the network system. In the absence of that remedy then a strong combination of remedies that target responsibility, audit quality and challenger growth are required.

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.

Agree with the suggestions. Early intervention is important. One can look to insolvency regimes, bank resolution planning and also proposals in insurance and asset managers for further ideas. Stress tests should play a part which also means not just being able to take control of partner capital but requiring regulatory capital.

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.

While people cannot be treated as assets for transfer that does not mean orderly planning of how parts of the business would move could not be done with capital and job continuity as the immediate incentives. The general principle of the plans and how continuity is to be maintained should be known by people and clients likely to be affected. There could be a ban on volume movements of partners from a big 4 firm to one of the others. It is harder to restrict client movement, but they would be aware of the various limitations on partner movement.

<u>Remedy 5: Full structural or operational split</u>

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.

Agree that a structural split is possible and importantly requires less ongoing regulatory interventions than operational separation. Unless some liberalizing measures about going outside networks are made, any use of a network member by both parts of the split firm would need to be covered by the rules outlined about where the advice for UK audits is permitted to come from, making sure that there is no bundling.   The structural split should include rebranding of one part.

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.

It is impossible that an operational split can be made as effective as a full structural split, especially in the relatively light way that is laid out. It is not clear what an operational split is intended to do other than escape a structural split and indeed it almost begs the question why has this not been done already as a matter of good governance given all the known concerns. It does not address footprint, relationships or the perception of relationships, trade marks, culture, conflicts or risk from shared systems.

Big 4 firms would continue to have the outsize footprint of both parts of the business and the omnipresence, moral hazard and scale of prejudice that blocks challenger firms. The perception of having worked with a particular one of the Big 4 names would remain. With structural separation the division is more concrete in perception, the scale of the footprint and relationships of the audit firm would be substantially reduced and provide some further levelling effect with regard to the challenger firm footprint (assuming that until grown in size separation would not be applied to them). In structural aeparation it should be expected that rebranding of one part would take place, for example as did KPMG Consulting in the US.

Regarding the operational separation details laid out they would not remove the common culture due to the shared central operations, systems, know-how, staff use, branding and day to day contacts. The supply of advice and staff for advice would be frequent (non-audit fees are stated to amount to10-20% of audit fees) and there would be other easy transfer of non-partner staff altogether creating a significant mingling. Apart from a separate board a lot of it looks more like an accounting than operational separation. In a structural separation there are not shared systems and mingling and an independent culture for the audit firm could develop.

Operational separation would not seem to put sufficient distance between the two parts of the firms to enable removal of blacklist conflict, or tax advice, because there would still be shared culture through the frequent use of staff and acceptance of advice as a matter of routine.

To come anywhere near making a cultural change operational separation would require a much more severe ring fencing, such as was required for retail banks, which would also need to restrict the supply of non-audit services, staff and systems.

Sharing of systems in operational separation leaves the audit side exposed to risks arising from the advisory side. How would sharing of central operations service the increasingly more regulated audit side preferentially to the higher earning, and larger, non-audit side?

Operational separation would require substantial monitoring and assessment as to whether it had provided any remedy as well as a more intense form of supervision by the regulator.

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

This would need to be agreed by the pension trustees but there seems plenty of information available including about the profit and billing of the different services on which to base the split of the pools. It might be best to treat it more or less the same as for structural separation.

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

If anyone can invent ways to circumvent or game what are largely accounting arrangements they are likely to be in the Big 4. Huge penalties must apply as a deterrent including striking off partners. A senior manager's regime with criminal offences should also apply for not taking steps to prevent circumvention. More regulatory reporting and checking would be required, which is a burden on both firm and regulator.

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

The timetable will be quicker with operational separation simply because it looks rather like business as usual with a separate board and accounting operation laid over. The continuing sharing of central operations (and the control matrix for that), systems, use of staff and know-how makes the relationship and culture very close so not much change, which is why it does not work for answering the culture and other challenges.

It is questionable whether the needed changes and capacity to the Regulator would be available quite so quickly.

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

The regulator would be using valuable resources better deployed elsewhere. It would be a poor use of public resources (even when raised by levy) for the cost burden to fall on the regulator and detract from other regulatory activity. So the Big 4 should pay additionally for any regulatory and investigation costs. The increased regulation and reporting would also have ongoing internal costs for the firms and require new procedures related to maintaining the required degree of separation that presently do not exist.

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

The regulator would need competences including reporting requirements, investigatory powers, penalties and resources. Use of a senior managers' regime with criminal penalties for failing to have the proper controls in place to prevent circumventions could be one tool. I am not a fan of monitoring trustees but that kind or arrangement might be required.

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

Operational separation does not justify any changes to any provisions already made. The 70% limit was for cultural reasons and for creating opportunities for challengers, neither of which are solved in an operational split. Given that the reputations, names and external relationships and omnipresence of the big 4 will persist at the same size with merely an operational split there would be no change to market dominance effects. All that applies and more so with regard to the blacklist.

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

Yes once they have grown larger, for example to 50% of the average size of the largest firms of 10% of the market measured by turnover.

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.

There is no objection to audit professionals having expertise that they can deploy including from some non-auditors. However the situation must not be created where the separated audit practices grow new advisory arms. The key point is that the auditors should be cautious and sceptical and the situation must not exist for example, where those who help design mark to market valuation models advise upon the veracity of those models. Any tying or bundling with the services of the separated part of the business should be prohibited.

Remedy 6: Peer review

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

A full peer review could run deeper than the FRC's AQR as those only look at process rather than outcomes, whereas a peer review could check the outcomes, assess true and fair, observe any acceptance of aggressive practices and so on. It could also observe the working of joint audit.

If replacing AQR it should be no less frequent or in scope that the current FRC audit quality reviews (every 5 years for FTSE 350) and it would need to cover PIEs and larger companies as well. On top of that additional reviews could be required on individual companies where there is cause for concern or other sensitivities such as size or nature of the business.

I do not see it as an alternative to joint audit as it is not frequent enough, nor likely to be as comprehensive, but as an additional tool for the regulator to check how audit is working, including observing joint audit.

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

They could be required to stress test to the maximum all assumptions and publish the cumulative difference that the judgements make to the accounts.

C - Next steps

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

The reasons for preferring a regulatory approach are understood and there is strong overlap with regulatory issues and public policy. It is the same decision that the EU took. The decision then had some greater certainty insofar as the Commission itself was simultaneously agreeing to legislate. The Government may not follow the recommendations or may not find the Parliamentary time.

Therefore it is important to ensure that there is follow through and a preparedness to return to the issue with a further study and market investigation reference if adequate regulation is not forthcoming in a reasonable time frame.