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Competition and Markets Authority
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Re: Statutory Audit Service Market Study (Updated Paper 18 December 2018)

Dear Sir/Madam

CFA Institute appreciates the opportunity to comment on the Competition & Markets Authority's (CMA) Statutory Audit Service Market Study (Audit Market Study), an update to the Statutory Audit Market Invitation to Comment (ITC). We offer general comments that we believe should be considered by the CMA as it pursues efforts to strengthen competition in the audit sector. We would observe that the time-period for response to both the Audit Market Study (approximately 30 days over the Christmas holidays) and the ITC (three weeks) are exceedingly short, particularly for investors who are not as directly engaged in the debate on a day-to-day basis as the audit industry itself. We did not comment on the ITC because of the short time frame for response. Our key concern with the ITC was the need to more thoroughly consider parameters of audit quality rather than strictly an analysis of the competitiveness of the audit market based upon the number of sellers. We are pleased the Audit Market Study seems to place more emphasis on audit quality than the ITC. We expand on this further below.

OUR AUDIT ADVOCACY EFFORTS ON BEHALF OF INVESTORS

CFA Institute,[1] is providing comments on the Audit Market Study consistent with our objective of promoting fair and transparent global capital markets and advocating for investor protections. An integral part of our efforts toward meeting those goals is ensuring that corporate financial reporting and disclosures – and the related audits – provided to investors and other end users are of high quality. Our advocacy position is informed by our global membership who invest both locally and globally.

CFA Institute has a long history of advocating for audit reforms globally including, most recently, reforms to enhance the auditor's report and to increase transparency regarding audit participants (e.g. disclosure of engagement partner names, audit tenures and affiliated firms). We have also advocated for audits of internal controls and auditor oversight reforms brought about by legislation such as the U.S. Sarbanes-Oxley Act of 2002 (SOX Act) and similar regulation globally. As an organization, we did not advocate for mandatory auditor rotation as we believed the other reforms were integral to increasing accountability and audit quality – our primary concern. While long tenured auditors can lead to "sticky" decisions, we believed routine tendering – along with reforms that enhance quality and transparency is a preferred approach.

We believe it is important to comment on the Audit Market Study as reforms in the UK related to its audit market have an impact on other audit markets given the interconnected nature of the audited companies under audit and the nature of the largest accounting firms – just as we have seen with mandatory tendering and rotation. As we review the Audit Market Study, global implications of the remedies proposed are most prominently discussed in the section on structural or operational separation of the

[1] With offices in Charlottesville, New York, Hong Kong, London, Brussels, Mumbai, Beijing and Abu Dhabi, CFA Institute is a global, not-for-profit professional association of more than 166,000 investment analysts, portfolio managers, investment advisors, and other investment professionals in 162 markets, of whom more than 160,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 154 member societies in 74 markets.

firms, we believe this should be a consideration as each of the remedies is evaluated. While companies follow auditing and accounting requirements in their country of domicile or registration, investors invest globally seeking comparative advantages – including advantages from jurisdictions with high-quality audits – in investment opportunities between jurisdictions. As an investor organization, we think about these issues globally and our consideration of the remedies are offered in that context.

Our response to the Audit Market Study provides our views on the proposed remedies of the CMA against the backdrop of our most important concern – audit quality and enhanced transparency – and our consideration of whether such remedies improve outcomes for investors. ***Auditing is a business vested with the need to create trust and protect the public interest and the role of regulators in providing guardrails in a cohesive fashion is important. For that reason, we believe any remedies provided by the CMA must be tightly connected to and orchestrated with the recommendations in the Independent Review of the Financial Reporting Council, the UK government's review regarding improving audit standards (i.e. Brydon Review) and the Business, Energy and Industrial Strategy Committee Inquiry***. It would be useful to articulate for investors how all such reviews are interconnected and how they will be brought forward in an organized and cohesive fashion that addresses audit quality.

CURRENT ENVIRONMENT: PERCEPTION VS. REALITY

Recent business failures in the UK and the related media attention have, again, raised the question of audit quality. There has been much in the press that has inflamed the reaction of many stakeholders (e.g. investors, politicians, pension trustees, and the broader public) We certainly don't disagree that such business failures are problematic and create significant consequences for not only investors but other stakeholders to an organization. While extensively reported upon by the UK media, there is much reaction, but not significant analysis of the causes of such business failures and the degree to which audit failures, aggressive accounting, fraud or market conditions that resulted in liquidity issues contributed to the lack of timely recognition of such business failures.

Audits do not necessarily prevent business failures as business failures stem from a lack of cash resulting from liquidity issues that can manifest quickly. Additionally, audit failures are not necessarily indicative of underlying business issues. There is much in the press that seems to inappropriately conflate accounting, auditing and business failures. For example, the accounting for goodwill has drawn the attention of media outlets such as the Financial Times and Economist. The write-off of goodwill does not create business failures, business failures create the write-off of goodwill. While there certainly can be more timely recognition of such impairments, amortization of goodwill – as some of the articles suggest – will not resolve these business failures. Amortization of goodwill will only artificially improve ratios such as return on assets over the amortization period. Sophisticated investors (i.e. price makers) generally write-off goodwill long before management, understanding the moral hazard of management's assessment. The cash related to the generation of goodwill is long gone. We disagree with the notion, that some management's like to communicate, when experiencing a write-off, that goodwill is a non-cash write-off. Rather, it is recognition, and communication, that the cash previously exchanged was not well spent. We highlight the issue of goodwill not to debate the merits of the accounting for goodwill, but to highlight the media's flawed analysis of many of the accounting, auditing and business issues. In a similar vein, some have used this moment as an opportunity to reignite the debate regarding fair value accounting. This is a red herring. Financial statements are replete with estimates – even the accrual of payables is an estimate. To suggest the financial statements be stripped of estimates such as fair value will have the effect of making the financial statements substantially less meaningful to investors. Financial statements that are simply a compilation of historical transactions offer little value to investors in considering the future prospects of the entity. They also – particularly in an age of technological disruption where there is discussion of the ability to audit 100% of historical transactions – would leave little value for the auditors to provide to investors in the information value chain. That said, auditors need to be able to effectively challenge management's estimates and to communicate in the audit report the uncertainty in such estimates and the procedures they performed to gain reasonable assurance over them. This is what investors want. It is where the value of an audit is derived in the eyes of investors. The future of the audit profession is inextricably linked with the profession's ability to provide such assurance as historical transactions will – in the near future – be easily auditable by machines.

Further, the Audit Market Study rightly references an expectations gap by the public regarding the nature of the auditors' responsibilities (e.g. responsibilities regarding fraud). This is something auditors and regulators need to better communicate to address the media distortion.

While we recognize there is much to do to improve audit quality, regulators must be cautious to clearly define the issues and remedies. The remedies must address the root causes, and the responses must not be disproportionate given the sometimes-flawed analysis of the issues by the media and politicians. Said differently, blunt instrument regulations may not be the remedy to nuanced and complicated issues that gave rise to the business failures that have put the auditing profession squarely in the sights of politicians, regulators and audit. The current perception should not drive the reality of the reforms truly necessary to improve audit quality.

AUDIT QUALITY: INVESTORS PRIMARY OBJECTIVE
As an investor organization, we strongly support the efficient functioning of markets. Markets generally benefit from broad competition. Such competition should lead to value for money and increased quality. The Big 4 (PwC, EY, Deloitte and KPMG) represent a formidable oligopoly***. However, for a market to be perfectively competitive***[2] ***not only does an efficient market need numerous buyers and sellers but they also <u>need them to be well informed</u>***. In the current audit market, buyers of audit services – ultimately investors – do not have the information necessary to judge audit quality. The inability to observe audit quality is rightly mentioned within the Audit Market Study (e.g. Paragraph 2.4)

Investors' rely on agents or intermediaries (the audit committee) and the seller (the accounting firm) to protect their interests and ensure the performance of high quality audits. These intermediaries, however, have incentives that may run counter to the objective of protecting investors' interests. Audit committees may pressure auditors to lower price to engender themselves to company management and auditors may seek to ingratiate themselves with management by exercising less professional skepticism – or being less challenging of management's decisions – as well as reducing audit procedures and quality to retain audit engagements and enhance their profits. The simple reference to companies under audit by auditors as the "client" has the effect of connoting a dependent rather than independent relationship and confusing the fact that the ultimate client, or the buyer, is the investor. These incentives, combined with limited information and transparency regarding the audit from both audit committees and auditors, makes it even more challenging for investors (buyers) to judge quality. Further complicating the ability to judge audit quality, is that audit regulators also provide little detail when communicating to investors and the public more broadly about audit quality. As we note above, the intense media reaction can distort the narrative on audit quality. Investors and other stakeholders want to, and should, rely on communications from three principal sources for gaining an understanding of the quality of the audit. These are: 1) the audit committee, 2) the auditor's, and 3) the regulator. An efficient market requires more than simply a plentiful number of buyers and sellers, but for them to be well informed by those charged with protecting their interests. This is not the case in the audit market.

Official bodies engaged in audit standard-setting and enforcement (e.g., FRC, IAASB, PCAOB, etc.) have worked to adopt improvements – including those we have advocated for – in standard-setting and

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2 The Oxford English Dictionary defines perfect competition as "the situation prevailing in a market in which ***buyers and sellers are so numerous and <u>well informed</u>*** that all elements of monopoly are absent and the market price of a commodity is beyond the control of individual buyers and sellers.

inspections over the last two decades. They have also worked to draw greater attention to the importance of audit quality by increasing the ability of auditors to pushback on "challenging clients." While these improvements are welcomed, regulatory inspection results over the last several years show that improvements – particularly in the communication from audit committees and auditors as well as from regulators are still needed. As we noted in [our recent letter to the Public Company Accounting Oversight Board (PCAOB's) in relation to its Strategic Plan (2018-2022)], investors have little transparency into the activities and findings of those charged with protecting their interests and that improvements continue to need to be made. Only recently have audit reports improved – recognizing that the UK market has lead the way in advancing some of these reforms[3]. That said, as we recently advised the PCAOB, we have little insight into the severity of the regulators findings and how to gauge the quality of the auditors work and the regulators findings. As we note in our letter to the PCAOB[4], we need more analysis, synthesis and contextualization of the regulators findings – not just in the US, but globally – to be able to gauge audit quality.

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[3] Investors have benefitted from the enhanced auditor's report over the last few years. The UK probably has the best audit report globally. Investors are now receiving more information to enable them to evaluate the quality of the audit. That said, this is still a work-in-progress as improvements in the auditor's report are still evolving. More robust discussion of audit risks and procedures along with the time spent on such risky areas are essential. Further as the nature of the audit changes over time, for example, with 100% testing, there may be a need to better explain the procedures performed and the changing definition of reasonable assurance.

[4] In our letter to the PCAOB (the Board) last August, we make the following observations regarding audit quality and transparency:
Audit Quality *– We note the Board seeks to provide more timely and relevant feedback on its inspection activities. Currently, it remains difficult for investors to gauge improvements in audit quality. We highlight below areas where the Board's attention to such matters could facilitate improved communication to investors and enhanced credibility for the PCAOB and the audit profession.*

A. Inspection Findings – The current communication regarding inspection findings is challenging for investors to contextualize and incorporate broadly into their investment decision-making process. Investors recognize that audit deficiencies are not necessarily financial reporting errors. We don't believe inspection findings should move markets or be directly actionable at a company level. That said, investors do need some information on the major issues and trends which provide them with a sense of the quality of the audits which they rely on to protect their interests. Without this, it is challenging to value the audit process.

Citations of large numbers of audit deficiencies or the topical areas where they occur (e.g. fair value) are not particularly helpful. Often the high numbers of audit deficiencies are cited – by the press – but the magnitude of the deficiencies or the implications on the risk of investing are hard to gauge.

Investors seek an understanding of the root causes of audit deficiencies. They seek to understand whether the deficiency drivers are, for example, underlying accounting standard issues, structural audit firm problems, or company process, control or audit committee issues. They seek this understanding to ask better questions or advocate for reforms in a constructive manner.

Better communication on the nature of inspection findings and root causes would improve investor confidence in the quality of audit and the work of audit regulators, including the PCAOB. Swift disciplinary action and communication in the event of high-profile audit failures is also an important deterrent.

B. Reconciling Narratives – Communication from the Board and audit regulators is necessary to counter narratives that diminish investors' confidence in audit quality and the work of audit regulators.
1. Audit Scandals: Fact or Fiction – Recent publicly reported scandals (e.g. KPMG audit partners, UK audit failures, KPMG South Africa audit issues) and the press associated with them may challenge the narrative of improved audit quality. Recognizing that there is always a disproportionate amount of press attributed to such examples, it would be helpful if the PCAOB and other audit regulators could respond in such situations regarding the steps the regulators take to mitigate and identify more timely such audit failures. For investors in companies listed in the United States, communication regarding how the PCAOB addresses issues at affiliate firms, for example, could improve investor confidence.
2. Too Detailed/Not Detailed Enough – Investors hear from auditors that the PCAOB is too detailed and too focused on immaterial items. On the other hand, when they read about the aforementioned audit scandals it seems the auditors failed to complete basic audit procedures. Investors struggle to reconcile these very different narratives. Communication regarding how the auditors assess risk and monitor risky clients and how the PCAOB supports them in this endeavor would be helpful in assessing the improvements which are necessary. Recognizing that getting this balance right is always challenging, and that the majority of audits work to mitigate such outcomes, communication by the PCAOB regarding how it addresses such issues would be useful.

Overall, investors are seeking communication from audit regulators that contextualizes other information they receive on audit quality and that communicates actions taken in response to highly visible audit failures to improve future audit quality.

Presently, there is little to no competition on audit quality not only because it is challenging for everyone to judge, but because managements generally don't influence the audit committee to select the toughest or highest quality auditor. Further, many audit committees and investors select the Big 4 firms, because they have limited ability to ascertain audit quality and they use brand identity (e.g. Big 4) and herding behavior as a basis for their decision-making.

While the Audit Market Study more fully considers the importance of audit quality (Pages 31-40), the remedies – in our view – suggest the CMA is perhaps still too narrowly focused on increasing the number of market participants (i.e. sellers) without precise articulation regarding how increasing the number of sellers will result in improvements in the quality or price of audits. Our view is that the CMA's attention needs to be on how to improve quality and communication (transparency) to investors. We believe the CMA research has the potential to contribute toward this end goal by enhancing the information exchange between market participants. With more information, investors will be able to better judge the quality of the audit; the price paid for the audit; the effectiveness of the audit committee in overseeing the auditors from selection, risk assessment, performance of audit procedures and reporting of results; and the effectiveness of regulators. We, therefore, want to emphasize that more choice in the market that leads to more competition does not necessarily deliver better quality audits. We are concerned that more participants might actually create more competition based upon price rather than quality. Audit quality – not increasing the number of market participants – is top of mind for investors

As investors – who strongly support efficient markets – the audit market cannot operate efficiently when there is a lack of transparency on audit quality. We believe a capital markets solution with regulatory oversight of quality and inappropriate incentives is the solution. We also believe improvements in regulatory oversight by an audit regulator are an integral part of the equation in improving audit quality. We do not believe the remedies proposed here should be implemented without a clear linkage of the actions to the responsibilities of audit regulators. Our response to the remedies that follow are guided by whether they will enhance this information exchange, increase audit quality and are regulations which balance a free, but fair, market.

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CONSIDERATION OF PROPOSED REMEDIES

Remedy #1: Regulatory Scrutiny of Audit Committees

Function & Qualifications of Audit Committees– The audit committee's primary function and purpose is to provide oversight of the financial reporting process, system of internal controls and compliance with laws and regulations. Their independent oversight of the audit is key to ensuring that the audit is of high quality. Representing investors in the selection and appointment of the auditors in an independently minded way is essential for audit quality – as is effective oversight of the execution, and price, of the audit. To this end, it is important that the audit committee be comprised of members who, among other skills, possess current and deep experience conducting audits as well as in the greatest risk areas associated with the audit. We believe audit committee chairs must have more recent and direct experience executing audits as well as having the requisite industry and risk management expertise.

Audit Fees – We worry when audit committee members laud their ability to reduce audit fees as if to engender themselves to management or flex their muscle on auditors who seek to retain their "clients". Investors – those who pay the bill – are less price sensitive to audit fees than one might expect. While the cost of an audit is important, pressuring auditors to reduce fees to the point where they are not allowed to make reasonable profits on the audit alone is not a model investors support, as it reduces audit quality. Auditors should be in position to make a reasonable profit in the provision of such services. Audits should not be loss leaders for the Big 4 as audit partners need to be seen as executing a valuable service to the firm. Partners should not be more highly valued for winning "clients" than performing quality audits.

We believe that competition is fierce among the Big Four within the confines of tendering rules and mandatory rotation in certain jurisdictions. That said, our view is that competition is largely based on audit fees (price) and delivery of services – not necessarily on audit quality. Currently, it is difficult for investors to challenge the audit committees or auditors who are meant to serve their interests as audit fees are very hard to compare across companies. They are generally large lump sums with very high-level qualitative explanations. This fee reporting, and the tendering process create perverse incentives [ ]. They also seek to gain clients for name recognition, marketing, and market sector expertise, [ ]. We believe greater reporting on the audit fees including the hours and fees – associated with significant audit areas or risk areas – would provide greater information content to all market participants and provide them with greater ability to judge the fairness of fees for the company relative to the disclosures in the auditor report and relative to peers.

Investors need greater reporting on audit hours, staff mix of hours, and rate per hour to be able to be well informed participants in the market place. Adding additional challenger firms has the potential to increase competition on price – without transparency to the buyer. It is not in the best interest of investors to increase competition for the audit without simultaneously providing better communication from the audit committee on a variety of issues including fees to allow the market to work more efficiently.

Regulatory Oversight – We don't believe the audit committee should be replaced by a regulator as we believe an important function of audit committee members is integrating their understanding of the totality of the board's oversight responsibilities, and understanding of the business, into an analysis and reporting of financial results. That said, we are generally supportive of increased regulatory scrutiny of audit committees. What is not clear from the CMA's Audit Market Study is who will act as the regulator with these oversight responsibilities and whether it would be the same regulator that oversees the auditor. We think it would be most effective if they were the same regulator.

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We note that the audit committee oversight remedy in the Audit Market Study focused on the oversight of the selection of the auditor. While we agree this is an important element of the role audit committees play, the oversight should include several other activities important to ensuring audit quality including:

1) Reviewing the selection and qualification of the audit committee members and the audit committee chair;
2) The process the audit committee follows in supervising the auditor's execution of the audit;
3) The time spent by the audit committee in overseeing the execution of the audit;
4) The audit committee's engagement on critical audit matters including communication with and by the auditor;
5) The audit committee's communication to investors regarding how it carries out its responsibilities with investors;
6) Review of the audit fee including, hours, staff mix, rates, hours spent in risk areas and audit firm profitability.

While these are not meant to be an exhaustive list of the areas of oversight, we see this suggested remedy as having the greatest potential to improve audit quality. A regulator that oversees the execution of these responsibilities – as well as performing audit inspections – and balances the incentives of audit committee members and auditors would be helpful in improving audit quality.

Remedy #2: Mandatory Joint Audit

We very strongly oppose the notion of the joint audit. In our view, joint audits reduce accountability to investors. When everyone is responsible, no one is responsible. Joint audits increase audit quality risk. Such audits require careful coordination, cooperation, division of responsibility and accountability between two firms, which has the potential to increase audit risk and decrease quality. ***While less averse to a shared audit, we aren't convinced either remedy improves audit quality***. The ten-page discussion in the Audit Market Study includes a discussion of the liability framework and how challenger firms would benefit. However, it falls short, in our view, in precisely articulating how this remedy will improve audit quality for the benefit of investors. We see this remedy as having the potential to increase fees without improving, and possibly decreasing, audit quality.

Competition for Management's Approval – We believe joint or shared audit situations create competition for the approval of management and the audit committee to the detriment of audit quality. Rather than having two organizations that work together to improve quality for investors, joint auditors spend a great deal of time trying to engender themselves to management and the audit committee and to appear reasonable and agreeable to management to retain or increase the level of their work. Not only do audit hours and fees increase, but you have audit firms competing in a "race to the bottom" when it comes to audit quality.

Communication to Investors – Further, the Audit Market Study indicates that joint auditors will review each other's work and not explain their division of responsibilities or their individual findings. The expanded auditors report in the UK makes questions regarding how this will be communicated – particularly as it relates to critical audit matters – more obvious to investors. The expanded audit report with both audit firm's names affixed at the bottom without a distinction or discussion of the division of work or responsibilities between the firms only adds another layer of complexity without transparency for investors (i.e. buyers). If the firms are performing work separately and reviewing each other's work, this should be clearly communicated to investors. Without this transparency, there is no improvement in communication and knowledge to the buyers of audit market services.

A shared audit raises similar questions. Will each firm issue an opinion explaining what elements of the audit it performed? Or, will there be a lead auditor who assumes responsibility for the work of the other auditor? This is not clear from our review of the Audit Market Study. In the U.S. audit market, the PCAOB has just introduced the reporting of work of other auditors to an audit engagement in the Auditor Search tool. In this tool, registered public accounting firms must report the percentage of audit work completed by other auditors on the engagement, including affiliated global network firms. From this database, investors can tell what percentage of an investee company is audited by other firms, including these affiliated firms. If a shared (or joint) audit regime is to be implemented in the UK, as an investor organization, we would advocate strongly for reporting similar to that in Auditor Search, if not on the face of the audit opinion.

Overall, before any change is to be made on this front, improvements must be made in how the work of each auditor would be communicated to investors. An opinion signed jointly by both firms, but not specific as to their responsibilities, is not something that would be seen as an improvement.

Remedy #2A: Market Share Cap

A market share cap combined with mandatory tendering, or rotation, would result in extensive complexity in both the tendering for and rotation of companies between audit firms. Without extensive scenario analysis, it is challenging to see how this would work practically. The rotation of one large engagement would seem to suggest that a cap could be pierced and require the shifting of several smaller clients to accommodate the larger client. With what is provided in the Audit Market Study, it is challenging to assess how this would work in a dynamic market. To some degree, it seems to reduce rather than increase choice. Further, there is no indication of how this will benefit investors by increasing audit quality. In the short-term, the Audit Market Study seems to convey that there will be a decrease in audit quality with the hope that the medium or long-term benefit will be increase competitors in the audit market. It is not clear in the long-run how this improves audit quality. The market cap seems to run counter to the notion that audits should be competed for on the basis of quality. Rather, it seems to suggest an increased number of participants will increase quality. We remain unconvinced of this conclusion.

Remedy #3: Additional Measures to Reduce Barriers to Challenger Firms

Ease of Staff Movement – Investors observe that movement of staff below the partner level between the firms is quite extensive. As it relates to partners, it is challenging for investors to assess the "stickiness" of such individuals given levels of compensation, pension vesting schemes, capital requirements and non-compete provisions in partnership agreements. Without such information, it is hard to assess the ease of staff and partner movement between Big 4 and challenger firms and the implication of such a remedy on competition and quality in the audit market.

Tendering Fund – Certainly, the cost of tendering is substantial, and it is a cost that regulators have pushed to the audit firms due to mandatory tendering in certain jurisdictions. The costs of preparing proposals is expensive and such costs are only recovered by winning an audit engagement. We understand completely while challenger firms would make the decision not to tender given the costs and limited probability of gaining the audit given the brand herding of audit committees. Some degree of remuneration could be paid by companies to those tendering to ensure that best efforts are made to compete for the engagement – not simply the challenger firms. That said, we remain unconvinced that paying challenger firms for tendering will increase the likelihood they are selected given the herding bias of audit committees and investors.

Access to Technology – This provision of the Audit Market Study should, in our view, be of concern to investors. In our view, this provision may have the effect of stifling innovation in a period when audit firms should be exploring ways to improve the efficiency and effectiveness of audits. While it is correct to see these as substantial capital investments, the challenger firms can be fast followers or license the technology. They should not be free riders as it reduces the incentive of the larger firms to innovate. An alternative approach could be for the audit regulator to help fund such innovation with a levy against all companies.

Overall –

The ITC and Audit Market Study don't, in our view, provide convincing arguments that efforts (e.g. joint or shared audits; market caps; increasing staff movement; a tendering fund; or increased access to technology) to facilitate competition by challenger firms will increase competition or improve audit quality given the brand identity, herding behavior and metrics upon which challenger firms are evaluated. We believe there is insufficient evidence that these reforms will substantially change the buying behavior of audit committees or investors unless these measures were followed by a subsequent measure to encourage the merger of a least two firms into a position to compete more effectively – though we recognize it is unlikely this can be done in the UK given the global nature of the audit firms and audited companies.

Remedy #4: Market Resilience

The mergers that converted the Big 8 (Peat Marwick, Deloitte Haskins and Sells, Touche Ross, Price Waterhouse, Coopers & Lybrand, Ernst & Whinney, Arthur Young and Arthur Anderson) into the Big 4 began in the late 1980s (KPMG, EY and Deloitte) into the Big 6 and then into the Big 4 a decade later with the merger to create PwC in 1998 and the demise of Arthur Andersen in 2002. The Big 4 have been the predominate market players for nearly 20 years. Investors observed the market movement of clients and staff away from Arthur Andersen to other audit firms or audited companies. Until recently, we could see many of such audited companies remained with their successor firm for the last 16-17 years. We saw Andersen staff and partners change employers (audit firms or companies) in rapid succession in 2002 with many employees switching employers within 2-3 years following the shuttering of Andersen. The audit market responded quickly in the move from 5 to 4 firms.

The current degree of concentration among the Big Four – and the market resilience – has existed for nearly twenty years. Accordingly, this concern is not new or unique to the UK. If another failure on the scale of Arthur Andersen were to occur, such a change would be disruptive to publicly listed companies, investors and firm employees as well as many other stakeholders. However, enhancing the competitiveness of the challenger firms through the aforementioned remedies doesn't seem like a viable plan for addressing the resilience of the market as many publicly listed companies wouldn't switch to a challenger firm for the reasons already articulated.

Given audit is a trust business, it doesn't seek likely that a troubled firm could be rehabilitated – particularly since there are no observable measures of quality to evidence such rehabilitation to buyers. Accordingly, we would support a regulatory plan for an orderly administration or liquidation of one of the firms – should red flags suggest it is necessary. Just as systemically important financial institutions must have a contingency plan, we believe it would be sensible to have such a framework in place for the audit industry. That said, we think firm partners should not be protected from loss of their partnership interests as we believe this risk provides an important behavioral incentive.

Remedy #5: Full Structural or Operational Split

The decision to make a full structural or operational split must be based upon a more rigorous and thorough analysis of the real and perceived impediments to audit quality of combined firms. To be able to support either structural or operational separation, investors would need more information that combined firms providing non-audit services to non-audit clients limits the ability to provide quality audits. While we understand that some firms may currently choose not to respond to audit tenders because they perceive the provision of non-audit services is more lucrative, we do not find that the conclusion that this reduces audit quality is an inevitable result. While it may limit choice, it does not necessarily reduce audit quality. It is also not a forgone conclusion that audit partners sharing in the profits of non-audit services of non-audit clients reduces their ability to exercise professional skepticism and challenge management. As some have suggested, this profit diversification may enable the firms to more effectively challenge and disassociate with low-quality, high-risk audit “clients”. We also see benefits of the audit personnel calling upon those providing non-audit services in executing certain audit procedures (e.g. valuation and impairment testing, etc.).

A thorough qualitative and quantitative analysis of the benefits and costs of combined firms must be undertaken and presented to investors before any such conclusion regarding structural or operation split is reached. This, again, is an instance where buyers of audit services have limited information on the structure, operational and financial results of sellers (e.g. Big 4). Greater transparency from the Big 4 on these structural, operational and financial results is likely a more meaningful first step that allows market participants to make their own judgements. Without greater transparency on the profitability of each segment of the firm’s business and the related profit sharing, it is challenging to make any definitive conclusions. While we understand these businesses are partnerships, and not publicly listed entities, they are organizations vested in serving the public interest and more information on the nature of their operations, strategy and profit sharing may be a more reasonable regulatory measure to consider. Just as with investing, informed investors will evaluate the information and make their own judgements. Without more information this remedy seems to be a very blunt instrument of regulation without evidence that it will address the quality issues that investors and other stakeholders are most concerned with.

While we are not favorably disposed to audit only firms, we are supportive of a full ban on non-audit services to audit clients. This seems to be a simple, but effective means of eliminating any potential conflicts in fact or in appearance.

It is also important to note that investors want greater detail and transparency on the level and profitability of audit fees. See discussion under Remedy #1.

Remedy #6: Peer Review

From the discussion included in the Audit Market Study, it appears the "peer" would be another audit firm, likely a challenger firm, appointed by the regulator. While framed as a proposal to increase audit quality, this remedy seems more focused on enhancing the ability of challenger firms to compete. We do not see this as an effective remedy for a variety of reasons.

First, the concept of peer review presumes the firms are truly peers – so another Big 4, not a challenger firm, reviewing the work of a competitor – with the resources and wherewithal to truly challenge the statutory auditor. In a contentious situation, it seems unlikely that challenger firms acting as a peer reviewer may have the resources to challenge the statutory auditor.

Second, it seems antithetical for the CMA to believe that audit quality will be improved by having another Big 4 or challenger firm – in an industry that is being criticized for lacking professional skepticism and performing low quality work – review the work of the statutory auditor. The Audit Market Study notes that the statutory auditor will be "kept on their toes" by a contemporaneous or retrospective review by another auditor (the peer reviewer). This proposal by the CMA would suggest it does not believe the problems with audit quality (e.g. professional skepticism, challenging management, independence, appropriate audit evidence) would be equally experienced by the peer reviewing firm. Investors must challenge this logic as it implies that the Big 4 or challenger firms are:

a) capable of exercising professional skepticism, challenging management, ensuring independence, and gaining appropriate audit evidence;
b) not incentivized to do so when the are the statutory auditor; but
c) will be incentivized to do so when they are acting as the peer reviewer.

Peer review – albeit not with appointment by the regulator – existed in the U.S. prior to the SOX Act and was not an effective mechanism in protecting investors. We find it unlikely to be highly effective in the UK market.

Third, we are not convinced peer review is an effective substitute for a stronger regulatory regime with more thorough review and stiffer sanctions of the audit sector. We also see a stronger regulator as having the ability to look across the market to make recommendations and liaise with other global audit regulators to improve audit quality. It is our view that any levies of public companies should be done to fund a stronger regulator over instituting peer reviews.

SUMMARY

In summary, we believe that the remedies proposed by the CMA need to be surgical in improving audit quality not blunt instruments of public rebuke of the audit firms that won't effectuate real change.

We see Remedy #1 (Regulatory Scrutiny of Audit Committees) as the most likely to improve audit quality by providing regulatory guardrails on audit committee incentives and improving communication to investors.

As we describe above, Remedy #2 (Mandatory Joint Audit), #2A (Market Share Cap), #3 (Additional Measure to Reduce Barriers to Challenger Firms) seem to focus on increasing the number of market participants by increasing the involvement in the audit market of challenger firms, but they don't seem to address the primary issue for investors, that of audit quality. We are especially concerned by creation of mandatory joint audits where auditors may be incentivized to compete on engendering themselves to management and audit committees rather than focusing on audit quality. How a market share cap would work in a dynamic market is also challenging to envision. ***Broadly, we don't see that joint audits, market caps or other measures to enhance competition of challenger firms is the solution to improving the audit market because we believe we need a market where buyers are more well informed not simply where there are more sellers.***

As it relates to Remedy #4 (Market Resilience), we think this is a real issue that is best addressed through monitoring of the firms by the audit regulator and developing a plan of administration prior to the occurrence of such an event.

We are more favorably disposed to a limitation on non-audit services than a full structural or operational split as described in Remedy #5 (Full Structural or Operational Split). An extensive analysis of whether the size of the firms or the provision of non-audit services to non-audit clients has been detrimental to audit quality must be performed before we can support this remedy. In our view, a full structural split seems like a blunt instrument of regulation that more likely addresses a perception issue than improves audit quality.

Remedy #6 (Peer Review) doesn't seem to enhance quality or transparency to investors. Having firms who have not exercised sufficient professional skepticism reviewing others who have not exercised sufficient professional skepticism seems like an inadequate remedy to improving audit quality. We think a stronger regulator performing such reviews, with real enforcement powers, is a better solution.

We believe any remedies provided by the CMA must be tightly connected to and orchestrated with the recommendations in the Independent Review of the Financial Reporting Council, the UK government's review regarding improving audit standards (i.e. Brydon Review) and the Business, Energy and Industrial Strategy Committee Inquiry. Auditing is a business vested with the need to create trust and protect the public interest and the role of regulators in providing guardrails in a cohesive fashion is important.

Overall, we would ask the CMA to consider whether buyers of audit services would be more well informed – and more effective market participants – after all such remedies were implemented.

CFA Institute

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If you or your staff have questions or seek further elaboration of our views, please contact Sandy Peters at [   ]

Sincerely,

/s/ Sandra J. Peters

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