RESPONSE TO CMA MARKET STUDY

Introduction

I was the first Chief Executive of the Financial Reporting Council, from 2004 until 2009, and led the FRC’s work on Choice in the Audit Market during that period. Since leaving the FRC I have continued to take a close interest in corporate governance, financial reporting and audit issues. I was the group internal audit director for a globally systemically important insurance company and was President of the Chartered Institute of Internal Auditors in 2016/17.

This paper is a personal response to the CMA’s update report on its study into the market for statutory audit services which was published in December 2018.

It argues that whilst the CMA is to be congratulated for highlighting the problems in the market for the audit of large companies (primarily to do with too many instances of poor quality, shortage of choice and a lack of resilience in the market) the package of remedies proposed by the CMA, taken as a whole, will be expensive, disruptive and, probably, ineffective.

It goes on to argue that one of the potential remedies which the CMA has provisionally rejected (relaxing the restrictions on the ownership of audit firms) has more potential benefits, fewer downsides and a greater level of stakeholder support than the CMA has hitherto recognised and should be pursued as part of the long-term strategy to improve the operation of the audit market.

My paper is structured in four sections as follows:

1. An assessment of the CMA’s findings about the market
2. An assessment of the package of remedies proposed by the CMA
3. Proposals to strengthen the remedies by relaxing the restrictions on the ownership of audit firms
4. Conclusions

I hope that the CMA will find the paper useful as it finalises its recommendations to the government and I would be happy to discuss the paper in more detail if the CMA would find that helpful.

I am also content for this response to be treated as non-confidential and to be attributed to me.

Paul Boyle
January 2019
Executive Summary

The CMA’s update report on its study into the market for statutory audit services has performed a useful function in confirming, with an extensive evidential base, that the market is not working well. There are three main problems in the market:

1) There are so many examples of **poor quality** audits that they cannot be dismissed as isolated examples.
2) Large companies face a very limited – and, in some cases, no – **choice** of audit firms with the skills and experience needed to be effective auditors.
3) The market is **not resilient** as there is a non-zero risk of one of the Big Four firms exiting the market and, given the existing limitations on choice, the withdrawal of one of those firms would be very damaging.

My overall conclusions with regard to the CMA’s findings which underpin the three main problems in the market are as follows:

1) **Audit quality** I agree with the CMA that the incidence of poor quality audit is too widespread to be dismissed as isolated incidents but I disagree with their assessment that a significant portion of the responsibility lies with Audit Committee members – their role would be easier if they faced more choice in the market.
2) **Choice** I agree with the CMA that there is insufficient choice in the FTSE 350 market but I think that the CMA has failed to attach sufficient weight to one of the major factors contributing to the lack of choice, namely the barriers to entry of new firms into the market.
3) **Resilience** I agree with the CMA that there is a problem with regard to the lack of resilience in the market but I think that they have under-estimated the significance of the problem.

The problems in the market are serious and long-standing and there are no indications that actions of market participants within the framework of the current rules governing the market will address the problems. For these reasons interventions by public authorities justified but there are no ‘quick fixes’ and all potential interventions will take some years to be effective.

The CMA has proposed a package of six remedies which it considers will improve the functioning of the market. It is surprising that several of the CMA’s proposed remedies for the problems of choice and competition in the audit market should involve more intensive regulation of, and less choice for, the clients and increased revenues for the auditors. In my view, although some of the proposed remedies are potentially helpful, the most significant of remedies proposed will be expensive, disruptive, require intrusive regulation and will, probably, ineffective. Some of them should be rejected and some modified.

The package of remedies could be improved by re-instating a potential remedy - relaxing the restrictions on the ownership of audit firms - which has been provisionally rejected by the CMA but which has greater potential benefits, less significant downsides and a greater degree of stakeholder support than the CMA has recognised.

The current restrictions on audit firm ownership are anti-competitive – they are a constraint on the ability of firms to enter the market and/or to grow. The intention of the restrictions is to reduce the threats to audit quality. The key public policy judgement to be made is whether the audit quality benefits of the restrictions outweigh the anti-competitive disadvantages?

In my opinion, which has been reinforced by the evidence in the CMA’s update paper, the answer is “No”.

The principal objective of relaxing the restrictions on the ownership of audit firms is to increase the likelihood of entry into the market of new firms with sufficient capital to fund the investment in
skills and systems to be effective competitors. That remedy may also make it more likely that existing mid-tier could fund the investment in the additional skills which they require in order to be more successful competitors. A further potential benefit of the remedy would be to improve the resilience of the audit market.

The remedy does give rise to some new challenges, for example in relation to independence, but those challenges are not new in principle and are surmountable in the audit market in similar ways to which they have been overcome in other markets and professions.

Relaxing the audit firm ownership rules is a de-regulatory, pro-competition measure which meets the CMA’s criteria for assessing remedies and which compares favourably to some of the CMA’s proposed remedies in terms of cost and impact on choice in the market.

A change to the ownership rules for audit firms will require legislation, but this is not a reason not to pursue this option as the CMA has already recognised that its other proposed remedies will be more effective if implemented by legislation rather than using the more limited competition powers available to it.

Over many decades there has been a one-way ratchet of increasing concentration in the audit market. Liberalisation of the ownership rules has genuine potential to reverse the ratchet.

Liberalisation of the ownership rules will not, on its own, solve all of the problems in the market and it may take many years to have a material effect. But letting the market forces which have generally operated well to improve market outcomes in other sectors of the UK economy be applied to the market for audit services is surely a better way forward than a substantial increase in the regulatory burdens on our largest public companies just a moment in history when the competitiveness of UK public companies could be more important than ever.
1. Assessment of the CMA’s findings about the market

The CMA’s update report on its study into the market for statutory audit services has performed a useful function in confirming, with an extensive evidential base, that the market is not working well. The three main problems in the market are:

1) There are so many examples of poor quality audits that they cannot be dismissed as isolated examples.
2) Large companies face a very limited – and, in some cases, no – choice of audit firms with the skills and experience needed to be effective auditors.
3) The market is not resilient as there is a non-zero risk of one of the Big Four firms exiting the market and, given the existing limitations on choice, the withdrawal of one of those firms would be very damaging.

The CMA’s principal findings which give rise to these three problems can be summarised as follows:

a) There are so many indicators of poor quality audits that they cannot be dismissed as isolated examples.
b) There are deficiencies in the processes for the selection and oversight of auditors by Audit Committees.
c) Large companies face a very limited – and, in some cases, no – choice of firms other than their current auditors with the skills and experience needed to be effective auditors.
d) Firms wishing to challenge the Big Four face significant barriers, both on the demand-side and supply-side.
e) The market is not resilient as there is a non-zero risk of one of the Big Four firms exiting the market and, given the existing limitations on choice, the loss of one of those firms would be very damaging.
f) The tension between the ‘client service’ mindset which is appropriate for the non-audit services which make up the majority of audit firms’ revenue and the ‘challenge’ mindset which is necessary for audit work means that the current structure of firms undermines the incentives for audit quality.

My observations on each of these findings are set out below.

a) Audit quality shortcomings cannot be dismissed as isolated examples

I am supportive of this finding.

It is necessary to be realistic about the role which audit can play, about the impossibility of having no audit failures and the adverse consequences which would flow from having a zero tolerance for audit quality deficiencies. The question as to what is an acceptable tolerance level for audit quality deficiencies is a matter of judgement on which reasonable, informed commentators might have different views. In my view the incidence of audit quality deficiencies is above an acceptable tolerance level.

I find three aspects of the audit quality finding particularly striking:

1) The high number of deficiencies identified in audits undertaken by the Big Four audit firms, who have reputations for being the best in the market and who have very substantial scope, including high profit margins, to invest in audit quality.
2) The fact that all of the Big Four have broadly similar levels of audit quality shortcomings.
3) The fact that, when looked at over a four year period, the audit quality indicators for the mid-tier, challenger firms are generally poorer than those of the Big Four, notwithstanding
that the challenger firms are auditing clients which are much smaller and simpler businesses than the clients of the Big Four.

The issues affecting audit quality are complex and multi-faceted and are likely to require actions by both the CMA and the audit regulator. There is a question as to whether the CMA has struck the right balance between remedies which it, as a competition regulator, should propose and those which are better initiated by the audit regulator. I will address this in section 2.

**b) Selection and oversight processes adopted by Audit Committees are deficient**

I think that this finding is harsh, for the following reasons:

1) The CMA has given little or no weight to the fact that Audit Committee members, and other non-executive directors on Boards, have strong reasons for wanting high quality audits. Although the formal position is that the auditors’ role is to report to the shareholders on the appropriateness of the financial statements which have been approved by the directors, it is also the case that the directors pay close attention to the views of the auditors before deciding what adjustments, if any, to the draft financial statements prepared by management. If there are any material deficiencies in the financial statements then the directors will want the auditors to draw those deficiencies to their attention before they give their approval to the financial statements. Directors are very conscious of the damage which has been done to the reputations of the directors of those companies where material errors in the financial statements have been retrospectively identified and they really do not want the same fate to befall them. Of course, there may be the occasional example of where non-executive directors have deliberately acquiesced with management in the approval of misleading financial statements but these cases are very rare and should not be regarded as the default assumption on which the regulatory regime is based.

2) The CMA has given inadequate weight to the difficulties faced by Audit Committees as a result of the widespread existence of quality deficiencies across the audit firms of in making their audit selection decisions more on grounds of audit quality. In other circumstances it might be reasonable for directors and (shareholders who subsequently have to endorse the directors’ proposals) to adopt a policy of refusing to appoint any audit firm which had been the subject of a regulatory sanction for poor audit quality in the past five years. However, if such a policy were to be adopted in the current market there would be virtually no firms eligible for appointment.

3) The CMA has underplayed the contribution which good working relationships between the auditors and management makes towards audit quality. Although it is necessary for auditors to retain a high degree of professional scepticism as to what management tell them, an effective audit cannot be conducted if there is not a good working relationship between them. Good working relationships can, for example, lead to management being persuaded not to pursue a particular accounting treatment without the need for the auditors to formally raise objections in their published audit opinions or even in their private reports to Audit Committees. The CMA’s lack of appreciation of this point has led them to regard the need for good relationships as an overly negative aspect of the selection processes currently used by companies.

4) The CMA’s point about the potential for divergence between the interests of shareholders and the wider stakeholders interests (eg pensioners) is an interesting one but it should not have influenced its recommendations on what to do about the audit market given the current responsibilities of auditors as stated in the Companies Acts. This point is better picked up in the Brydon review of the role of audit in society or in debates about other
aspects of regulation (eg whether the regulatory regime for pensions is sufficiently effective).

As I will explain in more detail in section 2, the fact that I am uncomfortable with the CMA’s finding on this topic means that I have significant reservations about its proposed remedy to address the finding.

c) **Shortage of choice of auditors of large companies**

I am supportive of this finding.

Although in some cases Audit Committee may find that they have an adequate range of firms with appropriate capabilities from which to chose, there is compelling evidence that this is not true in a sufficiently large number of cases for it to be regarded as a public policy problem which requires action.

The strength of this conclusion is substantially reinforced by the finding on market resilience below. Given this finding all remedies to increase the number of audit firms who could be effective auditors of large companies should be explored. In section 2 I will comment on the remedies proposed by the CMA and in section 3 I will comment on an additional measure which the CMA has rejected.

d) **Barriers to non-Big Four firms**

I am supportive of this finding that there are significant barriers to existing challenger firms who wish to be effective competitors in the FTSE 350 audit market.

There is a “push-me-pull-you” aspect to this finding. On the one hand, companies have, in some cases, genuine concerns about the present capabilities of challenger firms and so have a reluctance to appoint them whilst, on the other hand, challenger firms have genuine concerns about their willingness to invest in additional capabilities given the limited prospects for success in tenders. The lack of any meaningful change in the challenger firms’ share of the FTSE 350 market illustrates the powerful forces of inertia within the framework of the current rules governing the market.

Something needs to change for this inertia to be overcome. There is a question as to at which side of the market the changes are best targeted. As discussed in the next section the CMA’s most impactful proposed Remedies are targeted at the company side but there are grounds for focusing more effort on the firm side.

In addition to its finding, I think that the CMA has omitted to mention one other very important barrier which is relevant to the inertia in the FTSE 350 audit market: the barriers to new entrants to the market. This is a surprising omission given the widely recognised importance of new entrants to dynamic competitive markets and the formal Strategic Steer which the government has given to the CMA which includes a need for focus on “removing barriers that prevent new start-up businesses or new disruptive business models from accessing or expanding in existing markets”

As I will explain in section 3 I think that it may be possible to have more impact on inertia through the injection of some new DNA into the market.
e) Lack of resilience of the market for statutory audit

I am supportive of this finding and think that, if anything, the CMA has understated the probability and impact of the failure of a Big Four firm.

As regards probability, the incidence of failure of audit firms is rare and so it is impossible to reliably estimate the probability of failure. However, the following table illustrates the progressive nature of the risk. The entries are explained below the table.

Table: Build-up of probability of a failure of a Big Four firm (illustrative probabilities)

<table>
<thead>
<tr>
<th>Firm affected</th>
<th>Location</th>
<th>Line of business in which the event occurs</th>
<th>Time period</th>
<th>Illustrative probability (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 One specific firm</td>
<td>UK</td>
<td>Audit</td>
<td>Next 12 months</td>
<td>0.1</td>
</tr>
<tr>
<td>2 Any of Big Four</td>
<td>UK</td>
<td>Audit</td>
<td>Next 12 months</td>
<td>0.4</td>
</tr>
<tr>
<td>3 Any of Big Four</td>
<td>Anywhere in the global network</td>
<td>Audit</td>
<td>Next 12 months</td>
<td>1.0</td>
</tr>
<tr>
<td>4 Any of Big Four</td>
<td>Anywhere in the global network</td>
<td>Any service line</td>
<td>Next 12 months</td>
<td>5.0</td>
</tr>
<tr>
<td>5 Any of Big Four</td>
<td>Anywhere in the global network</td>
<td>Any service line</td>
<td>Next 5 years</td>
<td>10.0</td>
</tr>
<tr>
<td>6 Any of Big Four</td>
<td>Anywhere in the global network</td>
<td>Any service line</td>
<td>Next 25 years</td>
<td>50.0</td>
</tr>
</tbody>
</table>

Explanatory notes to the table

1) The probability that a specific individual Big Four audit firm might fail in the next twelve months triggered by a problem arising in its audit practice (eg a major audit failure leading to loss of client confidence and/or substantial damages awarded in litigation and/or a loss of the licence to audit) in the UK is likely to be low, but not zero. For the sake of illustration let’s assign a probability of 1-in-1,000 (0.1%) to such an event.

2) From a public policy perspective with regard to market resilience, the relevant probability is not that of a failure of a specific individual Big Four audit firm but the probability of any of the Big Four failing. The probability of any one of the Big Four firms failing in the next 12 months attributable to a problem in their audit practices in the UK may still be low, but it must be greater than that in row 1. On the assumption that the risks in the other firms are similar to those in the firm in row 1, then we could assign a probability of 1-in-250 (.04%) to such an event.

3) Due to their global nature of their international networks the Big Four audit firms are exposed to risks arising in other parts of the world. For example, the collapse of Arthur Andersen in the UK was attributable to events in the US. The Big Four networks operate in around 150 jurisdictions, including in many jurisdictions which might be regarded as “high risk” for reasons of financial crime or tax avoidance. Although it may be possible for the Big Four to prevent some issues arising in some jurisdictions from triggering the failure of their UK audit practice, it remains the case that the probability of any one of the Big Four firms in the UK failing in the next 12 months attributable to a problem in their audit service line anywhere in their global audit practices must be greater than that in row 2. For the purposes of illustration let’s assign a probability of 1-in-100 (1%) to such an event.
4) Due to their multiple service lines the Big Four firms are exposed to risks arising in service lines other than audit. For example, the firms are exposed to a very wide range of financial, regulatory and reputational risks arising from consultancy, tax and transaction advisory services. Indeed as the firms continue to expand the breadth of their services it is arguable that their risks may increase as their ability to manage a broader set of risks may diminish. As a consequence the probability of any one of the Big Four firms in the UK failing in the next 12 months attributable to a problem anywhere in the world from any one of their service lines must be greater than that in row 3. For the purposes of illustration, let’s assign a probability of 1-in-20 (5%) to such an event.

5) So far we have only considered the probability of a firm failing in the next 12 months, but the probability of an event is influenced by the duration of exposure to its consequences. The dominant position of the Big Four has existed for many years and, based on current public policies, there is little reason to believe that it will not continue for, say, the next 5 years. As a consequence the probability of any one of the Big Four firms in the UK failing in the next 5 years attributable to a problem anywhere in the world from any one of their service lines must be greater than that in row 4. For the purposes of illustration, let’s assign a probability of 1-in-10 (10%) to such an event.

6) Indeed the extended duration of Big Four dominance means that on current public policies it is likely to extend well beyond the next 5 years – perhaps for 25 years. As a consequence the probability of any one of the Big Four firms in the UK failing in the next 25 years attributable to a problem anywhere in the world from any one of their service lines audit practices must be greater than that in row 5. For the purposes of illustration, let’s assign a probability of 1-in-2 (50%) to such an event.

As acknowledged earlier in this section, there is no reliable basis for estimating the probability of the various events described in the table above and so the absolute values of the probabilities in the table must be regarded with caution – they may be too high or too low. However, the progressive nature of the trend of probabilities in the table does feel intuitively correct.

And of course, it would be unwise for public authorities to operate on the basis that Murphy’s Law (“if anything can go wrong it will do so”) does not apply to the audit market. What probability would have been assigned on 1 January 2001 to the collapse of Arthur Andersen in the UK later that year? During 2001 the probability of collapse of that firm went from “extremely low” to “inevitable” with only a short pause in “possible”.

As regards impact, the scope of the CMA’s study is the market for statutory audits (under the Companies Acts) in the UK of large companies, both listed and private, and public interest entities (PIEs) (ie companies traded on a regulated market, credit institutions such as banks and building societies and insurance companies). However, it is worth noting that the Big Four firms also have very large shares of the market for other services in which there is also a substantial public interest. Examples include the provision of audit or assurance services in relation to the financial information supplied to financial services regulators, the audit of the financial statements of local government and health service organisations, the review of prospectuses and profit forecasts and the provision of insolvency services. The collective share of the Big Four firms in these markets is also substantial, particularly in relation to the largest clients in those markets. This means that the issues of choice and lack of resilience will also be relevant to those markets: the demise of a Big Four firm would have a much wider impact than just the market for statutory audit services.

A further illustration as to why the impact of a demise of a Big Four firm may be even greater than stated by the CMA relates to timing. Finagle’s corollary to Murphy’s law states that “Anything that can go wrong, will do so – at the worst possible moment.” The most popular financial year-end for
FTSE 350 companies is 31 December and most of their audits are completed by the end of March. The collapse of a Big Four firm in the period from, say, November to March could leave many companies in the position where they face an even more limited choice of audit firms they may simply be unable to find any audit firm which could complete their audit within their normal reporting calendar, or possibly with the deadlines imposed by the Listing Rules.

It is also worth noting that whilst an audit failure affecting an individual company is undesirable its consequences are typically not widespread across the economy. The collapse of any one of the Big Four firms would cause a wholly greater level of detriment across a wide spectrum of the economy.

The CMA has acknowledged that the current range of regulatory tools for dealing with an audit firm which is in trouble are inadequate. Things can move very quickly as was seen in the case of Arthur Andersen when a ‘run on the firm’ (by clients and partners and staff) proved to be fast-moving and impossible to stop.

The public policy question is what is the appropriate risk appetite for the collapse of a Big Four audit firm. This question is also a matter of judgement on which reasonable, informed commentators might have different views. In my view, given the combination of non-zero probability of failure, widespread potential impact and the current absence of effective regulatory tools for dealing with the consequences of such a failure the risks are well outside what I would regard as a reasonable risk appetite.

The current position might reasonably be described as one in which the Big Four firms are too big to fail and simultaneously too complex to save.

In the light of this assessment my view is that the risks arising from a lack of resilience in the FTSE 350 audit market are even greater than the risks arising from audit quality failures and as a result it is very important that the remedies are focussed resilience at least as much as on quality.

f) Structure and culture of audit firms poses a threat to audit quality

I support the finding.

Some of the findings of the FRC’s AQR reviews and enforcement cases that fundamental technical or ethical errors were being made in the course of audits undertaken by all of the major firms, including challenger firms, suggests that there may be a broader cultural problem in the firms, which could be driven by a number of factors, including the pressure to maintain or increase profit-per-partner which is a key performance metric by which the firms judge their success. The fact that margins on audit work are generally lower than margins on other service lines may increase the threat to audit quality.

However, as is discussed in section 2, the remedy proposed by the CMA is only one, and possibly not the optimal, way of addressing this issue.

Overall conclusions on the CMA’s findings

In my view the CMA have done a good job in demonstrating that there is are significant problems in the market for audit services, albeit that the problems had already been well-documented and understood on several occasions in the past two decades.

My overall conclusions with regard to the CMA’s findings which underpin the three main problems in the market are as follows:

- **Audit quality** I agree with the CMA that the incidence of poor quality audit is too widespread to be dismissed as isolated incidents but I disagree with their assessment that a significant portion
of the responsibility lies with Audit Committee members – their role would be easier if they faced more choice in the market.

- **Choice** I agree with the CMA that there is insufficient choice in the FTSE 350 market but I think that the CMA has failed to attach sufficient weight to one of the major factors contributing to the lack of choice, namely the barriers to entry of new firms into the market.

- **Resilience** I agree with the CMA that there is a problem with regard to the lack of resilience in the market but I think that they have under-estimated the significance of the problem.

Given the vital role that audit services play in the economy, not just in relation to the capital markets but across a much broader range of activities, it would be unwise to leave these issues addressed – something must indeed be done! However, given that I do not fully agree with the CMA’s findings this has a bearing on my assessment of the CMA’s package of remedies, which is the focus of the next section.
2. **Assessment of the package of remedies proposed by the CMA**

The CMA has proposed a package of six remedies which it considers will improve the functioning of the market:

1. Regulatory scrutiny of Audit Committees
2. Mandatory joint audit **OR** 2.A Market share cap
3. Additional measures to support challenger firms
4. Market resilience regime
5. Split between audit and non-audit services: full structural **or** operational
6. Peer review

The CMA has identified the following criteria against which its proposed remedies should be assessed:

a) Do they address the underlying concerns identified?

b) Can they be implemented, monitored and enforced effectively?

c) Are they proportionate to the scale of the issue?

d) What are the potential risks and unintended consequences?

My assessment of each of these proposed remedies is set out below, together with proposals for modifying or, in some cases, rejecting the remedies.

**Remedy 1: Regulatory scrutiny of Audit Committees**

In my opinion this remedy is unlikely to be effective, is disproportionate, involves a significant extension of regulation and risks considerable unintended consequences. The main drawbacks in my view are:

a) The explicit premise on which this remedy is based is that Audit Committees cannot be trusted to act in the best interests of shareholders when it comes to the selection and oversight of auditors. This is an assertion which, if true, would have much wider implications. Audit Committee members have to make many decisions which have an impact on shareholders not only in the Audit Committee but in their capacity as Board members. Many of these decisions will have a much greater impact on shareholders than those related to auditors. Examples include the recruitment and dismissal of the CEO, whether to accept a takeover offer, whether to make an acquisition or enter a new market. In making their decisions directors have specific statutory duties with regard to the interests of shareholders and other stakeholders in the company and they face public and private legal risks if they disregard those duties.

Is it the view of the CMA that directors cannot be trusted to act in the interests of shareholders when they make those bigger decisions? If that were to be the case then the entire regime of corporate governance would be called into question.

In my experience the suggestion that directors of large companies do not base their decisions primarily on what is in the interests of the shareholders, having regard to their duties to other stakeholders, is unfounded. Yes, it would be easy to point to certain decisions whose wisdom could be challenged but it would be completely disproportionate to adopt a working assumption that generally speaking directors cannot be trusted to act in shareholders’ interests.

b) I think that the CMA has not given sufficient weight to the incentives for Audit Committee members for the audits of their companies to be of a high quality. The members of the
Audit Committee, as members of the board, have legal obligations to make sure that the financial statements which the company publishes give a true and fair view and meet the relevant disclosure requirements. In making their decisions as to whether to approve the financial statements the directors will want to know that the auditors are also content to give an unqualified audit opinion on the financial statements. Although there may be a few examples of companies where non-executive directors have colluded with management in publishing misleading financial statements, in the majority of cases non-executive directors are victims of poor audit quality. If poor audit quality results in the publication of inappropriate financial statements then this causes a lot of difficulties for the non-executive directors.

c) Even if there are some cases in which Audit Committees might be tempted to make auditor-related decisions which are not motivated by audit quality, I do not believe that a requirement to report to a regulator or to make decisions whilst a regulator is in the room will be effective in changing those decisions. What is more likely is that the “real” decisions and discussions will be moved to another meeting at which the regulator is not present and then the formal meeting will be stage-managed in order not to arouse regulatory suspicions.

d) The proposal to apply this remedy to all large companies with the objective of changing the behaviour of a small number of companies who might make inappropriate decisions is disproportionate. I consider that the CMA’s statement that “even a few Audit Committees falling short in meeting their obligations is too many.” (paragraph 4.22) is not an appropriate risk appetite for a public authority. The aim of achieving zero failures is unachievable and any attempt to do will impose disproportionate costs.

e) The proposal risks blurring the accountability of Audit Committees for their auditor selection and oversight decisions. For example, if the involvement of the regulator is to make any difference then presumably there will be occasions on which Audit Committee preferences will be altered as a result of regulatory intervention. This will blur accountability. If, on the other hand, it is not envisaged that these occasions would occur then what is the point of having the regulator involved.

f) I think that the impact of inappropriate or ineffective behaviour of Audit Committees to the problems in the audit market are minimal relative to other factors affecting audit quality. As the CMA has clearly demonstrated in its study, a substantial number of Audit Committees face limited or no choice when it comes to auditor selection. The much more important priority is to give Committees a larger number of credible and independent firms from which to chose. This would make it much easier for Audit Committees to give greater weight to audit quality in their selection decisions. How best to address this priority is discussed later in this paper.

g) The proposal that the remedy should be accompanied by a power for the regulator to public reprimand Audit Committees is based on a belief that the judgement of the regulator is superior to that of the Audit Committees. This is, in my view, incorrect. Auditor-related decisions are complex and can be affected by many factors, some of which may involve topics which are, properly, discussed in fora other than the Audit Committee. It is not likely that the staff working for the regulator will be more knowledgeable and experienced that the members of the Audit Committee. It is not likely that a regulator will be better-placed than the Audit Committee to make these judgements.

h) The issuance by a regulator of a public reprimand of Audit Committees could have a substantial impact on the company and the personal reputations of the Audit Committee members. Such a reprimand could only be issued after extensive due process, particularly
as the decisions are more judgemental rather than objective. The number of occasions on which such reprimands might be issued is likely to be very low, thus further reducing the impact of the remedy on audit quality.

i) A potential unintended consequence of this remedy is to reduce the willingness of talented individuals to join boards or to serve on Audit Committees. Some potentially good directors might decline to take up roles which expose them to the risk of potential scrutiny and reprimand by a regulator who is less well-informed than they are.

It is surprising that the CMA’s first proposed remedy for the problems of choice and competition in the audit market should be costly, intrusive - and likely ineffective - regulation of the clients rather than the auditors!

I think that a more appropriate Remedy would be a continuation of the trend over recent years of requiring greater transparency by Audit Committees of the efforts they have made to ensure that their auditors are effective.

The effectiveness of this alternative Remedy would be enhanced if there were a greater level of shareholder interest in matters relating to audit quality, more in line with the shareholder interest in executive remuneration. For this reason I recommend that the CMA makes a recommendation to the FRC or its successor body to reflect the expectation of greater shareholder interest in audit matters in the next iteration of the Stewardship Code.

Remedy 2: Mandatory joint audits

It is difficult to assess this Remedy as described by the CMA because of the significance of the design decisions which were left open in the update paper.

The most important open question is whether or not the design of the remedy should mandate that the audit pairs must include a non-Big Four firm. The CMA’s stated aim of this Remedy is “to reduce the barriers to auditing large companies faced by the challenger firms.” (paragraph 4.29)

This focus on the challenger firms is confirmed by the CMA’s statement that “we expect that the remedy would lead to a significant increase in the size of some challenger firms.” (paragraph 4.51)

In the light of these statements it is surprising that the CMA regards mandatory inclusion of a non-Big Four firm as being an open question. The introduction of mandatory joint audit in which it was permissible to appoint two Big Four firms would have the effect of increasing the size of the Big Four firms (and the gap between them and the challenger firms), especially given the observed preference of Audit Committees of FTSE 350 companies to chose Big Four firms rather than challenger firms.

Given the stated aim to improve the position of the challenger firms I presume that the CMA will, on reflection, conclude that the Remedy must mandate the inclusion of a non-Big Four firm. My assessment of this Remedy is based on this presumed modification.

The CMA noted that there may be some types of companies (eg banks) for which the challenger firms may not have the required skills. I suspect that there might be a much larger category of companies which fall into this category. Examples which readily come to mind are insurance companies, companies utilising complex commodity, currency or interest-rate hedging strategies as part of their risk management and companies with very extensive international operations. I expect that there will be considerable scope for debate as to which companies fall into this category. The CMA’s proposed approach to this category of companies is to permit the appointment of two Big Four firms as joint auditors but in the light of the point made in the previous paragraph about the perverse outcome of mandatory joint audit by two Big Four firms I
presume that the CMA will revise this proposal to accept that this category of companies will not be required to appoint joint auditors. In view of the additional costs to be faced by companies with joint auditors I imagine that this will increase the incentives for companies to argue that they fall into the “too complex for joint audit” category.

The main implications of this remedy would be the certain imposition of additional burdens and, possibly, audit quality risks on companies whilst the emergence of the hoped-for benefits would be highly uncertain.

That there would be additional burdens imposed on companies who are required to appoint joint auditors as a consequence of this Remedy is certain, even if the extent of those burdens is hard to predict. The main burdens would be:

i. Increased audit fees due to the need to have two audit firms do enough audit work to take full responsibility for the audit opinion.

ii. Increased costs of managing the rotation of the joint auditors across the various parts of the company. The CMA envisages that there would be regular changes in the allocation of audit procedures between the joint auditors over the years. This would mean that at an operational level the frequency of change of auditors would double which would result in increased costs due to, for example, the need to explain the systems and procedures to the newly allocated firm.

iii. Increased audit tender costs. The CMA has proposed that the two auditors be appointed in different years with unmatched appointment periods so that the joint auditors would normally leave one at a time when mandatory rotation was required. This would allow some knowledge and experience to be retained in the remaining audit firm. However, from the company’s perspective this would double the frequency of audit tenders, which are costly for companies to manage.

iv. Increased costs of the final stages of the audit due to the need to interact with, and potentially negotiate with two audit firms in order to arrive at an unqualified audit opinion

v. Reduced choice of auditors due to the need to have two auditors

vi. Potential reduction in audit quality in view of the (presumed) mandatory requirement to appoint a non-Big Four firm in circumstances in which it may be very difficult for Audit Committees to assess whether or not they have the necessary capabilities to deliver a high quality audit.

vii. Increased regulatory fees to pay for the extra tasks assigned to the regulator under this Remedy. The CMA is clear that the introduction of mandatory joint audit will need to be overseen by the regulator. It may, for example, need to fall to the regulator to determine whether a company falls into the category which would be exempt from the requirement to appoint joint auditors. These additional tasks for the regulator which result in higher direct costs (regulatory fees) and indirect costs such as time of Audit Committee members and management in interacting with the regulator.

viii. Finally, the involvement of the regulator in the decision-making over the appointment of joint auditors is likely to blur the accountability of Audit Committee members for their appointment decisions. For example, if the involvement of the regulator is to make any difference then presumably there will be occasions on which Audit Committee preferences will be altered as a result of regulatory intervention. This will blur accountability. If, on the other hand, it is not envisaged that these occasions would occur then what is the point of having the regulator involved.

The realisation of the hoped-for benefits of this Remedy is very uncertain for both supply and demand side reasons.
On the supply side, the effectiveness of the CMA’s remedy will be dependent upon the reaction of the challenger firms. Although at first glance one might have thought that they would jump at the opportunity being presented to them by the CMA’s remedy, there are some reasons why they may be cautious. Two reasons are likely to be prominent in their consideration.

First, their success in securing even “second auditor” status under mandatory joint audits will be dependent upon them demonstrating to Audit Committees (which will be under enhanced regulatory scrutiny under Remedy 1) that they have the capacity and skills to undertake their portion of the audit without putting audit quality at risk. This will require the firms to have recruited additional skilled and experience staff in advance of securing new joint auditor engagements. The challenger firms will have to reflect on whether they can fund the necessary investment and whether it is likely that they will see an adequate return on that investment.

Secondly, the projected rate of return which the challenger firms will require before confirming their willingness to invest will need to reflect the level of risk associated with the investment. The risk includes the additional exposure to litigation and enhanced regulatory scrutiny associated with being even a joint auditor of much larger and more complex clients than they have experience of. It remains to be seen what view they will take on this.

A further open question on the supply side is the reaction of the Big Four firms. The CMA’s hope that mandatory joint audit will give an opportunity for challenger firms to boost their capabilities is dependent on the co-operation of the Big Four firms. Under joint audit arrangements both audit firms are jointly liable for the entire audit, even for the parts of it which they did not themselves undertake. This means that the Big Four will have to take a view on their willingness to accept liability for audit work done by challenger firms who, at least in the early years, will not have much experience of auditing large companies. In making their decision the Big Four will no doubt have regard to the results of the FRC’s AQR inspections which show that the quality of audits undertaken by the challenger firms is lower than that of the Big Four, even though the challenger firms are auditing smaller and less complex clients than the Big Four. It remains to be seen what view they will take on this.

On the demand side, it remains to be seen how many companies will be able to secure exemption from the requirement to appoint joint auditors; this may in turn have an adverse impact on the willingness of the challenger firms to invest. The forces of inertia in the market may well prove to be more stubborn than the CMA hopes.

The appointment of joint auditors is legally permissible currently in the UK but there are almost no examples of it in practice from which it is reasonable to conclude that companies and, possibly, audit firms believe that its potential advantages are outweighed by its disadvantages. For this reason it would be a major market intervention to make the appointment of joint auditors mandatory.

My overall assessment is that the costs-benefits trade-off of this Remedy is unattractive and that it should not be pursued. As with Remedy 1, it is surprising that the second of the CMA’s proposed remedies for the problems of choice and competition in the audit market should be costly, intrusive - and potentially ineffective – burdens on the clients rather than the auditors!

However, the CMA’s underlying desire to strengthen the competitive position of firms outside the Big Four is appropriate … but there is another way of making that outcome more likely than it is at present, which I shall discuss in section 3.
**Remedy 2A: Market share cap**

As is the case with the joint audit Remedy, it is difficult to assess this Remedy as described by the CMA because of the significance of the design decisions which were left open in the update paper. In this case it is even more difficult as there are even more open design questions. However, it is possible to comment on the main overall implications of this Remedy.

As is the case with the joint audit Remedy, that there would be additional burdens imposed on companies as a consequence of this Remedy is certain, even if the extent of those burdens is hard to predict. The main burdens in this case would not be costs but rather:

i. Reduced choice as some firms who would like to appoint a Big-Four auditor would be unable to do so.

ii. Potential reduction in audit quality in view of the requirement to appoint a non-Big Four firm in circumstances in which it may be very difficult for Audit Committees to assess whether or not they have the necessary capabilities to deliver a high quality audit.

iii. Finally, the involvement of the regulator in the decision-making over the appointment of joint auditors is likely to blur the accountability of Audit Committee members for their appointment decisions. For example, if the involvement of the regulator is to make any difference then presumably there will be occasions on which Audit Committee preferences will be altered as a result of regulatory intervention. This will blur accountability. If, on the other hand, it is not envisaged that these occasions would occur then what is the point of having the regulator involved.

As in the case of the joint audit Remedy, the realisation of the hoped-for benefits of this Remedy is very uncertain, primarily for supply side reasons.

The effectiveness of the CMA’s remedy will be dependent upon the reaction of the challenger firms. Although at first glance one might have thought that they would jump at the opportunity being presented to them by the CMA’s remedy, there are some reasons why they may be cautious. Two reasons are likely to be prominent in their consideration.

First, their success in securing appointments will be dependent upon them demonstrating to Audit Committees (which will be under enhanced regulatory scrutiny under Remedy 1) that they have the capacity and skills to undertake their portion of the audit without putting audit quality at risk. This will require the firms to have recruited additional skilled and experience staff in advance of securing new joint auditor engagements. The challenger firms will have to reflect on whether they can fund the necessary investment and whether it is likely that they will see an adequate return on that investment.

Secondly, the projected rate of return which the challenger firms will require before confirming their willingness to invest will need to reflect the level of risk associated with the investment. The risk includes the additional exposure to litigation and enhanced regulatory scrutiny associated with being even a joint auditor of much larger and more complex clients than they have experience of. It remains to be seen what view they will take on this.

My overall assessment is that this Remedy should not be pursued. As with Remedies 1 and 2, it is surprising that the second of the CMA’s proposed remedies for the problems of choice and competition in the audit market should be costly, intrusive - and potentially ineffective – burdens on the clients rather than the auditors!

However, the CMA’s underlying desire to strengthen the competitive position of firms outside the Big Four is appropriate ... but there is another way of making that outcome more likely than it is at present, which I shall discuss in section 3.
Remedy 3: Additional measures to support challenger firms

I think that “liquidity” in the market for experienced auditors will be essential if there is to be a change in the relative competitive position of the firms in the audit market and the proposed Remedy relating to non-compete clauses is to be welcomed. However, I think that the extent to which constraints on personnel moves between firms is a contributor to the problems of quality, choice and resilience in the market is minimal relative to the other problems and so I expect that this Remedy will have little overall impact on the structure of the market.

The CMA was minded not to make proposals relating to a tendering fund or sharing of technology between Big Four and challenger firms in the light of the other Remedies which it had proposed. However, in view of my recommendation that Remedies 1, 2 and 2A not be pursued I think that the CMA should reconsider the merits of these other measures. I am not optimistic that they will make a big difference but at the margin they could be helpful and given the inertia in the market they are worth considering.

Remedy 4: Market resilience regime

In view of my assessment in section 2 of the significance of the risks caused by the lack of resilience of the market I am supportive of this Remedy and indeed think that it should be developed further.

There are potentially helpful lessons which can be drawn from financial services regulation, where there is a distinction between conduct of business regulation and prudential (or, as it is sometimes referred to, safety and soundness) regulation

In the financial services market, conduct of business regulation is concerned with customer outcomes: do the customers get products and service which meets their requirements? The regulator sets rules which financial services firms must comply with, monitors compliance and makes interventions, including in some cases, enforcement action in cases where they believe that customers’ interests are not being sufficiently safeguarded.

The broad equivalent in the audit market is audit quality regulation. There has been audit quality regulation in the UK for many years and it has been made more independent and intensive over the years, notably through the extension of the role of the FRC to audit regulation in 2004. The Kingman proposals will represent a further significant enhancement of audit quality regulation.

With regards to prudential regulation in financial services the aim has been to protect the resilience of the market and the interests of individual consumers in the event of a collapse of a financial services firm. The prudential regulator also sets rules which financial services firms must comply with, monitors compliance and makes interventions, including in some cases, enforcement action. Notably the prudential regulator also has specific duties in relation to failed firms and, following the financial crisis of 2008, now has additional powers to “resolve” failing firms.

In the audit market there has never been any form of prudential regulation. The FRC has in recent years taken some tentative steps in this direction in the light of its designation as the competent authority for audit regulation under the latest EU audit legislation but its remit falls well short of that of a full-scope prudential regulator.

In the light of the significance of the risks associated with the lack of resilience in the market I think that the CMA should recommend that the remit of the FRC or its successor under the Kingman recommendations should be extended to be equivalent to the prudential responsibilities of the PRA and the FCA. The objectives of this prudential regulation would be twofold:
1) To ensure that the audit firms were governed and managed in a way which reduced, but did not eliminate, the possibility of an unplanned collapse of the firm.

2) To ensure that there were, as far as is reasonably practicable, arrangements in place to ensure that a failing audit firm could be “resolved” in an orderly way.

The Kingman review has already recommended that the FRC’s successor should have a competition objective along the lines of that of the FCA and the interaction of these prudential objectives with that competition objective would require further consideration.

**Remedy 5: Full or operational split of audit firms**

**Full structural separation**

The CMA has concluded that this option would be disproportionate relative to other options and should not be pursued at this time. I am supportive of this conclusion.

**Operational split of firms**

As I indicated earlier in this paper, I agree with the findings of the CMA that the size and nature of the non-audit services provided by the major “audit” firms results in cultural tensions which may be prejudicial to audit quality. However, I think that this Remedy is unlikely to be effective and should be replaced by an alternative Remedy, which I propose below.

The major “audit” firms (both Big Four and challenger firms) have all adopted multi-disciplinary service lines. I believe that, with one major exception which needs to be addressed, the multi-disciplinary business model operates in the interests of clients and the firms. Specifically as regards audit clients, I am persuaded that the ability to access the services of specialists who are not primarily engaged in audit work but whose expertise can inform the judgements of the partners who are formally responsible for audit opinions makes a positive contribution to audit quality.

The firms clearly have a multi-disciplinary business model and culture. The range of services provided by the “audit” firms has expanded over time and is likely to continue to expand in future. A regulatory intervention which seeks to ‘cut across’ the business model of the firm is, in my view, unlikely to be effective. The CMA itself recognises that operational split would be complex to operate and would require stringent regulatory oversight to ensure that its aims were not circumvented.

Operational split has been likened by some to the “ring-fencing” arrangements whereby banks are required to separate their deposit-taking activities from their ‘casino banking’ investment banking activities. However, there is a very clear distinction between the objectives of “ring-fencing” in banking and the operational split envisaged by the CMA for audit firms.

In the case of bank “ring-fencing” there is a very specific financial objective to ensure that the safety of customers’ deposits is not put at risk by potential losses in the ‘casino banking’ activities. In the case of operational split of audit firms, the objective is to achieve cultural change to preserve the high degree of challenge required to deliver high quality audits. There is a well-known phrase that “culture eats strategy for breakfast” and I think that it is likely that in the case of firms which are operationally split but where all of the partners remain joint owners of the entire firm and where there is a high degree of service provision across the audit/non-audit boundary that the “multi-disciplinary firm culture will eat regulation for breakfast”.

I think that a more promising approach would be to accept the multi-disciplinary nature of the firms but to require strengthened management and governance arrangements to re-inforce the importance of audit quality but which would be applicable to the entire firm. These arrangements...
would be predicated on the need for all partners and staff in the firm to acknowledge the public interest nature of the firm’s audit assignments and to commit to meeting expectations of independence, objectivity and integrity.

It would be understandable if this proposal was to be met with a certain degree of scepticism but the values of independence, objectivity and integrity are applicable to all of an “audit” firm’s activities and would serve it well in relation to tax, corporate finance and other professional services.

The proposal would build on the Audit Firm Governance Code, which was instigated by the FRC during its work on Choice in the Audit Market in 2006 - 07. The most recent version of the Code was published in 2016. Its principal objectives are very relevant to the CMA’s market study:

- To promote audit quality
- To help the firm secure its reputation more broadly, including its non-audit business
- To reduce the risk of firm failure, which in relation to the largest firms would be of systemic significance

In the light of the CMA’s findings it would be fair to conclude that the Code has so far been insufficiently effective and so would benefit from strengthening. Ideas for strengthening could include:

i. Increase the number of Independent Non-Executive Directors (INEDS) on the firm’s governing body, possibly to the extent that they constituted a majority.

ii. Extend the role of the INEDs by requiring the establishment of audit and risk committees on which only the INEDs would be members.

iii. Strengthen and increase the independence of the risk, compliance and internal audit functions within the firms.

In the case of companies their compliance with the UK Governance Code is designed to be monitored by shareholders who have some enforcement powers through their right to vote on key governance motions (eg appointment of directors, remuneration policies, etc) at General Meetings. In the case of audit firms, the owners of the firm (ie its partners) are also its managers and so shareholder monitoring of audit firm governance is insufficiently effective to protect the public interest. For this reason the new audit regulator should be given the responsibility for monitoring and reporting publicly on the implementation of the code by audit firms.

Remedy 6: Peer review

I am not supportive of this Remedy.

There is one striking omission from the CMA’s explanation of how this Remedy might work in practice: there was no acknowledgement of the impact which this Remedy would have on the already limited choice of auditors faced by FTSE 350 firms.

The main implications of this remedy would be the certain imposition of additional burdens on companies whilst the emergence of the hoped-for benefits would be highly uncertain.

That there would be additional burdens imposed on companies as a consequence of this Remedy is certain, even if the extent of those burdens is hard to predict. The main burdens would be:

i. Increased costs (paying for peer reviewer).

ii. Increased costs of the final stages of the audit due to the need to interact with, and potentially negotiate with the peer reviewer in addition to the two audit firms in order to arrive at an unqualified audit opinion.
iii. Reduced choice of auditors due to the need to have two, or possibly three auditors
iv. Increased regulatory fees to pay for the extra tasks assigned to the regulator under this Remedy. The CMA is clear that the introduction of mandatory joint audit will need to be overseen by the regulator. It may, for example, need to fall to the regulator to determine whether a company falls into the category which would be exempt from the requirement to appoint joint auditors. These additional tasks for the regulator which result in higher direct costs (regulatory fees) and indirect costs such as time of Audit Committee members and management in interacting with the regulator.
v. Finally, the involvement of the regulator in the decision-making over the appointment of peer reviewers is likely to blur the accountability of Audit Committee members for their appointment decisions. For example, if the involvement of the regulator is to make any difference then presumably there will be occasions on which Audit Committee preferences will be altered as a result of regulatory intervention. This will blur accountability. If, on the other hand, it is not envisaged that these occasions would occur then what is the point of having the regulator involved.

Peer review as envisaged by the CMA might identify poor audit quality in real-time and nip it in the bud but even in isolation the additional costs (in the regulator, the direct cost of the peer reviewer and the indirect costs imposed on the audit firms and the companies) are likely to be significant – and even more so if this remedy is implemented as well as Remedy 2 (mandatory joint audits) as this would result in three audit firms reviewing a company’s financial statements before they are published. It is hard to see how this remedy could pass a cost-benefit assessment.

**Remedies which the CMA proposes not to take forward**

With one major exception, I agree with the CMA’s decision not to take forward a number of remedies on which it had consulted (paragraph 4.156):

- breaking the Big Four into smaller audit firms;
- introducing an insurance-based firm;
- creating an NAO-style auditor for private sector auditors;
- further changes to the frequency of auditor tendering or rotation; and
- changes to restrictions on ownership of audit firms.

The major exception relates to the possible changes to the restrictions on ownership of audit firms, which I discuss in detail in section 3.

**Overall assessment of the proposed remedies**

I think that there is a real danger that the package of remedies proposed by the CMA will cause more harm than good. I think that there are three main reasons why the CMA should reconsider its proposed remedies.

Firstly, whilst all three aspects of the problems in the market are important and to some extent they are inter-related, it is surprising to me how much emphasis the CMA has put on the quality aspect of the problem. The CMA has a remit and expertise as a competition regulator (the clue is in the name). It does not have a remit or expertise as a regulator of audit quality and I think that the development of proposals which are directed primarily to audit quality (as opposed to choice and market resilience) are better left to the FRC’s post-Kingman successor.
This, in my opinion, over-emphasis on quality has the potential to give rise to three significant adverse consequences:

1) Some of the CMA’s proposed remedies which are directed at quality are either unlikely to achieve their aim or might only do so at disproportionate cost – costs which will ultimately be borne by shareholders for whose benefit audit is intended to operate. For example:

   a. Remedy 1 (regulation of Audit Committees) is, in my opinion, likely to have a minimal, if any, impact on audit quality because there is such a wide causal gap between the auditor selection decision and the quality of audits actually delivered over the following ten years. And that remedy involves a significant extension of regulation which will result in higher direct costs for the regulator and higher indirect costs in companies. All of these costs will ultimately be borne by the shareholders.

   b. Remedy 6 (peer review) might identify poor audit quality in real-time and nip it in the bud but even in isolation the additional costs (in the regulator, the direct cost of the peer reviewer and the indirect costs imposed on the audit firms and the companies) are likely to be significant – and even more so if this remedy is implemented as well as Remedy 2 (mandatory joint audits) as this would result in three audit firms reviewing a company’s financial statements before they are published. It is hard to see how this remedy could pass a cost-benefit assessment.

2) Some of CMA’s proposed remedies have the potential to make the problem of choice even worse than it currently is. For example:

   a. Remedy 2 (mandatory joint audit) or 2A (market share cap) will reduce the effective choice of audit firms. It may be the case that in the long-term these remedies will so enhance the capabilities of the challenger firms that choice is improved but the causal connection between these remedies and enhanced capabilities in challenger firms is tenuous and the effect could take many years to emerge during which time there would be less choice in the market.

   b. Remedy 6 (peer review) will also reduce choice in the market because the firm selected to be the reviewer will then not be eligible for appointment as auditor. In contrast to its analysis of the impact of Remedy 2, in which it acknowledges that there will be an adverse impact, the CMA paper is completely silent on the adverse impact on choice of Remedy 6.

3) Some of CMA's proposed remedies involve a substantial increase in the scope and intensity of regulation, including requiring the staff of the regulator (which is just about to go through a major transformation of its operations) to make tricky judgements for which company directors – who are likely to be more knowledgeable and experienced - are accountable. For example:

   a. Remedy 1 will involve regulators having to come to real-time views on the quality of decision-making by Audit Committees on auditor selection and oversight.

   b. Remedy 2 or 2A will require detailed regulatory involvement in the operation of the dynamics of the market, altering the ability of companies to choose their auditors and audit firms to choose which audits to bid for.

   c. Remedy 5 might involve close regulatory scrutiny of the effectiveness of the potential operational split between the audit and non-audit parts of firms, a split which runs counter to the fundamental design of the business models of the firms.
d. Remedy 6 will involve the regulator in the selection and review of the findings of the proposed peer reviewers.

Secondly, it is surprising the extent to which the CMA has concluded that the solutions to the problems in the audit market are best addressed by remedies which will impose regulation, costs or other restrictions on the clients whilst at the same time increasing the revenues of the auditors. Examples of proposed remedies with these characteristics include:

1) Remedy 1 (regulation of Audit Committees) is targeted directly at Audit Committees and exposes them to a new risk of public sanction by the regulator.
2) Remedy 2 (mandatory joint audit) will eliminate the option which companies currently have to have a single auditor and will result in a significant increase in revenue for audit firms.
3) Remedy 2A (market share cap) will mean that some companies will be forced to change their auditors in circumstances in which they might – possibly for very sound reasons – not wish to do so.
4) Remedy 6 (peer review) imposes an additional layer of review on companies and will also increase the revenue of audit firms.

Thirdly, the CMA has provisionally rejected a remedy which has significant long-term potential to increase choice in the market and make it more resilient. It is striking that, in relation to a market in which one of the main problems is that there are too few effective competitors, the CMA had nothing to say in its update paper about what could be done to reduce barriers to entry into the market. This provisional decision by the CMA appears to be inconsistent with the formal “Strategic Steer” which the government has given to the CMA, which includes a need for focus on “removing barriers that prevent new start-up businesses or new disruptive business models from accessing or expanding in existing markets”.

The rejected remedy is discussed in the next section.

My recommendations on the six Remedies proposed by the CMA are summarised as follows:

<table>
<thead>
<tr>
<th>Description of Remedy</th>
<th>Recommendation</th>
<th>Key reasons</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Regulatory scrutiny of Audit Committees</td>
<td>Reject and replace with additional transparency by Audit Committees and additional engagement by shareholders</td>
<td>Unlikely to be effective, is disproportionate and risks considerable unintended consequences</td>
</tr>
<tr>
<td>2 Mandatory joint audit</td>
<td>Reject</td>
<td>Costs (significant and certain)-benefits (uncertain) trade-off is unattractive</td>
</tr>
<tr>
<td>2A Market share cap</td>
<td>Reject</td>
<td>Costs (significant and certain)-benefits (uncertain) trade-off is unattractive</td>
</tr>
<tr>
<td>3 Additional measures to support challenger firms</td>
<td>Accept and enhance</td>
<td>Potentially useful at the margin but not likely to have significant impact on market structure</td>
</tr>
<tr>
<td></td>
<td>Market resilience regime</td>
<td>Accept and enhance</td>
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<tr>
<td>5</td>
<td>Split between audit and non-audit services: full structural or operational</td>
<td>Reject and replace with enhanced audit firm governance code and monitoring by the regulator</td>
</tr>
<tr>
<td>6</td>
<td>Peer review</td>
<td>Reject</td>
</tr>
</tbody>
</table>
3. **Strengthening the package of Remedies by relaxing the restrictions on ownership of audit firms**

I believe that the package of remedies could be improved by re-instating one of the remedies rejected by the CMA: relaxing the restrictions on ownership of audit firms, specifically by allowing audit firms to be majority owned by external shareholders accompanied by additional measures to address potential risks to audit quality.

Before explaining this proposed remedy in some detail I would like to make two main points about the way in which the CMA has dealt with this option in its market study.

1) *In its ITC document, which it published in October 2018, the CMA gave signals that at the outset of its market study it attached low importance to this potential measure.*

For example, it did not adequately explain the potential benefits of relaxing the audit firm ownership rules and did not adequately explain how the potential downsides of such a relaxation might be mitigated. The relevant section of the ITC (paragraph 4.26) is reproduced in full below:

> “Some stakeholders have suggested that current restrictions requiring most voting rights in audit firms to be held by qualified auditors should be relaxed. This could affect the market in two ways:

a) it could broaden the owners (equity holders) of audit firms, and thus increase the quantum of capital invested in the mid-tiers. The mid-tiers could then invest this capital to take on audits of larger listed companies. However, some stakeholders have highlighted that this measure could risk reducing the independence and objectivity of auditors from commercial pressures; and

b) it could facilitate entry by non-audit firms. We note, however, that these new entrants would still face regulatory barriers that auditors need to comply with.”

This is in contrast to other potential measures discussed in the ITC for which there were more detailed explanations:

- a) Restrictions on non-audit services (paragraphs 4.8 – 4.10)
- b) Joint or shared audits (paragraphs 4.18 – 4.22)
- c) Incentives and governance (paragraphs 4.30 – 4.45)

In addition, the CMA did not ask a specific consultation about this potential measure but rather it was included within a general question: “please comment on the costs and benefits of each of the measures in Section 4 and how each measure could be implemented.) (Q14)

This is in contrast to other potential measures discussed in the ITC for which there were specific consultation questions:

- a) Restrictions non-audit services (Qs 16, 17 & 18)
- b) Market share cap (Qs 19, 20, 21, 22 & 23)
- c) Incentives and governance (Qs 24, 25, 26 & 27)

Through the structure of the ITC and the consultation questions it was evident that the CMA was signalling that at that early stage in the market study it attached greater weight to some measures than others. Given this, it is perhaps not surprising that the respondents to the ITC had less to say about restrictions on ownership than the measures on which specific questions were asked.
This impression is reinforced by the CMA’s comments in the update paper:

“[in the] invitation to comment document, we highlighted the challenges of implementing [this remed[y].]” (emphasis added) (paragraph 4.157)

A more open-minded approach might have referred to the ‘benefits and downsides’ of the potential remedy.

2) **In its update paper the CMA has inappropriately rejected the option of relaxing audit firm ownership rules.**

For example, the CMA’s summarisation of the views of those who responded to the ITC is surprising. Notwithstanding the absence of a specific consultation question on relaxation of the ownership rules 22 of the 75 responses which the CMA published commented on the option. The CMA’s summary of the responses is as follows (paragraph 4.157):

“In general stakeholders who responded to our document *did not support* th[is] remed[y].” (emphasis added)

I have analysed the responses which commented on the ownership restrictions and consider that they fall into the following categories:

<table>
<thead>
<tr>
<th>Category</th>
<th>Count</th>
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<tbody>
<tr>
<td>Broadly supportive, even if some reservations</td>
<td>12</td>
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<tr>
<td>Broadly neutral</td>
<td>5</td>
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<tr>
<td>Broadly negative</td>
<td>5</td>
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</tbody>
</table>

The detail underpinning this categorisation is set out in the Appendix to this paper.

Based on my analysis, I think that a fairer summary of the responses received would be:

‘The majority of the stakeholders who responded to our document were supportive or neutral about the possibility of relaxing the restrictions on ownership of audit firms, although respondents did identify some potential downsides which would need to be addressed. A minority of respondents believed that the downsides were sufficiently significant that the measure should be rejected, although some of those respondents might be expected to be competitively threatened by the entry into the market of a well-capitalised new firm.’

In addition, the basis for the CMA’s provisional conclusion that “the costs imposed by th[is] remed[y] would exceed any possible benefit [it] could bring” (paragraph 4.158) is also unclear given the very brief exploration of the potential benefits and means of mitigating the downsides of relaxing audit firm ownership rules in the two papers which it has published.

The remainder of this section seeks to give the CMA reasons to review its provisional conclusion by:

1) Explaining the current restrictions on the ownership of audit firms
2) Setting out the positive case for relaxing the restrictions on the ownership of audit firms
3) Assessing the significance of the additional downside risks of relaxation of the restrictions
4) Reviewing an example of similar reform in another profession: the market for legal services
5) Assessing the need for measures to mitigate the potential downsides of relaxing the rules
6) Considering who might want to invest in an audit firm
7) Illustrating how a new externally funded audit firm might break into the market
8) Considering how the audit regulator could facilitate the entry of new firms into the market
9) Acknowledging the need for legislative change to enable relaxation of the rules
1) The current restrictions on the ownership of audit firms

There have been restrictions on the ownership of audit firms in the UK for many decades. The essence of the restriction is that audit firms need to be majority-owned by qualified auditors. The rationale for the restriction is that if audit firms were owned by other parties then the professional and ethical standards required of auditors may not be adhered to.

The rules are now incorporated into EU law (the Audit Directive 2006 as amended by other Directives in 2008, 2013 and 2014). The relevant provisions are (Article 3(4)(b)):

“a majority of the voting rights in an entity [which is approved to be an audit firm] must be held by audit firms which are approved in any Member State or by natural persons who satisfy at least the conditions imposed by Articles 4 and 6 to 12 [ie the conditions relating to being fit & proper persons, education, training and experience which must be met by qualified auditors].”

The requirement is only that the majority of shares are owned by qualified auditors. This allows some ownership by non-auditors. In practice this flexibility is used by the firms to allow non-auditors such as economists, actuaries, IT specialists, etc to become partners. However, there are no significant examples of which I am aware of this flexibility being used by firms to raise capital from outside investors who have no involvement in their management or operations. From an investor’s perspective one can see that the prospect of becoming a minority shareholder in a firm which is majority-owned by partners who manage the activities on a day-to-day basis is not an attractive investment proposition.

The EU lawmakers nonetheless recognised that the possibility of some ownership by non-auditors did present a risk and so the 2014 Directive includes the following (paragraph 24):

“An audit firm shall establish appropriate policies and procedures to ensure that its owners or shareholders, as well as the members of the administrative, management and supervisory bodies of the firm, or of an affiliate firm, do not intervene in the carrying-out of a statutory audit in any way which jeopardises the independence and objectivity of the statutory auditor who carries out the statutory audit on behalf of the firm.”

Assessment of the current restrictions

The current restrictions are anti-competitive – they are a constraint on the ability of firms to enter the market and/or to grow. The intention of the restrictions is to reduce the threats to audit quality. The key public policy judgement to be made is whether the audit quality benefits of the restrictions outweigh the anti-competitive disadvantages?

In my opinion, which has been reinforced by the evidence in the CMA’s update paper, the answer is “No”.

The CMA has assembled a wide range of evidence that:

1. Audit quality in the market is currently not good enough - there is a higher than desirable incidence of poor quality audits, even from amongst those undertaken by the largest and most reputable firms in the market.
2. Competition and choice in the market is currently not sufficient – many companies face a limited or, in some cases, non-existent, choice of new auditors. When was the most recent new entrant of scale into the audit market? How does the record of entry of significant new firms into the audit market compare with other markets (eg airlines, hotels, automobiles, software, IT hardware, legal services, etc)?
In my view the time has come to revisit these restrictions with the aim of increasing competition whilst not damaging quality.

2) The positive case for relaxing the restrictions on the ownership of audit firms

Aims of the measure

The key aim of the measure would be to make it easier for one or more new firms to enter the market with a scale and capability sufficient to compete credibly in the market for audits of large companies.

A secondary aim of the measure would be to make it easier for existing challenger firms to expand their scale and capability to enhance their competitiveness in the market for audits of large companies.

A further aim of the measure would be to improve the resilience of the audit market. This might be achieved in two ways. Firstly, if the two aims above are successful then there will be more credible competitors at the top end of the market which will make it easier for the clients of a failed or failing audit firm to appoint a satisfactory replacement auditor. Secondly, a firm which is externally funded could be more easily re-capitalised than a firm financed solely by its partners; this would increase the likelihood that at least some of the capacity provided by that firm could be retained in the market, albeit that it would likely have fresh leadership.

The intention is that the combined effect of the measure would increase the number of credible competitors in the market for audits of large companies, which would, in turn, be expected to have a positive impact on audit quality, choice and resilience in the market.

Description of this measure

The proposed measure would relax the ownership rules by eliminating the requirement that at least 51% of the voting rights in the firm be controlled by qualified auditors.

It is accepted that such a de-regulatory change might increase actual or perceived risks of interference by non-auditors in audit judgements and that some additional safeguards may need to be introduced to mitigate these risks.

3) How significant are the additional downside risks of the measure?

The principal concern which has been raised about relaxation of the ownership rules is that it introduces the risk of interference in audit judgements by non-auditors who may be unduly motivated by profit rather than audit quality or may have a conflict of interest in relation to the clients of the audit firm.

In my view there are several reasons why these concerns about a change in the ownership rules are over-stated.

Firstly, similar potential risks exist in relation to many other industries but in those industries the risks are mitigated by regulation of the conduct of the business activities and not by restrictions on ownership. Two examples will serve to illustrate the point:

- **Airlines** It is evident that the safety of air passengers is an important public policy issue – a matter of life and death - and, justifiably, there is extensive regulation of the airline industry. For example:
  - Only pilots who are qualified and who meet minimum standards of physical fitness are allowed to fly.
o There are limits on the length of time that pilots can fly without an enforced rest period.

o There are mandatory maintenance routines and independent inspections of the condition of aircraft.

But there is no regulation which requires that qualified pilots must own the majority of shares in airlines ... and it is almost inconceivable that anyone would propose such a rule.

There remains a theoretical risk that the investors in EasyJet or Ryanair might put pressure on the management of those companies to reduce expenditure on pilot training or maintenance in order to boost dividends but the risk is very low. Firstly, the investors probably come to their own conclusions that to do so would be contrary to their own interests as an aircraft crash which was found to have been caused by poor training or maintenance could be very damaging to the value of the airline. Secondly, even if the investors thought that such expenditure cuts were a good idea would probably come to the conclusion that there was no likelihood of management agreeing to such a request. Thirdly, even if management did agree that such cuts were a good idea it is unlikely that they would implement them because of the high chances of the matter coming to light via whistleblowing staff or regulatory inspection.

**Pharmaceuticals** The safety of medicines is also an important public policy issue – also a matter of life and death – and, in that case too there is, justifiably, extensive regulation of the pharmaceutical industry (eg extensive safety trials, limitations on sale without prescription by a qualified doctor, inspection of safety standards in manufacturing, etc).

But there is no regulation which requires that qualified doctors or pharmacists must own the majority of shares in drug companies ... and it is almost inconceivable that anyone would propose such a rule.

As in the case of airlines, there remains a theoretical risk that profit-seeking investors might pressure companies to distort trial results in order to boost dividends but this would not be a rational thing for investors to request nor for management to agree to.

However, it is recognised that in both the airline and pharmaceutical industries liberalised ownership rules are accompanied by strong regulation of operational activities and that this balance would also need to be struck appropriately in the case of the audit industry.

Secondly, the risk of non-auditor interference in audit judgements already exists under the current ownership rules because at present most of the large audit firms have owners (ie partners) who are not qualified auditors. This risk is the focus of the CMA’s concerns about the impact on audit judgements of the culture of firms in which revenues and profits from non-audit services substantially exceed those derived from audit services.

The Rubicon of non-auditor ownership of audit firms was crossed many years ago and so the issue is no longer one of fundamental principle but rather of degree.

4) A similar reform in another profession: Alternative Business Structures for law firms

The audit profession is not the first to face questions about the continuing merits of restrictive ownership rules. The same issue arose more than a decade ago in relation to the legal profession. In 2003 the then Government asked Sir David Clementi to review the market for legal services in the UK. Sir David issued his report in late 2004. It contained a number of recommendations, the most relevant of which to this paper is that the rules relating to the ownership of law firms should be liberalised and that what have become to be known as “Alternative Business Structures” should be permitted.
There was at the time a wide range of concerns about the proposed liberalisation. A summary of how Sir David responded to these concerns is set out in the table below:

<table>
<thead>
<tr>
<th>Nature of concern</th>
<th>Clementi’s observations</th>
<th>Proposed mitigation</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Inappropriate owners</td>
<td>Some existing owners of law firms are unsuitable as demonstrated by the large number of disciplinary cases against solicitors</td>
<td>The regulator should apply a “fit to own” test to prospective owners</td>
</tr>
<tr>
<td>2 Outside owners would bring unreasonable commercial pressure to bear on lawyers which might conflict with their professional duties</td>
<td>It is possible to develop a package of safeguards which would prevent outside owners pursuing their own financial interests at the expense of clients or the values of the legal profession</td>
<td>Package of measures, including designated senior management roles which could only be filled by qualified lawyers</td>
</tr>
<tr>
<td>3 New owners would cherry-pick the best business</td>
<td>It should be recognised that cherries generally grow where there are restrictions to free trade. It should be expected that the admission of new capital will increase competition</td>
<td>No additional mitigants</td>
</tr>
<tr>
<td>4 Impact on access to legal services in rural areas</td>
<td>The question of access to legal services in rural areas is not related to the source of capital for firms</td>
<td>No additional mitigants</td>
</tr>
<tr>
<td>5 New owners would have conflicts of interest</td>
<td>The notion that for lawyers, unlike businessmen, making money is merely a happy by-product of doing their professional duty has limited resonance with the public</td>
<td>Firms should not be permitted to act for clients in which an outside owner has an interest in an adverse outcome. It should not be permitted for an owner to interfere in any client case or to have access to any client information</td>
</tr>
<tr>
<td>6 Whether some restrictions might be placed on the nature and extent of outside owners’ interests in the new firms</td>
<td>Such restrictions would limit access to capital and are not necessary given the focus of regulatory safeguards on the individuals who manage the firm and how they do so</td>
<td>No additional mitigants</td>
</tr>
<tr>
<td>7 There is no precedent for such outside ownership</td>
<td>There are such precedents in Australia and in relation to conveyancing services in the UK</td>
<td>No additional mitigants</td>
</tr>
</tbody>
</table>
The government accepted Sir David’s recommendations and they were given effect to by the Legal Services Act 2007. The White Paper which preceded the Act noted that Alternative Business Structures gave rise to potential benefits for:

Consumers of legal services:
- more choice
- reduced prices
- better access to justice
- improved service
- greater convenience
- increased consumer confidence

Providers of legal services:
- increased access to finance
- better spread of risk
- increased flexibility
- easier to hire and retain high-quality non-legal staff
- more choice for new legal professionals

The new arrangements are overseen by the Solicitors’ Regulation Authority (SRA), which has the power to monitor whether the requirements relating to law firms operating as Alternative Business Structures are being complied with. As of January 2019 the SRA’s register of ABS firms had 813 entries, of which 29 were quoted companies or subsidiaries of quoted companies. Interestingly, all of the Big Four and several of the challenger audit firms have taken advantage of the liberalised ownership rules to establish ABS legal firms.

It is not just in the UK that legal services providers are permitted to have non-lawyers as owners. The ownership rules have been liberalised in a number of countries including the USA, Canada, Australia and Singapore. A 2017 report by Thompson Reuters on the market for Alternative Legal Service Providers found that:

“... at $8.4bn and growing, ALSPs represent one of the most dynamic segments of the legal services industry and they are likely to play a role as competitors and disruptors for many years to come.”

Thomson Reuters estimated that the Big Four earned $900m of fees from providing legal services.

I am not aware of any serious suggestions that the Clementi reforms should be reversed and, indeed, any suggestion that they should be reversed would, I expect, receive a pretty dusty response from the CMA.

The lesson from the legal profession is that relaxation of the rules relating to ownership of firms can attract significant amounts of new capital into the industry leading to the development of strong new entrants many of whom have developed innovative ways of serving clients ... and with no detriment to the quality or professionalism of the services.

5) Mitigating the downside risks of the measure

Despite the examples from other industries and the legal profession and despite the fact that the risk of interference by non-auditors in audit judgements already exists, some stakeholders may take the view that elimination of the requirement for the majority of the voting rights in audit firms to be owned by qualified auditors would increase the threats to audit quality.
As I have noted above, I think that these concerns are not well-founded, but the CMA may wish to consider whether liberalisation of the ownership rules should be accompanied by additional measures to mitigate the downside risks. Such additional measures might include:

a) Limits on the maximum percentage (say, 30%) which could be owned by a single non-auditor shareholder as above that level the risks of interference might be regarded as too difficult to mitigate. I note, however, that Sir David Clementi concluded that such a measure was unnecessary in relation to law firms.

b) The policies and procedures to prevent non-interference, which are already required for audit firms, may need to be strengthened in the case of firms which are not majority-controlled by qualified auditors. Further work needs to be done to design these strengthened procedures but the measures which I have proposed in section 2 to strengthen the Audit Firm Governance Code and have independent monitoring of its application by the audit regulator might also be sufficient for this purpose too.

c) It may also be helpful to introduce a requirement for non-audit shareholders owning more than a certain percentage (say, 5%) of an audit firm to make a public statement confirming that they have not breached the “non-interference” policies.

6) Who might want to invest in an audit firm?

Relaxation of the ownership rules would only have an impact on the market if outside shareholders were willing to invest. Some stakeholders may argue that the risks of investing in audit firms (e.g., uncertainty of commercial success, exposure to damages awards, exposure to regulatory fines, etc) are so high that it is very unlikely that external investors could be attracted and so there is no point in relaxing the rules. However, I would argue that this is a counsel of despair, possibly motivated by a desire to maintain the status quo. The UK financial services industry has proven over many years that it is possible to attract capital to apparently high risk ventures, either through the public markets or via private equity. Given that the law currently prevents audit firms being majority-owned by external non-auditors there has been no serious attempt to raise capital from outside investors – it would simply be a waste of time. For this reason it is currently impossible to prove that willing investors could be found. However, were the ownership rules to be relaxed then the audit market could be exposed to the creativity of corporate finance practitioners.

So what sort of investors might plausibly be attracted to invest in an audit firm? Two possibilities immediately come to mind:

1. **Mainstream institutional investors** Pension funds and managed investment funds would be natural owners of audit firms. For a variety of reasons, institutional investors of this sort are arguably very appropriate owners of audit firms.
   a. The role of statutory auditors is to work in the interests of the shareholders to increase the confidence of shareholders in the reliability of companies’ financial statements. Ownership of audit firms by the same broad category of institution which owns the companies being audited would act as a counter-balance to the current tendency for audit firms to regard the management and directors of companies as being their clients.
   b. There would be an alignment of interests with regards to audit quality. Audit firms have often stated publicly their commitment to audit quality and institutional investors have been vocal about the importance of audit quality to them.
   c. Institutional investors are one of the categories of stakeholder who are most at risk from the current lack of resilience in the audit market. They would, therefore, be one of the principal beneficiaries of the increased resilience of the market which
would result from the existence of a few more well-capitalised competitors of scale. Given that the costs and disruption flowing from the withdrawal of one of the Big Four from the market would be very widespread (i.e., potentially affecting thousands of companies in which institutional investors have shareholdings) the benefits from increased resilience would also be widespread and significant.

d. The CMA has noted that the lack of choice of audit firms has the effect of reducing the incentives for high-quality audits. Institutional investors are one of the categories of stakeholders who are most disadvantaged by poor quality audits. They would, therefore, be one of the principal beneficiaries of the improvement in audit quality which might result from the existence of a few more well-capitalised competitors of scale. The benefits to institutional investors of improved audit quality would not just arise in the case of the clients of the audit firm in which they have invested but would, over time, arise across the entire portfolio of companies in which they have invested as quality across the entire market edges up.

e. Finally, institutional investors may well, over time, receive a direct financial return on their investment. The ability to assess the prospects for a financial return has been made more difficult to answer by the extensive redactions made by the CMA in its market update report. The CMA has obtained data on the profit margins of the Big Four audit firms and challenger firms for both audit and non-audit services. The update report notes that that information is summarised in tables 2.13 to 2.15 … but all of these tables have been redacted. The decision to redact so extensively is surprising given that all of the largest firms publish information on their overall profitability and, at the instigation of the FRC as a result of its work on Choice in the Audit Market in 2006 - 07, on the profitability of the audit business. However, the CMA did report that the audit market is profitable at an aggregate level (paragraph 3.166) and, so whilst a new entrant to the audit market is likely to make potentially substantial losses in its early years, there reasonable prospects for long-term financial returns, especially given the CMA’s findings that low prices are not a major factor in auditor selection decisions. (paragraph 3.17)

It should be noted, however, that the direct financial returns for institutional investors are likely to be trivial in comparison to the benefits for institutional investors of higher quality, increased choice and improved resilience across the entire market which would flow from the existence of a greater number of effective competitors.

It is only fair to acknowledge that there are some reasons as to why institutional investors might not be appropriate owners of audit firms. One obvious example is that it might make it more difficult for institutional investors to sue the auditors in the event of a failure of a company which had been audited by an audit firm in which they had invested. Whilst this argument may carry some weight, I think that it is not persuasive. The number of cases in which investors have succeeded in winning damages awards from audit firms is very low because the burden of proof in demonstrating that investors’ losses were attributable to audit firm failure is high. And, institutional investors would still be able to pursue litigation against an audit firm in which they had a small shareholding if they believed that they had strong chances of success in such litigation.

Institutional investors have been very vocal in response to the CMA’s current study and previous reviews by the Competition Commission and Parliamentary Select Committees about the importance they attach to improved quality and greater choice in the audit market. It will be very interesting to observe whether, in a world of liberalised ownership
rules, institutional investors are willing to back their desire for audit quality with hard cash. Given the downsides which they are exposed to as a result of the current market structure it is to be hoped that many of them would be willing to invest.

2. **Technology companies** The use of technology, including data analytics, is becoming an increasingly important component of the audit process. It is reasonable to assume that there is substantial scope to further improve the use of technology to improve the quality and efficiency of auditing. Although the audit firms have already invested heavily in audit technology their investment capacity and technical capability is small by comparison to that of some of the giants of the technology sector. It is possible that some of the major technology companies could make a significant contribution to the funding and technical capability of new entrants into the audit market.

Technology companies are not as promising investors in audit firms as institutional investors because they would not have so much to gain by way of increased resilience and quality in the audit. In addition, there may be a wider range of concerns over the security and potential misuse of client data. However, any new externally-financed audit firms would be subject to the same restrictions on client confidentiality as current audit firms and the “non-interference” provisions discussed above could be tailored to meet any additional concerns arising from having technology companies as investors in audit firms.

3. **User-owned mutual (“Clearing house” model)** There are examples from other industries of service providers being established on a user-owned mutual basis. For many years clearing houses operated on this basis in the financial services sector. Companies trading derivatives and commodities contracts faced a significant business problem (ie exposure to a high level of counter-party default risk) and they realised that the existence of a clearing house would help reduce that problem (ie reduced counter-party risk and more efficient rectification in the event of a default). Those companies came together to establish and finance a mutually-owned clearing house which was governed and operated on a basis which was independent of all of the market participants.

The adaptation of this model to the audit market is that many companies face a significant problem caused by the lack of choice in the audit market and exposure to the risk of an even more serious and widespread problem in the event of a Big Four firm leaving the market. The best way of reducing these problems would be for there to be more audit firms of scale in the market. If no other means of funding a new audit firm were to be found then it might be in the interests of FTSE 350 companies to fund the establishment of one or more audit firms. These audit firms would be governed and operated on a basis which was independent of the FTSE 350 companies.

FTSE 350 companies are not as promising investors in audit firms as institutional investors because there would be a higher level of concerns about conflicts of interest. However, the “non-interference” provisions discussed above could be tailored to meet any additional concerns arising from having FTSE 350 companies as investors in audit firms.

An externally funded audit firm might be a listed company but equally might not. I do not believe that potential benefits of liberalisation of the audit firm ownership rules are dependent on the choice of public or private equity ownership.

The three models listed above are simply examples rather than a comprehensive list of all possible models. If the ownership rules for audit firms were to be relaxed then creativity and originality might generate other models which are more attractive than the three examples. In addition, it would not be necessary to have one single model in operation in the market; there may be benefits
from having several new firms funded on different bases. Also, it may be possible to have a hybrid model such as a new firm which is funded by institutional investors alongside one or more technology companies.

7) How might a new externally funded audit firm break into the market?

There is no question that a new audit firm would find it challenging to break into a market which is so heavily dominated by the Big Four firms. Some might argue that the odds against are so overwhelming that it is not worth trying. However, there are many other industries in which new entrants have been faced by apparently overwhelmingly dominant incumbent firms and have yet become sustainably successful.

There are many ways in which such a firm might establish itself and, as the developments following liberalisation of the ownership rules in the legal market have illustrated, not all of the growth paths could have been predicted at the outset. However, in order to illustrate that it may be possible – albeit not easy, for a new entrant to establish itself, one possible approach is as follows:

i. Establish a strong independent Board to give confidence to potential investors, clients and the regulators.

ii. Recruit an experienced auditor as CEO of the new firm. It may well be possible to attract someone from the Big Four who is an experienced auditor and leader but who believes that he will not succeed to the most senior roles in his/her current firm. Such a person might well be attracted to the challenge of establishing an innovative new competitor which has a substantial capital base provided by outside investors.

iii. Raise capital – potential sources of capital were discussed above.

iv. Assemble a top management team of experienced auditors and other support staff.

v. Chose a memorable name and start initial awareness-raising marketing.

vi. Compete in tenders for suitable target clients. The new firm would want to be a player in the FTSE 350 market but would need to have relatively modest initial ambitions. For example, it is not realistic to think that the new firm’s initial clients might include the largest multinational companies such as BP or HSBC. However, there are many examples of smaller companies whose business is primarily or exclusively in the UK.

vii. Deliver initial audits.

viii. Compete in tenders for additional target clients.

It is important to acknowledge that it may take many years for one or more new audit firms to enter the market and even longer for this reform to have a meaningful impact on the structure of the market. But this extended timescale is also true of the CMA’s other proposed remedies and would not be a valid reason for not recommending liberalisation of the ownership rules.

8) Regulatory facilitation of entry of new firms into the market

There are regulatory barriers which, if interpreted literally, would make it impossible for a new audit firm to start-up. The most prominent is the requirement in the Ethical Standards published by the FRC which seek to guard against an audit firm being economically dependent on a client on the basis that it might make the firm reluctant to be sufficiently challenging towards the management or directors of the client. The standards prevent firms from earning more than 10% of their income from a single public interest client. This is an impossible standard for a new firm to meet.

The Kingman review of the FRC has noted that several other regulators have objectives to promote competition. For example:
• The Financial Conduct Authority (FCA) must “so far as is compatible with acting in a way which advances the consumer protection objective or the integrity objective, discharge its general functions in a way which promotes effective competition in the interests of consumers.”

• The Prudential Regulation Authority (PRA) must “so far as is reasonably possible act in a way which, as a secondary objective, facilitates effective competition in the markets for services provided by PRA-authorised persons ...”

The Kingman review has proposed that the successor body to the FRC should have a competition objective similar to that of the FCA: “the new regulator must ... discharge its general functions in a way which promotes effective competition in the market for statutory audit services.”

Both the FCA and the PRA have taken a number of practical steps to assist new entrants. The FCA has established an Innovation Hub, a regulatory “sandbox” and, jointly with the PRA, created a New Bank Start-up Unit. Given the challenge which would be faced by potential new entrants to the audit market it would be very helpful if the FRC’s successor were also to take similar practical steps to assist them.

It is recognised that the competition objectives which the financial services regulators have and, hopefully, the new regulator will have, are secondary to their principal consumer protection and market stability objectives. There may be a tension between these objectives, particularly in the short-term, and the striking of an appropriate balance between them requires difficult trade-offs but in a market such as audit, in which shortage of choice and lack of resilience are so serious, it would be appropriate for the sector regulator to give considerable weight to the benefits of new entrants.

The new audit regulator should undertake a thorough review of the auditing standards and regulations with a view to identifying those which might be prejudicial to new entrants and consider whether the intended purpose of those standards and regulations might be achieved by other means which were less damaging to new entrants.

9) Acknowledging the need for legislative change

Since the current ownership rules are set out in legislation it is important to acknowledge that this measure would require legislative change. However, whilst the difficulties of securing legislative change are not to be underestimated, I do not regard this as an insurmountable obstacle to inclusion of the proposal in the CMA’s final recommendations to the government. The CMA has already recognised that legislation would be the most effective way of implementing a number of its other proposed remedies.

There is, of course, a particular challenge in that the current ownership restrictions are defined in an EU Directive but Brexit may give the UK greater freedom for innovation in this respect. If that proves not to be the case then I would recommend that the UK government make the case to the EU authorities of the merits of the case for liberalisation.

Assessment of relaxation of the audit firm ownership rules against the CMA’s criteria

My assessment of the proposal to relax the audit firm ownership rules against the criteria which CMA considers remedies should be assessed is as follows:

a) Does it address the underlying concerns identified?

Yes, relaxation of the audit firm ownership rules has the potential to directly address the concerns about the audit market which the CMA has identified: audit quality, choice and resilience.
The effectiveness of the measure remains to be tested but there is considerable uncertainty as to the effectiveness of the other remedies proposed by the CMA.

**b) Can it be implemented, monitored and enforced effectively?**

Implementation will require legislative change in the same way as the other remedies proposed by the CMA.

There will be a need for some regulatory monitoring of the effectiveness of the governance procedures of the new audit firms but as the number of new audit firms is likely to be small this should not involve significant cost.

The measure is permissive rather than obligatory and so requires no enforcement.

**c) Is it proportionate to the scale of the issue?**

Unlike many of the other remedies proposed by the CMA, this measure will impose no new costs or other burdens on companies and it will have no adverse impact on audit choice.

**d) What are the potential risks and unintended consequences?**

The most significant potential downside is an increased risk of interference by non-auditors in audit judgments, but this risk exists at present and there are satisfactory measures which can be taken to reduce the risk to an acceptable level.

In summary, relaxation of audit firm ownership rules would be a de-regulatory pro-competition measure.
4. **Conclusions**

In finalising its proposals to the government, the CMA should reconsider some of its proposed Remedies and re-instate the rejected remedy of relaxing the rules on audit firm ownership.

Over many decades there has been a one-way ratchet of increasing concentration in the audit market. Liberalisation of the ownership rules has genuine potential to reverse the ratchet.

Liberalisation of the ownership rules will not, on its own, solve all of the problems in the market and it may take many years to have a material effect. But letting the forces which have operated well to improve market outcomes in other sectors of the UK economy be applied to the market for audit services must be a better way forward than a substantial increase in the regulatory burdens on our largest public companies just a moment in history when the competitiveness of UK public companies could be more important than ever.
Extracts from responses to the Invitation to Comment relevant to relaxation of audit firm ownership rules

I have analysed the responses which commented on the ownership restrictions and consider that they fall into the following categories:

<table>
<thead>
<tr>
<th>Category</th>
<th>Count</th>
</tr>
</thead>
<tbody>
<tr>
<td>Broadly supportive, even if some reservations</td>
<td>12</td>
</tr>
<tr>
<td>Broadly neutral</td>
<td>5</td>
</tr>
<tr>
<td>Broadly negative</td>
<td>5</td>
</tr>
</tbody>
</table>

The detail underpinning this categorisation is set out below.

The comments which I have classified as **broadly positive** are:

> “This is a critical measure in case the CMA recommends the introduction of audit-only firms. Audit-only firms would need capital to build the capacity to be better placed to take on audits of larger listed companies.”
> 
> *Mr Filip Lyapov*

> “There could be potential benefit here in terms of increased investment.”
> 
> *Association of Practising Accountants*

> “There could be potential benefit here in terms of increased investment.”
> 
> *BHP Chartered Accountants*

> “Significant investment is required to help mid-tier firms to scale up their operations to meet the demands of FTSE audits. Audit firms should consider how their business model and ownership structure can be adapted to achieve better access to finance.”
> 
> *Confederation of British Industry*

> “To encourage more entrants into the FTSE 350 market, we believe that the CMA should at least explore whether allowing outside capital to invest in audit firms would help bridge the large gap in size.”
> 
> *Johnston Carmichael*

> “There would be some merit across the entire profession for such a move, particularly at smaller firms ...”
> 
> *Kreston Reeves*

> “We think that this is worth considering and we are prepared to discuss potential changes to the current legal requirements on ownership of audit firms.”
> 
> *PwC*

> “… this could facilitate new entrants into the audit market (or provide incentive for consolidation of those firms outside the four largest) ...”
> 
> *Deloitte*

> “There is the potential benefit of increased investment ...”
> 
> *Duncan and Toplis*
“Wider ownership structures will not necessarily reduce quality. Quality depends on the governing body of the auditing company.”

*Intermediate Capital Group*

“Wider ownership structures will not necessarily reduce quality. Quality depends on the governing body of the auditing company.”

*Standard Life*

“... we believe there is a market resilience issue arising from the partner ownership structure of audit firms and how they are incentivised.”

*Legal & General Investment Management*

The comments which I have classified as **broadly neutral** are:

“We do not think that the other suggestions such as ... relaxing restrictions on audit firms’ outside equity would individually have a significant impact ...”

*Lloyds Banking Group*

“In the longer term could bring investment to support non-Big 4 to grow” but “Will be resisted by the firms.”

*Grant Thornton*

“It is unclear how this would meet the objectives since it would not change the regulatory barriers.”

*Moore Stephens*

“It is not without its challenges, and whilst it might enable firms to invest for the future, it might also pose risks to firm culture and behaviours.”

*Institute of Chartered Accountants of Scotland*

“The IA [Investment Association] is not convinced that changes to the ownership rules would necessarily result in new players entering the audit market.”

*Investment Association*

The comments which I have described as **broadly negative** are:

“We are particularly concerned that bringing in external investors may create pressures from those investors to prioritise commercial returns over audit quality.”

*Association of Chartered Certified Accountants*

“We would agree with the comments in the consultative document about the risk to independence and objectivity arising from commercial pressures.”

*Chartered Accountants Ireland*

“We do not believe this is a relevant causal factor ...”

*BDO*

“KPMG ... considers that the complexities ... would likely outweigh any benefits of the measure.”

*KPMG*
“... there would be risks to audit quality in reducing the current requirements requiring most voting rights to be held by qualified auditors.”

Mazars