



COMPETITION AND MARKETS AUTHORITY
STATUTORY AUDIT MARKET STUDY

RESPONSE TO UPDATE PAPER

1. Introduction

1.1 ICAS (The Institute of Chartered Accountants of Scotland) is a professional body for more than 21,000 world class business professionals who work in the UK and in more than 100 countries around the world. Our members have all achieved the internationally recognised and respected CA qualification (Chartered Accountant). We are an educator, examiner, regulator, and thought leader. We work primarily in the public interest.

1.2 Our goal in this response is to assist the CMA in concluding its study of the UK audit market and to ensure that any final paper supports the CMA's own strategic goals as articulated on their website and in particular:

“achieving professional excellence – by managing every case efficiently, transparently and fairly, and ensuring all legal, economic and financial analysis is conducted to the highest international standards”

1.3 This response provides a summary of key messages which we would invite the CMA to consider. It does not address each of the CMA questions in turn. Instead, and to help identify the matters which we believe the CMA should address in its final report, we have focused on the evidence and information supplied to and addressed by the CMA. We have considered the analysis and conclusions that the CMA have drawn from this evidence and information, and highlighted areas that may require further consideration. We have also addressed, where we can, the potential impact and workability of the proposed remedies.

2. Key Messages

Audit Quality, Understanding of Market, Rationale for Remedies

2.1 We support the general view evidenced by many and repeated by the CMA, that an overarching objective of any change in the landscape affecting statutory audit of Public Interest Entities (PIE) has to be to ensure high quality audit. This is and must remain the principal test against which any change in the existing audit and company framework is assessed.

2.2 External audit forms part of the wider governance framework that oversees corporates (i.e. Board of directors, audit committees, investors and regulators) and audit quality is of paramount importance to all these stakeholders. We welcome that the CMA has recognised choice, regulation (ie audit quality) and the scope of audit are intrinsically linked, and we strongly encourage the CMA to await the outcomes of the Brydon Review before assessing what remedies, if any, would be needed. The extent to which a revised scope of audit could lead to greater opportunities for challenger firms has yet to be considered. Furthermore, consideration of a basis for assessing audit quality may form part of the Brydon Review, and most certainly will form part of the scope of the proposed Audit, Reporting and Governance Authority (ARGA, which will have regulatory responsibility for audit quality).

2.3 In its final report the CMA could provide greater clarity of the evidence in support of its conclusions, and the remedies it has proposed. For example the final report should:-

2.3.1 provide more detail about choice within the wider PIE audit market. The CMA's analysis suggests that the UK audit market for PIE companies, as defined by fees earned, is £2.7bn. The FTSE 350 accounts for around £1bn (40%). For any review of a market there is a clear need to understand the market in its totality first, and in the context of this report the role that challenger firms play within the wider audit market (beyond the FTSE 350) is important too. Thereafter any conclusions that are drawn from the evidence and analysis would have a context and an independent informed reader could assess the reliability of the conclusions drawn.

2.3.2 Avoid the presentation of isolated issues as evidence of systemic concerns and ensure that statements can be fully supported with reference to empirical research. For example, the report states that there are systemic issues of poor audit quality in the UK (but only appears to evidence the FRC's inspection and enforcement action against Big Four and challenger firms, and the outcomes of the AQR inspection process). The CMA also

concludes that choice will address these problems - that is a strong assertion and we are not yet persuaded the case has been made out that choice will have such a profound effect on audit quality (solely based on the evidence presented in the report). As the paper highlights there have only been a very small number of FRC audit investigations into alleged audit failures in the last ten years given the total number of PIE company audits that have been undertaken over the same period (even if all cases related to FTSE 350 audit work, this is less than 1% of the FTSE 350 audit reports which were signed off over this period). The CMA also highlights the reduction in the number of large firm audits that achieved a “good or limited improvements” rating from the FRC’s AQR in 2018. However, this fails to acknowledge that the results in the previous several years reflected an upward trend.

- 2.3.3 Address all of the evidence provided by those who practice and understand the roles of audit committees. The analysis of the tenders interprets “closeness” and cultural fit” as negative attributes in the selection of an auditor and views these as incompatible with challenge and scepticism. We do not agree. Collaboration and challenge are not incompatible in the professional world of accountants and auditors – indeed this is what they are trained to do. We do not believe that an adversarial relationship would be conducive to audit quality but rather that there needs to be professional respect between the auditor and management. Within that professional relationship it is critically important for the auditor to exercise professional scepticism and to challenge management as appropriate.
 - 2.3.4 Provide greater evidence that its proposed remedies will achieve its set objectives which include: better choice in the audit market while ensuring high audit quality; and more fairness in the selection of auditors.
 - 2.3.5. Include demand side analysis of the audit needs of the FTSE 250 companies in the CMA report. There is a simplistic assumption that because a company is smaller, it is therefore less complex and can appoint a “challenger” firm. This may well be the case, particularly given the strength of challenger firms in the audit market outside the FTSE 350, but it could be referenced to empirical evidence to support this assumption.
- 2.4 Audit quality should always be subject to continuous improvement, and it is important to remember that the scope of audit is now subject to independent review. We understand and support the CMA view that it is not in a position to consider the “audit expectation gap”. We would encourage the CMA to reflect on whether it can draw definitive conclusions about audit quality, or whether it should defer such consideration until the outcome of the review by Sir Donald Brydon has been concluded.
- 2.5. We would like to see an environment where challenger firms are willing and able to compete in the markets of their choice. The CMA’s aspirations to remove market barriers are to be welcomed, but the proposals need to be shaped having regard to the evidence, and after detailed analysis of their respective strengths, weaknesses, opportunities and unintended consequences.

Remedy 1: Regulatory scrutiny of Audit Committees (Question 4)

- 3.1 The focus of the CMA review and its ultimate conclusions, along with the associated proposed remedies, appears to rest primarily on their judgement that the “principal/agent” structure has inherent issues of poor or perverse incentives and thus action needs to be taken. We do not see any compelling empirical evidence in the report that this is actually the case in practice. We cannot share the view that the proposed regulatory oversight of audit committees is the necessary way forward. In our experience, the vast majority of audit committees fulfil their role diligently and conscientiously, in an objective way which seeks to maximise the quality and effectiveness of the audit in the interests of the shareholders. Regulatory intervention in the work of one sub-committee of the Board could undermine the UK’s unitary board model under which all directors carry the same level of overall responsibility for the success of the company. This would be inconsistent with other aspects of UK corporate governance.
- 3.2 Investors are not close enough to each investee company (nor can they be – practically or legally) to provide any detailed oversight of the audit processes including the selection of auditors. They do however approve the proposed choice of auditors and their reappointment each year at the

annual general meetings. They are also free to engage with Boards and their audit committees at any time during the year on this and other matters. Public listed companies in the UK and their boards of directors are required to apply the UK Corporate Governance Code. Under the unitary board structure in the UK, the board has a majority of independent non-executive directors. The audit committee must be wholly made up of independent non-executive directors. Each director is also up for election each year allowing shareholders to remove any director who does not meet their standards.

- 3.3 As the CMA highlights, evidence from experienced audit committee chairs suggested that they were clear on their duties to shareholders, were focused on audit quality and not price and that overall the system works well. The CMA also states that “overall, the balance of views from audit committees and investors was that audit in the UK is generally of a high quality. Many stakeholders pointed to the fact that the UK has a high reputation internationally for the quality of its audit firms”. The CMA should reflect on whether adequate prominence is given in its conclusions to this evidence (as provided by the individuals who are closest to this subject matter).
- 3.4 The CMA also makes considerable comment on the “closeness” and “cultural fit” (CMA Report, Para 3.22) of audit committees to their auditors, assuming that each is incompatible with auditor scepticism and challenge and the pursuit of an effective auditor selection process and subsequent audit operation. This ignores the considerable effort that goes into the training of professional accountants and auditors where all of these factors are considered. A number of audit committee chairs with whom we have spoken have suggested that the CMA needs to observe the behaviour of audit committees at first hand and speak to those who are more closely involved, before pursuing its unnecessarily radical and costly proposals. They would also suggest that challenge from shareholders on the performance of the audit committee must be preferable to shareholders abdicating responsibility and relying on a regulator to review the work of the committee.
- 3.5 The CMA reports that “most stakeholders, including investors, were opposed to an independent appointment and monitoring body” (CMA Report, Para 4.10). This is consistent with our own research. If the CMA is mindful to explore this option, we would encourage the CMA to reflect on whether it is possible to design an oversight regime in such a way to ensure that Boards and shareholders are not disenfranchised.
- 3.6 The CMA claims that stronger regulation of audit committees would ensure that “they are all doing the job they are meant to do” (CMA Report, Para 4.15). The CMA presents little evidence to support the prospect that a regulator would be in a better position than audit committees and shareholders who scrutinise and approve their actions, to assure audit quality and more competition. Likewise, “a requirement that audit committees report directly to the regulator before, during and after a tender selection process” (CMA Report, Para 4.16a). This solution, along with the suggestion of an “observer”, presupposes that any regulator would have sufficient expertise and time to invest in understanding the specific audit needs of the company concerned to avoid a non value-added exercise. Our concerns in this regard also apply to the proposed requirement that audit committees report directly to the regulator throughout the audit engagement – demonstrating how they are monitoring quality. At a practical level, we question how the regulator will find the necessary executives and staff who have the experience and expertise necessary to perform the oversight, and who are free from conflicts of interest relating to the company and its audit committee members and potential auditors. Nevertheless, such a proposal ought not to be for the CMA but rather for ARGAs to explore in due course, within the context of future revisions of the Corporate Governance Code.
- 3.7 “The ability for the regulator to issue public reprimands, or direct statements to shareholders”. We are supportive of enhanced transparency when warranted and supported by proper evidence of failure.

Remedy 2: Mandatory Joint Audit (Questions 5, 6, 7, 8 and 9)

- 4.1 We understand that the CMA believe joint audit will “have the potential to improve audit quality over time” (4.29). We understand and accept that the introduction of mandatory joint audits together with the requirement for most joint audits to have one “challenger firm” as one of the selected auditors would increase the involvement of these firms in PIE audits and would over time enhance their capabilities. We also understand that it is the belief and desire of the CMA that “joint audit would increase competition from challenger firms if joint audit work enabled these firms to acquire

the capacities and reputation to make them able to compete for the role of “lead” joint auditor”. (4.48). From the demand perspective, there appears to be little support at present for joint audit. This reflects the views of investors, as well as those who sit on audit committees.

- 4.2 We are surprised that the CMA is proposing joint audit as a remedy when the Competition Commission in its 2013 Final Report on its audit market investigation concluded the following (paras 17.98 – 17.101):

“17.98 *We considered whether joint or shared audit would lower barriers to entry, expansion and selection. We consider that shared audit might encourage companies to use firms for parts of the audit that they may not have considered for the Group audit. However, we did not consider that this effect would be significant, as companies would retain incentives to engage auditors with the necessary global coverage and experience for the substantial part of the audit.*

17.99 *In relation to joint audit, we considered that companies would continue to have incentives to engage audit firms who could demonstrate experience and global coverage and that such a remedy would have little effect on barriers to entry, expansion and selection.*

17.100 *We have not been able to quantify the potential cost of imposing shared or joint audit on the market. However, we believe that across the market these costs would be potentially significant, particularly if the risk of a reduction in audit quality was to be avoided.*

17.101 *In relation to increasing visibility of audit quality and addressing the AEC, in that auditors have the incentives and ability to respond to executive management interests, and may therefore compete to satisfy a demand that is not fully aligned with shareholders’ interests, we consider that other elements of our proposed remedy package are effective in these respects (see paragraphs 18.7 and 18.8) and do not introduce the potential costs and risks associated with joint or shared audit. While we accept that joint/shared audit has some benefits in relation to lowering barriers to entry, expansion and selection, we were not convinced these benefits were significant, or certain, and did not justify the potential costs of such a remedy. We placed considerable weight on the views of investors who were almost universally opposed to such a remedy on the grounds of additional costs and risks to audit quality. In light of the above we have not adopted this remedy on the basis of its lack of effectiveness in remedying the AEC and its potential costs.”*

We are not suggesting that intervention measures could not encourage choice within the market, simply that we believe the CMA has not yet made its case – at least from the evidence presented - that mandatory joint audit is now the most effective remedy.

- 4.3 The CMA’s Questions 7 and 8 merely serve to illustrate the increased bureaucracy that a joint audit regime would entail. In terms of retaining knowledge of the entity concerned there are benefits to be had from appointing the joint auditors at different times. However, this increased cycle rate of the auditors will challenge quality as it will double the number of year ends when auditors are learning the business, or winding down prior to exit, as well as adding to the workload of the audit committee as they will need to undertake separate selection processes.
- 4.4 Should the CMA continue to propose mandatory joint audit we would encourage the CMA to emphasise to BEIS the need to revise the existing auditor liability provisions. We believe that the introduction of a proportionate liability regime would be essential if joint audit is to be introduced. We have long been supporters of the need for reform of auditor liability as the current “joint and several” approach is not proportionate. The existing ‘joint and several’ auditor liability regime is unfair whereby one audit firm may only perform a percentage of the audit but could end up being liable – at least in law - for the full amount of any loss incurred as a result of an audit failure by the other auditor. Both firms should only be responsible for their own respective failings. If not addressed, this could be a significant deterrent to challenger firms wanting to compete in the FTSE 350 audit market.

Remedy 2A: Market Share Cap (Questions 10 and 11)

- 5.1 On the alternative of a market share cap, careful consideration would need to be given to the case for such direct intervention, not least because of the way in which this measure would restrict choice for many FTSE 350 companies, may well prevent many companies and their audit committees from making the first choice for their company, their shareholders and other stakeholders including the public interest, and could interfere with (and ultimately weaken) the regulatory framework which has been proposed by Sir John Kingman where enhanced director accountability has been proposed.
- 5.2 We are still concerned that any market share cap is likely to leave some audit committees in the untenable position of a restriction in market choice when tendering, and, where appropriate, rotating their auditors. A market share cap implies a restriction of market choice, could potentially negatively impact audit quality, and it is not something that investors in the company concerned would be likely to welcome.

Remedy 3: Additional Measures to Support Challenger Firms (Questions 12 and 14)

- 6.1 We are not aware that there are undue barriers to the movement of partners and staff, but if they do exist then we support the proposal that they should be reduced or removed. We note the contradictory evidence that has been provided to the CMA on this matter by challenger firms, and we would encourage further analysis to be undertaken.
- 6.2 In terms of access to technology this is a matter that the CMA needs to explore further with the respective audit firms, but the principle of assisting the challenger firms to access improved technology platforms is welcomed.

Remedy 4 – Market Resilience (Questions 15 -18)

- 7.1 We believe that the relevant accountancy firms and Financial Reporting Council are best placed to provide information to allow the CMA to assess the market resilience proposals.

Remedy 5: Full Structural or Operational Split Between Audit and Non-Audit Services (Questions 19 -24)

- 8.1 We believe that the audit firms and regulator are best placed to provide an informed response to these questions. This is also likely to require discussions with international regulatory bodies to ensure that the full impact of such a remedy is considered. There is a real danger of unintended consequences if this approach is adopted without proper consideration.
- 8.2 Ultimately any decision on this matter would need to assess the importance of fairness (applicability to all firms) versus that of proportionality.

Remedy 6: Peer Review (Questions 25 and 26)

- 9.1 We do not believe the case has been made for the benefits of peer review as described by the CMA, against a background of a potential joint audit regime, and the increased role of the AQR audit inspection process set out in Sir John Kingman's Report. Furthermore, the CMA may not have fully considered the impact this may have on audit firms and companies.
- 9.2 Peer review is ordinarily a regulatory condition imposed by a Recognised Supervisory Body (RSB) and only where there are concerns about audit quality. The definition of peer review presented by the CMA could present considerable obstacles to its introduction. Such obstacles include, but are not limited to, the other firm's capability to undertake this task prior to the audit report being signed and confidentiality.
- 9.3 Notwithstanding the real practical difficulty of any regulator sourcing a team of independent auditors to carry out such reviews in any scale (especially if alongside any joint audit regime), the use of such a team would further reduce the choice for companies when a tender for new auditors is required. This goes directly against the desired intention of the CMA to increase the choice for companies when tendering for auditors.

Concluding Remarks

- 10.1 In preparing its final report we encourage the CMA to reflect on whether it will meet its own published standards for analysis and reporting, and to address shortfalls where they exist. The CMA should critically examine the conclusions to ensure that they fully support the proposed remedies. Furthermore, we believe it is important that key stakeholders, particularly on the demand side, can be presented with proposals which they feel able to support.
- 10.2 We return to our original premise that an overarching objective of any change in the landscape affecting statutory audit of Public Interest Companies (PIE) has to be to ensure high quality audit. This is and must remain the principal test against which any change in the proposed audit and company framework. We would encourage the CMA to apply this test to their proposed remedies and comment accordingly in their final report.
- 10.3 The audit “expectation gap” is a real one and it is critical for the future satisfaction of all stakeholders that the proposed Brydon Review on the Future of Audit is allowed to carry out its work before any final decision is made by HM Government on the application and implementation of any proposed remedies. We believe the CMA should support this position in its final paper.



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