

Statutory audit services market study

Final summary report
18 April 2019

Overview

1. Everyone in the UK is affected in some way by the quality of external audits, even if few people will ever read an audit report. Audits are there to check whether companies are giving an accurate picture of their financial performance. The decisions that this information supports affect us all, through our pensions or savings, or as customers or suppliers of companies. They are crucial to the efficient allocation of capital and therefore overall performance of the economy. Audits are also a vital contributor to the trust and confidence that is required in a modern economy.
2. Audits cannot be expected to prevent company failure, nor are they likely to be the cause of failure; but they are a vital part of the warning system that should protect savers' interests. Cases like Carillion or BHS show the size of the stakes when there is a high-profile failure; the regulator's quality reviews have revealed that shortcomings are widespread in the UK audit market.
3. Along with well-documented issues with regulation, the market exhibits a number of deep-seated problems: audit committees are only a partial solution to the problem that companies select their own auditors; high concentration among four big audit firms, resulting in limited choice and a market that is not resilient; audits being carried out by firms whose main business is not in audit.
4. There is no simple answer to these problems. Any change will need time to take effect, and there are trade-offs inherent in any proposal we could make. But the market shows no signs of self-correcting. The Secretary of State asked the CMA to 'be ambitious in its thinking and move swiftly on this issue'. We are making four recommendations to the Government.
 - a. Robust regulatory oversight of the committees that run the selection process for audited companies, and oversee the audit, to make them more accountable and ensure that they prioritise quality.
 - b. Mandatory joint audit, to increase the capacity of challenger firms, to increase choice in the market and thereby drive up audit quality. There should be initial limited exceptions to the requirement, based on criteria set by the regulator – mainly the largest and most complex companies. Any company choosing a sole challenger auditor should also be exempt. Audits of exempt companies may be subject to rigorous, real-time peer reviews commissioned by and reporting to the regulator.
 - c. An operational split between the Big Four's audit and non-audit businesses, to ensure maximum focus on audit quality.
 - d. A five-year review of progress by the regulator.

Introduction and context: shortcomings in audit quality

5. It is widely acknowledged that quality has fallen short of what the UK needs. There have been both specific high-profile failings, and a larger number of audits that have demonstrated shortcomings against the standards set by the regulator. In its 2018 reviews, the FRC reported that 27% of FTSE350 audits required improvements.¹ Many investors, the real customers of an audit, and now also three of the Big Four themselves,² have identified that quality is not adequate.
6. The fact that many companies will experience audits that are up to the required standard, and have said as much during the course of our study, does not justify inaction. The shortfall in audit quality is too widespread. The stakes are high; there is an overwhelming public interest in the quality of audits, because the audited numbers are so important to confidence in capital markets and to investment decisions that affect all of us.
7. As we said in our update paper,³ and as has been echoed by the Business, Energy and Industrial Strategy Committee (the 'BEIS Select Committee'),⁴ we are unpersuaded that the so-called 'expectations gap', between what people think an audit does and what it is required to do, is the main reason for the shortcomings in performance. We have however been surprised at the extent of disagreement even among experts, let alone the wider public, on the purpose and scope of an audit, and the relationship between UK law and international standards. Clarifying this, which is part of the purpose of the Brydon Review into the quality and effectiveness of audit,⁵ is essential and long overdue; but even if the standard is clarified, current performance is missing its target – the 'expectations gap' is no excuse for that failure.
8. The reasons for shortcomings in audit quality are complex and many-sided. They include some issues which have been or are being considered elsewhere in parallel to our work – the effectiveness of regulation (by Sir John Kingman⁶), and questions over the purpose and scope of audits (by Sir Donald Brydon). But they also include a market that has not worked well.⁷

¹ FRC, [Big Four Audit Quality Review results decline](#), 18 June 2018.

² Business, Energy and Industrial Strategy Committee, [The Future of Audit](#), 2 April 2019, p.15-16.

³ [Statutory audit market study](#), update paper, Appendix C.

⁴ A 'delivery gap'; BEIS Select Committee, [The Future of Audit](#), paragraph 56.

⁵ [The Brydon Review into the quality and effectiveness of audit](#).

⁶ [Independent Review of the Financial Reporting Council](#), December 2018. Now consulted on by the Government: [Initial consultation on recommendations](#), 11 March 2019.

⁷ The audit market has been the subject of many previous reviews going back decades, by regulators and in Parliament. For instance the Auditing Practices Board (1992), [The Future Development of Audit](#), 'the auditing profession needs to change'; the European Commission (2010), in [Audit Policy: Lessons from the Crisis](#),

9. We have taken into account the report produced by the House of Commons BEIS Select Committee on ‘The Future of Audit’, published on 2 April 2019. Rachel Reeves MP, Committee Chair, spoke of ‘no doubt that the problems on audit really are profound... seen against a backdrop of low public faith in business’.^{8 9}

Audit committees are only a partial solution to the problem of companies playing the primary role in selecting their own auditors

10. Some of the problems with the market are caused by longstanding, deep-seated and intractable features. High audit quality, despite being the overriding outcome desired from the market, is hard to judge. Secondly, the ultimate beneficiaries of a good-quality audit – ordinary savers or pension-holders – typically have no role in selecting auditors. Nor even do their representatives, in the shape of investment firms. They usually have little or no material role in selection. Instead, companies choose which firms to invite to tender and put forward to shareholders; the fact that the auditor selection process has been reserved for independent audit committees is only a partial solution to this.
11. This is just one element of the wider, long-standing, concerns over ‘ownerless corporations’.¹⁰ In public companies, the links between owners and managers of companies are distant, and ownership is diffuse, making it difficult for owners to monitor and affect the performance of companies that they own.

A fragile market with high barriers to entry, lacking in resilience and choice

12. This is a fragile market. Market resilience, and as a result long-term choice, is very limited, compounding the underlying features described above. There are only four firms auditing the biggest companies (100% of the FTSE100; 97% of FTSE350 companies, 99% of fees).¹¹

considered the possibility of audit-only firms; House of Lords Economic Affairs Committee (2011), [Auditors: market concentration and their role](#); Office of Fair Trading (2011), [Statutory audit: Market investigation reference to the Competition Commission](#); Competition Commission, [Statutory audit services market investigation](#), 2013.

⁸ Rachel Reeves MP, [Audit: a new product in a new market](#), speech at the Institute of Chartered Accountants in England and Wales, 2 April 2019.

⁹ In the course of our study, we have considered more than 170 submissions, held discussions with more than 100 parties, sent information requests to many audit firms and companies, and analysed a significant body of other evidence. In addition, we had the CC’s recent market investigation to build upon.

¹⁰ E.g. Business, Energy and Industrial Strategy Committee, [Corporate Governance](#), 4 April 2017, p36; Lord Myners in Financial Times, [Tackling ‘ownerless’ corporations](#), 8 November 2009; or Chris Philp MP in the Telegraph, [Shareholders need proper control in order to make capitalism work](#), 1 September 2016.

¹¹ CMA analysis of the Industry Background and Audit Analytics data sets. 100% Big Four FTSE100 since the January 2019 de-listing of Randgold, a BDO client.

13. There are several reasons for this lack of choice, not least of which is competition authorities' permission of the series of mergers in the 1990s that allowed the market to move from a Big Eight to a Big Five. Shortly thereafter the failure of Arthur Andersen reduced the market to the current Big Four. Since then there have proved to be very significant capacity and capability-related, and reputational barriers to other firms moving up through the market.
14. Worse than that, choice for any given company can be as few as two or even one of these four: Hobson's choice. Companies are required to change audit firms every 20 years, which removes one possible bidder. Risk of conflict between the firms' audit and non-audit practices is mitigated by a number of rules, the importance of which has been borne out in previous reviews. These necessary rules can mean that firms are prevented from bidding; or that they choose not to bid in audit tenders because auditing a company limits the amount of available non-audit revenue from that company. Firms' recent commitments further to reduce their non-audit work for audit clients might increase trust but are likely to make the choice problem worse.
15. This situation cannot be regarded as acceptable. If one of the Big Four were to go under – a plausible risk given the history of Arthur Andersen – choice would be rendered almost non-existent in many cases, leaving little competitive pressure on auditors. Meanwhile, one of the Big Four has sustained and recently increased its market share, despite recording less good scores in the regulator's quality reviews than its three big competitors.¹² In the long term, the UK needs more than the current four firms able to audit its biggest companies.

Accounting firms are less and less focused on audits

16. The combination of audit and non-audit services in the same firms is not only a problem because of the simple numbers of bidders in audit tenders. The need for the complicated rules that result in those limited numbers of bidders reveals the fundamental conflict between the two types of service.
17. The purposes and intended beneficiaries of audit and non-audit work are very different. Audit's purpose is to provide an independent check on the truthfulness and fairness of a company management's reporting, for the

¹² KPMG's market share increased by a quarter, from a fairly steady 20% of FTSE350 audit fees from 2011 through 2017 to 25% in 2018 (based on CMA analysis of financial information provided by audit firms). KPMG started a number of large audits in 2017/18, the largest of which were Barclays and BT Group. It recorded strong overall revenue and profit growth for its whole UK business, as reported in Accountancy Daily: [KPMG posts record 8% revenue hike](#), 5 December 2018. In each of the last three inspection years, the FRC graded between 35% and 50% of the KPMG FTSE350 audits it inspected as 'improvements required' or 'significant improvements required'.

benefit of shareholders and the wider public interest; the purpose of business advice services is generally to provide advice in order to further the client's interests.

18. The underlying conflicts between the two types of service are widely understood. In the absence of any rules, auditors might be responsible for reviewing accounting practices that were the product of their own colleagues' tax advice to the same company – ie marking their own homework.¹³ Or they might want to cross-sell non-audit business to an audit client. Either of these would be likely to lead to poorer-quality audits, and even more likely to undermine trust.¹⁴
19. Various rules are therefore in place to mitigate these conflicts. These include a 'blacklist' of non-audit services that may not be provided to audit clients, and a ban on cross-selling non-audit services to audit clients. But even if the rules are fully successful at the level of individual audits, the tension between the two types of service remains at the firm-wide level. And that tension can only increase, the smaller the proportion of the firms' business that comes from audit. Over time the biggest firms have transformed themselves from being audit firms with a side-line in business advice, into much broader professional services firms in which audit is far smaller than non-audit. Audit can represent as little as 15% of their revenue, and even less in terms of profit. Its importance to their brand means it almost certainly assumes greater importance than the simple numbers suggest; but it is also certain that it is less critical to the success of the firms than when it was their majority business line.
20. Profit-sharing gives audit partners a direct interest in the success of the non-audit business; an interest that has increased with growth in the size of non-audit business. Even while direct cross-selling to existing audit clients has been prevented, auditors can still cross-sell to other companies in the same sector, or the firm can sell lucrative non-audit work at the end of the audit contract. It is harder to maintain an independent audit discipline and governance, given the scale of non-audit work. The combination of audit and

¹³ Exacerbating this is the fact that the audit team might well draw on expertise from, for example, their tax advisory colleagues, in order to carry out the audit.

¹⁴ For example [EU Regulation 537/2014](#), Recital 8. [The summary of responses to the European Commission Audit Policy Green Paper](#) (2011), summarised investor concern about providing both internal and external audit services: 'obvious implications for audit independence in that the external audit firm will in effect audit its own work and may be taking on management functions', p19. The views of academics were summarised as: 'broad support for either a full cessation of non-audit services, as the best guarantee for independence, or the prohibition of non-audit services to audit clients', and that "[c]onsulting services may be beneficial to the auditor and client, but the ensuing lack of independence harms the interests of external stakeholders", p20. The European Commission (2016), [Reform of the EU Statutory Audit Market](#) states "the provision of certain services other than audit (non-audit services) involve an inherent threat to [auditors'] independence and may substantially increase the risks of conflicts of interest for statutory auditors and audit firms".

non-audit work weakens competition for audits. All this distracts from auditors' core purpose – delivering high-quality, challenging audits.

21. The firms advocate strongly for their multidisciplinary business model. They cite the increasing variety of non-audit expertise needed to carry out a modern audit, as well as a stronger recruitment offer and greater resilience. There is undoubtedly a convenience and reassurance value in being able to call in advice from a colleague with a shared brand. But even the effects of this are not indisputably positive for audit quality. For a very specialist non-audit service with a high degree of potential differentiation – cyber, for example – it should not be assumed that the in-house offer from auditors' non-audit colleagues is necessarily the best available on the open market in every case.

A package of remedies to reform the market

22. The market, supported by the right regulation, needs consistently to reward high-quality audits above all else, and penalise poor quality.
23. Previous attempts to improve the situation have helped, for instance through mandatory tenders following the Competition Commission's 2013 investigation, which create more opportunities to compete. But not enough has changed as a result, and the deep-seated characteristics of the market mean we can have little confidence that, left to its own devices, the market, or the firms within it, will self-correct.
24. Our recommendations are intended to achieve the following objectives, which follow on from the problems we see in the market:
 - a. Increase the effectiveness of audit committees across the FTSE350, ensuring that the selection and oversight of auditors is focused on quality – in the form of scepticism and challenge as well as technical expertise.
 - b. Increase long-run resilience and choice in the market. We need to arrive at a position where more than the current four big firms can and do audit the UK's biggest companies.
 - c. Address the problems in terms of focus on quality, and choice, caused by the firms' combined audit / non-audit services structures.
25. The difficulty of bringing about these changes should not be underestimated. The resilience problem, in particular, is reflected the world over, and has been entrenched following regulatory decisions and Andersen's failure 15-20 years ago. It will take time to get the market to a better position; and it would be

misplaced confidence to imagine we can predict exactly how the process will play out over that period.

26. The changes will need concerted action by the Government. They will also need to be overseen by the regulator, which we expect to become increasingly effective as it is reformed and given new powers following the independent review led by Sir John Kingman. There would be value in the regulator starting work on our recommendations before it is fully re-shaped following the Kingman changes, for instance on scrutiny of Audit Committees.
27. The changes recommended here should in time also be complemented by what emerges from the review by Sir Donald Brydon into the quality and effectiveness of audit. But as Sir Donald himself indicated to the BEIS Select Committee,¹⁵ making progress with changes to the regulator and to the market need not wait for the final outcome of his review.
28. We are making a number of recommendations to the Secretary of State, as follows.

Recommendations

- Recommendation 1 – audit committee scrutiny
- Recommendation 2 – mandatory joint audit, including at least one non-Big Four firm, for most large companies; peer reviews for the largest; and measures to mitigate the effects of a Big Four failure
- Recommendation 3 – an operational split between the audit and non-audit practices of the biggest firms
- Recommendation 4 – a five-year review of progress by the new regulator

Recommendation 1 – audit committee scrutiny

29. Audit Committees should come under greater scrutiny by the new regulator. This should increase accountability of Audit Committees. It should focus their selection and oversight of auditors on audit quality, while also mitigating any bias against non-Big Four firms.

¹⁵ Business, Energy and Industrial Strategy Committee (2019), [Future of Audit Inquiry – Oral Evidence](#), Q514-517.

30. We recommend that the Government legislate for the following elements of the remedy:
- a. The regulator should have the power and a requirement to mandate minimum standards for both the appointment and oversight of auditors.
 - b. The regulator should have the powers and a requirement to monitor compliance with these standards, including the ability to require information and / or reports from Audit Committees, as well as placing an observer on a Committee if necessary.
 - c. The regulator should take remedial action where necessary, by for example issuing public reprimands, or making direct statements to shareholders in circumstances where it is unsatisfied with Audit Committees. The more severe measures proposed by Sir John Kingman might complement our remedy ‘in the most serious cases’.¹⁶
31. Many Audit Committees may already be meeting expectations of them. But it is important to ensure that those that do not meet adequate standards can be held to account by shareholders. To that end the regulator will need to target its work carefully, and refine the oversight regime over time as it learns more about the strengths and weaknesses of Audit Committees.
32. This remedy could be complemented through enhancing engagement between Audit Committees and shareholders, for example by implementing recommendations from the BEIS Select Committee on transparency of fees¹⁷ and a requirement on the auditor to present at the audited company’s AGM.¹⁸
33. Earlier in our study, we considered the more radical step of moving responsibility for selecting auditors to an independent body, as did Sir John Kingman as an addition to his review of the regulator. This would address head-on one of the major features of the market – the fact that companies, through their Audit Committees, select their own auditors, albeit subject to confirmatory shareholder votes. We identified legal barriers to this change,¹⁹ but remain of the view that this would be worth keeping under consideration in the long term. The BEIS Select Committee also stated the view that this should remain a viable option for reform in the future.²⁰

¹⁶ Such as suggesting changes to the Audit Committee Chair, or ordering re-tendering. Sir John Kingman, *Independent Review of the Financial Reporting Council*, December 2018, Recommendation 50, page 50.

¹⁷ BEIS Select Committee, *The Future of Audit*, 2 April 2019, paragraph 150.

¹⁸ BEIS Select Committee, *The Future of Audit*, 2 April 2019, paragraph 54.

¹⁹ See CMA *Update Paper*, 18 December 2018, paragraph 4.12.

²⁰ BEIS Select Committee, *The Future of Audit*, 2 April 2019, paragraph 176.

Recommendation 2 – mandatory joint audit, including at least one non-Big Four firm, for most large companies; peer reviews for the largest; and measures to mitigate the effects of a Big Four failure

34. In order to ensure both acceptable choice and improved resilience of the audit sector, we need five, six or even seven firms auditing the largest companies in the UK, in the medium to long term, rather than the current four. The existing market structure is heavily entrenched, so this will not be easy, and will take time – perhaps some considerable time; but it will certainly not happen if the market is left unchanged.
35. Mandatory joint audit for most large companies is designed to address choice and resilience problems. The effect of this remedy should be to break down the barriers to expansion for non-Big Four firms, enabling them to build capacity, capability and reputation over time, as they gradually start to carry out substantial portions of audits for some of the UK's biggest companies, and as a result to increase long-term quality.
36. The direct and immediate effects on the quality of each individual audit, as long as audits are well planned and managed, should be at worst neutral. While opponents of joint audit suggested a negative effect, that has often been based on either an incomplete understanding of joint audit,²¹ or incorrectly cited past audits which were not truly 'joint',²² or a lack of direct recent experience,²³ or a combination. The evidence from France, where joint audit is a requirement, indicates both that it can have the intended effect of reducing the concentration of the largest audits in the hands of the Big Four, and that it is possible to implement it without significant adverse consequences.
37. Joint audit will need to be implemented carefully so as not to extend beyond challenger firms' ability to grow, and should be refined as time passes. All of this suggests that we should recommend the initial shape of the remedy, but that the regulator should monitor and refine it as appropriate, potentially considering removing it at some point in the future if availability of greater choice seems more settled.

²¹ Frequently-expressed concerns about issues 'falling between the gaps' were not shared by the French regulator or the French Audit Committee Chairs we spoke to.

²² For instance, in [KPMG's response to our Invitation to Comment](#), page 22. 'KPMG is aware of examples of notable failures of joint audits, such as the Bank of Credit and Commerce International and Parmalat, where market commentators have suggested that the use of joint audits contributed to fraud remaining undetected'. Our understanding that while both cases involved more than one auditor, neither was a joint audit – ie one where both auditors checked each other's work, and both were jointly liable.

²³ Joint audits have not been widely used in the UK for some years.

38. Several firms pointed us towards shared audits rather than joint audits as a way to achieve the same objective.²⁴ We remain of the view we expressed in our update paper. Shared audit would result in the smaller firm being very clearly subsidiary to the bigger; it would be less effective in achieving resilience and choice in the market. It would also present a risk to audit quality because the second auditor would not sign the audit report, and would not be jointly liable, as with joint audit.
39. We recommend that the Secretary of State legislate to give the regulator flexible powers to implement a joint audit regime based on further consideration of specific design issues, and adapt it over time. Key elements of the remedy are likely to be as follows:
- a. At least one joint auditor should be a non-Big Four firm.
 - b. Most FTSE350 companies should be required to appoint joint auditors. The regulator should establish criteria on which companies may need initially to be exempted, covering a small number of the largest and most complex companies; companies with very simple, single-entity accounts such as investment trusts are also likely to be candidates for exemption from the requirement.
 - c. Any company that would otherwise fall within the scope of the remedy should also be exempt if it appoints a non-Big Four firm as its sole auditor.
 - d. Other circumstances for exemption by the regulator should be limited – for example where all firms outside the Big Four firms are unable to provide a service.
 - e. The introduction of joint audit should be gradual, enabling adaptation over time, as suggested by the BEIS Select Committee; companies should make the transition to joint audit no later than when their next tenders arise (rather than all companies in scope having to make the change immediately), but could do so earlier if they choose.
 - f. Other than the existing mandatory rotation requirements, individual audit committees should be free to arrange the respective timings of each joint auditor’s appointment as they see fit.

²⁴ A shared audit being where a smaller firm carries out a minority portion of the audit, and feeds its work into the larger firm, which is the one that signs the audit report; as opposed to a joint audit, as used successfully in France, where two firms share the components of the fieldwork between them, but both check the consolidation of the components, and both sign the audit opinion.

- g. There should be a presumption that Audit Committees should ensure that the work of each of the two joint auditors is substantial and relatively equal, starting with each audit firm ordinarily receiving at least 30% of the audit fee.
 - h. No changes should be made to the existing UK audit liability framework, meaning that the joint auditors will have joint and several liability for the engagement.²⁵
 - i. The regulator should be empowered to adapt this remedy over time, for instance increasing or decreasing the coverage of the joint audit or peer review requirements, or changing the requirements on the balance of fees between joint auditors.
40. There are difficulties with challenger firms taking on even parts of the audits of the very biggest companies at this point. However, in the interests of introducing both an opportunity for challenger firms to gain experience and reputation with the biggest companies, and some additional quality assurance, we recommend that the regulator should have the power to appoint peer reviewers for a selection of companies that are not included in the joint audit remedy.
41. The main elements of this should be as follows, although as this would be a regulatory tool, the regulator should consider its detailed design further.
- a. The reviewer should not be one of the Big Four, apart from in exceptional circumstances, at the discretion of the regulator; for example if the Audit Committee had already chosen a challenger as its sole auditor.
 - b. These should be 'hot' reviews, ie in real time, and should report to, and be accountable only to, the regulator.
 - c. The peer reviewer should not sign the audit opinion, and should not be liable for the accuracy of the accounts.
 - d. The regulator should consider how to select peer review targets, either on rotation or incorporating an element of risk assessment, as is the case with its current quality reviews.

²⁵ The broader issue of liability, something brought up in various responses to us, is being looked at as part of the Brydon Review.

- e. The regulator should consider whether and how to make the results public, alongside its consideration of Sir John Kingman's recommendation to publish the results of its current quality reviews.
42. This would mainly be a direct quality-checking measure, as a complement to the regulator's Audit Quality Review process. But it should also have some effect in building non-Big Four firms' capacity, capability and credibility, albeit not to the same extent as joint audit.
43. The deployment of joint audit and peer reviews, the breakdown of fees between joint auditors, and the interaction between joint audit and the option to have a sole challenger auditor, will need to be adapted by the regulator as the years pass. There are so many variables; it would be unwise to specify now what should happen in 10, 15 or 20 years. The regulator will need the powers to act with sufficient flexibility and discretion. The joint audit requirement should remain in place until the regulator determines that choice and competition have improved enough to address the vulnerability of the market to the loss of one of the Big Four.
44. We have also considered a market share cap remedy as a potential alternative way to break down the barriers to non-Big Four firms.²⁶ A share cap could bring the benefit of an early increase in market share for challenger firms. But share caps present a number of problems. A cap carries a greater risk to short and medium-term audit quality through reduced choice and competition. There is a risk to quality because a cap might require challenger firms to act as sole auditors for companies which are significantly more complex than, or cover different sectors or geographical areas from, their current clients. By contrast, joint audit provides for a gradual scaling up of a challenger firm's share of work on a given company's audit, with it working alongside an experienced Big Four firm as the other joint auditor.
45. The reduction in auditor choice is more severe under a cap for the companies it affects, whereas with joint audits a company faces no restriction on its choice of the first joint auditor. A market share cap would also soften competition in the long term because it would segment the market between the Big Four and the challengers, reducing competition between them.
46. There is a significant risk that a market share cap causes 'cherry-picking' of audit clients by the Big Four; the Big Four would have every incentive to shed their highest-risk or lowest-profit clients, which would risk undermining both overall audit quality and the challenger firms' positions.

²⁶ As suggested by the BEIS Select Committee: *The Future of Audit*, 2 April 2019, paragraph 205.

47. We and the BEIS Select Committee both agree on the underlying problems – resilience, choice and quality. And like the Committee, we would not exclude share caps as a possible solution in future, depending on how the market develops, and on whether a design could be found that avoided the risks identified above. The application of caps to segments of the market could help in some respects. But the substantial problems of cherry-picking, limits on choice, and significant softening of competition appear likely to remain.
48. For these reasons, we have concluded, on balance, that the best route for early action lies with joint audit, plus the option for Audit Committees to choose between joint audit or a sole challenger auditor. This offers many of the potential benefits of a share cap, as highlighted by the BEIS Select Committee, without many of the risks. It serves the purpose of breaking down the barriers to non-Big Four firms, allowing challenger firms to build their market presence at a sustainable rate, while maintaining maximum choice for Audit Committees.

Measures to mitigate the effects of a Big Four failure

49. We have highlighted the risk of, and undesirable outcomes from, a Big Four firm failing. The primary way to mitigate this risk is to increase the number of credible audit firms, which the joint audit remedy offers the best prospect of accomplishing. Once that is achieved, this market should be more like any other, in that a firm that is failing as a result of poor performance should be allowed to fail, and its business taken by other, better-performing firms.
50. In the meantime it would be necessary to do as much as possible to preserve choice if a Big Four firm were in distress or approaching failure. This would mean seeking to prevent a similar outcome to Arthur Andersen's demise, in which the failing firm's clients and staff mostly transferred to the other four big firms. The remedy would seek to ensure that as many as possible of the audit clients of a distressed Big Four firm were transferred to a new firm, a challenger firm, or remain within the same firm while a turnaround was implemented.
51. The regulator should monitor the health of the audit firms. It should work with the firms' management to keep abreast of developments. If it became apparent that a Big Four firm was in distress or likely to fail, with audit contracts and staff moving to the remaining Big Three, the regulator should use additional powers and/or take executive control of the distressed Big Four audit firm to limit the movement of clients to the other Big Three, while maintaining audit quality.

52. We suggest that the regulator determine the precise mechanisms of this procedure and how it should be funded, for example from the firm's equity and cash. This is to prevent moral hazard – excessive risk-taking by audit partners in the expectation of a bail-out.

Recommendation 3 – an operational split between the audit and non-audit practices of the Big Four

53. As explained above, the multi-disciplinary structure of the firms creates two types of problems – a potential diminished focus on audit quality, and a reduction in choice and competition. The only way to remove both problems entirely would be to separate the firms' audit practices from their non-audit practices – in practice forcing them to divest one side or the other. This was the route proposed by the BEIS Select Committee.²⁷ If auditors' only financial interest was in their audit practices, their focus on delivering good audits would be strengthened; and the absence of non-audit services-related conflicts would free more firms to compete in tenders.
54. The case made by the Select Committee is strong, given the shortcomings of the current market identified in its report.²⁸ However, an immediate full structural split carries a number of risks.
55. These are global firms carrying out global audits. Such a separation would have to be carried out internationally in order to be fully effective. A UK-only separation would focus UK auditors exclusively on audits, thereby dealing with one of the two problems, but would leave in place many of the conflicts. If a UK firm were split into audit and non-audit practices, the conflict rules would (as they do now) prevent a situation where the newly separate audit practice could be carrying out a bank audit on which its Irish sister firm might have provided the tax advice. A significant relaxation of the conflicts rules would almost certainly be undesirable, given the risks with these conflicts established by a series of past reports.²⁹ Additionally there would be a need to consider the one-off costs associated with any such structural change.
56. An international structural split is not in the UK Government's gift. But this is a debate that the regulator and / or the Government should initiate at international level, while recognising that an agreed solution may be elusive and would certainly take a long time to negotiate.

²⁷ BEIS Select Committee, *The Future of Audit*, 2 April 2019, paragraph 141.

²⁸ BEIS Select Committee, *The Future of Audit*, 2 April 2019, paragraphs 5-11.

²⁹ See footnote 16.

57. We recommend that at this stage the Government put in place an operational split between the audit and non-audit practices of the biggest firms in the UK – initially only the Big Four, but with the regulator able to add other firms in later years when they have grown to closer to the Big Four’s size.
58. Creating a separate status for audit practices will have a number of benefits: it will increase the focus on audit quality, with a reduction in the distracting interest in non-audit work; it will create transparency around audit practices, allowing the regulator to monitor their performance and resilience; it will give audit practices a place within the firms that compensates for their diminishing share of the firms’ revenue, and reflects the public interest and concern; and it will give audit practices every possible incentive – short of a structural split – to bid competitively for more tenders, without trading off against possible non-audit revenues.
59. However, by keeping the firms structurally intact while operationally separate, this recommendation will allow the firms to preserve the elements of their multi-disciplinary practices that they prize most highly: the ability for audits to draw on non-audit expertise from staff with a shared brand; and attracting recruits with the potential to carry out different types of work across audit and non-audit.
60. The regulator should be given the powers to design the specific details of the remedy, and refine it over time. The key elements of the operational split are likely be as follows:
 - a. No profit-sharing between the audit practice and the non-audit practice, with audit partner remuneration linked to the profits of the audit practice only.
 - b. Separate financial statements for the audit practice, consisting of a profit and loss statement for the audit practice.
 - c. Transparent transfer pricing, checked by the regulator, particularly for the use of non-audit specialists on audits.
 - d. The audit practice should also include audit-related services, such as various regulatory reporting requirements that regulators regard as being best carried out by companies’ auditors.
 - e. A separate CEO and board for the audit practice, populated by a majority of independent non-executives, who should be answerable to investors in audited companies, and to the public interest via the regulator.

- f. The audit board should be responsible for all remuneration and career progression decisions within the audit practice.
 - g. The board should conduct an annual general meeting and produce an annual report.
 - h. Remuneration and career progression should be strongly linked to audit quality, with the audit board setting and overseeing quality standards.
61. As suggested by the BEIS Select Committee,³⁰ a ‘cooling-off’ period could be introduced after the end of an audit, during which the firm would not be allowed to carry out any non-audit work for the company concerned. This should be considered by the regulator, in the context of its existing review of its ‘Ethical Standard’.³¹
62. If it proves impossible to complete an operational split that delivers the expected improvements – for example if the firms found ways to erode the separation – a re-examination of the merits of a full structural split in the UK would be necessary.

Recommendation 4 – a five-year review of progress by the new regulator

63. It will be important to set a specific point at which progress can be reviewed, and the effectiveness of the overall package of remedies assessed. The regulator should be required to do this, for instance five years from full implementation, in addition to its continuing oversight of the implementation and maintenance of the remedies. The BEIS Select Committee also emphasised the importance of such a review.³²
64. This review should examine the effectiveness of the remedies. It should return to the following questions in particular:
- a. The merits of moving to independent appointment of auditors, depending on the effectiveness of the regulatory scrutiny of Audit Committees.³³

³⁰ BEIS Select Committee, *The Future of Audit*, 2 April 2019, paragraph 182.

³¹ *FRC issues Position Paper: next steps for development of Ethical and Auditing Standards*, 5 March 2019.

³² BEIS Select Committee, *The Future of Audit*, 2 April 2019, paragraph 141.

³³ This would require changes to, or an ability to depart from, European legislation.

- b. The possible need for a structural split between audit and non-audit services, depending on the effectiveness of the operational split, as well as on the level of international engagement in this question.
- c. Joint audit will almost certainly take longer than five years to bring the desired effects, but the regulator should consider how to fine-tune the remedy to adapt to market developments, to the extent it has not already done so.

Other possible measures

65. There are a number of other ideas that do not form part of the core of our recommended package of remedies, but which merit careful consideration by the Government and / or the regulator. They include:
- a. **Remuneration deferral and clawback.** Any profit share and unit awards for partners could be deferred for a period from the year of the award, with a portion of the award vesting in each subsequent year. The retained amounts could be subject to a clawback provision, whereby the audit board would have the option to reduce the payment to individuals. This would be similar to the financial services industry, where a framework introduced in 2015 aimed to ‘further align risk and individual reward in the banking sector to discourage irresponsible risk-taking and short-termism’.³⁴
 - b. **Audit firm ownership rules.** Re-considering the necessity of the audit firm ownership requirements, which currently require that audit firms are majority owned by qualified auditors. Although the existence of potential entrants following different business models is highly uncertain, such businesses may never even be contemplated if their route to launch is blocked by regulation. Liberalising the ownership rules could also encourage greater capital investment, allowing new entrants and existing challengers to scale up more quickly; but this would need weighing up against potential impacts on independence.
 - c. **Technology licensing.** Keeping under review the possibility of cross-industry technology licensing, potentially facilitated by the regulator and / or the professional bodies. Access to technology has not been cited as a major barrier, at least by the bigger challenger firms, but technology changes are likely to play a potentially significant role in the

³⁴ Bank of England Prudential Regulation Authority (PRA) and Financial Conduct Authority (FCA) (2015), *Strengthening the alignment of risk and reward: new remuneration rules*, pp7-9. *The PRA and the FCA announce new rules on remuneration*, 23 June 2015.

way the sector develops in coming years. Compulsory licensing of technology carries risks if implemented badly, in deterring investment and innovation, but should be kept in mind if technology proves to be an increasing barrier to competition in future.

- d. **Measures to improve information for shareholders**, and increasing transparency of Audit Committees, especially during tendering. The BEIS Select Committee made various recommendations in this area, for instance in disclosing audit staff hours and fee breakdowns, which we agree would be worthy of consideration.³⁵ Other examples include a requirement on the regulator to provide a public database of audit partners and firms, similar to that maintained by the US accounting regulator, the PCAOB, to make it easier to identify where a partner was responsible for another audit where there were concerns.
- e. **Notice periods and non-compete clauses**. We heard some suggestions during our study that barriers to challenger firms growing could be reduced if notice periods for partners and senior staff in Big Four firms were reduced, and non-compete clauses were limited in scope.
- f. **Requirements on tendering and rotation periods**. The current requirement on Public Interest Entities is to carry out an audit tender at least every ten years, change audit firm at least every twenty, and for the audit firm to change the lead partner every five years. The BEIS Select Committee recommended revisiting this, moving to a fixed term of seven years.³⁶ We have not considered this in detail as part of our study, in the belief that lack of available tenders has not been a significant factor holding back challenger firms from expanding. However, the Committee identified an additional reason to do this: to disrupt the ‘familiarity’ that can arise between auditor and audited company. This relates closely to the regulator’s requirements on independence, so we suggest the regulator considers changes along these lines.

Early implementation

- 66. We suggest that the Secretary of State should take forward these recommendations at the earliest opportunity. Each year that passes without any action taken runs the risk of major audit failures. Even in the best possible

³⁵ BEIS Select Committee, *The Future of Audit*, 2 April 2019, paragraph 150.

³⁶ BEIS Select Committee, *The Future of Audit*, 2 April 2019, paragraph 179.

scenario, significant change will take a number of years to result in improvements in outcomes.

67. In our Update Paper we gave notice of our proposal not to make a market investigation reference.³⁷ We also set out our reasons for that proposal and sought views.³⁸
68. Of those responses that addressed the market investigation reference question, most respondents supported the CMA's proposal not to make a market investigation reference, for reasons including the risk of delay to reforms. Others disagreed, suggesting that a CMA market investigation, or alternative review of an equivalent standard, was needed to gather further evidence and consider the proposed remedies in detail. Many respondents emphasised the need for the various audit reviews to be considered holistically, and reforms to be implemented in a coherent way.
69. The CMA has decided not to make a market investigation reference. Instead, we have made recommendations to the Secretary of State. Our reasons for doing so are that:
 - a. The Secretary of State can consider all market features and potential reforms as a whole, drawing together our recommendations, the Kingman review, the Brydon review, the BEIS Select Committee report and other reforms proposed by the FRC.³⁹ The Secretary of State has already indicated that he intends to legislate to create a new audit regulator.⁴⁰ Our recommendations will provide him with as much information and guidance as possible as to the powers the new regulator should have, for example to enable it to meet its proposed new competition duty.⁴¹
 - b. Recommendations enable the sector to move forward without delay. A market investigation could take up to two years from the point at which it started, and might well in any case conclude with recommendations.

³⁷ As required by section 131A(2)(a) of the Enterprise Act 2002.

³⁸ As required by section 131A(2)(b) of the Enterprise Act 2002.

³⁹ *FRC consults on stronger Going Concern standard for auditors*, 4 March 2019; *Post Implementation Review of the 2016 Auditing and Ethical Standards: Next Steps*, March 2019.

⁴⁰ Secretary of State's foreword to the [initial consultation on the recommendations from the Independent Review of the Financial Reporting Council](#), pp3-4.

⁴¹ See, for example, Recommendation 73 from the *Independent Review of the FRC* which states that: 'The Review recommends giving the regulator the powers it needs to support a competition duty and an ongoing market review function. In particular, it will need powers to require firms to provide audit pricing, cross-subsidy and market share data and powers to act to address competition issues where necessary. The position should be reviewed again following completion of the CMA's market study to ensure that the regulator has the powers needed to implement or monitor the CMA's competition remedies and to act on evolving or new competition issues in the future'.

By making recommendations now and enabling the Government to take these forward swiftly, the sector can move into an implementation and improvement phase rather than continued lengthy reviews. This is consistent with the Secretary of State's request to the CMA at the start of the study to 'be ambitious in its thinking and move swiftly on this issue'.⁴²

⁴² Rt Hon Greg Clark MP to Lord Tyrie, 9 October 2018.