

# Statutory audit services market study

Final report  
18 April 2019

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## 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.

# 1. Introduction

- 1.1 In this section we explain why we have looked at the market for the supply of statutory audit services in the UK. We cover:
- (a) why audit is important;
  - (b) some background facts about the UK audit sector;
  - (c) the concerns that have arisen around audits, and other relevant reviews;
  - (d) our response to recent reviews (the independent review of the Financial Reporting Council (FRC) led by Sir John Kingman, the Business, Energy and Industrial Strategy (BEIS) Select Committee's inquiry, and Sir Donald Brydon's ongoing review); and
  - (e) how we have examined the concerns around audits.

## Why audit is important

- 1.2 Most people will never read an auditor's opinion on a company's accounts. But often without realising it, tens of millions of people depend, directly or indirectly, in some way on independent audits to help ensure that companies report truthfully on their performance. Unreliable accounts can lead to the wrong investment decisions and undermine shareholder scrutiny of management, which in turn risks people's jobs, their pensions and their savings. The availability of trustworthy financial information on the performance of companies is vital to providing the confidence that is necessary for the proper functioning of a market economy.

## The UK audit sector

- 1.3 All companies in the UK are required, under the Companies Act, to have their annual accounts audited externally, unless exempt.<sup>1</sup> There are many audit firms in the UK that can carry out these statutory audits, but few such auditors currently audit the largest publicly listed companies, including those listed on the FTSE 350.<sup>2</sup>

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<sup>1</sup> A company's auditor must make a report to the company's members on the accounts produced, and for public companies these reports are laid before the company in a general meeting. For Public Interest Entities (PIEs), audit committees typically have a key role in the selection, appointment and removal of auditors, as well as agreeing the terms and fees to be paid, and making recommendations to the company board concerning these matters.

<sup>2</sup> The FTSE 100 and 250 collectively are referred to as the FTSE 350.

- 1.4 The large auditors in the UK are part of similarly branded international networks of audit firms. Audit firms in these networks are experienced at working together to provide international companies with a seamless audit service across borders, so a company may only need to appoint one single auditor for its global business.
- 1.5 In the UK, 97% of audits of FTSE 350 companies are undertaken by the Big Four auditors, which are PricewaterhouseCoopers (PwC), KPMG, Ernst & Young (EY) and Deloitte.<sup>3</sup> While there are many smaller audit firms that carry out audits for unlisted and smaller companies, there are several challenger firms, some of which have a small number of clients in the FTSE 350. Challenger firms include BDO, Crowe, Grant Thornton, Mazars and RSM. Many challenger firms have international networks of firms like the Big Four, although these are more limited.
- 1.6 There has been consolidation in the audit sector in the last 30 years. Before 1987, there were eight large international audit firms in the UK, and there have been four large audit firms since 2002, following Arthur Andersen's demise that year and the merger of Price Waterhouse and Coopers & Lybrand in 1998.

## Concerns about the audit market are both widespread and longstanding

- 1.7 The earliest auditors, in the 19<sup>th</sup> century, were heralded as protecting investors against unscrupulous company managers, particularly in the early decades of the UK rail industry.<sup>4</sup> Today's big audit firms have their roots in, and indeed often retain the names of, these 19<sup>th</sup> century pioneers.
- 1.8 Audit falls into the category of services that only attract public commentary when things go wrong. And the last 20 years have seen plenty such commentary, both in the UK and elsewhere, as well as various reviews finding audits to be sub-standard. A sample is below.
- (a) **Enron and Arthur Andersen.** Enron, the seventh largest company in the United States, filed for bankruptcy in 2002 after it was found to have misinformed about its profits. Having failed to reveal Enron's flawed accounting, its auditor at the time, Arthur Andersen, came under intense scrutiny and was found guilty of deliberately destroying evidence of its relationship with Enron.<sup>5</sup> Although this conviction was subsequently

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<sup>3</sup> FRC (2018), *Developments in Audit 2018*, p27.

<sup>4</sup> See for example Deloitte, *Leaders and Shapers*, William Welch Deloitte.

<sup>5</sup> BBC news (2002), *Enron scandal at a glance*.



overturned by the United States' Supreme Court, the incident is widely perceived to have contributed to the collapse of Arthur Andersen.

Reflecting on these significant corporate failures, one commentator suggested 'the consequences of Enron's directors' clubbiness...were compounded by conflicts at [Arthur] Andersen, which earned more from consulting for Enron than from monitoring its books'.<sup>6</sup>

- (b) **Bank failures during the 2008 financial crisis.** According to a House of Lords committee: 'We do not accept the defence that bank auditors did all that was required of them. In the light of what we now know, that defence appears disconcertingly complacent. It may be that the Big Four carried out their duties properly in the strictly legal sense, but we have to conclude that, in the wider sense, they did not do so.'<sup>7</sup>

And similarly, according to the Parliamentary Commission on Banking Standards: 'Auditors and accounting standards have a duty to ensure the provision of accurate information to shareholders and others about companies' financial positions. They fell down in that duty. Auditors failed to act decisively and fully to expose risks being added to balance sheets throughout the period of highly leveraged banking expansion. Audited accounts conspicuously failed accurately to inform their users about the financial condition of banks.'<sup>8</sup>

According to the Public Company Accounting Oversight Board (PCAOB) Investor Advisory Group: 'The recent financial crisis presented auditors, and by extension the Sarbanes-Oxley Act audit reforms, with their first big test since these reforms were put into place. By any objective measure, they failed that test.'<sup>9</sup>

- 1.9 The BEIS Select Committee's report, 'The Future of Audit', cited previous calls for reform in the 1930s, 1970s, 1980s, and 1990s.<sup>10</sup> More recent examples of audits giving rise to public concerns are listed below.

- (a) **BHS's demise and PwC's failings.** Both PwC and the individual audit partner admitted misconduct in their audits of BHS and the Taveta Group,

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<sup>6</sup> Andrew Hill, The Financial Times (2011), [Ten years on, Enron remains an open sore](#).

<sup>7</sup> House of Lords Economic Affairs Committee (2011), [report on audit market concentration](#), paragraph 142.

<sup>8</sup> Parliamentary Commission on Banking Standards (2013), [Changing Banking for Good](#), volume I, paragraph 25.

<sup>9</sup> PCAOB Investor Advisory Group (2011), [The Watchdog That Didn't Bark... Again](#). For an explanation of the Sarbanes-Oxley Act, see below.

<sup>10</sup> BEIS Select Committee (2019), [The Future of Audit](#), paragraph 12.

which owned it, following BHS's sale to Dominic Chappell and its subsequent demise in 2016.

- (b) **Carillion's failure.** In early 2018, Carillion, a British multinational facilities management and construction services company which was at the time audited by KPMG, went into liquidation. This collapse led to project shutdowns and delays, job losses, and financial losses, including to Carillion's 30,000 suppliers, generating widespread public and political concerns. According to two House of Commons committees: 'KPMG's long and complacent tenure auditing Carillion was not an isolated failure. It was symptomatic of a market which works for the members of the oligopoly but fails the wider economy'.<sup>11</sup>
- (c) **2018 FRC Audit Quality Review (AQR) findings.** In its most recent AQR, the FRC found that there was a decline in quality for all of the Big Four, and an 'unacceptable deterioration' at KPMG, while the four challenger firms reviewed showed 'general improvements'.<sup>12</sup>
- (d) **Other FRC enforcement findings.** In May 2018, the FRC announced it had delivered formal complaints in respect of Deloitte's audit of Autonomy Corporation plc including an alleged failure by Deloitte to adequately challenge the company's accounting and disclosure of purchases and sales of computer hardware.<sup>13</sup> In July 2018, the FRC announced an investigation into the audit by KPMG of Conviviality plc, which went into administration in April 2018.<sup>14</sup> In August 2018, the FRC announced a severe reprimand and fine of £3 million for KPMG, and a separate reprimand and fine of £80,000 for one of its audit partners, after the FRC found misconduct in respect of KPMG's audit of Ted Baker plc.<sup>15</sup>
- (e) **Other international cases.** In 2016, senior staff at KPMG's South Africa division resigned following audit failures linked to a wider political corruption scandal surrounding the Gupta family. KPMG had audited various Gupta family businesses for fifteen years but its staff were found to have failed to act on warnings regarding the integrity and ethics of the family.<sup>16</sup> In India, PwC received a ban in early 2018 from auditing listed

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<sup>11</sup> House of Commons Business, Energy and Industrial Strategy and Work and Pensions Committees (2018), [Carillion, second joint report](#), paragraph 210.

<sup>12</sup> FRC (18 June 2018), [Big Four Audit Quality Review results decline](#).

<sup>13</sup> FRC (31 May 2018), [Disciplinary action in relation to Autonomy Corporation plc](#).

<sup>14</sup> FRC (3 July 2018), [Investigation into the financial statements of Conviviality plc](#).

<sup>15</sup> FRC (20 August 2018), [Sanctions against KPMG and Senior Statutory Auditor in relation to the audits of Ted Baker Plc](#).

<sup>16</sup> Financial Times (15 September 2017), [KPMG South Africa executives dismissed over Gupta scandal](#).

companies in the country for two years after failing to spot \$1.7 billion of fraud at Satyam Computer Services for five years from 2003.<sup>17</sup>

- 1.10 Over the same period, regulators, governments and other authorities have made attempts to improve audits.
- (a) The Competition Commission (CC) conducted a market investigation into statutory audit services between 2011 and 2013, resulting in an Order that came into force on 1 January 2015.<sup>18</sup> The CC identified several features of the market<sup>19</sup> that were leading to adverse effects on competition and decided on a package of remedies with a number of elements. These remedies included mandatory tendering of audit contracts by the FTSE 350 companies at least every ten years, greater review of audits by the FRC, greater shareholder engagement with company management on audits, greater accountability of auditors to Audit Committees, and a recommendation for the FRC to have a competition objective.<sup>20</sup>
  - (b) In light of concerns about EU audit markets similar to those investigated by the CC in the UK, the European Commission introduced additional legislative change. This came into force in June 2016. This legislation applies EU-wide and in terms of substance closely mirrored the CC's remedies, and introduced several additional reforms including mandatory switching of audit contracts for Public Interest Entities (PIEs) (which in the UK is required at least every twenty years). It also placed specific obligations on PIEs in connection with auditor appointments.
  - (c) The Statutory Auditors and Third Country Auditors Regulations 2016 (SATCAR 2016), which came into effect in June 2016, implemented the EU legislation in the UK. SATCAR 2016 designated the FRC as the UK's Competent Authority responsible for public oversight of statutory auditors. SATCAR 2016 also amended the Companies Act 2006 to reflect the EU reforms, including the process for auditor appointments, retendering and rotation.<sup>21</sup>
  - (d) In the United States, in response to major corporate failures such as Enron, the Sarbanes-Oxley Act (2002) was passed (often referred to as

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<sup>17</sup> Financial Times (11 January 2018), [PwC hit with 2-year India audit ban for Satyam case](#).

<sup>18</sup> [CMA case page for statutory audit services market investigation](#).

<sup>19</sup> These included barriers to switching; challenger firms facing barriers to entry, expansion and selection, as well as experience and reputational hurdles; company management's ability to influence auditors; and information asymmetry between shareholder and audit firm; see Competition Commission (2013), [Statutory audit services for large companies market investigation](#), paragraph 13.3.

<sup>20</sup> Competition Commission (2013), [Statutory audit services for large companies market investigation](#), p7.

<sup>21</sup> FRC (17 June 2016), [Statement from Stephen Haddrill, Chief Executive of the Financial Reporting Council, regarding the implementation of the EU Audit Regulation and Directive](#).

SOX). The Act introduced major changes to the regulation of financial practice and corporate governance. For audit, the changes included establishing standards for external audit independence, introducing audit partner rotation, and restricting auditors from providing non-audit services for audit clients. An overarching oversight board (the PCAOB) was also established by the Act.<sup>22</sup>

## Recent concerns and reviews during the market study

- 1.11 Immediately prior to commencing the market study, and during the course of our work, there has been more public commentary on audit problems. quality... Did the auditors challenge enough? Did they actually ask whether the accounts met the higher order true and fair view test? This is not as simple as robotic adherence to accounting standards.’<sup>23</sup> Politicians have described audit as ‘a failing market’<sup>24</sup> and suggested there have been ‘structural problems over far too many years.’<sup>25</sup> A report for the Labour Party suggested that auditors have been ‘unable to deliver independent and robust audits and the auditing industry is in disarray, dysfunctional and stumbles from one crisis to another’.<sup>26</sup> Academics and experts have stated ‘the culture and ethics of auditing have failed miserably at too high a cost to society.’<sup>27</sup>
- 1.12 In the last few months, the audit for the café chain Patisserie Valerie has received considerable public interest. Following the discovery of potentially fraudulent accounting irregularities in Autumn 2018, the FRC commenced an investigation into Grant Thornton’s audit of Patisserie Holdings Plc’s financial statements, and also an investigation into the preparation of the statements by its former Chief Finance Officer. The FRC’s investigations are ongoing.<sup>28</sup>
- 1.13 Our market study has taken place at the same time as three other significant reviews into the audit sector. The focus of each review is different but in combination their findings and recommendations present a unique opportunity to address the concerns about the audit sector.
- (a) In April 2018, the government asked Sir John Kingman to conduct an independent review of the FRC. On 18 December 2018, the review

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<sup>22</sup> More details about the Sarbanes-Oxley Act can be found at <http://www.soxlaw.com/>.

<sup>23</sup> Natasha Landell-Mills, Head of Stewardship at Sarasin & Partners in the Financial Times (29 August 2018), *A return to prudence – how to restore faith in accounting*.

<sup>24</sup> Rachel Reeves MP, Chair of BEIS Select Committee in City AM (1 October 2018), *Pressure mounts on the CMA to break up the Big Four*.

<sup>25</sup> Sir Vince Cable MP in City AM (1 October 2018), *Pressure mounts on the CMA to break up the Big Four*.

<sup>26</sup> Professor Prem Sikka et al (December 2018), *Reforming the auditing industry*.

<sup>27</sup> A group of academics and audit experts including Professor Atul Shah and Richard Murphy, the Financial Times (13 November 2018), *Big Four warn against breaking up UK audit firms*.

<sup>28</sup> FRC (21 November 2018), *Investigations in connection with the financial statements of Patisserie Holdings Plc*.

published its final report with 83 recommendations to reform and improve the oversight of audit and corporate reporting.<sup>29</sup>

- (b) In November 2018, the BEIS Select Committee launched an inquiry into the future of audit and published its findings on 2 April 2019. The inquiry focused on the likely impact of the CMA market study and the review of the FRC by Sir John Kingman in improving quality and competition in the audit market and reducing conflicts of interest.<sup>30</sup>
- (c) On 18 December 2018, the government announced that Sir Donald Brydon would lead an independent review into the quality and effectiveness of the UK audit market.<sup>31</sup> The review, which is covering the ‘expectations gap’, is now under way and expected to report by the end of 2019. On 10 April 2019, Sir Donald issued a call for views document.<sup>32</sup>

- 1.14 As the most recent public commentary and the other reviews indicate, there remain concerns despite the previous changes to improve audits; we explain in section two the extent to which past changes have made improvements or left issues unresolved.
- 1.15 Throughout this report we describe the interactions between our work and the other three reviews. In particular, in sections three (issues) and four (remedies) we address the BEIS Select Committee’s specific recommendations to us. In addition to responding to these relevant points, we also set out below some overall comments in response to each review. The reviews cover matters that are not directly related to the focus of our work but are important in helping to realise wider improvements in the audit sector.

## **Our response to the independent review of the FRC, including BEIS’s initial consultation on the review’s recommendations**

- 1.16 In our update paper, we said that competition and regulation should work together so that audit firms and individuals all have the strongest possible incentives to deliver quality. Part of this is about the regulator setting

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<sup>29</sup> Further details can be found at <https://www.gov.uk/government/publications/financial-reporting-council-review-2018>.

<sup>30</sup> Further details can be found at <https://www.parliament.uk/business/committees/committees-a-z/commons-select/business-energy-industrial-strategy/inquiries/parliament-2017/future-of-audit-17-19/>.

<sup>31</sup> BEIS press release (18 December 2018), <https://www.gov.uk/government/news/government-takes-next-step-in-improving-standards-of-uk-audit-market-with-new-independent-review-into-audit-standards>.

<sup>32</sup> Independent Review into the Quality and Effectiveness of Audit (2019), *Call for views*.

standards and enforcing against them, and we noted that this was the focus of the independent review into the FRC led by Sir John Kingman.<sup>33</sup>

- 1.17 We support Sir John Kingman's recommendations to reform and improve the oversight of audit, and welcome the government's initial consultation on the recommendations.<sup>34</sup> We offer some specific comments below in response to the government consultation.
- (a) In response to question two of the consultation, we support the new regulator having duties and being required to act in a way which promotes competition in the market for statutory audit services and is collaborative, working closely with other regulators both in the UK and internationally. We also support the new regulator's functions including 'to monitor and report on developments in the audit market, including trends in audit pricing, the extent of any cross-subsidy from non-audit work and the implications of the quality of audit.'<sup>35</sup> Further monitoring of the audit market by the new regulator would complement our package of recommendations.
  - (b) In response to question eight of the consultation, we are supportive of the regulator developing a robust market intelligence function to identify emerging risks at an early stage. Such a function is fundamental for a high-performing regulator, and a necessary feature to support our recommendation on mitigating the effects of failure of a Big Four firm. When taking forward this and other recommendations in relation to chapter three of the final report of the independent review of the FRC, we suggest the government bears in mind the relationship with our recommendations.
  - (c) In response to question eleven of the consultation, we strongly agree with the need for the new regulator to be given a competition duty, a specific statutory function to keep the audit market under review and the powers it needs to support this duty and function. These powers will be crucial for monitoring and adapting our package of remedies, once implemented through legislation.
  - (d) In response to question fourteen of the consultation, we note Sir John Kingman's proposed changes for the appointment of auditors in three specific circumstances and the government's intention to consult on these proposals separately. Subject to the specifics of their implementation,

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<sup>33</sup> CMA (18 December 2016), [Statutory audit services markets study update paper](#), p6.

<sup>34</sup> BEIS (March 2019), [Independent Review of the Financial Reporting Council - initial consultation on the recommendations](#).

<sup>35</sup> Ibid, p14.

these proposals could complement our proposed recommendation to increase the scrutiny on audit committees.

## **Our response to the BEIS Select Committee's report on the future of audit**

- 1.18 At the launch of our market study, we noted that when investigating the collapse of Carillion, the Joint Select Committees had concluded that 'waiting for a more competitive market that promotes quality and trust in audits has failed. It is time for a radically different approach', and had proposed we review the market.<sup>36</sup>
- 1.19 We welcome the BEIS Select Committee report into the future of audit, which followed up on its concerns about Carillion (and BHS), and considered how our study, and Sir John Kingman and Sir Donald Brydon's reviews, could tackle audit failings. We welcome the Select Committee's aim through its report to ensure that 'what emerges from these reviews is a coherent framework for auditing that could regain the confidence of investors and the public.'<sup>37</sup>
- 1.20 The Select Committee's report made arguments for radical change, concluding 'people are tired of hearing excuses for failure and are intolerant of blame being shifted from one set of well-paid people to another. As a result, the public and key stakeholders who rely on audits for essential information have become disillusioned with the reliability of audits and distrustful of the performance of [company] directors.'<sup>38</sup> The Select Committee sought to address this current situation with 'a set of proposed reforms that are pragmatic and designed to deliver solutions that prove to work the best.'<sup>39</sup>
- 1.21 Alongside its specific recommendations to us regarding our remedies, which we consider later in this report, the Select Committee reached findings and made proposals on other matters that we think worthy of further consideration.
- (a) In respect of the audit product, the Select Committee did not accept the attempts of auditors to underplay the role or scope of audit, stating 'the delivery gap is far wider than the expectation gap and this is what must be fixed as soon as possible.'<sup>40</sup> We agree. As we set out in our update paper, the 'expectations gap' is no excuse for audits too often falling

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<sup>36</sup> CMA (9 October 2018), [Statutory audit services invitation to comment](#), p9.

<sup>37</sup> BEIS Select Committee (2 April 2019), [The Future of Audit](#), paragraph 15.

<sup>38</sup> Ibid, paragraph 261.

<sup>39</sup> Ibid, paragraph 264.

<sup>40</sup> Ibid, paragraph 56.



short.<sup>41</sup> The Select Committee made proposals which mirror many of the issues we identified with the ‘expectations gap’. These proposals included that the detection of material fraud is, and must continue to be, a priority within an audit, audits should be more forward-looking, the FRC should make graduated findings mandatory, and the scope of the audit could be extended to cover the entire annual report.<sup>42</sup>

- (b) In respect of the audit product, the Select Committee made recommendations to increase investor engagement. We support these proposals for: a requirement in the new Stewardship Code for investors and asset owners to consider audit matters; auditors to make a presentation at a company AGM to show how they have challenged management; and for the regulator to consider requiring companies to publish the audit report at the same time as results are announced.<sup>43</sup> These could work well with our recommendation for greater regulation of Audit Committees.
- (c) In respect of capital maintenance, the Select Committee noted a number of issues with compliance, accounting standards and the law, goodwill, prudence, disclosure and a solvency-based system.<sup>44</sup> The Select Committee suggested a number of proposals to address this, including that the government and the FRC should work together to produce simple and prudent guidance for companies and auditors to follow, and that the regulator should vigorously enforce the revised capital maintenance regime.<sup>45</sup>
- (d) In respect of fees, the Select Committee recommended that the regulator require greater reporting on audit fees, potentially including the disclosure of audit hours, staff mix, and rate per hour.<sup>46</sup> But it considered greater transparency alone is not enough and that the regulator should be given more powers over audit fees. The Select Committee endorsed Sir John Kingman’s proposal that the regulator be given powers to intervene in the interests of quality, and suggested that the regulator could investigate whether the structure of fees is fit for purpose.<sup>47</sup>
- (e) In respect of the regulation of audit, the Select Committee agreed with Sir John Kingman’s review that the FRC has been for too long a weak and

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<sup>41</sup> CMA (18 December 2018), [Statutory audit services markets study update paper](#), p9.

<sup>42</sup> BEIS Select Committee (2 April 2019), [The Future of Audit](#), paragraphs 31, 35, 41, 45 and 57.

<sup>43</sup> Ibid, paragraphs 53, 54 and 55.

<sup>44</sup> Ibid, section 3 on capital maintenance.

<sup>45</sup> Ibid, paragraphs 78 and 80.

<sup>46</sup> Ibid, paragraph 150.

<sup>47</sup> Ibid, paragraph 153.



ineffective regulator.<sup>48</sup> The Select Committee welcomed the government's commitment to accept Sir John Kingman's recommendations to establish the new regulator, Audit, Reporting and Governance Authority (ARGA), and made a number of recommendations for ARGA's role and remit. The Select Committee's recommendations included that the new regulator should conduct and publish a swift but comprehensive review of any future audit failure to share lessons with the wider audit market, prioritise the quicker delivery of investigations into audit failures, and not be shy of imposing tough sanctions, including large fines.<sup>49</sup>

- (f) In respect of the regulation of audit, the Select Committee endorsed Sir John Kingman's recommendation that AQRs be a statutory requirement and published in full but also recommended that AQRs should not be anonymised. The Select Committee recommended the AQRs move beyond process-driven box-ticking and offer a robust appraisal of the opinions offered in audit and the evidence used.<sup>50</sup>
- (g) The Select Committee welcomed the government's commitment to consider and consult on the possibility of introducing a strengthened framework around internal controls on a similar basis to Sarbanes-Oxley. It considered this would improve the reliability of financial reporting.<sup>51</sup>
- (h) The Select Committee recommended that the government and the regulator explore whether non-accountancy entrants, such as technology firms could also play a role in the statutory audit market. It believed this could help address competition, innovation and resilience issues.<sup>52</sup>

## **Our response to Sir Donald Brydon's call for views**

1.22 In our update paper, we set out what we had heard about the 'expectations gap' and highlighted some issues that we thought would be worth addressing in any future review on the purpose and scope of audit.<sup>53</sup>

1.23 We identified the main categories of argument put forward to explain the 'expectations gap':

- (a) auditors' role and duties versus company directors' roles and duties;

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<sup>48</sup> Ibid, paragraph 153.

<sup>49</sup> Ibid, paragraphs 238, 244 and 248.

<sup>50</sup> Ibid, paragraph 252.

<sup>51</sup> Ibid, paragraph 255.

<sup>52</sup> Ibid, paragraph 259.

<sup>53</sup> CMA (18 December 2018), [Statutory audit services markets study update paper](#), Appendix C.

- (b) misunderstanding or lack of clarity about the purpose of an audit;
- (c) scope – extent of audit coverage;
- (d) scope – the extent to which an audit is supposed to spot fraud;
- (e) time; backward-looking audits and companies' future viability; and
- (f) form and content of the auditor's output.

1.24 We welcome Sir Donald Brydon's call for views taking into account our suggestions and addressing the areas we identified regarding the 'expectations gap'.

1.25 The call for views also contains questions on auditor liability and the extent to which liability might be an issue.<sup>54</sup> We have considered liability in the context of our remedy relating to joint audit and welcome Sir Donald's proposal to consider this further in his work.

## **How we have examined the concerns about audit**

1.26 We have gathered a wide range of evidence and views, including from the following:

- (a) 95 responses to our update paper and 75 responses to our invitation to comment;
- (b) information request responses from nine audit firms and 31 companies; and
- (c) speaking with over 100 parties including auditors, investors, companies, other public authorities, academics and other relevant parties.

1.27 The appendix sets out more detail on how we have conducted the study.

1.28 We focused our attention on the audits of larger companies, both listed and private, but remained open to evidence and views on the smaller end of the market, where some different conditions may prevail.

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<sup>54</sup> Independent Review into the Quality and Effectiveness of Audit (2019), [Call for views](#), chapter 9, questions 40-44.

## **Structure of the remainder of this final report**

- 1.29 In section two, we provide some information on market context and on what we have seen of audit quality.
- 1.30 In section three, we give our views on the range of issues we have examined, taking selection and oversight of auditors, competition and choice, barriers to expansion facing challenger firms, resilience, and incentives and audit firms' structure in turn.
- 1.31 In sections four to eight, we set out our recommendations in order to realise improvements to the way the statutory audit market operates. In section nine, we detail our decision not to make a market investigation reference.
- 1.32 The paper is accompanied by a supporting appendix on how we have conducted our market study, and a glossary.

## 2. Market context and outcomes

### Summary

- 2.1 The statutory audit market has changed over the past five years following the introduction of the CC and European Commission remedies. Mandatory tendering has led to a higher rate of tendering and switching of auditors than previously.
- 2.2 However, switching by the FTSE 350 has been almost entirely between the Big Four auditors. The Big Four still account for over 97% of audit clients in the FTSE 350 and over 99% of audit fees. Although the larger challenger firms have grown their overall UK audit revenues more strongly than the Big Four, they have collectively won only a handful of FTSE 350 audit contracts since the introduction of mandatory tendering.
- 2.3 Stakeholders agreed that the most important outcome in this market is audit quality. While there is no single agreed definition of audit quality, we have defined audit quality as the need for auditors to display sufficient scepticism, objectivity, integrity and independence in their work, as well as to appropriately challenge management despite strong pressure to conform to their judgements.
- 2.4 There are widespread public concerns about audit quality.<sup>55</sup> While some Audit Committee Chairs (ACCs) and companies questioned whether there was a systemic and significant quality problem, the views of investors – the ultimate customers of statutory audits – were more supportive of our analysis that there is a persistent problem of variable or poor audit quality.
- 2.5 Many stakeholders argued that the public concerns arise in part from an expectation gap about the role of audit, and we heard various views about how the role of audit should change in the future. These issues are now being addressed through the Brydon Review.
- 2.6 However, while the arguments around the expectation gap and role of audit are important, the evidence suggests that audit quality is not as high as it should be in a well-functioning market. In particular:
- (a) the FRC has found a number of company audits inspected to have required limited or significant improvements since 2013;

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<sup>55</sup> See paragraphs 1.7 to 1.11 above for a summary of these public concerns.

- (b) there has been a number of instances of poor audit quality that resulted in the FRC taking enforcement action against an auditor or audit firm;
  - (c) the FRC's AQR reports have continually raised concerns about lack of challenge by auditors and their poor demonstration of professional scepticism; and
  - (d) many stakeholders – including some audit firms – accepted that recent instances of high profile corporate failures have damaged trust in the audit sector and raised serious concerns around the quality of audited financial statements.
- 2.7 These issues cannot be dismissed as isolated events, or solely the result of an expectations gap.
- 2.8 In the remainder of this section we set out:
- (a) The market context, including the characteristics of the statutory audit market and changes in the market in recent years;
  - (b) Evidence on audit quality, including what the different indicators of quality show; and
  - (c) Our assessment of the potential wider economic impact of poor quality audit on trust in commercial relationships and financial information.

## **Market context**

- 2.9 This section sets out background on the market for statutory audit services in the UK. We focus particularly on changes since the 2013 CC report. We first describe the legal basis for statutory audit. We then briefly describe key characteristics of the market and how competition has developed since the 2013 CC report.

## ***Legal requirements***

- 2.10 The Companies Act, and various domestic codes and regulations, set out legal requirements in respect of statutory audit in the UK, including reflecting elements of the European legislative framework. The key pieces of European legislation in respect of audits are the Audit Directive<sup>56</sup> and Audit

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<sup>56</sup> Directive 2006/43/EC (most recently amended by Directive 2014/56/EU).

Regulation.<sup>57</sup> Aspects of the legal framework particularly relevant to our study include:

- (a) a requirement that a company's accounts must be audited each financial year, unless the company is exempt;<sup>58</sup>
- (b) a requirement that a company's auditor is selected by a vote of shareholders;<sup>59</sup>
- (c) a requirement that, in the case of PIEs, the company's Audit Committee is responsible for the audit selection process (leading to a recommendation by management to shareholders), and specific requirements as to how that selection process must be conducted;<sup>60</sup>
- (d) mandatory rotation of auditors of PIEs (in the UK rotation is required within 10 years of initial appointment, with the possible extension by 10 years in circumstances where a competitive tender takes place within 10 years);<sup>61</sup> and
- (e) Restrictions on the provision of non-audit services to PIEs by the statutory auditor. In particular:
  - (i) a 'blacklist' of services that cannot be provided by the audit firm or its network during the audit or in the financial year preceding the audit.<sup>62</sup>
  - (ii) a cap on the level of other non-audit services the audit firm may provide to its PIE audit clients. This cap limits services to no more than 70% of the average fees paid in the last three consecutive financial years for the statutory audit(s) of the audited entity (and certain other related undertakings).<sup>63</sup>

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<sup>57</sup> Regulation (EU) No 537/2014.

<sup>58</sup> Section 475(1) of the Companies Act 2006. A company may be exempt if it meets certain defined terms, being: small companies, certain subsidiary companies, dormant companies, or non-profit making and subject to public sector audit.

<sup>59</sup> Article 37(1), Directive 2006/43/EC and see Companies Act 2006, Part 16. We note that there are some exceptions to this requirement.

<sup>60</sup> Article 16, Regulation (EU) No 537/2014. There are some exceptions to the requirement that Audit Committees take responsibility for the selection procedure.

<sup>61</sup> Article 17, Regulation (EU) No 537/2014 transposed by section 494ZA of the Companies Act 2006.

<sup>62</sup> Article 5, Regulation (EU) No 537/2014. Blacklisted services include, for example, certain tax services, payroll services, and promoting, dealing or underwriting shares in the audited entity.

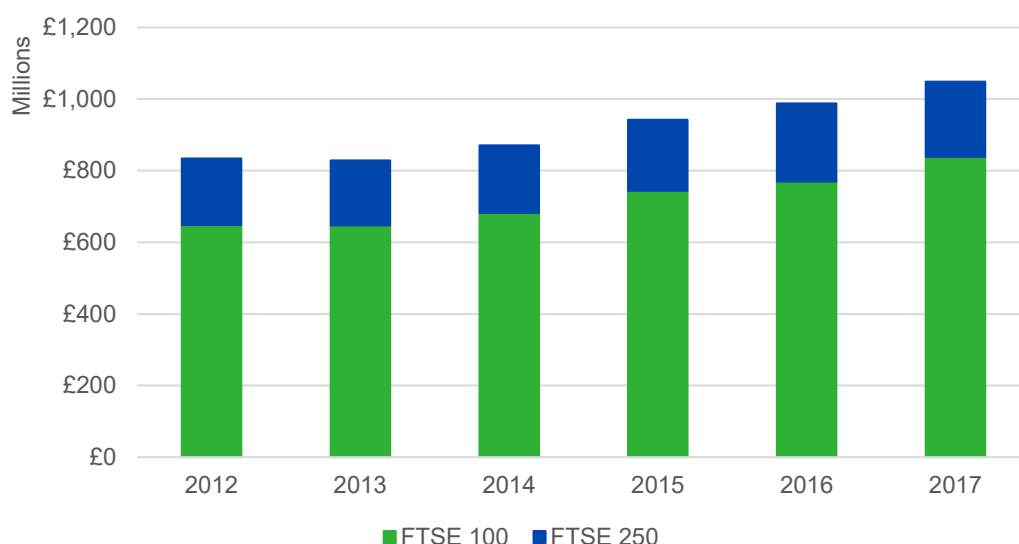
<sup>63</sup> Article 4, Regulation (EU) No 537/2014.

## Characteristics of the statutory audit market

2.11 Total audit fees paid to auditors of UK PIEs were £2.7 billion in 2017 – an increase of 14% since the completion of the 2013 CC investigation.<sup>64</sup> The audit fees paid by FTSE 350 companies were around £1 billion in 2017 – accounting for 39% of the total audit fees paid by all PIEs.<sup>65</sup> By comparison, the total audit fees paid by companies in the FTSE Small index were £59 million in 2017 and were £72.9 million for companies in the FTSE Alternative Investment Market (AIM) in the same year.<sup>66</sup> The audit fees paid by large private companies included in the Top Track 100 totalled £16.3 million in the same year.<sup>67</sup>

2.12 Figure 2.1 shows the trend in audit fees paid by FTSE 350 companies in the period 2012 to 2017. The total audit fees paid by companies in the FTSE 350 have increased by 25% since 2012.<sup>68</sup>

**Figure 2.1: Total audit fees paid by FTSE 350 companies**



Source: CMA analysis of the Industry Background data set.

2.13 The relative size of the audit fees paid by FTSE 350 companies in each of the FTSE 100 and FTSE 250 indices is also shown in Figure 2.1. The audit fees

<sup>64</sup> Figures taken from the FRC's [Key Facts and Trends in the Accountancy Profession](#) reports.

<sup>65</sup> CMA analysis of the Industry Background data set and figures taken from the FRC's [Key Facts and Trends in the Accountancy Profession](#) reports.

<sup>66</sup> The FTSE Small index figure is the CMA's analysis of Audit Analytics data, with the AIM figure taken from FRC *Developments in Audit: 2018* (October 2018). (The FRC used data from a survey of FTSE 350 companies published by Accountancy magazine and for 2017 it is drawn from an amalgam of FRC analysis and Audit Analytics data.)

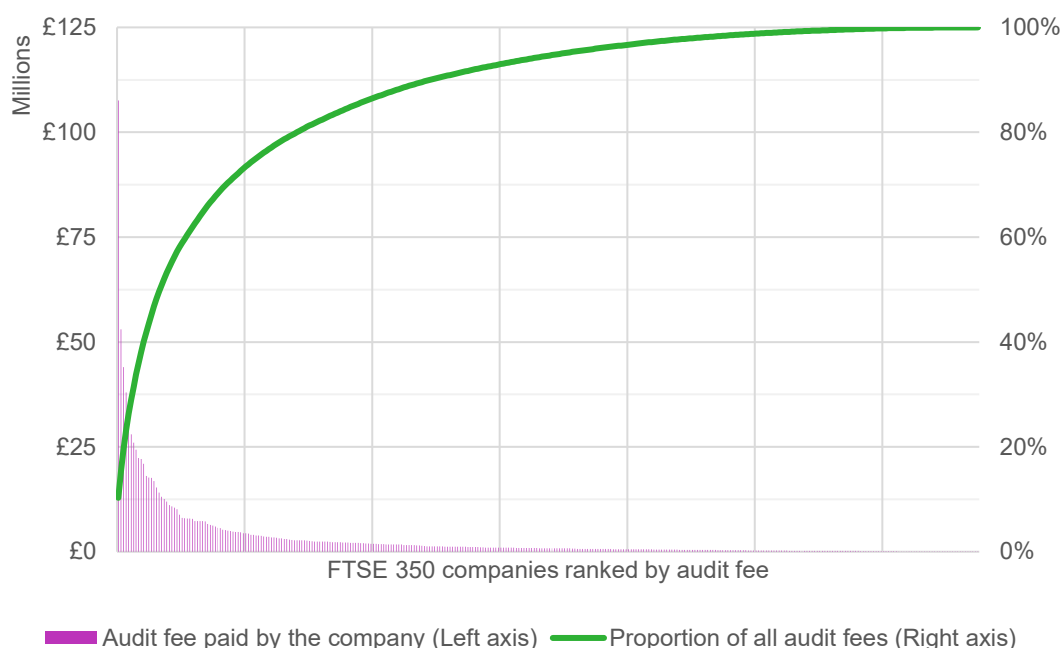
<sup>67</sup> Top Track 100 is based on CMA analysis of the Industry Background data set.

<sup>68</sup> CMA analysis of the Industry Background data set.

paid by companies in the FTSE 100 have been between 77% and 80% of the FTSE 350 total in the period 2012 to 2017.<sup>69</sup>

- 2.14 There is a significant difference in audit fees between the largest companies and the long tail of other companies in the FTSE 350. Figure 2.2 shows that the top 71 audit fees from FTSE 350 companies made up 80% of the total in 2017, whereas the smallest 80 fees accounted for only 1% of total in the FTSE 350.

**Figure 2.2: FTSE 350 audit fees in 2017**



Source: CMA analysis of the Industry Background data set.

- 2.15 This variation in fees reflects significant differences in audit complexity between companies in the FTSE 350. Several of the auditors suggested that there are in fact at least two audit market segments within the FTSE 350: the top end, comprising perhaps 30 or 40 companies with particularly complex audits; and a longer tail of companies with relatively less complex audit requirements. This complexity can be driven, among other things, by the international scope of the business and the degree to which the audit requires specific technical knowledge and processes (for example in financial services).
- 2.16 Figure 2.3 shows the audit fees paid by FTSE 350 companies in 2017 arranged by sector.<sup>70</sup> The largest sector by audit fees in the FTSE 350 was

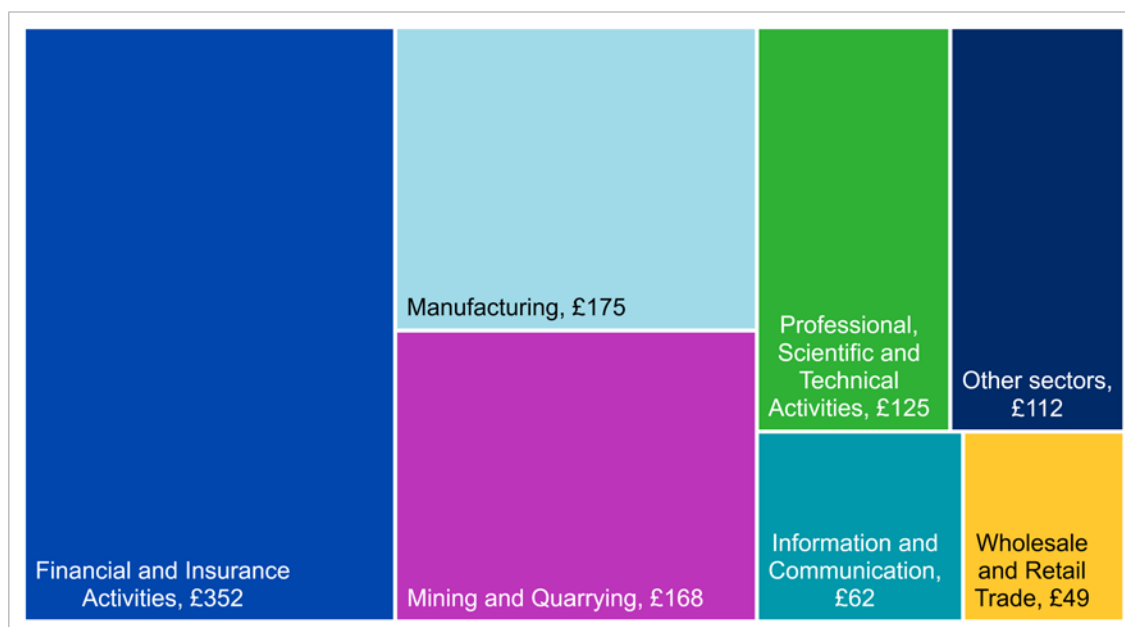
<sup>69</sup> CMA analysis of the Industry Background data set.

<sup>70</sup> We have used the ONS's current Standard Industrial Classification (SIC) to classify businesses according to the main type of economic activity in which they are engaged.



Financial and Insurance Activities (representing around 34% of the total audit fees paid in the FTSE 350), followed by Manufacturing (17%) and Mining and Quarrying (16%). Companies from these three sectors account for 43 of the 71 companies that make up 80% of the total audit fees paid by constituents of the FTSE 350.<sup>71</sup>

**Figure 2.3: FTSE 350 audit fees by sector in 2017 (£m)**



Source: CMA analysis of the Industry Background data set.

- 2.17 Outside of the FTSE 350, we have gathered data on large private companies (the 'Top Track 100'). Our analysis has found a similarly large variation in the audit fees paid by companies in this index – suggesting that private companies range significantly in audit complexity and scope. The largest private companies (such as Dyson and John Lewis Partnership) have audit fees that are comparable to companies listed in the FTSE 250.<sup>72</sup>

### **Market shares**

- 2.18 The Big Four firms were the statutory auditor for 84% of all UK PIEs in 2017. The five largest challenger firms were the statutory auditor for 13% of all UK PIEs.<sup>73</sup>
- 2.19 The gap between the Big Four and challenger firms is starker in the FTSE 350, where the overall share of the Big Four by number of audit clients has

<sup>71</sup> CMA analysis of the Industry Background data set.

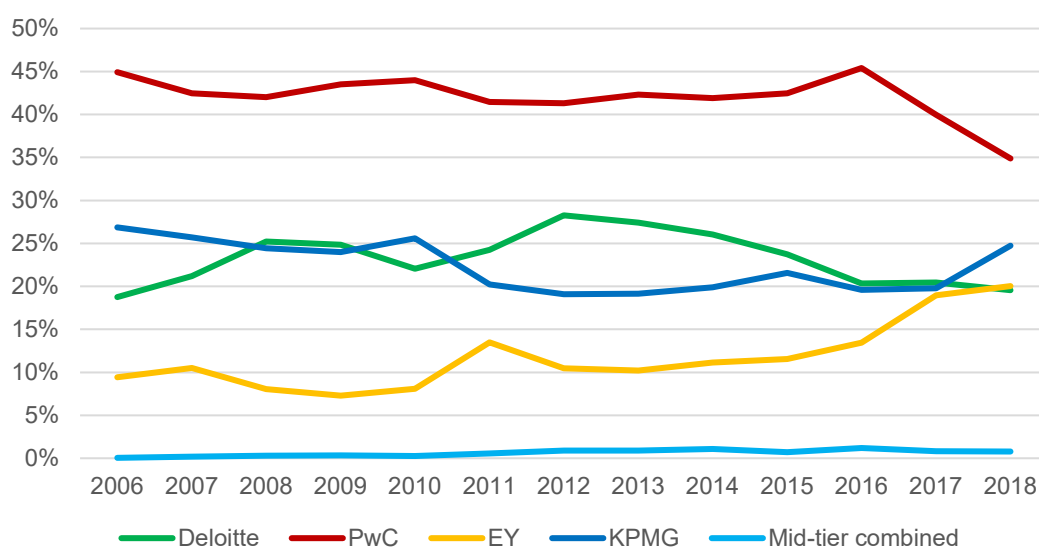
<sup>72</sup> Information taken from the Industry Background data set.

<sup>73</sup> Figures taken from the FRC's [Key Facts and Trends in the Accountancy Profession](#) reports.

increased from 95% in 2011 to 97% in 2017.<sup>74</sup> The only challenger firms that audited a FTSE 350 company in 2017 were BDO and Grant Thornton, having five and four FTSE 350 audit clients respectively in that year.<sup>75</sup>

- 2.20 The combined share of the Big Four firms is even greater in terms of their share of audit fees paid by FTSE 350 companies. Figure 2.4 shows that, while each of the Big Four firms received between 20% and 35% of the audit fees paid by FTSE 350 companies in 2018, the challenger firms combined had less than a 1% share.

**Figure 2.4: Audit firm shares of FTSE 350 audit fees**



Source: CMA analysis of financial information submitted by audit firms

- 2.21 Outside of the FTSE 350, the Big Four firms also received a sizeable proportion of the audit fees paid by smaller listed companies. The share of audits carried out by the Big Four in the FTSE Small index was 89% in 2017, which corresponded to 92% of the total audit fees paid by these companies in the same year.<sup>76</sup> A survey of the FTSE AIM 100 conducted by *Accountancy* found that the Big Four received 86% of audit fees paid by the companies in 2017, with the top 20 companies by audit fee value all audited by one of the Big Four firms.<sup>77, 78</sup> Our analysis of private companies in the Top Track 100 found that, for the years 2012 – 2017, the Big Four firms carried out the audit

<sup>74</sup> CMA analysis of financial information submitted by audit firms.

<sup>75</sup> Information taken from the Industry Background data set.

<sup>76</sup> CMA analysis of Audit Analytics data.

<sup>77</sup> *Accountancy Briefing: AIM Survey* (September 2017).

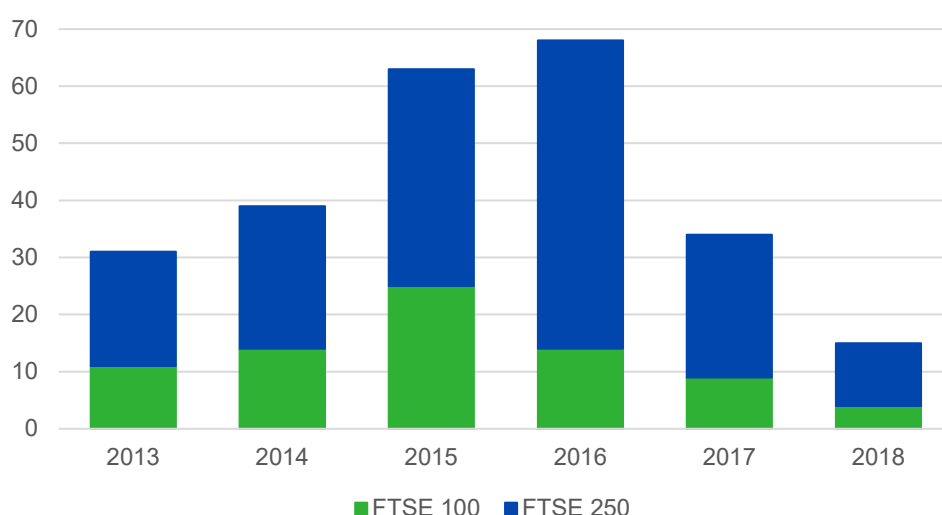
<sup>78</sup> It should be noted that only AIM listed companies with a market capitalisation higher than €200m are considered to be PIEs in the UK.

for around two-thirds of the companies included in the index, receiving 85% to 90% of the total audit fees.<sup>79</sup>

## ***Tendering and switching***

2.22 Over half of FTSE 350 companies have tendered their external audit since 1 January 2013. Figure 2.5 shows the number of tenders in the FTSE 350 that were completed between January 2013 and October 2018, with the increased tendering in 2015 and 2016 being due to the transition arrangements put in place as part of the CC and then EU audit legislation.<sup>80</sup> We have identified at least 250 audit tenders in the FTSE 350 during this period, which is a significant increase compared to the 52 included in the analysis conducted by the CC for the period 2007 to 2011.<sup>81,82</sup>

**Figure 2.5: FTSE 350 engagements tendered per year**



Source: CMA analysis of auditors' tender data.

Note: Data for 2018 is based on tenders completed before October 2018.

2.23 Of the FTSE 350 tenders included in our analysis, around three-quarters resulted in a switch of auditor.<sup>83</sup> As shown in Figure 2.6, we found that the overall annual switching rate for FTSE 350 audits grew from 6% in 2013 to 14% in 2015, before falling to below 3% in 2018. When excluding those

<sup>79</sup> CMA analysis of the Industry Background data set. We do not have information on all the companies in the Top Track 100 in each year (either as they are not audited or as information was not available for some companies on the FAME database). This means that the estimated Big Four share of audit clients could be an underestimate and audit fees could be an overestimate.

<sup>80</sup> CMA analysis of auditors' tender data.

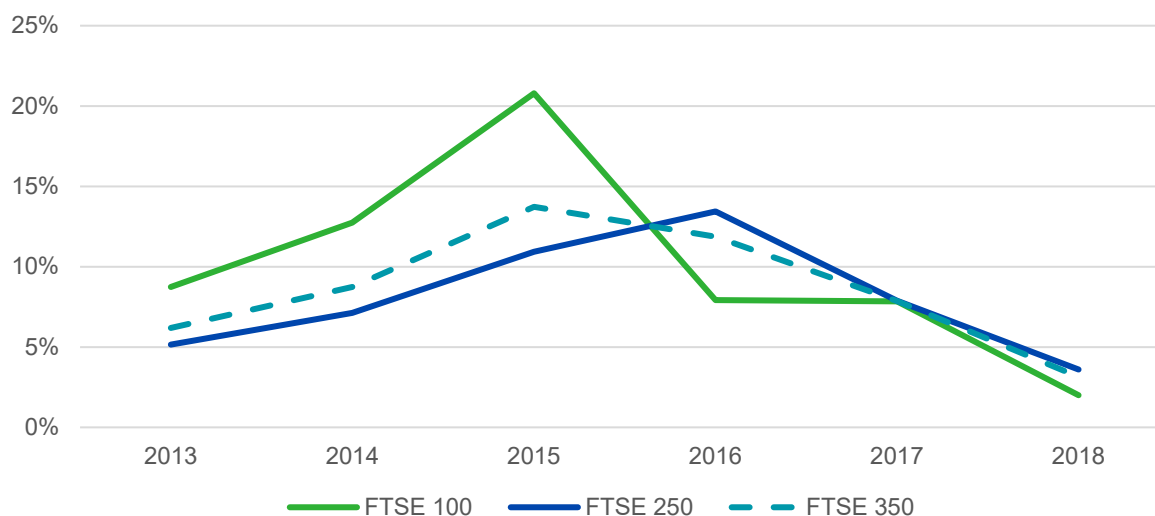
<sup>81</sup> CMA analysis of auditors' tender data.

<sup>82</sup> CC, [Statutory audit services market investigation: Final report](#), 16 October 2013, see paragraph 14 of Appendix 7.1.

<sup>83</sup> CMA analysis of auditors' tender data.

tenders where the incumbent auditor did not bid (a key factor being the EU rotation requirements<sup>84</sup>), we have found that around 50% resulted in a switch away from the incumbent auditor.<sup>85</sup>

**Figure 2.6: Audit firm engagement switching rate in the FTSE 350**



Source: CMA analysis of auditors' tender data.

**2.24** While the rate of switching has increased significantly since the introduction of the CC and EU remedies, we have found that switching has been almost entirely between the four largest auditors in the FTSE 350. This is shown in Figure 2.7, with 92% of tenders since 1 January 2013 resulting in a Big Four firm winning an audit from a Big Four incumbent for a FTSE 350 company. Only five FTSE 350 companies (all in the FTSE 250) switched away from a Big Four firm to a challenger firm.

**Figure 2.7: Switching in the FTSE 350 between Big Four and challenger firms**

		<i>Appointed</i>	
		Big Four	Challenger
<i>Incumbent</i>	Big Four	92%	3%
	Challenger	5%	0%

Source: CMA analysis of auditors' tender data.

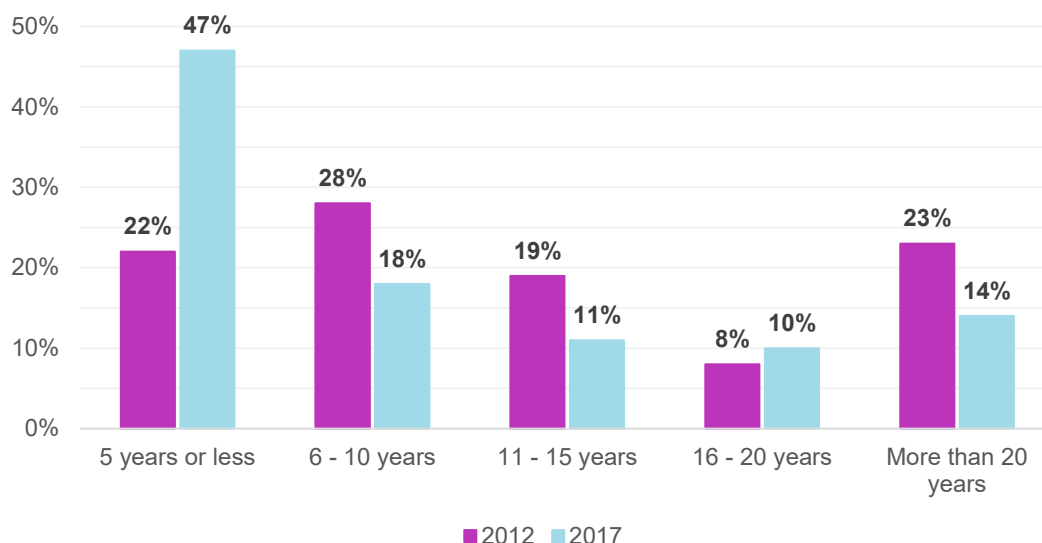
**2.25** Another indicator of the increased rate of auditor rotation by companies in the FTSE 350 is the reduction in length of current auditor engagements between 2012 and 2017. This is shown in Figure 2.8, with an analysis conducted by

<sup>84</sup> In over 85% of the cases where the incumbent did not participate and the incumbent provided a reason for its non-participation, the reason cited was rotation (source: CMA analysis of auditors' tender data).

<sup>85</sup> These results are consistent with analysis submitted by KPMG. See KPMG Invitation to Comment (ITC) response.

the FRC showing a significant increase in the number of audit engagements with a tenure of less than five years – from 22% in 2012 to 47% in 2017.

**Figure 2.8: Length of audit firm engagement for FTSE 350 companies**



Source: FRC *Developments in Audit: 2018* (October 2018). The FRC used data from a survey of FTSE 350 companies published by *Accountancy* magazine and for 2017 it is drawn from an amalgam of FRC analysis and Audit Analytics data.

2.26 A 2017 survey of the FTSE AIM 100 conducted by *Accountancy* found that 64% of companies had an audit engagement of fewer than ten years, with only 3% of the AIM 100 having had the same auditor for a period of more than 20 years.<sup>86</sup> Our analysis of private companies in the Top Track 100 indicates that the proportion of companies in this index that tendered is much lower, likely reflecting the fact that these companies may not always be subject to the mandatory tendering and auditor rotation requirements.<sup>87</sup>

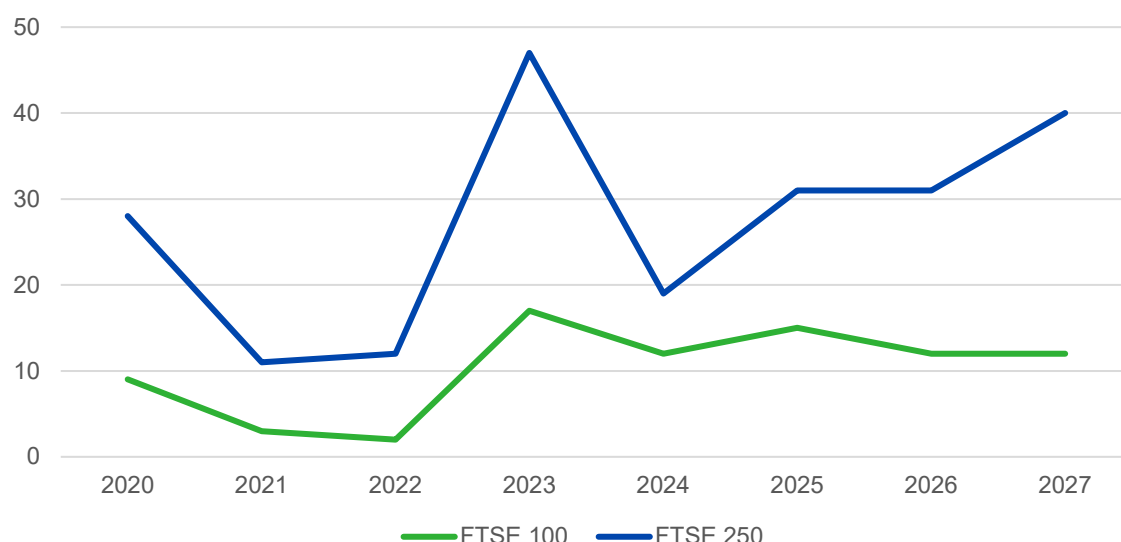
2.27 We have also estimated the number of audits expected to be tendered by FTSE 350 companies, based on the mandatory tendering and rotation rules which became effective in 2016.<sup>88</sup> This gives an indication of potential future switching opportunities. The estimates are shown in Figure 2.9.

<sup>86</sup> *Accountancy Briefing: AIM Survey* (September 2017).

<sup>87</sup> CMA analysis of auditors' tender data.

<sup>88</sup> Part 16, s485A and s489A of the Companies Act 2016.

**Figure 2.9: Projected number of audits to be tendered by FTSE 350 companies 2020 - 2027**



Source: CMA analysis of Audit Analytics data.

Note: Our analysis assumes that companies tender at the point they are required to do so by the mandatory tendering rules. In practice companies may choose to tender at an earlier point, which would bring forward some of the tenders shown in the chart.

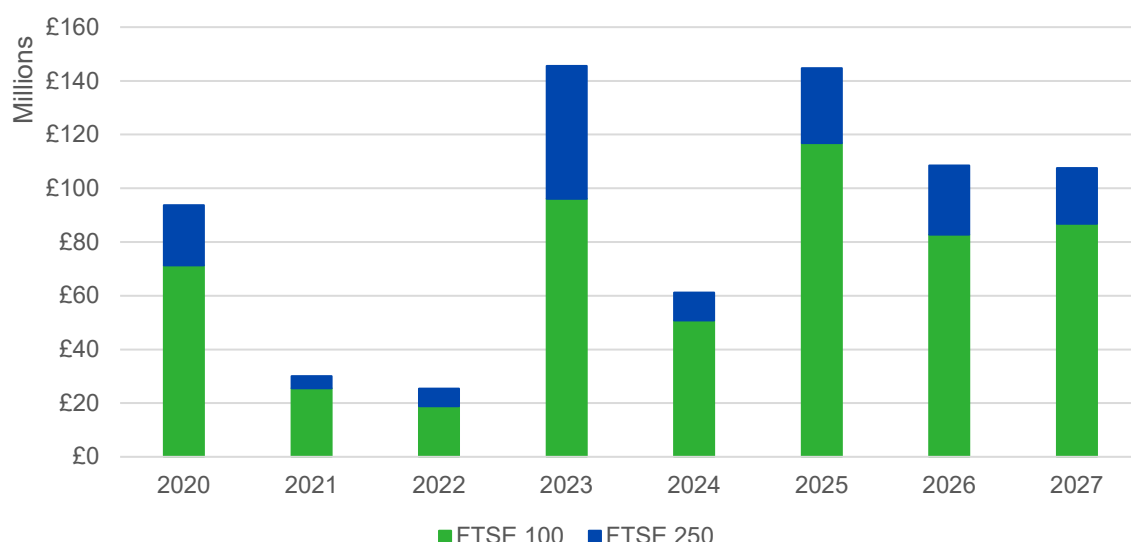
2.28 Figure 2.9 shows that the number of audits tendered in each year changes significantly in the period 2020 to 2027, with this difference across years largely due to the tenders by companies in the FTSE 250. This variance is a consequence of the transition arrangements put in place as part of the CC and then EU audit legislation for companies with long audit engagements.<sup>89</sup> Under these transition arrangements, around 57% of all the FTSE 350 audits due to be tendered between 2020 and 2022 will require companies to change auditor for the first time in at least 17 years.<sup>90</sup>

2.29 We have used the audit fees paid by these FTSE 350 companies in 2017 to understand the size and complexity of the audits that are required to be tendered in the period 2020 to 2027. This is shown in Figure 2.10.

<sup>89</sup> Companies with audit engagements that started before 1994 and 2003 are required to appoint a new auditor by the year 2020 and 2023, respectively.

<sup>90</sup> CMA analysis of Audit Analytics data.

**Figure 2.10: Fees for audit tenders by FTSE 350 companies 2020 - 2027**



Source: CMA analysis of Audit Analytics data

2.30 Based on 2017 audit fees, the fees from FTSE 250 companies range from 15% to 35% of the total fees available to auditors from tenders expected in the FTSE 350, peaking at around £50 million in 2023<sup>91</sup>. In contrast, fees available to auditors from the FTSE 100 in the same year is £96 million and peak at £116 million in 2025.<sup>92</sup> Over the full period, the total audit fees available to auditors for FTSE 100 and 250 companies are around £550 and £170 million respectively.

### ***Fees from audit clients***

2.31 Figure 2.11 shows trends in total fees earned by the Big Four and challenger firms<sup>93</sup> from all their audit clients in the period 2011 to 2018. Audit fees have increased in nominal terms by 34% during this time, whereas there has been a 3% decrease in the total non-audit fees that the firms earned from services provided to their audit clients.<sup>94</sup>

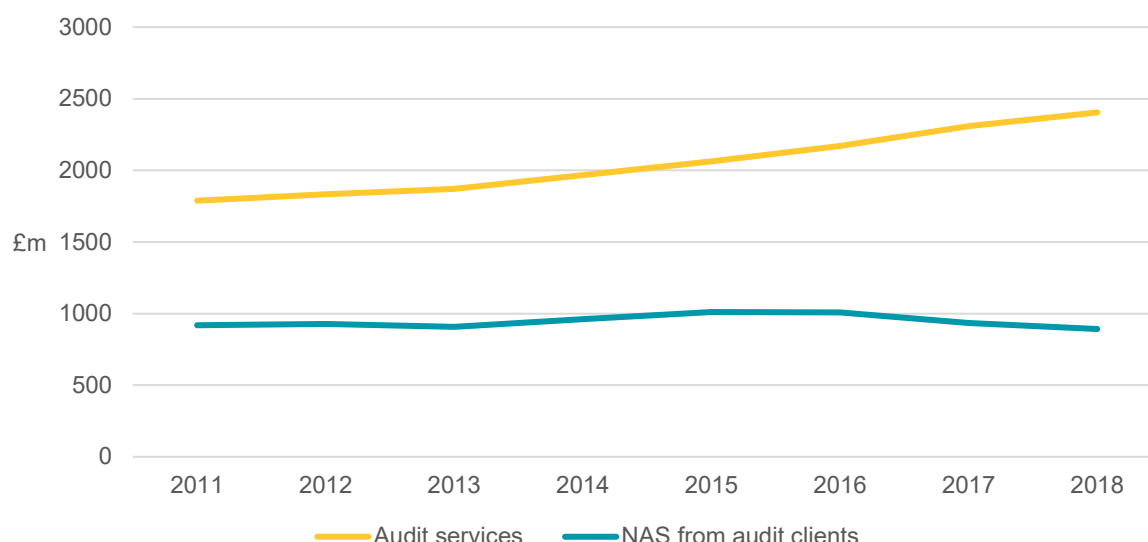
<sup>91</sup> CMA analysis of Audit Analytics data.

<sup>92</sup> CMA analysis of Audit Analytics data.

<sup>93</sup> Figures for challenger firms in this section are based on information provided by BDO, Grant Thornton, Mazars, RSM and Moore Stephens.

<sup>94</sup> CMA analysis of financial information submitted by audit firms.

**Figure 2.11: Fees received by Big Four and challenger firms from their audit clients**



Source: CMA analysis of financial information submitted by audit firms

2.32 When only considering the fees received by firms from their audit clients in the FTSE 350, there has been a 25% increase in the audit fees and a 35% decrease in the non-audit fees paid by audit clients between 2012 and 2017.<sup>95</sup> This decrease in non-audit fees received by audit firms means that the ratio of non-audit to audit fees received from FTSE 350 audit clients was 16% in 2017.<sup>96</sup> By comparison, the ratio of non-audit to audit fees received by audit firms from their audit clients in the FTSE AIM 100 was 61% in 2017.<sup>97</sup>

### **Non-audit services**

2.33 We gathered evidence from the audit firms on their total revenues from audit and non-audit services. Figure 2.12 shows aggregate total revenues from all clients for the Big Four audit firms for the years 2011 to 2018.

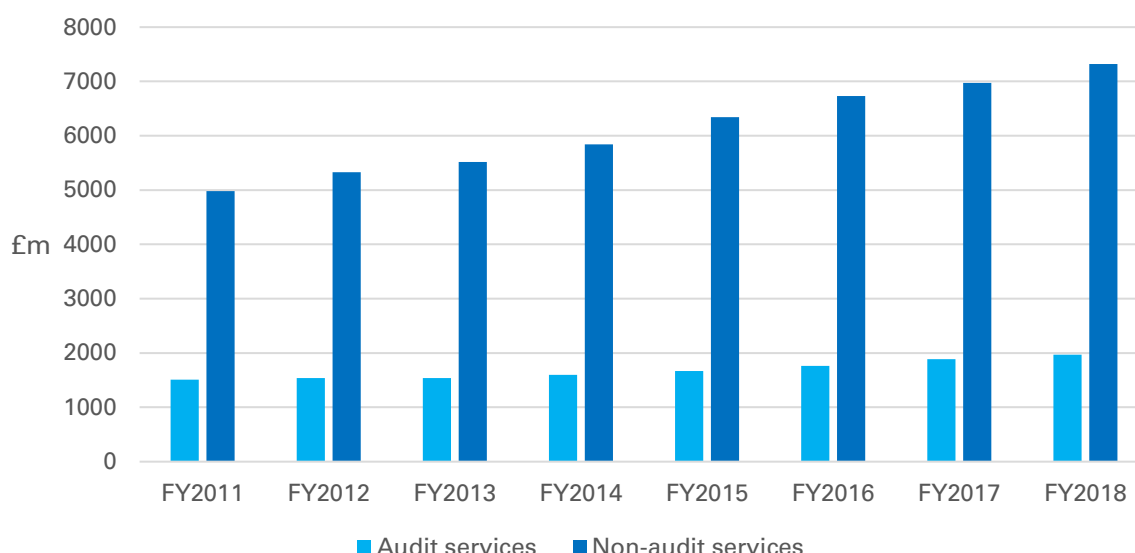
<sup>95</sup> CMA analysis of the Industry Background data set.

<sup>96</sup> CMA analysis of the Industry Background data set.

<sup>97</sup> Accountancy Briefing: AIM Survey (September 2017).



**Figure 2.12: Aggregated audit and non-audit revenues for the Big Four 2011 to 2018 (£million)**

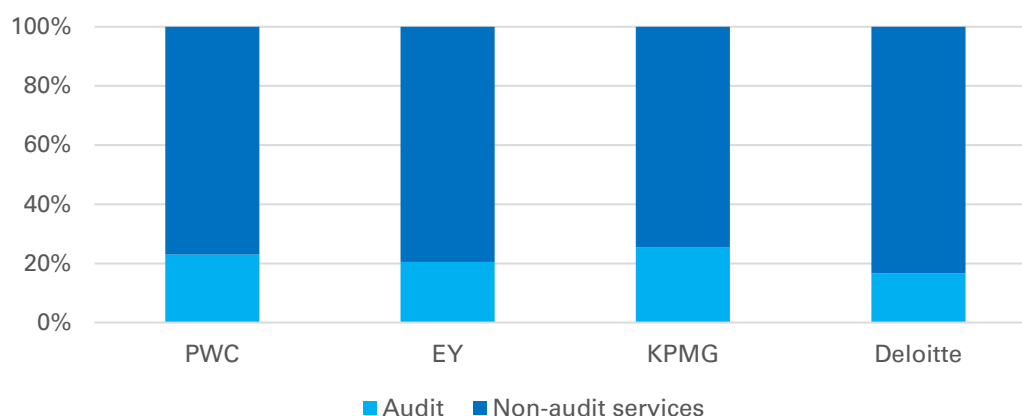


Source: CMA analysis of financial information submitted by audit firms

2.34 Figure 2.12 shows that the Big Four derive substantially more revenue from non-audit services than they do from audits. Across the Big Four as a whole, non-audit services accounted for 79% of total revenues in 2018 (a slight increase from 77% in 2011).<sup>98</sup>

2.35 There is some minor variation between the Big Four firms, with Deloitte deriving the largest share of revenue from non-audit services (83% in 2018). However, each of the Big Four generates at least three quarters of its revenue from non-audit services, as shown in Figure 2.13.

**Figure 2.13: Audit and non-audit FY2018 revenue split for each Big Four firm**

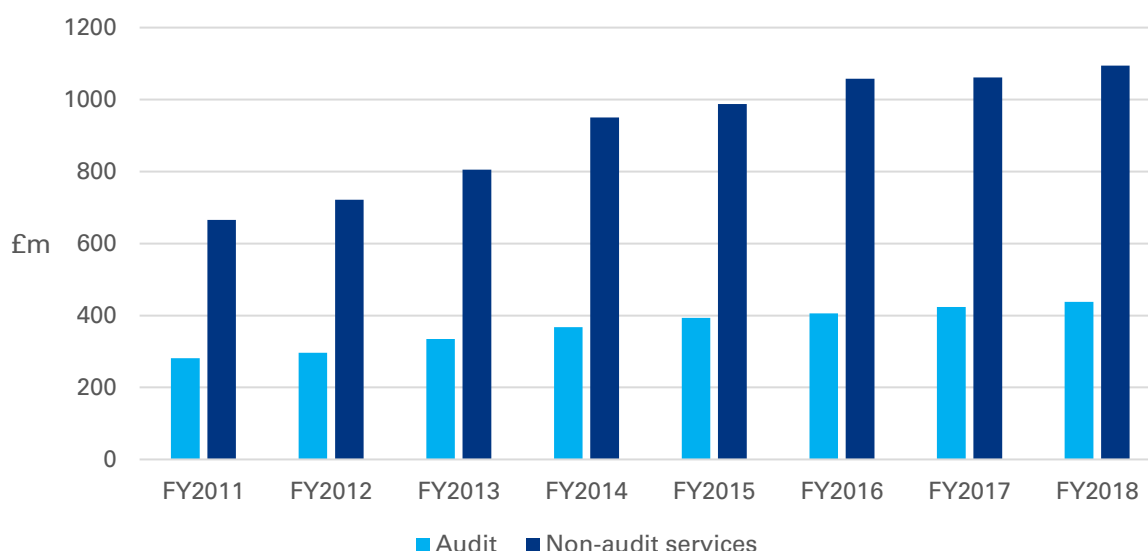


Source: CMA analysis of financial information submitted by audit firms.

<sup>98</sup> Note that most of these non-audit fees come from clients for whom the firms do not provide audit services. As illustrated in Figure 2.11, the non-audit fees provided to audit clients have been relatively small and falling in recent years.

2.36 Figure 2.14 shows that the challenger firms also generate a majority of their revenues from non-audit services rather than from audits (although revenues from audit services account for a higher proportion of total revenue compared with the Big Four). The challenger firms have seen stronger growth in audit revenues than the Big Four; since 2011, total audit revenues have grown in nominal terms by around 33% for the Big Four compared with 57% for the challenger firms.

**Figure 2.14: Aggregated audit and non-audit revenues for the challenger firms 2011-2018 (£million)**



Source: CMA analysis of financial information submitted by audit firms.

2.37 In 2018 the challenger firms derived 29% of their revenue from audits, slightly higher than the corresponding Big Four figure of 21%.

### **Profitability**

2.38 The results set out below show the relative profitability of Big Four and challenger firms, and of audit and non-audit services, respectively.

2.39 Figure 2.15 shows, for Big Four audit firms, aggregate audit revenues and aggregate pre-exceptional items EBIT<sup>99</sup> margins for the period 2011 to 2018. While revenues have increased, margins have fallen from over [✂].

**Figure 2.15: Aggregate audit revenue and aggregate EBIT margin, Big Four firms**

[✂]

Source: CMA analysis of financial information submitted by Big Four audit firms.

<sup>99</sup> Earnings before interest and taxation.

- 2.40 Figure 2.16 shows the same calculation for challenger firms. This shows that challenger firm revenues have increased at a faster rate than those of Big Four firms. EBIT margins have also increased over the period and are now similar to those achieved by Big Four firms.

**Figure 2.16: Aggregate audit revenue and aggregate EBIT margin, challenger firms**

[✂]

Source: CMA analysis of financial information submitted by audit firms.

- 2.41 Figure 2.17 shows, for Big Four audit firms, aggregate non-audit services revenues and aggregate EBIT margins, for the period 2011 to 2018. This shows that non-audit services revenues have increased at a faster rate than audit revenues. Again, margins have fallen from around [✂].

**Figure 2.17: Aggregate non-audit services revenue and aggregate EBIT margin, Big Four firms**

[✂]

Source: CMA analysis of financial information submitted by audit firms

## Audit quality

- 2.42 This section outlines the evidence we have gathered on current audit quality.
- 2.43 There was agreement among stakeholders we spoke to that audit quality should be the key focus in assessing whether the market was producing good outcomes. A well-functioning market should produce high-quality audits that are in the interests of shareholders and the wider public, delivered at an appropriate cost.
- 2.44 There is, however, no single agreed definition of audit quality. Academic literature has suggested that a high quality audit is performed by an auditor that can both discover a problem in a company's accounting practices and be sufficiently independent to report this problem to the company's board and its shareholders.<sup>100</sup> This definition is useful as it encompasses both the input and process of the audit (such as the experience of the audit team and the extent of sampling undertaken), as well as the audit outcome itself (such as the greater accuracy and conservatism in the audited financial statements of the companies).
- 2.45 The International Auditing and Assurance Standards Board (IAASB)'s *Framework for Audit Quality* includes these elements from the academic

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<sup>100</sup> DeAngelo, L. E. (1981) 'Auditor Size and Audit Quality', *Journal of Accounting and Economics*, Issue 3 (December 1981), pp183 – pp200.

literature as well as other factors that improve the quality of an audit, such as the interactions an auditor will have with other stakeholders in the 'financial reporting supply chain'.<sup>101</sup> The IAASB's definition of quality also differentiates between what can be influenced by an auditor (who is ultimately responsible for the provision of audited financial statements) and the wider corporate governance environment required to maintain audit quality at a high level throughout an engagement.

- 2.46 The FRC uses a definition of quality that puts the role of an audit in its wider economic context, such that 'high quality audit provides investors and other stakeholders with a high level of assurance that the financial statements of an entity give a true and fair view, and provide a reliable and trustworthy basis for taking decisions'.<sup>102</sup> The FRC's definition also requires a quality audit to be 'driven by a robust risk assessment informed by a thorough understanding of the entity and its environment, and provides challenge, transparency and insight in a clear and unambiguous way', as well as to provide 'strong deterrent effect against actions that may not be in the public interest, underpins stakeholder confidence, and drives continuous improvement'.<sup>103</sup>
- 2.47 We have defined audit quality with reference to the academic literature and the views of stakeholders. Our definition includes the need for an experienced and properly resourced audit team to display sufficient scepticism, objectivity, integrity and independence in their work, as well as to appropriately challenge management with a well evidenced report despite the strong pressure to conform to their judgements. However, auditors cannot deliver a quality audit without a robust corporate governance structure being in place at the company to assist in the preparation of accurate financial statements.
- 2.48 One of the key challenges with the audit product is that these aspects of quality are difficult to observe and measure. This is the case when an intervention by an auditor has improved the quality of a company's audited financial statements or when the lack of challenge by an auditor has lowered audit quality. While it may be possible to observe whether suitable audit processes are in place and whether the audit report is properly evidenced, it is much harder to assess whether an auditor is demonstrating professional scepticism and independence.<sup>104</sup>

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<sup>101</sup> IAASB (2014) *Framework for Audit Quality: Key Elements that Create an Environment for Audit Quality* (accessed on Monday 11 March 2019)

<sup>102</sup> [FRC - Developments in Audit 2018](#), pp4-pp6.

<sup>103</sup> Ibid

<sup>104</sup> In its response to the Update Paper (p4) the ACCA said that 'throughout the auditing standards there are requirements for the auditor to exercise professional scepticism. As a result, the application of 'suitable audit processes' and the 'proper evidencing' of the audit report require the exercise of professional scepticism.' We

- 2.49 Despite these measurement challenges, the available evidence indicates there is a persistent problem of variable and sometimes poor audit quality. Although there have been some changes in the market since the CC's investigation in 2013, similar quality concerns to those observed by the CC still remain. We have come to this conclusion based on:
- (a) The assessments of individual audits by the FRC;
  - (b) Enforcement actions taken by the FRC due to audit failures;
  - (c) Evidence of poor quality practices within UK audit firms;
  - (d) The experience of teams used on audit engagements; and
  - (e) The views of stakeholders on audit quality.
- 2.50 Some stakeholders told us that concerns about audit quality are not isolated to the UK and have been raised in a number of different jurisdictions. As the audit of UK based companies relies heavily on the global networks of UK audit practices, we engaged with several international regulators and national competition authorities to understand their work in the audit sector. We provide an international perspective on audit quality at the end of this section.

### ***The FRC's reviews of company audits***

- 2.51 Each year the FRC reviews a sample of audits at individual audit firms. These reviews focus on the appropriateness of key audit judgements made in reaching the audit opinion and the sufficiency and appropriateness of the audit evidence obtained. Audits are graded as either 'good', 'limited improvements required', 'improvements required', or 'significant improvements required'.
- 2.52 The FRC has a target of 90% of FTSE 350 audits requiring no more than limited improvements by 2019. An audit will be assessed as requiring significant improvements where the FRC has 'significant concerns in relation to the sufficiency or quality of audit evidence, or the appropriateness of key audit judgments, or the implications of other matters are individually or collectively significant'.<sup>105</sup>

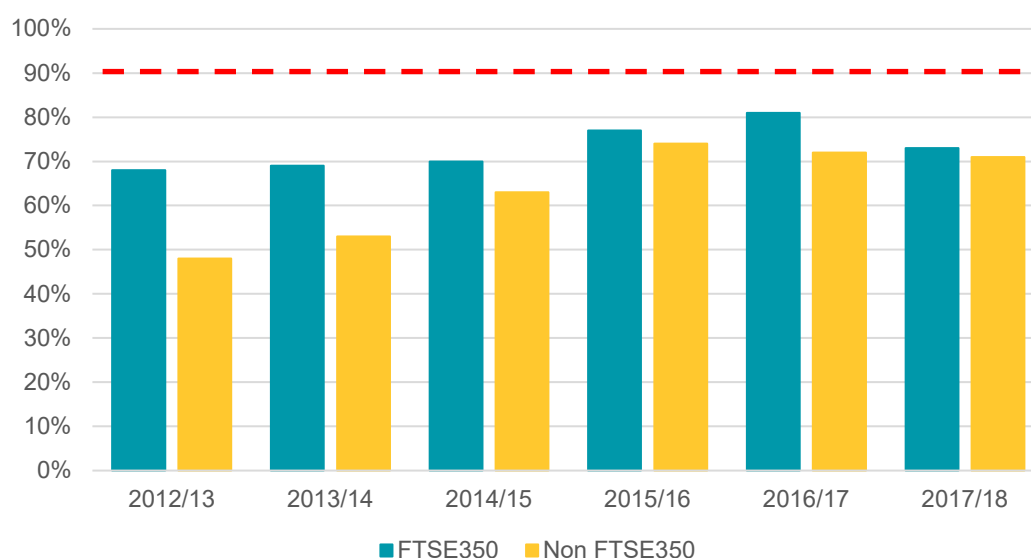
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agree with the ACCA that the auditing standards include requirements around professional scepticism. However, we remain of the view that it is difficult to observe and measure directly whether an auditor is demonstrating professional scepticism.

<sup>105</sup> [FRC - Developments in Audit 2018](#), p8.

2.53 Figure 2.18 shows the percentage of FTSE 350 and non-FTSE 350 audits inspected by the FRC assessed as good or requiring limited improvement over the period 2012/13 to 2017/18. In 2017/18, just 73% of FTSE 350 audits were assessed as good or requiring limited improvement.<sup>106</sup> This figure is well short of the FRC's target of 90% of audits requiring no more than limited improvements by 2019.

**Figure 2.18: Percentage of audits inspected by the FRC rated as 'good' or 'required limited improvement'**



Source: CMA analysis of FRC AQR reports.

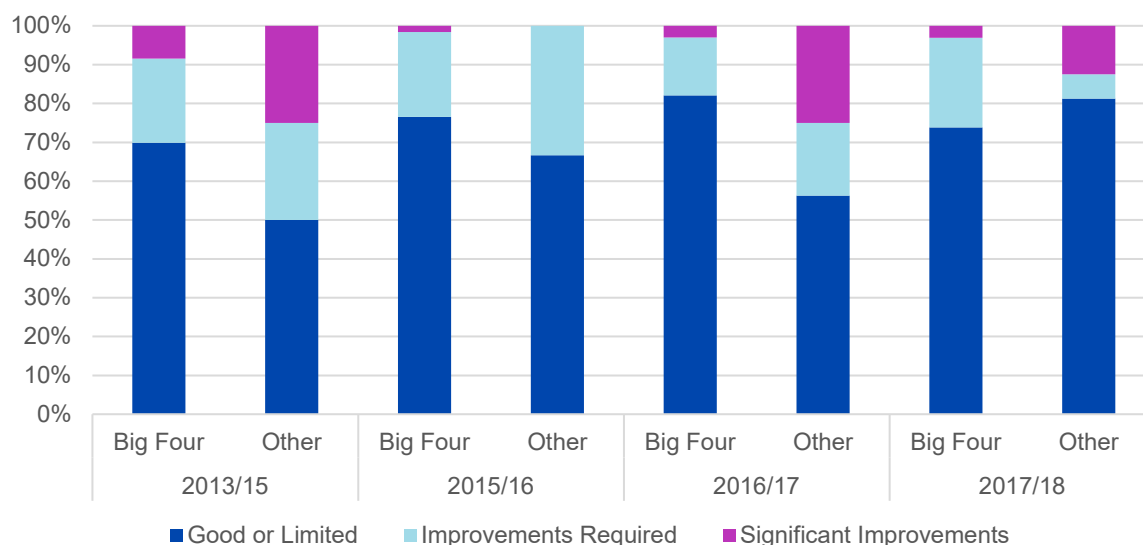
2.54 Figure 2.19 shows for Big Four and challenger firms the percentage of audits inspected rated as 'good or limited improvement required', 'improvement required' and 'significant improvement required, over the last five years.<sup>107</sup> For Big Four firms this is limited to FTSE 350 audits. For challenger firms it is all PIE audits. This figure shows that in 2017/18, for Big Four firms, 23% of FTSE 350 audits required improvement and 3% significant improvement. Over the five-year period, the figures were 20% and 4% respectively for the Big Four firms and 18% and 18% respectively for the challenger firms.<sup>108</sup>

<sup>106</sup> [FRC - Developments in Audit 2018](#) – p.4: 'Audit Quality and Our Response'.

<sup>107</sup> CMA analysis of AQR results in [FRC - Developments in Audit 2018](#). The challenger firms relate to only BDO and Grant Thornton.

<sup>108</sup> Source: FRC.

**Figure 2.19: Analysis of FTSE 350 audits inspected by the FRC, for Big Four (FTSE 350 audits) and challenger firms (all audits)**



Source: CMA analysis of FRC AQR results.

- 2.55 Some respondents to our Update Paper did not agree with our view that these AQR results were evidence of a widespread problem. For example, the Institute of Chartered Accountants of Scotland said that we had failed to ‘acknowledge that the results in the previous several years reflected an upward trend’ – indicating that audit quality had improved since 2013.<sup>109</sup> The ACCA similarly said that our provisional conclusion that there had been a ‘persistent failure of the sector to meet the FRC’s AQR targets for quality’ ignored the apparent improvement in quality over six years.<sup>110</sup>
- 2.56 However, we need to be particularly cautious in interpreting these results as demonstrating trends over time. The FRC states that ‘the proportion of audits falling within each category from year to year reflect a wide range of factors, which may include the size, complexity and risk of the individual audits selected for review and the scope of the individual reviews’.<sup>111</sup> For these reasons, and given the sample sizes involved, changes in the FRC’s AQR results from one year to the next are not necessarily indicative of any overall change in audit quality from year to year.
- 2.57 Some respondents noted that the challenger firms had, on average, a higher proportion of audits requiring significant improvement than the Big Four.<sup>112</sup> We note that it is difficult to compare like with like because the challenger firms carry out very few FTSE 350 audits; the AQR results in Figure 2.19

<sup>109</sup> ICAS, Response to Update Paper, 10 February 2019.

<sup>110</sup> ACCA, Response to Update Paper.

<sup>111</sup> FRC, [Developments in Audit 2018](#), p6.

<sup>112</sup> For example see KPMG, Response to Update Paper; ACCA, Response to Update Paper.

relate to all PIE audits carried out by the challengers that have been reviewed by the FRC, whereas the Big Four results relate only to FTSE 350 companies. We consider this issue further in the discussion of barriers facing the challenger firms in chapter 3.

- 2.58 Some respondents have suggested that the reviews carried out by the FRC are focused on the process of the audit, rather than its outcome, and rely on only a small number of companies audited in any given year.<sup>113</sup> Respondents also told us that it is difficult to observe the independence or scepticism of an auditor from the documents contained in the audit files, meaning the FRC could not observe these aspects of a good quality audit as part of their reviews.
- 2.59 These views were refuted by Stephen Haddrill, Chief Executive of the FRC, in his evidence at the BEIS Select Committee's *Future of Audit* inquiry.<sup>114</sup> He told the inquiry that the FRC goes beyond assessing the process of an audit to 'test the judgement of the auditor on the key audit matters' identified by the company, auditor and audit committee, as well as to ensure that these key matters have been properly reviewed by the auditor.
- 2.60 While these AQR results are based on a small sample of company audits, the FRC inspections have continually identified a number of cases where there was poor performance or instances of material shortcomings in the provision of audits to large companies. The number of audits found by the FRC to be requiring significant improvements since 2013 are evidence of a persistent problem of variable and sometimes poor audit quality.

### ***FRC enforcement actions***

- 2.61 The FRC considers whether enforcement action is appropriate for the audits it has assessed as requiring improvements or significant improvements in the AQR process, as well as against auditors when there appears to be misconduct or a breach of professional standards.
- 2.62 In recent years, there has been a number of high-profile cases of audit failures that have come to the FRC's attention (in some instances, following the extreme case of a corporate failure) that led to an enforcement finding

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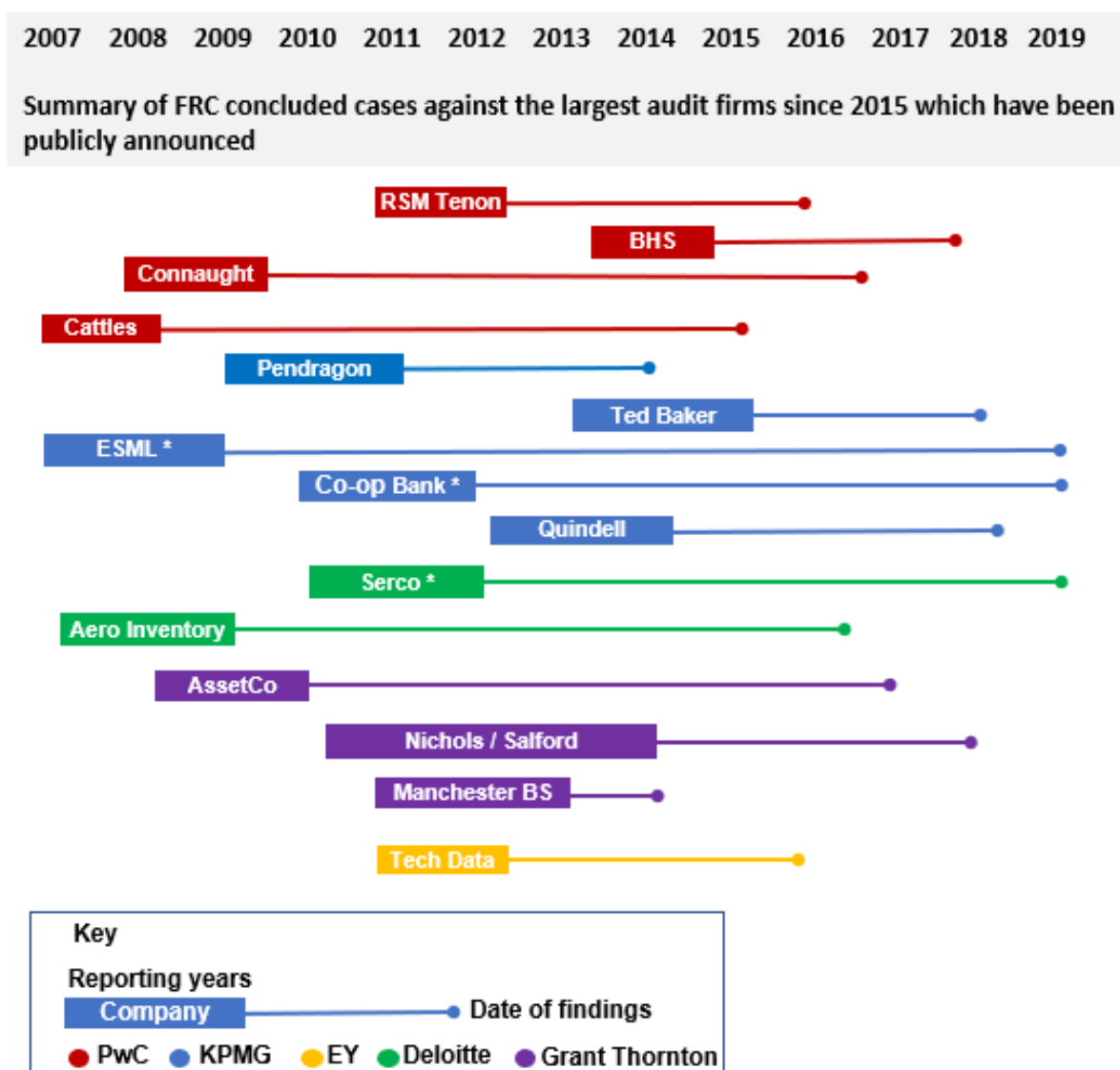
<sup>113</sup> For example: PwC, Response to Update Paper, 21 January 2019, Q1; KPMG, Response to Update Paper, 25 January 2019, Q1.

<sup>114</sup> Business, Energy and Industrial Strategy Committee (4 February 2019), [Future of audit inquiry – oral evidence](#), Q514 and Q535.



against the audit firm or partner responsible.<sup>115</sup> These are summarised in Figure 2.20.

**Figure 2.20: Summary of FRC enforcement cases that have been concluded and led to actions against an audit firm or partner**



Source: FRC (correct as of 11 April 2019).

\* denotes that these cases have been concluded but are awaiting publication by the FRC.

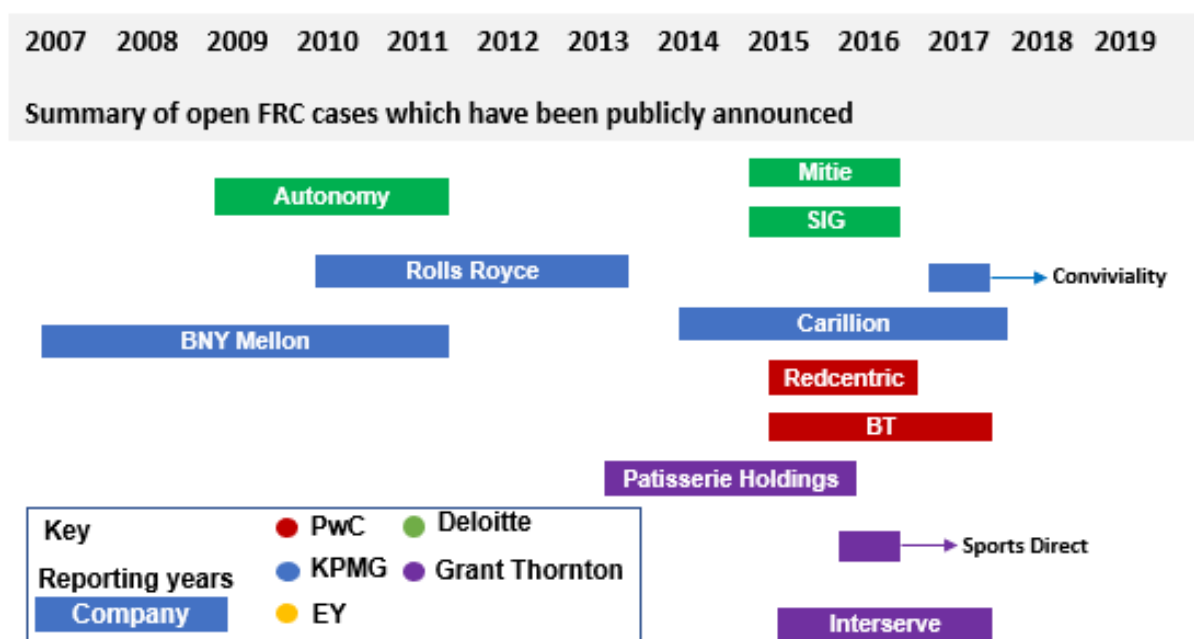
2.63 The FRC told us that all its recent enforcement findings have to some extent related to a lack of sufficient professional scepticism or challenge by the auditor – they do not simply reflect procedural errors. We reviewed the FRC enforcement findings for 11 of the cases concluded and published since 2015 and found that the most frequent reasons for findings of misconduct include:

<sup>115</sup> Not all enforcement cases opened or concluded by the FRC are made public.

- (a) failure to exercise sufficient professional scepticism or to challenge management (most cases);
- (b) failure to obtain sufficient appropriate audit evidence (most cases); and
- (c) loss of independence (three out of a total of 11 cases reviewed).

2.64 The FRC also have a number of ongoing investigations into instances of audit failures that have recently come to the FRC's attention, which may lead to enforcement action being taken against the audit firm or partner responsible.<sup>116</sup> These are summarised in Figure 2.21.

**Figure 2.21: Summary of ongoing FRC enforcement cases that have been publicly announced**



Source: FRC (correct as of 11 April 2019).

2.65 In its response to our Update Paper, the ACCA suggested that the cases listed in Figure 2.21 should be seen in the wider audit context given that they represent around 2% of the 1,200 listed companies on the London Stock Exchange main market.<sup>117</sup> While we agree that these cases are a small proportion of the large number of audits conducted in the UK each year, we note that the FRC opens enforcement cases when a matter has been drawn to its attention. This means that failures in the audit process or poor performance by auditors may be more widespread than Figure 2.21 suggests as they will escape enforcement action by the FRC if they go unreported.

<sup>116</sup> Please note that not all enforcement cases opened or concluded by the FRC are made public.

<sup>117</sup> ACCA, response to the Update Paper.

- 2.66 The ACCA also noted that the various FRC enforcement actions are not all equally serious and have a range of causes.<sup>118</sup> We agree that the FRC's cases necessarily cover a range of different circumstances. However, as set out above, all of the FRC's cases have to some extent related to a lack of sufficient professional scepticism or challenge by the auditor.
- 2.67 We therefore consider the evidence that the FRC has had grounds to take enforcement action against a number of auditors and audit firms in recent years, as well as the likelihood that there are more instances of audit failure that may continue unreported, to be indicative of a persistent problem of variable and sometimes poor audit quality.

### ***The FRC's review of audit firms***

- 2.68 As part of its review of individual company audits, the FRC is able to assess the practices of audit firms across a number of audit engagements in any given year. This allows the FRC to identify problems with firm-wide procedures, such as ensuring compliance with professional standards and applicable legal and regulatory requirements.<sup>119</sup>
- 2.69 In recent years the FRC has expressed ongoing concern and frustration with the failure of firms to address recurring problems it has identified. These include a lack of professional scepticism exercised by auditors when auditing key judgement areas and failure to adequately challenge management's assumptions. The FRC has also identified bank audits, group audit oversight and the audit of pension balances as particular areas of concern.<sup>120</sup>
- 2.70 In its most recent *Development in Audit* report the FRC again identified 'exercising appropriate scepticism' and 'challenging company assumptions' as areas where improvement was required.<sup>121</sup> Further areas requiring improvement included: independence, process failures,<sup>122</sup> and communication with Audit Committee/Audit Committee Chair as key areas for improvement. This suggests to us that there is a systemic problem of insufficient challenge across a proportion of large company audits.
- 2.71 Stephen Haddrill, Chief Executive of the FRC, told the BEIS Select Committee's *Future of Audit* inquiry that audit firms continue to fall short of the

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<sup>118</sup> ACCA, Response to the Update Paper.

<sup>119</sup> [IFIAR - Survey of Inspection Findings 2017](#) – p6: Firm Wide Quality Control Inspection Results.

<sup>120</sup> [FRC - Developments in Audit 2018](#) – p9: 'Specific Quality Issues'.

<sup>121</sup> [FRC - Developments in Audit 2018](#) – p8: 'Specific Quality Issues'.

<sup>122</sup> This included issues in relation to revenue recognition and loan loss impairment and the audit of accounting policies and disclosures (with particular concern in relation to the audit of pension scheme assets and liabilities).

FRC's AQR target as 'they are failing to challenge the company sufficiently' due to time constraints, which prevents auditors from finding sufficient evidence to support a major assumption or valuation made by the company.<sup>123</sup> The FRC also told us that the AQR process does not comment on the opinion issued by an auditor by design, although serious concerns raised by its inspections may have implications for the soundness of the accounting judgements made by the auditor.

- 2.72 A high-quality audit requires the auditor to challenge management or to demonstrate professional scepticism and believe that is best assessed across an audit firm as a whole. We therefore consider the findings of the FRC's most recent audit firm inspections and the continued inability of audit firms to address the FRC's findings over time as evidence of a persistent problem of variable and sometimes poor audit quality.

### ***Experience of teams used on audit engagements***

- 2.73 Our definition of audit quality includes the need for the team used in each engagement to include staff experienced in demonstrating sufficient scepticism and objectivity in their work. This is supported by evidence we received from our sample of companies, which showed that the experience, expertise and skill of the audit team were important criteria in the selection process of new auditors. Companies we spoke to often cited the capability and industry experience of the lead audit partner as a key reason for selecting their new auditor.
- 2.74 We also heard views from stakeholders that high quality audits require experienced and capable staff. The Chartered Institute of Management Accountants (CIMA) said that 'quality audits rely on highly competent people performing the audits', with the increasing use of integrated and strategic reporting requiring audit staff to 'understand the whole business and not just the financial aspects'.<sup>124</sup> The Investment Association told us the use of fair value accounting 'requires more judgement due to the difficulties in valuing and auditing certain assets and liabilities', with the ability to demonstrate professional scepticism being 'vital when key areas of accounting and disclosure depend on management's judgement'.<sup>125</sup>

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<sup>123</sup> Business, Energy and Industrial Strategy Committee (5 February 2019), [Future of audit inquiry – oral evidence](#), Q574 and Q575.

<sup>124</sup> CIMA, Response to ITC, 30 October 2018, paragraph 2.6.

<sup>125</sup> Investment Association, Response to ITC, 30 October 2018, Q2.

- 2.75 In this context, we would expect to see the role of partners in each engagement increasing over time as more experienced staff are required to deliver high audit quality. However, data provided by audit firms shows that the proportion of FTSE 350 and other large company audit engagement hours worked by partners has fallen from 5.2% in 2014 to 4.3% in 2017.<sup>126</sup> We also observed a similar trend in the proportion of UK audit hours worked by partners across all the Big Four's audit engagements, with a particularly sharp decrease in the proportion of hours worked by audit partners at one of these firms.
- 2.76 These results are supported by our analysis of the information published in the FRC's Key Facts and Trends in the Accountancy Profession series.<sup>127</sup> We found that the number of PIE audit engagements for each audit principal employed by the Big Four increased slightly from 2.4 in 2015 to 2.7 in 2017.<sup>128</sup> This change is more pronounced for KPMG – rising from 2.4 engagements in 2015 to 3.4 in 2017.
- 2.77 As the financial reports prepared by some smaller or less complex audits are signed-off by a 'responsible individual', rather than a partner at an audit firm, we also assessed the number of PIE audit engagements for each responsible individual at the Big Four firms.<sup>129</sup> We found that while the number of PIE audit engagements for each responsible individual employed by the Big Four overall had increased only marginally, the change at KPMG was again particularly pronounced – increasing from 1.3 engagements in 2015 to 1.7 in 2017.<sup>130</sup>
- 2.78 While we should interpret this evidence cautiously, since the proportion of work carried out by partners can be affected by the type of company being audited and may change over time, we would expect the proportion of audit hours worked by partners to increase as key audit matters are likely to require greater judgment.<sup>131</sup> We therefore consider this fall in the use of experienced staff in each audit to be consistent with the persistent problem of variable and sometimes poor audit quality identified by the FRC's reviews of audit firms.

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<sup>126</sup> CMA analysis of financial information submitted by audit firms.

<sup>127</sup> Financial Reporting Council [Key Facts and Trends in the Accountancy Profession](#)

<sup>128</sup> Audit Principals are partners or members of an LLP that are qualified to prepare audit reports.

<sup>129</sup> Responsible Individuals are those individuals who are able to sign audit reports and include Audit Principals and Employees.

<sup>130</sup> Financial Reporting Council [Key Facts and Trends in the Accountancy Profession](#)

<sup>131</sup> Similarly, a 'responsible individual' may hold an audit qualification but could be used in other roles at a firm, rather than be included in the staff available for PIE audit engagements

## ***Views of stakeholders on audit quality***

- 2.79 The balance of views put to us by audited companies throughout our study have said that the provision of audit to large companies in the UK was generally of a high quality. Indeed, many of the large companies that responded to our Update Paper did not have concerns about the quality of their audit process or did not think that the evidence we presented indicated that there was a systemic problem with audit quality in the UK.<sup>132</sup>
- 2.80 This assessment was shared by the ACCs we heard from through our study, with some noting the recent introduction of mandatory tendering and rotation of auditors at large companies had led to an improvement in audit quality as they brought a fresh perspective to the company. This positive overall regard for audit quality among ACCs is also reflected in a recent FRC survey, which found that 86% of respondents rated their external auditor as either ‘excellent’ or ‘above average’.<sup>133</sup>
- 2.81 Some respondents to our Update Paper told us that they did not agree with our conclusion that there is a problem with audit quality in the UK as we had used a relatively small number of corporate failures to demonstrate a more widespread problem.<sup>134</sup> However, this was not a universal view. Many stakeholders – including audit firms – accepted that recent instances of high profile corporate failures have exposed serious concerns around audit quality and diminished trust in the audited financial statements of large companies overall.
- 2.82 Submissions from investors – the ultimate customers of audited financial statements – agreed with us that recent corporate failures have not only highlighted the problems in the audit market but have undermined their trust in the provision of audit to large companies.<sup>135</sup> Aberdeen Standard Investments told us that ‘recent corporate failures have highlighted weaknesses in the audit market’, encompassing not only the audit process but also the appointment and oversight of auditors.<sup>136</sup> Legal & General Investment Management said

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<sup>132</sup> BP Response to Update Paper, 21 January 2019; National Grid Response to Update Paper, 21 January 2019; Perendie Response to Update Paper, 21 January 2019; RBS Response to Update Paper, 21 January 2019; Rio Tinto Response to Update Paper, 21 January 2019; Rothesay Life Response to Update Paper, 21 January 2019.

<sup>133</sup> FRC, ‘Developments in Audit 2018’, p34.

<sup>134</sup> Chartered Accountants Ireland Response to Update Paper, 28 January 2019; GC100 Response to Update Paper, 28 January 2019; David Lindsell Response to Update Paper, 21 January 2019; Ian Barlow Response to Update Paper, 21 January 2019.

<sup>135</sup> Aberdeen Standard Investments Response to CMA Update Paper, 21 January 2019; LAPFF Response to the CMA Update Paper, 18 January 2019; LGIM Response to CMA Invitation to Comment, 1 November 2018; Roliscon Limited Response to the CMA Update Paper, 18 January 2019;

<sup>136</sup> Aberdeen Standard Investments Response to CMA Update Paper, p1.

that they ‘feel let down by poor audit quality’ and ‘believe that trust in audit has been shaken due to the recent high profile accounting scandals’.<sup>137</sup>

- 2.83 These concerns were shared by groups that represent a number of investors and smaller shareholders. The Pensions and Lifetime Savings Association submitted that while there are good quality audits in the UK, ‘high profile failures or even the perception of failure can be extremely damaging to investor (and public) confidence’.<sup>138</sup> The Investment Association said that high profile failures have had serious implications ‘for companies, the people they employ, their suppliers and shareholders’ and agreed with our conclusion that poor quality audits may be more widespread but are likely underreported as not all instances result in failure.<sup>139</sup>
- 2.84 Other stakeholders also agreed that recent corporate failures have exposed concerns in audit quality. The ICAEW said that while the majority of audits were of a high standard ‘any failure is one too many’ and agreed that public trust in audit has been damaged as a result of a series of high-profile failures.<sup>140</sup> Baroness Bowles noted that ‘concern about failures is rooted in lack of warning’ rather than an expectation nothing ever fails, and agreed that the potential impact of poor quality audit could be prevented with an earlier identification of commercial or other problems.<sup>141</sup>
- 2.85 While the submissions of the Big Four audit firms did not agree with the analysis of audit quality presented in our Update Paper, they recognised the need to restore public confidence and regain the trust of stakeholders in audit.<sup>142</sup> KPMG told us that while audit quality is generally of a high standard in the UK ‘the particular challenge is one of consistency to ensure that this is always achieved’. Representatives of the Big Four also informed the BEIS Select Committee’s *Future of Audit* inquiry that they are actively taking steps to improve the quality of audit at their firms, with only Kevin Ellis of PwC stating that he is ‘happy with the standards of the audit quality of my firm’.<sup>143</sup>
- 2.86 The majority of responses from other audit firms agreed with our analysis that there has been a persistent problem of variable and sometimes poor audit

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<sup>137</sup> LGIM Response to CMA Invitation to Comment, 1 November 2018.

<sup>138</sup> Pensions and Lifetime Savings Association, Response to CMA Invitation to Comment, 5 November 2018.

<sup>139</sup> Investment Association Response to the CMA Update Paper, 18 January 2019.

<sup>140</sup> ICAEW Response to Update Paper, 23 January 2019.

<sup>141</sup> Baroness Bowles Response to Update Paper, 21 January 2019.

<sup>142</sup> Deloitte Response to Update Paper, 21 January 2019, Q1; EY Response to Update Paper, 21 January 2019, Q1; PwC Response to Update Paper, 21 January 2019, Q1; KPMG Response to Update Paper, 25 January 2019, Q1.

<sup>143</sup> Business, Energy and Industrial Strategy Committee (30 January 2019), [Future of audit inquiry – oral evidence](#), Q466 – Q478.

quality.<sup>144</sup> BDO said that recent financial reporting and audit failures, particularly concerning PIEs, have shown that ‘quality is not consistently high enough’ and ‘does not meet stakeholders’ expectations’.<sup>145</sup> Mazars agreed that high profile audit and corporate failures have raised concerns that poor audit quality ‘is more widespread but has not been identified or brought to public attention’. Grant Thornton stated that all audit firms ‘must continue to strive to improve the quality of audit’ and that ‘quality ought to be the key focus’ in a well-functioning audit market.

- 2.87 Evidence heard by the BEIS Select Committee’s *Future of Audit* inquiry pointed towards the interaction between auditors and companies as a source of poor audit quality. Vinita Mithani of Middlesex University noted that ‘there have been far too many cases where auditors have been found not to have challenged the most contentious management assertions’ and the presence of information asymmetry leads to limitations in any audit.<sup>146</sup> Professor Karthik Ramanna from the University of Oxford told the inquiry that audits have ‘moved further and further away’ from providing some assurance of the reporting judgements used by a company’s management when assessing what ‘investments in this period realise in the future’.<sup>147</sup>
- 2.88 Some responses to our Update Paper suggested that other parts of the financial reporting process affected the quality of an audit. Schroders told us that auditors have contributed to poor disclosures from companies that do not adequately identify the risks of business, stating that audit firms can and should do more to ensure companies clearly and unambiguously report the underlying business and financial risks that they face.<sup>148</sup> The Investment Association stated that ‘too often audit firms consider the audited entity to be their client’ despite a company’s shareholders being reliant upon ‘the auditor’s work and to whom the auditor reports’.<sup>149</sup>
- 2.89 Our Update Paper set out the views of some respondents that public concerns around audit quality may arise in part because of the existence of an ‘expectations gap’ between the purpose of audit and what it is expected to

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<sup>144</sup> BDO Response to Update Paper, 21 January 2019; Crowe Response to Update Paper, 21 January 2019; Grant Thornton Response to Update Paper, 21 January 2019; Kreston Reeves Response to Update Paper, 21 January 2019; Mazars Response to Update Paper, 21 January 2019; RSM Response to Update Paper, 23 January 2019.

<sup>145</sup> BDO Response to Update Paper, p2.

<sup>146</sup> Business, Energy and Industrial Strategy Committee (15 January 2019), [Future of audit inquiry – oral evidence](#), Q1.

<sup>147</sup> Business, Energy and Industrial Strategy Committee (15 January 2019), [Future of audit inquiry – oral evidence](#), Q2.

<sup>148</sup> Schroders, Response to CMA Invitation to Comment, 5 November 2018

<sup>149</sup> The Investment Association, CMA Invitation to Comment Response, 30 October 2018. See also David Miller, Response to CMA Invitation to Comment, 19 October 2018, p11.



deliver to meet the needs of stakeholders.<sup>150</sup> While the Brydon Review will consider the role of auditors and the scope of their work, this will not remove the real concerns around audit quality set out above. An effect of reviewing the purpose and scope of audit might well be to raise the requirement for what is expected of auditors, but this would not alter the fact that a number of audits have been found by the FRC to require significant improvements since 2013.

### ***International perspectives on quality and the audit market***

2.90 Concern with audit quality is not isolated to the UK. In our Update Paper, we set out a number of international examples of audit failure that emphasised ‘the importance of ensuring that the underlying causes of poor quality are tackled’.<sup>151</sup>

2.91 To understand these international concerns around audit quality, we sought views from the European Competition Network and engaged with several international regulators and national competition authorities. Regulators in meetings and their reports have expressed views including:

- (a) that there are ongoing issues regarding audit quality deficiencies;<sup>152</sup>
- (b) their concerns regarding the market structure and the degree of concentration in certain sectors affecting a company’s choice of auditor;<sup>153</sup>
- (c) that the market structure with ‘too few to fail’ or firms being ‘too big to fail’ raises resilience concerns for the sector;<sup>154</sup> and
- (d) a greater focus on audit quality could be achieved by having a market where audit partners only focus on the audit part of the business.<sup>155</sup>

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<sup>150</sup> CMA (2018), [Statutory audit services: Update Paper](#), paragraph 2.67 – 2.72. Our views on these submissions are set out in ‘Annex C – Expectations Gap’ to our Update Paper.

<sup>151</sup> CMA (2018), [Statutory audit services: Update Paper](#), p38, paragraph 2.61.

<sup>152</sup> The Dutch Authority for the Financial Markets (2018), [Vulnerabilities in the structure of the accountancy sector](#), p5.

The South African Independent Regulatory Board for Auditors (2019), ‘[Public Inspections Report 2018](#)’, indicates that with regards to firm wide quality inspection reports, the inspection results “remain a cause for concern as they are indicative of systemic quality control deficiencies”, p2.

The United States Public Company Accounting Oversight Board identified faults in the audit work of Deloitte Malaysia, EY Japan, KPMG Canada and PwC Canada, Mexico and South Africa, ‘[PCAOB finds audit deficiencies at Big Four firms](#)’, 20 February 2019.

<sup>153</sup> European Commission (2010), [Green Paper Audit Policy: Lessons from the Crisis](#), p15.

<sup>154</sup> European Commission (2010), [Green Paper Audit Policy: Lessons from the Crisis](#), p4.

<sup>155</sup> The Dutch Authority for the Financial Markets (2018), [Vulnerabilities in the structure of the accountancy sector](#), pp33-36.

- 2.92 Audit quality and issues regarding the audit market are the focus of many international regulators.<sup>156</sup> We are aware of efforts taking place to address audit market related concerns across several countries, including in the Netherlands and South Africa.
- 2.93 In November 2018, the Dutch Authority for the Financial Markets (AFM) published its report ‘Vulnerabilities in the structure of the accountancy sector’. The AFM identified five major structural features which give rise to vulnerabilities and market failures in the audit market, leading to issues such as those identified by the CMA regarding audit quality.<sup>157</sup> While the AFM’s report did not recommend any particular remedies, it discussed the extent to which certain structural changes could remove the sources of market failure.<sup>158</sup>
- 2.94 Following the publication of the AFM’s report, the Dutch Committee for the Future of Accountancy was established and has been given the responsibility to research and advise how to improve the quality of statutory audits and which policy or legislative changes are desirable and feasible. The Committee is expected to report on its findings and recommendations by the end of 2019.<sup>159</sup>
- 2.95 The South African audit regulator, the Independent Regulatory Board for Auditors (IRBA), indicated there is overlap between the issues identified by the CMA and those which are being addressed in South Africa. IRBA has introduced several initiatives to improve audit quality and restore confidence in the profession, including the Audit Quality Indicators Project as well as measures that focus on audit firm governance, and tools and guidance to assist and strengthen audit committees, such as transparency reporting and a future guide to joint audits.
- 2.96 We also reviewed the Survey of Inspection Findings published by the International Forum of Independent Audit Regulators (IFIAR) in 2018. This survey summarises the ‘key inspection findings from the audits of listed public interest entities ... and [audit] firm systems of quality control’ reported by 42

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<sup>156</sup> US PCAOB (2019), [Report on 2017 Inspection of KPMG LLP, Public Company Accounting Oversight Board](#), reports that of the audits examined, the PCAOB found that in 26 audits some deficiencies were of such significance “that it appeared to the inspection team that the Firm, at the time it issued its audit report, had not obtained sufficient appropriate audit evidence to support its opinion.”

Commonwealth of Australia (2019), [The Australian Parliamentary Joint Committee Report on Corporations and Financial Services](#), pp11–14.

<sup>157</sup> The Dutch Authority for the Financial Markets (2018), [Vulnerabilities in the structure of the accountancy sector](#), p10.

<sup>158</sup> The Dutch Authority for the Financial Markets (2018), [Vulnerabilities in the structure of the accountancy sector](#), p55.

<sup>159</sup> Accountant, ‘[Members of the Future Accountancy Sector Committee announced](#)’, 18 December 2018.

regulators that are members of IFIAR.<sup>160</sup> The survey reported that of the 918 listed PIE audits performed by 120 audit firms, 40% had at least one inspection finding.<sup>161</sup> The two areas with the highest rate and greatest number of findings related to:<sup>162</sup>

- (a) accounting estimates (i.e. failure to assess the reasonableness of assumptions, including consideration of contrary or inconsistent evidence); and
- (b) internal control testing (i.e. failure to obtain sufficient persuasive evidence to support reliance on manual internal controls, as well as to sufficiently test controls over the accuracy and completeness of data or reports produced by management).

2.97 Although the IFIAR report is not intended precisely to measure changes in audit quality, it noted that “the recurrence and level of findings reflected in the survey indicate a lack of consistency in the execution of high quality audits and the continuing need for improvement”.<sup>163</sup> Of particular concern to the IFIAR was that ‘the global audit firm networks’ progress in reducing the rate of findings is not observed consistently across jurisdictions’, suggesting that some firms are able to respond to instances of poor audit quality in a more timely manner than other parts of the same network.<sup>164</sup>

2.98 In their responses to our Update Paper, KPMG and PwC both questioned our use of international examples of poor audit quality. KPMG told us that these international cases were not supportive of concerns about quality in the UK as ‘no context is given as to the examples or relative frequency with which they occur or the relevant regulatory scheme of the country concerned’.<sup>165</sup> PwC noted that the countries referenced in the Update Paper have different corporate governance systems and regulatory approaches from those in the UK, before stating that these examples are not ‘evidence of the likelihood of systemically poor audit quality within the UK’.<sup>166</sup>

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<sup>160</sup> IFIAR, ‘[IFIAR publishes report of 2017 survey inspection findings](#)’, 9 March 2018.

<sup>161</sup> IFIAR collects information from its members about two categories of inspection activities. The first category relates to inspections performed on firm-wide systems of quality control relating to policies and processes established by audit firms that affect the quality of their audits. The second category relates to inspection findings of individual audit engagements which relate to an audit firm’s execution of auditing standards on a particular audit. Inspection findings reported in the survey generally relate to auditors’ failures to comply with applicable standards or requirements. [The Survey of Inspection Findings 2017](#), March 2018, p15.

<sup>162</sup> IFIAR (2018), [The Survey of Inspection Findings 2017](#), p10.

<sup>163</sup> IFIAR (2018), [The Survey of Inspection Findings 2017](#), p4.

<sup>164</sup> IFIAR (2018), [The Survey of Inspection Findings 2017](#), p1.

<sup>165</sup> KPMG Response to Update Paper, 25 January 2019, 1.15.

<sup>166</sup> PwC Response to Update Paper, 1 (e) iii.

- 2.99 This evidence is relevant to the provision of audit services in the UK because the Big Four cite the capacity and capability of their international networks as part of their ability to deliver high quality audits globally. PwC told us that for ‘audits of multinational companies, global reach is an important criterion and a firm not part of a comprehensive global network could be at a disadvantage’.<sup>167</sup> This view was shared by EY, stating that multinational companies ‘require audit firms with global reach in order to ensure consistently high quality audits’.<sup>168</sup> Deloitte noted that, in relation to the barriers to expansion faced by challenger firms, the Big Four ‘have invested significantly in their business over many decades’ which has improved the ‘breadth and depth of their global networks’.<sup>169</sup>
- 2.100 We also heard from ACCs and companies that one of the main barriers preventing some challenger firms from effectively competing for the audits of large companies in the UK is their small international network. HSBC said that, in addition to expertise and other capabilities, ‘one or more non-Big Four firms would need to develop their global footprint’ significantly to provide greater choice of auditors that would meet its ‘requirements in respect of audit and non-audit services’.<sup>170</sup> Rio Tinto told us, when agreeing with the assessment of the barriers to challenger firms for FTSE 350 audits we set out in our Update Paper, that ‘auditing a global organisation, with the scale and size of Rio Tinto, is a major undertaking requiring global presence and technical skills in depth’.<sup>171</sup>
- 2.101 While we have not relied upon this evidence as part of our assessment of audit quality in the UK, this international perspective is important for our understanding of potential issues with the provision of statutory audit services to UK based companies that rely heavily on firms’ global networks. Further, a significant audit failure in part of the global network of an audit firm – particularly one of the Big Four – may have implications for the reputation and sustainability of their UK practices.

### ***Conclusion on audit quality***

- 2.102 Shareholders and other users of audited financial statements rely on the oversight provided by Audit Committees and regulators to ensure auditors consistently deliver high quality audits. However, the FRC has found a number of audits to be requiring significant improvements since 2013, and

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<sup>167</sup> PwC Response to ITC, 11 (a).

<sup>168</sup> EY Response to ITC, p2.

<sup>169</sup> Deloitte Response to ITC, 11.1.

<sup>170</sup> HSBC Response to ITC, 2b.

<sup>171</sup> Rio Tinto Response to Update Paper, p3.

that audit firms have continually failed to improve on the traits necessary to provide high quality audits.

- 2.103 A number of recent high-profile instances of poor quality practices have damaged confidence and trust in audit overall. While audit firms are not ultimately responsible for corporate failures, had auditors carried out their work to a higher standard, it is possible that commercial or other problems could have been identified earlier. This would have limited the potential impact of poor audit quality on those affected by allowing them the opportunity to make better informed decisions.
- 2.104 The evidence we have gathered, as well as the views of audit firms and other stakeholders, suggests that there is a persistent problem of variable and sometimes poor audit quality in the UK. These issues cannot be dismissed as isolated events or due to the 'expectations gap'.

### **Potential impact of poor quality audit**

- 2.105 While recent corporate failures have exposed instances of poor audit quality, the FRC has found a more persistent and widespread problem of lower quality audit than we would expect in a well-functioning market. Where a company does not fail, the potential impact of poor audit quality will be harder to observe, but the harm resulting from poor quality audit may continue for some time before being addressed.
- 2.106 The potential impact of poor audit quality goes further than the inadequate practices found on one audit engagement. Concerns around audited financial statements also affect the public trust in the corporate governance structure of other large UK companies, limiting the investment opportunities of companies and investors, as well as the productive potential of the wider economy.
- 2.107 While the benefits of higher audit quality could be large, it would be difficult for anyone to estimate the impact of an incremental change in audit quality. We have therefore assessed the potential impact of poor audit quality based on:
- (a) The link between audit quality and trust in commercial and financial relationships; and
  - (b) The benefits of higher quality audit as part of an effective corporate governance regime in the wider economy.

### ***Audit quality and trust***

- 2.108 While there is no single agreed definition of audit quality, it is acknowledged that high quality audits contribute to accuracy and conservatism in audited

financial statements. This increased reliability in the information published by companies will lead to a reduction in the 'agency costs' borne by those that enter a commercial or financial relationship with the company.<sup>172</sup>

2.109 The potential impact of lower agency costs from higher quality audit will not only benefit investors, but also employees and other stakeholders in the company. For example:

- (a) A reduced incentive for management to manipulate earnings forecasts to meet short-run revenue or profit targets, which will decrease the likelihood that shareholder equity will be diluted in the longer term – either through the issuance of more shares to increase the capital held by the company or due to the failure of the company leading shareholders to lose their investment.<sup>173</sup>
- (b) Any reduction in agency costs will decrease the company's cost of capital and allow the company to increase the number of opportunities available to investors to fund specific projects or to use its existing assets more productively – securing the position of current employees as the company remains in business and becomes less likely to fail.<sup>174</sup>
- (c) Customers and suppliers will be more likely to invest in firm-specific relationships confidently as the company is more likely to remain in business until the end of its contract – ensuring that any owed goods or services are supplied to customers and owed funds are paid to the supplier rather than being lost due to the company's collapse.

2.110 This suggests that the benefits of good audit quality could be large, as it will lessen the agency costs found in commercial and financial relationships formed with companies by many distinct categories of stakeholders, but that it would be hard to directly estimate the impact of an incremental change in audit quality. However, the impact of these agency costs is likely to be widespread as they will affect the trust investors and other stakeholders have in the incentive of the company to behave in their interests.

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<sup>172</sup> 'Agency costs' are the actual and perceived costs borne by 'agents' when there is a principal-agent problem. These costs are a result of the different incentives and access to information the company ('agent') has relative to shareholders, suppliers, customers and regulators (the 'principals').

<sup>173</sup> 'Earnings management' is a process of choosing a set of accounting policies to present a particular view of the firm's performance to other parties. These can either take the form of understating losses when they are announced by the company or through taking an overly optimistic approach to abnormal accruals (ie when earnings forecasts are substantially revised upwards).

<sup>174</sup> The link between financial information, agency costs and a company's cost of capital is set out in Bushman, R.M. and Smith, A.J. (2001) 'Financial Accounting Information and Corporate Governance', *Journal of Accounting & Economics* Vol. 32, December 2001.

- 2.111 As the CC noted, the link between audit quality and trust means that even small imperfections in the provision of a statutory audit may be highly damaging.<sup>175</sup> This would be the case where we only observe some relatively isolated instances of problems in audit quality that apply to only a few companies or when the performance of audit firms has been found to fall short of the expected standards in a number of audits and over a longer period of time.
- 2.112 Lack of trust in the provision of audits will undermine credibility and confidence in the quality of audits and the accuracy of financial statements published by large companies. These will prevent investors, customers and suppliers from being able to identify the companies that have more effective and those that have less effective audits (other than in the extreme case of corporate failure).

### ***Benefits of effective corporate governance***

- 2.113 While the role played by audit firms is only one component in the effective corporate governance of companies, this does not mean the role of a statutory auditor is insignificant. Auditors provide a source of independently verified financial statements that are not easily replicated by investors, regulators or other stakeholders that monitor the performance of a company. Auditors are also required to report on the adequacy and effectiveness of internal controls at a company as part of an audit.
- 2.114 The positive impact of effective corporate governance on the wider economy has been set out by a number of institutions and international bodies, who have found that it can lead to: a more efficient allocation of capital, improving productivity and growth; a better functioning financial system due to increased public disclosure by banks and insurers; and is the 'bedrock' of trust between business and society.<sup>176</sup>
- 2.115 The Organisation for Economic Co-operation and Development (OECD) has said that an effective corporate governance system, within an individual company and across an economy as a whole, contributes to providing the confidence that is necessary for the proper functioning of a market economy.<sup>177</sup> As a result, the cost of capital is lower and firms are encouraged

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<sup>175</sup> CC, *Statutory audit services for large companies market investigation*, 15 October 2013, paragraph 14.36.

<sup>176</sup> For example: the Department of Business, Innovation and Science (reference); the Bank of England (<https://www.bankofengland.co.uk/-/media/boe/files/quarterly-bulletin/2017/pillar-3-disclosures-looking-back-and-looking-forward.pdf?la=en&hash=468DA87C061529E83D14A90554D2D44B4487529F>); the CBI (<http://www.cbi.org.uk/news/uk-rightly-recognised-as-a-world-leader-in-corporate-governance/>); and the US PCAOB ([https://pcaobus.org/News/Speech/Pages/12032014\\_Doty.aspx](https://pcaobus.org/News/Speech/Pages/12032014_Doty.aspx)).

<sup>177</sup> OECD (2002), *Corporate Governance and responsibility: Foundations for market integrity*.

to use resources more efficiently, thereby underpinning growth. When this trust is undermined, lenders and investors are said to lose their appetite for risk, and shareholders to sell their equity, resulting in lost value and reduced availability of capital.

2.116 This relationship between corporate governance and the cost of capital or the equity price of companies was used by the CC to illustrate the potentially large financial benefits of greater investor confidence that may result from an improved trust in audit.<sup>178</sup> Using the market capitalisation of the FTSE 350 at the end of February 2013, the CC's analysis found that:

- (a) A one basis point (0.01%) increase in the market capitalisation of the FTSE 350 would represent a benefit to shareholders of around £200 million; and
- (b) A one basis point decrease in the cost of capital would represent an increase in the overall market capitalisation of the FTSE 350 of around £3.8 billion.

2.117 While we cannot be certain about the magnitude of these benefits from an incremental improvement in the corporate governance framework, the above illustrates that even a very small effect would have a very large financial impact.

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<sup>178</sup> CC (2013), [Statutory audit services for large companies market investigation](#), paragraph 14.39.



### 3. Issues

#### Introduction

- 3.1 The previous section summarised our concerns that audit quality has fallen short of what we would expect in a well-functioning market. This section sets out our view on what is driving these quality concerns.
- 3.2 In a well-functioning market, competition and regulation would combine to ensure the right incentives through a variety of mechanisms.
- (a) Selection and oversight of auditors would ensure that competition would be focused on quality, so that firms win more business if they deliver good quality and lose business if the quality of their audit service is poor.
  - (b) There would be enough opportunities to compete, and there would be sufficient choice of viable competitors over the long term, without undue barriers to entry and expansion, to enable intense competition.
  - (c) Within firms, individual auditors' personal success would depend to a very large extent on whether they deliver high-quality audits, and audit practices as a whole would be focused on the success of the audit business rather than non-audit activities.
  - (d) Regulation would provide an external check on quality, increasing transparency and punishing sub-standard performance both by firms and by individuals. This would support competition on quality because buyers would have better information on a service whose quality is otherwise hard to judge.
- 3.3 Previous interventions have attempted to make these mechanisms work more effectively. For instance, the CC and EU remedies strengthening audit committees have brought about some changes in the way auditors are selected and overseen; the CC and EU mandatory tendering and rotation remedies addressed parts of (b); regulation has attempted to improve (c), for example by restricting the ability of audit partners to cross-sell non-audit services; and the CC's recommendations for more frequent, strengthened AQRs related to (d).
- 3.4 But as the outcomes described in the previous section show, these interventions have not been sufficient to create the right regulatory and competitive environment in which auditors have the incentives to deliver consistently to high standards. In particular, the changes have not yet created

an environment in which auditors are rewarded for delivering to high standards and punished for delivering audits that fall short of these standards.

- 3.5 The recent Independent Review of the FRC has proposed additional measures to strengthen the regulatory regime, which are now being taken forward by the Government. If implemented in full, these reforms should go a long way to ensuring that the regulator has the powers to tackle poor audit quality and create the right incentives for the market to work effectively. However, regulation alone cannot produce a well-functioning market. Regulation needs to work alongside effective competition, with genuine choice of providers, so that auditors that perform particularly well can gain market share and those that provide a poor-quality service lose out.
- 3.6 This section considers the reasons why the audit market is not working well, aside from regulation. The key ones are:
- (a) **Selection and oversight of auditors** is insufficiently focused on quality. Audit Committees are only a partial solution to the underlying problem that companies procure their own audits.
  - (b) **Choice.** There are limits on choice, driven by a combination of regulatory requirements and barriers to competition from challenger firms.
  - (c) **Barriers to expansion facing challenger firms** resulting from a combination of demand and supply-side factors.
  - (d) **Resilience.** The lack of choice and barriers to expansion faced by challenger firms intensifies the concerns around long-term choice and quality.
  - (e) **Incentives resulting from audit firm structure.** The provision of both audit and non-audit services by firms weakens the incentives on audit partners to deliver high-quality audits.
- 3.7 In response to the Update Paper, most interested parties did not provide detailed comments on our analysis of the issues, focusing on the potential remedies. Where detailed views were given on specific issues we have taken these into account in the relevant part of the analysis below. In general, responses on the investor side were supportive of our analysis of the drivers of poor audit quality.<sup>179</sup> Of the Big Four auditors, Deloitte<sup>180</sup> broadly agreed that these are sensible issues to consider in relation to quality concerns but

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<sup>179</sup> See responses from Hermes and Investment Association.

<sup>180</sup> Deloitte response to the Update Paper, paragraph 2.1.

said that its views on these issues were not fully aligned with the CMA. EY said<sup>181</sup> that the expectation gap was the fundamental cause of public concern on audit quality (a view supported by other audit firms). KPMG made detailed comments on our analysis<sup>182</sup> which are considered below. PwC said<sup>183</sup> that the evidence demonstrates a market in which competition generally works well. The challenger firms were broadly supportive of our analysis.<sup>184</sup> The views of industry bodies were mixed.<sup>185</sup>

## Selection and oversight of auditors

### Summary

- 3.8 A first condition for the audit market to function well is that auditors are selected and monitored in a way that is focused on ensuring high-quality audit.
- 3.9 We have found that there are limits to what we can expect from shareholders in providing oversight of the conduct of the Audit Committee or, directly, of the audit itself. There is little direct investor engagement in audit issues. It is very rare for investors to reject the appointment of an auditor. Investors argued that this was partly a function of lack of transparency about the detail of the audit – they argued that if there was more information available about eg key audit issues then they would have an incentive to be more engaged.
- 3.10 This means that the system is very reliant on Audit Committees, and ACCs in particular, in driving audit quality. We found that the CC’s remedies have strengthened the role of the Audit Committee particularly in the appointment of the auditor. All the ACCs that we spoke to were clear that their duty is to provide an independent function representing the interests of shareholders and valued the professional scepticism and challenge of the auditors.
- 3.11 However, shareholder confidence in the appointment of auditors requires selection criteria to be transparent and to be focused on what matters for high-quality audits – independence, scepticism and challenge. We found that

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<sup>181</sup> ET response to the Update Paper, Appendix B paragraph 2.

<sup>182</sup> KPMG response to the Update Paper, Part A

<sup>183</sup> PwC response to the Update Paper

<sup>184</sup> See BDO response to the Update Paper page 3; Grant Thornton response to Update Paper, pages 5-7; Mazars response to Update Paper, page 5; RSM response to Update Paper, page 1

<sup>185</sup> The Institute of Chartered Accountants in England and Wales (response to the Update Paper, page 5) and the Institute of Chartered Accountants of Scotland (response to the Update Paper, paragraphs 2.1 to 2.4) were generally supportive of our findings. The Institute of Chartered Secretaries and Administrators (response to the Update Paper, paragraphs 2a to 2e) was supportive of some findings. The Association of British Insurers (response to the Update Paper, page 3) questioned the strength of the evidence. The Association of Chartered Certified Accountants (response to the Update Paper, page 5) was not supportive of the findings as set out in the Update Paper.

weight was attributed to factors like ‘cultural fit’ and ‘chemistry’, which calls into question whether the current tendering approach rewards auditors for being close to management, rather than providing independent challenge. We also found that company managers still play a significant role in the tender process and in advising the Audit Committee on audit appointments.

3.12 Once an appointment has been made, we found that it is hard for Audit Committees to observe directly the quality of the audit work undertaken. There is also significant variation in the resources available to Audit Committees. Overall, while some Audit Committees appear effective in overseeing the activities of auditors, the evidence suggests that there is significant variability among Audit Committees in the FTSE 350.

3.13 The remainder of this section sets out the evidence we have gathered on:

- (a) the purpose of audit and the role of the Audit Committee in selecting and monitoring audit activities on behalf of shareholders;
- (b) selection processes for audit tenders, including the criteria used to assess bids;
- (c) the effectiveness of Audit Committee monitoring and oversight once an auditor has been appointed; and
- (d) the degree of engagement by shareholders in audit matters.

### ***Purpose of audit and the role of the Audit Committee***

3.14 Statutory audit has evolved as a means of addressing the incentive problems inherent in modern corporate governance structures. In a public limited company, the separation of ownership and control creates a ‘principal-agent’ problem – the owners want the managers to run the company in their interests but can only partially observe the actions of those managers. Statutory audit provides a way of addressing this principal-agent problem. By appointing an independent auditor to validate the financial accounts produced by management, owners and the wider public can have confidence in the company’s financial figures, which in turn gives managers a stronger incentive to act in the interests of the company’s owners.

3.15 Given this purpose of audit, a key challenge is how to ensure that the auditors are acting in the interests of the company’s owners rather than in the interests of the company’s managers. Since auditors need to work closely with a company’s managers on a day-to-day basis in order to carry out an audit, it is important that owners can be confident that the auditors are independent from

management and challenge managers sufficiently.<sup>186</sup> For example, Pirc<sup>187</sup> recently reported on several examples of alleged conflicts of interest arising from ‘inappropriate’ relationships between companies and Big Four audit firms.<sup>188</sup>

- 3.16 Audit Committees play a key role in representing the interests of owners (shareholders) and ensuring that incentives are aligned. According to guidance produced by the FRC,<sup>189</sup> while all directors have a duty to act in the interests of the company, the Audit Committee has a particularly important role, acting independently from the executive, to ensure that the interests of shareholders are properly protected in relation to financial reporting and internal control.
- 3.17 The CC and EU put in place a package of measures to strengthen the position of Audit Committees, to enhance the accountability of the Audit Committees to shareholders and to promote shareholder engagement in the audit process, including by promoting information flow between companies and investors in relation to the external audit. We have assessed the impact of these changes in relation to the appointment of auditors, ongoing monitoring of their activities, and the direct engagement of shareholders in audit matters, as set out in the sections below.

### ***Selection processes for audit tenders***

- 3.18 We have assessed whether aspects of the selection processes could result in the selection of auditors with the interests of the company and its management rather than those of the shareholders in mind. In particular, we have examined:
- (a) the criteria used in the evaluation of bids; and
  - (b) the involvement of management in the tender process.

### ***Selection criteria***

- 3.19 We asked a sample of companies that had recently carried out tenders to provide us with details of their selection processes.<sup>190</sup> We also collected

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<sup>186</sup> Prof Prem Sikka et al. noted that, ‘Ever since the inception of modern audits there have been concerns about company directors selecting and remunerating auditors and thereby defeating the very concept of an independent audit.’ [Reforming the auditing industry](#), December 2018.

<sup>187</sup> Pensions & Investment Research Consultants Ltd is an independent corporate governance and shareholder advisory consultancy created by pension funds.

<sup>188</sup> See <https://www.thisismoney.co.uk/money/markets/article-6817551/Shamed-Eight-major-companies-forced-defend-cosy-links-auditors.html>

<sup>189</sup> FRC (2016), [Guidance to Audit Committees](#)

<sup>190</sup> See appendix for details of the approach taken to sampling.

information from auditors on all the tenders that they had participated in over the past five years. We used this evidence to understand how companies evaluate bids.

- 3.20 Overall, the evidence from recent tenders suggests that quality is typically viewed as more important than price, which matches the preference of most shareholders and other stakeholders. However, that factors such as ‘cultural fit’ are considered calls into question the weight given in auditor selection to independence, scepticism and ability to challenge, the main attributes Audit Committees should be demanding of auditors.

*Importance of price in judging tenders*

- 3.21 We found that bids are typically evaluated against a list of criteria. While the list varies from company to company, the criteria will, in addition to price, usually include:

- (a) experience and technical capability of the audit partner, the audit team and the firm;
- (b) geographic coverage of the firm’s network;
- (c) understanding of the company’s business and industry knowledge; and
- (d) working relations with senior management.

- 3.22 Some stakeholders have raised concerns that too much weight is attached to price as ‘a company’s managers may value lower pricing over a rigorous audit process’,<sup>191</sup> and that competition is putting downward pressure on price to the detriment of quality. We found little evidence to support a claim that Audit Committees focus overly on price in the selection of auditors.

- 3.23 There was general agreement among the ACCs that we spoke to that audit quality should matter more than price. A number of ACCs stated that cost was not a significant determinant when selecting an auditor, with one Chair stating that in their experience ‘the prime concern of the audit committee has been to ensure that the auditors perform a robust audit, unconstrained by fees’.<sup>192</sup>

- 3.24 The 100 Group, which represents the views of FTSE 100 finance directors and several large UK private companies, stated that, in its experience, Audit Committees are focused ‘on the quality and challenge provided by the audit

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<sup>191</sup> Grant Thornton, Response to CMA Invitation to Comment, 2 November 2018, p3.

<sup>192</sup> SD Barber, Response to CMA Invitation to Comment.

firm. The cost of delivery is a relatively minor consideration in selecting an audit firm, with a greater weighting typically being applied to other factors such as quality, innovation, sector expertise and efficiency'.<sup>193</sup>

- 3.25 It was not always clear from the documents provided by the companies precisely how much weight was attached to price relative to quality. However, based on data provided by the auditors we observed that the winning bid was not the cheapest bid in the majority of cases (57% of the 229 FTSE 350 tenders for which we had data and where there were two or more bidders).<sup>194</sup>
- 3.26 This is supported by our analysis of the audit fees received by the auditors of FTSE 350 companies in the period 2012 to 2017. We found that the audit fee paid to a newly appointed auditor in their first year was almost as likely to be lower (44%) as it was to be higher (46%) than the fee paid to the previous auditor in the last year of their engagement.<sup>195</sup>

#### *Assessment of audit quality in tenders*

- 3.27 Aside from price, the criteria used by companies are similar to those listed in the FRC 'good practice' tender guidelines.<sup>196,197</sup> The main exceptions were criteria such as 'easy to work with', 'cultural fit' and 'chemistry'. Such criteria raise concerns around independence of the auditor. The UKSA stated that when it comes to auditor appointment, large companies and public interest entities appear to take the position that 'the only real requirement for selection is that they get on well with the audit partner(s)'.<sup>198</sup>
- 3.28 We looked at the information provided on evaluation criteria in our sample of recent audit tenders. Figure 3.1 shows the selection criteria applied by the sample of FTSE 350 companies. We found that 23 out of 24 FTSE 350 companies explicitly included 'fit', 'cultural fit' and/or 'chemistry',<sup>199</sup> whereas only nine explicitly included 'exercising scepticism' and/or 'challenging management'.<sup>200</sup>

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<sup>193</sup> The 100 Group, Response to CMA Invitation to Comment, 26 October 2018.

<sup>194</sup> CMA analysis of auditors' tender data.

<sup>195</sup> CMA analysis of Industry Background data set based on 131 completed auditor rotations. (There was no observed change in audit fee for the remaining 10% of observations.)

<sup>196</sup> FRC (February 2017), [Audit tenders notes on best practice](#).

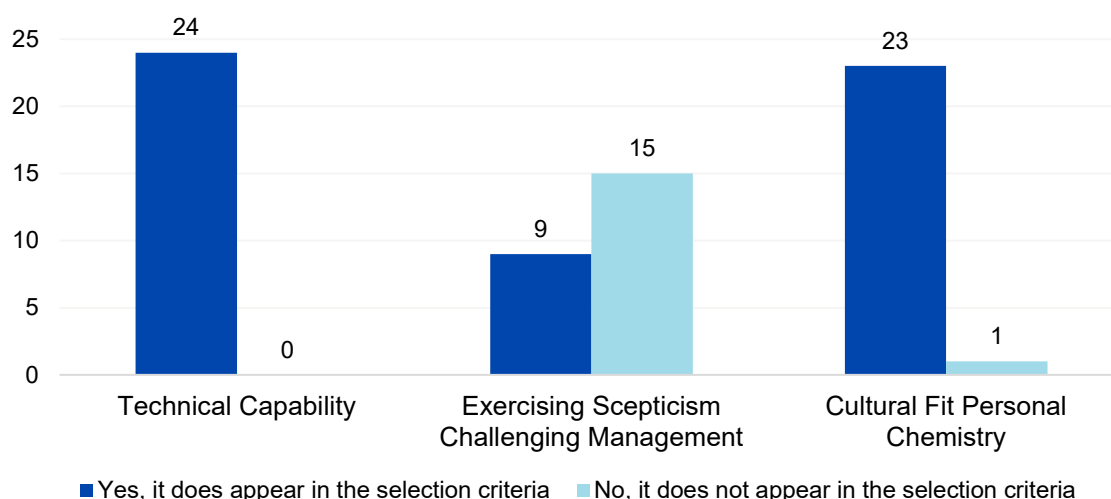
<sup>197</sup> Industry expertise of the firm and audit team; experience and audit quality record of the lead partner and the firm; planned use of technology in the audit process; geographical coverage of the network firm; and experience in transitioning similar audits.

<sup>198</sup> The United Kingdom Shareholders Association, Response to CMA Invitation to Comment, 30 October 2018, p3.

<sup>199</sup> Includes any reference to, at least one, of the following: cultural or strategic fit; alignment with culture; and chemistry.

<sup>200</sup> Includes any reference to, at least one, of the following: robust or thorough audit; challenging management; objectivity and exercising scepticism.

**Figure 3.1: Selection criteria applied in audit tenders (FTSE 350 companies)**



Source: CMA analysis of information request responses.

- 3.29 We also found evidence that factors like ‘cultural fit’ and ‘personal relationships’ have been important in decisions made by ACCs on auditor selection. For example:
- 3.30 Minutes for the [X] final selection committee state that ‘throughout the process, the importance of the relationship having the right chemistry had been emphasised and, when considered across the entire group, it was felt that [X] more collaborative style was more closely aligned with that of the group and on balance there was a closer affinity with [X] than [X].’
- 3.31 One of the main reasons why [X] was not chosen by [X] was ‘the lack of chemistry between the teams both internally to [X] and with [X]’. Similarly, ‘the evaluation teams felt that [X] were too blunt in their approach and it wouldn’t be a collaborative relationship’.
- 3.32 A [X] document outlining the assessment criteria states that ‘chemistry is probably the most important element’.
- 3.33 There are a variety of ways to interpret the phrase ‘cultural fit’. One ACC stated that this includes the audit partner displaying maturity in being able to deal with events in a calm and constructive manner, with the strength to make the right decisions. Interpersonal skills and an understanding of the organisation, its culture and ambitions may be relevant to an auditor’s ability to effectively question and challenge management.
- 3.34 However, there are also examples that suggest an interpretation and application that is contrary to what a ‘good auditor’ should be. For example, in [X] tender, [X] scored well on ‘challenge and tension’ but poorly on ‘culture



and style'. While in terms of 'challenge and tension' it was positively noted that a 'lack of relationship building meant a bigger focus on what we do and how we do it', the same 'lack of focus on relationship building' negatively affected the score on 'culture and style'. For the winning bidder, [X], the partner is reported to have disagreed with certain accounting treatments and to have 'resisted challenge well'. However, it was also noted that [X] showed 'not much challenge during the process' and that the conversation on accounting treatments 'was not difficult'. The result was a low score on 'challenge and tension', which was almost completely compensated for by a high score on 'culture and style', based on (among other things), the firm being 'relationship focussed', showing 'strong desire to work with [the company]', and coming across as 'personable and approachable, with good humour'.<sup>201</sup>

- 3.35 That terms like 'cultural fit' can be understood in different ways is also illustrated by the [X] tender. Under the title of 'cultural fit', the Audit Committee considered, amongst other things, whether the 'Lead Partner and team bring adequate challenge, courage and integrity'. However, under the same title they also considered how the Lead Partner and key team members will 'fit with [X] culture' and whether management could 'work with this team'. These are very different considerations.
- 3.36 Audit Committee Chairs told the BEIS Select Committee that the number one factor in the selection of auditors is robustness of the audit, but that people have to work together and so have to get on with each other.<sup>202</sup> In response to the Update Paper, several of the auditors and companies challenged our interpretation of the evidence on 'cultural fit' on the grounds that:
- (a) the CMA's analysis of tender criteria is based on a sample of only 24 FTSE 350 companies;<sup>203</sup>
  - (b) there is no evidence for the CMA's interpretation of 'cultural fit' criteria in the selection of auditors, or that disproportionate weight is put on such considerations;<sup>204</sup>

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<sup>201</sup> [X] noted that, under "Technical expertise", the audit partner "confirmed that [X] do not agree with [the] accounting treatment of IBAs, and resisted challenge from [Finance Director] well".

<sup>202</sup> Business, Energy and Industrial Strategy Committees (2019), *Future of audit inquiry – oral evidence*, Q105

<sup>203</sup> KPMG response to the Update Paper, paragraph 2.4

<sup>204</sup> Deloitte response to the Update Paper Appendix 2.2, KPMG response to the Update Paper, paragraphs 2.3 and 2.4

- (c) audit teams must have a professional working relationship with management, and it is entirely appropriate that Audit Committees consider this in the selection of the auditor;<sup>205</sup>
  - (d) terms like ‘cultural fit’ and ‘chemistry’ are not well defined and, therefore, cannot be inferred as implying a lack of independence;<sup>206</sup> and
  - (e) the use of terms like ‘chemistry’ and ‘cultural fit’ simply reflect the role of important service quality factors, which are key parameters of competition in an industry like auditing.<sup>207</sup>
- 3.37 In response to these challenges, we note that our results are based on a sample of 24 companies that responded to information requests sent to 35 FTSE 350 companies (selected to be representative of the FTSE 350). All these companies provided internal documents for their most recent tender. With the exception of just one tender, criteria such as ‘cultural fit’ were a consideration in the selection of the auditor. On this basis, we consider that it is reasonable to conclude that ‘cultural fit’ is a common selection criterion in audit tenders.
- 3.38 We recognise that criteria such as ‘cultural fit’ are open to interpretation, and that auditors need to be able to establish effective working relationships with management which allow for problems to be dealt with in a mature and professional manner. Generally, however, our review of the tender documents does not support this interpretation of these criteria. In particular, our review does not suggest that Audit Committees are consistently prioritising scepticism and challenge, or that firms understand that demonstrating these qualities will be a driver of success in tenders. We therefore remain concerned about a tension between ‘cultural fit’ and independence.
- 3.39 The Investment Association agreed with us on this point. In particular, it was concerned that selection criteria can include matters such as ‘easy to work with’, ‘cultural fit’ and ‘chemistry’.<sup>208</sup>
- 3.40 The Select Committee heard that Audit Committees should be looking for ‘robustness, tenacity and the ability to follow through’ rather than ‘any kind of cultural fit or personality fit’.<sup>209</sup>

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<sup>205</sup> Deloitte response to the Update Paper Appendix 2.2

<sup>206</sup> KPMG response to the Update Paper, paragraphs 2.3 and 2.4

<sup>207</sup> KPMG response to the Update Paper, paragraph 2.4

<sup>208</sup> Investment Association response to the Update Paper, p7.

<sup>209</sup> Business, Energy and Industrial Strategy Committees (2019)

<http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/business-energy-and-industrial-strategy-committee/future-of-audit/oral/95047.pdf>, BDO response to Q205 to Q207, p4.

- 3.41 Overall, shareholder confidence in the appointment of auditors requires selection criteria to be transparent and to be focused on what matters for high quality audits – independence, scepticism and ability to challenge. The weight attributed to factors like ‘cultural fit’ and ‘chemistry’ calls into question whether the current tendering approach rewards auditors for being close to management, rather than providing independent challenge.

#### *Role of management in audit appointments*

- 3.42 Based on submissions received from investors and shareholder representatives, it appears that the last few years have seen an increasing involvement of Audit Committees in the appointment of auditors, with choices based more on audit quality than on price. However, some investors told us that there is still an excessive involvement of companies’ CFOs and top management in the conduct of the tender process, and expressed a view that, while executives can be consulted for relevant information, auditor selection should be the exclusive role of the Audit Committees.<sup>210</sup>
- 3.43 Based on the evidence we gathered on 24 FTSE 350 tenders, it appears that Audit Committees are now actively involved in most, if not all stages, of the tender process. This includes the design of the process, the evaluation of bids, the final presentations by short-listed firms, and the decision on the recommendation to the board. The clearest examples we found of Audit Committees delegating heavily to management were before the CC order came into force. However, management still plays a significant role in the tender process and in advising the Audit Committee.
- 3.44 Senior management involvement in the selection process provides an opportunity for them to influence auditor appointment, particularly given the importance attached to factors like ‘cultural fit’ and ‘chemistry’. This is illustrated by the [X] tender. In particular, the committee delegated responsibility for selection, agreed on the importance of relationships and ‘the right chemistry’, and ‘felt that [X] more collaborative style was more closely aligned with that of the group’ and that there was a ‘closer affinity with [X] than [X]’. While some senior management involvement is inherent to the process, confidence in the selection requires Audit Committees to have effective oversight of the process at all stages.
- 3.45 The selection process would be a more effective driver of audit quality if the criteria applied were consistently focused on audit quality, and the participation of senior management in the process were kept to the minimum

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<sup>210</sup> Hermes response to the Update Paper, Sarasin Response to CMA Invitation to Comment, 6 November 2018, p5 and p8.

necessary for an effective selection process (taking into account the constraints on the time and resources that Audit Committee members could allocate to the process).

- 3.46 In response to the Update Paper, investors generally supported our analysis in relation to auditor selection.<sup>211</sup> The Investment Association<sup>212</sup> said that audit committees should direct the planning and oversee the process, including identifying candidates, setting the audit quality criteria for selection and conducting the interviews. Sarasin said it was alarmed by our findings given the central importance to shareholders of professional scepticism by the auditor.<sup>213</sup>
- 3.47 Challenger firms were also generally supportive of our analysis. Grant Thornton said that culture and behaviours are important in auditor selection, but whether there is a fit between the auditor's and the audit client's culture is not.<sup>214</sup>

### ***Effectiveness of Audit Committees in overseeing auditors***

- 3.48 Even if the Audit Committee appointed an auditor in a way that was completely aligned with the interests of shareholders, problems could still arise if auditors' activities were not properly monitored. This could be the case, for example, if auditors get too 'close' to the company's management and exercise insufficient scepticism or challenge. It could also simply reflect an incentive for auditors to minimise costs, given that audit quality may be difficult to assess unless things go wrong.
- 3.49 We have considered:
- (a) how far Audit Committees can and do monitor audit quality; and
  - (b) whether Audit Committees have sufficient resources to carry out their ongoing oversight role effectively.

### ***Ability of Audit Committees to monitor audit quality***

- 3.50 Guidance produced by the FRC<sup>215</sup> specifies that the Audit Committee should annually assess, and report to the board on, the qualification, expertise and

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<sup>211</sup> In addition to response from Investment Association and Sarasin, see response from Hermes (p 3) and UK Shareholders Association/ShareSoc (p1 and p2).

<sup>212</sup> Investment Associations response to the Update Paper, p7.

<sup>213</sup> Sarasin response to the Update Paper, p 4.

<sup>214</sup> Grant Thornton response to the Update Paper, paragraph 2a), p5.

<sup>215</sup> <https://www.frc.org.uk/getattachment/6b0ace1d-1d70-4678-9c41-0b44a62f0a0d/Guidance-on-Audit-Committees-April-2016.pdf>.

resources, and independence of the external auditors and the effectiveness of the audit process. The Audit Committee should meet the external and internal auditors at least annually, without management. Moreover, it is expected that the Audit Committee Chair, and to a lesser extent the other members, will keep in touch on a continuing basis with the key people involved in the company's governance, including the external audit lead partner.

- 3.51 Some of the investors responding to our invitation to comment (ITC) acknowledged that Audit Committees are increasingly involved in monitoring and evaluating the activity of auditors.<sup>216</sup> However, concerns have been expressed as to how independently this activity is performed.<sup>217</sup> Several investors were concerned that Audit Committees do not sufficiently challenge management on their judgements or auditors on the depth of work and analysis they have undertaken.<sup>218</sup> In particular, it was noted that in several cases Audit Committees appear to rely on executive feedback on the auditor as the main input into annual reviews of performance, therefore assessing auditors based on the feedback from the very people whose work is being audited.<sup>219</sup>
- 3.52 Members of the Audit Committee Chairs Independent Forum (ACCIF) told us that they felt confident in their ability to assess the quality of the key aspects of the audit of their companies, in particular by discussing with the auditors the work performed on areas of higher audit risk and the basis for the auditors' conclusions on those areas, supplemented by their other interactions with the auditors. That enabled them, for example, to gauge the depth of the auditors' understanding of the company's business. They were critical of the reviews conducted by the FRC. They felt that FRC reports are not sufficiently focussed on what matters to the quality of the audit outputs.
- 3.53 Overall, it is difficult for Audit Committees to observe directly the quality of the audit work undertaken. Rather, Audit Committees will discuss with the auditors the work performed on areas of higher audit risk and the basis for the auditors' conclusions on those areas, supplemented by their other interactions with the auditors.<sup>220</sup> This makes the system fragile, by being reliant on Audit

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<sup>216</sup> Invesco Response to CMA Invitation to Comment, 6 November 2018, p. 3.

<sup>217</sup> Sarasin Response to CMA Invitation to Comment, 6 November 2018, p. 8; Hermes Investment Response to CMA Invitation to Comment, 5 November 2018, p. 8.

<sup>218</sup> Investment Association Response to CMA Invitation to Comment, 5 November 2018, p. 6; Sarasin Response to CMA Invitation to Comment, 6 November 2018, p. 8, Schroders Response to CMA Invitation to Comment, 5 November 2018, p. 3.

<sup>219</sup> Sarasin Response to CMA Invitation to Comment, 6 November 2018, p. 8.

<sup>220</sup> The ACCA noted that its research into key audit matters in audit reports found that, by providing a focus for discussions between the audit committee and the external auditor, key audit matters enhance the quality of these discussions. ACCA Response to the Update Paper, p.6.

Committees and ACCs to drive auditors to focus on providing high quality audit based on professional scepticism and challenge.

- 3.54 In response to the Update Paper, PwC said we were wrong to suggest that Audit Committees cannot observe directly the quality of audit work undertaken as high-performing, highly engaged Audit Committees ask the right questions and have frequent opportunities to observe the challenges that auditors present to management.<sup>221</sup> Highly engaged Audit Committees that allocate considerable time to overseeing the audit should have a good understanding of the audit work undertaken and, therefore, be well placed to judge audit quality. However, it remains our view that the auditor and management will be closer to the day-to-day audit work undertaken than the Audit Committee, and so better informed in relation to the quality of the audit. In addition, as we discuss below, the evidence suggests that while some Audit Committees are effective in overseeing the activities of auditors, there is significant variability among Audit Committees in the FTSE 350.

#### *Variation between Audit Committees in resources and approach*

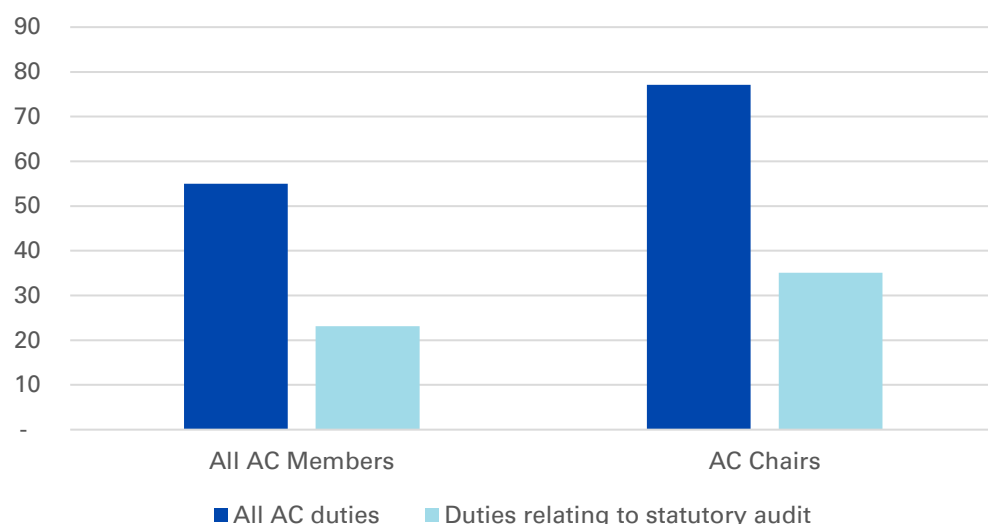
- 3.55 Like its responsibilities in appointing auditors, the extent to which the Audit Committee might mitigate the principal-agent problem in relation to the monitoring of auditors depends on the resources it is provided with and on its independence of judgement.
- 3.56 We have information from 18 FTSE 350<sup>222</sup> companies on the amount of time spent by Audit Committees on external audit-related matters. We found that this varied significantly based on the size and complexity of the company. Figure 3.2 shows that, on average, Audit Committee members reported spending 55 hours on all their Audit Committee duties in the last financial year, and 23 hours on duties relating to the statutory audit. For ACCs, the equivalent figures are 77 hours and 35 hours respectively.

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<sup>221</sup> PwC response to the Update Paper, p8, paragraph 2b)

<sup>222</sup> Of the 35 FTSE 350 companies that were sent formal information requests, 18 were able to provide reliable information. Others said that they did not keep these records.

**Figure 3.2: Average number of hours spent by Audit Committee members in the past year**



*Note:* We excluded from our analysis any AC member who had been appointed in the last 18 months to reduce the effect of individuals who had not been in post throughout the last full financial year.

3.57 However, these averages are significantly affected by the time spent by some Audit Committees. For example, for the largest company in our sample, the five Audit Committee members spent 1,030 hours on Audit Committee duties in the last full year.

3.58 This suggests that the amount of time and resources spent by Audit Committees varies significantly between companies (including between similar companies). We found that the total Audit Committee time spent on the external audit (excluding time spent on a tender), ranged from more than 400 person-hours in a year to less than 20 hours. This included several FTSE 100 companies recording less than 40 hours in a year. While some variation is not surprising given the variance in scale and complexity of companies within the FTSE 350, it raises a question about whether smaller and less well-resourced Audit Committees are properly able to oversee and monitor the activities of the statutory auditor.

3.59 For some, the hours suggest that Audit Committees cannot be taking as proactive a role as envisaged by the FRC. The FRC guidance<sup>223</sup> states that the ‘audit committee should consider key matters of their own initiative ... discuss what information and assurance it requires in order to properly carry out its roles to review, monitor and provide assurance or recommendations to the board and, where there are gaps, how these should be addressed...

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<sup>223</sup> FRC (2016), [Guidance on Audit Committees](#)

satisfy itself that these sources of assurance and information are sufficient and objective.’

- 3.60 Following our Update Paper, Audit Committee Chairs told the BEIS Select Committee<sup>224</sup> that they were surprised by our findings on audit committee hours. They would expect Audit Committee Chairs to be speaking to auditors throughout the year on a weekly or monthly basis. They would expect audit partners to spend a substantial amount of their time with the company, particularly towards year end, including time spent talking to audit committee chair and the audit committee.
- 3.61 Audit firms generally emphasised that, in their experience, Audit Committees were effective and highly focused on quality<sup>225</sup> and sophisticated purchasers of audit services.<sup>226</sup> However, we were also told that this may not uniformly be the case<sup>227</sup> and that initiatives to make quality more consistent were welcome.<sup>228</sup> Several companies said that their Audit Committees are effective<sup>229</sup> or questioned the evidence to the contrary,<sup>230</sup> but another said that Audit Committees could do more in monitoring audit quality.<sup>231</sup>
- 3.62 Other respondents on the investor side agreed that there was variability in Audit Committee effectiveness<sup>232</sup>. Aberdeen Standard said<sup>233</sup> that it was aware that audit committees fulfil their responsibilities to different degrees; some are highly engaged but others are not. The Investment Association said it agreed that many audit committees are not adequately monitoring the audit process or devoting sufficient time to their duties.
- 3.63 Investors told the BEIS Select Committee<sup>234</sup> that Audit Committees are required to report on the effectiveness of the audit and the independence of the auditor, but few actually say how they have satisfied themselves that they have received a quality audit.
- 3.64 The FRC has also found, for example, that Audit Committees vary in the quality of their published Audit Committee Reports (ACRs).<sup>235</sup> ACRs provide

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<sup>224</sup> [Evidence to the BEIS Select Committee](#), Q112-117, pages 8-10.

<sup>225</sup> See Deloitte response to the Update Paper, Appendix paragraph 2.2.

<sup>226</sup> See KPMG response to the Update Paper, paragraph 2.2.

<sup>227</sup> See KPMG response to the Update Paper, paragraph 2.2; PwC response to Update Paper page 8.

<sup>228</sup> See KPMG response to the Update Paper, paragraph 2.2; PwC response to Update Paper, page 8.

<sup>229</sup> See response to the Update Paper from Aviva (page 2); BP (page 2) and Smiths Group (pages 1 and 2).

<sup>230</sup> BT response to the Update Paper page 2.

<sup>231</sup> RBS response to Update Paper page 5.

<sup>232</sup> In addition to response to Update Paper from Aberdeen Standard and Investment Association, see responses from Hermes paragraph 2a, Page 3.

<sup>233</sup> See Aberdeen Standard's response to the Update paper.

<sup>234</sup> [Evidence to the BEIS Select Committee](#), Euan Stirling, Global Head of Stewardship & ESG Investment, Aberdeen Standard Investments; Q61 page 24

<sup>235</sup> FRC (December 2017), [Audit Committee reporting](#).



investors with information that provides insight into the quality and rigour of the Audit Committee. The FRC found that some Audit Committees provide 'excessive description of process in the ACR, which is often boilerplate and uninformative'.

- 3.65 Overall, while some Audit Committees are effective in overseeing the activities of auditors, the evidence suggests that there is significant variability among Audit Committees in the FTSE 350.

### ***Shareholder oversight of auditors***

- 3.66 Finally, we have considered how far shareholders act as a constraint on the activities of Audit Committees and are directly engaged in audit matters.
- 3.67 Although the Audit Committee is meant to represent the interests of shareholders, in practice most stakeholders we spoke to suggested that investors have little engagement with audit matters. Several Audit Committee Chairs confirmed a lack of active engagement in audit matters by shareholders and other investors.
- 3.68 Shareholders have to approve the appointment of the auditor each year, but in most cases this appears to be a formality. One recent exception was the shareholder vote in May 2018 to reject the reappointment of Deloitte as auditor of SIG. This came after SIG admitted that it had overstated its profits in previous accounts.<sup>236</sup>
- 3.69 We are also aware of instances where investors and shareholder representatives have a degree of influence on audit firm appointment, potentially encouraging an Audit Committee to appoint a Big Four audit firm.
- 3.70 Investors told the BEIS Select Committee<sup>237</sup> that they could and would like to be more engaged. In response to the Update Paper, investors said that the lack of information available to shareholders is an obstacle to engagement and that, with improved transparency,<sup>238</sup> there is a significant opportunity to increase investor engagement by enabling them to hold auditor committees and auditors to account. They said that often little information was provided about tender processes. In addition, limited information is provided about

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<sup>236</sup> The Financial Times, [SIG shareholders reject reappointment of Deloitte as auditor](#), 10 May 2018.

<sup>237</sup> <http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/business-energy-and-industrial-strategy-committee/future-of-audit/oral/95047.pdf>, Liz Murrall, Director, Stewardship and Reporting, The Investment Association, Q36 page 18.

<sup>238</sup> Investors said that there needs to be greater transparency around identifiable financial risks along with explanations of judgements or assumptions made in quantifying such risks and their materiality, in order to allow investors to make informed judgments.

issues and concerns raised by auditors, the reasons underlying the identification of key risks, and whether the Audit Committee believe the audit has been challenging and the auditor has exercised professional scepticism. Communications to shareholders are generic and often based on answers to questionnaires drafted by audit firms.<sup>239</sup>

- 3.71 Investors told the BEIS Select Committee<sup>240</sup> that Audit Committees needed to be more transparent in relation to how they have satisfied themselves on the quality of the audit undertaken and that the auditors have challenged management and questioned the key assumptions and judgments. Baroness Bowles told us that ‘there is not a culture of external transparency around the appointment or monitoring of auditors.’<sup>241</sup>
- 3.72 Both investors and ACCs commented that the level of shareholder engagement on the external audits compares unfavourably with that on senior executive remuneration. For example, the Audit Committee Chair for National Express said that shareholders are ‘overly concerned’ with remuneration and should give more attention to the work of the audit committee and the external audit, which ultimately address greater systemic risk. Invesco Perpetual, in commenting on the scope for improvement, suggested adopting an approach similar to ‘AGM votes on remuneration reports and policies, AGM votes on audit committee reports should be considered’.<sup>242</sup>
- 3.73 On the disclosure of information to investors on appointments, FRC guidance states that: investors need to be aware at an early stage that the tender is taking place; companies should seek investor views to inform their choice of participating firms; investors should be informed on the firms being invited to tender; investors would like transparency on how potential conflicts have been mitigated and/or will be managed; and investors would like to know what factors led to the decision.<sup>243</sup>
- 3.74 The lack of transparency is illustrated by our findings in relation to the information provided to shareholders on tenders of external audit engagements. We asked the sample of FTSE 350 companies to provide details of any direct communications with shareholders when the company

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<sup>239</sup> See Aberdeen Standard response to the Update Paper; Hermes responses to the Update Paper, page 5; See Investment Association response to the Update Paper, pages 1 and 3; and Sarasin response to the Update Paper page 4.

<sup>240</sup> <http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/business-energy-and-industrial-strategy-committee/future-of-audit/oral/95047.pdf>, Liz Murrall, Director, Stewardship and Reporting, The Investment Association, Q80-81 page 31.

<sup>241</sup> Baroness Bowles response to the Update Paper, page 4.

<sup>242</sup> Invesco response to ITC.

<sup>243</sup> FRC (February 2017), *Audit Tenders – Notes on Best Practice*, p6.

last tendered the external audit. We found just one example of any direct communications.

- 3.75 Barclays confirmed in its 2014 Annual Report that it would be launching an external audit tender in 2015. Barclays prepared a briefing note for major shareholders covering the timetable and selection process and confirming that the Chairman of the Audit Tender Oversight Sub-Committee would be happy to discuss further with stakeholders. The tender document including the evaluation criteria was published on Barclays' website.
- 3.76 Since 2013 external auditors have been required to prepare Extended Auditor's Reports including information of their assessed risks of material misstatement, materiality and the scope of their audit. The intention was to enhance the level of investor confidence in audit, by providing greater insight into and understanding of the work of auditors. While investors have welcomed the information included in these reports, many feel that more could be done. In particular, investors would like greater transparency over the assumptions made by management and the benchmarks used by auditors in making key judgements.<sup>244</sup>
- 3.77 Shareholders are aware that most of this information is of a confidential nature and cannot be made public. However, they argue that a mechanism should be created for allowing shareholders to have a better sense of how aggressive the accounting has been.
- 3.78 KPMG told us about its 'graduated audit' product, developed to address perceived institutional investor needs, and applied initially on a number of audits including Rolls-Royce where shareholder criticism of a lack of clarity made acceptance by the Audit Committee easier. The product provided greater disclosure and transparency for stakeholders. KPMG had tried to promote wider interest in the product with investors and Audit Committees, but had 'not gained traction'. KPMG said that, while generally positively received, there was some nervousness on the part of Audit Committees around market perceptions.
- 3.79 Some investors recognised the limited capacity or willingness to engage. The active management industry is fragmented and does not always have the in-house capacity for handling engagement with non-executive directors. It was suggested that this issue could be addressed through the FRC's review and potential strengthening of the Stewardship Code. PwC are supportive of

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<sup>244</sup> FRC, [Extended auditing reporting - summary](#)

‘[i]ncreased engagement and challenge from shareholders’ as it ‘would sharpen the focus of Audit Committees on audit quality even further.’<sup>245</sup>

- 3.80 While we must be realistic about the ability and incentives for investors to be more engaged, we have received submissions from a range of investors on the case for greater transparency. More disclosure could make it easier for investors to engage.
- 3.81 The better informed and more involved investors are in the auditor appointment and conduct of the audit, the more confident we, and they, can be that audits are being carried out with the interests of investors in mind. Greater disclosure should have the further benefit of providing greater visibility on the effectiveness of Audit Committees in representing the interests of investors.

## **Competition and choice in the audit market**

### ***Summary***

- 3.82 A second condition for the audit market to work effectively is that there is sufficient choice between auditors available to Audit Committees to drive effective competition. All things being equal, the more choice that Audit Committees have in selecting their auditor, the stronger competition will be. In turn we would expect this to drive better market outcomes, including higher audit quality, under the right regulatory framework.
- 3.83 In some respects, competition appears to be working more effectively following the previous reforms to the market. Tenders occur more frequently than in the past. In most cases tenders involve detailed and comprehensive processes that should allow the company to make well-informed decisions. Although there are costs of tendering and switching, the switching process has generally gone smoothly. Many companies believe that they have sufficient choice.
- 3.84 However, for a substantial minority of FTSE 350 companies, Audit Committees are faced with fewer than three credible bidders for an audit tender. Competition is, in these circumstances, fragile. If one of the bidders fails to impress, the company is left, in effect, with no choice at all.

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<sup>245</sup> PwC response to the Update Paper, Annex 2c

- 3.85 Based on the evidence described in the subsequent paragraphs, this lack of choice is driven by a combination of:
- (a) Mandatory switching rules, which mean that the incumbent bidder cannot participate (so the Big Four becomes the big three).
  - (b) Lack of confidence that the challenger firms would have the capability to carry out a complex audit, including perceptions that the international networks of the challenger firms do not have the same reach, strength and consistency as those of the Big Four firms.
  - (c) The need to avoid conflicts between audit and non-audit services. In some cases auditors are willing to drop non-audit work in order to take on an audit client and the Audit Committees manage the process to allow time for the incoming auditor to become 'clean'. However, there are other cases where the company views a particular piece of non-audit work as particularly important and so does not want the firm in question to tender for the audit, or where a tender has to be arranged quickly, for example where the company has concerns about its current auditor.
  - (d) There are also some cases where an auditor chooses not to participate. This can be for a variety of reasons including: not wanting to have too many clients in a particular sector; not wanting to exit significant non-audit work for the client; and an expectation that there is a low probability of winning.
- 3.86 The remainder of this section sets out the evidence on:
- (a) How competition works in the audit market, including the relationship between competition and quality;
  - (b) Extent of choice in recent audit tenders; and
  - (c) Factors limiting choice.

### ***How competition works and the relationship between competition and audit quality***

#### ***The audit tender process***

- 3.87 Competition in the audit market takes the form of periodic competition through tenders for audit engagements. Effective competition requires that audits are tendered sufficiently frequent to allow opportunities for competitors to bid for contracts, and that companies have a genuine choice of alternative auditors when they carry out a tender.

- 3.88 At the time of the CC market investigation the primary concern related to infrequent tenders and low switching rates.<sup>246</sup> Now, as a result of the CC's remedies and EU regulations, all PIEs must tender their audit at least every ten years and switch auditor at least every 20 years. Rates of tendering and switching have increased significantly. Over 50% of companies in the FTSE 350 have tendered their audit since January 2013 and the overall annual switching rate for FTSE 350 audits peaked at 14% in 2015.
- 3.89 The documentary evidence we gathered from companies and auditors suggests that tenders usually involve detailed and comprehensive selection processes. A typical tender process, from Request for Proposal (RFP) to decision, takes around three months but pre-preparation time may be several months or years. Conflict checks will typically take place at an early stage in the process, as well as at later stages. There may be a 'pre-selection' of the audit partners, where firms put forward two or three partners for the Audit Committee to choose who should lead the tender process. Data rooms are widely used in the tender process and access provided to management, enabling firms to gain an understanding of the business. 'Technical' challenges are widely used in the tender process.<sup>247</sup>
- 3.90 There are risks and costs associated with switching for both auditors and companies. To date, we heard that most of these costs appear to have been largely absorbed by the audit firms. This may have contributed to some of the lack of choice, as discussed further below. However, from a company perspective the experience of switching is generally judged to have been good and in line with the Audit Committee Chair's expectations.
- 3.91 For example, an Audit Committee Chair noted the benefits of having a 'fresh pair of eyes' and new insight and challenge from the new auditor. We did come across some exceptions – for example, [X]. However, the majority of companies appear to believe they have benefited from the switching process.

### *Relationship between competition and audit quality*

- 3.92 A key question for our market analysis is whether more choice and competition is likely to drive better outcomes in the form of higher quality audits. Some have raised concerns that competition might drive worse outcomes if it encourages too great a focus on cutting costs and too little focus on quality.

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<sup>246</sup> For example, the CC found that the tenure of current auditor was more than ten years for 67 per cent of FTSE 100 companies and 52 per cent of FTSE 250 companies.

<sup>247</sup> For example, it has become normal to test a firm's technology, including its data analysis capabilities. See PwC response to the ITC, Annex.

- 3.93 Our view is that competition can play an important role in driving higher quality if the incentives in the market are structured in the right way so that firms compete on quality. Regulation is important in setting and maintaining minimum standards for audit. Competition, in turn, if focused on matters important to investors, can sharpen the incentives for auditors to deliver to a consistently high standard.
- 3.94 The importance of the interaction of competition and regulation was generally echoed by stakeholders we spoke to. For example, a number of parties recognised a role for both competition and regulation in driving audit quality. One challenger firm submitted that '[e]ffective competition and proportionate regulation combined are key to delivering better audit outcomes'.<sup>248</sup>
- 3.95 The main challenge raised by some respondents to the Update Paper was that there is little direct evidence of competition and choice as drivers of audit quality.<sup>249 250 251</sup> Academic research evidence on the link between competition and audit quality is relatively limited. However, this reflects the difficulties in measuring audit quality on a consistent basis.<sup>252</sup>
- 3.96 In spite of this, we believe that in a regulatory regime that ensures that competition is focused on what matters to shareholders, competition should be an effective mechanism for driving audit quality. In particular, where Audit Committees have real choice in the selection of their auditor (that is, they are confident that more than one firm could deliver a good quality audit), competition through tenders should reward those audit firms that deliver to high standards and punish those that do not.
- 3.97 Several respondents to the Update Paper agreed that there is the potential for competition to drive improvements in audit quality. Two Big Four audit firms

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<sup>248</sup> Kreston Reeves, Response to CMA Invitation to Comment, 30 October 2018; The International Federation of Accountants, Response to CMA Invitation to Comment, 30 October 2018.

<sup>249</sup> Deloitte response to the Update Paper, Appendix paragraph 2.3.

<sup>250</sup> KPMG response to the Update Paper, paragraph 2.8.

<sup>251</sup> PwC response to the Update Paper, page 8.

<sup>252</sup> Recent studies of the relationship between audit competition or audit market concentration and audit quality include (i) Boone, J.P., I.K. Khurana, and K.K. Raman (2012) Audit market Concentration and Auditor Tolerance for Earnings Management, *Contemporary Accounting Research*, 29(4), 1171-1203; (ii) Dunn, K.A., M.J. Kohlbeck, and B.W. Mayhew (2013) The Impact of Market Structure on Audit Price and Quality. Available at SSRN: <https://ssrn.com/abstract=2258091>; (iii) Francis, J.R., P.N. Michas, and S.E. Seavey (2013) Does Audit Market Concentration Harm the Quality of Audited Earnings? Evidence from Audit Markets in 42 Countries, *Contemporary Accounting Research*, 30(1), 325-355; (iv) Kallapur, S., S. Sankaraguruswamy, and Y. Zang (2010) Audit market concentration and audit quality. Available at SSRN: <https://ssrn.com/abstract=1546356>; (v) Newton, N.J., D. Wang, and M.S. Wilkins (2013) Does a Lack of Choice Lead to Lower Quality? Evidence from Auditor Competition and Client Restatements, *Auditing: A Journal of Practice & Theory*, 32(3), 31-67; and (vi) Newton, N.J., J. Persellin, D. Wang, and M.S. Wilkins (2016) Internal Control Opinion Shopping and Audit Market Competition, *The Accounting Review*, 91(2), 603-623.

said that competition in tenders has been a driver of audit quality.<sup>253 254</sup>

Investors agreed that competition can play a crucial role in driving quality, and that effective competition requires adequate choice when the audit is tendered.<sup>255 256 257</sup> Several FTSE 350 companies also expressed support for a positive relationship between competition, choice and audit quality.<sup>258</sup>

3.98 We have been told that reputation, trust and credibility are all important features of competition in the audit market. We have also been told that trust in the brand is enhanced by the firm's position in the audit market. This suggests that audit firms should expect any damage to their reputation to have serious consequences for their audit business. Our concern is that this appears not to be happening currently in the market – it is not clear that firms over which concerns have been raised about audit quality have in fact been losing market share. If there were stronger choice and competition, firms would face a much greater risk of losing market share if their audit quality was poor.

3.99 For example, KPMG's market share has remained fairly constant at around 20% of FTSE 350 audit fees over the period 2011 to 2017 and increased to 25% in 2018. Also, KPMG recently announced its strongest growth in a decade, with revenues up by 8%<sup>259</sup> and underlying profit by 18%.<sup>260</sup> KPMG's AQR results for FTSE 350 audits have been less good than its peers in the Big Four in each of the last three years for which we have results (2015/16 to 2017/18),<sup>261</sup> with the FRC reporting a 'deterioration in the quality of the audits that [it] inspected to an unacceptable level' at the firm.<sup>262</sup> The FRC launched investigations into KPMG's audit of: Quindell in August 2015; Rolls Royce in May 2017; Carillion in January 2018; and Conviviality in July 2018.

### ***Extent of choice in recent audit tenders***

3.100 For competition to be effective in driving quality, there must be some degree of choice open to audit committees. Our evidence suggests that, for the

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<sup>253</sup> KPMG response to Update Paper, paragraph 2.9.

<sup>254</sup> BEIS Select Committee, [Oral evidence](#), 30 January 2019, Q399.

<sup>255</sup> See Investment Association response to the CMA Update paper.

<sup>256</sup> See Aberdeen Standard response to the CMA Update paper.

<sup>257</sup> See Hermes response to the CMA Update paper.

<sup>258</sup> Responses to the Update Paper from: AstraZeneca (Page 1); Aviva (Page 1); BT (page 1); Legal and General (Page 1); and RBS (page 1).

<sup>259</sup> For the financial year ended 30 September 2018.

<sup>260</sup> <https://www.accountancydaily.co/kpmg-posts-record-8-revenue-hike>.

<sup>261</sup> In each of these years between 50% and 65% of KPMG FTSE 350 audits were graded as 'good' or 'limited improvement required'; between 35% and 50% were graded as 'improvements required' or 'significant improvements required.' For each of the other Big Four firms, around 80% to 90% of FTSE 350 audits were graded as 'good' or 'limited improvements required'.

<sup>262</sup> FRC Developments in Audit 2018, p4.



majority of FTSE 350 audit tenders, audit committees were content with the level of choice.<sup>263</sup> However, for a substantial minority choice was limited.

- 3.101 We have been told by ACCs that a choice between three bidders is generally sufficient to ensure a competitive tender. For example, [X] said that ‘a maximum of three firms was in line with [its] desire to execute a streamlined, efficient tender process without impacting choice or quality’. One FTSE 100 ACC noted that ‘companies needed two bidders to provide valid choice in a tender process and that three bidders would be quite sufficient to provide valid choice in a tender process’. However, more generally, ACCs have expressed concern where choice is limited to two credible bidders. The FRC guidelines state that a typical tender process should involve three or four audit firms.<sup>264</sup>
- 3.102 To test the extent of choice in recent audit tenders we requested information from the audit firms and from a sample of companies:
- (a) We asked the audit firms to provide comprehensive information on all audit tenders they had been involved in since January 2013;
  - (b) We also approached a sample of 35 FTSE 350 companies that had conducted recent audit tenders to understand which firms had been invited to tender and how they had reached decisions on which firm to appoint. We received responses from 24.
- 3.103 Based on the information provided by the audit firms, we found that around 25% of the 250 FTSE 350 tenders in our dataset had fewer than three competing bidders.<sup>265</sup> This was consistent with analysis submitted by KPMG.<sup>266</sup>
- 3.104 Evidence from the sample of companies we spoke to was also consistent with the data provided by the audit firms. The majority of companies said they felt that they had sufficient choice of auditor. However, for five of the 24 FTSE 350 companies that were asked to provide information on their recent tender, choice appears to have been limited to two firms. These examples illustrate the circumstances in which choice might be limited:

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<sup>263</sup> Based on responses provided by the sample of 24 FTSE 350 companies and from meetings with ACCs.

<sup>264</sup> [https://www.frc.org.uk/getattachment/53c85956-d712-47d2-989f-2f8eff42be29/Audit-Tenders\\_notes-on-best-practice-Feb-2017.pdf](https://www.frc.org.uk/getattachment/53c85956-d712-47d2-989f-2f8eff42be29/Audit-Tenders_notes-on-best-practice-Feb-2017.pdf). The legal requirement is that at least two firms are presented to the full board by the Audit Committee, with a justified preference for one firm - see Article 16(2) of the Audit Regulation. Also <https://www.frc.org.uk/directors/corporate-governance-and-stewardship/uk-corporate-governance-code/frc-guidance-for-boards-and-board-committees>.

<sup>265</sup> We consider this to be an upper bound as we are aware of occasions in our dataset where an auditor has not included a tender in its submission when it did in fact participate in that tender. CMA analysis of auditors' tender data

<sup>266</sup> KPMG Response to CMA Invitation to Comment, 30 October 2018, p5

- (a) [X] was limited to a choice between two firms ([X]). Challenger firms were not considered to have the capability or ‘global footprint’. Independence considerations meant that [X] was precluded from inviting [X] to tender<sup>267</sup> and [X] had decided that it wanted to switch from [X].<sup>268</sup> However, the audit committee felt ‘that [X] both provided compelling propositions that demonstrate very strong capability’.
- (b) [X] invited five firms to submit proposals ([X] – [X] was the incumbent).<sup>269</sup> Only two submitted proposals ([X]). The other three declined to submit proposals (none of them had existing non-audit services relationship with [X]). While happy with the outcome,<sup>270</sup> [X] would have liked all five firms to bid.
- (c) [X] invited five firms ([X]) to tender. [X] was the incumbent.<sup>271</sup> Three firms declined to tender due to ‘being unable to confirm their independence under the new EU directive on audit independence’. An internal document suggest that [X] was content with the choice it had: ‘the decision was finely balanced but gave particular weight to the quality of the lead partner from [X], the benefits of being a [X] and their ability to deploy a “fresh pair of eyes” on the sector’.
- (d) In the case of [X], [X] as incumbent could not be reappointed. [X] declined due to conflicts of interest including the expected need to stop acting as auditor of a number of pension schemes where [X] group entities act as investment manager. The Audit Committee considered that it had sufficient choice, but would have preferred to have received a full tender response from the three firms invited to tender.
- (e) Similarly, in the case of [X], [X] as the incumbent could not be reappointed. [X] was excluded from the process [X] and potential conflicts of interest. Five firms were invited ([X]). [X] said that it had limited choice as: [X] had declined to bid due to the cost of bidding and lack of capacity to deliver. [X] declined to bid as winning [X] would further increase its exposure to [X]. [X] was also concerned about [X] capacity – [X]. [X] has effectively been left dealing with [X].

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<sup>267</sup> [X].

<sup>268</sup> [X].

<sup>269</sup> [X] had been [X]. Suggests that [X] could not participate given rotation requirements.

<sup>270</sup> Internal document states [X] will bring ‘smooth transition, ‘efficiency’, ‘robust and a challenging audit’, ‘experienced and stable audit team, ‘Clear communication to management and the audit committee’ and ‘15% saving on current audit fee’. We were told that [X] had met expectations.

<sup>271</sup> [X].

- 3.105 In response to the Update Paper, several companies recognised a lack of choice in the audit market.<sup>272</sup> The Investment Association<sup>273</sup> also agreed that there is limited choice and that an entity may be faced with only two viable choices. With so few players, investors questioned whether auditors are really competing on quality. The Investment Association considered the failure of firms to compete on meeting the market's needs for quality audits, and the lack of innovation, to be evidence of weak competition.
- 3.106 In contrast, some of the auditors challenged our provisional finding that choice is limited. For example, KPMG said<sup>274</sup> that the Competition Commission previously found that competition during tenders was strong and yet the CMA is now saying that competition and choice is not sufficient without justifying its reasoning. KPMG said<sup>275</sup> that the majority of companies tendering an audit have at least three bidders, and that this rivalry drives audit quality and the incentive to invest in audit quality. Large companies as a group have sufficient choice to drive strong competition in audit services. PwC also said that 'competition is fierce' in the large company audit market and that it believed that the market interventions made by the CC and EU have increased the degree to which competition focuses on audit quality.<sup>276</sup>
- 3.107 We agree that our analysis suggests that the majority of companies had a choice of three bidders, but for a substantial proportion (around 25%) of companies, choice was limited to, at most, two firms. This evidence comes through consistently both in our assessment of all the tender bids submitted by the audit firms and in evidence provided by a sample of Audit Committees. Investors told the BEIS Select Committee that 'there is a lack of real choice available to audit committees and that this is particularly acute when there is the provision of non-audit services because it means that choice of four can quickly become three or two'.<sup>277</sup>
- 3.108 We do not agree with KPMG that our findings are inconsistent with the conclusion of the 2013 Competition Commission investigation. Since the Competition Commission report was published in 2013, there have been material changes in regulations, including EU obligations in relation to mandatory switching and rotation, and restrictions on the provisions of non-audit services. These have changed the competitive dynamics in the audit market. As set out further below, while the tendering and conflicts rules have

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<sup>272</sup> See responses to the Update paper from AstraZeneca, (p1); Aviva (p1); Lloyds, (p 2); National Grid, (p1); and Rio Tinto (p3).

<sup>273</sup> Investment Association response to the Update Paper, Annex, p10

<sup>274</sup> KPMG response to Update Paper paragraph 2.8

<sup>275</sup> KPMG response to the Update Paper, paragraph 2.9

<sup>276</sup> PwC response to Update Paper, Annex 2e

<sup>277</sup> <http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/business-energy-and-industrial-strategy-committee/future-of-audit/oral/95047.html>, Q64, page 26

alleviated some previous concerns about the market, they have also exacerbated the problem of lack of choice.

### ***Factors limiting choice***

3.109 Looking across the evidence provided by companies and auditors, we identified four main reasons for lack of choice in some tenders: mandatory rotation rules; concerns about capability of firms outside the Big Four; conflicts rules; and choices by the audit firms not to bid.

### ***Mandatory rotation***

3.110 The first driver of lack of choice is a straightforward consequence of the EU rules on mandatory rotation. PIEs must tender their audit at least every ten years and rotate their auditor at least every 20 years. Where a company has reached the point where it is required to switch auditor, its current auditor is excluded from the tender process. For those FTSE 350 companies that perceive that only a Big Four auditor could carry out their audit, the best-case scenario is that they will receive tenders from the remaining ‘big three’.

3.111 Based on tender data provided by three of the Big Four, of those cases where they chose not to bid, around 40% were explained by the mandatory rotation rules.<sup>278</sup> These three Big Four auditors identified a total of 82 tenders between them that were affected by the mandatory rotation rules.<sup>279, 280</sup>

3.112 This evidence was confirmed by the information provided by companies. Several Audit Committee Chairs identified mandatory rotation rules as a key reason for limited choice.

### ***Lack of presence of challenger firms in tenders***

3.113 A second driver is a perceived lack of capability of auditors outside the Big Four to carry out audits of FTSE 350 companies, and in some cases the reluctance of challenger firms to take part in tenders even when invited.

3.114 Based on data provided by the auditors, we estimate that one or more challenger firms were approached to participate in around 30% of tenders for

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<sup>278</sup> Based on tenders where the auditor provided a reason why it did not submit a tender proposal. CMA analysis of auditors’ tender data.

<sup>279</sup> We were unable to include the results for the other Big Four auditor because of concerns about reliability of the data.

<sup>280</sup> If anything, this is likely to be an underestimate as audit firms were not in all cases able to confirm all the past tenders in which they did not bid.

FTSE 350 audits between 2013 and 2018. However, a challenger firm submitted a proposal in fewer than 20% of FTSE 350 tenders.<sup>281</sup>

3.115 Of the 24 FTSE 350 companies to whom we sent information requests, only four sent non-Big Four firms formal 'Requests for a Proposal'. Out of the 24 tenders:

(a) [REDACTED].

(b) [REDACTED].

3.116 [REDACTED]. We analyse the barriers faced by challenger firms in more detail in the following section.

3.117 The reasons given by companies for why challenger firms were eliminated at an early stage included lack of sufficient scale, international presence and experience with large companies, and lower perceived quality. One company noted that its contribution to a challenger firm's total fee income would have been significant, potentially impacting independence.

### *Conflicts issues*

3.118 Third, the multi-disciplinary nature of the large audit firms, combined with regulations to prevent conflicts between audit and non-audit work, can lead to a significant reduction in choice in some cases. The recent commitment by three of the Big Four firms<sup>282</sup> to stop providing non-essential non-audit services to companies that they audit is likely to further reduce choice.<sup>283 284</sup>

3.119 Under the EU rules, the auditor carrying out the statutory audit of a PIE is not allowed to provide certain prohibited non-audit services including tax and valuation services. Permitted non-audit services are subject to a 70% cap of the average audit fee over the last three financial years. This means that, where an audit firm is providing a significant amount of non-audit work for a client, there needs to be a process of 'cleaning' the conflicts (i.e. ending certain non-audit work) before the firm can be appointed as the auditor.

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<sup>281</sup> CMA analysis of auditors' tender data.

<sup>282</sup> EY, KPMG and PwC.

<sup>283</sup> Business, Energy and Industrial Strategy Committees (2019), Future of audit inquiry – oral evidence, questions 354-357 and 365-374; and KPMG response to the Update Paper, paragraph 2.25 and 20.5

<sup>284</sup> Deloitte included, as part of the package of remedies it suggested, a ban on non-audit services being provided to companies in the FTSE 350 and large private companies that it audited.

- 3.120 Several Audit Committee Chairs, including Go Ahead,<sup>285</sup> Pension Insurance Corporation, [X],<sup>286</sup> and Thomas Cook<sup>287</sup> all identified the rules around conflicts of interest and independence as creating a restriction on choice.
- 3.121 We were told that companies and audit firms can often take steps to manage conflicts of interest. In advance of the tender, a company will have discussions with potential bidders. This is an opportunity to identify potential conflicts of interests and for these to be addressed. For example, [X] told us that audit firms were invited to tender on the understanding that the winner would, as necessary, transition out of the provision of non-audit services. [X] said that this approach allowed it to choose the best auditor. The ACCA also said that it was unconvinced that the multidisciplinary nature of the large audit firms can lead to a significant reduction in choice, and that this issue is the responsibility of the Audit Committee to manage.<sup>288</sup>
- 3.122 However, the process of managing client conflicts can be complex, particularly as the rules apply to provision of non-audit services by any firm in the international network to the company or parent companies. In most cases the main constraint appears to come from the restricted services (where auditors need to demonstrate independence) rather than the broader cap of 70% on permitted non-audit work.
- 3.123 We also heard that companies sometimes did not want to retender non-audit work, particularly where one of the Big Four had a particular specialism and was providing ongoing advice. For example, [X] told us that [X] was providing it with advice on [X] over a number of years, and that it was not feasible to switch to an alternative provider. This meant that it did not invite [X] to tender for the audit contract. We heard several other similar examples from other Audit Committee Chairs.

#### *Decisions by auditors not to bid for contracts*

- 3.124 Finally, we found that in a number of cases auditors chose not to bid for audit contracts. In many cases their reasons for not bidding related to the conflicts between audit and non-audit services outlined in the previous section.
- 3.125 We received information from the Big Four and three challenger firms on a total of 155 instances where an auditor was approached, formally or

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<sup>285</sup> Two firms decided to withdraw from the process due to conflicts of interest in the provision of related services to the Go-Ahead Group plc and its subsidiaries.

<sup>286</sup> [X].

<sup>287</sup> Deloitte was conflicted as they offered tax advisory to Thomas Cook already.

<sup>288</sup> ACCA Response to the Update Paper, p.6.

informally, to take part in a tender, but did not submit a formal tender proposal.<sup>289</sup> The reasons cited by these auditors for not submitting a formal tender proposal varied considerably and in most cases it was not clear if the auditor had rejected the invitation or if the auditor did not make the final tender shortlist.

- 3.126 The information from the Big Four is consistent with the hypothesis that the conflicts rules on non-audit services restrict choice of auditor. The most common reason cited by the Big Four for not participating when invited was the provision of non-audit services (roughly 57% of the time).<sup>290</sup> Each of the other reasons were only cited by the Big Four in relation to 10% of tenders or less, and included the auditor considering it had a low likelihood of success and other actual or perceived independence conflicts.<sup>291</sup>
- 3.127 EY told us that a factor in considering whether to participate would be maintaining a balanced audit business. It would want to avoid being overly exposed to problems that might emerge in a certain sector. Related to this, in the banking sector, the prudential regulator would be unlikely to want one auditor to dominate the audit of retail banking.
- 3.128 In contrast to the Big Four, the three challenger firms only cited the provision of non-audit services in a small number of cases. Rather, at least one challenger firm told us that in many cases they did not make the final tender shortlist for some unspecified reason. Other reasons cited, both for rejecting an invitation and not making the final shortlist, included having a lack of credentials or sector expertise and a lack of a relationship with the tendering company.
- 3.129 One of the challenger firms (Grant Thornton) told us that it did not participate in some tenders because it had decided not to bid for the audits of FTSE 350 companies.<sup>292</sup> It told us that the drivers of this decision were the time and costs associated with the tender processes combined with a bias in favour of the Big Four. In the absence of market reform, the commercial opportunities for Grant Thornton were in advisory services and in developing its audit practice in companies outside the FTSE 350 and in the public sector. If the market conditions change, Grant Thornton said that it would consider again tendering for FTSE 350 audits.

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<sup>289</sup> That is, these instances are where the auditor was both invited, informally or formally, to tender and provided a reason why it did not submit a tender proposal. CMA analysis of auditors' tender data.

<sup>290</sup> Information received from the Big Four showed that, when including those they were not invited to, the most important reason cited for why they did not participate in a tender was due to rotation requirements.

<sup>291</sup> CMA analysis of auditors' tender data.

<sup>292</sup> CMA analysis of auditors' tender data.

3.130 BDO told us that it had, in recent years, declined some approaches to tender for FTSE 350 audits. BDO tended to focus on clients in certain sectors. In addition, a decision on whether to submit a proposal would be based on a number of factors including: the other firms likely to be invited to tender and their relationships with the company and Audit Committee members; potential conflicts; and BDO's previous working relationship with the company.

## **Barriers to expansion facing challenger firms**

### ***Summary***

- 3.131 A third condition for the market to work effectively is that new firms should be able to enter and expand, creating competitive pressure on the large incumbent providers.
- 3.132 As identified in the previous section, one of the main constraints on choice and competition in the market for FTSE 350 audits is the difficulty faced by firms outside the Big Four in expanding their position. Challenger firms continue to have a very limited presence in the FTSE 350. They had only nine FTSE 350 audit clients and around 1% share of FTSE 350 audit fees in 2017 (as set out previously), despite more frequent tendering and switching of audit contracts.
- 3.133 There are both demand-side and supply-side barriers that are preventing challenger firms from building on their presence in the FTSE 350 market.
- 3.134 On the demand side, there are concerns about the capability of challenger firms to carry out the most complex audits, particularly those requiring large international teams. However, we also found that the challenger firms faced a 'chicken and egg' problem – they were frequently ruled out of tenders on the basis of lack of experience, but would only be able to build that experience by gaining a more substantial foothold in the market. In addition, we saw evidence of a reluctance on the part of some investors to support Audit Committees who recommended hiring an auditor from outside the Big Four.
- 3.135 On the supply side, challenger firms appear reluctant in general to bid for FTSE 350 audits. Given current market conditions, this may be a rational reaction to the cost of tendering, likelihood of winning, and risk for a smaller firm of taking on a large audit client. Breaking out of this cycle is likely to take significant action to reset the market.



3.136 In response to the Update Paper, KPMG<sup>293</sup> acknowledged that challenger firms may face experience and reputational hurdles, but said that this largely reflects market forces and the need for firms to compete to employ the highest quality staff. KPMG argued that these are not ‘barriers’ to smaller firms as defined in the CMA’s market guidelines (intrinsic, strategic and regulatory barriers); rather the smaller audit firms’ position has resulted from competitive quality enhancing market forces.

3.137 However, the CMA’s guidelines state<sup>294</sup> that barriers to entry include natural or intrinsic barriers, strategic and other ‘first mover’ advantages, and regulatory barriers. The guidelines give investment in the costs of acquiring a reputation (e.g. for producing quality products) as an example of sunk costs that would amount to ‘natural’ barriers.. ‘First-mover’ advantages may also make it difficult for other firms to enter a particular industry because experience or an established reputation is necessary to compete effectively.

3.138 The remainder of this section sets out the evidence on demand-side and supply-side constraints facing the challengers.

### ***Demand-side constraints***

3.139 On the demand side, we found a mix of concerns raised by Audit Committee Chairs and investors. Some of these related to the capability of the challenger firms, but others related to a perception of risk in taking on a firm outside the Big Four, even if it was thought to have the capability to carry out an audit.

### ***Capability, capacity, reputation and credibility of the challenger firms***

3.140 It appears to be widely accepted that challenger firms do not currently have the capability to audit the largest, most complex companies at the top end of the FTSE 350. This is in part because of the size of the audit teams and international networks required to carry out these audits and, in some cases, because the challenger firms do not have the required sector or other expertise.

3.141 This does not, however, explain why challenger firms have not been more successful in establishing a presence among smaller companies in the FTSE 350. There is evidence that when challenger firms are given serious consideration and the opportunity to demonstrate their capability, they can win

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<sup>293</sup> KPMG response to the Update Paper, paragraph 2.13

<sup>294</sup> See

[https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/284390/cc3\\_revised.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/284390/cc3_revised.pdf) paragraphs 210, 211 and 222.

audit contracts (for example the recent JD Wetherspoons and Mitie tenders). Grant Thornton said that ‘mid-tier firms do possess the requisite capacity and quality to deliver quality audit services to all but the largest companies’. BDO said that it could ‘deliver high quality consistently for all but the largest and most complex entities’.<sup>295</sup>

3.142 Even for the smaller and less complex companies in the FTSE 350, several Audit Committee Chairs argued that the capability of the challenger firms was substantially below that of the Big Four in a number of ways. Respondents frequently cited:

- (a) Challenger firms’ smaller international networks;
- (b) lack of capacity of the challenger firms to put together a team of sufficient scale for a complex audit;
- (c) concerns about quality of the challenger firms (for example as suggested through perceived lower AQR scores in some cases, and comparatively lower investment in technology and systems compared with the Big Four); and
- (d) lack of experience of auditing similar firms; and/or lack of experience gained through providing non-audit services to the client.

3.143 For example, having considered the Group’s needs and the experience of audit firms in leading and coordinating global audits, the directors of RELX Group concluded that ‘It is unlikely that a firm outside the Big 3 could provide an integrated audit with suitable quality assurance’.<sup>296</sup> [X] told us that it excluded [X] due to size, capability and also their responsiveness to some of the work undertaken on the group’s smaller audits this year’. Mondi concluded that Grant Thornton and BDO, while having the international coverage, had at the time of the tender process in 2015 ‘limited FTSE 100 coverage, with only 1 client each and much weaker AQRT scores’. Mondi also said that its ‘contribution to total fee income would be significant, potentially impacting independence’.

3.144 There is some academic literature suggesting that smaller audit firms may be expected to provide, on average, lower quality audits. This may be because larger firms have more reputational capital to protect, higher litigation risk and greater regulatory scrutiny; are less financially dependent on any given client,

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<sup>295</sup> BDO response to Update Paper, page 1

<sup>296</sup> In order to meet the requirements of RELX Group’s listing in the Netherlands, the incumbent audit firm, Deloitte, could not be invited to tender.

which reduces their incentives to compromise their independence; and are able to attract and retain higher-quality human resources and expertise, therefore increasing their competence. Empirical evidence from recent studies (based on US data) offers some support for this argument, although it is unclear how far the findings might read across to the UK.<sup>297</sup>

### *Perceptions and risk of taking on a challenger firm*

- 3.145 Aside from the objective capabilities of the challenger firms, some have claimed that firms outside the Big Four face a perception bias. For example, we heard that Audit Committees may have an incentive to hire the Big Four because they risk criticism for hiring one of the challenger firms if things go wrong.
- 3.146 The Institute of Chartered Secretaries and Administrators told us that the attitudes of the large corporates' shareholders and regulators 'inevitably play a part in this reluctance' to switch to challenger firms and there is 'much truth' in the proposition that 'no-one was ever fired for hiring IBM'.<sup>298</sup> A former audit partner at Grant Thornton and KPMG said that Audit Committees see appointing a non-Big Four as a risk and '[t]he often mentioned expression of "who ever got blamed for selecting IBM" still prevails in the selection of audit firms'.<sup>299</sup>
- 3.147 We did not see clear evidence of this 'IBM effect' in the sample of tender documents that we reviewed. However, we found that there is a lack of objective information available to Audit Committees to validate their judgements on quality of the challenger firms, which made it hard for them to justify appointing a challenger firm. This suggests that the challenger firms face a significant 'chicken and egg' problem – they need audit experience in order to prove their capability, but without existing experience they cannot win significant audit contracts in the first place.<sup>300</sup>

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<sup>297</sup> These studies show that, compared to non-Big Four auditors, Big Four auditors are significantly more likely to issue going concern opinions to distressed clients and are less prone to false positive and false negative errors; this is indicative both of greater independence and greater competency. Accounts audited by Big Four auditors also show lower levels of discretionary accruals (a widely used measure of 'earnings management'). See (i) Berglund, N. R., J. D. Eshleman, and P. Guo (2018). Auditor Size and Going Concern Reporting. *Auditing: A Journal of Practice & Theory*, 37(2), 1-25; (ii) DeFond, M., D. H. Erkens, and J. Zhang (2017). Do Client Characteristics Really Drive the Big N Audit Quality Effect? New Evidence from Propensity Score Matching. *Management Science*, 63(11), 3628-49.

<sup>298</sup> The Institute of Chartered Secretaries and Administrators, Response to CMA Invitation to Comment, 1 November 2018, p. 4.

<sup>299</sup> David Miller, Response to CMA Invitation to Comment, 19 October 2018, p. 6.

<sup>300</sup> The ACCA submitted that a key question was whether existing regulatory and policy framework incentivises audit committees to select from a narrow group of large firms (see ACCA response to the Update Paper). The submission from the Challenger firms did not identify such regulatory barriers.

3.148 The challenger firms highlighted these perception problems in their responses to us. For example, BDO said that

audit committees are appropriately diligent and seek to fulfil their duties conscientiously. However an audit is a “credence good” where quality is difficult to measure and as such false proxies are used such as the size of the audit firm or a firm's current roster of clients in the sector. The correlation of these factors to audit quality is weak. We believe these false proxies explain why challenger firms with better records on audit quality are consistently being unsuccessful in tenders and becoming frustrated that they are there simply to make up the numbers rather than be a real contender.<sup>301</sup>

3.149 Grant Thornton said that, on the demand-side, Big Four firms are seen as ‘a safe option’ and that ‘Audit committees have little incentive to make anything other than a conservative choice’. Also, that there is ‘a bias towards Big 4 firms as a result of the professional background of audit committee and management alumni, incumbent relationships with Big 4 firms, or familiarity with the brands’.<sup>302</sup>

3.150 Moore Stephens said that there has ‘not been a desire by companies to select non-big four firms, even when they are equally able and qualified’ and that Audit Committees could not be blamed for choosing a Big Four firm ‘even were something to go wrong.’<sup>303</sup>

3.151 RSM said that there is a ‘deep-rooted resistance by UK listed companies to appointing a non-Big 4 firm as their auditor. The Big 4 firms enjoy a number of advantages of scale, size, familiarity, and a marked level of subliminal bias that act in their favour’. RSM also said that because of ‘their large consulting and other non-audit activities, the dominant firms are known by, and have worked with, far more companies listed on the main market than challenger firms’. In addition, ‘their alumni are in leading positions across the business and financial communities, further strengthening their brand recognition and endorsement’.<sup>304</sup>

3.152 This view about Big Four alumni appears to be supported by a recent survey in *Accountancy* magazine,<sup>305</sup> which found that 64% of FTSE 100 Audit Committee Chairs had previously worked for a Big Four firm. The presence of ex-Big Four employees on Audit Committees is perhaps unsurprising given

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<sup>301</sup> BDO, Response to CMA Invitation to Comment, p2.

<sup>302</sup> Grant Thornton, Response to CMA Invitation to Comment, p. 8

<sup>303</sup> Moore Stephens, Response to CMA Invitation to Comment, p. 5

<sup>304</sup> RSM, Response to CMA Invitation to Comment, Annex, p. 2.

<sup>305</sup> Published by Croner-i Ltd.

that the Big Four do employ a disproportionate share of financial professionals and therefore it is to be expected that senior staff are more likely to have links to Big Four firms than challenger ones. However, it raises questions about whether Audit Committee members' greater familiarity with the Big Four might lead them to favour Big Four firms when assessing audit tenders.

- 3.153 We also saw some evidence that the perception challenge facing the challenger firms extends to investors as well as Audit Committees. For example, we were told of at least one example where a challenger firm was chosen as the preferred bidder by the Audit Committee but then rejected following intervention by investors ([REDACTED] audit).
- 3.154 Also, while JD Wetherspoons appointed Grant Thornton, the Audit Committee Chair advised the board that 'if the decision to award the contract to Grant Thornton is ratified, the advice from [REDACTED] is for the Chairman of the Audit Committee to write to our top 10 shareholders explaining the decision to move from PwC to Grant Thornton. This would be a proactive measure to head off questions that could possibly arise with this move from a 'top-tier' to 'mid-tier' firm'. JD Wetherspoons told us that no response was received from any of the shareholders written to after the Grant Thornton appointment.

### ***Supply-side barriers***

- 3.155 On the supply side, the barriers facing challenger firms include: high tender costs; an emphasis during tender processes on experience in auditing FTSE 350 companies; greater regulatory, financial and reputational risk involved in conducting audits for FTSE 350 companies; and the risk that, in securing audit work, conflicts rules will bar a firm from securing more lucrative advisory work.
- 3.156 There are significant costs involved in scaling up an audit business to take on more complex audit clients. One challenge is in hiring suitably experienced staff to conduct complex audits. While experience was mixed, two of the challenger firms said that they had experienced problems recruiting audit partners from other firms. Grant Thornton said that notice periods for partners can extend to two years and gardening leave and restrictive covenants can mean that an individual can be out of the market for a long time. Mazars told us that 'it is unduly hard for challenger firms to recruit audit partners from Big 4 firms'. For example, a partner it had wanted to recruit advised Mazars that they had a two year long notice period and, during that time, would earn only their guaranteed level of remuneration which would be a fraction of their normal total remuneration. And several of the challenger firms mentioned the

cost of investing in IT systems to carry out complex audit processes, although they noted that they were indeed willing to carry out this investment.<sup>306</sup>

- 3.157 The Big Four firms have different notice policies which may be negotiable and are often dealt with on a case by case basis. [X] has six month and three month notice periods respectively for partners and staff (below partner down to the manager grade).<sup>307</sup> [X] said that a partner moving to a competitor is put on 12 months gardening leave (with a substantial cut to base pay without a bonus), and a (further 12 months) restriction on competing with [X] for the same business. However, in the next update of [X] Partnership agreement, it will remove the 6 month post-termination restriction on audit partners leaving to join non-Big Four firms. [X] has twelve and six month notice periods for partners and directors, respectively, and further six month non-compete restrictions.
- 3.158 In addition to the difficulties of scaling up, challenger firms are currently reluctant even to compete for every tender where they are given the opportunity. For example, Grant Thornton said in March 2018 that it only audits a small number of clients in the FTSE 350 and that 'it continues to be extremely difficult to penetrate this market'. As a result, Grant Thornton had 'taken the strategic decision to move away from tendering for statutory audit work in the FTSE 350'.<sup>308</sup> While other challenger firms are continuing to compete for some FTSE 350 audits, our view is that the general reluctance to bid is a rational response to their perception of the return on investment they can expect.
- 3.159 As noted above, the challenger firms are invited to fewer tenders than the Big Four. Among these invitations, they choose to bid on a smaller proportion of occasions and have a lower success rate than the Big Four (around 10% success rate for the challenger firms vs. around 30% for the Big Four on average).<sup>309</sup> Given that bidding seriously for large audits is universally recognised as expensive and time-consuming, it is not surprising that the challenger firms think twice about participating in FTSE 350 tenders.
- 3.160 A further common concern raised by the challenger firms is of not wanting to take on too much risk by having a single audit client making up a large share of the auditor's total audit revenues.
- 3.161 Finally, several firms outside of the Big Four raised concerns about the regulatory costs and risks of competing for larger audits. This appears to be a

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<sup>306</sup> For example, see Grant Thornton response.

<sup>307</sup> [X].

<sup>308</sup> <https://economia.icaew.com/en/news/march-2018/grant-thornton-takes-a-bow-from-audit-market>.

<sup>309</sup> CMA analysis of auditors' tender data.

particular concern for smaller firms that might be considering starting to bid for PIE audits. But it also seems keenly felt by Grant Thornton following recent fines. For recent cases, the fines resulting from enforcement action were, for the Big Four firms, in the range of 0.4% - 1.2% of UK firm audit fees in the relevant year.<sup>310</sup> By comparison, Grant Thornton has been fined twice for infringements of independence rules. There was no suggestion of any audit failure and yet the fines amounted to 1.8% and 2.5% of its UK firm audit fee revenues in the relevant year.

3.162 A number of challenger firms have suggested that FRC enforcement activity has raised the barriers to them competing for FTSE 350 audits. Crowe told us that one of the principal supply side barriers they have observed was the 'additional risk and exposure to non-Big Four firms from being caught in litigation and also regulatory enforcement'.<sup>311</sup> The inference is that, given their relative size and financial resources, there would be a disproportionate impact on smaller firms of the reputational damage and/or fines resulting from any enforcement action. This may deter challenger firms from bidding for FTSE 350 audit engagements, given the opportunity.

3.163 In our view, these supply-side barriers are significant, but many of them relate strongly to the demand-side constraints. If the challenger firms had a higher chance of winning FTSE 350 audit contracts then they would be able to invest to overcome the supply-side barriers.

## **Resilience**

### ***Summary***

3.164 A fourth condition for the market to work effectively is that there is sufficient long-run choice and competition to ensure that the market is resilient.

3.165 Given the already limited choice in the market, we would be very concerned about the failure or withdrawal of one of the Big Four auditors if this led to the creation of a more consolidated 'Big Three'. With the current rules around conflicts and mandatory rotation, we would not see a market of three large auditors as being sustainable in the long run and would expect audit quality to further decline.

3.166 If one of the large audit firms failed, we might be able to use competition tools, including merger review, to mitigate the consolidation of the market. However,

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<sup>310</sup> The 1.2% figure is the £10 million fine, discounted to £6.5 million, for BHS audit failures.

<sup>311</sup> Crowe, Response to CMA Invitation to Comment, 30 October 2018, p. 8. Crowe was the 14<sup>th</sup>-biggest accounting firm in the UK in 2017 according to Accountancy Age.

this would be subject to jurisdictional thresholds being met. It is also not clear that the challenger firms would have the capacity to take on a large number of existing Big Four audits at short notice.

- 3.167 A lack of choice and resilience means that incumbent audit firms are less likely to lose market share even if their audit quality is relatively low, because Audit Committees do not have sufficient viable alternatives that they could switch to.
- 3.168 A further concern is that resilience issues might create an incentive for the regulator not to take appropriate action against a large audit firm that was performing poorly because of the fear that this might drive the firm out of business. We have not found any evidence that this is currently affecting the FRC's approach. However, it is possible that these concerns might increase in the future, for example if regulatory sanctions were strengthened and if the challengers failed to grow their capability to carry out complex audits.
- 3.169 From responses to the Update Paper there is general agreement that the failure of one of the Big Four firms would have very serious consequences for the integrity of the audit market in the UK.
- 3.170 The remainder of this section sets out evidence on:
- (a) The potential impact on choice of failure of a large audit firm;
  - (b) The impact of lack of resilience on regulation and competition.

### ***Potential impact on choice of failure of a large audit firm***

- 3.171 The first concern relating to resilience is that, if one of the Big Four auditors were to fail, this would leave only three remaining large players. Given our finding that there is already very limited choice for some FTSE 350 audits, the loss of one of the four large auditors would clearly exacerbate these problems. Some companies would have no or limited choice in the appointment of their auditor, weakening competition, and we would expect audit quality to suffer.
- 3.172 In response to the Update Paper, Deloitte said<sup>312</sup> that the withdrawal or failure of a Big Four firm could be catastrophic for the market. PwC agreed<sup>313</sup> that, while the risk is small, the failure of one of the large audit firms could have a

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<sup>312</sup> Deloitte response to the Update Paper, paragraph 2.4.

<sup>313</sup> PwC response to the Update Paper, Annex paragraph 2j.



negative impact on audit quality as any unplanned process of transitioning audit clients to another firm would increase audit risk.

- 3.173 Overall, there is general agreement that an audit market dominated by four large firms is a problem given the likelihood that the failure of one would result in the Big Four becoming the Big Three. This would create a significant choice problem. While there is no suggestion that any of the Big Four are likely to suffer a failure in the short term, the previous experience of Arthur Andersen showed that reputational problems can rapidly undermine the viability of the business.
- 3.174 We have considered, first, how likely it is that an audit firm might fail, and, second, whether, in the event of failure, regulators would be able to step in to limit the degree of consolidation of the market.

### *Resilience of the large audit firms*

- 3.175 Recent experience suggests that the Big Four firms are resilient. They have withstood the reputational harm caused by a number of high profile cases of audit failure in the UK and elsewhere.
- 3.176 There are a number of factors likely to be contributing to this including: the regulatory requirement for listed companies to appoint an external auditor; that choice for larger and more complex companies appears to be limited to the Big Four firms; the size of these firms and the support provided by their international networks; that clients cannot switch quickly; and the ability of firms to contain the reputational harm to individual teams and partners.
- 3.177 For example, Deloitte told us that, '[they] in common with the other four largest firms, are a partnership with significant revenues in the UK. Being part of such large and balanced businesses affords a number of benefits. It offers a high degree of resilience to allow weathering of adverse events'.<sup>314</sup>
- 3.178 PwC told us that 'there are a number of reasons that a firm might fail, including reputational damage arising from audit failures', but that there is not 'a significant risk that the audit market lacks resilience'.<sup>315</sup> It said that should a firm in part of a global network fail, a new network affiliate could re-enter the national market (as has happened with PwC in Japan). There would also be the potential for other firms (including challenger firms) to take on audits of the failed firm.

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<sup>314</sup> Deloitte Response to CMA Invitation to Comment, 30 October 2018, p7.

<sup>315</sup> PwC Response to CMA Invitation to Comment, 30 October 2018, p9.

- 3.179 These features have allowed the Big Four firms to withstand reputational damage. That it can take time for companies to switch auditor (including the time taken to manage conflicts caused by non-audit work) gives both the firm and regulators time to address concerns and restore confidence. This is helped by the weight attached by clients to the reputation, experience and capability of individual partners and audit teams, which has allowed firms to 'contain' the harm caused by audit failures. While this all increases resilience, it might weaken the incentives on firms to deliver to high audit quality.
- 3.180 However, concerns remain about the ability of the market to manage more catastrophic failure (such as that seen with Arthur Andersen in the past). The risk may be small, but it cannot be dismissed as a possibility. This could be triggered by audit failures in the UK or another major firm in the global network.
- 3.181 We discussed with each of the Big Four firms their experience of problems that could have threatened the future of the firm. There was general agreement that the biggest risk to the sustainability of an audit firm is damage caused to the reputation of the UK or another major firm in the global network. The two following examples were identified:
- (a) In 2002 Equitable Life sued EY for alleged negligence<sup>316</sup> with a claim over £2bn (which EY's insurance coverage could not have met). EY said that it was extremely difficult to attract new staff, especially partners, while the claim persisted. Equitable Life dropped its claim in 2005.
  - (b) In 2005 the SEC found that partners in the US KPMG tax practice had developed tax shelters that contravened legislation. The outcome for KPMG was a fine of \$0.5 billion and deferred prosecution with a monitoring person appointed. [§].

### *Regulatory response to audit firm failure*

- 3.182 The impact of failure of one of the large firms on competition would be mitigated if it were possible to prevent the failed firm's audits from moving to the remaining three large auditors. For example, if the failed firm's audits and partners could instead be moved to one of the challenger firms (or shared between a number of them) then the concerns about the impact on choice would be significantly diminished.

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<sup>316</sup> Equitable Life claimed that EY ought to have warned the directors that the provisions which Equitable included in its accounts in respect of its guaranteed annuity rate liabilities for the years ended 1997 to 1999 were inadequate and, had EY done so, it would not have declared certain bonuses which it did over the relevant period and would have put itself up for sale from 1998.

- 3.183 The existing insolvency regimes applicable to audit firms are not designed to protect choice or resilience, as discussed further in our remedies section.
- 3.184 Whether or not the merger regime would ‘bite’ in case of assets moving from a failed or failing auditor to a competitor would depend on whether or not such a transaction would qualify for assessment by the CMA or EU under the merger control rules.<sup>317</sup>
- 3.185 If a merger were to qualify under the jurisdictional thresholds, the CMA would proceed to a substantive assessment of whether it would result in a significant lessening of competition (SLC). Any decision of the CMA on whether or not the SLC test is met would be context-and fact-specific.
- 3.186 In practice our view is that the merger rules would provide protection against only certain forms of consolidation during or following failure of one of the Big Four. Although a wholesale transfer of assets could fall within jurisdiction of the merger rules, it is possible, depending on the factual circumstances, that the merger rules may not apply in the event that partners and staff gradually moved to other firms.
- 3.187 Therefore, we have concluded that failure of one of the large auditors would be very likely to materially worsen the current choice problems in the market and weaken competition.

### ***Evidence of the impact of lack of resilience on regulation and competition***

- 3.188 The second, related concern is that fears about the impact of allowing one of the large audit firms to fail might reduce the effectiveness of competition and regulation.
- 3.189 In a well-functioning market there needs to be an expectation that if firms perform poorly, they will lose customers. This requires Audit Committees to have an effective choice of alternative providers in the long run. It also requires the regulator to be able to take action to tackle poor quality, and be willing to allow firms to lose business and ultimately fail if they are unable to address the performance problems. In the absence of these market features

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<sup>317</sup> The jurisdictional test for the CMA to be able to assess a relevant merger situation is threefold: first, two or more enterprises (which broadly speaking would be business activities of any kind) have ceased to be distinct or that arrangements to that effect are in progress or contemplation; second, that either the turnover or the share of supply test would be met; and third that the merger either has not yet taken place (or has taken place less than four months ago). The concept of ‘ceasing to be distinct’ provides that any two enterprises cease to be distinct if they are brought under common ownership or common control; ‘control’ is not limited to the acquisition of outright voting control but may include situations falling short of it. See sections 23, 24, 26 and 33 of the Enterprise Act 2002.

there is risk of moral hazard, weakening the incentives for firms to focus on high quality audits.

- 3.190 We set out above our concerns that a lack of choice might lead firms not to lose significant market share even if they suffer from quality problems. A lack of resilience in the long-run would exacerbate these concerns. For example, we are aware of at least one situation in which an Audit Committee was concerned about the ability of one of the firms to maintain its sectoral capacity had it failed to win the tender, limiting choice to the remaining auditors with capacity to audit the sector in the long term.
- 3.191 In relation to regulatory impacts, in response to our invitation to comment document one group of academics stated that, despite regulators holding concerns about the market structure and the impact on choice, ‘the profession is likely to escape censure from either the government or regulators who fear that any crackdown will only force one or more of the firms out of business and make the situation worse’.<sup>318</sup>
- 3.192 Some commentators have referred to the Big Four as being ‘too big to fail’.<sup>319</sup>
- 3.193 We looked at whether there was any evidence that the FRC is currently constrained in its actions by concerns about lack of resilience. We first considered the sanctions resulting from FRC enforcement action. At less than 0.5% of annual revenues of the UK firm, these have fallen well short of levels that could threaten the financial viability of firms, given our view on the overall resilience of the sector outlined above. There is, however, no evidence that the FRC would have considered larger fines, but for concerns about the impact on the financial viability of the firms.
- 3.194 Deloitte<sup>320</sup> and KPMG<sup>321</sup> said that fines imposed on firms are not small, and that fines in the UK tend to be higher than anywhere else in the world. They said that the fines should be compared with the size of the profits of the audit practice (approximately £50m for Deloitte in 2018). KPMG also said that the CMA has not found any evidence that any such ‘too big to fail’ considerations are currently affecting the approach of the FRC.
- 3.195 More generally, the FRC told us that it did not see concerns about resilience as constraining its ability to take action. It noted that firm failure was more

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<sup>318</sup> Professor Atul Shah, Mr Brian Little, Mr Paul Moore and Professor Richard Murphy Response to CMA Invitation to Comment, 30 October 2018, p3.

<sup>319</sup> For example, see The Financial Times, [Concerns raised about ‘too big to fail’ KPMG](#), 19 July 2018.

<sup>320</sup> Deloitte response to Update Paper, Appendix 2.4

<sup>321</sup> KPMG response to Update Paper, paragraph 2.19

likely to be triggered by litigation or a more general loss of reputation or confidence, rather than directly as a result of regulatory action. This was consistent with views expressed by most of the stakeholders who commented on this issue in their responses to the launch document.

- 3.196 A review of FRC sanctions was undertaken by Sir Christopher Clarke which took effect in June 2018.<sup>322</sup> The Independent Review of the FRC noted a wide range of financial and non-financial sanctions is available to the FRC, including exclusions of up to ten years for dishonesty, and unlimited fines for seriously poor audit work. In the light of these changes, as well as the outcomes of recent enforcement cases, the Review did not believe there is any shortfall in the severity of sanctions available to the FRC or Tribunal.
- 3.197 The Independent Review of the FRC found that since January 2017, the largest fine levied by the PCAOB following enforcement has been \$1.5 million, compared with £6.5 million (after discounting for early settlement) by the FRC. Fines levied against individuals have also been considerably lower although the PCAOB applies a wider range of sanctions for audit misconduct, including censures, limitations on firms' practice, revocations of firm registrations, or bars and suspensions of individuals.
- 3.198 The Independent Review of the FRC report<sup>323</sup> noted: 'substantial criticism of the FRC's historic enforcement performance. In particular, that the FRC has been widely viewed as reluctant to act, slow to achieve results and therefore failing to create an adequate deterrent to wrongdoing'. The Review recognised significant improvement in the FRC's approach but recommended<sup>324</sup> continued and close monitoring of its enforcement performance. It also recommended that the new regulator should report on this in its Annual Report, and the regulator should regularly be held accountable by Parliament through appearances at the BEIS Select Committee.
- 3.199 If the FRC or the new regulator is under greater pressure to exercise its inspection or enforcement powers, concerns about consequences of the reputational harm caused to a firm might be a more significant issue for the regulator in future.

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<sup>322</sup> See the Independent Review of the FRC (2018), [final report](#), paragraph 2.59.

<sup>323</sup> [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/767387/frc-independent-review-final-report.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/767387/frc-independent-review-final-report.pdf), paragraphs 2.54 – 2.58.

<sup>324</sup> See recommendation 32.

## Incentives and audit firm structure

### *Summary*

- 3.200 The final issue we have considered is whether the audit practices, teams and partners of the large audit firms currently have strong incentives to deliver high audit quality. For the audit market to work well, auditors need to be rewarded for delivering high-quality audits. The combination of non-audit and audit work in multidisciplinary audit firms raises questions about whether this affects the incentives for audit quality.
- 3.201 Audit firms are increasingly dominated by non-audit work. More than three-quarters of revenues and a higher proportion of profits come from non-audit activities. This trend is likely to continue over time as the firms develop new areas of non-audit business.
- 3.202 Non-audit activities carried out by the firms are varied and diverse but are connected by the fact that they are providing a service to the client. Audit is fundamentally different in requiring objectivity and challenge to the client on behalf of shareholders.
- 3.203 Historically, concern has focused on the conflict between carrying out audit and non-audit work for the same client. The concern was that auditors would have an incentive to use audit to cross-sell other services and would have an incentive to 'go easy' on a company for fear of losing non-audit work. These concerns have led to increasing regulatory restrictions on firms' ability to sell non-audit work to audit clients. Three of the Big Four firms have now committed to stop providing non-essential non-audit work to the FTSE 350 companies they audit.<sup>325</sup>
- 3.204 However, while these changes have mitigated the cross-selling incentives, they have not removed the underlying tensions between audit and non-audit parts of the firms, and in some respects have created new challenges. There are at least four reasons why the dominance of non-audit work within these firms is likely to affect audit incentives, in spite of the conflicts rules.
- 3.205 First, auditor partners share in the profits earned by non-audit services. This gives them a stake in the profits of the whole business, not just the part which is focused on audit.

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<sup>325</sup> Business, Energy and Industrial Strategy Committees (2019), Future of audit inquiry – oral evidence, questions 354-357 and 365-374;

- 3.206 Second, while regulation has reduced the opportunities to cross-sell non-audit work to audit clients directly, the firms still use the sectoral and other expertise of audit partners to help sell non-audit work to other clients. This call on audit partner time is a risk for audit quality. In addition, the loss of an audit engagement opens up new opportunities for selling non-audit work, building on the in-depth knowledge of the business gained from carrying out the audit. The evidence suggests that the firms typically earn substantial non-audit fees in the years following the end of an audit contract. This contributes to an incentive for auditors in exercising judgement to take a more favourable view of the management position, as they near a tender or rotation, for fear of losing future non-audit work.
- 3.207 Third, the culture and governance of the firms explicitly encourages a 'one firm' culture with core values, purpose and goals that are common to and shared by all parts of the firm. Although firms have pointed to benefits of a 'one-firm' culture, our view is that it risks undermining the public interest purpose of audits. This is because, while non-audit activities carried out by the firms are varied and diverse, they are connected by the fact that they are providing a service to the client. Audit is fundamentally different in requiring objectivity and challenge to the client on behalf of shareholders.
- 3.208 Despite statements by the firms that audit remains core to their business and on the importance of reputation of the firm in delivering high quality audit to the brand, audit appears to have a relatively weak voice within these firms in driving culture and values. Many of the firms have recently carried out initiatives to ensure that there is a focus on audit quality and have also tightened up their processes for reflecting audit quality in partners' performance reviews. However, we are not convinced that the long-term incentives are such that these internal changes can be relied on to protect the independent culture within audit and the long-run focus on quality.
- 3.209 Related to this, the audit practice is able to draw on non-audit services within the firm more cheaply than a stand-alone audit firm would be able to. The effect of this is likely to be that audit prices are lower than would be the case in a competitive market with standalone audit firms. There is little transparency over these cost transfers, and they are likely to reinforce the commitment of the audit practice to the overall strategy and direction of the multidisciplinary firm, rather than focusing solely on audit quality.
- 3.210 Fourth, the conflicts rules exacerbate the internal tensions between audit and non-audit and risk weakening choice and competition. When considering whether to bid for audit work, firms will take into account the potential loss of current or future non-audit work. As a result, auditors sometimes choose not to bid for audit work, reducing choice for the Audit Committee. More generally,

the effect of the conflicts rules is likely to be a softening of competition between the auditors, because where firms fail to win an audit contract, the expectation is that they will have a chance to win non-audit work instead.

3.211 The combination of audit and non-audit services creates benefits as well as costs. The firms told us that these benefits include the ability to fund investment across the different business units and to attract and train high quality staff. Such benefits are relevant in considering the proportionality of any remedies aimed at addressing our concerns. However, they need to be balanced against the concerns that we have articulated about the long-run impacts on audit quality.

3.212 The remainder of this section sets out:

- (a) the relative scale, growth and profitability of the audit and non-audit businesses of the large audit firms;
- (b) whether there are incentives at the client level which affect audit quality;
- (c) how the culture and governance of the audit practices is influenced by the wider non-audit business, and how this affects incentives on auditors to focus on audit quality;
- (d) evidence on possible cross-subsidies between audit and non-audit work;
- (e) how the combination of audit and non-audit work weakens the incentives to compete strongly for audit work, exacerbating concerns around lack of choice in the market; and
- (f) the firms' arguments about the benefits of the multidisciplinary model and other challenges in response to the update paper.

### ***Relative scale, growth and profitability of audit and non-audit***

3.213 A striking feature of the audit market is that the big audit firms carry out a large volume of other non-audit business – they are professional services firms rather than audit-only providers. This is demonstrated by several trends which are common across the Big Four, including those listed below.

- (a) Relative scale of audit and non-audit fees: in 2018 audit fees accounted for between 17% and 25% of the UK firms' total fees. This figure has been declining in recent years from an average of 23% in 2011 to 21% in 2018 across the Big Four in aggregate.



- (b) Relative growth of audit and non-audit fees: the firms' non-audit fees have grown faster than their audit fees. Over the period 2012 to 2018, the non-audit fees increased by 46% compared with audit fees increasing by 30%.
- (c) Relative profitability of audit and non-audit fees: on average across the Big Four firms audit work has been less profitable than non-audit services, in each year 2011 to 2018. In 2018, for the Big Four firms, EBIT margins for non-audit services were, on average, [X]% compared with [X]% for audit. Some firms told the BEIS Select Committee that audit was less profitable than non-audit.<sup>326, 327, 328, 329</sup>
- (d) Relative change in audit and non-audit profitability: overall, audit EBIT over the period 2013 to 2018 fell by [X]% and the EBIT for non-audit service increased by [X]%.
- (e) Number of audit partners: audit partners now account for 19% of total partners compared with 22% in 2011.

3.214 Figure 3.22 shows that the bulk of non-audit services are provided to companies that are not audit clients. The average value of non-audit services provided by the Big Four firms to their audit clients has fallen from around 55% of audit fees in 2011 to 38% of audit fees in 2018.

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<sup>326</sup> For a record of the evidence to the BEIS Select Committee see:

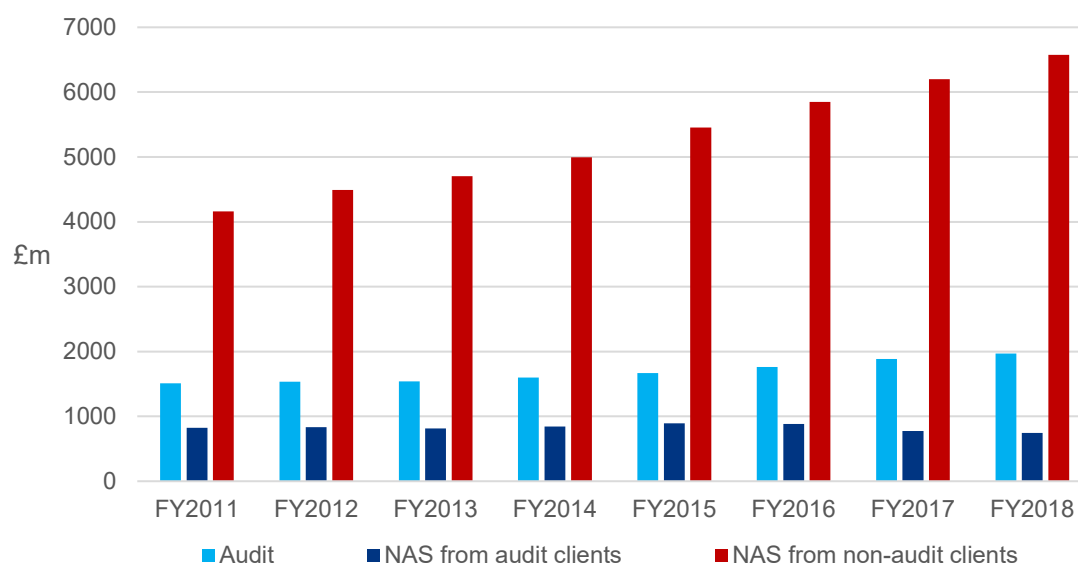
<http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/business-energy-and-industrial-strategy-committee/future-of-audit/oral/95825.pdf>.

<sup>327</sup> PwC said that the margin on the audit business was 18% compared with 26% on non-audit services (see transcript Q414 to Q419).

<sup>328</sup> EY said that the audit business would be marginally less profitable than the rest of the business (see transcript Q420).

<sup>329</sup> Deloitte said that in the last two or three years, audit has been less profitable because of the investment they have made in both winning new audits (see transcript Q421 and Q422).

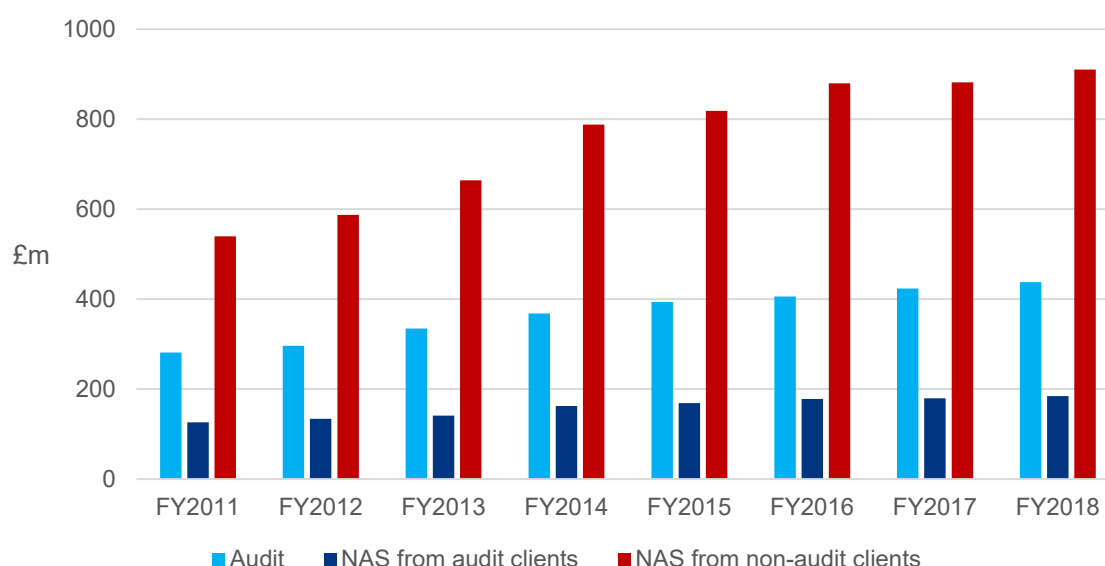
**Figure 3.22: Audit and non-audit revenues earned from audit clients, Big Four, 2011-2018**



Source: CMA calculations based on auditors' responses.  
Note: Revenues shown relate to all clients, not just FTSE 350.

3.215 Figure 3.23 shows the equivalent revenue breakdown for the challenger firms. The average sales of non-audit services to audit clients appear to be slightly higher for the challenger firms than for the Big Four – in 2018, the average value of non-audit services to audit clients was around 42% of audit fees for the challenger firms compared with 38% for the Big Four.

**Figure 3.23: Audit and non-audit revenues earned from audit clients, challenger firms, 2011 to 2018**



Note: Revenues shown relate to all clients, not just FTSE 350.  
Source: CMA calculations based on auditors' responses.

3.216 However, the challenger firms<sup>330</sup> are, on average, more focused on audit than the Big Four, albeit with variations between them:

- (a) for the challenger firms, the audit practices generate a larger proportion of total fees: overall, in 2018 audit fees accounted for between 23% and 36% of total fees;
- (b) on average, across the challenger firms, audit has been more profitable than non-audit services in each year over the period 2011 to 2018. In 2018, on average, the audit EBIT was [X]% compared with a non-audit EBIT of [X]%;
- (c) overall, the challenger firms' non-audit fees have grown faster than their audit fees, but the difference is less marked: over the period 2012 to 2018, the non-audit fees increased by 64% compared with audit fees increasing by 56%; and
- (d) audit partners accounted in 2018 for around a third of all partners of the challenger firms.

#### ***Potential for conflicts at the client level***

3.217 In past investigations of the audit market, one of the key concerns has been the threat to independence created by cross-selling opportunities. The concern was that auditors may be reluctant to act objectively and robustly in their audit work for fear that this could be damaging to their relationship with the company management resulting in the loss of non-audit work.

3.218 The evidence above shows that the proportion of non-audit sales to audit clients has fallen in recent years. In large part this is due to EU interventions that restrict the overall amount of non-audit services that can be provided and prohibit certain types of services to audit clients entirely.<sup>331</sup>

3.219 Using information provided by the firms, we estimated that, in 2017/18, revenues earned by the Big Four firms from non-audit services provided to their FTSE 350 audit clients were, on average, around 20% of their FTSE 350 audit fees. This figure varies between the Big Four firms.<sup>332</sup>

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<sup>330</sup> The evidence in this paragraph is based on information provided by BDO, Grant Thornton, Mazars, Moore Stephens, and RSM.

<sup>331</sup> Council Regulation (EC) 537/2014 of 16 April 2014 on specific requirements regarding statutory audit of public interest entities [2014] OJ L158/77 (EC Audit Regulation).

<sup>332</sup> Given the small number of FTSE 350 audits carried out by Challenger firms, we cannot make a meaningful comparison with the Challenger firms.

- 3.220 We heard that, in many cases, auditors who were successful in a tender had to exit or significantly scale back their existing non-audit work. We also found that in some cases auditors and Audit Committees were keen to go beyond the regulations to ensure that their auditor provided no non-audit services (aside from a narrow range of services that were considered to be directly related to the audit), in order to remove any perception of conflicts. This was particularly the case for the largest companies in the FTSE 100.
- 3.221 Three of the Big Four firms have now committed to stop providing non-essential non-audit services to FTSE 350 companies that they audit with immediate effect.<sup>333</sup> Taken together, this suggests that revenues from non-audit services to audit clients are likely to fall further in the coming years. These developments are likely to reduce the short-term incentives for auditors not to challenge company management for fear of losing non-audit work.
- 3.222 However, in the longer term, FTSE 350 companies must rotate auditors at least every 20 years and must put the audit contract out to tender every ten years. We would, therefore, expect all the Big Four firms to have ongoing programmes for managing the anticipated loss of some FTSE 350 audit clients and the opportunities this creates in the provision of non-audit services. When a company switches auditor, the previous auditor is freed up to take on non-audit work. At the same time the new auditor may have to exit from or scale down its non-audit work with the client. This cycle has the same potential to weaken the incentives of the incumbent auditor to challenge a company's management or exercise scepticism if it knows that it will be in a position to sell non-audit services in the future. The risk will clearly be lower when a firm first acquires a FTSE 350 audit, when the audit term has longer left to run (or at least expected to run).
- 3.223 We asked the audit firms to provide information on non-audit fees in a sample of sectors – banking, mining and quarrying, outsourcing and insurance sectors. We chose these sectors because they are some of the largest in the FTSE 350 by audit fees, have needed to commission significant pieces of non-audit work related to changes in financial reporting standards, and include a number of companies that have recently rotated their auditor.
- 3.224 We looked at how audit fees compared with non-audit fees earned by the Big Four firms over the period 2012 to 2017. We found that in all sectors total non-audit fees earned by the Big Four and Challenger firms were much larger

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<sup>333</sup> Business, Energy and Industrial Strategy Committees (2019), Future of audit inquiry – oral evidence, questions 354-357 and 365-374

than the audit fees. This ranged from audit fees being 13% of non-audit fees in the banking sector to 43% in the mining and quarrying sector.

- 3.225 We identified six FTSE 350 companies in these sectors that had switched auditor during the period.<sup>334</sup> In each case, the 'departing' audit firm subsequently earned substantial non-audit fees from the same client. In two instances the non-audit fees gained exceeded the audit fees by a substantial margin. Overall, it ranged from the firm earning, on average, annually non-audit fees that amounted to around 60% of the annual audit fee in the last year of the engagement, to non-audit fees being more than double the audit fee.
- 3.226 This evidence suggests that there remains a financial incentive for an audit firm planning for the potential or anticipated loss of an audit to maintain a good working relationship with their audit client. In addition, the conflicts rules themselves create a strategic tension within the firms, because they need to choose either to carry out audit work or non-audit work for a particular client. The incentives that result from this tension are considered further below.

### ***Wider impacts of non-audit work on auditors' incentives***

- 3.227 This section sets out evidence on whether there might be a wider impact of non-audit work on auditors' incentives, beyond the narrow focus on cross-selling to existing audit clients described above. We set out:
- (a) the context and reasons that have been identified in previous reports to suggest that the combination of audit and non-audit work might affect audit quality;
  - (b) evidence on auditor remuneration; and
  - (c) evidence on internal organisation of the firms and how this might affect audit culture.

### ***Context and academic literature***

- 3.228 The Enron case and failure of Arthur Andersen prompted a debate on whether the provision of non-audit services by audit firms might reduce audit quality even if the services are not provided to a firm's audit clients.<sup>335</sup> Academic

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<sup>334</sup> HSBC switched from KPMG to PwC in 2015, RBS switched from Deloitte to EY in 2016, Shell switched from PwC to EY in 2016, Aviva switched from EY to PwC in 2012, Interserve switched from Deloitte to Grant Thornton in 2015, and Serco switched from Deloitte to KPMG in 2016.

<sup>335</sup> See, for example, (i) Wyatt, A. R. (2004) *Accounting professionalism – They just don't get it!* Accounting Horizons, 18(1), 45-53; (ii) Boyd, C. (2004) *The structural origins of conflicts of interest in the accounting profession*, Business Ethics Quarterly, 14(3), 377-398.

literature has highlighted at least three mechanisms through which the increasing importance of non-audit services could affect audit quality incentives, as set out below.

- (a) The provision of both audit and non-audit services generates internal competition for resources, including both staff and investments, and distracts the attention of senior managers away from audit.
- (b) The impact on audit partners' incentives of remuneration depends on the profitability of the whole firm, including its non-audit business. With the provision of non-audit services accounting for an increasing proportion of a firm's profits, audit partners' interest in the success of non-audit business has increased.
- (c) The behaviour of individuals in an organisation both determines and is influenced by the social norms for the organisation.<sup>336</sup> In the context of an audit firm, the provision of non-audit services could encourage cooperation with client companies' management, eroding the norms of accounting professionalism. The importance of non-audit services for an audit firm may also erode professional norms by increasing profit pressure.

3.229 These insights explain how the increasing importance of non-audit services for audit firms may impact on the firms' culture, values and professionalism in ways that are detrimental to audit quality. Non-audit services typically involve working in collaboration with a client's management. An auditor, on the other hand, must challenge management and provide an independent review of the client's business. The combination of audit and non-audit services in a multi-disciplinary firm can create a tension between an advisory culture focused on profitability and short-term interests, and an audit culture based on public interest and professional values.

3.230 A recent study on the Big Four in the United States has found empirical evidence of a negative relation between the importance of non-audit services at the firm level and audit quality.<sup>337</sup> As the study controls for the provision of non-audit services to audit clients,<sup>338</sup> the observed impact on quality is likely to be explained as the result of internal competition for resources, non-audit

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<sup>336</sup> See Fisher, P., and S. Huddart 2008. *Optimal contracting with endogenous social norms*, American Economic Review, 98(4), 1459-1475.

<sup>337</sup> Meckfessel, M. D., and D. Sellers (2017). *The impact of Big 4 consulting on audit reporting lag and restatements*. Managerial Auditing Journal, 32(1), 19-49.

<sup>338</sup> Moreover, the data mostly refer to a period after the introduction of the Sarbanes-Oxley Act, which prohibited the provision of many non-audit services to audit clients.

fee pressure on audit partners, reduced management attention to audit, or a change in the firms' culture.

- 3.231 Other studies have explored wider elements of the cultural relationship between audit firms and their clients. While not specifically relating to the provision of non-audit service, they indicate how the centrality of 'client service' within accounting firms may conflict with notions of independence, public service and ethical standards.<sup>339</sup> Auditors' identification with their clients has been found to affect auditors' objectivity even in the absence of financial incentives.<sup>340</sup>
- 3.232 In 2018 the Dutch Authority for the Financial Markets (AFM) published a report 'Vulnerabilities in the structure of the audit sector'.<sup>341</sup> The academic literature is reported to find that even where there are limitations on cross-selling, there remain risks to auditor independence so long as the firm provides both statutory audits and advisory services. Several factors are said to be involved:
- (a) first, the combination of advisory and audit services in a single multi-disciplinary firm creates friction between an advisory culture that is focused more on commercial interests and an audit culture that should be focused on the public interest and the long term;
  - (b) second, the attention of the management could shift from the audit to the advice practice, if the latter contributes more to growth and profitability; and
  - (c) third, the partners in the audit practice could have an incentive to make a career in the advisory practice, given the more favourable commercial prospects for growth and the limited risks of liability in this field with a risk of encouraging a focus on the importance of good relationships with audit clients rather than audit quality.

#### *How partners are appraised and rewarded*

- 3.233 Audit partners' profit shares are paid out of a combined profit pool covering the firms' audit and non-audit businesses. This means that auditors have a

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<sup>339</sup> See Anderson-Gough, F., C. Grey, and K. Robson 2000, *In the name of the client: The service ethic in two professional service firms*, Human Relations, 53(9), 1151-1174.

<sup>340</sup> See Bamber, E. M., and Iyer, V. M. 2007. *Auditors' Identification with Their Clients and its Effect on Auditor Objectivity*, Auditing: A Journal of Practice & Theory, 26(2), 1-24 .

<sup>341</sup> *Vulnerabilities in the structure of the audit sector*, Dutch Authority for the Financial Markets (2018), <https://www.afm.nl/en/nieuws/2018/nov/kwetsbaarheden-structuur-accountancysector>.

direct interest in the overall profit of the firm, the majority of which is earned through non-audit work.

- 3.234 Following the Update Paper, we gathered further evidence on auditors' remuneration arrangements.<sup>342</sup> We found that the approach to partner remuneration was similar across each of the audit firms that we reviewed, typically being based on a combination of individual performance and profit share based on the overall profits of the firm. The firms' policies confirmed that partners are rewarded for their individual performance, but also benefit from the growth of firm-wide profits, including both audit and non-audit sales.
- 3.235 The audit firms use a range of different metrics to assess partner performance. These typically take account of factors such as a partner's contribution to winning new work, their level of responsibility, and complexity and scale of their audit engagements, alongside measures of audit quality. Quality is generally measured through a combination of external reviews (for example, FRC AQRs and PCAOB reviews), internal reviews (which generally follow a similar approach to the external AQRs), and broader measures such as partners' involvement in training and contribution to developing the quality of the audit practice.
- 3.236 Each of the audit firms emphasised the importance of audit quality as a key factor determining individual partner remuneration. The firms highlighted specific ways in which quality is measured and affects the overall assessment of partner performance.
- 3.237 We found that the firms had processes for assessing quality independently from other factors in the partners' performance reviews. We also saw evidence of cases where partners' remuneration was reduced because of quality issues that had arisen. On the other hand, we found that for most partners, remuneration is also driven significantly by success in winning audit work and building the audit business.
- 3.238 We did not see evidence of auditors being rewarded directly for sales of non-audit services to their audit clients. Several of the firms' remuneration policies explicitly stated that performance would not depend on sales of non-audit work to audit clients.
- 3.239 However, we observed some references in some of the firms' performance reviews to success at winning non-audit work for non-audit (rather than audit) clients. The examples reflected the fact that the audit firms typically have

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<sup>342</sup> We requested evidence on remuneration policies and appraisals from eight audit firms: BDO, Deloitte, EY, Grant Thornton, KPMG, Mazars, PwC and RSM.



several audit and non-audit clients across sectors or practice areas, and the audit partners assist with development of these wider practice areas.

3.240 [X] argued that, even with a shared profit pool, the incentive on individual audit partners to seek to increase non-audit profits is likely to be small.<sup>343</sup>

3.241 We agree that individuals' incentives to increase non-audit profits would not be strong if this risked lowering the assessment of their overall performance. However, we remain of the view that, because audit partners are remunerated partly on the basis of the shared profit pool, the majority of which comes from non-audit activities, audit partners have an incentive not to damage non-audit revenues. This could impact on how they carry out an audit.

#### *Firm-level governance and management focus*

3.242 The representation of the audit practice on the firms' senior management Boards provides further insight on the voice and influence of the audit practice, at a senior level, in the management of these firms. It is also an indicator of the opportunities for audit firm partners to progress to the most senior management levels in the firms.

3.243 We found that within the Big Four firms, audit partners make up between 17% and 23% of the partnership in 2018. This is lower than in previous years.

3.244 Currently, none of the Big Four firms is led by a partner with significant audit background.

3.245 For the Big Four firms we looked at how members of the Boards (or equivalent senior management group) are described in their professional profiles on the firms' websites. We found that a majority of partners do not include audit in the descriptions of their backgrounds.<sup>344</sup>

(a) At Deloitte the Executive Committee has 12 members.<sup>345</sup> Deloitte told us that 'six of these had worked on audits for some or all of their time post-

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<sup>343</sup> [X] noted that the difference an audit partner can make to the performance of the non-audit part of the business is marginal, and furthermore any increase in the performance of the non-audit business would be shared by the whole partner population. By contrast, any actions taken by an audit partner that risks sacrificing audit quality have a direct and substantial impact on their remuneration, and there is therefore no financial incentive for audit partners to somehow put non-audit profit ahead of audit quality.

<sup>344</sup> In reviewing the firms' websites, we particularly focused on audit experience. Some firms told us that other members of their boards had accountancy qualifications or were members of accountancy professional bodies.

<sup>345</sup> At Deloitte UK, the Senior Partner and Chief Executive has responsibility for the development of policies and strategic direction, and financial performance, working with the Executive Group.

qualification'. However, in reviewing the profiles of these twelve members on Deloitte's website, only one mentions audit experience.<sup>346</sup>

- (b) The EY Board has 10 members. EY told us that six currently 'hold senior-level audit positions and have strong audit experience'. However, reviewing the profiles of these 10 on EY's website, only two mention audit experience.<sup>347</sup>
- (c) The KPMG Board has 11 members.<sup>348</sup> KPMG told us that six hold an appropriate qualification for an auditor. However, reviewing the profiles of these 11 on KPMG's website, only four mention audit experience.<sup>349 350</sup>
- (d) The PwC Management Board has 12 members.<sup>351</sup> PwC told us that 'six hold the Audit Qualification with the ICAEW including the Chairman'. However, in reviewing the profiles of these twelve members on PwC's website only three mention audit experience.<sup>352</sup>

3.246 Overall, the representation and voice of audit at the most senior levels varies between firms, but generally audit appears to be poorly represented. This may be an indicator of the priorities, values and culture of firms, and the value firms put on audit experience in the progression of its people.

3.247 This senior-level governance is also consistent with the strategic focus of the firms being on non-audit businesses. For example, we are aware that the Big Four auditors have all made acquisitions of smaller companies over the past five years. Our review of these acquisitions suggests that they mainly involve technology or consulting firms. We are not aware of any acquisitions relating directly to audit services. This is consistent with our broader view that much of the management focus and growth of the Big Four firms is on non-audit services.

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<sup>346</sup> <https://www2.deloitte.com/uk/en/pages/about-deloitte-uk/articles/the-executive-group.html>: Stephen Griggs Managing Partner UK Head of Audit.

<sup>347</sup> <https://www.ey.com/uk/en/about-us/our-global-approach/our-leaders/ernst-and-youngs-uki-leadership-team>: Hywel Ball Assurance Service Line Leader and Debbie O'Hanion, National Markets Leader.

<sup>348</sup> KPMG UK is led by the Senior Partner, Bill Michael, who leads the Board, the main governance body of KPMG LLP which provides leadership to the organisation.

<sup>349</sup> <https://home.kpmg/uk/en/home/about/leadership-governance.html>: Bill Michael, Chairman and Senior Partner; Paul Korolkiewicz, Senior Elected Member; Tony Cates, Nominated Member; Christine Hewson Elected Member.

<sup>350</sup> We note that in January 2019 KPMG took the decision to have a smaller and more focused Board with an Advisory Group of senior external individuals to advise the Chair and the Board and strengthen independent challenge to the executive team on key issues.

<sup>351</sup> The PwC Management Board is responsible for the policies, strategy, direction and management of the UK firm.

<sup>352</sup> See <https://www.pwc.co.uk/who-we-are/executive-board.html>; Marco Amitrano - Head of Consulting; Laura Hinton, Head of People; and Hermione Hudson, Head of Assurance

## *Firm culture and values*

- 3.248 The FRC's recent Audit Culture Thematic Review looked at how the Big Four firms and four Challenger firms establish, promote and embed a culture that is committed to delivering consistently high quality audits.<sup>353</sup> The FRC defines the 'building blocks' of culture as being purpose, values and encouraged behaviours.
- 3.249 The report draws on a wide range of evidence including internal firm documents; interviews with the firms' leadership, INEs, investors and audit committee members; a survey of audit partners and staff; and a series of focus groups run by the Institute of Business Ethics.
- 3.250 The FRC said that culture is important because:<sup>354</sup>
- (a) High quality audit is supported by fundamental principles, rigorous standards, due process and mandated quality assurance. However, auditing, by its very nature, is judgemental and based on human decisions and actions. There are many factors that influence the environment within which auditors make their decisions and act. There can be tension between these factors and auditors are faced with competing priorities.'
  - (b) 'In this context, it is important that firms create a culture where achieving high quality audit work is valued and rewarded, and which emphasises the importance of 'doing the right thing' in the public interest. Auditors must also consider it their duty to serve the needs of shareholders, rather than management of the audited entity.'
- 3.251 The FRC found that firms needed to give more prominence to audit-specific behaviours and values including the fundamental principles of integrity, objectivity, independence and professional scepticism that underpin high quality audit. It also found that firms needed to ensure that all audit partners and staff appreciate that a good audit is of significant societal value and helps to underpin transparency and integrity in business. More generally, the FRC said that more could be done to promote audit specific values and make auditors feel valued for the work they do.
- 3.252 The FRC focus groups identified that auditors did not have a strong sense of the societal value of their task. Only in one firm was there a clear sense of

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<sup>353</sup> FRC (May 2018), *Audit Culture Thematic Review*, <https://www.frc.org.uk/getattachment/2f8d6070-e41b-4576-9905-4aeb7df8dd7e/Audit-Culture-Thematic-Review.pdf>.

<sup>354</sup> FRC (May 2018), *Audit Culture Thematic Review*, <https://www.frc.org.uk/getattachment/2f8d6070-e41b-4576-9905-4aeb7df8dd7e/Audit-Culture-Thematic-Review.pdf>, paragraph 1.2

audit being there to provide confidence in the capital markets. Instead, there was a very strong emphasis on managing reputational risk for the firm and helping clients achieve compliance.

3.253 We also looked at documents published by the Big Four for evidence in relation to their strategic focus and culture.<sup>355</sup> Overall, our findings are consistent with those of the FRC. While firms recognise the wider importance of audit to society (for example, in promoting trust in business and capital markets) and talk about their commitment to a focus on audit quality, there is limited focus on audit-specific behaviours and values that are essential to high quality audits, and how these are embedded in the culture of the audit practice.

#### *Governance of the audit practice*

3.254 The FRC states that the aim of its Audit Firm Governance Code is to enhance trust and confidence in the value of audit amongst the public and particularly investors.<sup>356</sup> We note in particular that the Code states that firm's governance and management structures should establish and promote firm-wide an appropriate culture, supportive of the firm's public interest role and long-term sustainability.<sup>357</sup> It also states that independent non-executives should pay particular attention to risks to audit quality<sup>358</sup> and should have audit experience.<sup>359</sup>

3.255 We are supportive of the FRC in providing guidance and support to the audit firms in putting in place appropriate governance arrangements with the aim of promoting audit quality. We question, however, whether the Code as it currently stands (and last amended in 2016) is sufficiently robust to have the desired outcome of embedding within firms a focus on audit quality.

3.256 The FRC said in its recent review of audit culture<sup>360</sup> that it is imperative that firms create an operating environment where individuals feel that achieving consistently high-quality audit is valued and rewarded above other performance considerations. The FRC also identified a strong sense of

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<sup>355</sup> The key documents were the published 2018 Annual Reports and the 2018 Transparency Reports. For some firms these directed us to other documents of interest.

<sup>356</sup> FRC (2016), Audit Firm Governance Code, <https://www.frc.org.uk/getattachment/8e2026c0-cac0-4faa-8326-4713511f139a/Audit-Firm-Governance-Code-July-2016.pdf>.

<sup>357</sup> Clause B.1.1.

<sup>358</sup> Clause C.1.1.

<sup>359</sup> Clauses C2 and C3.3.

<sup>360</sup> <https://www.frc.org.uk/getattachment/2f8d6070-e41b-4576-9905-4aeb7df8dd7e/Audit-Culture-Thematic-Review.pdf> See section 3.7

auditing being under financial pressure, and that cost and budget pressures may act as a disincentive to auditors doing the right thing.

- 3.257 Overall, our view is that firms need to do more to put in place arrangements for the governance of the audit practice that recognise and reward the values required to deliver high audit quality. We note that audit firms have themselves recognised the need for separate governance arrangements for the audit practice focussed on audit quality and public interest.<sup>361, 362, 363, 364</sup> Investors agree<sup>365</sup> on the need for major improvements in governance of audit. KPMG said that it had already taken a number of steps to strengthen the governance and performance management of the audit business, including the establishment of a Board subcommittee focused on audit quality and the primacy of audit quality goals for all audit partners.<sup>366</sup>

### *Conclusions on wider impacts of the multidisciplinary structure on audit quality*

- 3.258 The evidence considered above suggests that the impact of multidisciplinary firms has been to dilute the focus on delivering high quality audit. This is reflected in how the firms are managed and operate, and how partners are rewarded. Contrary to statements that audit remains core to their businesses, audit appears to have a relatively weak voice, compared with other business areas, at the top of two of the firms. This is reflected in both the backgrounds of the managing partners and the make-up of the Boards (or Executive Committee).
- 3.259 The culture and values of the firms are determined and promoted at a 'one-firm' level with limited focus on audit-specific behaviours and values (including independence and challenge) that are essential to high quality audits, and how these are embedded in the culture of the audit practice.
- 3.260 The profit-sharing arrangements mean that the audit partners have benefited directly from the success of the firms in growing more profitable non-audit service business and are, therefore, less likely to challenge this situation. Less focus on the audit business risks lowering audit quality.
- 3.261 Finally, we have concluded that the governance of the audit practices is not sufficiently robust in embedding a focus on audit quality. The FRC has said

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<sup>361</sup> BDO response to the Update Paper, Q20

<sup>362</sup> EY response to the Update Paper, appendix Part 5, section 2

<sup>363</sup> Mazars response to the Update Paper, Q19

<sup>364</sup> Deloitte response to the Update Paper, Summary paragraph 1.19 and 7.6

<sup>365</sup> See Hermes and Investment Association responses to Update Paper

<sup>366</sup> KPMG response to the Update Paper, paragraph 2.24

that it is imperative that audit creates an operating environment where high audit quality is valued and rewarded above other performance considerations.<sup>367</sup> Audit firms have themselves recognised the need for change that delivers separate governance arrangements for the audit practice focussed on audit quality and public interest.

### ***Cross-subsidies between audit and non-audit***

3.262 In this section we consider whether the multidisciplinary structure might affect audit costs and fees, and whether this might in turn affect audit quality.

3.263 We heard two related concerns, which were also reflected in the recent Select Committee report.<sup>368</sup>

(a) First, that the non-audit businesses within the audit firms may be ‘cross-subsidising’ audit, meaning that audit costs are below what would be expected in a counterfactual of audit-only firms.

(b) Second, that the firms have an incentive to under-bid on price, which might have the effect of driving down quality and making it harder for challenger firms to compete.

3.264 On the first of these concerns, we found evidence to suggest that costs are shared within the firms in a way that tends to reduce audit fees relative to a counterfactual where there were audit-only firms. For example, auditors are able to call on non-audit advice from within their firms more cheaply than if it were procured from third-party providers.

3.265 The effect of these cost transfers is to reduce the apparent cost of audit. This is likely to lead to lower audit fees than would be the case if the firms had to bear the full costs of sourcing additional non-audit advice externally. In turn it ties the audit practice into the overall strategy of the firm and is likely to draw auditors’ focus away from audit quality. It also makes it more difficult for new entrants to pursue an audit-only business model, because they would not be able to replicate the cost transfers within the multi-disciplinary model.

3.266 On the second concern about under-pricing audit services, the Select Committee found that 37% of audits end up costing significantly more than originally budgeted. In 73% of these instances, a higher fee for the audit was

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<sup>367</sup> FRC, Audit Culture Thematic Review, <https://www.frc.org.uk/getattachment/2f8d6070-e41b-4576-9905-4aeb7df8dd7e/Audit-Culture-Thematic-Review.pdf> See section 3.7.

<sup>368</sup> Business, Energy and Industrial Strategy Committee The Future of Audit Nineteenth Report of Session, paragraphs 112 to 118 and 143 to 146 2017–19 <https://publications.parliament.uk/pa/cm201719/cmselect/cmbeis/1718/1718.pdf>.

subsequently negotiated. The Select Committee suggested that this indicated that auditors were consistently under-bidding for audit work.

- 3.267 Our evidence on bid prices and subsequent audit fees was broadly in line with that of the Committee. However, we found that in over 50% of cases the winning bid selected was not the cheapest bid, suggesting that price was not the main driver in the majority of Audit Committee decisions. We also did not find that the Big Four were systematically bidding lower prices than the challenger firms. Finally, the evidence on profitability provided by the firms did not suggest that audit was being priced below cost. Therefore, we did not find strong evidence to suggest that the firms were engaged in strategic underpricing of audit contracts. We note in any case that the rules preventing sales of non-audit work to audit client significantly reduce any incentive on the firms to under-bid for audit work as a loss leader.
- 3.268 From our discussions with audit firms and Audit Committees, we think that the increase in audit fees after the tender has typically reflected the difficulty for a new bidder in assessing the degree of risk and complexity in any audit. In these circumstances, the previous audit fee (which is publicly known) acts as focal point for pricing future bids. We heard of several examples where firms had bid in this way, but ended up having to put in place more costly processes than had been expected.
- 3.269 Nevertheless, we agree with the Select Committee that there would be merit in audit prices more closely reflecting audit costs, removing the implicit transfers between non-audit and audit businesses. This would ensure that auditors were basing audit fees on the true costs of audit.

### ***Impact of multidisciplinary model on competition and choice in audit***

- 3.270 In addition to the direct impacts on audit quality noted above, we have also considered whether the scale of non-audit work could affect the incentives of the audit firms to compete for audit contracts. Since in the long run we would expect more effective choice and competition to drive better audit quality, we would be concerned if the current structure of the firms softened their incentives to compete strongly for audit work.
- 3.271 Our concerns stem from the restrictions on firms carrying out non-audit work for audit clients. As noted above, three of the Big Four firms have gone beyond the regulatory requirements and committed to stop providing non-essential non-audit work to FTSE 350 companies that they audit. From the buyer side, we have also heard that Audit Committees are increasingly concerned to avoid any perception of conflict between audit and non-audit contracts. These developments have reduced the possibility that client-level

conflicts might undermine incentives to focus on audit quality. However, they create the potential unintended consequence of exacerbating tensions between the audit and non-audit businesses within the audit firms.

- 3.272 Taking on audit work excludes firms from providing non-audit services for the same clients. Firms therefore have to make a strategic decision on the desirable balance between the size of their audit and non-audit work. We found a number of cases where auditors chose not to bid for audit contracts and in many these reasons related to conflicts between audit and non-audit services. This is direct evidence of firms, faced with a choice between providing audit or non-audit services to a company, deciding to give priority to the provision of non-audit.
- 3.273 Firms have told us that their presence and reputation in the audit market is important to their credibility in selling non-audit services. Combined with findings on the relative profitability of audit and non-audit services, and the scale of non-audit business opportunities available to Big Four firms,<sup>369</sup> firms have an incentive to invest in maintaining a presence in audit that is sufficient to secure the reputational benefits of providing audit services, but not necessarily to compete to win significantly larger shares of the audit market.
- 3.274 Audit partners are more likely to accept a strategy that restricts the scope to grow the audit business where they have a shared financial interest in the overall profitability of the firm, which they do as a result of the existing profit-sharing arrangements between the audit and non-audit sides of the business.
- 3.275 These concerns have been confirmed in conversations we have had with audit firms. For example, [X] told us that one reason why the failure of a Big Four would be a concern was that it would have to increase its market share from around [X] to [X]%, which it would not want to do because it would want to maintain a balanced portfolio of work across all service lines given the importance of the multidisciplinary model to audit quality.
- 3.276 This weakens competition for audit engagements, with associated risks for audit quality. In the short term, the strong negotiating position of some Audit Committees could mitigate these effects. We have heard from some Audit Committees that they are in a position to insist on firms tendering for an audit (given a credible threat that the firm would not be considered for non-audit work regardless of the outcome of the audit tender). However, as explained above, we would expect the investment that firms make in their audit capacity

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<sup>369</sup> For four sectors (banking, mining and quarrying, insurance and outsourcing), we looked at the size of audit fees earned by the Big Four firms compared with non-audit fees, over the period 2012 to 2018. In each sector, the non-audit fees exceeded audit fees. Audit fees ranged between 15% and 45% of non audit fees.



to be aligned with strategic decisions on the scale of their presence in the audit market and, as such, the scope for firms to participate in tenders may be constrained by their capacity to take on additional engagements.

***Benefits of the multi-disciplinary model and other challenges to our findings in the Update Paper***

3.277 The audit firms (both Big Four and challengers) disputed that combining audit and non-audit leads to lower audit quality.<sup>370</sup> Among the key points made in their responses to the Update Paper were that:

- (a) The CMA's own evidence suggests that direct client-level conflicts are no longer a problem, largely because of the regulations that have been put in place since the previous 2013 CC report.
- (b) Audit partners' remuneration is linked to their delivery of audit quality. Although profit share is drawn from the firm's overall profits (including non-audit), the marginal benefit to an audit partner of an increase in the firm's non-audit profits is much smaller than the marginal benefit of increasing their individual performance score on audit quality.
- (c) There is no evidence that auditors have weak incentives to challenge management or exercise scepticism by virtue of being part of a multi-disciplinary firm. Audit has a significant reputational impact on the wider business, so multidisciplinary firms have a strong interest in maintaining audit quality and avoiding audit failures. There is no empirical evidence that the culture of the Big Four firms is driven by non-audit services.
- (d) Several respondents argued that our analysis did not properly reflect benefits of the multi-disciplinary business model including: resilience; economies of scope; and development of cross-practice sector expertise.

3.278 With regard to (a), there is no dispute on the impact regulations have had on cross-selling or the expected impact of the firms' recent commitments in relation to cross-selling. However, for the reasons given above, we do not agree that these developments put an end to concerns around conflicts created by firms providing both audit and non-audit services.

3.279 With regard to (b), we have carried out a more detailed analysis of auditors' remuneration, summarised above. This suggests that, while audit quality plays a part in the assessment of audit partners' remuneration, in many cases

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<sup>370</sup> Similar arguments were also put to us by other respondents, including for example trade bodies such as the ACCA.

other factors (such as revenue raising and profitability) are more significant. We have also explained above in our analysis of wider effects of the multidisciplinary model how profit-sharing can affect the collective decisions made by the audit business within the overall firm. Even if individual partners may not see a significant impact on remuneration as a result of supporting non-audit work, collectively the sharing of profits can affect both the culture of the audit business, and choices on whether to compete for audit contracts.

- 3.280 KPMG said that the lack of credible evidence, in relation to the CMA's concerns, is consistent with the findings of the CC in 2013, which found no link between audit profitability and the level of non-audit services provided.<sup>371</sup> KPMG also referred to the CC finding that there was no evidence that audit was a loss leader or subsidised by non-audit services. However, we have not argued that the Big Four firms are loss-leading in bidding for audit services (ie pricing lower in order to win more valuable non-audit work).
- 3.281 With regard to (c), the Big Four firms argued that the serious consequences for the firm (both the audit and non-audit practices) and individual audit partners of a failure to deliver quality audits create strong incentives to deliver to high standards. KPMG said that external and internal controls exist to protect the professionalism of the firms and partners. Also:
- (a) Deloitte said it took very seriously the CMA's concerns that the mix of skill sets and disciplines at multidisciplinary firms could adversely influence the way audits are carried out, but believed this was overstated and theoretical.<sup>372</sup> Audit partners were said to have clear regulatory responsibility and accountability for their work, and this drives a culture of challenge that is not influenced by non-audit service line. Also, Deloitte has an extremely strong set of governance principles and procedures that mean that audit partners' incentives are aligned with audit quality.
  - (b) KPMG said that the CMA did not take sufficient account of the commercial and regulatory context. External regulation and internal controls exist to protect the professionalism of the audit function within firms.<sup>373</sup> Auditors practice in firms which rely heavily on trust in their audit service in order to build the reputation of their brand. Failure to deliver high quality audits is likely to be punished by audit clients. Individual auditors compete both with other firms and with other individuals within their own firm for career

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<sup>371</sup> KPMG response to Update paper

<sup>372</sup> Deloitte response to the Update Paper, paragraph 7.5 and Annex paragraph 7.5

<sup>373</sup> KPMG response to the Update Paper, Part A, paragraphs 2.33 to 2.37.

progression and financial success, which provides a very strong incentive to offer a high-quality service and act with integrity.

- (c) PwC said that the evidence does not support the CMA's concern that the culture of the four largest firms is driven by non-audit services, with a suggestion that this therefore has a negative impact on audit quality.<sup>374</sup> PwC also said that non-audit services to audit clients have reduced significantly since the implementation of the Ethical Standard which requires that at a client level there is very limited opportunity or incentive to sell non-audit services to audit clients due to caps on non-audit services. At the level of the audit firm, there remains significant incentive for the audit practice to generate growth in the market as it currently stands.

3.282 However, the firms have themselves acknowledged that their current internal controls and governance structures are in need of change. For example, KPMG recognised the criticism that the profession's current operating model is opaque and brings with it the potential to impair market confidence.<sup>375</sup> KPMG said there is scope for further enhancing the governance and performance management of the audit business and to improve transparency.<sup>376</sup> Deloitte has proposed audit governance and performance management structures to address actual or perceived cultural issues resulting from a multidisciplinary structure.<sup>377</sup> Also, three of the Big Four firms have committed to stop providing non-essential non-audit services to FTSE 350 companies they audit in response to concerns around conflicts. PwC was open to remedies designed to enhance audit firm governance in order to better embed the right culture and increase the focus on audit quality.<sup>378</sup>

3.283 More generally, as set out above, the FRC's review of audit culture raised similar concerns around culture, and the Investment Association agreed that the current multi-disciplinary nature of the firms can influence the way they undertake audits.

3.284 With regard to (d), we have acknowledged that there are benefits of the current multi-disciplinary model. The auditors told us that benefits of the multi-disciplinary model included the points listed below.

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<sup>374</sup> PwC response to the Update Paper, Annex, paragraphs 2 l) to n).

<sup>375</sup> Business, Energy and Industrial Strategy Committees (2019), *Future of audit inquiry – oral evidence*, question 353.

<sup>376</sup> KPMG response to the Update paper, page 3.

<sup>377</sup> See Deloitte response to the Update paper, paragraph 1.8.

<sup>378</sup> PwC response to the Update Paper, Annex, paragraph 24.b.

- (a) The ability to draw on a range of specialist skills from across the firm at short notice to support audit work.<sup>379</sup> We estimated, using data provided by the Big Four firms, that, on average, non-audit services accounted for about 20% of the overall audit advice.<sup>380</sup> The firms told us that, although in principle it would be possible to contract externally for this advice, this would be likely to increase the cost; make it more difficult to secure advice at short notice (which is sometimes required given the timescales for agreeing an audit opinion); and could make it more difficult to ensure that the external advice was properly focused on audit quality.<sup>381</sup>
- (b) The ability to attract and retain talent because of the breadth of work covered by the multi-disciplinary firms.<sup>382</sup>
- (c) The need for considerable ongoing investment in technology, methodologies, training and quality assurance in order to support audit.<sup>383</sup> Firms told us that the large multi-disciplinary firms benefit from economies of scale in making these investments and audit can benefit from innovations originating in other parts of the firm drawing on a wider pool of skills.<sup>384</sup> KPMG said that the importance of audit to the overall brand of the firm creates a strong incentive for the firm to invest in audit quality for the benefit of the whole firm, and that a growing non-audit practice can facilitate the ability to invest in the audit practice.<sup>385</sup>
- (d) Large multi-disciplinary firms are more resilient to shocks, whether financial or reputational.<sup>386</sup> PwC said that there is some evidence that adequate insurance protection would be more difficult, or more expensive to obtain for a smaller audit practice.<sup>387</sup> KPMG said that multi-disciplinary firms are less dependent on the revenues from the larger audits.<sup>388</sup>

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<sup>379</sup> See Deloitte response to the Update Paper Appendix paragraph 19.5; EY response to the Update Paper Appendix A Part 5, page 3; KPMG response to Update Paper, paragraph 19.2; PwC response to the Update Paper, Annex 24 c.

<sup>380</sup> This is based on the percentage of total hours (staff and partners) booked to FTSE 350 and Top Track 100 audit engagements accounted for by non-audit staff and partners.

<sup>381</sup> See KPMG response to Update Paper, paragraph 19.3.

<sup>382</sup> See Deloitte response to the Update Paper Appendix paragraph 19.7; EY response to the Update Paper Appendix A Part 5, pages 4 and 5; KPMG response to Update Paper, paragraph 19.5; PwC response to the Update Paper, Annex 24 c.

<sup>383</sup> For example, EY response to the Update Paper Appendix A Part 5 page 3 and PwC response to the Update Paper, Annex, 24 c).

<sup>384</sup> See KPMG response to the Update Paper, paragraph 19.6 and 19.11; PwC response to the Update Paper, Annex 24 c.

<sup>385</sup> KPMG response to the Update Paper, paragraph 2.39 to 2.41.

<sup>386</sup> For example, Deloitte response to the Update Paper Appendix paragraph 19.6; and EY Response to Update Paper, Appendix 5, page 2

<sup>387</sup> PwC response to the Update Paper, Annex 24 h

<sup>388</sup> See KPMG response to the Update Paper, paragraph 19.10.

3.285 We agree that the combination of audit and non-audit creates some benefits for the firms. However, we do not accept that all of the benefits claimed by the firms necessarily rely on the combination of audit and non-audit.

- (a) With regard to being able to draw on specialist advice from across the firm, it is common for professional services firms to provide each other with advice on a contracted basis, sometimes at very short notice. For example, EY suggested that specialist advice could be accessed on a contractual basis, albeit at greater cost. EY also noted that any contractual advice must meet the necessary independence requirements. We recognise that there would be increased transactions costs if the firms were not able to source advice internally. On the other hand, in the long run audit customers might benefit because there would be competition to provide advice and the audit firm would be able to contract with the most suitable provider rather than automatically going to the in-house service.
- (b) With regard to the need to attract specialist skills, we found that there is relatively little movement between audit and non-audit parts of the business. Although there is variation between firms and types of staff, annually less than 5% of audit staff working for the Big Four and Challenger firms have moved to non-audit roles.<sup>389</sup> We agree that the variety offered by the firms is likely to help attract talented graduates. However, it is not clear in a counterfactual with audit-only firms that the businesses would be any less able to attract trained audit specialists.
- (c) With respect to investment, we are sceptical that the Big Four audit firms would be unable to support necessary investment even if they were not able to draw on funding from the non-audit business. The audit businesses of the large UK firms generate significant revenues and profits (in 2018, audit fees of the Big Four firms were, on average around £500 million<sup>390</sup>). We have also been told that certain investments (particularly IT) are coordinated at the international network level.<sup>391</sup> Global audit revenues of the Big Four firms are, on average, around £10 billion.<sup>392</sup> Finally, much of the investment, as described by the firms, is audit-specific (including investment in people, skills, methodologies, processes

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<sup>389</sup> This is based on information provided by the Big Four and Challenger firms for the period 2012 to 2018 in response to information requests.

<sup>390</sup> This is based on financial information provided by the Big Four firms in relation to the provision of audit and audit related services (as defined by the Competition Commission in the Statutory Audit Market Investigation.

<sup>391</sup> For example, KPMG told us that the international network had made investment in audit technology totalling [£] over five years. See KPMG response to the update paper, paragraph 2.41.

<sup>392</sup> Source Statista.

and systems), and as such, there appear to be relatively few economies of scope between audit and non-audit investments.<sup>393</sup>

- (d) With regard to resilience, we are again sceptical that the Big Four audit firms would be significantly more vulnerable to adverse events without the support of their non-audit businesses. As set out above, even as standalone audit-only businesses, the Big Four would be large UK firms with the support of large international networks. Similarly, it is not clear why the risks of an audit-only business would be higher than the current multidisciplinary firms, and hence why there should be higher insurance premiums for a large audit-only business. Finally, as set out above, there are a number of factors likely to contribute to the resilience of the audit business including: the regulatory requirements for listed companies to appoint an external auditor; that choice for larger and more complex companies appears to be limited to the Big Four firms; the size of these firms and the support provided by their international networks; that clients cannot switch quickly; and the ability of firms to contain the reputational harm to individual teams and partners.

3.286 We have further considered the benefits of the multi-disciplinary model in assessing the proportionality of remedies relating to the separation of audit and non-audit work.

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<sup>393</sup> For example, PwC told us that the majority of its recent investment was in technology (in particular its worldwide audit tool and journals tools), and it had also invested in methodology and global quality monitoring. These 'audit focussed tools' were a cost to the international network of PwC member firms.

## 4. Remedies

- 4.1 The previous section described the various factors that lead to the market failing to deliver high-quality audits. We reiterate these factors below. The remainder of this section sets out our recommendations to address the issues we have found.
- (a) **Selection and oversight of auditors** is insufficiently focused on quality. Audit Committees are only a partial solution to the underlying problem that companies procure their own audits.
  - (b) **Choice.** There are limits on choice, driven by a combination of regulatory requirements and barriers to competition from challenger firms.
  - (c) **Barriers to expansion facing challenger firms** resulting from a combination of demand and supply-side factors.
  - (d) **Resilience.** The lack of choice and barriers to expansion faced by challenger firms intensifying concerns around choice and quality.
  - (e) **Incentives resulting from audit firm structure.** The provision of both audit and non-audit services by firms weakens the incentives on audit partners to deliver high-quality audits.
- 4.2 The market, supported by the right regulation, needs consistently to reward high-quality audits above all else, and penalise poor quality.
- 4.3 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.
- 4.4 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 FTSE 350, 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.

- 4.5 The difficulty in 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 unforeseen events 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.
- 4.6 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.
- 4.7 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,<sup>394</sup> making progress with changes to the regulator and to the market need not wait for the final outcome of his review. The public interest will be best served if our proposals are taken forward with due urgency.
- 4.8 We set out in the table below our recommendations. Some remedies address more than one of the issues we have found.

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<sup>394</sup> Business, Energy and Industrial Strategy Committee (2019), [Future of Audit Inquiry – Oral Evidence](#), Q514-517.



**Table 4.1: Our recommendations and how they address the issues**

<i>Issue(s)</i>	<i>Mechanism</i>	<i>Remedy</i>	<i>How does it take effect?</i>
<b>Selection and oversight of auditors</b>	Increase the effectiveness of FTSE 350 audit committees to deliver consistently high-quality audits	<b>Recommendation 1: Scrutiny of Audit Committees</b>	<ul style="list-style-type: none"> <li>• Focuses appointment and oversight of auditors on quality</li> <li>• External accountability for Audit Committees</li> <li>• Minimises any barriers from bias against challenger firms</li> </ul>
<b>Choice</b>	Increase resilience and choice in the market	<b>Recommendation 2a: Mandated joint audits and peer review</b>	<ul style="list-style-type: none"> <li>• Joint audits allow challenger firms scope to invest, acquire experience and build expertise, without sacrificing quality</li> <li>• Peer reviews to give opportunities for challenger firms to gain experience and reputation and also provide quality assurance</li> </ul>
<b>Barriers facing challenger firms</b>			
<b>Resilience</b>	Limit further concentration in the audit market	<b>Recommendation 2b: Measures to mitigate the effects of distress or failure of a Big Four firm</b>	<ul style="list-style-type: none"> <li>• Limits the extent to which clients and staff in a distressed or failing Big Four firm move to another Big Four firm</li> </ul>
<b>Incentives</b>	Greater focus on quality of individual audit partners	<b>Recommendation 3: Operational split between audit and non-audit services</b>	<ul style="list-style-type: none"> <li>• Full focus by auditors on audit and audit quality due to accountability to the audit board and a ban on profit sharing between audit and non-audit practices.</li> </ul>

## **Recommendation 4: A five-year review of progress by the new regulator**

4.9 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.<sup>395</sup>

<sup>395</sup> BEIS Select Committee, Future of Audit report, paragraph 141.

- 4.10 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.
  - (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.

## **Scope of our recommendations**

- 4.11 Our analysis of the issues has mainly focussed on audit services provided to companies in the FTSE 350, so our recommendations are also focused on this area. However, the constituents of the FTSE 350 are not fixed, and many of our recommendations would also benefit companies and audits outside the FTSE 350. There are also many large private companies which would benefit (for example BHS was a private company at the time of its collapse). We expect the new regulator to consider whether the scope of these should be expanded in due course. This should be considered alongside Sir John Kingman's recommendation that government review the UK's definition of a PIE.
- 4.12 Many of our recommendations refer to audit or audit services. Sir Donald Brydon is currently conducting a review of the scope of audit. We would expect the final implementation of our recommendations to reflect the outcome of that review.

## **Structure of our remedies assessment**

- 4.13 In the following sections we set out the recommendations we are now making to the Secretary of State as well as other suggestions for the regulator and government to consider.
- 4.14 For each remedy we set out:
- (a) the aim of the remedy;
  - (b) a summary of the evidence we have received in hearings and in response to the update paper and further information requests;

- (c) a detailed description of the design;
  - (d) an assessment of the effectiveness and proportionality of the remedy; and
  - (e) any further related suggestions we are making to the regulator or government.
- 4.15 We have also considered how the individual remedies will interact with each other and the proportionality of the remedy package as a whole. This assessment is based on our work to date. Certain details of implementation for some of our remedies will need to be determined by the government as it takes our proposals forward in the context of the broader audit reforms. In doing so, we expect the government will also consider the proportionality of the full legislative package as part of its impact assessment.
- 4.16 With respect to our remedies as described in this report:
- (a) We expect the regulatory scrutiny, operational split recommendations and peer review to operate individually to improve incentives; these remedies will be effective individually.
  - (b) We expect mandatory joint audit and the measures to mitigate the effects of distress or failure of a Big Four firm together to increase the resilience of the audit market by reducing the risk of greater concentration in the market. We also expect mandatory joint audit (and peer review) to increase the choice available to audit committees by allowing challenger firms the scope to invest, increasing the number of available choices. We expect these recommendations to support each other and removing one would reduce the effectiveness of the remaining remedy.
- 4.17 We expect all of our recommendations together to lead to an increase in audit quality over the longer term. The package of remedies will operate effectively together and reinforce each other.
- 4.18 We have also made some additional suggestions to the regulator where we have identified other measures that the government and/or regulator could consider alongside these primary recommendations.

## 5. Recommendation 1: Audit Committee scrutiny

### Summary

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

### Recommendations to the Secretary of State

We recommend that the government legislate for the following elements of the remedy:

- The regulator should have the power and a requirement to mandate minimum standards for both the appointment and oversight of auditors.
- 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.
- 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'.<sup>396</sup>

### Additional suggestions

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 fees and a requirement on the auditor to present at the audited company's AGM.

## Introduction

- 5.1 Audit Committees have a vital role in selecting and managing the performance of auditors to ensure that auditors maintain professional scepticism, challenge management, and thus deliver high quality audits.

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<sup>396</sup> 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.

- 5.2 Overall, while some Audit Committees are effective in overseeing the activities of auditors, the evidence in section 3 suggests that there is significant variation in the performance of Audit Committees within the FTSE 350, and that selection and oversight of auditors is not sufficiently focused on quality. Moreover, as we have highlighted in section 2, the evidence suggests that there is a persistent problem of variable and sometimes poor audit quality. Therefore, this remedy is primarily aimed at improving under-performing Audit Committees and ensuring that there is consistency of high performance among all Audit Committees.
- 5.3 This remedy is required because some standards that are already in place are insufficient. Various standards for how Audit Committees should behave are already in place, through a variety of instruments: the UK Corporate Governance Code, the FRC's Guidance on Audit Committees, the EU Audit Regulation and the Companies Act 2006, and the CC's orders following its market investigation.<sup>397</sup> However, the first two lack statutory force and the latter three all make relevant improvements but have not had sufficient effects to alleviate our concerns. While there may be some overlap between existing regulations and codes that govern Audit Committees and the minimum standards that Audit Committees would have to follow, this remedy gives the regulator a set of enforcement powers which do not exist in the existing governance framework.
- 5.4 We also considered the possibility of moving the power to select auditors away from Audit Committees to an independent body. We remain of the view, in agreement with the BEIS Select Committee,<sup>398</sup> that this would be worth keeping under consideration in the long term, incorporating the feature that

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<sup>397</sup> Summary content of these is as follows:

- The [UK Corporate Governance Code](#) sets out the standards of good practice for listed companies on board composition, remuneration, shareholder relations, accountability and audit. The target audience of this code is the board. However, it functions on a comply or explain basis without an enforcement mechanism;
- The FRC's [Guidance on Audit Committees](#) is designed to assist boards and Audit Committees when implementing the UK Corporate Governance Code. However, boards are not required to follow this guidance and there is no enforcement mechanism.
- The EU Audit Regulation and the Companies Act 2006 requirements which strengthen Audit Committees' role in the selection of auditors for public interest entities. However, this does not provide the level of detail we consider should be included in the minimum standards; and
- The [CC's Market Investigation](#) aimed to enhance the influence of Audit Committees compared to that of auditors. The CC's investigation concluded that auditors' incentives resulted in them aligning to the interests of company management at the possible expense of shareholders' interests. The CC tried to remedy this issue by strengthening the role of Audit Committees, and by reducing the involvement and influence of the finance director and staff on key aspects of the auditor's engagement. The CC's Order provided that only the Audit Committee could negotiate the terms, scope and fee of the audit agreement with the auditor. The Order also required that only the Audit Committee could authorise the auditor to provide any non-audit services to the company of the group. However, we continue to see company management influence the appointment of Audit Committees (see issues section).

<sup>398</sup> Business, Energy and Industrial Strategy Committee, [The Future of Audit, Nineteenth Report of Session 2017–19](#), 2 April 2019, paragraph 176.

shareholders would have the right to vote on the selection proposed by the independent body. Such a solution would have the potential to better serve shareholders and the public interest, by addressing the current disjoint between the public interest and the appointment process.

- 5.5 However, as Sir John Kingman observed, shareholder groups (e.g. institutional shareholders and asset managers) overwhelmingly opposed the independent appointment of auditors, and therefore he did not make such a recommendation. An independent body appointing auditors on a generic or blanket basis would be inconsistent with current EU legislation. Therefore, in the update paper, we consulted on a remedy to scrutinise Audit Committees, which we are now recommending to the Secretary of State. The BEIS Select Committee fully supported our remedy on greater scrutiny of Audit Committees.<sup>399</sup>
- 5.6 When scrutinising Audit Committees, the regulator should take a broad view of shareholders – it should include, where possible, the interests of the ultimate beneficial owners and their direct representatives, not just direct shareholders.<sup>400</sup> This broader approach should align with the direction taken by the Kingman Review and the scope of the Brydon Review.<sup>401</sup>
- 5.7 We are also making some additional suggestions for the regulator to consider, including the regulator improving the flow of information for shareholders and promoting investor activism in the audit process.

## Aims of the remedy

- 5.8 The aim of this remedy is to improve audit quality. It will achieve this by increasing the accountability of Audit Committees, ensuring fair competition and a focus on quality in tenders and ensuring that Audit Committees continue to focus on audit quality during the audit tenure. The remedy will give

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<sup>399</sup> Business, Energy and Industrial Strategy Committee, [The Future of Audit, Nineteenth Report of Session 2017–19](#), 2 April 2019, paragraph 166.

<sup>400</sup> This broader view is essential because a sizable proportion of the FTSE 350 shareholdings is in the hands of institutions that are quite often making investments on behalf of other institutions and nominees that are not the beneficial owners. The broader view will also allow for the interests of small and retail investors to be considered.

<sup>401</sup> Sir John Kingman has suggested that the new regulator should be concerned primarily with the accuracy and completeness of the reporting, so that shareholders and other stakeholders have accurate information and are not misled, [Independent Review of the Financial Reporting Council](#), 2018: Final Report, paragraph 2.48. He added that the regulator needs to engage at more senior level in a much wider and deeper dialogue with UK investors, both fund managers and representatives of end-investors. Moreover, the Brydon Review is considering how far audit can and should evolve to meet the needs of investors and other stakeholders, [Press release, government takes next step in improving standards of UK audit market with new independent review into audit standards](#).

the regulator powers to require Audit Committees to follow minimum standards and to take steps to improve under-performing Audit Committees.

- 5.9 Greater regulatory scrutiny of Audit Committees will also increase their accountability to shareholders (including beneficial owners) over the interests of company management. Shareholders should have a stronger incentive than company management to demand higher quality audits.
- 5.10 A well-functioning governance framework would require that Audit Committees are primarily accountable to shareholders – this includes that Audit Committees remain independent from company management and that they should be responsible for selecting and performance managing auditors.<sup>402</sup> This remedy takes a stronger step to achieve these outcomes.

## **Summary views of the parties**

- 5.11 A broad range of stakeholders, such as audit firms, some Audit Committees, academics and many investors strongly supported the key elements of the remedy that was proposed in the update paper. Some large non-Big Four firms further submitted that this remedy could help address what they considered was buy-side bias by Audit Committees in favour of the Big Four.
- 5.12 Stakeholders also suggested that the remedy's effectiveness could be increased by requiring Audit Committees to be more transparent - for example, by making tender material public, requiring annual dialogue between shareholders and auditors outside of the AGM, and requiring the ACC to report to shareholders and conduct a Q&A at the AGM.
- 5.13 The Big Four supported the remedy in principle, and generally agreed on increased oversight of Audit Committees. Most of the Big Four considered that it could help to ensure consistency of performance across Audit Committees and enhance the capability of Audit Committees.<sup>403</sup>
- 5.14 PwC submitted that existing reporting requirements such as those in the corporate governance code already required Audit Committees to be transparent with the public (including shareholders), and that the remedy should take advantage of these requirements, with enhancements, where

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<sup>402</sup> This also implies that the participation of senior management in the auditor selection and performance management process should be kept to the minimum (see section 3).

<sup>403</sup> PwC suggested that the remedy should be applied to FTSE 350 companies, PwC's response to the Update Paper, page 10. EY did not comment on whether the remedy could help ensure consistency of performance and enhance the performance of Audit Committees.

relevant.<sup>404</sup> The FRC submitted that expanding the existing reporting obligations on Audit Committees could support the proposed remedy.<sup>405</sup>

5.15 However, a range of parties, most notably several Audit Committees, opposed the proposed remedy. They claimed that the remedy:

- (a) would be burdensome, complex and unnecessary regulation, noting that we should give time for the CC's Order and the EU Audit Regulation to take effect;
- (b) would be disproportionate as there are some high performing Audit Committees; and
- (c) could undermine shareholder rights if the Audit Committee were answerable to a third party, and not solely to shareholders via the existing corporate governance framework.

5.16 Some stakeholders also raised concerns with certain features of the proposed remedy:

- (a) the Big Four and some non-Big Four firms generally suggested that the proposed scrutiny during the audit tenure needed careful consideration, in contrast to their relatively favourable position towards the proposed scrutiny in relation to the audit tender;<sup>406</sup>
- (b) Deloitte submitted that material disagreements between the auditor and management would be reflected in the audit report.<sup>407</sup> EY highlighted the difficulty of defining 'material disagreements' versus 'challenge and debate';<sup>408</sup>
- (c) some stakeholders opposed having an observer sit in on Audit Committee meetings. They raised concerns that discussions among the Audit Committee members would take place in other forums, where the observer would not be present; and

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<sup>404</sup> [PwC's response to the Update Paper](#), pages 11 and 12 citing the UK Corporate Governance Code and the EU Audit Regulation.

<sup>405</sup> [FRC's response to the Update Paper](#).

<sup>406</sup> [PwC](#) was generally supportive of the remedy, but it raised concerns with certain features, such as implementation. [KPMG](#) added that primary area of shareholder concern in relation to Audit Committees appeared to relate to the audit tender and that outside the audit tender, the responsibilities of the Audit Committees in relation to the audit and auditors are already well-defined and seeking greater specificity in this area carries the danger of a "checklist" approach to compliance. [BDO](#) suggested that the issues regarding underperformance of Audit Committees related to the audit tender.

<sup>407</sup> [Deloitte's response to the Update Paper](#), paragraph 4.4, page 5.

<sup>408</sup> [EY's response to the Update Paper](#), Appendix A, Part 1.



- (d) some stakeholders suggested that any proposed public reprimand needed careful consideration to avoid undermining high performing Audit Committees and the concept of non-executive directors.

## **Design and how the remedy would work in practice**

- 5.17 We recommend to the Secretary of State that the regulator should be given the powers to proactively scrutinise Audit Committees, in relation to both the appointment (audit tender) and oversight (audit tenure) of auditors. This recommendation consists of three elements that would require the regulator to have the power to:
- (a) mandate minimum standards for both the appointment and oversight of auditors;
  - (b) monitor compliance with the minimum standards; and
  - (c) take remedial action where necessary.
- 5.18 In relation to audit tenders, the regulator should consider the minimum standards that it should set, drawing on relevant parts of the current voluntary codes, but these could include requirements to:
- (a) prioritise independence, challenge and technical capability above 'cultural fit';
  - (b) avoid management influencing Audit Committees on their recommendation of auditor to the board;
  - (c) encourage non-Big Four firm firms to participate in tenders, and give their tenders fair and objective consideration; and
  - (d) manage conflicts of interest arising from auditors' provision of non-audit services, to maximise choice of suitable auditors for the audit tender.
- 5.19 The regulator should mandate that all Audit Committees succinctly report to it explaining how they have complied with the above minimum standards during the tender selection process. The regulator will be best placed to determine when Audit Committees should submit these reports. This should allow the regulator to grade the performance of Audit Committees and identify under-performing Audit Committees as well as highlighting high-performing Committees.
- 5.20 Similarly, in relation to audit oversight during the audit tenure, the regulator should consider the minimum standards that it should set, drawing on existing

voluntary codes. These should focus on ensuring that Audit Committees are continuously monitoring audit quality, and consistently demanding challenge and scepticism from auditors.<sup>409</sup> The regulator should determine which Audit Committees it focuses its scrutiny on each year, for example selecting particular industries, selecting at random or using a risk-based approach to identify underperforming Audit Committees.

- 5.21 The regulator will need new powers in order to allow it to monitor compliance effectively. The regulator should be able to obtain sufficient information to put it in a position to grade Audit Committees' performance, in order to highlight both poor and good performance. These powers should be cast broadly to allow flexibility, but the new regulator will need to use them judiciously in order to avoid undue bureaucracy. They could include the ability to:
- (a) request information and reports from Audit Committees - for example, tender and bid-related materials, minutes of Audit Committee meetings, Committees' oversight activities, correspondence between Audit Committees and auditors, key audit matters, or on material areas of disagreement between management and auditors;<sup>410</sup> and
  - (b) if necessary, place an observer on the Audit Committee, or in another part of the audit process.<sup>411</sup>
- 5.22 The regulator will need the ability to take remedial action. This could include:
- (a) publishing its findings, or summaries of its findings, on both poorly performing and high-performing Audit Committees;
  - (b) writing to Audit Committees, highlighting any specific areas of deficiency; and
  - (c) writing to shareholders, giving them the information needed for them to challenge Audit Committees and auditors, for example at AGMs.
- 5.23 Sir John Kingman made a recommendation for the new regulator to have stronger remedial powers. For example, he proposed that the regulator be given the power to order the removal of the auditor or require an immediate

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<sup>409</sup> See Section 3 for examples of how some Audit Committees have not prioritised audit quality.

<sup>410</sup> The regulator will have to form a view on how it frames and defines material disagreements with a view to capture the spirit of this requirement.

<sup>411</sup> The regulator should have oversight of the observer process to ensure that decisions taken by the Audit Committees follow the minutes of the meetings where the observer was present. This is to avoid discussions among the Audit Committee members taking place in other forums and decisions being made, where the observer would not be present.

retendering,<sup>412</sup> and to recommend to the shareholders that they consider changing the Audit Committee or its chair.<sup>413</sup> Such measures could complement our remedy set out above in extreme cases; but these are for the Government to consider as it implements Sir John's recommendations.

5.24 The regulator should initially apply this remedy to all FTSE 350 Audit Committees. Thereafter, the regulator could consider expanding it to two groups:

- (a) a selection of large PIEs based on any new definition;<sup>414</sup> and
- (b) large privately-owned companies, based on factors such as audit risk, concerns over audit quality and relative importance of companies to the economy.<sup>415</sup>

## Effectiveness

5.25 The remedy will be effective for the following reasons. First, the remedy would be capable of effective implementation, monitoring and enforcement for the following reasons:

- (a) the remedy clearly sets out the role of the regulator and the powers that the regulator will need to carry out its monitoring and remedial functions. Hence, it is unlikely to be complex to implement, and the remedial powers of the regulator will ensure that it is unlikely to function like a checklist; and
- (b) the regulator would have to build its capacity to carry out its functions, and this is achievable. The regulator could model the department or team along the lines of an expert panel, build the capability in-house, or use a combination of the two. Irrespective of the model, the leadership of this function should have a degree of independence from the regulator;<sup>416</sup> and the leaders should have relevant and prior experience as members and chairs of Audit Committees. The regulator should aim to recruit and retain

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<sup>412</sup> [Independent Review of the Financial Reporting Council, 2018: Final Report](#). Recommendation 49.

<sup>413</sup> Sir John Kingman recommended that, in the most serious cases, the regulator should change the Audit Committee or its chair. [Independent Review of the Financial Reporting Council, 2018: Final Report](#). Recommendation 50.

<sup>414</sup> Sir John Kingman has recommended that the Government should review the UK's definition of a Public Interest Entity (PIE). See [Independent Review of the Financial Reporting Council, 2018: Final Report](#), page 9.

<sup>415</sup> Not all companies are required to have Audit Committees. In circumstances where the Audit Committee role is performed by company management, some of the oversight mechanisms in this remedy could still be applicable.

<sup>416</sup> This independence element is to guard against the conflict of interest that could arise within one organisation which (1) issues AQR gradings on audits, and (2) scrutinises Audit Committees. The latter function may be hesitant to act on underperforming Audit Committees whose audits may have received a favourable AQR rating.

a diverse range of staff as was also recommended in the Kingman Review,<sup>417</sup> and the government has welcomed this recommendation.<sup>418</sup>

- 5.26 Second, the remedy can be implemented in the short term, and it should start to show results immediately upon implementation. The details of the minimum standards to be applied can be developed in consultation with BEIS soon after the publication of this report, with these standards being finalised and enforcement commencing once the relevant regulatory powers and funding are in place.
- 5.27 We do not propose a sunset clause for this remedy, although we would expect the regulator to keep it under review. The incentives of company management to lobby Audit Committees will persist, and this remedy is required to ensure that Audit Committees remain fully accountable first and foremost to shareholders.
- 5.28 Third, the remedy could aid compliance with existing regulations, for example the EU Audit Regulation.<sup>419</sup> We would also expect this remedy to work alongside future legislation arising from the Kingman and Brydon Reviews. As we have noted above, the Kingman Review could help strengthen the enforcement mechanism for this remedy. Likewise, the Brydon Review will consider areas of overlap with this remedy: strengthening links between shareholders and auditors, and the requirement for the Audit Committee to engage with shareholders outside the AGM.<sup>420</sup>
- 5.29 Fourth, this remedy requires that Audit Committees should give fair and objective consideration to non-Big Four firm firms during an audit tender and that they should report to the regulator on their actions. This requirement should apply to those FTSE 350 companies (and potentially other PIEs in the future) that are not jointly audited during the implementation glidepath. This would support the joint audit remedy, which mandates that, where appropriate, the joint audit pair must include a non-Big Four firm.

## Proportionality

- 5.30 The remedy will be proportionate. First, the remedy will be effective in achieving its aim. As we have described above, the remedy can be

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<sup>417</sup> [Independent Review of the Financial Reporting Council, 2018: Final Report](#). Recommendation 67.

<sup>418</sup> [Independent Review of the Financial Reporting Council, 2018: Initial consultations on the recommendations](#), page 31.

<sup>419</sup> One aspect of this is that the designated competent authorities need to report to the European Commission (EC) on the performance of Audit Committees (EU Audit Regulation, Article 27(1)(c)). However, the EU did not devise an assessment framework. Our remedy, which includes regulatory oversight during the audit tender and audit tenure along with an assessment framework, should aid the regulator in its reporting to the EC.

<sup>420</sup> [Independent Review into the Quality and Effectiveness of Audit, call for views, 10 April 2019](#).

implemented in the short term following legislation and it should contribute towards achieving its aim soon after implementation.

5.31 Second, the remedy is designed so that it is no more onerous than needed to achieve its aim:

- (a) with respect to obligations on companies, we do not envisage that compliance with the minimum standards will be onerous. Some of the minimum standards set out requirements that all Audit Committees should already comply with, and some already perform these requirements to a high standard without difficulty;
- (b) with respect to obligations on the regulator, the minimum standards during the tender would only apply to those companies that are tendering for an audit. Assuming that an audit tender occurs once every ten years for a given company, the regulator will have to review 35 tenders annually on average for the FTSE 350. Likewise, the Audit Committee running tenders will only have to comply with this aspect remedy once every ten years; and
- (c) the minimum standards of this remedy require Audit Committees to follow some requirements that are already laid out in the existing standards, but which lack our proposed enforcement mechanisms. Hence, the incremental burden on Audit Committees of this remedy should not be significant. Moreover, only some Audit Committees (ie not all) will have to report to the regulator during the audit tenure. The above should ensure that the remedy will not be burdensome and disproportionate, especially with regards to high performing Audit Committees.

5.32 Third, we could not identify another effective remedy that could deliver the same outcome as this remedy and so there was no choice between effective remedies. As noted above, we have designed a remedy that will not be onerous.

5.33 Fourth, the remedy will not produce disadvantages that are disproportionate to its aim. A well-resourced and competent regulator, using the flexibility that the remedy design offers, will be well placed to avoid any unintended consequences. This remedy will strengthen, not undermine, shareholder rights – the regulator will make information available to shareholder so that they will be more able to challenge Audit Committees and auditors. Moreover, as explained above, this remedy builds on existing rules and guidance including the corporate governance framework applying to Audit Committees with stricter governance, and it will therefore not disrupt the workings of Audit Committees or the audit process in general. For example, Audit Committees

are already required<sup>421</sup> to report to the board on significant issues and to give an assessment of the effectiveness of the external audit process, and to discuss what information and assurance they require to properly carry out their duties. Compliance with these and other requirements should go a long way to meeting the requirements of this remedy.

- 5.34 The remedy will involve some initial set-up and ongoing monitoring costs at the regulator. However, the regulator should be able to build on existing rules and guidance in developing minimum standards. Monitoring the performance of Audit Committees should be more straightforward than the AQR process for monitoring auditor performance (there would, for example, be no need for scrutiny of detailed audit documentation).
- 5.35 Overall, the compliance and regulatory costs associated with implementing this remedy are more than likely to be outweighed by the benefits of improved Audit Committee performance and, therefore, the confidence stakeholders can have in financial statements.<sup>422</sup> The remedy is expected to play a vital role in improving audit quality and this benefit should exceed any costs that the remedy is likely to impose.

## **Additional suggestions to the regulator**

- 5.36 During our study, parties put forward several ways to enhance shareholder rights, which we think merit further consideration. The regulator should consider consulting stakeholders (especially investors) on the merits of introducing these measures and how they could be implemented in practice.
- 5.37 First, the regulator might want to investigate how it could use its enhanced powers and its market intelligence function to improve the flow of information between the company and shareholders. Better informed and active shareholders should add weight to the demand for higher quality audits. Possible ways to do this might include the regulator:
- (a) working with proxy agencies that provide research for investors to help them assess the performance of Audit Committees and auditors;
  - (b) increasing transparency for shareholders around the audit process. For example, the regulator could consider:

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<sup>421</sup> [Guidance on Audit Committees by the FRC](#).

<sup>422</sup> As noted in the issues section, the average number of hours per year spent by the Audit Committees Chair of a sample of FTSE 350 companies in carrying out statutory audit duties was 35 hours. Given that the regulator will not for example be managing tenders (the Audit Committees will) but will be reviewing succinct reports and taking corrective action, the hours that the regulator is likely to spend on an average should be significantly less than that spent by the Audit Committee Chair.

- (i) disclosing tender documents to shareholders once the Audit Committee has selected an auditor, but before the selection is put to a shareholder vote at the AGM;
  - (ii) disclosing certain aspects of the audit contract to shareholders – this should be subject to confidentiality and at a minimum it could disclose the commitments to audit quality made by the auditors so that auditors could subsequently be held to account for their underperformance.
- (c) maintaining and publicly disclosing a database of audit partners and firms of current and past audit engagements, similar to that maintained by the PCAOB in the USA;
  - (d) encouraging greater dialogue between shareholders and the Audit Committees outside of the formal AGM;
  - (e) requiring Audit Committee Chairs to participate in live Q&A sessions at the AGMs; and
  - (f) publishing the time spent by key members such as the partners and the hourly rate charged.
- 5.38 Second, the regulator might want to consider taking steps to promote investor engagement in the audit process and take concrete steps to reflect this in its upcoming iteration of the Stewardship Code.<sup>423</sup> One way to achieve this would be by making the Code (or certain provisions of it) mandatory. This might require legislation.
- 5.39 The sharing of this information and other measures listed above could also facilitate a meaningful shareholder vote against an auditor appointment that was either put forward by the Audit Committee or was initiated by shareholders outside the normal rotation cycle to seek an early termination of an audit contract. This could complement Sir John Kingman's recommendations.<sup>424</sup>

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<sup>423</sup> [Consulting on a revised UK Stewardship Code](#). The FRC currently encourages institutional investors to report if and how they have complied with the Code.

<sup>424</sup> [Operation of the audit market: letter from Sir John Kingman to Rt Hon Greg Clark](#).

## 6. Recommendation 2a: mandatory joint audit and peer review

### Summary

#### Mandatory joint audit and peer review

This remedy requires FTSE 350 companies to be jointly audited by at least two audit firms, with at least one being a non-Big Four firm. There should be some exceptions, one being that initially the largest and most complex companies instead be subject to periodic audit peer reviews commissioned by the regulator.

The aim of the remedy is to ensure both acceptable choice and improved resilience of the audit sector.

#### Recommendations to the Secretary of State

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.

- At least one joint auditor should be a non-Big Four firm.
- Most FTSE 350 companies should be required to appoint joint auditors. The regulator should establish criteria on which companies should be exempted, covering the largest and most complex companies; companies with very simple, single-entity accounts such as investment trusts are also likely to need exemption from the requirement.
- 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.
- Other circumstances for exemption should be limited – for example where all firms outside the Big Four are unable to provide a service.
- 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.
- 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.



- There should be a presumption that Audit Committees should ensure that the work shares of the two joint auditors are relatively equal, starting with each audit firm ordinarily receiving at least 30% of the audit fee.
- 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.<sup>425</sup>
- 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.

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. 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.

- 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.
- These should be ‘hot’ reviews, ie in real time, and should report to, and be accountable only to, the regulator.
- The peer reviewer should not sign the audit opinion, and should not be liable for the accuracy of the accounts.
- 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.
- 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.

## Introduction

- 6.1 A joint audit requires two audit firms to sign off on the accounts of an audited entity. The two audit firms carefully plan the audit to divide the necessary fieldwork between them, and both firms audit those areas that are highly material and/or involve a high level of judgement (the entity’s going concern status, for example). Responsibility for the audit opinion, and audit liability,

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<sup>425</sup> The broader issue of liability, something brought up in various responses to us, is being looked at as part of the Brydon Review.

rests with both auditors. A joint audit regime has been in place for large companies in France for a considerable period of time.

- 6.2 In our update paper we said that mandatory joint audits would reduce barriers for challenger firms, and thus reduce market concentration. We also said that our preferred way of achieving this was by mandating that at least one of the joint auditors must be a non-Big Four firm. We said that the remedy should apply to FTSE 350 companies, bar some limited exceptions (such as investment companies). In light of the consultation responses, we are recommending a combination of joint audits for most FTSE 350 companies and peer review for others.
- 6.3 Several firms pointed us towards shared audits rather than joint audits as a way to achieve the same objective.<sup>426</sup> 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.
- 6.4 We have also considered a market share cap remedy as a potential alternative way to break down the barriers to non-Big Four firms.<sup>427</sup> 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.
- 6.5 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.

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<sup>426</sup> 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 actually 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.

<sup>427</sup> As suggested by the BEIS Select Committee: *The Future of Audit*, 2 April 2019, paragraph 205.

- 6.6 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.
- 6.7 We and the BEIS Select Committee both agree on the underlying problems – resilience, choice and quality. And like the Committee, we would not exclude the possibility of share caps as a possible solution in future, depending on how the market develops, and if 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.
- 6.8 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.
- 6.9 In our update paper, we proposed that the regulator’s toolkit should include a peer reviewer who is able to identify underperformance as it happens and whose presence may actually stop any underperformance occurring. We said the peer reviewer should be independent, appointed and paid by the regulator, and owe a duty of care only to the regulator. We are recommending peer review for some FTSE 350 companies.

## **Joint audit remedy**

### ***Aims of the remedy***

- 6.10 The aim of the joint audit remedy in the medium term is to improve the resilience of the audit market. Increasing the number of credible audit firms will also lead to stronger competition in the provision of large company audit, leading ultimately to better audit quality. This will be achieved by breaking down the barriers that prevent challenger firms from auditing large companies.

### ***Summary views of the parties***

- 6.11 A number of parties expressed support for joint audit in response to our update paper:

- (a) The challenger firms, with the exception of BDO, broadly supported mandatory joint audit. RSM told us that this remedy ‘would increase competition without risking audit quality’<sup>428</sup> and Mazars said the remedy ‘has substantial merits in the FTSE 350 compared with the alternative market cap approach’.<sup>429</sup> Specifically addressing audit quality, Grant Thornton was ‘not of the view that there is a risk of issues being missed or “falling through the gaps” as a result of a joint audit approach’.<sup>430</sup>
- (b) The FRC said that joint audit ‘offers a mechanism to support the growth in capacity of challenger audit firms to take on additional FTSE 350 audit engagements’ and that ‘a rigorous joint audit may mitigate the risks to audit quality’.<sup>431</sup> Baroness Bowles told us that ‘this is a very powerful remedy as it covers aspects of audit quality as well as being the best way in which challenger firms will acquire a significant share of audits’.<sup>432</sup>
- (c) Some investor groups also expressed support for our proposed remedy, such as Aberdeen Standard Investments which saw ‘significant merit in mandatory joint audits as a means of increasing competition and audit quality’.<sup>433</sup>

6.12 On the other hand, some parties expressed reservations about joint audit:

- (a) BDO said that joint audit ‘could “lock in” challenger firms to being the minority parties’,<sup>434</sup> and it was concerned that ‘the current dominance of the Big Four will be reinforced’.<sup>435</sup>
- (b) PwC told us that ‘there are material risks to audit quality in a joint audit regime’<sup>436</sup>, and that a ‘fragmentation of accountability [is] inherent in such a regime’.<sup>437</sup>
- (c) KPMG also expressed concerns about quality risks arising, including through ‘the introduction of less experienced, smaller audit firms’,<sup>438</sup> as the evidence on the impact of joint quality is mixed. However, it did recognise that there are some potential benefits; KPMG’s UK Chairman and Senior Partner, Bill Michael, told the BEIS Select Committee that

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<sup>428</sup> RSM’s response to update paper, page 2.

<sup>429</sup> Mazars’ response to update paper, page 8.

<sup>430</sup> Grant Thornton’s response to update paper, page 2.

<sup>431</sup> FRC’s response to update paper, page 2.

<sup>432</sup> Baroness Bowles’ response to update paper, page 8, lines 16-19.

<sup>433</sup> Aberdeen Standard Investment’s response to update paper, page 3, paragraph 5a.

<sup>434</sup> BDO’s response to update paper, page 5.

<sup>435</sup> BDO’s response to update paper, page 5.

<sup>436</sup> PwC’s response to update paper, page 13, paragraph 9b.

<sup>437</sup> PwC’s response to update paper, page 14, paragraph 9b.

<sup>438</sup> KPMG’s response to update paper, page 26 of the appendix, paragraph 5.3.

‘[joint audit] provides another pair of eyes’ and ‘it addresses some of the potential asymmetry you have between management and audit’.<sup>439</sup>

- (d) Deloitte told us that from a review of academic studies ‘it is difficult to draw a conclusion that mandatory joint audit has been associated with a significant improvement in audit quality’,<sup>440</sup> and also that ‘joint audits are more complex to administer’.<sup>441</sup>
- (e) EY submitted multiple ‘factors that may impact the quality of an audit’, including that there is an ‘opportunity and incentive for management to leverage differences in views’<sup>442</sup> between the joint auditors.
- (f) The 100 Group, which represents the views of the finance directors of the FTSE 100 and several large UK private companies, told us it did not support mandatory joint audits because of concerns over their impact, most notably in the short term, on quality and efficiency of audit delivery.<sup>443</sup>
- (g) EY also said that a joint audit regime ‘is very likely to “challenge the challengers” because of the level of investments required’<sup>444</sup>, and Deloitte expressed concerns that the necessary challenger firm growth would be ‘impracticable’.<sup>445</sup>
- (h) Many respondents agreed with EY that ‘mandatory joint audit would also substantially increase costs’,<sup>446</sup> and EY also told us that the remedy could cause ‘additional operation costs for companies due to added burden on finance functions’.<sup>447</sup> PwC told us that there would be ‘considerable cost increases and demands on Audit Committees and the regulator’.<sup>448</sup>
- (i) Many large businesses and their Audit Committee Chairs told us that they oppose mandatory joint audit because challenger firms do not have sufficient capacity to undertake a significant share of these businesses’ audit engagements. They also said requiring them to appoint two Big Four firms as joint auditors would severely restrict choice for the companies and therefore competition when it comes to mandatory rotation.

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<sup>439</sup> BEIS Select Committee, [Future of Audit, Oral evidence, 30 January 2019, question 327](#).

<sup>440</sup> Deloitte’s response to update paper, page 5 of the appendix, paragraph 5.1.

<sup>441</sup> Deloitte’s response to update paper, page 6 of the appendix, paragraph 5.2.

<sup>442</sup> EY’s response to update paper, Appendix A, part 2, page 4.

<sup>443</sup> The 100 Group, Response to update paper, p1.

<sup>444</sup> EY’s response to update paper, Appendix A, part 2, page 3.

<sup>445</sup> Deloitte’s response to update paper, page 6 of the appendix, paragraph 5.8.

<sup>446</sup> EY’s response to update paper, page 3.

<sup>447</sup> EY’s response to update paper, Appendix A, part 2, page 5.

<sup>448</sup> PwC’s response to update paper, page 15, paragraph 9j).

- (j) Several parties, particularly audit firms, told us that the introduction of a joint audit regime would necessitate changes to the UK's audit liability regime. These views, and our assessment of the issue, are discussed in more detail below.
  - (k) PwC raised a concern that the CC chose not to pursue joint audit as a remedy at the conclusion of its market investigation in 2013 for several reasons 'including cost implications for businesses and the threat they posed to audit quality'.<sup>449</sup> PwC said it did not see 'any evidence that would contradict those findings'.<sup>450</sup>
- 6.13 We spoke to a range of ACCs and CFOs from large French companies and discussed with them the various criticisms of joint audit that had been put to us. We heard almost unanimous disagreement with the criticisms, including in particular with the ideas that joint audits are of a lower quality and are significantly more expensive than engagements that use a sole auditor.
- 6.14 A number of respondents supported the aim of reducing barriers to challenger firms, but preferred shared audit or market share caps as a means of achieving that objective.
- (a) BDO told us that 'market caps will result in the most significant market change in the short to medium term'.<sup>451</sup>
  - (b) KPMG was 'not opposed in principle' to the joint audit remedy, but it said that the detail of how this remedy might be implemented in practice would be key, and it said that 'a market share cap for a finite period is the better option'.<sup>452</sup>
  - (c) Deloitte told us that 'shared audit would be a more effective and proportionate remedy',<sup>453</sup> and it proposed that instead of our joint audit remedy 'an equivalent change in the structure of the market can be achieved more effectively with a combination of shared audits and market share caps'.<sup>454</sup> It told us that shared audit would prevent any issues 'falling through the gaps' because the statutory auditor would have oversight of the entire company, and that challenger firms might prefer it because the statutory auditor would retain the audit liability. Deloitte

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<sup>449</sup> PwC's response to update paper, page 13, paragraph 9a.

<sup>450</sup> PwC's response to update paper, page 13, paragraph 9a.

<sup>451</sup> BDO's response to update paper, page 4.

<sup>452</sup> KPMG's response to update paper, page 2.

<sup>453</sup> Deloitte's response to update paper, page 7 of the appendix, paragraph 5.11.

<sup>454</sup> Deloitte's response to update paper, page 6, paragraph 4.11.

therefore argued that it presented a less risky method than joint audit of giving challenger firms the opportunity to expand.

- (d) ICAEW told us a cap 'could have just as positive an impact on the market, with significantly less disruption and cost, and could be implemented in a shorter timeframe than mandatory joint audit'.<sup>455</sup>

6.15 However, other parties raised concerns about the underlying principles of a market share cap. For example, they queried whether:

- (a) challenger firms could build the necessary capability and capacity, and how quickly;
- (b) the measure would undermine the principle of audit committees and shareholders being able to freely select their auditor; and
- (c) a cap would lead to fee increases, 'cherry-picking' by the Big Four of which audits to give up, and reductions in choice and audit quality.

### ***Design and how the remedy would work in practice***

6.16 We have considered the responses received to our update paper and the BEIS Select Committee report, but remain of the view that joint audit would be a more effective and proportionate remedy than shared audit or a market share cap.

#### ***Joint audit vs shared audit***

6.17 A shared audit would be carried out with one firm (the statutory auditor) taking overall control, responsibility and liability for the audit. Another audit firm would support the statutory auditor on certain aspects of the audit (e.g. carrying out audit functions on subsidiaries). In the update paper we said that we did not believe that shared audit would be as effective a remedy as joint audit.

6.18 The main reason why we are not recommending shared audit is because we do not believe it would be as effective as joint audit in reducing barriers for challenger firms:

- (a) A shared audit with a challenger firm reporting directly to a Big Four firm would do nothing to change audit committee perceptions. It would achieve the opposite, and reinforce the idea that any auditor outside of the Big

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<sup>455</sup> ICAEW's response to update paper, page 9, paragraph 32.

Four must be less capable. With a joint audit, the audit committee would work with the audit partner from the challenger firm.

- (b) Challenger firms would also develop their capacity and capability more slowly under shared audits, as they would only work narrowly on small sections of the audited company. They would not gain any experience of working on more complex areas of an audit, which would still be carried out by the Big Four statutory auditor. In contrast, joint audit would provide challenger firms with experience of auditing all parts of companies, and they would still review the overall audit engagement before signing the audit report.

#### *Joint audit vs market share cap*

- 6.19 In the update paper we considered the market share cap remedy as a potential alternative to mandatory joint audit. The market share cap remedy would involve capping the market shares of the Big Four firms, so that a proportion of the market would have been reserved for challenger firms. As with mandatory joint audits, this remedy would aim to reduce barriers for challenger firms and thus increase competition and the overall resilience of the market. However, as we describe below, we prefer joint audit as a solution to the choice and resilience issues for a number of reasons.
- 6.20 In the short term, a market share cap would constrain choice and competition far more than mandatory joint audit would. Therefore, a market share cap carries a greater risk to audit quality. For example:
  - (a) challenger firms currently have limited experience in auditing FTSE 350 companies, and requiring them to act as sole auditors for companies that they currently may not have the capability or capacity to audit would create a significant short-term risk to audit quality. In contrast, with the joint audit remedy, this risk would be mitigated by a gradual scaling up of the challenger firms' shares of work, allowing the challenger firms to build capacity. This could start with the parts of companies that challenger firms have the most capability to audit.
  - (b) the challenger firm would have the benefit of working alongside an experienced Big Four firm as the other joint auditor, which would help develop the challenger firm's capability.



- (c) an audited company faces no restriction on its choice of the first joint auditor.<sup>456</sup> This suggests that a joint audit regime would prevent any problems arising from cherry picking or restricted supply, as would be the case under a market share cap.
- 6.21 Some parties told us that the risks of cherry-picking could be mitigated by designing a market share cap in a particular way. For example, Deloitte said one way to introduce a cap would be ‘by temporarily excluding Big Four firms from participating in FTSE 250 audit tenders within certain sectors’.<sup>457</sup>
- 6.22 Applying multiple share caps to different segments of the market could help in some respects, but would not deal with potential quality risks arising from the short-term reduction in choice for those companies within a cap. There would also still be some arbitrariness within sectors as to which companies are and are not subject to the cap, and given that companies within a specific sector are likely to be direct competitors, this risks having a distorting competitive effect.
- 6.23 Selecting companies to be within the cap by reference to the time of their next re-tender could also help, but risks creating unintended consequences. For example, if such a system were to be brought into force, then, without adequate safeguards, any company in a sector to which a cap would apply would have an incentive to immediately re-tender their audit prior to the cap coming into force. It would also still result in a relatively random selection of companies, and further down the line it would concentrate into a short time period the rotation points for challenger firms, which risks causing disruption.
- 6.24 When considering timescales we were told, for example by PwC, that ‘the time required [for joint audit to be effective]... would be significantly longer than, for example, the time it would take to impose and reach a market share cap target’.<sup>458</sup>
- 6.25 We do not agree with this view. We indicate below that the main limiting factor on the speed with which either type of remedy could take effect is the rate at which the challenger firms can develop their capacity and capability. The timescale for introducing either remedy will ultimately therefore be a function of the remedy’s design, rather than being inherent in the choice of remedy.

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<sup>456</sup> In appointing its first joint auditor, an entity would, subject to the usual conflict and mandatory rotation rules, be free to appoint any Big Four or challenger audit firm. In appointing its second joint auditor, the entity would have either i) another unrestricted choice, if it had already appointed a challenger firm, or ii) a choice of only the challenger firms, if it had first appointed a Big Four firm. The most restricted choice it could face (ie scenario ii) above) would therefore be the same as if it was an entity within the scope of a market share cap.

<sup>457</sup> Deloitte’s response to update paper, page 6, paragraph 4.14.

<sup>458</sup> PwC’s response to update paper, page 14, paragraph f.

- 6.26 This can be seen from noting above that some parties said challenger firms could have practical difficulties in achieving the necessary growth for our joint audit remedy. There is a contradiction between this argument and the argument that a market share cap would be effective more swiftly. The development needed by a challenger firm to act as sole auditor for any given large company must be at least as great as the development it would have to make to be able to take on (say) 50% of the engagement as a joint auditor.
- 6.27 If a market share cap target could be reached more quickly than the full introduction of our joint audit remedy, it must be because the companies within such a cap would either be:
- (a) disproportionately weighted towards smaller, less complex audits nearer the bottom of the FTSE 350, since these are the entities that challenger firms could initially act as sole auditors for; or
  - (b) a much smaller range of companies, compared to our joint audit remedy which introduces challenger firms across the majority of the FTSE 350 market.
- 6.28 Also, reaching a market share cap target quickly does not necessarily mean that the extra resilience and choice would be sustainable in the market once the cap is removed.
- 6.29 Deloitte also told us that in a joint audit regime ‘revised auditing standards will be required’<sup>459</sup> whereas ‘market share caps could be introduced without the need for new auditing standards’,<sup>460</sup> which would therefore be another reason why a cap remedy could be introduced more quickly than joint audits.
- 6.30 We discussed this with the FRC, which issues the mandatory auditing standards used in the UK, and it disagreed. Its view is that although there would need to be strong and effective communication between audit firms to coordinate and review their work, the firms could still satisfactorily carry out the engagement by complying with all the existing standards. The FRC told us that although a joint audit engagement would be carried out by two audit firms, it would still require the auditors to plan and perform their audit to gather sufficient, appropriate audit evidence to allow them to conclude as to whether the financial statements give a true and fair view. Auditors are experienced in coordinating their work with other audit firms, as this often happens in a group

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<sup>459</sup> Deloitte’s response to update paper, page 5, paragraph 4.3.3.

<sup>460</sup> Deloitte’s response to update paper, page 6, paragraph 4.10.

audit scenario if a particular subsidiary uses an audit firm other than the group auditor.

- 6.31 In the medium term, under a market share cap there would come a point at which challengers would find it much harder to grow as fast as they had done previously and as they would under a joint audit regime. This would be caused by the complexity of audits in the top and middle quartiles of the FTSE 350, to which the challenger firms would not have been exposed. Mandatory joint audit is a far more effective tool by which challengers could develop into this part of the market.
- 6.32 Therefore, in the medium to long term, the aims of greater choice and resilience would be achieved more quickly and sustainably under mandatory joint audit than under a market share cap. With the passage of time, challenger firms will be in a better position to act as joint auditors for ever larger (and/or more complex) companies than they would be able to act for as sole auditors under a market share cap.
- 6.33 This result is most amply demonstrated by Mazars France, which has grown significantly by increasing its share on existing and large audits, and winning new mandates, since the French regulator imposed a balanced approach to joint audits in 2011. Mazars France also appears to be a credible alternative to the Big Four in the eyes of many French Audit Committee Chairs. Challenger firms will be able to build their capacity and capability more quickly under joint audits and this should be accompanied by a change in the perceptions held by audit committees.

### *Assessment of the design*

- 6.34 We now discuss the core of the design of the remedy. The joint audit remedy should not initially apply to the entire FTSE 350. We propose exemptions from joint audit for:
- (a) The very largest and most complex companies, as determined by the regulator; the regulator should instead have the power to commission a periodic peer review of the audit engagement;
  - (b) Investment trusts and companies that do not prepare consolidated accounts;
  - (c) Any company that appoints a non-Big Four firm as its sole auditor;
  - (d) Companies that need an exemption on a limited basis as determined by the regulator.

- 6.35 We do not consider it is currently feasible for challenger firms to undertake audits for the very largest companies in the FTSE 100, even on a joint basis. We anticipate though that in the medium term, once challenger firms have grown, it may be appropriate to bring these companies into scope.
- (a) Even BDO and Grant Thornton, as the largest challenger firms, told us that in the short term they lack the capacity and experience to act as a joint auditor for the most complex FTSE 100 companies. We recognised this in our update paper, and suggested that such companies might therefore appoint two Big Four firms as joint auditors.
  - (b) After reviewing the responses and further considering how mandatory rotation would apply in a joint audit regime, we are now of the view that effectively requiring companies to appoint two Big Four firms would cause a reduction in choice, leading to potential risks to audit quality.
  - (c) Those entities that challenger firms would not, in the short term, be able to act as joint auditors for would, in effect, face little choice when it came to mandatory rotation of their joint auditors. They would not be able to reappoint either of the existing Big Four joint auditors, and this would leave them choosing only from the other two Big Four firms as the new joint auditor. We set out in the Issues section our concern that competition is fragile in tenders where there are fewer than three bidders.
  - (d) We therefore recommend that joint audit should initially be mandated only for those companies which challenger firms have the current capacity and capability to joint audit. A segment of the largest FTSE 100 companies will need to be excluded from the initial scope of our remedy. The specifics of this could be determined by the regulator, based on size and complexity of audits.
  - (e) We have modelled the mandatory re-tender occurrences for FTSE 350 companies over the next ten years. Defining an exempt segment in the above way provides a realistic growth requirement for challenger firms to service the rest of the FTSE 350 audit market.
  - (f) The regulator should keep the audit market under review following the introduction of our remedy package. It is not possible for us to identify today exactly how quickly the challenger firms will develop their capacity, capability and reputation. The regulator will therefore need to monitor and refine our initial remedy design as time passes, including the respective scopes of and interactions between peer review and joint audit.
  - (g) Greater choice of auditor is needed at all levels of the UK large company market, including for the very largest companies, as they are the most

systemically important. The regulator's aim over time should therefore be to refine our remedy so that this choice for the largest companies is created as quickly as possible. The precise action needed to achieve this will depend on how the market develops, but one option would be for the regulator to extend the scope of the remedy to the very largest companies once challenger firms are able to audit them.

- (h) For the large companies outside the initial scope of mandatory joint audit, we propose that the regulator should have the power to commission a peer review of the audit engagement. The design of this part of the remedy is discussed below.

6.36 Some FTSE 350 entities are very simple businesses without consolidated accounts, and joint audit would be inappropriate for these businesses:

- (a) Investment companies carry out essentially no business activities other than the holding of investments. The Association of Investment Companies told us that audits of these companies are 'relatively simple when compared to [those] of a trading company',<sup>461</sup> with the most recent audit fee for even the largest investment company being only £44,000.<sup>462</sup> We recommend that investment companies be outside the scope of the remedy.
- (b) We also recommend that any company that is sufficiently simple that it operates just one legal entity and does not prepare consolidated group accounts should be outside the scope of the remedy. Such a simple structure and correspondingly simple audit would not lend itself well to the division of labour involved in a joint audit. Baroness Bowles told us that 'once a company prepares consolidated accounts it introduces a level of complexity and opacity that requires more challenge'.<sup>463</sup>

6.37 The aim of this remedy is to remove the barriers faced by challenger firms. We therefore propose an exemption from joint audit for companies that choose to appoint a sole challenger firm as their auditor:

- (a) The scope of the remedy is set broadly at the FTSE 350 because these are the companies where we have assessed that the barriers are greatest. However, if a company within the FTSE 350 has appointed a challenger firm as its sole auditor, then that company could reasonably

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<sup>461</sup> Association of Investment Companies' response to update paper, page 1.

<sup>462</sup> Association of Investment Companies' response to update paper, page 5.

<sup>463</sup> Baroness Bowles' response to update paper, page 8, line 21.

argue that by definition the challenger firms face no barriers to winning that company's audit.

- (b) We therefore propose that any company with a challenger firm as its sole auditor should be exempt from the requirement to appoint joint auditors. This will apply to any company that appoints a challenger firm at or before its next re-tender point.
- (c) This extra condition will allow the joint audit requirement to be tightly focused on those companies where the greatest barriers to challenger firms exist. It will also provide flexibility for individual audit committees, who have the best knowledge of their particular company's audit engagement, to decide what the most appropriate approach for their company is.

6.38 As mentioned above, the introduction and development of the remedy will need to be overseen by the regulator, and it should have the power to grant individual specific exemptions from the joint audit requirement. It should exercise this power only in exceptional and extremely limited circumstances, and only once it has exhausted all other options – the regulator must not permit this to be used to circumvent the aim of the remedy.<sup>464</sup> Importantly, the regulator should not exercise its power simply at the request of companies or audit committees.

6.39 The FTSE 350 is not a fixed group of companies, since its constituents change over time as the market capitalisation of companies changes. However, this variability would apply to almost any group of businesses that might be used to define the scope of our remedy. The regulator should establish rules for businesses moving in and out of the FTSE 350 – one option might be to require companies to appoint joint auditors within a set number of years of joining the FTSE 350, and to only remove businesses falling out of the FTSE 350 from the scope of the remedy if they remain outside of the index for a set period of time.

6.40 With respect to the timeframe for implementation:

- (a) We propose that each FTSE 350 company within the scope of our remedy should appoint a joint auditor no later than when it next re-tenders its audit

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<sup>464</sup> For example the regulator could consider using this exception if all challenger firms said that they were unable to tender, perhaps due to an audited entity carrying out most of its activity in a particular location with little challenger coverage.

engagement. This means that within ten years at the latest, all companies within the scope of the remedy will have appointed joint auditors.<sup>465</sup>

- (b) Our modelling suggests that this should be a realistic timeframe for challenger firms to deliver the necessary increases in their capacity and capability. Assuming that most companies choose to appoint a joint auditor at the time of their next tender (to minimise tender costs and Audit Committee time), challenger firms would be able to deliver the extra audit work required by this remedy without their annual audit revenue growth exceeding 5-10% at any point over the 10 year phasing-in period.<sup>466</sup> At the end of the ten year period, the challenger firms could expect to have at least a 10-12% share of FTSE 350 audit fees.<sup>467</sup>
- (c) This timeframe for introducing the remedy does mean that some companies will have to appoint joint auditors sooner than other companies will have to. However, any transition process that avoids this would be impractical, as challenger firms cannot deliver overnight the necessary growth that would allow them instantly to begin operating across the entire FTSE 350 market.

#### 6.41 With respect to the allocation of work between joint auditors:

- (a) Each joint auditor should carry out a significant part of the audit engagement. Multiple French company Audit Committee Chairs, amongst others, told us that a joint auditor performing too small a share of the audit work would not have a suitably weighty voice with the client's management or Audit Committee, and that ideally each joint engagement should aim for as close to a 50:50 balance as possible.
- (b) We therefore propose that no joint auditor should be allocated less than 30% of the total audit engagement fees, although this is very much a minimum share rather than a target. We expect that for many FTSE 350 companies it will be entirely feasible to achieve close to a 50:50 split of the engagement, and our remedy providing for scrutiny of Audit Committees will ensure that bids from challenger firms receive objective consideration.

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<sup>465</sup> The CC's Order requires companies to re-tender their audit engagement at least every ten years.

<sup>466</sup> Although the mandatory re-tendering points of FTSE 350 companies are spread over a ten year period, they are not distributed uniformly. For example, a disproportionate number of audits (and consequently a disproportionately high level of audit fees) will have to be re-tendered in 2023, while there are comparatively few in 2021 or 2022. This is caused the recent mandatory rotation and re-tendering reforms and in particular their transition rules, which applied to a large number of companies because they had historically been audited by the same audit firm for a very long time.

<sup>467</sup> Based on their expected share of the audit fees of FTSE 51-350 companies.

- (c) In the long term we would also expect every engagement to move towards a balanced share of work, with less complex audits achieving this at a faster rate than larger company or complex audits. As the joint audit market matures, we recommend that the regulator considers whether it may be appropriate for the minimum allocation figure to be revised upwards to 40% in the medium term.
- (d) The regulator should be empowered to monitor and enforce this requirement for balanced shares of work. Our Audit Committee scrutiny remedy means that there will be increased communication between the regulator and audited entities, and this will allow the regulator to satisfy itself that the audit plan has designed a suitably balanced engagement. It should have the power to intervene during the process if necessary.
- (d) The regulator should also have the flexibility to allow companies, in exceptional circumstances and for a limited period, to allocate one joint auditor a slightly smaller share of the total work. This flexibility might be required if, for example, a company makes a significant acquisition in a new geographical territory where one joint auditor has limited capacity, or if one of a company's discrete revenue streams would represent a sensible quantum of work but falls slightly short of the 30% requirement.

#### 6.42 With respect to liability between the joint auditors:

- (a) Joint audit is already permitted as an option for any UK company, and the current default legal position is that both joint auditors would have joint and several liability for the overall audit. This is an important aspect of the remedy as it provides the incentive for the joint auditors to carry out to a high standard the cross-reviews of each other's work.
- (b) We set out in our update paper that any change to this would represent a major departure from the UK's current liability regime and would require significant further consideration by the regulator and by Parliament. We do not recommend any changes to the UK's existing liability regime as a result of introducing this remedy. This is discussed in detail later in this section.

#### 6.43 With respect to auditor appointment:

- (a) We said in our update paper that joint auditors should be appointed at different times, so that the ongoing joint auditor's knowledge of the company could be retained. We understand that this is common practice, although not a legal requirement, in France, and several large French companies told us that the practical difficulties of changing both joint auditors simultaneously mean that they would not consider doing so.



- (b) However, several parties told us that our approach risks undermining the ‘fresh eyes’ principle of mandatory rotation. They said that individual Audit Committees will be best placed to decide whether or not joint auditor appointment should be staggered for their particular company’s engagement.
  - (c) Additionally, we have not been told that currently there are particular quality concerns over companies transitioning to a new auditor. This is despite the current system meaning that there is no continuity between the new audit team and the previous one, as would be the case if both joint auditors were replaced simultaneously.
  - (d) We therefore now propose that, apart from existing mandatory rotation requirements, there should be no further restriction on when joint auditors can be appointed.
- 6.44 We described above how this overall remedy will lead to growth in the capacity and capability of the challenger firms. The regulator will need to monitor the continuing distinction between Big Four firms and challenger firms, as action is likely to be needed when this distinction becomes less clear.
- 6.45 If the regulator observes a significant increase in choice and resilience across the market, then it might decide to remove the remedy, or elements of it.

### ***Effectiveness***

- 6.46 As identified in the ‘Issues’ section, significant barriers to entry for the challenger firms include the perception amongst ACCs that challenger firms have smaller international networks and lack the capacity and capability needed for complex audits. Some ACCs also cited concerns about the quality of challenger firms, for example through perceived lower AQR scores.
- 6.47 The joint audit remedy would overcome these perceptions by guaranteeing that Audit Committees have experience of working directly with challenger firms, thus improving their reputations.
- (a) Joint audit will provide an opportunity for skill sharing between Big Four and challenger firms.
  - (b) In a joint audit, work can be allocated between the firms in a way that makes best use of their international networks.
  - (c) Joint audit is an effective way to manage the quality risks associated with challenger firms taking on more complex audits.

- 6.48 The lower concentration of the audit market in France, where joint audit is mandatory, suggests that the introduction of joint audit in the UK is likely to lead to a significant increase in the share of large company audit fees of challenger firms.
- 6.49 Even though in France there is no restriction on the composition of joint audit pairs, only 44% of companies listed on the SBF120 are audited by two Big Four firms.<sup>468</sup> The workload in cases is shared between the joint auditors in a reasonably balanced way, with a challenger firm often receiving around 40% of the audit, which indicates that in these cases the challenger firms are perceived as being on a par with the Big Four.
- 6.50 Some parties told us that since joint audit has been in place in France for 50 years, we should not rely too much on its current market concentration statistics. However, this does not take into account the more recent introduction in 2011 of the requirement for French joint audit engagements to be balanced, and we have also set out above how the design of our remedy would mean it is fully introduced no later than in ten years' time.
- 6.51 Our analysis of joint audit pairs in the SBF 120 shows that even outside of Mazars, 18 companies have appointed a non-Big Four audit firm. Nine of these companies use one of the large challenger firms that are present in the UK market (ie BDO, Grant Thornton or RSM), but the remaining nine use an audit firm outside of this group. This suggests that in a joint audit regime, some smaller audit firms below our recognised challengers might also bid for some of the FTSE 350 tenders.
- 6.52 In the UK however, the position is very different, with 97% of FTSE 350 companies selecting a Big Four audit firm. We therefore believe it is necessary to require that at least one joint auditor is a challenger firm. If the remedy were to be implemented without this condition then, in the absence of any other action to remove barriers for challenger firms, we would expect audit committees simply to appoint two Big Four firms, and the remedy would not be effective.
- 6.53 We considered whether the requirement that one of the joint auditors be a challenger firm might create a risk of segmentation of the market, with competition to be the second joint auditor effectively being limited to the Big Four.<sup>469</sup> However, given the limited degree of competition currently faced by the Big Four from challenger firms, we concluded that any impact of the

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<sup>468</sup> EY's response to update paper, Appendix A, part 2, page 2. The SBF 120 is a French stock index that EY suggests is the most comparable French index to the FTSE 350.

<sup>469</sup> ACCA, response to update paper, p9.

requirement on competitive pressure faced by the Big Four was likely to be limited. We also concluded that there were greater risks of a reduction in choice under a market share cap than under joint audit with a requirement for one of the auditors to be a challenger firm.

- 6.54 This remedy should lead to a significant increase in the size of some challenger firms. This should make the audit market more resilient as, in the event of the failure of one of the Big Four, the greater capacity of the challenger firms would enable them to attract senior staff more easily from the failed auditor and induce large companies to begin choosing them as auditors.
- 6.55 As well as the enhanced reputation and capacity, challenger firms would also develop their capabilities through gradually being introduced to more complex audit engagements than they currently carry out. This would, in part, come from working alongside Big Four firms.
- 6.56 As set out above, our design of the initial remedy means that all companies within its scope will have appointed joint auditors within ten years. The remedy could not reasonably be implemented any more quickly as challenger firms may not be able to sufficiently develop their capacity and capability over any shorter a period. Any other remedy to reduce barriers for challenger firms would face a similar restriction on how quickly it could be introduced.
- 6.57 As designed, this remedy does, though, allow flexibility for challenger firms to scale up gradually depending on how quickly they find they are able to. They can grow the percentages of each engagement they carry out as the Audit Committees aim to move to balanced shares of work. Equally, the regulator can monitor the growth of challenger firms to ensure that the remedy is having a timely effect without causing the firms to overreach themselves and grow too quickly.
- 6.58 On an individual engagement level, this remedy would help achieve the aims of our resilience remedy. If each large company has two audit firms acting as joint auditors then, in the case of one of the Big Four firms failing, the challenger firm already participating in the engagement is more likely to be able to take on additional work than in the current single auditor regime. This could help prevent the entirety of a failed firm's market share moving to other Big Four firms, effectively creating a Big Three.

- 6.59 The existing legislative framework and auditing standards accommodate joint audit.<sup>470</sup> If consequential amendments to the legislative framework or auditing standards are required to implement joint audit, we do not consider that these amendments would present an impediment.
- 6.60 A number of audit firms raised joint and several liability as a potential barrier to joint audit.
- (a) KPMG said that it would be difficult for a Big Four firm to take on the risk of conducting a joint audit with a challenger firm if the challenger firm did not have the requisite capabilities or insurance cover to participate in the relevant audit.<sup>471</sup> KPMG said that larger audit firms may be concerned about a smaller audit firm's ability to finance their share of any liability, such that there is potential for the larger firm to have to cover the smaller firm's liability.<sup>472</sup> PwC said that it 'cannot envisage conducting a joint audit without liability caps'.<sup>473</sup>
  - (b) Crowe and Mazars separately submitted that joint and several liability for joint audit may increase the cost of insurance cover for the challenger firms.<sup>474</sup> Grant Thornton submitted that joint and several liability could be a potential additional cost that will impact those who want to enter the market in the short term, over and above the additional costs required to invest in technical and human capacity.<sup>475</sup>
- 6.61 Most audit firms suggested that a proportionate liability model would be more appropriate than joint and several liability. A range of suggestions were put forward as to how liability could be split proportionately.
- (a) PwC said that liability should be proportionate to the degree of responsibility taken by each auditor for the work.<sup>476</sup>
  - (b) Deloitte submitted that liability could be proportionate to each joint auditor's share of the overall audit fee.<sup>477</sup>

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<sup>470</sup> The Companies Act 2006 allows for a company's accounts to be audited by more than one auditor. Where more than one person is appointed as an auditor, the Companies Act 2006 requires, amongst other matters, that (a) all persons appointed jointly make the auditors' report and include a statement as to whether all auditors agreed on the matters contained in the report and, if not, why not (s485(5)); and (2) all those appointed to sign the auditors' report (s503(6)). Similarly, the FRC told us that the auditing standards accommodate joint audit.

<sup>471</sup> KPMG's response to update paper, page 28 of the appendix, paragraph 5.10.

<sup>472</sup> KPMG's response to update paper, page 32 of the appendix, paragraph 9.4.

<sup>473</sup> PwC's response to update paper, page 15, paragraph k.

<sup>474</sup> Crowe's response to update paper, page 6; Mazars' response to update paper, page 13.

<sup>475</sup> Grant Thornton's response to update paper, page 12.

<sup>476</sup> PwC's response to update paper, page 15, paragraph j.

<sup>477</sup> Deloitte's response to update paper, page 10 of the appendix, paragraph 9.3.

(c) BDO said that liability should be proportionate to 'blame' taking into account the share of the relative work performed and the specific roles and responsibilities of each firm.<sup>478</sup>

(d) Mazars' position was similar to BDO's, submitting that each party should be liable in proportion to the losses incurred as a result of their own actions or defaults.<sup>479</sup>

6.62 In contrast, KPMG said that 'any system of liability that provided for an asymmetric apportionment of liability for the audit findings, whether based on relative fees or otherwise, would reduce the economic incentives of the firm with the lesser liability to provide a high-quality audit'.<sup>480</sup> KPMG also noted, 'The firm with the larger liability would in effect be forced to take an oversight role given its greater financial exposure. This would be inconsistent with the notion of a joint audit, and more in line with the shared model which we suggested as a possible remedy in our response to the CMA's ITC...'.<sup>481</sup>

6.63 A proportionate liability regime may not be appropriate for a joint audit model where each auditor is required to sign the auditor's report which covers the entirety of the financial statements. Joint and several liability creates a strong incentive for each audit firm to carry out its cross-review role to a high standard. Proportionate liability, whether based on relative fees or fieldwork, is more aligned with shared audit. A proportionate liability model may not appropriately recognise that in a joint audit, regardless of the share of fieldwork apportioned to each auditor, both auditors are required to sign off the entirety of the accounts.

6.64 Any change to the existing liability regime would require an in-depth review beyond the scope of this market study.<sup>482</sup> Sir Donald Brydon's recent call for views on his review of the quality and effectiveness of audit has made clear that he will be considering various questions relating to liability. In particular,

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<sup>478</sup> BDO's response to update paper, page 7.

<sup>479</sup> Mazars' response to update paper, page 13.

<sup>480</sup> KPMG's response to update paper, page 31 of the appendix, paragraph 9.2.

<sup>481</sup> KPMG's response to update paper, page 31 of the appendix, paragraph 9.3.

<sup>482</sup> The Law Commission has previously considered whether to change the liability regime in the United Kingdom (Law Commission, Feasibility Investigation of Joint and Several Liability, London, February 1996). The Law Commission was not convinced by the arguments against joint and several regime and so concluded that a full project into the liability regime should not be undertaken. The review was not specific to audit, although audit was a case study along with the building industry. When considering how the joint and several regime impacted on audit firms, the Law Commission was not considering joint audit. The European Commission (EC) issued a Recommendation in 2008 concerning the limitation of civil liability of statutory auditors and audit firms (2008/473/EC of 5 June 2008; [2008] OJ L162/39). The EC recommended that the liability of auditors carrying out statutory audits of listed companies should be limited except for intentional breach of duties. The EC recommended that Member States choose a method of limitation most suitable for its civil liability system: liability caps, limiting liability to fault, or via contract. The Recommendation was issued after the Companies Act 2006 provisions for liability limitation agreements came into force.

he has asked 'Is the audit profession's willingness to embrace change constrained by their exposure to litigation?'.<sup>483</sup> We expect that Sir Donald Brydon will consider the comments made by parties about their preferences for proportionate liability in a joint audit regime.

6.65 Having said that, we are not convinced that a joint and several liability regime presents too great a risk for audit firms (large or small) to conduct a joint audit.

(a) First, it is important to note that a joint and several liability regime does not necessarily mean that both firms will be liable for any loss. There is scope within the existing regime for joint auditors' liability and consequential damages to be apportioned according to fault.<sup>484</sup> We do not agree that auditors would find themselves liable in circumstances where they are not at fault.<sup>485</sup>

(b) Second, the FRC told us that it did not foresee any issues with challenger firms obtaining adequate insurance cover. It told us that the insurance cover needed by challenger firms for joint audit clients should be no greater than if they undertook sole audits for the same companies.

(c) Third, we were told by The Haut Conseil du Commissariat aux Comptes (H3C), the French public audit oversight body, that joint and several liability applies in France and has not hampered the success of joint audit.

6.66 We also note that the Companies Act 2006 enables auditors to limit their liability via contract. Auditors can enter into a liability limitation agreement with the company to limit their liability to the company to an amount that is fair and reasonable. Shareholders must approve any liability limitation agreement. We have been told that such agreements are 'extremely rare' in practice.<sup>486</sup> But it is not inconceivable that the introduction of joint audit may lead to firms and shareholders taking a different view of this existing liability limitation tool.

6.67 As noted by PwC, our assessment of joint audit differs from that carried out previously by the CC in its 2013 report.

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<sup>483</sup> [Call for views](#); Independent Review into the Quality and Effectiveness of Audit; Question 40, page 40.

<sup>484</sup> The common law principle of joint and several liability will apply in a case where the joint auditors are both negligent and each of their negligent acts causes the plaintiff the same, indivisible damage. That means that the plaintiff can either sue both Auditor A and Auditor B for 100% of their loss, or only sue Auditor A for 100%. In the second scenario, as between defendants, Auditor A could recover a contribution from Auditor B (via the Civil Liability (Contribution) Act 1978). The court would determine the contribution taking into account culpability and causation. However, if Auditor B was insolvent for any reason, Auditor A may be required to pay for a larger proportion of damages than they would have been if Auditor B was not insolvent.

<sup>485</sup> For example, in high level terms, if only Auditor A is negligent and Auditor B could not have detected that negligence, such that Auditor B has not caused any loss, Auditor B will not be liable for that loss.

<sup>486</sup> KPMG's response to update paper, page 32 of the appendix, footnote 70.

- (a) The CC concluded that joint or shared audit did not by itself address the particular adverse effect on competition that the CC was required to remedy: namely, that auditors have the incentives and ability to respond to executive management's interests.<sup>487</sup> The CC considered at the time that its remedies package would more effectively address that particular adverse effect on competition.<sup>488</sup> The CC did not quantify the potential cost of imposing shared or joint audit but did conclude that these would be potentially significant.<sup>489</sup>
- (b) As noted in the Issues section, we have identified that there are issues with audit market concentration and resilience. Based on our assessment of the evidence today, and taking account of the changes in the market since the CC's assessment, we consider joint audit will be an effective and proportionate way to improve choice and resilience.

### ***Proportionality***

- 6.68 Joint audit is a proportionate remedy to address the issues of choice and resilience set out in the Issues section. In particular, the remedy will be effective in achieving its aim, is no more onerous than necessary, is the least onerous effective measure and does not produce disadvantages disproportionate to the aim.
- 6.69 As set out above, the remedy will be effective in ensuring that challenger firms play a meaningful role in auditing the UK's largest companies. The remedy will in time increase choice and resilience by ensuring we have more than four audit firms capable of carrying out these audits.
- 6.70 Our proposed formulation of joint audit is no more onerous than necessary to address the existing choice and resilience concerns:
  - (a) Transitional provisions will ensure that challenger firms are not required to grow more quickly than is safe to protect audit quality, nor be expected to audit the most complex companies at the top of the FTSE 100 before they have had an opportunity to build experience.
  - (b) The exemption for investment companies and companies without consolidated accounts means that very simple companies will not be required to have joint auditors.

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<sup>487</sup> CC's final market investigation report, page 304, paragraph 17.101.

<sup>488</sup> CC's final market investigation report, page 304, paragraph 17.101.

<sup>489</sup> CC's final market investigation report, page 304, paragraph 17.100.

- (c) The exemption allowing a challenger firm to act as a sole auditor means that audit committees and shareholders retain choice as to whether they would prefer a sole challenger carrying out their audit or joint auditors (which could include a Big Four firm).
  - (d) Allowing companies to introduce joint audit in line with their existing mandatory re-tender schedule helps minimise the costs imposed on companies.
  - (e) Empowering the regulator to give a specific exemption from the remedy in exceptional circumstances mitigates any extreme cases where no non-Big four firm can act.
  - (f) Companies retain the flexibility to discuss with the joint auditors which parts of the company each should audit, allowing them to accommodate any specialities that an audit firm might have in particular geographies, business lines etc.
- 6.71 For the reasons set out above we do not consider that other remedies, in particular a market share cap or shared audits, would be as effective as joint audit in achieving the aims of the remedy.
- 6.72 We do not consider that joint audit would create disadvantages that are disproportionate to its aims. The two key disadvantages put forward by stakeholders were:
- (a) that joint audit could lead to quality issues; and
  - (b) that joint audit could lead to significant increased costs.
- 6.73 We do not accept that joint audits would cause a significant risk to audit quality:
- (a) Many parties submitted a wide range of reasons why joint audit could result in higher or lower audit quality, and we were told that different arguments recognised in academic economic literature point towards both an increase and a decrease in audit quality. In our update paper we noted that no firm conclusion in either direction can therefore be drawn from the literature.
  - (b) Turning to the specific academic arguments as to why joint audit might reduce audit quality, the most common point put to us was that joint audit creates the risk of some audit issues ‘falling through the gaps’ and not being identified by either joint auditor because neither has oversight of the entire audited company.



- (c) H3C did not share this view, and nor did the argument gain support from any of the various French ACCs that we spoke to. They all said that effective communication between the joint auditors is a fundamental part of a joint audit, and that as long as the audit is properly planned and performed, following the applicable standards, this risk should not arise. The joint auditors will ensure that the agreed audit plan has been adhered to when they review each other's work before finalising their opinion.
- (d) H3C also pointed out that the joint auditors rotate regularly the specific parts of the audit that they carry out over the years, perhaps according to activity location or financial statement item. This contributes, for each joint auditor, to the development of an in-depth understanding of the entire business. Baroness Bowles told us that 'it is hard to give any credence to the notion of gaps caused by joint audit when what happens is to add independent analysis of everything important and nothing is taken away'.<sup>490</sup>
- (e) Another common argument was that the smaller of the joint auditors, bearing a smaller proportion of the litigation and reputation risk in case of an audit failure, would have an incentive to 'free ride' on the effort of the larger audit firm.
- (f) Our remedy says that joint audit engagements need to have relatively balanced work shares, and as a result the litigation and reputation risks would also be broadly balanced between the joint auditors. In addition, with joint and several liability each audit firm has a strong incentive to perform an adequate review of the other's work, because if a joint auditor should have identified errors in the other firm's work then it might also be liable for damages.
- (g) In contrast, we heard anecdotal evidence that, contrary to giving management an opportunity to leverage a potential difference in views, having two joint auditors gives the auditors a stronger position from which collectively to challenge a company's management. We also heard that Audit Committees can benefit from receiving two technical points of view when holding management to account. H3C expressed to us its strong belief in the positive impact of joint audit on audit quality, as did many of the French ACCs and finance staff that we spoke to. We were struck by the difference in opinion between those individuals who had practical

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<sup>490</sup> Baroness Bowles' response to update paper, page 10, line 1

experience of joint audit and those who were addressing it from a theoretical point of view.

- (h) The Big Four all perform joint audits in France, and none of them suggested to us that their French offices are delivering below par quality on their audit engagements. In addition, an EY audit partner (from their French practice, with experience of both joint and single audit) attended a recent meeting of the Audit Committee Chairs Independent Forum and told the Forum that, in their experience, the quality produced by a joint audit should not be viewed any differently to the quality of a single audit.<sup>491</sup>
- (i) The BEIS Select Committee spoke to a range of audit firms, investors, Audit Committee Chairs and academics as part of its 'The Future of Audit' inquiry. After hearing this evidence, the Committee concluded that 'joint audits may lead to marginal improvements in audit quality and that if proper checks are put in place, such as effective communication between the joint auditors and regulatory monitoring, they will not lead to a decline in audit quality'.<sup>492</sup>

6.74 Although audit fees will increase as a result of the remedy, that cost increase is proportionate given the importance of the remedy's objectives. Over time, we also expect that audit firms will become more efficient at joint audit as their experience of it grows, and this will mitigate the effects of the cost increase.

- (a) We acknowledged in our update paper that the introduction of joint audit will lead to an increase in audit fees as, when compared to the current situation, some extra planning will be needed (to account for how the joint auditors will co-ordinate) and there will be one extra level of review (when each auditor checks the work of the other).
- (b) We noted in our update paper that academic literature suggests a cost increase of 25-50%.<sup>493</sup> Analysis carried out by Audit Analytics as a result of our update paper found that across quartiles of the SBF 120 and FTSE

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<sup>491</sup> A complete extract from the ACCIF minutes of the 31 January 2019 meeting reads: 'The French audit partner was able to compare her experience of both audit models: she informed the ACCs that her approach to an audit was the same in both a joint audit and a sole audit; the quality produced and the processes underpinning the audit were the same; she did not believe a user should view the quality of the audit report on a French CAC 30 any differently from the audit report on a UK FTSE 100; 'yes there are the other firm's eyes in a joint audit, but all of the firms have significant internal independent review processes (other eyes) for sole audits.'

<sup>492</sup> *The Future of Audit*, BEIS Select Committee, page 61, paragraph 201.

<sup>493</sup> For a literature review, see Ratzinger-Sakel, N. V. S., S. Audoussert-Coulier, J. Kettunene, and C. Lesage (2013) Joint Audit: Issues and Challenges for Researchers and Policy-Makers, *Accounting in Europe*, 10(2), 175-

100 average audit fees relative to revenue were higher in France by 0 to 28%.<sup>494</sup>

- (c) We reviewed a sample of audit plans and identified that work on planning and finalisation, being the main areas where work would be duplicated in a joint audit, constituted in the range of 5 to 10% of the total audit work. This would be a lower bound for any cost increase though, as the nature of extra work means it is likely to be disproportionately carried out by more senior members of an audit team (which may in itself provide an incidental benefit to audit quality).
- (d) We noted in the Issues section that the ACCs we spoke to were generally agreed that audit quality should matter more than price, and that The 100 Group stated that ‘the cost of delivery is a relatively minor consideration in selecting an audit firm’.<sup>495</sup> The FRC reports that some audit committees carry out tenders on ‘a “fee blind” basis, where the audit fee is negotiated after the decision on which firm to appoint’.<sup>496</sup>
- (e) Additionally, the BEIS Select Committee noted in its ‘The Future of Audit’ report that, while it ‘accept[s] that joint audits might cost significantly more... we believe that the extra cost can be justified’.<sup>497</sup>
- (f) Multiple parties noted that Denmark had abandoned its joint audit regime because of unnecessary high audit costs, which were not compensated for by tangible benefits. This was supported by a reference to the Basis for Conclusions of the Danish Financial Statement Act, as quoted in an academic paper. However, the conclusion of this same academic paper noted that ‘the Danish case evidences no higher costs’ and ‘one should be cautious when arguing about the additional cost’.<sup>498</sup> Further, in relation to the benefits to be weighed against any higher costs, the Danish joint audit regime had no requirement for balanced work shares, unlike our remedy.

6.75 We set out in the Issues section that there is a lack of choice and resilience in the large company audit market. These are longstanding issues, with the Big Four having dominated the market since the collapse of Arthur Andersen in 2002. The BEIS Select Committee described in its report how previous

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<sup>494</sup> [Implications of the CMA’s call for a joint audit among the FTSE 350](#), Audit Analytics.

<sup>495</sup> The 100 Group, response to CMA Invitation to Comment, page 3.

<sup>496</sup> [Audit tenders – Notes on best practice](#); FRC, February 2017, page 13.

<sup>497</sup> The Future of Audit; BEIS Select Committee, page 61, paragraph 202.

<sup>498</sup> Cédric Lesage, Sabine Ratzinger, Jaana Kettunen. Struggle over joint audit: on behalf of public interest?. Comptabilités et innovation, May 2012, Grenoble, France. pp.cd-rom, 2012, page 31.

reforms ‘have proved totally ineffective in increasing competition’<sup>499</sup> and suggested that as a result ‘radical change is needed’.<sup>500</sup>

- 6.76 Any effective measure to create this change through reducing barriers to challenger firms, whether by the introduction of mandatory joint audit or of a market share cap, would be a substantial adjustment to the current audit regime and create costs for the market. Inaction would also bring costs, as it would lead to the continuation of the regular audit failures that have occurred recently.
- 6.77 Our view therefore is that a moderate increase in audit fees would be a proportionate cost for our remedy when it is balanced against the importance of the issues that it addresses.

## **Peer review remedy**

### ***Aims of the remedy***

- 6.78 The key objective of peer review is to improve audit quality by introducing an additional, independent quality check. Ensuring that the peer review is not carried out by a Big Four firm will allow challenger firms to gain some additional experience that may assist in reducing barriers to some extent.

### ***Summary views of the parties***

- 6.79 Many respondents agreed with KPMG that peer review ‘would have a valid role in certain circumstances but would be less necessary where there is a requirement for joint audit’.<sup>501</sup> Grant Thornton told us that ‘this remedy should only be applied if joint or shared audit solutions are not taken forward’,<sup>502</sup> and Mazars explained that this is because ‘each of the joint auditors would be actively reviewing the work of the other’.<sup>503</sup>
- 6.80 Legal & General told us that this remedy ‘could be an effective method of improving audit quality’,<sup>504</sup> and Sarasin saw ‘merit in a system of peer

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<sup>499</sup> *The Future of Audit*; BEIS Select Committee, page 82, paragraph 260.

<sup>500</sup> *The Future of Audit*; BEIS Select Committee, page 82, paragraph 261.

<sup>501</sup> KPMG’s response to update paper, page 4.

<sup>502</sup> Grant Thornton’s response to update paper, page 3.

<sup>503</sup> Mazars’ response to update paper, page 19.

<sup>504</sup> Legal & General’s response to update paper, page 10, paragraph 6.1.

review'.<sup>505</sup> Baroness Bowles said that 'a full peer review could run deeper than the FRC's AQR as those only look at process rather than outcomes'.<sup>506</sup>

- 6.81 PwC warned however that 'there are also important practical issues which would need to be considered',<sup>507</sup> and these concerns were echoed by a variety of other parties. In particular the parties said that the remedy could cause delays to reporting, inevitably increase costs, cause capacity issues and potentially restrict choice in audit tenders if an audit firm has carried out a peer review.

### ***Design and how the remedy would work in practice***

- 6.82 The regulator should have the power to commission a peer review of the audit engagements of the largest companies that are outside the scope of the mandatory joint audit remedy. 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. The regulator should also 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.
- 6.83 This peer review would be a 'hot' review carried out prior to the signing of the audit report. In contrast, a 'cold' review, carried out after the finalisation of the audit report and financial statements, would not be sufficiently prompt in making the regulator aware of any audit quality concerns. A 'cold' review would also be more similar to the FRC's current AQR process, and would therefore be a less useful complement to the current system than a 'hot' review would be. The peer reviewer would act in an observer capacity. Unlike joint audit, the reviewer would not sign the audit opinion, and would not be liable for the accuracy of the accounts.
- 6.84 The peer review should not be carried out by a Big Four firm, apart from in exceptional circumstances at the discretion of the regulator. Permitting a Big Four firm to perform the review would reduce the company's choice of auditor, as the Big Four firm would be conflicted as a result of carrying out the peer review work. It would also prevent the challenger firms accruing any benefits that carrying out peer reviews might have on their capability.

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<sup>505</sup> Sarasin & Partners LLP's response to update paper, page 8.

<sup>506</sup> Baroness Bowles response to update paper, page 19, line 11.

<sup>507</sup> PwC's response to update paper, page 23, paragraph 26d.

6.85 This aspect of the remedy will have a clear interaction with Recommendation 47 made by Sir John Kingman in his review of the FRC.<sup>508</sup> The government has welcomed this recommendation and noted that it will require primary legislation to implement. Assuming that in due course the recommendation is implemented, the regulator may already have the necessary legal powers to commission the peer review that we are proposing here.

### ***Effectiveness***

6.86 The primary aim of a peer review remedy is different to that of mandatory joint audit. It would aim to directly improve audit quality by providing an independent check of audit work. But it could also potentially help challenger firms to develop their capabilities, as it will expose them to more complex companies than they currently audit.

6.87 We recommend that the regulator should have the power to commission peer reviews for those large companies which are outside the initial scope of the mandatory joint audit remedy. Peer reviews would be effective in keeping statutory auditors 'on their toes' as a regulator-appointed reviewer would be less susceptible to forming the cosy relationship that we were told can develop between the audit committee, executive management and statutory auditor.

6.88 For joint audit engagements, there is cross-review by each joint auditor of the other's work. An additional peer review would therefore provide fewer additional quality benefits, and this is why we have not proposed a wider introduction of peer review.

### ***Proportionality***

6.89 The largest FTSE 100 companies are the most systemically important companies to the UK economy. While the current capacity and capability of challenger firms prevents our joint audit remedy being effectively applied to these 50 companies, the peer review remedy would be effective in providing a check of audit quality. The cost of such a review would not be onerous when compared to the multimillion pound audit fees of these companies, and the quality benefits arising from the review would outweigh its cost.

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<sup>508</sup> 'The Review recommends that the new regulator should be able to commission a skilled person review, paid for by the company, in circumstances where there is any significant interest arising from its strategic objective: "To protect the interests of investors and the wider public interest by setting high standards of corporate governance, corporate reporting and statutory audit, and by holding to account the companies and professional advisers responsible for meeting those standards."' [Independent Review of the FRC](#); Sir John Kingman, page 49, recommendation 47.

- 6.90 Our design of this remedy is no more onerous than it needs to be. The regulator will decide which engagements should be reviewed, rather than applying it to every company every year, and engagements being carried out by joint auditors will not be subject to the remedy due to the inherent cross-review already involved.

### **Other potential measures aimed at reducing barriers to challenger firms**

- 6.91 We have set out above why mandatory joint audit is the most effective and proportionate remedy to address the issues identified. However, during the course of our market study we were told by some parties that the barriers to entry faced by challenger firms could be further reduced if:
- (a) Notice periods for partners and senior staff in Big Four firms were reduced, and non-compete clauses were limited in scope;
  - (b) Big Four firms were required to share their audit technology with challenger firms;
  - (c) A tendering fund was created to meet the tendering costs incurred by challenger firms;
  - (d) There was a clearer framework for the handover of data from the incumbent audit firm to the new auditor; or
  - (e) The restriction on ownership of audit firms was removed.
- 6.92 The regulator may want to consider in due course if there is any merit in implementing any of these actions to generate further ancillary benefits. With respect to notice periods and non-compete clauses, practice currently varies across firms. One Big Four firm has a notice period of six months and we suggest the regulator considers whether all Big Four firms should limit their notice periods to six months to assist challenger firms in building the additional capacity required in the years ahead. Further evidence on notice periods is set out in the Issues section.
- 6.93 The BEIS Select Committee suggested moving to a seven-year mandatory rotation period that can only be terminated in exceptional circumstances, as a change from the current ten-year mandatory tender period and 20-year mandatory rotation.<sup>509</sup> There was extensive debate through the CC's investigation on the right length of such periods; consensus seems to be that

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<sup>509</sup> BEIS Select Committee, [Future of Audit](#), paragraph 179.

the market was able to handle the changes more effectively than was suggested at the time. As we indicated in the Issues section, the introduction of mandatory tendering was an important step in introducing competition, but as we also said, it appears not to have delivered reduced concentration in FTSE 350 audits. If the limiting factor on challenger firm growth turned out to be availability of tenders, increasing frequency would be a necessary step; but our modelling has suggested that their ability to grow sustainably is likely to be the main limiting factor to the speed of change. If that turns out not to be the case, we suggest the regulator revisits this question.

- 6.94 Another reason for more frequent rotation, as the BEIS Select Committee indicated, would be to reduce ‘familiarity’ between auditors and audited companies. That is an important question, but one which relates more closely to regulation than competition. We suggest the regulator considers this; it might as a result change rotation frequency even if it agrees with our analysis in the previous paragraph of the effects of frequency on speed of challenger firm growth.



## 7. Recommendation 2b: Measures to mitigate the effects of the distress or failure of a Big 4 firm

### Summary

This remedy aims to preserve choice if a Big Four firm were in distress or approaching failure and 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.

The regulator should monitor the health of the audit practices and have powers to intervene when necessary.

### Recommendations to the Secretary of State

We recommend that the regulator should be given the powers to:

- obtain the information it needs to monitor the health of audit practices to act as an early warning, including requiring Audit Committees to inform it of upcoming tenders; and
- intervene as necessary.

### Introduction

- 7.1 The collapse of Arthur Andersen in 2002 demonstrates what could happen if a Big Four audit practice were to collapse – all audit contracts, assets and staff could move to one or more of the remaining Big Three. The market would become more concentrated with even less choice and competition. This outcome would be unacceptable, and so this remedy aims to mitigate the negative effects that might arise from such a fall-out.
- 7.2 Other important sectors such as banking and care homes have regulatory oversight of the operators' financial health, and the banking and retail energy sectors have bespoke insolvency regimes. The purpose of these regimes is to ensure continuity of service.
- 7.3 Our recommendation for the audit market would differ in one important way – it would also aim to prevent further concentration. This is necessary because neither the merger control framework nor any existing legislation would necessarily prevent clients and staff moving from a failing Big Four firm to the other Big Four firms. Moreover, the UK insolvency framework, which currently applies to audit firms, places greater emphasis on maximising distributions to

creditors (and then shareholders) over other outcomes such as ensuring the resilience of the market.

- 7.4 The FRC's Audit Firm Monitoring Approach (AFMA) requires the six biggest audit firms to draw up contingency plans in the case of distress. It is currently a voluntary initiative.<sup>510</sup> Sir John Kingman has recommended that the regulator should be given statutory powers to carry out this monitoring work with AFMA, and BEIS has proposed bringing this forward via legislation.<sup>511</sup> While we welcome these initiatives, AFMA would not prevent audit contracts of a distressed audit practice from migrating to the remaining Big Four firms. Nevertheless, AFMA could work alongside our remedy as we describe below.
- 7.5 Hence, our remedy is necessary. The BEIS Select Committee has also recommended that we should work with the regulator to draw up proposals to mitigate the consequences of an audit market failure.<sup>512</sup>

## **Aims of the remedy**

- 7.6 This remedy aims to avoid further concentration in the audit market by incentivising and/or preventing as large a proportion of the audit contracts of a distressed Big Four firm as possible from migrating to another Big Four firm. Preventing further concentration would maintain choice in and the resilience of the market.
- 7.7 The regulator could achieve this outcome in one or more of these ways: audited companies of a distressed Big Four firm could be transferred to a new firm,<sup>513</sup> to a non-Big Four firm<sup>514</sup>, or remain within the same firm while a turnaround was implemented.<sup>515</sup> A by-product of this remedy is that it would ensure continuity of supply in the short term, in the event of a Big Four firm failing, while also ensuring audit quality was maintained.
- 7.8 This remedy does not aim to signal nor to prevent the failure of an audit practice at all costs – failure for good reason, such as that arising from

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<sup>510</sup> The FRC has responsibility to regularly monitor and mitigate risk in the audit market under the EU Audit Regulation.

<sup>511</sup> [Independent review of the Financial Reporting Council \(2018\), Initial consultation on the recommendations by BEIS](#), page 17.

<sup>512</sup> [Business, Energy and Industrial Strategy Committee, The Future of Audit, Nineteenth Report of Session 2017–19](#), 2 April 2019, paragraph 217.

<sup>513</sup> It could separate the distressed audit practice into a 'good practice' from a 'bad practice'. This is similar to how regulators considered splitting distressed banks into good and bad banks.

<sup>514</sup> It may not be possible for all audit contracts of a failing Big Four firm to move to a non-Big Four firm or firms. The regulator would have to consider which audit contracts were too large and complex for non-Big Four firms.

<sup>515</sup> If restrictions can be placed on the movement of audited companies to another Big Four, then the assets (including staff) are more likely to follow the audited companies of that firm.

systematic and firm-wide poor-quality audits, must not be prevented. This would mitigate the risks arising from moral hazard as we describe below.<sup>516</sup>

- 7.9 There are many different ways in which an audit practice could decline, and as we explain below, this decline could be gradual or sudden. The more sudden the decline the more likely that regulatory intervention would be needed.
- 7.10 A gradual decline could arise from the steady loss of UK audited companies; for example, if an audit practice suffered from loss of reputation arising from poor audit quality with the problem mostly limited to the UK national market. Alternatively, it could occur if there were reputational concerns with small international member firms affecting the UK audit practice. In either case, audited companies would mostly be lost incrementally through unsuccessful tenders.
- 7.11 In the initial stages of a gradual decline, management of the audit practice would have primary responsibility for stabilising and turning around the audit practice.
- 7.12 A sudden decline in an audit practice could arise in several ways: a brand damaging event (for example, Andersen in 2002) could result in a major loss of market confidence in the firm, regulatory intervention such as the revocation of a licence or a substantial fine, or major litigation. The source of any of these problems could either arise in the UK or in an important network firm abroad, leading to audited companies terminating their audit contracts early, and/or staff leaving the distressed audit practice. At this stage the regulator should focus on stemming the flow of early terminations of audit contracts and staff leaving the audit practice.

## Summary views of the parties

- 7.13 Aberdeen Standard Investments and the Investment Association submitted that ring-fencing of partner equity may help to discourage excessive risk taking.<sup>517</sup> L&G and LGIM added that the low capital levels in audit firms, which are driven by partner remuneration structures, make audit firms less resilient to large shocks.<sup>518</sup> Baroness Bowles suggested that audit firms should hold

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<sup>516</sup> Moral hazard is the risk that the remedy signals to stakeholders that the audit practice could be 'bailed out', resulting in excessive risk taking by audit partners.

<sup>517</sup> [Aberdeen Standard Investments' response to the Update Paper](#), page 6; and the [Investment Association's response to the update paper](#), page 4.

<sup>518</sup> [L&G and LGIM's response to the update paper](#), paragraph 4.3.

regulatory capital.<sup>519</sup> However, Deloitte told us it had access to lines of credit from financial institutions to manage working capital, and it had insurance cover to guard against fines and litigation.

7.14 Some stakeholders raised several concerns with the proposed remedy.<sup>520</sup> They questioned whether the proposed remedy was required. For example:

- (a) The ICAEW had no particular concerns about the resilience of the current market<sup>521</sup> and Professor Bhaskar believed that the Big Four would be financially resilient under a wide variety of assumptions;<sup>522</sup>
- (b) BDO suggested that FRC's AFMA potentially made the proposed remedy redundant;<sup>523</sup>
- (c) The ACCA argued that this proposed remedy would be unnecessary, if what it considered as resilience-reducing remedies such as audit/non-audit services splits, a market share cap and joint audits were excluded from any remedies package;<sup>524</sup>
- (d) EY added that while it supported the opportunity to put effective safeguards in place, many of the CMA's proposals posed direct threats to the resilience of UK audit firms;<sup>525</sup> and
- (e) KPMG argued that the proposed remedy needed to be considered in the context of other measures that the CMA is considering – the success of some other remedies aimed at increasing choice would clearly reduce the CMA's concern in relation to resilience.<sup>526</sup>

7.15 Some stakeholders suggested that the proposed remedy could not be implemented on practical and legal grounds. For example:

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<sup>519</sup> [Baroness Bowles response to the update paper](#), page 14.

<sup>520</sup> EY also argued that many of the CMA's other proposals posed direct threats to the resilience of UK Audit firms. See [EY's response to the Update Paper](#), page 3 of its cover letter and Appendix A, Part 4.

<sup>521</sup> [ICAEW's response to the update paper](#), paragraph 41.

<sup>522</sup> [Professor Bhaskar's response to the update paper](#), page 13: Professor Bhaskar added that while an Arthur Andersen type failure can never be ruled out, UK law is prone to be more partial to auditors than US law and that the Big Four European or US audit networks would aid any equivalent failure in the UK because of the nature of cross-country subsidiaries and entangled business relationships in today's complex business world.

<sup>523</sup> [BDO's response to the update paper](#), page 10.

<sup>524</sup> [ACCA's response to the update paper](#), page 12

<sup>525</sup> [EY's response to the update paper](#), page 3 of its cover letter.

<sup>526</sup> [KPMG's response to the update paper](#), paragraph 15.2.

- (a) BDO and Grant Thornton said that mandating that audit contracts of a failing Big Four firm were transferred to non-Big Four firm(s) required non-Big Four firms with greater capacity than at present;<sup>527</sup>
- (b) PwC, EY, ACCA, ICAEW and HSBC highlighted the challenges in requiring companies to be audited by, and staff to remain within, a failing Big Four firm, or to be transferred to a challenger firm in the event of a Big Four failing or exiting;<sup>528</sup>
- (c) ACCA noted that the resilience regime and any associated process could not necessarily be funded through equity and cash at audit firms, which may not be sufficient to meet the liabilities;<sup>529</sup>
- (d) Deloitte suggested that if people and clients choose to leave a failing firm, then there may be little value left in that firm to prevent moral hazard, and that creating a special insolvency regime would be a challenging endeavour;<sup>530</sup> and
- (e) The 100 Group submitted that the design of the proposed remedy would require involvement by audit firms on an international scale in order to be effective.<sup>531</sup> KPMG added that it would need to have regards to factors outside the UK.<sup>532</sup>

## Design and how the remedy would work in practice

- 7.16 We recommend that the regulator should oversee and administer measures to preserve choice if a Big Four firm were in distress or approaching failure. These measures should give the regulator the ability to gather the information that it needs and to intervene where necessary.<sup>533</sup>
- 7.17 The regulator should be given the powers to:

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<sup>527</sup> [BDO's response to the update paper](#), page 10; and [Grant Thornton's response to the update paper](#), page 15..

<sup>528</sup> [PwC's response to the update paper](#), paragraph c page 19, PwC noted that it would be difficult given the current arrangements for auditor appointment; [EY's response to the update paper](#), page Appendix A, Part 4; [ACCA's response to the update paper](#), page 13; [ICAEW's response to the update paper](#), paragraph 47; and [HSBC's response to the update paper](#), response to remedy 4.

<sup>529</sup> [ACCA's response to the update paper](#), page 12.

<sup>530</sup> [Deloitte's response to the update paper](#), page 13.

<sup>531</sup> [100 Group's response to the update paper](#), page 4.

<sup>532</sup> [KPMG's response to the update paper](#), paragraph 15.3.2. KPMG gave the following examples: whether the UK firm failure was part of the failing international network, or the prospect that the firm subject to this remedy would not be permitted to continue to operate as part of the international network.

<sup>533</sup> Sir John Kingman also recommended that the new regulator keep the market under review. See the [Independent Review of the Financial Reporting Council, December 2018](#), recommendation 44.

- (a) obtain timely and periodic submissions from the Big Four audit practices and/or firms and possibly the large non-Big Four firms on their financial health;
  - (b) require Audit Committees to inform it of upcoming tenders and any other information that the regulator considers necessary;
  - (c) obtain, and then review, the modified contingency plans from large audit firms, which should encompass the turnaround plans; and
  - (d) require non-Big Four firms to draw up plans on how they could incorporate migrating audited companies or staff from a distressed Big Four.
- 7.18 The regulator should consider how it will implement these measures and work with government to seek and obtain the powers that it considers necessary.
- 7.19 We suggest that as part of its ongoing monitoring, the regulator should consider undertaking the following tasks:
- (a) obtaining periodic submissions from audit practices on key metrics to measure upcoming or imminent distress of the firms;<sup>534</sup>
  - (b) using, where relevant, information that it obtains from audit firm contingency plans under AFMA to form a view on potential distress of the audit practices;
  - (c) holding conversations with audit firms and relevant stakeholders such as other sector regulators (eg PRA), lenders and audit companies (audit committees and management) to gather market intelligence on distress and viability; and
  - (d) working with non-Big Four firms to prepare plans on how they would accommodate migrating audited companies from a distressed Big Four.
- 7.20 Once the regulator has identified signs of distress, we would expect it to exercise its judgement on any form of intervention. It should continue to work closely with stakeholders, and we suggest the regulator should consider:
- (a) requiring the audit practice to identify the source of the problem; and

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<sup>534</sup> This would function similarly to the [Market Oversight](#) of adult social care, where the CQC obtains timely data from providers. The regulator might also request data to measure the financial health of the non-audit services practice.

- (b) requiring the audit practice to modify its contingency plan under AFMA to include a turnaround plan with solutions to the identified problem.

7.21 We recommend that the regulator considers how it will be able to:

- (a) discourage audit contracts transferring to the remaining Big Four and providing incentives for them to transfer to non-Big Four firms, for example by working closely with Audit Committees;
- (b) incentivise audit teams to move to non-Big Four firms along with their existing audited companies;<sup>535</sup>
- (c) use appropriate regulatory reliefs for audit practices to help retain or move staff; and
- (d) provide certainty to the markets and transparency to staff to prevent a 'run' on a distressed audit practice.

7.22 In certain circumstances it may only be possible partially to achieve this outcome. For example, if the major international network(s) of the UK firm were put out of business in the short term, with audited companies and staff in those jurisdictions moving to the remaining Big Four firms, the UK firm would no longer have an international network. In this scenario, the regulator could focus on incentivising smaller FTSE 350 audited companies<sup>536</sup> to transfer to non-Big Four firms; the larger audited companies would probably have to migrate to the remaining Big Three.

7.23 However, once joint audits are more common, non-Big Four firms will be in a better position to audit larger companies, both as lead joint auditor for FTSE 350 and a selection of other PIEs, and as sole auditors for some of the market. Nevertheless, we suggest that the regulator should engage in regular dialogue with international regulators with regards to the resilience of the big audit practices.

7.24 There would be benefits in requiring the large audit practices to ringfence a proportion of audit partners' equity and we recommend that the regulator considers how this could be implemented. The ringfenced equity could be used to pay the fees of the regulator to administer the distress process, and distributions to audit partners could only be made if the turnaround were successful. This would thus help to mitigate the risk arising from moral hazard. This could also be used to incentivise audit partner movement by

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<sup>535</sup> Recognising that the auditor appointment process sits with companies and its shareholders.

<sup>536</sup> For example, those audited companies with a limited international footprint.

approving audit partner distributions of salaries and drawings at the distressed audit practice.<sup>537</sup>

- 7.25 The regulator may also need the ability to intervene in executive decision-making and we recommend that the regulator considers whether and how this power could be used. For example, it might start by the regulator, or an appointee of the regulator (such as an independent turnaround specialist) having a seat on the executive board with the power to exercise a veto, and if the regulator considers it necessary, then the regulator (or its appointee) might require the option of taking executive control of the audit practice. This may require a special or modified insolvency regime for large audit practices that prioritises the resilience of the market in line with the aims of this remedy.

## Effectiveness

- 7.26 The remedy would be effective in achieving its aim. First, the remedy would be capable of effective implementation for the following reasons. The remedy would lay out the functions of the regulator and the powers that it will need to carry out those functions. Moreover, the remedy would allow the regulator to follow a set of principles to protect choice and resilience – it will have to apply judgment and thus follow a flexible approach to solve the issue at hand. This flexibility in the design would increase the effectiveness of the remedy.
- 7.27 The regulator would have to build its capacity to carry out its duties. It would include building a depth of expertise and recruiting staff, in-house and/or on retainer, with front line experience in managing distressed firms.
- 7.28 Second, the remedy could be implemented in the short term, and it could start to show results immediately upon implementation. The regulator could immediately start monitoring the sector, after the necessary legislation.
- 7.29 Subject to the levels of concentration becoming significantly lower in the market for large company audits, the regulator could consider reducing the scope of its monitoring activities and any necessary interventions.
- 7.30 Third, this remedy would work well alongside joint audit and operational split remedies. The scope of these measures concerns almost all the audited companies of the Big Four audit practices which extends beyond the FTSE 350. We would expect the regulator to be mindful of how this remedy interacts with companies that will be jointly audited. If a Big Four firm were to fail, non-Big Four firms engaging in joint audits with it would likely be well-placed to

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<sup>537</sup> This would work to incentivise audit partners of a distressed Big Four firm to either stay within the same firm, or move to a non-Big Four firm.



take over as the lead joint auditor on those contracts, and other non-Big Four firms would also be in better position than today to take on the role as the other joint auditor.

- 7.31 The requirement in the operational split remedy to prepare separate accounts for the audit practice could help the regulator monitor the financial sustainability of the audit practice. The requirement for the audit practice to have its own board could facilitate the regulator (or its appointee) in exercising some form of intervention in respect of the audit practice.

## Proportionality

- 7.32 The remedy would be proportionate. First, as we have described above, the remedy could be implemented immediately after legislation to start monitoring the market's resilience. The focus on principles will allow the regulator to work out the specifics of how it implements this remedy and use judgment to carefully consider when to use any powers.
- 7.33 Second, the design of the remedy could be structured so that it is no more onerous than needed to achieve its aim. For example, it would give scope to management to turn around the audit practice, before the regulator may need to intervene.
- 7.34 Third, we did not identify another effective remedy that could deliver the same outcome as this remedy. Hence, this is the least onerous effective remedy to address market resilience. Moreover, as noted above, we have designed a remedy that will be no more onerous than needed to achieve the objectives.
- 7.35 Fourth, the remedy would not produce disadvantages that are disproportionate to its aim. The actions of a well-resourced and competent regulator, using the flexibility that the remedy design offers, are unlikely to generate unintended consequences of moral hazard and regulatory intervention creating the risk of a self-fulfilling prophecy.<sup>538</sup> The regulator could mitigate this risk by carefully monitoring a distressed audit practice and it should be mindful of this risk when communicating to stakeholders in the public domain.
- 7.36 The remedy would entail initial set-up and ongoing monitoring costs by the regulator, and compliance cost for audit practices, but neither of these is likely

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<sup>538</sup> The latter could occur if the regulator brings information to the public domain in trying to assist the firm but instead causes the distressed audit practice to collapse, where a more discreet turnaround plan could have succeeded.

to be significant. The regulator's annual recurring expense to carry out its market monitoring activities could be met out of a levy on the firms.

- 7.37 Moreover, the costs of this remedy would be outweighed by the benefits of greater resilience and choice, with the by-product of better continuity of service.

## 8. Recommendation 3: An operational split between the audit and non-audit practices of the Big Four

### Summary

This remedy would require the Big Four to put in place a strong strategic and operational split between their audit and non-audit services practices, including separate governance and strategy, separate accounts and remuneration policies, and no profit-sharing between audit and non-audit.

The aim of this is to ensure auditors' full focus is on conducting high quality audits, without their incentives being affected by the much greater revenue and profits from the non-audit side of the firm.

### Recommendations to the Secretary of State

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 closer to the Big Four's size.

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:

- 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.
- Separate financial statements for the audit practice, consisting of a profit and loss statement for the audit practice.
- Transparent transfer pricing, checked by the regulator, particularly for the use of non-audit specialists on audits.
- 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.
- 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.
- The audit board should be responsible for all remuneration and career progression decisions within the audit practice.

- The board should conduct an annual general meeting and produce an annual report.
- Remuneration and career progression should be strongly linked to audit quality, with the audit board setting and overseeing quality standards.

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.

#### Additional suggestions

In addition to the recommendations above, the government and the regulator could consider introducing a deferred compensation and clawback regime for senior audit staff and partners, in the event the regulator considered it necessary to strengthen the remedy package. Such a measure would further link remuneration to audit quality.

## **Introduction**

- 8.1 In the update paper we said that our aim was to address the real and perceived risk of non-audit services' culture affecting audit quality. We suggested that this could be achieved by structurally separating audit and non-audit services. We also said that structural separation might increase auditor choice due to potential relaxation of the conflict rules. However, we recognised practical challenges in creating audit-only firms arising from the use of non-audit experts on audits, the importance of international networks and potential costs and disruption to the business.
- 8.2 Therefore, we also considered other variants of separation that could be effective, but less costly, in addressing our concerns. We said that a possible solution could be an operational split between the audit and non-audit parts of the firm, with separate profit pools and separate governance arrangements for audit and non-audit services respectively.
- 8.3 Having reviewed stakeholder responses to the update paper and other evidence, we recommend an operational split as our preferred remedy.

## **Aims of the remedy**

- 8.4 The aim of the remedy is to improve audit quality, by reducing auditor interest in non-audit work. The remedy will achieve this objective by ensuring that:
- (a) Auditor objectives and staff remuneration are strongly linked to audit quality. Currently auditor incentives have regard to the interests of the

wider firm and remuneration depends on several factors, including the overall profitability of the firm. Audit practices are smaller and less profitable compared to non-audit, potentially resulting in less importance being placed on the objectives and culture relevant to the audit practice. The remedy will give the audit practices a special status within the firms that compensates for their smaller share of the firms' revenue and reflects public interest.

(b) Competition for audit contracts is strengthened. Currently a firm's incentives to bid for audit may be weak if the firm already provides non-audit services to the client, or sees a strong prospect of future lucrative non-audit services work. An operational split should incentivise the audit business to compete for audit tenders even where the firm has significant non-audit contracts.

- 8.5 The remedy will also provide the regulator with greater transparency of the audit business that will allow effective monitoring of the audit firms' performance and assist with its monitoring of the resilience regime.
- 8.6 We previously suggested that separation might improve choice, if it allowed relaxation of the conflict rules related to non-audit services. In theory, an audit practice that is completely structurally separate from non-audit would achieve improvement in choice as more audit firms would be free to compete for audit work. The separation would also improve auditor focus on quality as their remuneration would be independent from the performance of the non-audit business. This was the preferred remedy of the BEIS Select Committee.<sup>539</sup>
- 8.7 However, in practice, the firms providing audit are part of global networks, so the separation would have to be carried out internationally to be effective in improving choice. A separation in the UK would be successful in making UK auditors focus on audits, thereby improving audit quality. However, the majority of conflict rules apply to the international network, so a unilateral separation in the UK would not improve choice. It is also unlikely to be desirable to relax conflict rules sufficiently to make a difference to choice, even if this could be done in the UK alone. For example, if a UK firm were split into audit and non-audit practices, the conflict rules would rightly still prevent a situation where the newly separate audit practice could be carrying out a bank audit on which its Irish sister company might have provided the tax advice. We would also need to consider one-off costs associated with a structural split.

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<sup>539</sup> BEIS Select Committee (2019), future of audit report, p223, paragraph 141.

- 8.8 Another way to create more choice would be to separate the biggest audit firms into two firms each, with both providing audit and non-audit services. In this case, conflict rules would still apply to the networks, but there would be double the number of large audit firms in the market. However, to be structurally separate, at least one of the two new audit firms in each case would have to be cut off from its current international network. This would remove its ability to carry out international audits, which is crucial to the audit of larger companies. Hence, a split would need to be carried out in such a way as to create two international networks in each instance, i.e. the remedy could only work if applied internationally.
- 8.9 Given the importance of international cooperation in making a structural split work, we encourage the regulator to remain open to further efforts internationally in this regard.

## Summary views of the parties

- 8.10 LG and LGIM shared the CMA's 'concerns that the current structural set-up of audit firms creates a culture and incentivisation that is not conducive to a relentless and singular focus on audit quality'.<sup>540</sup> Notably, UKSA and Sharesoc, Sarasin and Baroness Bowles supported structural separation, with the latter being concerned that an operational split could be circumvented.<sup>541</sup>
- 8.11 We saw some support for operational ringfencing (but not legal separation) from some smaller audit firms, the FRC and other respondents. Some qualified their response by saying that costs and benefits of this approach need to be balanced. The FRC said that it would like to see the firms demonstrate that their audit business does not rely on subsidy from the wider network or other service lines for investment.<sup>542</sup> Deloitte, KPMG and EY each suggested a version of operational ringfencing with a focus on an enhanced governance structure rather than a formal split.<sup>543</sup> PwC was open to remedies designed to enhance audit firm governance.<sup>544</sup>
- 8.12 Aberdeen Standard Investments supported operational separation 'which could give audit functions a far greater degree of independence and autonomy' and said that operational separation 'will also help to allay fears

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<sup>540</sup> LG and LGIM response to Update paper, paragraph 5.1

<sup>541</sup> Baroness Bowles (February 2019), Response to CMA update paper, p17.

<sup>542</sup> FRC response to Update paper, p 4, paragraph 5.

<sup>543</sup> Deloitte response to Update paper, paragraph 20.2-20.5; KPMG response to Update paper, paragraph 21.8-21.9; EY response to Update paper, Appendix 5, page 7, section 2.

<sup>544</sup> PwC response to Update paper, p 20, paragraph 24 (b).

that the impartiality of audits can be tainted by conflicts of interest or other commercial considerations'.<sup>545</sup>

- 8.13 Responses indicated substantial opposition to both structural and operational split on grounds of cost (eg tax, pensions, technology) and lack of evidence that at present audit culture is influenced adversely by the non-audit culture. Respondents pointed out that the remedy would have little effect on auditor choice and conflicts of interest rules, as these apply to the network. Both audit firms and other respondents were concerned about potential negative effects on audit quality because of loss of access to the international network and non-audit experts.
- 8.14 The arguments raised by many respondents against a structural and operational split fell into the following main categories:
- (a) Threat to the multidisciplinary model and audit quality, for example, due to access to non-audit staff (particularly due to the seasonality of audit<sup>546</sup>) and the international network;
  - (b) A smaller separate audit firm would be less resilient, more dependent on audit clients, less able to invest in technology and retain/recruit staff and partners, reliant on more expensive insurance;
  - (c) Damage to the UK economy, ranging from the consolidation of regional offices to the UK audit firms exiting the market and UK audits being provided by non-UK audit firms;
  - (d) The remedy is unnecessary as companies increasingly do not commission any non-audit services from their auditors and the larger audit firms either announced or are actively considering not providing non-audit services to audit clients;
  - (e) The remedy is unnecessary because the firms recently introduced or proposed governance improvements that address the issues.
- 8.15 Some respondents also questioned the effectiveness of any form of separation remedy given that a significant amount of audit work is performed outside the UK, which would not be subject to any applicable UK requirements for structural or operational separation.

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<sup>545</sup> Aberdeen Standard Investments response to update paper, page 7.

<sup>546</sup> They argued that audit work peaks at fixed points of the year as companies tend to have the same year end.

- 8.16 Respondents had different views as to whether the remedy should apply only to the Big Four firms. Some smaller audit firms generally stated that the remedy should apply to the Big Four only on grounds of proportionality and fairness and due to the significant investment needed in building up joint audit capability by smaller firms. Some respondents (eg ACCA<sup>547</sup>) said that, if implemented, they would not support excluding challenger firms from the scope of the remedy. Deloitte argued that the culture is the same across the firms and any size threshold would be arbitrary.<sup>548</sup> Some suggested that firms other than Big Four could be included at a later date or once they have reached a certain size (eg Baroness Bowles<sup>549</sup>).

## **Design and how the remedy would work in practice**

- 8.17 We recommend that the Secretary of State empowers and requires the regulator to design the specific details of the remedy, and refine it over time. But key elements of the operational split are likely be as follows:
- (a) A separate CEO and board for the audit practice, populated by a majority of independent non-executives, who would be accountable to shareholders of audited companies, and to the public interest (subject to conclusions of the Brydon review) via the regulator;
  - (b) The audit board should be responsible for all remuneration and career progression decisions within the audit practice, including recommendation to promotion to partnership;
  - (c) Remuneration and career progression should be strongly linked to audit quality, with the audit board setting and overseeing quality standards;
  - (d) The audit board should conduct an annual general meeting (in addition to business as usual meetings) and produce an annual report with disclosures to be determined by the regulator but including reporting on audit quality measures;
  - (e) Separate financial statements for the audit practice, consisting of an income statement;
  - (f) Transparent transfer pricing, checked by the regulator, eg for the use of non-audit specialists on audits;

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<sup>547</sup> ACCA response to Update paper, page 16, paragraph 2.

<sup>548</sup> Deloitte (February 2019), response to CMA update paper, p18, paragraph 23.1

<sup>549</sup> Baroness Bowles, response to Update paper, page 18, paragraph 35.



- (g) No profit-sharing between the audit practice and the non-audit practice; and
  - (h) The audit practice for the purposes of this remedy includes audit and essential non-audit services closely related to audit.<sup>550</sup>
- 8.18 The regulator will require the powers to implement these recommendations and enforce continued compliance, following legislation.
- 8.19 We discuss each of the elements of the remedy in more detail below.
- 8.20 The governance regime should include the audit business having its own CEO and separate board. The audit board should have responsibility for setting the audit business strategy and ensuring a culture of audit quality within the audit business, such as formulating, overseeing and enforcing quality control and remuneration policies (eg approving staff and partner remuneration, ensuring audit quality breaches are followed up and deciding the level of internal fines). In particular, we recommend that audit partner remuneration and career progression is directly linked to audit quality, as formulated and overseen by the audit board.
- 8.21 The board should have a majority of non-executive directors and should report on measures related to audit quality to the new regulator. Non-executive appointments should be approved by the regulator.
- 8.22 The issue of the board having a wider public interest responsibility should be informed by recommendations from the Brydon review on auditors' responsibility to the public. The public interest measures and associated reporting should be set by the regulator at a later date.
- 8.23 The board should conduct an annual general meeting (in addition to business as usual meetings) and produce an annual report. The regulator should determine more precisely what disclosures are required in the annual report, but they should include reporting on how audit quality is measured.
- 8.24 We recommend that the audit business produces and publishes separate accounts from the non-audit services business, consisting of an income statement. To do so will require the firms to put in place a transfer pricing regime (based on arm's-length prices), to ensure that the audit business is not cross-subsidised by other service lines and the international network. This should ensure that the audit business meets the full cost of resources and staff deployed.

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<sup>550</sup> These will be defined by the FRC in the Ethical Standard in 2019.

- 8.25 The firms should be required to produce and publish a non-confidential version of a transfer pricing manual. A confidential version of the manual (at the point when it is updated) and an explanation of material transfers (annually) should be provided to the regulator.
- 8.26 We recommend that any profit sharing between the audit and non-audit parts of the business outside the transfer pricing arrangements be prohibited. Given our recommendation that the audit business has a separate profit pool, the audit partners' pay should not be higher than the profits of the audit business (and associated essential non-audit services) in any given year. This is consistent with the requirement in the FRC's Ethical Standard that says, 'In particular, the amount of revenue that the firm derives from providing non-audit/additional services to the entity shall not form part of the performance evaluation and remuneration of any covered person involved in, or able to influence the carrying out of, an engagement'.
- 8.27 We recommend that the remedy initially applies to the Big Four. The issues that we have identified as detracting from a focus on audit quality, such as reward structures and the relative importance of non-audit services within a firm, are common to the Big Four and challenger firms. However, smaller firms will need additional resources to scale up quickly to take advantage of the proposed joint audit remedy and the proposed operational split may limit the investment that could be delivered by the wider firm. To ensure the effectiveness of our package of remedies as a whole, the operational split should apply to the Big Four initially. We recommend that the regulator considers whether elements of this remedy should be extended to other audit firms in due course or at the same time as the remedy becomes applicable to the Big Four.

## **Effectiveness**

- 8.28 The remedy should be effective in achieving a focus on audit quality rather than non-audit services. There should be increased oversight from an independent audit board, which should be able to set objectives prioritising the interests of audit and put systems and sanctions in place to ensure the focus on audit culture and audit quality.
- 8.29 Audit partner remuneration and promotion should be closely linked to partners' individual performance on audits and to the performance of the audit practice, due to the requirement for the board to ensure that objectives and remuneration are supported by audit quality measures. This would strengthen partner incentives to focus on audit quality.

- 8.30 In order to accurately track performance of the audit practice, the remedy should require separate accounts for the audit practice and transparent transfer pricing. These measures should ensure that there is transparency around performance of the audit practice. The measures delineate the financial performance of the audit practice that audit partners' pay should be based on, which should help further align their incentives with the success of the audit business.
- 8.31 The remedy should be fully effective if audit partner remuneration no longer depends even in part on the success of the non-audit business. This would only be the case if the non-audit business could not share part of its profits to supplement the audit profit pool. We therefore recommend a ban on profit sharing between audit and non-audit parts of the audit firm. The ban on profit sharing, together with a transfer pricing regime and a link of audit partner remuneration to the profit of the audit practice and audit quality measures should help ensure the audit partners' complete focus is on audit quality.
- 8.32 Publication of an annual report, separate accounts and a non-confidential transfer pricing manual (based on the principle of arm's length pricing) for the audit business should provide transparency to stakeholders and certainty that the audit business operates separately from non-audit. Stakeholders can also feed back to the regulator any issues they identify in the published documents and help best practice develop. Visibility of the publications should help address perception of audit partners continuing to be influenced by non-audit interests.
- 8.33 The AGM conducted by the audit board should enable audit partners to understand performance of the audit practice and its strategy and therefore embed the remedy in the audit practice. Non-executive members of the audit board should be approved by the regulator, to ensure independence of the board, an appropriate mix of skills and a focus on audit quality. The regulator will need to develop a policy for the independent appointment process.
- 8.34 We also expect that the existence of the separate audit board will incentivise the audit business to bid effectively for audit tenders, as its strategy will be set separately from the non-audit business. A separate profit pool will maximise such incentives, as any success in bidding for audit work will directly contribute to an increase in the audit business profit and the audit partner profit share. These measures should ensure greater competition for audit work.
- 8.35 The main threat to the effectiveness of the remedy is the potential that audit partners' decisions (eg whether to bid for an audit) may still be influenced by consideration of non-audit services, most notably if partners' pay is still

partially linked to the non-audit business. For example, transfer pricing could be set incorrectly, and the profit of the audit business might be artificially higher, subsidised by the non-audit business. In the regime where relative profits are transparent, it is possible that transfer prices will be set at a fair level, due to competing incentives of audit and non-audit partners to maximise their respective profit pools. However, the remedy, including transfer pricing and effectiveness of the audit board, will also require regulatory oversight, so the process and outcomes can be monitored. Therefore, the transfer pricing manual should be provided to the regulator.

- 8.36 Even in the situation where the remedy is fully effective and there are positive effects on audit quality and competition, perceptions of cultural mix within the firm and of audit work being influenced by considerations of non-audit work may remain, as audit staff will continue to work alongside non-audit experts within the same firm. This could be mitigated by making the new regime more visible, for example by the audit boards publicly explaining their role, providing regular reports to the regulator or publishing these. The publication of separate accounts and transfer pricing manuals should also make the distinction between audit and non-audit businesses more transparent.
- 8.37 There is a large behavioural element in the recommended remedy, as we are expecting audit partner incentives to change and become more focussed on audit quality and competing for audit work. The remedy will need some time to become fully effective. We recommend that the regulator revisits the remedy five years into its implementation to review its effectiveness and if necessary consider a more stringent version of the remedy, such as a full structural split, as part of the wider five-year review suggested earlier. This echoes the BEIS Select Committee's view that in the event of operational separation being ineffective in the near future, full structural separation should remain an option.<sup>551</sup>
- 8.38 We considered legal separation (within the same firm ownership) as a potential element of the remedy. BDO recently announced that it is putting plans in place to separate its audit and non-audit businesses. The audit division would be legally ringfenced and would 'demonstrate that it is sustainably profitable and not being subsidised by other parts of the firm, and have levels of governance to ensure that it is run by auditors, protecting the audit culture'.<sup>552</sup> The BEIS Select Committee's report also cited an example of operations within Big Four audit firms that have been legally separate, such

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<sup>551</sup> BEIS Select Committee (2019), The future of audit report, paragraph 141.

<sup>552</sup> 'BDO pushes ahead with plans to split audit and consulting units UK's fifth-largest accountant acts as MPs urge competition regulator to seek Big Four break-up', Financial Times, 7/04/2019.

as law practices.<sup>553</sup> It is therefore possible to put legal separation into practice within these firms.

- 8.39 Notwithstanding the BDO example, we recognise that legal separation may have tax implications and require some operational reorganisation of the business, eg in terms of employment contracts. Our proposed remedy includes the elements that we require for it to be effective<sup>554</sup> and we propose that the firms can choose the method of implementation that achieves our objectives – for example, some firms may wish to implement legal separation if it makes operational sense (along the lines of what BDO is doing).
- 8.40 Regulatory monitoring will be key for this remedy. It is feasible for the regulator to monitor the remedy implementation and its effectiveness as there will be easily observable milestones, such as the set-up of an audit governance board, production of a transfer pricing manual and separate accounts, as well as metrics, such as audit quality ratings.
- 8.41 The separate governance measures require changes to the Audit Firm Governance Code and may require changes to members' agreements. Separate accounts for the audit business could be put in place either via changes in legislation or changes to the Audit Firm Governance Code. The firms will need to consider and implement transfer pricing mechanisms.
- 8.42 We expect that the measures can be implemented within 12-18 months. Deloitte said that its proposed version of a change to the governance structure could be implemented within this period.<sup>555</sup> While our recommendation is more far-reaching than Deloitte's proposal, this indicative timing represents a reasonable guideline. As an example, the recent split of BT from Openreach took 18 months – this required significantly more work than our proposed remedy for the audit market is likely to involve, as the BT changes included separation of staff, assets, separate branding and resolving pension scheme issues<sup>556</sup>. Similarly, National Grid Electricity System Operator has been operating as a legally separate company within the National Grid group from 1 April 2019. The split took around 12 months to implement. The audit firms have all the expertise needed to implement this remedy quickly and effectively. We recognise that the operational split is not the only change affecting the audit firms and they will need to implement a

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<sup>553</sup> BEIS Select Committee the future of audit report, paragraph 135.

<sup>554</sup> These elements include profit pool separation and transfer pricing, which the Select Committee specifically highlighted delivering separation of economic interests for audit and non-audit (BEIS Select Committee report, paragraph 120).

<sup>555</sup> Deloitte response to Update paper, p17, paragraph 21.5.

<sup>556</sup> BT had a form of operational separation in place before. Eg BT undertakings in 2005 included establishing Openreach.

number of new processes at the same time (eg prepare to perform joint audits), consequently the implementation may take longer than the timeframe indicated above.

- 8.43 In terms of interaction with other remedies, the split would work alongside the resilience remedy. In particular, separate accounts for the audit business will make its financial performance transparent, enabling regulatory oversight and timely intervention if the business deteriorates.

## Proportionality

- 8.44 The remedy will be proportionate. First, it is effective in achieving its aims as described in the section above. Second, the remedy is no more onerous than necessary. Weakening any element of the proposed remedy would render it less effective.
- 8.45 The separate governance regime is required to ensure that the objectives of an audit practice and remuneration policies are clearly linked to audit quality and the implementation of such policies is monitored. An alternative arrangement may be allowing the firm (which includes the non-audit practice) to monitor audit quality objectives and remuneration policies. However, this is very similar to the current governance regime and would risk diluting the audit objectives because non-audit services form a larger part of the firm's revenues and therefore has potential to divert attention from audit services. We therefore concluded that a separate audit board is required. In addition, regulatory oversight is necessary in order to ensure that the remedy is implemented effectively.
- 8.46 It is necessary for audit partner remuneration to be linked to both audit quality and to the performance of the audit practice, hence the need for separate accounts, profit pools and transfer pricing between audit and non-audit practices. In absence of transfer pricing, some transfers between the audit and non-audit part of the business could be priced incorrectly and weaken audit partners' incentives to focus on audit quality. If profit sharing between audit and non-audit continued to be allowed, attention would continue to be divided between audit quality and the performance of the wider firm. We agree with the BEIS Select Committee, which said that 'an economic separation of audit and non-audit is highly desirable'.<sup>557</sup>
- 8.47 The remedy should allow legitimate transfers, such as non-audit staff working on audit assignments, payments for IT and HR support and loans from

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<sup>557</sup> BEIS Select Committee, *The future of audit*, 2 April 2019, paragraph 122.

another part of the firm. Regulatory oversight of transfer pricing mechanisms will ensure that these are operating as envisaged and disseminate transfer pricing best practice among the audit firms. Publication of the non-confidential version of the manual should aid transparency and allow stakeholders to identify and raise transfer pricing issues with the regulator.

- 8.48 The main one-off implementation costs are likely to include setting up a governance board (including recruitment), a transfer pricing regime, changing remuneration and audit quality enforcement policies, communicating the changes within the firm and establishing regular reporting to the regulator. None of these are fundamental changes to the structure of the firms. We expect that most firms will have the relevant experts readily available and therefore should be able to use internal expertise.
- 8.49 Ongoing costs will include salaries of the non-executive directors and the time requirement to engage with the regulator. We do not anticipate such costs to be significant. The requirement to obtain non-audit advice (and other input) at market rate may also result in an increase in costs to the audit practice. It is difficult to predict whether these increases will be significant and if they would be compensated by the non-audit part of the business paying the audit practice for auditor contributions. If such an increase is significant, audit fees will need to increase to cover such costs.
- 8.50 The regulator will require experts to monitor elements of the remedy and maintain a regular dialogue with the audit firms. We do not anticipate significant additional costs to the regulator as the regulator already has the relevant expertise, however there may be a need to recruit additional staff. Once the regime is set up, the ongoing monitoring costs are not expected to be significant.
- 8.51 A further separation of the audit and non-audit business, such as having separate legal entities under the same ownership, separate branding or a structural separation could also be effective in achieving our objectives. In terms of costs associated with such arrangements, respondents highlighted potential difficulties with access to non-audit staff, tax and pension costs and the ability of a structurally separate firm to succeed. We therefore selected our remedy, which is no more onerous than necessary.
- 8.52 Third, we have considered whether this represents the least onerous remedy between equally effective remedies.
- (a) As noted above, structural or legal separation could achieve the aims of this remedy but, for the reasons also stated above, would be more onerous.

(b) Some parties suggested less onerous remedies but we consider that these would not be as effective as the remedy we are proposing.

8.53 A number of stakeholders suggested a ban on non-audit service provision to audit clients. Certain large audit firms committed to not providing non-essential non-audit services to their FTSE 350 audit clients and the FRC is planning to consult on the revised text of relevant standards in July 2019.<sup>558</sup> The ban would address some of the issues we identified, such as removing incentives on audit partners to sell non-audit services to audit clients. However, it is unlikely to focus auditor attention on quality in absence of changes to remuneration and quality measures. For example, audit partners' profit shares will continue to be paid out of a combined profit pool covering the firms' audit and non-audit businesses, so the auditors will continue to have a direct interest in the overall profit of the firm, the majority of which is earned through non-audit work. For this reason, our remedy is necessary even if audit companies undertake not to provide non-audit services to audit clients.

8.54 The ban on non-audit service provision may also have adverse consequences for choice in the market.<sup>559</sup> This remedy is less effective than the one we propose, and we are therefore not recommending it.

8.55 Fourth, we have considered whether the remedy could produce any significant disadvantages and disproportionate adverse consequences. We list below the potential consequences we identified and explain why this is unlikely.

(a) Respondents raised concerns over the potential impact of our remedies on recruitment and retention of audit staff and partners. While the proposed remedy may have a negative effect on overall pay packages due to the ban on profit sharing, our analysis showed that audit businesses of the large audit firms were profitable on a standalone basis. The audit business is also likely to be able to increase audit fees if required to provide appropriate compensation to staff and partners. Audit staff will retain the ability to move to the non-audit side of the firm and international member firms, in the same way as they do now. We also said in the Issues section that only a small proportion of staff actually move from audit to non-audit. Therefore, we do not believe that our proposal would affect recruitment and retention.

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<sup>558</sup> FRC position paper, March 2019. [https://www.frc.org.uk/getattachment/7335d389-dbd0-4c4d-b265-1278ce9af5bb/Position-Paper-post-implementation-review-audit-ethical-standards-next-steps-\(March-2019\).pdf](https://www.frc.org.uk/getattachment/7335d389-dbd0-4c4d-b265-1278ce9af5bb/Position-Paper-post-implementation-review-audit-ethical-standards-next-steps-(March-2019).pdf)

<sup>559</sup> Incentives arising from the ban on non-audit service provision are discussed in more detail in the Issues sections, paragraphs 3.205-3.208.



- (b) Some firms went further and suggested these changes to firm structures might result in them pulling out of audit entirely. While divestment does not seem totally implausible under certain scenarios, what does seem implausible is that firms would simply withdraw from businesses that offer hundreds of millions of pounds of revenue, and adequate operating profits. Moreover, the international structures of these firms makes withdrawal even less likely – global audits often require UK coverage, so the international networks are likely to continue to need a UK audit firm.
- (c) We have been told that our remedies would make it more difficult for audit companies to access non-audit staff resource, particularly due to the seasonality of audits, and to ensure the quality and freedom from conflicts of such resource. Under our remedy, the audit and non-audit business would operate within the same firm, which already has established procedures to ensure non-audit staff availability and quality. The firm could put in place service level agreements to ensure appropriate access to resource to mitigate against potential friction due to separation requirements. Some firms also told us that they already outsource a limited amount of audit work to external experts in certain specialist areas. EY also suggested that specialist advice could be accessed on a contractual basis, albeit at greater cost and ensuring that necessary independence requirements are met. This suggests that quality of audits can be maintained even if there is some increased friction in obtaining non-audit advice within the firm due to our remedy, or if some non-audit services have to be commissioned externally.
- (d) Another concern we have heard is that an operationally separate audit practice would not be able to access the latest technology and training required for the audit firm, due to the loss of scale. This remedy does not prevent the audit practice from cooperating with both its international network and the non-audit service arm of the firm in order to develop and use the latest technology and training, and to share expertise, in the same way as they do now.
- (e) Separating audit and non-audit profits might deter investment in audit if the audit business could not obtain required finance or prioritised partner pay over investment. We do not consider that this is likely as the audit board would be able to influence the direction of the audit business. Moreover, our remedy will not preclude the audit business from accessing finance, and it should be able to borrow on favourable terms, given the predictability of cashflows. UK audit businesses are also large and profitable, and there is evidence that certain investments are coordinated by the international network (see Issues section), therefore we do not expect investment to be affected.

- (f) We have been told that an audit practice run separately from the larger non-audit practice would be less resilient, particularly in the context of being more dependent on large audit clients. However, we do not think that this is a real risk under the current remedy. Audit businesses have relatively predictable cashflows, which contribute to business stability. Audit businesses of the Big Four are sizeable separate businesses with UK revenues of £500-600m in 2018. We also do not see a significant risk that the auditors would reduce audit quality in an attempt to keep a large audit client if their personal remuneration largely depends on audit quality and there is a robust enforcement regime in place. There are also a number of further factors that contribute to resilience as described in the Issues section.
- (g) We considered whether the remedy is likely to result in higher indemnity insurance premiums for the audit business. The remedy should incentivise a focus on audit quality and therefore a lower risk profile of the business. As insurance is obtained for the wider firm rather than the audit business separately and the remedy does not envisage a business restructure, an increase in insurance premiums as a result of the remedy is unlikely. However, a larger part of the insurance cost could be recharged to the audit practice as most of the risk relates to audit. This is in line with our expectation that the audit business pays for the full cost of audit. Audit fees may need to increase as a result.
- (h) Some audit firms also said that a separation remedy may result in audit firms having to consolidate their regional offices and cause job losses and damage to the economy. Our chosen remedy does not change regional demand for audits, so regional office closures are unlikely. The remedy is expected to produce better quality audits, which would underpin confidence in the businesses that operate in the UK and therefore support the economy.
- (i) Some audit firms said that recent or proposed governance improvements make the remedy unnecessary. We have taken account of the firms' governance proposals when designing the remedy. However, as we said above, governance arrangements alone are insufficient to address our concerns and ensure audit partner focus on audit quality, if their remuneration continues to be partly linked to non-audit profit. In order to link audit partner pay more directly to their individual performance on audits and performance of the audit practice, we require other elements of the remedy, such as transfer pricing, separate accounts and a ban on profit sharing.

- 8.56 Based on the above, we have concluded that the proposed remedy should be both effective and proportionate.

## **Other suggestions aimed at linking audit partner remuneration to audit quality**

- 8.57 We have set out in this section why the operational split as described above is the most effective and proportionate remedy to address the issues that we identified. However, during the course of our study we were told that one element of an operational split should be a deferred compensation and clawback provision for senior staff and audit partners<sup>560</sup>, similar to that in the banking sector.<sup>561</sup> In the event the regulator considered it necessary to strengthen the remedy package, this remedy might help ensure that audit partner remuneration is further linked to audit quality.
- 8.58 Another option is to introduce cooling off periods during which non-audit services cannot be sold to a client once an audit engagement has ended for a set period of time (eg the BEIS Select Committee suggested three years).<sup>562</sup> This would ensure that auditors are focussed on audit quality without considering potential implications for future non-audit engagements with the client. This could be something for the regulator to consider already, as it carries out its review of its 'Ethical Standard', and as it subsequently implements this operational split remedy.

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<sup>560</sup> LG and LGIM response to the Update paper, section 5.2.3.

<sup>561</sup> 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.

<sup>562</sup> BEIS Select Committee report, paragraph 182.

## 9. Decision not to make a market investigation reference

- 9.1 In our Update Paper we gave notice of our proposal not to make a market investigation reference.<sup>563</sup> We also set out our reasons for that proposal and sought views.<sup>564</sup>
- 9.2 Of those responses that addressed the market investigation reference question, most respondents supported the CMA's proposal not to make a market investigation reference. Reasons included that a market investigation reference would delay reforms which would not be in the public interest.
- 9.3 However, some respondents said that the CMA should make a reference, or carefully consider making a reference. We heard 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. Some audit firms told us that recommendations of the nature proposed by the CMA were not an appropriate outcome for this market study.
- 9.4 Many respondents emphasised the need for the various audit reviews to be considered holistically and any reforms to be implemented in a coherent manner. In this respect, some suggested that the best way forward would be for the CMA to wait for the Kingman recommendations to be implemented, and the Brydon Review to be completed, before making an intervention – warning of unintended consequences given the changing regulatory landscape. Others took the view that recommendations to government would be more appropriate and pragmatic than a market investigation reference and would allow the government to consider all potential reforms in parallel.
- 9.5 The CMA has decided not to make a market investigation reference.<sup>565</sup> 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; and
  - (b) recommendations enable the sector to move forward without delay.

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<sup>563</sup> As required by section 131A(2)(a) of the Enterprise Act 2002.

<sup>564</sup> As required by section 131A(2)(b) of the Enterprise Act 2002.

<sup>565</sup> In accordance with section 131B(5) of the Enterprise Act 2002.

## The Secretary of State can consider all market features and potential reforms as a whole

- 9.6 The audit sector is facing significant scrutiny on many fronts. It is unusual for the CMA to undertake a market study at a time when the relevant sector is also subject to multiple other reviews, and the sector regulator is facing an overhaul. In this case, the government is currently consulting on the recommendations made as part of the Kingman Review; the Brydon Review is expected to produce a report later this year; the BEIS Select Committee has recently published its own report on the future of audit;<sup>566</sup> and the FRC has proposed a number of audit reforms.<sup>567</sup>
- 9.7 We agree with stakeholders that audit reforms should be considered as a whole and implemented in a cohesive way. In particular, it is important that the recommendations made as part of the Kingman Review are able to be considered in light of our proposals. The Secretary of State is taking forward recommendations to create a new audit regulator and, with our recommendations, he can do so with as much information and guidance as possible as to the powers that new regulator should have.<sup>568</sup>
- 9.8 As set out in this report, we have commented on proposals made by or in contemplation of other reviews where we considered those of particular relevance to our proposed remedies. But ultimately, the Secretary of State is best placed to bring proposals together and take forward coherent reform that has the best chance of addressing the intractable problems in the market.<sup>569</sup>

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<sup>566</sup> HC 1718, 2 April 2019, available at: [https://library.cronerico.uk/system/files/assets/cln/cch\\_uk/cln/pdf%3A05-04-19-1718.pdf](https://library.cronerico.uk/system/files/assets/cln/cch_uk/cln/pdf%3A05-04-19-1718.pdf)

<sup>567</sup> *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.

<sup>568</sup> See, for example, Recommendation 73 from the Kingman Review 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'.

<sup>569</sup> We note also that the Secretary of State will be best placed to determine whether, or to what extent, reforms will be affected by the Brydon Review. His comments to the Select Committee hearing indicate that he does not intend to wait for the Brydon Review to complete before bringing forward audit legislation to address the Kingman and CMA proposals but that anything emerging from the Brydon Review at that time can be communicated to the Secretary of State and considered: 'There is absolutely no intention of waiting. We will have the CMA report and we will have the Kingman report. Once we publish the legislation, as the Permanent Secretary says, anything that is emerging from the Brydon review can be communicated - that would be to this Committee as well as to me - and can be considered, but we are not going to hold back from legislation' (see Greg Clark response to Q680 and Q681 at the BEIS Select Committee hearing).

## Recommendations enable the sector to move forward without delay

- 9.9 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.
- 9.10 A CMA market investigation could take up to two years from the point at which it started, to reach a final report. Issues in the audit market have been looked at many times before. The benefits of a market investigation would be incremental in this case, whereas the potential costs and risks are significant:
- (a) A market investigation would delay implementation of the CMA's proposed reforms. We have moved swiftly in carrying out this market study taking account of the request by the Secretary of State.<sup>570</sup> We did this in order to ensure that the issues in this market – which have so far largely survived numerous attempts at reform – can be addressed without delay. The Secretary of State indicated to the BEIS Select Committee that he will seek to bring audit legislation forward as soon as possible.<sup>571</sup> The Secretary of State also indicated that it may be appropriate to deal with matters arising from the CMA's report in that proposed audit legislation.<sup>572</sup> This legislative window represents a clear opportunity for our proposals to be taken forward swiftly.
  - (b) In addition, it is not inconceivable that were we to prolong the CMA process through a market investigation, other reforms could be delayed. As noted above, stakeholders have told us that the outcomes of all of the parallel reviews should be considered as a whole.
- 9.11 By making recommendations to the Secretary of State and enabling the government to take these recommendations forward swiftly, the sector can move forward into an implementation and improvement phase rather than continued lengthy reviews.
- 9.12 Furthermore, if government takes forward our proposals for consultation and prepares draft legislation, the benefits of our remedies could be accelerated further still – as, for example, challenger firms would have a strong signal they should start to invest in growing their audit practices and the Big Four could

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<sup>570</sup> Letter from the Rt Hon Greg Clark to Lord Tyrie, 8 October 2018.

<sup>571</sup> Greg Clark response to Q648 at the BEIS Select Committee hearing regarding legislative reforms following the Kingman Review (<http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/business-energy-and-industrial-strategy-committee/future-of-audit/oral/98214.pdf>).

<sup>572</sup> Greg Clark response to Q667 at the BEIS Select Committee hearing.

begin preparing for, and possibly taking voluntary steps to implement, an operational split, ahead of the legislation being passed.

- 9.13 Audit is a heavily regulated sector. Following the Kingman Review we expect the UK to have a new and improved audit sector regulator. Over the medium to long term, it is likely that any remedies the CMA might propose are better monitored, adjusted and enforced by the sector regulator. If we still took this view at the conclusion of a market investigation, it is likely that recommendations would be considered more appropriate than CMA orders in any event.
- 9.14 Our remedies, if implemented, would result in significant change for the audit sector and would have a material impact on audit firms, FTSE 350 companies and other stakeholders. It is important to note that stakeholders will have opportunities to respond to further consultation and help shape the remedy design as part of the next stage of the process.

## Appendix: Conduct of the market study, and our data sets

1. This appendix provides a chronological description of the conduct of our market study and a description of the data sets we compiled.

### *Chronology*

2. On 9 October 2018, the CMA published a Market Study Notice and Invitation to Comment document, along with an administrative timetable.<sup>573</sup>
3. Since then our market study has involved various elements, as listed below.
  - (a) We invited responses to our Invitation to Comment document between 9 and 30 October 2018 and subsequently published on our website 75 responses we received.
  - (b) In October 2018 we sent requests for information to the Big Four and five challenger firms. We sought information on audit tenders, firms' financials, individual audit engagements, market data, audit and non-audit services, investment in technology and their internal documents relating to measures they may be considering in response to concerns about the statutory audit market.
  - (c) Between October and November, we sent requests for information to 63 audited companies in the FTSE 350 and Top Track 100 companies. Further details of the requests are set out below in the description of our data sets. We have also sought information from other companies in relation to the number of audit firms which bid for their audits.
  - (d) Between 9 October and early December, we held telephone calls and face to face meetings with over 60 parties to discuss the issues in the audit market and potential remedies. The parties included the Big Four and challenger firms, ACCs, investors, the FRC, Prudential Regulation Authority and pensions regulator, academics, BEIS, Sir John Kingman's independent review team and relevant regulatory bodies abroad.
  - (e) On 18 December 2018, the CMA published an Update Paper, which contained its findings on issues in the statutory audit market study as well proposals for remedies for consultation. We subsequently published on our website 95 responses we received.

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<sup>573</sup> See the [CMA's case page for the market study](#).



- (f) From 8 January 2019 to early April, the CMA conducted face-to-face meetings and telephone conferences with over 40 parties to discuss the issues and remedies outlined in the Update Paper. We held discussions with a range of stakeholders including, the Big Four and challenger firms, investors, companies, ACCs, the FRC, academics, and international regulatory bodies.
  - (g) On 7 February 2019, the CMA sent requests for information to the Big Four and four challenger firms. We sought information on audit partner remuneration, performance evaluation processes and criteria, as well as penalty systems relating to audit quality.
4. We would like to thank all who have assisted in our market study.

### ***Data sets***

5. We compiled data sets using information provided by companies, audit firms and other third parties (supplemented by public sources).
- (a) Industry background data set: information on the external auditor, fees paid to the external auditor and other commercial details for each company included in the FTSE 350 or Top Track 100 in the period 2012 to 2017.
  - (b) Tender data: details of tenders of FTSE 350 and Top Track 100 external audits, in the period 2013 to 2018, including the firms that participated and the fees bid.
  - (c) Audit Analytics data: information collected by Audit Analytics on the external auditor, fees paid to the external auditor and other commercial details for companies listed on the London Stock Exchange and other European financial market indices.
  - (d) Company sample: for a sample of 24 FTSE 350 companies, information in relation to i) tenders for the external audits and ii) the hours spent by audit committee members of audit related matters.
  - (e) Financial data: for each of the Big Four firms and bigger challenger firms (BDO, Grant Thornton, Mazars, RSM and Moore Stephens) information on audit and non-audit fees, costs and margins, for the UK firms.

### ***Industry Background data set***

6. We sent formal requests for information to each of the Big Four and bigger challenger firms (BDO, Grant Thornton, Mazars, RSM and Moore Stephens)

to provide data for all their audit clients in the FTSE 350 or Top Track 100 in the period 2012 to 2017. For this information request, we defined a company to have formed part of the FTSE 350 index if they had been in the FTSE 100 or 250 for at least two quarters of any year in this period.

7. For each company identified as being part of the FTSE 350 or Top Track 100 in the period 2012 – 2017, the Industry Background data set included the following:
  - (f) The registration number of the company and the UK Standard Industry Classification (SIC) Primary code used to classify businesses according to the main type of economic activity in which they are engaged;
  - (g) The name of the company's auditor and the year of the company's first audit engagement with their auditor in each year; and
  - (h) The fees received by the audit firm from the company in each year, with these fees split into the those received for audit or non-audit services during the financial year.
8. Around 86% of the observations included in the Industry Background data set were taken from the submissions of the nine audit firms, with the remaining 14% sourced from the FAME database. The majority of the company information taken from FAME (around 61% of the observations sourced from FAME) were for companies that were included in the Top Track 100 during the period 2012 to 2017.

#### *Tender data*

9. We sent formal requests to each of the Big Four and challenger firms for information on any tenders for FTSE 350 or Top Track 100 audits that they participated in since January 2013. This included tenders where there was an informal approach by or discussion with the company.
10. We merged the response to compile information on 250 FTSE 350 tenders and 23 Top Track 100 tenders which were completed between January 2013 and October 2018.<sup>574</sup> In doing this we used information from the market data to identify the incumbent audit firm for each tender.
11. In compiling the final data set we:

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<sup>574</sup> Our sample of FTSE 350 tenders increased from 247 tenders at the time of the Update Paper. This was due to additional data being provided by the Big Four in response to clarification questions on audit tenders in the FTSE 350.

- (a) excluded information on tenders that occurred before 1 January 2013 and ongoing tenders;
  - (b) excluded information on tenders where there was no identified winner or date;<sup>575</sup>
  - (c) excluded information on tenders where the tendering company was not in the FTSE 350 or Top Track 100 for at least two quarters of the year in which the tender occurred;<sup>576</sup> and
  - (d) excluded the information provided by one challenger firm due to concerns about its accuracy.
12. The information provided may not be absolutely complete. For example, we are aware of occasions in our dataset where an audit firm has not included information on a tender in its submission when it did in fact participate in that tender.

#### *Audit Analytics data*

13. Audit Analytics is a market research firm that collects information on publicly listed companies in North America and Europe. We used data provided by Audit Analytics to:
- (a) estimate the number and timings of tenders for FTSE 350 audits during the period 2020 to 2029 based on rules on mandatory tendering and rotation, as well as the transition arrangements put in place for companies with historic audit engagements, and the expected level of fees each tender;
  - (b) provide information on the provision of audit services to companies listed in the FTSE Small and AIM indices in 2017; and
  - (c) understand the characteristics of the audit market for French companies listed on the SBF 120 and CAC Small in the period 2012 to 2017.
14. The information provided by Audit Analytics is similar to that held in the Industry Background data set, including:

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<sup>575</sup> Where date information was missing from an individual firm's submission we first identified whether the relevant tender appeared in other firms' submissions. Where this was the case we assumed that the tender information with the missing date was for the same date as the most common date for that tendering company across other firms' submissions.

<sup>576</sup> Where necessary we standardised dates across all firms' submissions. For example, where, based on information from all firms, the same company appeared to tender in consecutive years we assumed there was only one tender.

- (a) the UK Standard Industry Classification (SIC) Primary (or French NAICS) code used to classify businesses according to the main type of economic activity in which they are engaged;
  - (b) the name of the company's auditor(s) and the year of the company's first audit engagement with their auditor in each year; and
  - (c) the audit fees received by the audit firm(s) from the company in each year.
15. This information was supplemented by publicly available information on the constituents of the FTSE and AIM indices in 2017, as well as by company information taken from the FAME database.

### *Company sample*

16. We sent informal information requests to a sample of 58 companies that were included in the FTSE 350 or Top Track 100 in 2018 and had tendered their external audit in the period 2012 to 2018.
17. We took a two-stage approach to selecting the sample: First, we used the full list of 450 companies to select 45 companies that would provide a representative sample. This sampling approach used the company's total turnover, turnover from the UK, total and net assets, as well as the company's UK SIC code to ensure the sample represented the variation of companies included in the FTSE 350 or Top Track 100 in 2018. Second, we then added companies from the full list of 450 companies that allowed the sample to include companies audited by challenger audit firms or in sectors particularly important to the UK economy (such as companies that provide financial and insurance services).
18. We asked the companies to provide information on the following:
- (a) details of the most recent tender for statutory audit services including information on tender lists, and fees bid and agreed;
  - (b) certain documents relating to the most recent tender including: the request for a proposal; score cards or other methods used by the audit committee to evaluate bids; records of the audit committee decision in relation to the selection of the successful audit firm; and any papers submitted by the audit committee to the main company board and/or shareholders;
  - (c) information on the time spent by audit committee members on audit committee and external audit related matters, details of the resources

available to ACC and details of communication with the FRC on audit matters;

- (d) key considerations in selecting the firms invited to tender, factors limiting choice, views on level of choice, switching costs and experience of switching; and
- (e) the effects of recent technological developments in audit and financial reporting on switching auditor.

19. We received full responses from 24 FTSE 350 companies and only one Top Track 100 company, with some of the requested information provided by one further Top Track 100 company.

### *Financial data*

20. As noted above, we asked the Big Four firms and five challenger firms<sup>577</sup> to supply us with financial data covering the period from 2011 to date. We asked for information covering the following categories:

- (a) an analysis of total annual revenues into three revenue streams: audit services, non-audit services to audit clients, and non-audit services to other clients;
- (b) for each of audit and non-audit services, a breakdown of annual revenues and average revenue recovery rates by specific category of client (FTSE, AIM, Top Track, etc.);
- (c) a breakdown by the same specific categories (FTSE, AIM, Top Track, etc.) of each firm's number of audit clients and aggregated annual audit hours deployed;
- (d) the audit and non-audit fees received by the UK practice of audit firms from the largest companies in selected industries, including the Banking, Information and communication, Insurance, Mining and quarrying and the Outsourcing sectors;
- (e) overheads, direct staff costs and profit margins associated with each of audit and non-audit services;
- (f) amounts invested into audit IT systems, both globally and in the UK;

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<sup>577</sup> Grant Thornton, BDO, RSM, Mazars and Moore Stephens.

- (g) the number of partners, trainees and graduates, support staff and other staff employed by both the audit and non-audit arms of each firm;
  - (h) annual average rates of staff switching from audit to non-audit teams, analysed separately for trainees and graduates and other staff; and
  - (i) average annual partner salaries and drawings, and average annual staff salaries.
21. We used the information received to analyse the financial performance of the firms. In particular we compared and contrasted the audit arms and non-audit arms within firms, and also collectively the Big Four firms against the challenger firms.

#### *Auditor Remuneration*

22. In February 2019, we sent formal requests for information to each of the Big Four and four challenger firms (BDO, Grant Thornton, Mazars, RSM) to provide information and documents relating to:
- (a) audit firm partner and staff remuneration proposals and criteria against which staff are assessed;
  - (b) remuneration policy documents for audit partners and audit staff; and
  - (c) the number of members of the audit firm's defined benefit pension scheme.
23. We used the information received to understand how audit partners are appraised and rewarded, including the extent to which audit quality performance affects individuals' pay, and whether there are any specific incentives on auditors to promote non-audit work.

# Glossary

<b>The Act</b>	Enterprise Act 2002.
<b>AC</b>	Audit Committee.
<b>ACC</b>	Audit Committee Chair.
<b>ACCA</b>	Association of Chartered Certified Accountants.
<b>ACCIF</b>	Audit Committee Chairs' Independent Forum.
<b>ACR</b>	Audit Committee Reports.
<b>AEC</b>	Adverse effect on competition.
<b>AFM</b>	Dutch Authority for the Financial Markets.
<b>AGM</b>	Annual general meeting.
<b>AIM</b>	Alternative Investment Market.
<b>AQR</b>	Audit Quality Review (team of the <b>FRC</b> ).
<b>ARGA</b>	Audit, Reporting and Governance Authority.
<b>Auditor</b>	A person or a firm appointed by a company to execute an audit.
<b>Audit Analytics</b>	Market research firm that collects information on publicly listed companies in North America and Europe.
<b>Audit-related services</b>	Services provided to clients that are of a similar nature to statutory audit.
<b>BDO</b>	BDO LLP.
<b>BEIS</b>	Department for Business, Energy and Industrial Strategy.
<b>BHS</b>	British Home Stores.
<b>Big Four</b>	Collective term for the four largest audit firms: <b>Deloitte</b> , <b>EY</b> , <b>KPMG</b> and <b>PwC</b> .
<b>Brydon Review</b>	The independent review into the quality and effectiveness of audit led by Sir Donald Brydon.
<b>CAC Small</b>	Stock market index used by the Paris Bourse.
<b>Carillion</b>	Carillion Plc was a facilities management and construction services company that went into liquidation in 2018.

<b>Challenger firms</b>	Audit firms outside the <b>Big Four</b> . For example, firms such as <b>BDO</b> , <b>Grant Thornton</b> , <b>Mazars</b> , <b>RSM</b> , and <b>Crowe</b> .
<b>CC</b>	The Competition Commission.
<b>CC investigation</b>	The Competition Commission's Statutory Audit Market Investigation.
<b>CFO</b>	Chief Financial Officer.
<b>'Cherry-picking'</b>	A process by which the Big Four would reduce their market share by shedding their most risky or least profitable audit clients.
<b>CIMA</b>	Chartered Institute of Management Accountants.
<b>Crowe</b>	Crowe U.K. LLP.
<b>The Companies Act</b>	Companies Act 2006.
<b>Company</b>	An audited entity.
<b>Deloitte</b>	Deloitte LLP.
<b>EBIT</b>	Earnings before interest and taxation.
<b>EC</b>	European Commission
<b>EU</b>	European Union
<b>EY</b>	Ernst & Young LLP.
<b>'Expectations gap'</b>	The mismatch between the role of auditors and public expectations of their role.
<b>Fame database</b>	Database of company information and financials for UK and Irish businesses.
<b>FCA</b>	Financial Conduct Authority.
<b>FD</b>	Finance Director.
<b>FRC</b>	Financial Reporting Council.
<b>FTSE 100 Index or FTSE 100</b>	The largest 100 companies by market capitalisation which have their primary listing on the London Stock Exchange.
<b>FTSE 250 Index or FTSE 250</b>	Companies 101 to 250 when companies which have their primary listing on the London Stock Exchange are ranked by market capitalisation.
<b>FTSE 350 Index or FTSE 350</b>	A market capitalisation weighted stock market index incorporating the largest 350 companies by capitalisation which have their primary listing on the London Stock



	Exchange. It is a combination of the <b>FTSE 100 Index</b> of the largest 100 companies and the <b>FTSE 250 Index</b> of the next largest 250 companies.
<b>FTSE small</b>	Index of small market capitalisation companies consisting of companies 351 to 619 when ranked by market capitalisation.
<b>Grant Thornton</b>	Grant Thornton UK LLP.
<b>H3C</b>	The Haut Conseil du Commissariat aux Comptes, the French public audit oversight body.
<b>IAASB</b>	The International Auditing and Assurance Standards Board.
<b>ICAEW</b>	Institute of Chartered Accountants in England & Wales.
<b>IFIAR</b>	International Forum of Independent Audit Regulators.
<b>INEs</b>	Independent Non-Executives.
<b>Investor</b>	A person that allocates capital with the expectation of a future financial return.
<b>IRBA</b>	The South African audit regulator, the Independent Regulatory Board for Auditors.
<b>ISA</b>	International Standards on Auditing.
<b>ITC</b>	Invitation to Comment to the Market Study (the launch document for the study).
<b>Kingman Review</b>	The independent review of the Financial Reporting Council led by Sir John Kingman.
<b>KPMG</b>	KPMG LLP.
<b>L&amp;G</b>	Legal & General Group Plc.
<b>LAPFF</b>	Local Authority Pension Fund Forum.
<b>LGIM</b>	Legal & General Investment Management Limited.
<b>LLP</b>	Limited liability partnership, a partnership which has been incorporated, and where the liability of the members is limited to the capital held in the company.
<b>Mandatory rotation</b>	European Union rules compelling companies to tender their audit at least every ten years and switch their auditor at least every twenty years.
<b>Mazars</b>	Mazars LLP.

<b>Moore Stephens</b>	Moore Stephens International Ltd. Former audit firm that merged with BDO in February 2019.
<b>Moral hazard</b>	It is the risk that the remedy signals to stakeholders that the audit practice could be 'bailed out', resulting in excessive risk taking by audit partners.
<b>Non-big Four</b>	All audit firms excluding, the Big Four being Deloitte, EY, KPMG and PwC.
<b>OECD</b>	Organisation for Economic Co-operation and Development.
<b>OFT</b>	Office of Fair Trading.
<b>PCAOB</b>	Public Company Accounting Oversight Board in the United States.
<b>PIE</b>	Public Interest Entity. Defined by the European Audit Directive as any entity whose transferable securities are traded on a regulated market, credit institutions such as banks and building societies, and insurance undertakings.
<b>PIRC</b>	Pensions & Investment Research Consultants Ltd.
<b>PRA</b>	Prudential Regulation Authority.
<b>PwC</b>	PricewaterhouseCoopers LLP.
<b>RSM</b>	RSM UK.
<b>Sarbanes-Oxley Act (SOX)</b>	An act to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities law, and for other purposes.
<b>SATCAR</b>	The Statutory Auditors and Third Country Auditors Regulations 2016
<b>SBF 120</b>	French stock market index.
<b>Shareholder</b>	An individual or institution that legally owns one or more shares of stock in a public or private corporation.
<b>Sharesoc</b>	Not-for-profit organization, created by investors.
<b>SIC code</b>	Standard Industrial Classification code (a system for classifying industries using four-digit codes).
<b>SLC</b>	Significant lessening of competition
<b>Top Track 100</b>	The largest 100 private companies in the UK by sales.
<b>UKSA</b>	UK Shareholders' Association.

