

Restoring trust in audit and corporate governance

Response from the Competition and Markets
Authority

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Summary

1. This paper sets out the Competition and Markets Authority's (CMA) response to the UK Government's [Restoring trust in audit and corporate governance](#) White Paper. The White Paper seeks views on proposals to strengthen the UK's audit and corporate governance regimes, following the CMA's 2019 [audit market study](#) as well as Sir John Kingman's review of the Financial Reporting Council (2018) and Sir Donald Brydon's review of the quality and effectiveness of audit (2019).
2. In its market study, the CMA concluded that the audit market suffers from deep-seated problems.¹ The CMA therefore welcomes the Government's commitment to restoring trust in audit through a range of ambitious reforms arising from the three independent reviews. The consultation contains many proposals that take on board the CMA's findings and recommendations and can make a lasting difference to the health and quality of the audit market. In particular, we welcome the focus on increasing choice and resilience, the separation of audit practices, and the regulatory scrutiny of audit committees. We also welcome the proposed competition objective for the regulator, which should underpin the approach taken to the sector. Healthy competition is critical to raising audit quality and building a more resilient industry. In some areas, such as the remuneration of audit partners, the Government may need to do more.
3. Ultimately, the reforms should be judged by the results they produce. For the Big Four, this means putting into effect plans to separate their audit practices and focussing on improving audit quality. For the Challengers,² this means expanding their operations with confidence and growing into a position to compete with the Big Four. The CMA is pleased that the Government intends to take reserve powers to go further than the current proposals, if these do not deliver the deep change that is needed. The final question by which success should be measured is: does the market compete effectively to deliver high-quality audits, and can it be assumed to do so for the long term? A key outcome that a reformed, well-functioning market should yield is fewer audit failures.
4. The CMA's response details how healthy competition can be restored to the audit market, for the benefit of all. We would be happy to discuss any of the material in this paper.

¹ See: CMA, Statutory audit market study: [Summary of final report](#), 18 April 2019.

² "Challengers" are audit firms outside the Big Four (Deloitte, Ernst and Young, KPMG, PwC). This group includes firms such as BDO, Grant Thornton, Mazars, RSM, and Crowe.

Consultation Response

1. Background – the role of the CMA

- 1.1 The Competition and Markets Authority (CMA) is an independent non-Ministerial government department and is the UK's lead competition and consumer authority. Its mission is to make markets work well in the interests of consumers, businesses and the economy. This paper sets out the CMA's response to the UK Government's [Restoring trust in audit and corporate governance](#) White Paper published on 18 March 2021.
- 1.2 In October 2018, the Government asked the CMA to consider what can be done to improve competition in the audit sector.³ The CMA responded by launching a market study into statutory audit services. When we completed the study in April 2019, we concluded that the audit market is not delivering the choice and quality that a well-functioning market ought to, and that its structure is dangerously fragile.⁴
- 1.3 The CMA's report made recommendations to Government to fix the problems that afflict the sector. The goal was and remains to create a market where more than four firms can audit the largest and most complex companies; a resilient market where poor quality is punished through loss of business and good quality rewarded. The CMA's principal recommendations were:
- (a) An operational separation of the audit practice from the rest of the firm, where the audit practice has its own leadership, separate remuneration and separate profits. This remedy would raise quality by mitigating firm-level conflicts of interest and reducing cultural tensions between audit (challenging management) and consulting services (helping management). The separate profit pool for the audit practice would ensure that audits are fully priced, which would benefit competition too.⁵
 - (b) Joint audits for most large companies involving at least one auditor from outside the Big Four or the appointment of a single non-Big Four auditor if a company does not want joint auditors. This remedy would enable firms outside the Big Four to develop the capacity and capability to audit the UK's

³ [Operation of the audit market: letter from Rt Hon Greg Clark to Lord Tyrie, CMA Chair](#), 9 October 2018.

⁴ CMA, [Statutory audit market study](#), 18 April 2019.

⁵ The audit fee should cover the full economic cost: audit operating costs, audit partner remuneration, and the costs associated with managing the litigation risks (e.g. insurance premiums). Full pricing should benefit competition by levelling the playing field and encouraging bidding and entry, as we explain later.

biggest companies. Building up the Challenger firms would increase choice for companies and make the market more resilient.

- (c) The introduction of statutory powers to enable the regulator to scrutinise closely the work and decisions of companies' audit committees, and hold them to account. This remedy would focus competition on quality by ensuring that audit committees choose auditors that are likely to provide the most robust and constructive challenge to the company's accounting practices, instead of auditors who show 'cultural fit' or appear accommodating.
- (d) Powers to monitor the market and intervene to preserve choice in the event of distress or failure of a Big Four firm. The regulator would seek to minimise the number of audit contracts that transferred to the remaining Big Three in such a scenario.

1.4 It is clear from the CMA's report, the other independent reviews⁶ and the report of the BEIS Select Committee⁷ that fixing the audit market requires a package of reforms, and that there is a range of viable options. All involve trade-offs, none is perfect, but taken together they must deliver the goal set out above. In responding to this consultation, the CMA aims to help the Government design such a package and give it the best chance of success.

⁶ [Sir John Kingman's Independent review of the Financial Reporting Council \(2018\)](#) and [Sir Donald Brydon's independent review of the quality and effectiveness of audit \(2019\)](#).

⁷ BEIS Committee, [Future of Audit Report](#), April 2019.

2. The importance of healthy competition in the audit market

- 2.1 At all times, a healthy economy requires reliable information. Audits, in particular, provide an independent check on the information⁸ that companies produce and assess how future risks might affect the reliability of that information. In doing so, robust, challenging audits increase trust in business and markets, improve the allocation of capital and ultimately support better economic outcomes for the benefit of all. Conversely, recurring audit failures lead to wasted capital and opportunities, and ultimately erode trust in markets.
- 2.2 At times of deep uncertainty and economic turbulence, such as those we are currently facing, the importance of high-quality audits is greater than ever. Unlocking the full contribution that audit ought to make to the economy and society is a vision shared by the Government, the three independent reviews⁹ and the BEIS Select Committee¹⁰.
- 2.3 A well-functioning competitive market should deliver the high-quality audits that the economy needs. But the audit market as it stands is broken. It is not providing the right incentives to drive up quality. With so few players, there is too little choice, and the position could worsen dramatically if one of the Big Four firms collapsed or withdrew. The decisions and actions of audit partners are potentially compromised by firm-level tensions between what should be an independent and sceptical audit practice and a commercially-focussed consulting arm, with the latter having come to dominate the profits and culture of the entire firm.
- 2.4 Regrettably, the quality of too many audits in the UK has remained substandard year after year. A quarter of the audits that the Financial Reporting Council (FRC) reviewed in 2018/19 required improvements, rising to a third in 2019/20 – a level the FRC described as ‘unacceptable’.¹¹ The FRC highlighted ‘insufficient audit evidence and challenge of management’ as ‘recurring findings over several years, with a factor being inadequate application of professional judgement and scepticism’, along with ‘late timing’ and ‘insufficient resourcing’.¹² The 2020 results stressed again that auditors are not ‘standing up to management’ enough.¹³ After the cases of BHS, Carillion and Patisserie

⁸ Mostly, though not only, financial. The Brydon review also recommended widening the scope of audits.

⁹ Sir John Kingman, [Independent Review of the Financial Reporting Council](#), December 2018; CMA, [Statutory audit services market study: Final report](#), April 2019; Sir Donald Brydon, [Independent Review into the quality and effectiveness of audit](#), December 2019.

¹⁰ BEIS Committee, [Future of Audit Report](#), April 2019

¹¹ FRC, [Audit Quality Inspection](#), July 2020, p. 5

¹² FRC, [Achieving high quality audits consistently \(letter to audit firms\)](#), 8 November 2019

¹³ FRC, [Audit Quality Inspection](#), July 2020, p. 5

Valerie, Wirecard appears to be the latest example of the destructive consequences that can flow from a lack of challenge and scepticism by auditors.

- 2.5 In a well-functioning market, companies delivering an inadequate quality of service lose business to better ones. But in the audit market, alternatives are few, sometimes none. A quarter of the most important audits have only one or two bidders to choose from, because conflicts of interests and mandatory rotation rule out one or more of the Big Four.¹⁴ If one of the Big Four exited the market, many of the UK's largest companies would be left with no choice at all. So, not only is there little real choice, but the current setup is also a threat to the resilience of the system, in the event of a firm collapsing or withdrawing. The Big Four are too few to fail.
- 2.6 That is why restoring healthy competition to the audit market is essential to increasing quality, choice and resilience. This package of reforms needs to ensure that the market produces strong incentives to deliver high-quality audits, fostering greater choice to underpin a race to the top and improve the resilience of the sector. The recommendations in the CMA's report and the other reviews contribute precisely to establishing these conditions – a less concentrated market where competition is focussed firmly on quality.
- 2.7 Finally, we believe that the competition objective for the new regulator is crucial to facilitate a shift away from the longstanding reliance on direct regulatory oversight as the single means of improving audit quality. Our assessment, like that of Sir John Kingman, is that this approach has not worked well enough to date, and that more attention needs to be devoted to ensuring that market mechanisms are working to support high-quality audits now and in the future. This means fostering greater choice to underpin a race to the top; and it means supporting the emergence of new competitors to improve the resilience of the sector.

¹⁴ CMA, Statutory audit services market study: Final report, 18 April 2019, para 3.103

3. Views on proposals in the White Paper

3.1 The consultation contains many promising proposals that take on board the CMA's findings and recommendations and could make a lasting difference to the health and quality of the audit market. Some proposals differ in some respects from those recommended by the CMA in its market study. But the test of their merit is not how precisely they conform with the CMA's recommendations, but the outcomes they are likely to produce. Above all, do they lead to a market that competes effectively to deliver high-quality audits, and that can be confidently assumed to do so for the long term? The details will be crucial. In particular:

- (a) Will the FRC be able to focus competition in the audit market firmly on quality through the thorough scrutiny and vigorous challenge of the work and decisions of companies' audit committees?
- (b) Are the market opening measures likely to result in Challengers bidding for and winning tenders of the largest companies as sole, high-quality auditors when the measures are lifted?
- (c) Will the FRC's 'principles for operational separation' ensure that audits are fully priced and audit partners solely focussed on and remunerated for delivering good audits, without financial interests in the performance of the rest of the firm?
- (d) More generally, will the approach to regulation recognise the role that healthy competition has to play in improving audit quality, rather than relying solely on rules and supervision?

3.2 The following section discusses the details that are key to delivering long-lasting reform, in response to the relevant consultation questions.

In response to questions listed in the consultation document

Q52. Do you agree that ARGA should be given the power to set additional requirements which will apply in relation to FTSE 350 audit committees?

3.3 With the right conditions, incentives and regulations in place, competition can be a powerful driver of quality. The CMA's recommendation that audit committees should come under greater scrutiny by the regulator will increase their accountability and focus the selection of auditors on quality.

- 3.4 To achieve that, the CMA recommended that the regulator have the duty and power to mandate minimum standards for both the appointment and oversight of auditors.¹⁵ Among other things, the standards should:
- (a) prioritise independence, challenge and technical capability above ‘cultural fit’;
 - (b) prevent management from influencing Audit Committees on their recommendation of auditor to the board;
 - (c) encourage non-Big Four firm firms to participate in tenders, and ensure that their tenders are given 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.
- 3.5 We are pleased that this recommendation has been taken forward and support the Government’s proposals.

Q53. Would the proposed powers for ARGA go far enough to ensure effective compliance with these requirements? Is there anything further the Government would need to consider in taking forward this proposal?

- 3.6 The CMA recommended new powers to allow the regulator to monitor compliance effectively.¹⁶ The regulator should obtain sufficient information to put it in a position to grade Audit Committees’ performance and 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 to avoid undue bureaucracy. They should include the ability to:
- (a) request reports from Audit Committees – the regulator should mandate that Audit Committees succinctly report to it explaining how they have complied with the standards it set;
 - (b) request information 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; and

¹⁵ CMA, [Statutory audit market study](#), 18 April 2019, Recommendation 1.

¹⁶ CMA, [Statutory audit market study](#), 18 April 2019, Recommendation 1.

- (c) if necessary, place an observer on the Audit Committee or in another part of the audit process.
- 3.7 The regulator also needs powers to take remedial action where non-compliance is found. We made the following suggestions:
- (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 to challenge Audit Committees and auditors, for example, at AGMs.
- 3.8 We are pleased that these recommendations have been taken forward and support the Government's proposals.
- 3.9 We believe that this package will be effective on its own terms. In extreme cases, however, it could be complemented by the regulator's ability to reach for the stronger powers recommended by Sir John Kingman. For instance, Sir John proposed that the regulator be given the power to order the removal of the auditor or require an immediate retendering,¹⁷ and to recommend to shareholders that they change the Audit Committee or its chair.¹⁸ Such last-resort powers could also serve as a deterrent.

Q61. Should the 'meaningful proportion' envisaged to be carried out by a Challenger be based on legal subsidiaries? How should the proportion be measured and what minimum percentage should be chosen under managed shared audit to encourage the most effective participation of Challenger firms and best increase choice?

- 3.10 To increase choice in the market, the CMA recommended building up the capacity and capability of Challenger firms to take on large and complex audits. To do that, the CMA recommended that Challenger firms be appointed alongside the Big Four to carry out the audits of FTSE 350 companies.
- 3.11 The model we recommended for this in our market study report was joint audits. That said, joint audit is not the only model of partnership between Challenger and Big Four that could prove effective. We explained this in an opinion piece for the ICAEW magazine (published in February 2020), and in written evidence

¹⁷ Independent Review of the Financial Reporting Council, 2018: Final Report, Recommendation 49.¹⁸ Independent Review of the Financial Reporting Council, 2018: Final Report, Recommendation 50.

¹⁸ Independent Review of the Financial Reporting Council, 2018: Final Report, Recommendation 50.

to the BEIS Select Committee's inquiry on delivering audit reform (published in October 2020).¹⁹ What matters most is the substance of the arrangement. We set out two key criteria against which to judge the likely effectiveness of alternative models in our written evidence:

- (a) Does the model develop the capacity, skills and experience of the Challenger, substantially and at pace?
- (b) Does it give the Challenger clout over management (e.g. the ability to issue a negative opinion on the accounts) and make its work prominently visible to the outside world (e.g. by publishing the Challenger's report alongside the company's accounts)?

If so, it stands a good chance of delivering the CMA's end goal of healthy and resilient competition in a market where Challengers bid for and win tenders of the largest companies as sole, high-quality auditors. The ultimate test of managed shared audits is what happens when they are lifted.

3.12 In our submission, we also listed the features that should be considered seriously in order to meet these criteria in practice:

- (a) The Challenger firm should be responsible for auditing material, complex parts of the business.
- (b) It should write a separate audit report, published alongside the company's accounts, and be responsible and liable for it.
- (c) The audit partner from the Challenger firm should engage with and report to the company directly, including the group Audit Committee.
- (d) The Challenger firm should be guaranteed, wherever possible, a substantial percentage of the overall fees of the engagement.
- (e) The number of companies that are automatically exempted from the remedy should be minimised; alternatively, the remedy could be applied to the whole market, with companies having to individually justify to the regulator why they are unable to comply.
- (f) The option for companies to appoint a sole Challenger instead of Challenger and Big Four together.

3.13 The subsidiaries model of shared audit proposed by the Government has strengths. It would ensure that the second firm engages directly with the group

¹⁹ ICAEW, [Opinion: the CMA on the future of audit](#), 19 February 2020; [CMA's submission](#) to BEISCom's Delivering Audit Reform inquiry, October 2020.

audit committee, audits a complete set of accounts, issues an audit opinion on these and is fully liable for it. Through the auditor's report, the firm's work would be clear to the outside world. Thus, this model directly supports features (b) and (c) set out above. The White Paper proposes to apply the measure to all companies, thus delivering feature (e) – to apply the remedy to the whole market and minimise exemptions. The possibility of bringing the largest and most complex companies in scope of the remedy early on is an advantage of shared audits that should be seized.²⁰ The White Paper also includes feature (f), the option for companies to appoint a sole Challenger as group auditor instead of a shared appointment.

3.14 All of which leaves the related features (a) and (d), which ensure that the Challenger firm audits material, complex parts of the business and claims a substantial share of the overall fees. The two go hand in hand because the Challenger's audit fee will reflect the quantity and complexity of the work undertaken. And they go to the heart of this consultation question.

3.15 The White Paper proposes to define and calculate the Challenger's meaningful proportion:

with reference to one or more of the total audit fee (in the prior year), group revenues, profits and assets of the company, with the Challenger's proportion to be no less than 10% of these criteria and preferably closer to 30%. It is recognised that the Challenger's proportion is likely to be at the lower end of this range for the largest and most complex FTSE 350 companies, at least at the outset.²¹

3.16 Before going into some detail, it is worth reiterating the long-term goal that this measure needs to achieve: getting Challenger firms to a position where they can individually bid for and win tenders to audit the largest and most complex companies. We wish to state clearly that the shared audit model (replacing joint audits) and its implementation will need to be very ambitious to have a good chance of success within a reasonable timeframe.

3.17 The consultation notes that '[t]he CMA's initial modelling indicated that after ten years of the measure, Challenger firms could expect to have at least a 10-12% share of FTSE 350 audit fee'.²² However, this isn't and shouldn't be interpreted as a goal, since it falls far below the choice and resilience that need to be fostered in this market. Rather, it was a description of what would happen at the end of a 10-year phasing-in period for joint audits, if each company in the

²⁰ This is because, under the joint audit model, Challengers would not have been in a position to manage the complexity and liability of auditing the largest and most complex companies on a joint basis from the outset.

²¹ Para. 8.1.17.

²² Para 8.1.4.

FTSE 51-350 appoints joint auditors no earlier than its next mandatory re-tendering of the audit engagement.²³ This modelling excluded the top 50 companies in the FTSE, which is where the largest audit fees are concentrated. Shared audits can and should go faster since the remedy can be applied to the whole market, as discussed above.

3.18 With respect to the allocation of work between joint auditors, the CMA proposed:

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 [...].

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.²⁴

3.19 In this light, we would encourage the Government and the FRC to set the 30% Challenger proportion of fees as a harder target, rather than an ambition that risks being undershot more, and more often, than needed.²⁵ Although 30% is unlikely to be achievable, at least initially, for the largest and most complex companies (as stated above in the White Paper), setting a high target should have a significant anchoring effect in discussions and decisions; and the burden would then be on individual companies to justify why they were unable to meet the target. This would be far preferable to a system that anchors discussions and decisions around a 10%-30% range. Put simply, 30% should be the starting point. The target and minimum floor should be kept under review and the FRC should be free to raise either or both, if progress is too slow.

3.20 In terms of how the proportion should be measured, we believe that the audit fee is the better proxy to ensure that the work of the Challenger is material and substantial. While three of the metrics listed (audit fee, revenue and assets) correlate with the size of the audit work, the audit fee should track it more reliably. For example, not all assets and revenues are created equal: some are

²³ CMA, [Statutory audit market study](#): Final report, 18 April 2019, para. 6.40.

²⁴ CMA, [Statutory audit market study](#): Final report, 18 April 2019, para. 6.41.

²⁵ See above quote from White Paper describing the Challenger proportion as 'preferably closer to 30%'.

straightforward to audit, while others require high degrees of expertise and professional judgement, and are inherently riskier. We would caution, however, against using the share of profits. Profits and losses are naturally volatile. And since the difference between reporting a profit or a loss is qualitatively material in and of itself, small profit figures can warrant just as much audit work as large ones.

- 3.21 Moreover, there is a direct read-across between the share of the audit fee and the measurement of market shares. Given that market shares is a critical way to measure the progress of this remedy, it makes sense to have a target at the individual audit engagement level that links to the overall aim. In conclusion, our view is that the share of the audit fee should be the primary metric, which may or may not be usefully complemented by other metrics such as the share of revenue or assets.

Q62. How could managed shared audit be designed to incentivise Challenger firms to invest in building their capability and capacity? What, if any, other measures, would be needed?

- 3.22 The Challengers' limited engagement to date with the audit tenders of FTSE 350 companies reflects at least in part the low to negative expected return on the investment. Building up the capacity and capability to bid for and carry out a large audit is a substantial investment, and one that a firm will only undertake if it believes it has a good chance of success. If Challengers think that their chances are low because the market is tilted towards the Big Four, they will not invest in competing head-to-head.
- 3.23 Therefore, the key to incentivising Challengers to invest is to change that calculus. Crucial to doing this is a transparent, credible and swift timetable from the Government and the FRC to implement the market opening measures. In addition to reducing uncertainty, the size of the opportunity is critical too: the greater the prize on offer, the larger the investment the Challengers are likely to make. This point reinforces the recommendation in our previous answer that the Government and the FRC should aim high in the implementation of the shared audit model. Likewise, this is another reason to use the audit fee to set the target and minimum floor for the Challenger's share of the audit: to provide more certainty over the size of the opportunity.
- 3.24 The broader package of measures matters a great deal too. For example, the regulator's new standards for, and scrutiny of, audit committees holds much promise in ensuring that the selection of auditors is not biased in favour of the Big Four. Eliminating the bias – both real and perceived – will improve the Challengers' expected pay-off from bidding.

3.25 Lastly, the importance of general confidence in the Government's commitment to the end goal of seeing Challengers audit the largest companies as sole auditors cannot be understated. The Government can sustain confidence through a clear message that the goal – and the will to do what it takes to reach it – are here to stay.

Q63. Do you have comments on the possible introduction in future of a managed market share cap, including on the outlined approach and principles? Are there other mechanisms that you think should be considered for introduction at a future date?

3.26 The CMA is pleased that the Government intends to take reserve powers to implement a managed market share cap. This will be based on reserving a proportion of upcoming tenders for Challengers if shared audits do not help them become sole auditors of FTSE 350 companies quickly enough. We are supportive of the principles the Government outlines, which address the issues we set out in our 2019 market study as well as our 2020 opinion piece and submission to the BEIS Committee. We agree that:

This approach acts to preserve choice and competition between the largest audit firms by not setting individual market share caps and to ensure there is independent regulator oversight and supervision of which FTSE 350 audits are reserved for Challengers.²⁶

3.27 The managed market share cap probably involves more work and risk for the regulator. On the other hand, it carries the benefit of matching the capacity and capability of Challengers to upcoming audit tenders that the regulator would set aside for them.

Q64. Do you have any further comments on how the operational separation proposals should be designed, codified (in legislation and regulatory rules), and enforced in order to achieve the intended outcome of incentivising higher audit quality?

3.28 We are pleased that all but one of the key elements of the operational split that the CMA recommended have been taken forward.²⁷ The CMA's consistent view has been that audit partners should only be remunerated from the profits of the audit business. We restated that view most recently in our BEISCom submission in October 2020.

²⁶ Para. 8.1.29

²⁷ See: CMA, [Statutory audit services market study: Final report](#), April 2019, p. 187-8

- 3.29 The importance of the missing element is, however, worth restating. Operational separation should improve quality by reducing firm-level conflicts of interests and realigning the culture and incentives of the audit practice towards delivering high-quality audits. Critical to this is ensuring that audits are fully priced, and audit partners solely focussed on and remunerated for delivering good audits, without financial interests in the performance of the rest of the firm. In other words, the interests of the wider firm should not be allowed to compromise the incentives of audit partners.
- 3.30 Currently, it appears that the rest of the firm subsidises the remuneration of audit partners. For example, according to KPMG's submission to the CMA's market study, without non-audit profits, 'audit partner remuneration could not be maintained at a sufficiently competitive level to continue to attract the requisite talent based on the current audit prices.'²⁸ The CMA believes that a situation where audit partners benefit financially from non-audit business is not a good one. It can only lead to audit partners being mindful of the interests of the wider firm, compromising incentives to provide the robust and challenging audit that is needed by investors, employees and the wider public.
- 3.31 Closely related to this, it is important that the price of audits covers their full economic cost. Ensuring that audits are fully priced would level the playing field with the Challengers, who may not be able to support their audit practice with the consultancy's profits and below-price specialist skills in the way that the Big Four can.²⁹ For the same reason, cross-subsidised audit pricing reinforces the dominance of multidisciplinary, mostly non-audit firms. It makes it all but impossible for an audit-only or audit-mainly model to compete viably. It runs contrary to the goal of encouraging the emergence of firms with a greater focus on audit. In sum, if separation pushes prices to reflect the full economic cost of providing the service, that will strengthen the financial independence of the audit practice, support investment in quality, increase bidding and encourage entry.
- 3.32 The FRC (as well as the industry) have taken positive steps to start implementing the elements of operational separation that we outlined in our report.³⁰ The FRC published 22 'principles for operational separation' on 6 July 2020. The FRC's objectives, which are to ensure that 'people in the audit practice are focused above all on delivery of high-quality audits in the public

²⁸ KPMG, Response to CMA's Audit update paper, (25 January 2019), para 21.15.

²⁹ For example, because their consultancy arms are smaller as a proportion of the firm. The audit share of the Big Four's income in 2019 was 19%; outside of the Big Four, the audit share was 28%. See: FRC, [Key Facts and Trends in the Accountancy Profession](#), October 2019, p. 43-4.

³⁰ See: CMA, [Statutory audit services market study: Final report](#), April 2019, p. 187-8

interest', and that 'no material, structural cross subsidy persists between the audit practice and the rest of the firm',³¹ match the goals the CMA set out.

- 3.33 On the specific question of the distribution of profits to audit partners, Principle 17 aligns with the CMA recommendation, even though the aim is achieved by different means:

[T]he FRC will assess whether the overall distribution of profits to the partners in the audit practice and to those in the rest of the firm is consistent with their respective contributions to firm profits, with no material, structural cross subsidy persisting in either direction.

This assessment will take account of any non-recurring items and investment to improve audit quality.³²

- 3.34 The difference with the CMA's proposal is that our preferred implementation is structural, while the FRC's is principles-based. A separate profit pool (our recommendation) would automatically ensure that audit partners are paid out of the profits of the audit practice.³³ Any alternative solution should be devised to achieve the same outcome. In other words, the total amount of profits distributed to audit partners should equal the profits distributed out of the audit practice. That is what Principle 17, its application by the firms and enforcement by the FRC should be judged against. The FRC should also clarify that the costs of audit failure (e.g. fines, litigation, damages) must ultimately be borne by the audit practice and partners alone, not the wider firm.
- 3.35 On a point of detail, we are not opposed in principle to the FRC allowing some limited and well-defined flexibility for the audit practice to spread the cost of exceptional, non-recurring items over several years – so long as certain conditions apply. Any flexibility should be justified on audit quality and/or resilience grounds; it should be well-policed; and it should not alter the incentives of audit partners. The distribution test should still be met for the period over which the exceptional cost is spread, i.e. the total amount of profits distributed to audit partners should still equal the profits distributed out of the audit practice. Any further flexibility should only be countenanced in exceptional circumstances that pose a clear threat to the survival of the audit practice.
- 3.36 Ultimately though, if the FRC's model doesn't deliver the full pricing and transparency needed, the regulator ought to have the power to impose a

³¹ FRC, [Principles for operational separation of audit practices](#), 6 July 2020, p. 1

³² FRC, [Principles for operational separation of audit practices](#), 6 July 2020, p. 3

³³ And to be clear, separate pools would be no barrier to the audit practice sharing investments, for example buying specialist software, with the rest of the firm. The Big Four already share technologies and investments with the overseas members of their network, who are entirely separate and separately owned foreign entities. See: BEIS Select Committee, [The Future of Audit](#), April 2019, p. 38

separate profit pool. We therefore welcome the Government's intention to 'give ARGA powers to strengthen the governance of audit practices, building on the Financial Reporting Council's principles'.³⁴ As discussed above, these principles do aim to eliminate material profit sharing (Principle 17). For the same reason, we also welcome the proposed reserve powers 'to enable the regulator to deliver a full structural separation in future'³⁵ if the current proposals fail to deliver an absolute focus on audit quality in the audit practice.

3.37 In sum, the FRC shares the CMA's view on the remuneration of audit partners – and they have already announced and asked the industry to work towards this goal. The Government should support this ambition.

Q65. The Government proposes to require that all audit firms provide annual reports on their partner remuneration to the regulator. This will include pay, split of profits, and which audited entities they worked on. Do you have any comments on this approach?

3.38 This proposal is sound if it supports the regulator's ability to monitor remuneration and ensure it is linked to quality. However, this does not and should not replace the separation of profits (whether structural or principles-based), as discussed in the previous answer. Audit quality is difficult to measure at the best of times. And even assuming that a strong link between remuneration and quality is obtained, the Government should still ask itself why other partners are seemingly content to subsidise the pay of their audit colleagues. At a minimum, the firms' remuneration report should make clear the extent of this subsidy (by comparing actual pay to what it would have been under separate profits and arms' length transfer pricing).

QQ66-67 on how to implement split profit pools and how to implement full separation of professional services firms, should the Government wish to do so in future.

3.39 We wish to register again our support for these reserve powers, as discussed in answer to question 64. With regard to the specific questions being asked on implementation, the CMA's thinking is set out in our market study report.

Q68. [With regard to the resilience of audit firms and the audit market] Do you have comments on the proposed measures? Are there any other measures the

³⁴ Para. 8.2.8

³⁵ Para. 8.2.15.

Government should consider taking forward to address the lack of resilience in the audit market?

- 3.40 The CMA is broadly happy with the package of proposals. The Government proposes using the managed market share cap power to address the risk that clients and employees will automatically migrate to one of the remaining large audit firms in the event of a Big Four failure. We are supportive of this power, as discussed in answer to question 63.
- 3.41 This section of the consultation also proposes giving ARGA the power to carry out market studies under Part 4 of the Enterprise Act 2002 (EA02) and the power to take enforcement action against anti-competitive practices and abuses of a dominant position under the Competition Act 1998 (CA98). ARGA would exercise these powers concurrently with the CMA, under the concurrency regime.
- 3.42 We support concurrent powers under EA02. We note the proposal for concurrent powers under CA98. The establishment and maintenance of concurrent CA98 expertise and capability alongside ARGAs sector regulatory expertise and capability will entail operational costs which will need to be weighed against the extent to which the CA98 powers are likely to be utilised, and the relative importance of competition law enforcement and pro-competition regulation in the audit sector. While it is true that CA98 enforcement has a potential role to play in embedding a culture of competition, in our view, CA98 powers are unlikely to be the main route to driving competition in the audit sector. We feel it is less important here than the role ARGAs must play in driving competition through its regulatory decision-making. As such, we see the statutory competition objective as substantially more important.
- 3.43 The CMA strongly supports the competition objective, and sees it as a major positive step for the new regulatory regime. The objective should permeate all decisions ARGAs takes, and encourage a regulatory approach that seeks to deliver outcomes by working with the grain of the market. It should also ensure that ARGAs is focused on fostering a more resilient sector in the longer term. In practice, of course, the extent to which this happens will depend on how the new regulator interprets this duty and translates it into its policy decisions and use of regulatory powers.