

Competition and Markets Authority

Statutory Audit Market – Invitation to  
Comment

Response from the Investment  
Association

30 October 2018

## EXECUTIVE SUMMARY

The Investment Association<sup>1</sup> (IA) welcomes the CMA undertaking this review of the Statutory Audit Market and the opportunity to respond to the Invitation to Comment. In preparing this submission, feedback was sought from the IA's members and also from the members of the Company Reporting and Auditing Group (CRAG) in that it is the main UK grouping of buy side institutional investors that specifically focuses on accounting and auditing issues.

In managing assets for both retail and institutional investors, the IA's members are major investors in companies whose securities are traded on regulated markets. They have an interest in the requirements governing the preparation and audit of companies' accounts as users. We consider this is an opportune time to review if the perceived lack of competition in the audit market is impacting audit quality. The IA's members rely on the quality and robustness of audits when making investment decisions and holding company management to account. A high quality audit is vital to ensure the markets trust and have confidence in the information companies report.

Set out below are the IA's key observations on the matters raised in the Invitation to Comment, and in the attached Annex its answers to the particular questions raised.

- On the whole, IA members consider that historically the audit sector has served stakeholders well in that instances of audit failure have been relatively isolated. This is a function of the professional qualifications required, the systems and processes that operate, and effective regulation. That said, when failures do occur they can have serious implications (question 1).
- For investors audit quality is key. Whilst in the past the FRC's AQR noted that its audit inspection results were improving, in June 2018 it indicated that "the Big Four audit practices must act swiftly to reverse the decline in this year's audit inspection results if they are to achieve the targets for audit quality set by the Financial Reporting Council". Whilst it is difficult for investors to judge the quality of individual audits, this trend is concerning and undermines investor confidence in audit which is vital to the effective operation of the capital markets. This needs to be addressed (question 1).
- Audit committees are expected to challenge auditors and their work and investors consider they may not be carrying out this role effectively. Whilst audit committees report on how they assessed the independence and effectiveness of the external audit, investors would like them to give more insight into audit quality. Committees should

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<sup>1</sup> The IA champions UK investment management, a world leading industry which helps millions of households save for the future while supporting businesses and economic growth in the UK and abroad. Our 250 members range from smaller, specialist UK firms to European and global investment managers with a UK base. Collectively they manage £7.7 trillion for savers and institutions, such as pension schemes and insurance companies, in the UK and beyond. Forty per cent of this is for overseas customers. The UK asset management industry is the largest in Europe and the second largest globally.

assert whether they believe the audit has been challenging, the granularity of key accounting issues and how the auditor challenged management's judgement and assertions, and exercised professional scepticism. At present this is not transparent (question 3).

- Investors are concerned that the Big Four appear to be largely "cosily competitive" with each other in that there is little evidence of the development that a fully competitive market can bring to meet market needs (see question 2). This can impact audit quality and the IA's members consider it critical that companies prioritise audit quality when selecting an auditor. This is further impacted by the limited choice an audited entity can have when it tenders its audit. For example, the incumbent may be time barred and unable to participate in the tender process; others could be precluded as they are providing prohibited non-audit services to the entity; and others could audit competitors of the entity (question 6 and 8).
- To address the above, it is vital that the non Big Four scale up their operations so that they can compete for the audit of large, complex audits. In this context, the audit committee of a FTSE 350 company can be reticent to appoint non Big Four auditor on the basis they do not consider they are credible for the scale and complexity of their business. This can mean that non Big Four firms are reticent to participate in a tender. In addition, the costs of tendering a major audit can be more easily absorbed by a large audit firm and can be a barrier to entry for the non Big Four firms. Investors expect a wide range of firms to be invited to tender and that only the larger multinational groups should have to restrict their choice to the Big Four (question 5, 6 and 11).
- The ongoing resilience of the audit market needs to be addressed. The present level of market concentration compromises regulatory oversight in that the regulator might not be willing to impose significant sanctions for fear of driving one of the major players out of the market. Resilience could mean other auditors take on the clients of an existing auditor following exit. However, this could serve to exacerbate choice issues in that, as happened with the demise of Anderson where staff transferred to Deloitte, it is likely to result in the Big Three as opposed to the Big Four (question 12).
- Investors do not consider that "audit only" firms and separating the ownership of the audit and non-audit services practices of the UK audit firms a solution. A quality audit requires quality staff who can challenge and apply economic rationale. If firms were restricted to providing only audit services, it could impact their ability to attract and retain such staff. That said, independence is important for quality and a number of investors consider a limited ban on non-audit services could be introduced. This could be to ban the provision on non-audit services to audit clients in the FTSE 350 and/or PIEs (questions 16 and 18).
- The Big Four audit firms are international and are often responsible for the audit of global companies. They need to remain connected to the international network to service global clients. Any remedies cannot be viewed in isolation but need to have

international reach in order to be effective. This needs to be acknowledged more by the CMA (question 17).

- Some investors consider a market share cap that sets a limit on the proportion of large companies that the Big Four could audit could be a means of increasing the number of audit firms in the market. It would also be preferable to a forced break up which would take a long time, be fraught with legal difficulties and be an issue if the UK splits firms whilst the global networks remain unified. Others have reservations as to how this would play out in practice. For example, say a cap was imposed of 20% of the audit market for any one auditor. The Big Four would thus take 80%. Given we understand that the top half of the FTSE 350 accounts for 94% of all FTSE 350 fees; these are unlikely to be a big part of the non-Big Four's 20%. In addition, this remaining 20% is likely to be particularly risky, costly in terms of geographic distribution, complex and have reputational issues (questions 19 to 22).

We trust that the above and attached are self-explanatory but if you require any clarification of the points raised or wish to discuss any issues further then please contact Liz Murrall at [liz.murrall@theia.org](mailto:liz.murrall@theia.org) or on +44 (0) 207 269 4668.

## THE IA'S ANSWERS TO THE DETAILED QUESTIONS RAISED

The IA's answers to the detailed questions raised are set out below.

### A) ISSUES

#### 1. How well is the audit sector as a whole serving its stakeholders?

On the whole, IA members consider that historically the audit sector has served stakeholders well in that instances of audit failure have been relatively isolated. This is a function of the professional qualifications required, the systems and processes that operate, and effective regulation. That said, when failures do occur they can have serious implications for companies, the people they employ, their suppliers and shareholders.

A well-functioning market for audit services and high quality audits is essential to ensure there is trust in corporate reporting. Whilst in the past the FRC's AQR noted that its audit inspection results were improving, in June 2018 it indicated that "the Big Four audit practices must act swiftly to reverse the decline in this year's audit inspection results if they are to achieve the targets for audit quality set by the Financial Reporting Council<sup>2</sup>".

For investors quality is key and this trend is concerning in that it undermines investor confidence in audit which is vital to the effective operation of the capital markets. This needs to be addressed.

In addition, we consider that all too often audit firms consider the audited entity to be their clients. It is a company's shareholders that rely on the auditor's work and to whom the auditor reports. Auditors should consider the investor community to be their true clients and ensure their needs for a quality audit are met. In this context, certain major investors would welcome audit firms discussing the planning process with them so that any significant concerns they have can be addressed.

Specifically as regards audit quality, investors consider it can be particularly impacted by a lack of independence and objectivity which can arise from:

- The incentives that operate.
- The limited number of players and the resilience of the market.
- Non-audit services and the conflicts that result.

We thus welcome this Invitation to Comment and the CMA looking at these issues. We set out under the questions that follow our views on each of these matters. It is an opportune

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<sup>2</sup> The FRC highlighted that 73% of FTSE 350 audits reviewed in 2017/18 were categorised as requiring "no more than limited improvements" as compared to 81% in 2016/17.

## THE IA'S ANSWERS TO THE DETAILED QUESTIONS RAISED

time to review if the perceived lack of competition in the audit market is impacting audit quality.

### THEME 1: THE AUDIT FRAMEWORK

#### **2. How well does the audit framework support the interests of both direct shareholders and also wider stakeholders in the economy?**

We set out above how in general we consider the audit framework is serving the interests of direct, long-term shareholders but note that there are concerns.

As noted in the Invitation to Comment, over time accounting standards have moved from historic cost to an approach based on fair value. Fair value accounting requires more judgement due to the difficulties in valuing and auditing certain assets and liabilities. In this context, it is a concern that a continuing theme in AQR reports is a lack of professional scepticism by auditors and challenge to management in relation to key judgements. Professional scepticism is vital when key areas of accounting and disclosure depend on management's judgement. However, as noted by the AQR, auditors sometimes do not challenge management enough and focus too much on gathering and accepting evidence to support management's assertions.

Investors are also concerned that auditors are not necessarily developing their offering to meet market needs. For example, we welcomed the enhanced audit report in particular the clarity around the risks of material misstatement and what the auditor did. However, only one audit firm reported on their findings – what they found, graduated as appropriate– for around nine audits. That firm wrote to all the entities it audits asking if they would agree to their audit reports being enhanced in this way. However, the entities refused in spite of investors asking for this. This does not send a particular good message to investors who rely on the auditors work and to whom the auditor reports. It is important that auditors consider the investor community as the true clients.

In addition, the annual report and accounts are not necessarily the only measure of a company's performance and there may be some benefit in exploring whether audit should cover the wider metrics a company considers important. We also recognise that reporting and auditing is increasingly meeting a growing set of needs and is aimed at wider stakeholders than just shareholders. Shareholders, as the providers of a company's risk capital and bearers of the residual risk, want companies to report how they are creating, sustaining, and protecting value over the long term – see IA's [Long Term Reporting Guidance](#). We consider that other stakeholders' interests are very much aligned with this in that if shareholders' needs are satisfied, then we believe the needs of other external users are likely to be also.

### THEME 2: INCENTIVES AND GOVERNANCE

**THE IA'S ANSWERS TO THE DETAILED QUESTIONS RAISED****3. To what extent do the decisions made by audit committees support high quality audits, whether through competition for audit engagements or otherwise?**

For investors audit quality is key. Investors are concerned that audit committees do not sufficiently challenge management on their judgements or auditors on the depth of work and analysis they have undertaken, and are not necessarily carrying out their role effectively. The IA welcomed the increased transparency by audit committees following successive revisions of the UK's Corporate Governance Code. Audit committees are required to report on how they assessed the independence and effectiveness of the external audit. However, investors have been disappointed in that in practice often the description is generic and based on the answers to questionnaires that in the main have been drafted by audit firms. Investors would like audit committees to give more insight into audit quality. They should assert whether they believe it has been challenging, the granularity of key accounting issues and how the auditor challenged management's judgement and assertions, and exercised professional scepticism. At present this is not transparent.

We also supported the EU Audit Regulation from June 2016 requiring audit committees to be responsible for the audit tender process and the final recommendation to the board. Whilst the tender process may involve operations and finance functions, oversight by the audit committee is important in the interests of ensuring the tender is managed and directed in the interests of a company's shareholders. We consider the audit committee should direct the planning and oversee the process, including identifying candidates, setting the audit quality criteria for selection and conducting the interviews. In this context, the whole committee should be involved in that the tender should not just be the responsibility of the audit committee chair. The audit committee should also ensure there is an RNS announcement when the decision is made. See IA's [Audit Tender Guidelines](#).

Another concern that investors have is that an audit committee's members often include those that were previously a partner in, or employed by, an audit firm. This can give rise to a perceived conflict of interest if that audit firm is a prospective tender candidate and it is important that the appointment process is seen to be independent. A balance needs to be struck between ensuring the audit committee has the right skill set and managing such conflicts. Thus conflicts should be identified well in advance of the tender process. Investors' general preference is that at least three years should have elapsed from when a company director was a partner in, or employed by, an audit firm before the firm can be considered for appointment as auditor. That said, an audit firm may be appointed where the audit committee takes steps to manage and mitigate any conflicts.

**4. How has this changed following the Competition Commission's intervention?**

The IA supported the Competition Commission's remedies following its report and order effective from 1 January 2015. However, this was soon followed by the EU Audit Regulation

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and Directive implemented from June 2016. It is difficult to establish causality, but we consider it was these later interventions, together with revisions to the UK Corporate Governance Code, that have had the most impact on the role of audit committees.

**THEME 3: CHOICE AND SWITCHING****5. Is competition in the audit market working well? If not, what are the key aspects hindering it?**

The IA considers the fact that the Big Four firms dominate the audits of companies in the FTSE 350 is not healthy for competition or choice. As we set out under question 6, in practice large companies do not have much choice when carrying out an audit tender. Moreover, as noted in the Invitation to Comment, the audit committee of a FTSE 350 company can be reticent to appoint an auditor that is not from the Big Four on the basis they do not consider they are credible for the scale and complexity of their business. This can mean that non Big-Four firms are reticent to participate in a tender. In addition, the costs of tendering a major audit can be more easily absorbed by a large audit firm and can be a barrier to entry for the non Big Four firms. It is vital that the non Big Four scale up their operations so that they can compete for the audit of large complex audits.

In this context, we do not believe it likely that there will be an organically developed competitor to the Big Four in the medium term. Furthermore, the situation could be aggravated in that there is a risk that one of the main four firms could fail.

**6. In particular, how effective is competition between the Big Four and between other firms and the Big Four?**

The IA is concerned that the Big Four are largely "cosily competitive" with each other in that there is little evidence of the development that a fully competitive market can bring to meet market needs (see question 2). This can impact audit quality. This lack of competition is further impacted by the limited choice an audited entity can have when it tenders its audit. Thus the incumbent may be time barred and unable to participate in the tender process; others could be precluded as they provide prohibited non-audit services to the entity; and others could audit competitors of the entity. It is clear that previous reforms which aimed at addressing competition and choice have not been effective – question 7.

To ensure confidence in corporate reporting, it is essential to have a well-functioning market for audit services. Investors expect a wide range of audit firms to be invited to tender and, where practical, firms other than the Big Four should be included. Each candidate should have a genuine prospect of being successful. Investors consider that, depending on each group's circumstances, only the larger multinational groups should have to restrict their choice to the Big Four audit firms.

**7. How has this changed following the Competition Commission's intervention?**

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The 2013 [report](#) of the Competition Commission on the provision of statutory audit services noted that the overwhelming majority of audits in the FTSE 350 are undertaken by one of the four largest audit firms: Deloitte; EY; KPMG; and PWC. As the Invitation to Comment notes since then there has been a slight increase in the number of FTSE 350 audited by the Big Four. This indicates that competition in the audit market is not working well and that the measures taken since 2013 be they the Competition Commission's remedies or the EU Audit Directive and Regulation have only served to exacerbate the situation.

### 8. **What is the role for competition in the provision of audit services in delivering better outcomes (i.e. consistently higher quality audits)?**

Given the importance of a quality audit to the capital markets, the IA's members consider it critical that companies prioritise audit quality when selecting an auditor. Investors want the auditor that will provide the highest quality audit appointed and prospective auditors should demonstrate clearly that they can provide a quality service and compete on quality issues. This should help drive innovation in the market place and achieve consistently higher quality audits over time.

Our members consider it important that the audit committee ensures that in making its recommendation for an auditor's appointment it puts audit quality and not price as its main criterion. Fees should be considered as part of the tender process in that they should be reasonable, i.e. not too low to suggest audit quality could be impaired and not too high as to be excessive. However, they should not be the main deciding factor particularly in the early stages of the tender process. In this context, over time if the firms invest in more and better technology then this should result in a reduction in the cost of audits and associated fees.

### 9. **In practice, how much choice do large companies and public interest entities have in the appointment of an external auditor?**

As noted under question 6, large companies do not have much choice in terms of candidates for appointment. The incumbent may be time barred and unable to participate in the tender process; others could be precluded as they are providing prohibited non-audit services to the entity; and others could audit competitors of the entity.

### 10. **What are the key factors limiting choice between auditors?**

The IA considers there are a number of factor that limit an entity in its choice of auditor, which can include the auditor's:

- Technical skills
- Industry and/or sector specific knowledge
- Geographical reach
- Adequacy of resource

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- Technological advances

### 11. What are the main barriers to entry and expansion for non-Big Four audit firms?

Even if a non-Big Four audit firm can provide the necessary skills/knowledge set out in question 10, there are still barriers to entry in that:

- The audit committee of a FTSE 350 company can be reticent to appoint an auditor that is not from the Big Four on the basis they do not consider they are credible for the scale and complexity of their business.
- The above can mean that non Big Four firms are reticent to participate in a tender. We are aware, and it is noted in the Invitation to Comment, that Grant Thornton announced earlier this year that it will no longer compete for FTSE 350 audits in that it was losing out to the Big Four.

The costs of tendering a major audit can be more easily absorbed by a Big Four audit firm and can be a barrier to entry for the non-Big Four firms.

## THEME 4: RESILIENCE

### 12. Is there a significant risk that the audit market is not resilient? If so, why?

The IA considers that the present level of market concentration compromises regulatory oversight of the market in that the regulator might not be willing to impose significant sanctions for fear of driving one of the major players out of the market - they are 'too big to fail'. Whilst, as acknowledged in the Invitation to Comment, resilience could mean the ability of other auditors to take on the clients of an existing auditor following exit, we are concerned that this could serve to exacerbate the choice issues in that, as happened with the demise of Anderson where staff transferred to Deloitte, it is likely to result in the Big Three as opposed to the Big Four.

## THEME 5: REGULATION

### 13. What is the appropriate balance between regulation and competition in this market?

Competition and regulation interact closely in the audit market and it is important that an appropriate balance is struck and that one does not impede the other. Generally, investors favour increasing competition as opposed to regulation in that the former reduces and the latter increases costs. As regards the regulatory oversight of the sector, the IA responded to

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Sir John Kingman's Review of the Financial Reporting Council (FRC). In our response we noted that:

- Members have concerns over the quality of FRC's enforcement and investigation work in the audit market, and question whether the FRC is doing enough to hold auditors to account. There are concerns that both auditors and the FRC are too focused on complying with a set process rather than achieving the right outcomes.
- An effective regulator needs to employ effective deterrents. Some members have suggested that the FRC's use of audit fines is ineffective as they are insignificant when compared to the revenue of these firms. Members feel that the non-financial sanctioning of individual auditors has had a significant impact.
- Investor views on the FRC's audit work are mixed. Some investors feel that the FRC is doing a good job, with no clear evidence that there are underlying issues over the quality of audits. However, others believe that the FRC needs to make adjustments, such as looking at more audits through the AQR and publishing the outcomes of individual companies' AQRs. Investors support increasing the number of AQRs and increasing the sample size for these reviews, in order to improve the reliability of the results.

In addition, whilst not raised in the response to Sir John Kingman's review, certain investors consider that it is important that rulemaking and enforcement in respect of audit are separated in that at present these are both within the remit of FRC.

### B) POTENTIAL MEASURES

#### **14. Please comment on the costs and benefits of each of the measures in Section 4 and how each measure could be implemented.**

The IA comments on each of the measures in Section 4 after question 15.

#### **15. Are there any other measures that we should consider that address the issues highlighted in section 3? If so, please describe the following: a) aim of the measure, b) how it could be designed and implemented, and c) the costs and benefits of each such measure.**

The IA has not identified any other measures that should be considered to address the issues in section 3.

### INCREASE COMPETITION BETWEEN THE BIG FOUR

#### ***Restrictions on audit firms providing non-audit services***

#### **16. One way to create audit-only firms would be through separate ownership of the audit and non-audit services practices of the UK audit firms. Could this be effective, and what would be the relative scale of benefits and costs?**

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In the main investors do not consider that "audit only" firms and separating the ownership of the audit and non-audit services practices of the UK audit firms a solution. A quality audit requires quality staff who can challenge and apply economic rationale (not simply box tick). If firms were restricted to providing only audit services, it could impact their ability to attract and retain such staff. Moreover, due to the level of complexity and judgement in undertaking a major audit, specialist non-audit staff are often needed to help and advise. Investors want professional scepticism to be exercised in audits which necessitates audit firms having access to the widest possible experience so that they can see economic substance over form. If this resource is not available to audit-only firms this is likely to reduce rather than enhance audit quality.

In addition, smaller firms may not have the necessary economies of scale to recruit and fund such resource in an audit only environment. Nor is it clear, at current fee levels, that "audit only" firms would be financially viable without compromising audit quality. This could result in a "race to the bottom". Moreover, it may only serve to exacerbate the dominance of the Big Four in that they would no longer be precluded from participating in audit tenders on the basis of the non-audit services they provide.

That said, there are certain investors that consider the conflicts and the actual and/or perceived lack of independence that exist by allowing audit firms to provide non-audit services merit the creation of audit only firms.

**17. How do the international affiliations of member firms affect the creation of audit only firms? What is the extent of common ownership of audit firms at the international level?**

The Big Four audit firms are international and are often responsible for the audit of global companies. For example, a UK audit-only firm would need to remain connected to the international network to service global clients leaving questions over the non-audit services provided by that network. Any remedies cannot be viewed in isolation but need to have international reach in order to be effective. There needs to be more acknowledgement of this international dimension by the CMA.

**18. What should be the scope of any measures restricting the provision of non-audit services? For example, applying to the Big Four only, the Big Four and the mid-tier audit firms, or any firm that tenders for the audits of large companies and PIEs?**

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The EU Audit Regulation extended the list of prohibited non-audit services for PIEs<sup>3</sup> such as tax advice, book keeping and internal audit, and permitted non-audit services up to a cap of 70 per cent of the average audit fee paid in the last three consecutive years. However, there is no outright ban. For the audit of a FTSE 350/PIE, independence is paramount. Therefore, a number of investors consider a limited ban on non-audit services could be introduced as opposed to splitting the firms into audit only and non-audit services firms. This could be to ban completely the provision on non-audit services to audit clients in the FTSE 350 and/or PIEs. Any restriction should be applied consistently across audit firms irrespective of whether they are Big Four or non-Big Four. However, consideration would need to be given to any unintended consequences given we understand high margins can be earned from non-audit services.

### INCREASE COMPETITION FROM NON-BIG FOUR

#### *Measures to reduce the barriers to build their capacity*

- **Market cap share**

**19. How should the market shares be measured? - number of companies audited, or audit fees or some other measure?**

**20. Could the potential benefits (greater choice, and resilience) of a market share cap be realised?**

**21. What do you consider to be the relative scale of the costs of a market share cap, such as increased prices and potentially reduced competition, and potential benefits?**

**22. What should be the appropriate level of such a cap, collectively for the Big Four for the measure to achieve its objective? For example, 90%, 80%, 70%?**

The Invitation to Comment suggests that a way of reducing the barriers to non-Big Four firms expanding their audits of the largest companies would be introducing a market share cap. This is supported by some investors in that it would set a limit on the proportion of large companies and PIEs that the Big Four could audit and be a direct way to increase the number of audit firms in the market. It would also be preferable to a forced break up which would take a long time, be fraught with legal difficulties and be an issue if the UK splits firms whilst the global networks remain unified.

However, others have reservations about how this would play out in practice. For example, say a cap was imposed of 20% of the audit market for any one auditor. The Big Four

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<sup>3</sup> A PIE, as defined, is an entity incorporated in an EU Member State with equity or debt listed on an EU regulated market; or a credit institution or insurance undertaking.

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would thus take 80%. Given we understand that the top half of the FTSE 350 accounts for 94% of all FTSE 350 fees; these are unlikely to be a big part of the non-Big Four's 20%. In addition, this remaining 20% is likely to be particularly risky, costly in terms of geographic distribution, complex and have reputational issues.

- ***Joint or shared audits***

### **23. Could a joint audit be an effective means of implementing a market share cap?**

The IA has concerns about mandating joint audits and the use of firms from more than one audit network. Years ago, the large audit firms underwent a series of mergers resulting in the Big Five, and due to the loss of Andersons, the Big Four today. We believe that these mergers were a response to the increasing globalisation of companies and sought to minimise risks and costs of using firms from one network to audit a large multinational company. Therefore, to encourage participants to use firms from more than one audit network could be a retrograde step.

Moreover, we are concerned with the practicalities of:

- Variation (a) as per the Invitation to Comment and two audit firms signing off on the accounts of their audit client, including conflicting views, lack of consistency in audit approach and increased costs.
- Variation (b) where one party would always be the junior party and unlikely to increase their market share as a result.

We believe there should be a wider discussion of the implications of this recommendation before it is considered in that there is little substantive evidence that joint audits lead to improved audit quality.

- ***Direct support by the Big Four and professional bodies to the mid tiers***

The IA would be concerned about the benefits of such a measure and cross support. First, each of the firms has its own audit processes / software giving rise to a huge learning curve. Secondly, it is highly likely that the Big Four would only put their worst performing staff into the open source pool available for all. There is also the possibility that training could deteriorate if there was no longer exclusive access to the staff a firm had spent money training. However, it is likely to be the international ramifications that are the most complex to resolve.

- ***Reducing the barriers for senior staff to switch between firms***

Whilst this measure could allow the non-Big Four to hire experienced staff from the Big Four, and thus help build their capacity, as noted in the Invitation to Comment, the IA considers there is a risk that the Big Four staff switch only among the Big Four, and not to

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the mid-tier audit firms. Also as noted above, it is highly likely that the Big Four would only allow their worst performing staff to switch and each firm has its own audit processes/software giving rise to a huge learning curve.

In addition, we would be concerned if an existing audit partner in a Big Four firm where the firm was required to rotate from the audited entity moved to a non Big Four firm for the purposes of the tender. Whilst the audited entity may feel more comfortable with the experience of the non Big Four firm, the audit partner concerned would not bring the necessary fresh perspective expected of a new auditor.

- ***Changes to restrictions to ownership of audit firms***

The IA is not convinced that changes to the ownership rules would necessarily result in new players entering the audit market.

First, an audit firm's main resource is its human capital which it develops and trains over time. This is likely to be more important than financial capital in order to enable firms to expand internationally. For example, for a firm to be able to compete for the audit of a major company it is likely to require a global network of quality people. We are not clear how external investment would necessarily help this.

Secondly, external capital could have a negative impact on auditor independence, for example, audit firms could find themselves auditing clients in which their own investors have an interest. Whilst existing regulations may go some way to address this, they were devised with current ownership structures in mind and may not be effective should such structures become more diverse. Before any changes were considered, it would be vital that that this aspect is addressed.

That said, most players in the capital market operate under long term incentive plans that include malus and claw-back provisions that can be triggered by poor performance or personal misconduct. Audit firms are constituted under partnership law where profits are paid out annually. Given the systemic importance of the firms and the need to develop and innovate over the long term in the interests of ensuring audit quality, consideration should be given to addressing any constraints in partnership law that may prevent the operation of long term incentive plans.

- ***Break-up the Big Four into smaller firms.***

As noted in the Invitation to Comment, breaking up the Big Four would pose significant challenges:

- One of the separated businesses would be likely to lose its affiliation to the international network of the consolidated firm.

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- The separated business without an international network could be placed at a competitive disadvantage, even compared to the mid-tiers with international networks. An international footprint is often a pre-requisite to tender for large companies with international operations.
- The measure could be circumvented as staff might move between firms after a break-up.

In conclusion, such a measure would need to be introduced on an international basis as otherwise it could significantly impair the capability of UK-registered audit firms to audit global companies.

## MEASURES TO IMPROVE INCENTIVES

### *Mitigate the effects of current incentives*

- ***Improve transparency around the tendering process***

In 2017 the IA issued Audit Tender Guidelines after consultation with its members. In terms of the audit tender candidates, this clarified that investors would like disclosure of:

- Any restrictions on a firm being able to tender.
- Whether any mid-sized firms will be invited to tender and an explanation where this is not the case.
- How any conflicts between Audit Committee members and tender candidates will be managed and mitigated.
- Whether the incumbent will be invited to re-tender.

Following the tender, the Audit Committee should consider reporting on the following:

- The various stages in the tendering process and the timetable.
- How firms were assessed and the issue of fees addressed.
- Details as to why the firm concerned was chosen.
- A summary of the handover process.

- ***Strengthen audit committees and/or their links to shareholder***

Our views on how audit committees should be strengthened are set out under question 3 above. We also consider there is a case for committees including more investor representation so that their interests can be better safeguarded.

- ***Break the link between company management and auditors***

**24. Should the auditors and those that manage them (e.g. audit committees, or an independent body as described in section 4) be accountable to a wider range of stakeholders including shareholders, pension fund trustees, employees, and creditors, rather than the current focus on shareholders?**

## THE IA'S ANSWERS TO THE DETAILED QUESTIONS RAISED

**25. If yes, should audit committees (in their current form) be replaced by an independent body that would have a 'public interest' duty, including for large privately-owned companies? Should this body be responsible for selecting the audit firm, managing the scope of the audit, setting the audit fees and managing the performance of the audit firms?**

**26. Please describe the benefits, risks and costs of such an independent body replacing audit committees.**

The IA's members do not support the introduction of an independent body such as the London Stock Exchange to appoint auditors to FTSE 350 companies. They support the current construct where the audit committee effectively runs the audit tender process and makes a recommendation to the board. If the board does not accept that recommendation then, in accordance with the UK Corporate Governance Code, the audit committee has to explain why in its report. The investors then ratify the appointment at the AGM.

To put the appointment in the hands of an independent body would disenfranchise shareholders and remove directors' responsibilities to shareholders in this respect. It also goes against requirements that have recently strengthened the role of audit committees. Moreover, it would be difficult for an independent third party to have the appropriate knowledge of the business to evaluate the quality of an audit tender and, therefore, we do not believe that such an arrangement would be practical or increase in audit quality.

Whilst Public Sector Appointments Limited appoints auditors to local public bodies, including councils, police and crime commissioners, and fire and rescue authorities, such bodies do not have external shareholders.

- ***Reform mandatory tendering and rotation***

**27. Should companies be required to tender their audits and rotate their auditors with greater frequency than they currently are required to do? What would be the costs and benefits of this?**

The mandatory auditor rotation requirement in the EU Audit Regulation became effective from June 2016. This required PIEs to change their auditor after a maximum term of 10 years which can be extended to 20 years, or 24 years in the case of a joint audit, if a tender has taken place. These are still relatively new requirements and have resulted in a significant amount of activity. The IA welcomed these requirements in that they broke the long tenure of auditor appointments at certain companies. These changes should be given more time before further reforms are considered. Moreover as noted under question 7, the mandatory rotation requirements have increased concentration as opposed to opening up the market.