THE INVESTMENT ASSOCIATION

# Department for Business Energy and Industrial Strategy

# Market Study on Statutory Audit Services

# Initial consultation on the Competition and Markets Authority's recommendations

Response from the Investment Association

12 September 2019

# EXECUTIVE SUMMARY

The Investment Association[1] (IA) welcomes the opportunity to respond to BEIS's initial consultation on the Competition and Markets Authority (CMA) recommendations for the UK statutory audit market. In preparing this submission, feedback was sought from the IA's members and also from members of the Company Reporting and Auditing Group (CRAG). CRAG is the main UK grouping of institutional investors that specifically focuses on accounting and auditing issues, and provides input to the IA's responses.

In managing assets for both retail and institutional investors, the IA's members are major investors in listed companies. They 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.

Investors, however, are concerned that the dominance of the Big Four as auditors of FTSE 350 companies and the lack of choice an entity can have when it tenders its audit (audit firms can be precluded from participating if they provide prohibited non-audit services) can impact audit quality. With such limited choice, investors question whether audit firms are really competing on quality issues and innovating sufficiently to improve quality.

The IA thus welcomed BEIS inviting the CMA to look at the statutory audit market and audit quality, and the opportunity to now comment on the Government's proposals to take the CMA's Remedies forward. In this context, investors do not have a clear consensus around the Remedies and do not consider there is necessarily a single silver bullet that will address the problems identified. Whilst each Remedy would bring certain benefits, there are issues with a number that need to be considered before they could be taken forward. In addition, one of the Remedies is for there to be a five year review of progress by the new regulator. We support this but also consider it needs to go wider than the CMA's remedies, and look at the outputs from the Brydon review and the impact of the new regulator. To help with this we believe criteria should be established to measure the success, or otherwise, of any of the proposals that are ultimately implemented, and consider the ultimate cost to investors and their beneficiaries.

---

[1] 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.

Set out below are the IA's key observations on the matters raised in the Government's consultation paper and in the attached Annex its answers to the particular questions raised.

- *Audit committee scrutiny*. It is important that the audit committee oversees auditor appointments and monitors the relationship with the auditor to ensure the auditor is independent and objective, and safeguards the interests of a company's shareholders. Whilst the best audit committees are very good and genuinely independent of company management, not all are and do not necessarily appoint the auditor that will deliver the best audit, improve reporting and challenge company management.

  We thus support more regulatory scrutiny of audit committees' role and effectiveness to help address these shortcomings and importantly, ensure the committee selects the auditor that can and does deliver a quality audit. We welcome the CMA proposing that standards should be set for audit committees when they undertake an audit tender; how compliance with these standards should be overseen; and what remedial action should be taken in respect of poor performing committees.

  The audit committee also has an important ongoing role in monitoring that the auditor delivers a quality audit. However, there is no mention as to whether there will be standards in this regard. This needs to be addressed so that the regulator can hold audit committees to account for their ongoing scrutiny of the auditor. Audit committees need to ensure that auditors, as well as audit committee members themselves, challenge managements' assumptions and judgements, and deliver high quality audits that are undertaken with the appropriate level of scepticism and independence from management.

  Initially we consider that ARGA should request reports from audit committees on how they have met the standards set. Over time the processes may need to evolve so that there is closer oversight and monitoring by ARGA. That said, we have a concern about including an observer from the regulator in all or a sample of audit committee meetings. The discussions at an audit committee can be confidential and the committee needs to challenge management's judgements. The presence of a regulator could impact on the discussion at, and dynamics of, the meeting.

- *Mandatory joint audit and peer review*. To address the lack of competition and choice in the audit market, it is vital that the challenger firms scale up their operations so that they can compete for the audit of large, complex entities. The CMA favours requiring joint audits whereby two firms share components of the audit fieldwork, and both check the consolidation of the components and sign the audit report. It considers they could lead to an improvement in the quality and capability of the challenger firms. This Remedy also brings the benefit of additional scrutiny and challenge.

  That said, if joint audits are to be explored further then investors would need to be persuaded that they would work in practice in that: there is no evidence that joint audits increase audit quality, independence and choice; there would be practical issues with two audit firms signing off the accounts, including lack of consistency in approach and increased costs; and lines of accountability are not necessarily clear in that liability is jointly held even if a particular party performed a weak audit, which may affect incentives to carry out quality work. Nor do we support a shared audit where a smaller firm carries out a small proportion of the audit and feeds its work into the work of the larger firm which signs the audit report. In this instance, one party would always be the junior party and unlikely to increase its market share as a result.

We consider there could be merit in exploring peer reviews in that they could benefit audit quality by providing an additional, independent quality check. However, we would be concerned if they were required to be completed before results are reported to the market in that this would result in announcements being delayed. There would also be issues around the split of liability should there be errors in the audited numbers which have been subject to a peer review.  These matters would need to be addressed before this remedy could be taken forward.

- *Market share cap*. Investors support a market share cap and a limit on the proportion of large companies the Big Four audit.  This could allow challenger firms to achieve greater scale and experience and increase the number of large companies they audit. It could also trigger more mobility of ambitious audit staff conscious of the limits to opportunity within the Big Four. Nevertheless, there are a number of complex factors that would need to be addressed and, as noted in the consultation paper, safeguards introduced so that the Big Four do not cherry-pick the less risky audits, among others.

- *Mitigating the effects of the distress or failure of a Big 4 Firm*. The IA is concerned that 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 - they are  'too big to fail'.  In particular, if one of the Big Four failed and its staff and clients transfer to another Big Four it would exacerbate the choice issues faced by audit committees. Thus the regulator should be responsible for monitoring the health of the audit firms and have powers to intervene when necessary.

  As suggested, it may also be necessary to ring-fence the equity within a failing firm relating to all audit and non-audit partners with partner drawings coming under regulatory review. The equity could be used to pay the regulator's fees to administer the distress process, and if the regulator approves the distributions of drawings at the distressed practice, it could incentivise audit partner movement, say to a challenger firm as opposed to another Big Four. More broadly given the firms' systemic importance and the need for them to develop and innovate over the long term, consideration should be given to addressing any constraints in partnership law where profits are required to be paid out annually that may prevent the operation of long term incentive plans.

- *Operational split.* Subject to detailed regulatory oversight to ensure it is effective in delivering the anticipated benefits, the IA is broadly supportive of an operational split to address the conflicts that arise when the auditor provides non-audit services. When audit firms sell advisory and consultancy work, it can impair the perception of auditor independence and objectivity in that the significant revenues generated and the nature of the non-audit services can lead the auditor to identify themselves with the interests of company management and not always questioning management sufficiently on their judgements. In view of this, we support a wider ban such that the provision of non-audit services to audit clients in the FTSE 350 and/or large PIEs is prohibited.

In the main investors consider that there would be issues with a full structural split, and in particular given the firms are international, any such remedy would need to have international reach to be effective.  Nevertheless there are certain investors that consider the actual and/or perceived conflicts and threats to independence that exist by allowing audit firms to provide non-audit services merit a full structural split and the creation of audit-only firms.

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 or on +44 (0) 207 269 4668.

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

## 1. Audit Committee Scrutiny

**Q1. Do you agree that the new regulator should be given broad powers to mandate standards for the appointment and oversight of auditors, to monitor compliance and take remedial action? What should those powers look like and how do you think those powers would sit with the proposals in Sir John Kingman's review of the Financial Reporting Council?**

The IA agrees with the CMA that audit committees have an important role in appointing, monitoring and challenging auditors. Auditors and audit committees are vital lines of defence for shareholders in that they hold company management to account. However, whilst the best audit committees are very good and genuinely independent of company management, not all are and do not necessarily appoint the auditor that will deliver the best audit, or use the relationship with the auditor to improve reporting and add challenge to the boardroom. Nor do all committees sufficiently challenge management on their judgements or auditors on the depth of their work and analysis. They are not necessarily carrying out their role effectively.

We thus support more regulatory scrutiny of audit committees' role and effectiveness to help address this and importantly, ensure the committee selects the auditor that can and does deliver a quality audit. We consider such powers would sit with Sir John Kingman's proposals and the request in our response to his Review of the Financial Reporting Council for "a strong, independent regulatory body with a remit of upholding audit standards, financial reporting and corporate governance[2]".

The CMA is clear that there should be standards for audit committees when they undertake an audit tender; how compliance with these standards should be overseen; and what remedial action should be taken in respect of poor performing committees (see paragraph 1.5 of the consultation paper). For investors it is important that when the committee recommends the appointment of a particular auditor, the auditor that will provide the highest quality audit is appointed. We 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. At the time, to help audit committees meet investors' needs we issued IA Guidelines on Audit Tenders. These set out the processes investors expect committees to follow during the tender process and the disclosures that should be made to the market. We consider these would form a good basis point for standards for audit committees undertaking tenders.

The audit committee also has an important ongoing role in ensuring the appointed auditor delivers a quality audit. In particular, audit committees may not observe the quality of the audit directly, leading to a fragile system. We see many audit committees that are not adequately monitoring the audit process or devoting sufficient time to their duties. Moreover during the audit, the auditor will understandably develop a close relationship with the audited entity's management. This can result in auditors not always questioning management sufficiently on their judgements.

Audit committees need to ensure that auditors, as well as audit committee members themselves, challenge managements' assumptions and judgements, and deliver high quality audits that are undertaken with the appropriate levels of scepticism and independence from management. Professional scepticism is vital when key areas of accounting and disclosure

---

[2] Page 3.

depend on management's judgement. Auditors also need to assign appropriate expertise and sufficient hours to audit the high risk areas and have a well-planned audit. These elements are critical to delivering high quality audit.

Thus the committee should monitor the planning of, execution of and findings from the audit. The IA considers that more regulatory scrutiny of audit committees monitoring of audits will help improve audit quality. However, there is no mention as to whether there will be standards in this regard. This needs to be addressed so that the regulator can hold audit committees to account for their ongoing scrutiny of the auditor.

Audit committees also need to be transparent to investors, say in their audit committee reports, as to how they have complied with the standards set for the appointment and oversight of an auditor. This would allow investors to hold audit committees to account better for fulfilling their responsibilities.

**Q2. What comments do you have on the ways the regulator should exercise these new powers?**

- **For instance, do you have any comments on the conditions that should be met for the regulator to exercise its powers to take remedial action?**
- **Are there particular events (such as a poor audit quality review, early departure of an auditor or a significant restatement of the company's accounts) which should trigger the regulator's involvement**?

For the regulator to be effective in exercising these new powers, it needs to set out the standards it expects audit committees to adhere to in both tendering and monitoring the audit. It should request information and reports from audit committees to evidence their adherence to these standards. It should also be clear as to when it will take remedial action, and the extent and circumstances under which these powers would be used. An audit committee's repeated failure to meet the standards should result in remedial action. As noted under question 1, there should be transparency to the market as to how the audit committee has complied with the standards, so that investors can better hold audit committees to account.

Events that would trigger regulatory involvement should include but not be limited to:

- Early resignation of an auditor.
- A material restatement of the company's results.
- An adverse Corporate Reporting Review finding.
- An adverse AQR finding which is not followed up and reported on in the audit committee report.
- Audit committee member resignations.
- Significant share price weakness combined with increased interest from short sellers linked to concerns over accounting and reporting.
- A significant write down of assets,
- Significant votes against auditor or audit committee members re-appointment.

**Q3. How should the regulator engage shareholders in monitoring compliance and taking remedial action?**

Investors have historically felt that their views were not always appropriately considered or actioned by the FRC. ARGA should address this issue by beginning a wider and deeper programme of stakeholder engagement. In particular, it should reach out to investors to see if they have any issues and be responsive to any concerns raised.

This engagement should take the form appropriate to the issue under discussion. For example, for an issue that impacts an individual company, the regulator should engage with individual shareholders in the company, while for more wide ranging issues such as general policy issues or in the setting of standards, collective engagement or engagement with industry bodies may be more appropriate.

While engagement with shareholders and other stakeholders is important, investors also expect that in a number of circumstances, the regulator should have the confidence and powers to take action itself. In our response to Sir John Kingman's Review we noted that in relation to enforcement the FRC was often viewed by stakeholders as toothless and unwilling to act[3]. ARGA should have the necessary powers to enforce high standards of corporate reporting and behaviour and should be willing to use these powers.

In this context, Sir John recommended that "in the most serious cases", ARGA should be able to issue a report to shareholders suggesting that the company's dividend policy should be reviewed, or that they consider the case for a change of CEO, CFO, Chair or Audit Committee Chair (Recommendation 50).

We do not support this in that where ARGA considers that a change in dividend policy or board composition is required, it should have the confidence and powers to take action itself. The regulator should set out the specific circumstances in which this power would be used, and then use the power as needed. This will provide an effective deterrent and help position the regulator as one that is dynamic and willing to act. If the regulator makes such a recommendation to shareholders, shareholders may feel they have no option but to follow it. This would impinge on their rights and responsibilities. The regulator should direct companies to make changes to dividend policy or board composition itself rather than seeking to direct shareholders to take action.

**Q4. What would be the most cost-effective option for enabling greater regulatory oversight of audit committees? Please provide evidence where possible.**

Given these are new powers, we consider that the options for regulatory oversight should be explored and evolve over time. It is important that ARGA gains the trust of the market to ensure that it is used effectively. Initially ARGA should request reports from audit committees on how they have discharged their obligations and met the standards set. Over time the processes may need to evolve so that there is closer oversight and monitoring by ARGA. That said, we have a concern about including an observer from the regulator in all or a sample of audit committee meetings. The discussions at an audit committee can be confidential and the committee needs to challenge management's judgements. The presence of a regulator could impact on the discussion at, and dynamics of, the meeting.

## 2. Mandatory joint audit and peer review

**Q5. Do you agree with the CMA's joint audit proposal as developed since its interim study in December?**

[3] Page 10

Investors want to see more competition and choice in the audit market in the interests of ensuring high quality audits. As such we welcomed the CMA's Update Paper proposing a number of Remedies to deliver this.

The CMA's proposed Remedy for mandatory joint audit, where two firms share components of the audit fieldwork, and both check the consolidation of the components and sign the audit report, brings the benefit of additional scrutiny and challenge. However, if it is to be explored further then investors would need to be persuaded that it would work in practice in that:

- There is little evidence to suggest that joint audits increase audit quality, independence and choice. Joint audits are mandated in France. As investors in French companies, the IA's members have not seen an improvement in audit quality as a result. We also understand that Denmark abandoned the practice in 2005 and that there is no academic evidence that joint audits improve audit quality.
- Indeed joint audits could reduce choice in the number of firms that could be invited to tender in that there would be two incumbents as opposed to one. (We disagree with the assertion in the consultation paper that the proposal would "achieve sustainable progress towards that aim [create a more competitive market] in a reasonably short period of time, without depriving audit clients of choice in their selection of auditor[4]".) They would also reduce the number of providers for other services that the auditor is prohibited from providing to the audited entity.
- There would be practical issues with two audit firms signing off the accounts of the client, including lack of consistency in audit approach and increased costs.
- We note that audit regulators have highlighted examples of poor co-ordination and oversight of component auditors' work. Joint audits may only serve to exacerbate this.
- With a joint audit there is not necessarily a clear line of accountability. Joint auditors sign off the same audit and liability for any issues is jointly held regardless of whether a particular party delivered a weak audit. This could act as a disincentive to carry out quality work.
- All of the large audit firms have undergone a series of mergers resulting in the Big Five, and following the collapse of Arthur Andersen, the Big Four today. 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. To require companies to use firms from more than one audit network could be a retrograde step.

**Q6. Do you agree with the CMA's proposed exemptions to the joint audit proposals? How should the regulator decide whether a company should qualify for the proposed exemption for complex companies?**

Due to our reservations noted under question 5, we do not support joint audits. However, if this Remedy is to be taken forward then we propose that a pilot study is conducted first to determine its impact. Thus initially we consider joint audits should be applied to audits of FTSE 350 companies with exceptions, as stated in the consultation paper:

- For the audits of the largest and most complex companies, where there may be insufficient capacity from challenger firms to participate in joint audits.

---

[4] Paragraph 2.11

- For the audits of investment companies and companies that do not prepare consolidated accounts.
- For audits where an audit committee has appointed a challenger firm as its sole auditor.

In addition, we agree with the CMA's recommendation that:

- The regulator should have the power to grant specific exemptions to the proposed joint audit requirement in exceptional and limited circumstances.
- Each FTSE 350 company within the scope of joint audit should appoint a joint auditor no later than when it next re-tenders its audit engagement.
- No joint auditor should be allocated less than 30% of the total audit engagement fees.

We consider the exemption for complex companies should apply to those types of companies, such as banks, insurers and large multinationals, where challengers may not have the skills or geographical reach to perform the audit. These should be agreed on a case by case basis with the regulator.

**Q7. Do you agree that challenger firms currently have capacity to provide joint audit services to the FTSE350? If a staged approach were needed, how should the regulator make it work most effectively? If not immediately, how quickly could challenger firms build sufficient capacity for joint audit to be practised across the whole of the FTSE350?**

We have noted that some audit committees are reticent to appoint a challenger firm on the basis they are concerned they are not necessarily credible for the scale and complexity of their business. An audit committee may be concerned that challenger firms have smaller international networks; a lack of experience conducting FTSE 350 audits; and may not be able to deliver a quality audit. In addition, some audit committees composed of Big Four alumni may favour their old firms when considering tender candidates. Thus challenger firms may not be invited to tender which can lead to a more concentrated market-place.

From the perspective of the challenger firms, they may avoid bidding for audit tenders due to factors such as high tender costs (which can be more easily absorbed by large firms); the lower likelihood of winning; and the greater potential risk should they be appointed to audit a large group and the increased regulation involved (which could have a disproportionate effect on these firms). These factors can result in challenger firms being reticent to participate in tenders and not building the capacity to do so.

Nevertheless, we recognise the concerns of audit committees and should it decide to do so, the regulator needs to establish a staged approach to introducing joint audits so that challenger firms can build their capacity. As to how quickly they could achieve this is not within the IA's remit. In this context, the IA's Tender Guidelines are clear that investors expect the committee to ensure a wide range of firms are invited to participate in a 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 or complex groups should have to restrict their choice to the Big Four audit firms. Moreover, challenger firms should be able to undertake the audit of many companies outside the FTSE 350 enabling them to build their capacity as a result.

**Q8. Do you agree with the CMA's recommendation that the liability regime would not need to be amended if the joint audit proposal were implemented?**

We note that France follows a joint and several liability regime. Thus we understand each joint auditor performs a review of the work performed by the other. In addition, the audit summary memoranda and working paper files for the engagement are subject to reciprocal peer review. This review, which leads to the joint audit opinion being issued, has to be documented for each engagement. If effective this should improve audit quality but we question whether challenger firms would have the skills and capacity to review the files of a Big Four firm. We do not consider a challenger firm would have the same level of professional indemnity insurance as a Big Four firm in the event there is a failure. We thus do not necessarily agree with the CMA and consider that if this Remedy is taken forward then the liability regime would need to be reviewed so joint audits are not undertaken with joint and several liability.

**Q9. Do you have any suggestions for how a joint audit could be carried out most efficiently?**

If joint audits are taken forward then the IA suggests that the model adopted in France is followed where they have been required for over 50 years. In France a professional standard, NEP-100, sets requirements in this area. NEP 100 stipulates that the audit work should be split on a balanced basis reflecting criteria which may be quantitative or qualitative in nature. If a quantitative basis is used, the split may be by reference to the estimated number of hours of work required to undertake the audit. If a qualitative basis is adopted then the analysis may be the qualifications and experience of the members of the audit teams. Where a group entity is audited by a firm that is not one of the joint audit firms, the third party auditor's work is supervised by one of the joint audit firms.

The overall balance sought is reflected in the split of the audit fees. The objective will normally be for each joint auditor to receive between 40% and 60% of the total fees. A split of up to 70%/30% may be accepted. Splits of less than 30% for one of the joint auditors, and greater than 70% for the other, may be tolerated but are monitored by the regulator with a view to progressively readjusting them.

**Q10. The academic literature cited in the CMA's report suggests the joint audit proposal would lead to an increased cost of 25-50%. Do you agree with this estimate?**

The IA considers it likely that the joint audit proposal would increase audit costs, and from the academic literature understand that this could be as much as 25%. However as noted above, there is no evidence that this would improve audit quality. There also may be an additional cost to the audited company in terms of management and audit committee time in maintaining a relationship with two auditors as opposed to one. In this context, the IA's Tender Guidelines clearly set out that in considering an audit tender the audit committee should consider audit fees in that they should be neither too low to suggest audit quality could be impaired nor too high as to be excessive. However, fees should not be the main factor under consideration, particularly in the early stages of the tender process. If the audit firms invest in more and better technology then this should ultimately result in a reduction in the cost of audits and associated fees.

**Q11. Do you agree with the CMA's assessment of the alternatives to joint audit, including shared audit?**

As with joint audits, if shared audits are to be explored further then investors would need to be persuaded that they would work in practice in that there is no evidence that they increase audit quality, independence and choice. With a shared audit a smaller firm carries out a small proportion of the audit and feeds its work into the work of the larger firm which signs the audit report. We understand that shared audits used to be common for many international businesses but, over time, due to the development and strengthening of international networks most listed companies have migrated to being audited by one audit firm. It can also be simpler if just one firm tests group-wide systems, processes and controls. Another factor in the reduction of shared audits has been regulatory and investor pressure to select a single audit firm in response to past audit failures, in particular that of Parmalat in 2003[5]. Where shared audits still exist, there is often a specific reason, such as when a component of a larger business that is a listed company in its own right has a distinct set of business systems, processes, controls and corporate governance arrangements.

However, with a shared audit our real concerns is that one party would always be the junior party and unlikely to increase their market share as a result.

**Q12. How strongly will the CMA's proposals improve competition in the wider audit market, and are there any additional measures needed to ensure that those impacts are maximised?**

Investors want to see more competition and choice in the audit market in the interests of ensuring high quality audits. We welcome the CMA proposing Remedies to deliver this. We set out our view on the CMA's individual Remedies in our response to the CMA's update paper. There we highlighted an additional Remedy, which Government does not appear to be taking forward: market share caps. Investors support a market share cap as a means of reducing the barriers to challenger firms expanding the number of large companies they audit. A limit on the proportion of large companies the Big Four audit could increase the number of audit firms in the market by allowing challenger firms to achieve greater scale and experience. It could also trigger more mobility of ambitious audit staff conscious of the limits to opportunity within the Big Four. Nevertheless, there are a number of complex factors that would need to be addressed:

- Ensuring there is sufficient sector expertise and global reach in the market. There could be a decline in audit quality if firms are appointed that do not possess the necessary capabilities.
- Whilst a market share cap may open the market to new entrants, it could blunt incentives for audit firms to compete, reducing competition and resulting in audit fees increasing or quality falling.
- Companies would have less choice if an audit firm is at its capped limit. This could also impact the attractiveness of the UK for international companies to list.
- It is important that safeguards are introduced so that the Big Four do not cherry-pick the less risky audits. For example, say a cap was imposed of 20% of the audit market for any one auditor. The Big Four would thus take 80% and the remaining 20% is likely to be particularly risky, costly in terms of geographic distribution, complex and have

[5] The Parmalat scandal in 2003 involved a shared audit, with international operations audited by a different audit firm to the group auditor. The perception at the time was that the use of two different firms had made it more difficult to detect fraud by management, although subsequent audit failures have highlighted that this can also be an issue for audits by a single audit firm.

reputational issues. Prohibiting the Big Four resigning without the audited company's approval and limiting the Big Four's choice as to which company they can bid for would each have unintended consequences.

In conclusion, more work is needed to determine how the cap should be constructed, monitored and reviewed before this Remedy could be taken forward.

**Q13. Do you agree with the CMA's proposals for peer review? How should the regulator select which companies to review?**

We consider there is merit in exploring the introduction of peer reviews in that they could benefit audit quality by providing an additional, independent quality check. We note that the FRC's AQR reported in June 2018 that there had been a decline in the year's audit inspection results and no firms achieved the FRC's target in 2019. This was concerning and undermined investor confidence in audit which is vital to the effective operation of the capital markets. Peer reviews could help address this. However, we would be concerned if requiring a peer review to be undertaken before results are reported to the market would result in announcements being delayed. There may also be questions around the split of liability should there be errors in the audited numbers which have been subject to a peer review. These matters would need to be addressed before this remedy could be taken forward.

**Q14. Are any further measures needed to ensure that the statutory audit market remains open to wider competition in the long term?**

Please see our answer to question 12 and our support for a market share cap subject to certain of the issues around the construction of the cap being addressed.

## 3. Measures to Mitigate the Effects of the Distress or Failure of a Big 4 Firm

**Q15. What factors do you think the regulator should take into account when considering action in the case of a distressed statutory audit practice**?

The IA is concerned that 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 - they are 'too big to fail'. We thus welcome the regulator being required to monitor the health of audit firms and given powers to:

- Obtain timely and periodic submissions from the Big Four firms and possibly the large non-Big Four firms on their financial health.
- Require audit committees to inform it of upcoming tenders and any other information that the regulator considers necessary.
- Obtain, and then review, the contingency plans from large audit firms, which should encompass their turnaround plans.
- Require non-Big Four firms to draw up plans for how they could, if required, take on migrating auditors and/or audit clients from a distressed Big Four.

**Q16. What powers of intervention do you think the regulator should have in those circumstances, and what should be their duties in exercising them?**

The IA supports the regulator having powers to intervene as set out in paragraph 3.7 of the consultation paper and having a range of options. A particular concern is that should one of the Big Four fail and its staff and clients transfer to another Big Four, as happened with the demise of Arthur Andersen where staff transferred to Deloitte, this would exacerbate choice issues and result in the Big Three as opposed to the Big Four. To help prevent this, we consider it important that the regulator has powers to intervene when necessary.
As suggested, it may also be important to ring-fence the equity within a failing firm relating to all audit and non-audit partners with partner drawings coming under regulatory review. The equity could be used to pay the regulator's fees to administer the distress process, and if the regulator approves the distributions of drawings at the distressed practice, it could incentivise audit partner movement, say to a challenger firm as opposed to another Big Four.

## 4. Operational split between Audit and Non- Audit Practices

**Q17. Do you agree with the CMA's analysis of the impacts on audit quality that arise from the tensions it identifies between audit and non-audit services?**

To produce a quality audit, auditors need to be independent, objective and free from conflicts. We consider a factor that impacts audit quality is the conflicts that arise when the auditor provides non-audit services. We agree with the CMA's analysis of the impact on audit quality that arises from the tension from providing audit and non-audit services in that:

- Audit partners share in the profits earned by non-audit services, giving them a stake in the profits of the whole business rather than those exclusively arising from audit.
- Firms continue to use sectoral expertise of audit partners to help sell non-audit work to clients, drawing on partner time and risking audit quality.
- There is a 'one firm' culture in multidisciplinary firms, with shared values and goals. Although there are benefits to this shared culture, the CMA concludes that audit requires a distinct set of values centred on objectivity and challenge.
- Conflict rules exacerbate internal tensions between audit and non-audit work, as firms will take into account the potential loss of current or future non-audit work when considering whether to bid for audits.

In particular, when audit firms use audit services to sell advisory and consultancy work, it can impair the perception of auditor independence and objectivity in that the significant revenues generated and the nature of the services can lead the auditor to identify themselves with the interests of company management rather than investors. (Too often auditors consider the audited entity to be the client as opposed to investors.) This could result in auditors not always questioning management sufficiently on their judgements. For auditors to deliver quality audits they need to challenge managements' assumptions and judgements, and exercise appropriate standards of scepticism. Professional scepticism is vital when key areas of accounting and disclosure depend on management's judgement.

**Q18. What are your views on the manner and design of the operational split recommended by the CMA? What are your views on the overall market impact of such measures?**

The CMA proposes that the operational split should be designed such that there is:

- A separate CEO and board for the audit practice, populated by a majority of independent non-executives, who would be accountable to shareholders of audit clients, and to the public interest (subject to the conclusions of the Brydon review) via the regulator.
- The audit board should be responsible for all remuneration and career progression decisions within the audit practice, including recommending promotion to partnership.
- Remuneration and career progression should be strongly linked to audit quality, with the audit board setting and overseeing quality standards.
- The audit board should conduct an annual general meeting and produce an annual report, with disclosures to be determined by the regulator, but including a report on audit quality measures.
- Separate financial statements for the audit practice, consisting of an income statement; transparent transfer pricing, checked by the regulator, e.g. for the use of non-audit specialists on audits.
- No profit or information/contract sharing between the audit practice and the non-audit practice.
- The audit practice for the purposes of this remedy includes audit and essential non-audit services closely related to audit.

We are broadly supportive of an operational split in order to address the issues set out in our answer to question 17. However, it would be complex to implement and would require detailed regulatory oversight to ensure it is effective in delivering the anticipated benefits for audit, such as reviewing transfer pricing and information-sharing arrangements, without the downsides of a structural split. Thus, as noted in question 4, it is important that ARGA is established as an effective regulator and is trusted by the markets.

**Q19. Are there alternative or additional measures which would meet these concerns more effectively or produce a better market outcome?**

The EU Audit Regulation went some way to address the conflicts that exist from providing non audit services in that for PIEs, it prohibited a wider range of services and limited others. The IA supports a wider ban on non-audit services such that the provision of non-audit services to audit clients in the FTSE 350 and/or large PIEs is prohibited. Once the firm has stopped providing non-audit services there should be a cooling off period before it can be appointed as an auditor. This restriction should be applied consistently across audit firms irrespective of whether they are Big Four or challenger firms. In addition, in the interests of efficiencies, the auditor should still be allowed to provide certain audit-related services, such as reviewing preliminary announcements or auditing regulatory returns. There should be a full consultation on what constitutes an allowed non-audit service.

**Q20. Do you agree with the CMA's proposal to keep a full structural separation in reserve as a future measure?**

The consultation paper acknowledges one of our key concerns over a full structural split in that such a Remedy cannot be viewed in isolation but needs to have international reach to be effective. The Big Four audit firms are international and often responsible for the audit of global groups many of which will have a holding company listed on the UK market. The 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. There is also a risk that the international networks break away from the UK audit-only firms impacting the firms' global reach and the attractiveness of the UK market.

In addition, 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, particularly due to the seasonality of audits (the majority of companies have 31 December year ends), it could impact their ability to retain such staff. Moreover, due to the level of complexity and judgement required in undertaking a major audit, specialist non-audit staff are often needed to help and advise. Investors want auditors to exercise professional scepticism which necessitates access to the widest possible experience so that their staff can see economic substance over form and are up to date with accounting requirements. If this resource is not available to audit-only firms this is likely to reduce rather than enhance audit quality.

Lastly, smaller firms may not have the necessary economies of scale to recruit and fund such resources in an audit-only environment. A structural spilt also 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, if the above issues are addressed certain investors would go further and consider the actual and/or perceived conflicts and threats to independence that exist by allowing audit firms to provide non-audit services merit the creation of audit-only firms. The complex structures and range of non-audit services provided by the Big Four can be a substantial barrier for entry for the non-Big Four or challenger firms. An audit-only firm environment could encourage new entrants. They also consider that an audit-only firm would be able to procure the specialist knowledge required in the market or if there is sufficient demand, retain it in-house.

**Q21. What implementation considerations should Government take into account when considering the operational split recommendations? Please provide reasoning and evidence where possible.**

As noted in question 17 an operational split would be complex to implement and would require detailed regulatory oversight to ensure it is effective in delivering the anticipated benefits for audit, such as reviewing transfer pricing and information-sharing arrangements.

## 5. Other Measures

**Q22. Do you agree with the CMA's other possible measures? How would these suggestions interact with the main recommendations? How would these additional proposals impact on the market?**

Please see answers to questions below.

**Q23. Do you agree with the CMA's suggestions regarding remuneration deferral and clawback?**

The IA agrees with the CMA's suggestions regarding remuneration deferral and clawback such that awards to partners could be deferred, with a portion of the award vesting in subsequent years. The retained amounts could be subject to a clawback provision, giving the audit board the option to reduce payment. This could discourage irresponsible risk-taking and short-termism, in a similar way to the framework introduced in the financial services sector in 2015. In particular, 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.

**Q24. How would a deferral and clawback mechanism work under a Limited Liability Partnership structure?**

As noted above, we consider any constraints in partnership law that may require profits to be distributed annually should be addressed as should individual partner's liability to tax as we understand that their tax liability is on the basis of profits accrued as opposed to those paid out in cash.

**Q25. Do you agree that liberalising the ownership rules for audit firms would reduce barriers for challengers and entrants to the market?**

- **What positive and negative impacts would this have?**
- **Do you have any specific proposals for a reformed ownership regime?**

Currently audit firms are required to be majority owned by qualified auditors. Some consider that liberalising the ownership rules could encourage greater capital investment allowing new entrants and challengers to scale up more quickly. We have reservations as to whether liberalising the ownership rules would necessarily achieve this.

First, as acknowledged in the consultation paper, changes to the ownership rules would be likely to impact on independence and create conflicts of interest. For example, audit firms could find themselves auditing clients that have links to their own investors which could have a negative impact on audit quality. There are safeguards that address this in that:

- The ethical standards prohibit firms providing services to those able to influence the firm, including owners or affiliates of owners.
- The Companies Act 2006 requires that owners or shareholders do not intervene in the execution of a statutory audit in a way that jeopardises the independence or objectivity of the statutory auditor[6].

However, it is not clear how effective these measures would be. In particular, they were devised with current ownership structures in mind, and their implementation and enforcement could be a different matter should such structures become more diverse. In summary, before any changes are considered we believe it vital that there are adequate safeguards to ensure auditor independence and audit quality, and that conflicts of interest are addressed.

Secondly, we understand that the main objective in reviewing the ownership rules is to increase auditor choice. However, we are not convinced that this would necessarily follow.

---

[6] Schedule 10, Part 2, paragraph 9 (3), Companies Act 2006

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 with consistent methodologies and quality of people. We understand that an audit firm's main resource is its human capital which it develops and trains over time. We are not clear how external investment would necessarily help this. We also understand that it is mainly the smaller firms that are receptive to the idea of outside investment[7]. However, this size of firm is unlikely to impact the main quoted company audit market.

**Q26. Do you agree with the CMA's suggestions regarding technology licensing?**

- **What changes would you like to see made to the current licensing framework?**

The CMA is proposing that there should be cross-industry technology licensing, potentially facilitated by the regulator, to remove barriers to competition in the future. For example, the Big Four firms could be required to share their audit technology with challenger firms.

The IA has reservations about such a measure. 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 resource into the open source pool available for all. There is the possibility that innovation could stall if a firm no longer had exclusive access to the systems it had developed. The international ramifications would also be likely to be complex to resolve. We noted in our response to the CMA that the lack of competition in the audit market has resulted in a lack of innovation. Requiring firms to share their technology would only exacerbate this.

**Q27. Do you agree with the CMA's suggestions to provide additional information for shareholders? Do you have any observations on the impact of the Public Company Accounting Oversight Board's database on the US audit market?**

The CMA is proposing to increase the transparency of audit committees, especially during tendering. Other possible measures include disclosing audit staff hours and fee breakdowns, and a requirement to provide a public database of audit partners and firms. This database could be similar to the one maintained by the US regulator, the Public Company Accounting Oversight Board, to make it easier to identify all audits for which a partner was responsible.

The IA supports such measures. We recognise investors have an important role to play in ensuring quality audits but there is largely a lack of transparency and information to enable them to do so, particularly about audit tenders and the audit process. The IA Audit Tender Guidelines state that when a company plans to enter into a tender it should issue an RNS announcement so that investors can, if they wish, engage with it on the tender. It should also contact its major shareholders and engage with them on the process. For example: on the timetable; how the audit committee intends to assess audit quality; the selection criteria and assessment mechanism that will be applied; and the conclusion reached.

In terms of the audit tender candidates, the Guidelines clarify that investors would like disclosure of:

---

[7] http://www.accaglobal.com/members/publications/accounting_business/archive/2007/julyaugust/2980606

- 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 tender 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.

The audit committee should also ensure there is an RNS announcement when the decision is made.

As many tenders are completed significantly before the new auditor takes office due to the need to 'cleanse' of threats to independence, such as when an auditor provides non-audit services, consideration could be given to giving shareholders the opportunity to approve the appointment of the new provider. This would provide a focus for the audit committee to set out the process, and why it chose that particular auditor and considered the fee to be at the right level. This vote to approve the new auditor would be a significant new power for shareholders at a time when there is more scope for influence, and ought to add an important new dynamic to the appointment process.

In this context, investors would also welcome, as suggested, the establishment of a register of audit partners which includes a list of the companies where they have been the lead partner – along the lines of the US model. This would enable them to identify if a partner had been responsible for the audit of a company where investors are aware there had been issues.

Lastly, investors would like audit committees to give more insight into the steps they have taken to ensure a quality audit in their audit committee reports. If there has been a tender then the committee should be transparent as to why it recommended a particular auditor and considered that firm would provide a quality audit. Annually it should assert whether it believes and how it determined that the auditor had provided a quality audit, been challenging, the granularity of key accounting issues and how the auditor challenged management's judgement and assertions, and exercised professional scepticism. The committee should report on what it itself challenged and the specific areas it asked the auditor to look at and why. At present these matters are rarely transparent. We set out under question 1 that we consider audit committees should set out how they have complied with the standards set by the regulator for the appointment and oversight of an auditor. Increased transparency would help facilitate more and better investor engagement with both auditors and audit committees on these issues.

**Q28. Do you agree with the CMA's suggestions regarding notice periods and non-compete clauses? Do you agree that the regulator should consider whether Big Four firms should be required to limit notice periods to 6 months?**

We note the CMA received suggestions that barriers to the growth of challenger firms could be reduced if notice periods for partner and senior staff in Big Four firms were reduced, and non-compete clauses were limited in scope. In response, the CMA suggests that the regulator should consider whether Big Four firms should limit their notice periods to six months.

We do not consider that this would necessarily be effective in that:

- There is a risk that the Big Four staff switch only among the Big Four, and not to the challenger audit firms. As we note under question 12, a market share cap could trigger more mobility of ambitious audit staff conscious of the limits to opportunity within the Big Four.
- It is likely that only those staff that have little chance of future promotion would move from the Big Four.
- Each firm has its own audit processes/ software giving rise to a huge learning curve.

In summary, this recommendation may only be effective if notice periods are limited for those partners and/or employees that are leaving to join a challenger firm.

**Q29. Do you agree with the CMA's suggestions regarding tendering and rotation periods?**

The current requirement is that Public Interest Entities have to carry out an audit tender at least every ten years and to change audit firm at least every twenty years. The BEIS Select Committee recommended revisiting this, and moving to a fixed term of seven years, in order to disrupt the 'familiarity' that can arise between auditor and audited company.

The IA considers that effective competition can play a crucial role in driving quality and requires audits to be tendered sufficiently frequently and adequate choice when the audit is tendered. Prior to EU Audit Regulation's measures for mandatory tendering and rotation, which were effective from June 2016, audit firms tended to hold office for long periods. This concerned investors in that it can impact the firms' integrity, independence and objectivity, each of which is important in ensuring audit quality.

The Regulation largely addressed this – over 50% of companies in the FTSE 350 have tendered their audit since 2013 and the overall switching rate peaked at 14% in 2015. However, whilst the long terms auditors held office has been addressed, it is clear it is still a concentrated market. The Big Four firms maintain a dominant position as auditors of companies in the FTSE 350. Given that the mandatory tendering and rotation requirements were only introduced in 2016 we consider it too soon to review the time periods involved. Moreover, the Regulation has actually adversely impacted market concentration in that the proportion of FTSE 350 audits carried out by the Big Four has only increased since its introduction[8]. Further shortening the period may only serve to exacerbate this.

It is essential to have a well-functioning market for audit services and more competition and choice in the interest of ensuring audit quality. There are concerns that the lack of choice

---

[8] Page 22 of the CMA's Statutory Audit Services Market Study update paper: "the overall share of the Big Four by number of audit clients [in the FTSE 350]has remained stable since 2011 – increasing slightly from 95% to 97% in 2017".

when an entity tenders its audit can impact audit quality. Thus an entity may be faced with only two viable "choices" in that: the incumbent may be time barred and unable to participate in the tender process; other audit firms could be precluded as they provide prohibited non–audit services to the entity; and others could audit competitors of the entity. With so few players, investors question whether auditors are really competing on quality issues. However, as opposed to looking at the tendering and rotation periods, we consider it important that the challenger firms scale up their operations so that they can compete for the audit of large, complex entities in the FTSE 350. This should help drive quality.

**Q30. Do you have other proposals for measures to increase competition and choice in the audit market that the CMA has not considered? Please specify whether these would be alternatives or additional to some or all of the CMA's proposals, and whether these could be taken forward prior to primary legislation.**

We set out in question 12 our preference for the CMA's remedy of a market share cap.

**Q31. What actions could audit firms take on a voluntary basis to address some or all of the CMA's concerns?**

Given the timeframe involved with establishing a new regulator and introducing legislation to address the CMA's concerns, the IA would welcome the firms taking action on a voluntary basis.

**Q32. Is there anything else the Government should consider in deciding how to take forward the CMA's findings and recommendations?**

The IA has no further comments to make.