

# Statutory audit services market study

Update paper  
18 December 2018



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Appendix C – The ‘expectations gap’; the purpose and scope of audit – has been published separately

## Summary

1. Mostly without realising it, everyone in the UK benefits if the market for audit services works well; but we suffer if it does not. The information companies provide about themselves is used by investors to make decisions that affect people in many ways: through pension schemes, both those open to all and those for company employees; through other investments or savings; as customers or suppliers; or simply as participants in an economy which relies on trust and confidence to run smoothly.
2. Independent audits should ensure that company information can be trusted; they provide a service which is essential to shareholders and also serves the wider public interest. But recent events have brought back to the surface longstanding concerns that audits all too often fall short. And in a market where trust and confidence are crucial, even the perception that information cannot be trusted is a problem.
3. The fact that companies select and pay their own auditors is an impediment to high-quality audits. Shareholders and the public cannot see what goes on inside a company, so they need auditors to check; but it may be in company managers' interests not to be fully transparent. Mandating that audit committees make the selection has only been a partial solution, as we have seen from the prevalence of 'chemistry' and 'cultural fit' in tender criteria.
4. Choice of auditor is extremely limited for the biggest companies: sometimes to as few as one or two firms. Past remedies have improved some aspects of the market, but have not broken down the barriers to challenger firms stepping up. Such a big gap between the Big Four and the rest is not healthy, and will persist unless it is tackled. And choice could get worse rather than better if left unaddressed; choice would be severely further curtailed if one of the Big Four were to cease to operate.
5. A well-functioning market would produce high-quality audits. Competition and regulation should work together so that audit firms and individuals all have the strongest possible incentives to deliver quality. Part of this is about the regulator setting standards and enforcing against them; that has been the focus of the independent review into the Financial Reporting Council (FRC), led by Sir John Kingman (whose report has also been published today, and with whom we have liaised throughout). But competition, enabled by regulation, should ensure that firms and individuals succeed financially and reputationally if they produce the highest quality over and above the minimum standards. In order to create the strongest possible incentives for highly competent, professionally sceptical audits, competition must be focused on

quality, and there must be sufficient choice of viable competitors over the long term.

6. Based on our analysis to date, we propose the following remedies to create incentives for better audit quality, in tandem with improved regulation as recommended in the separate review of the FRC.

- a. **Regulatory scrutiny of auditor appointment and management.**

Auditor appointments need to be made with a focus on ensuring that companies' numbers are tested as effectively as possible. This could be fully achieved if appointments were taken away from audited companies, particularly in the absence of widespread investor focus on audit. But our current understanding is that it would not be possible to do this on a generic basis for all large companies, at least not now, as the European legal framework appears to preclude it. The practical complexities of appointing auditors for the biggest companies also present challenges, although we expect these would be surmountable.

As an alternative, we propose close scrutiny of audit appointment and management by the regulator, to secure audit committees' accountability and independence from companies. This must ensure a clear priority on quality and challenge from auditors, as well as minimising any bias against firms from outside the Big Four.

- b. **Breaking down barriers to challenger firms – mandatory joint audit.** The market structure needs to change to ensure that there are enough realistic alternative audit providers so that every incumbent auditor feels another firm breathing down its neck, ready to serve shareholders' and the public's interests better. Achieving this after 15-plus years of an entrenched Big Four will not be easy; but no direct attempt has yet been made to do this.

We propose that FTSE350 audits should be carried out jointly by two firms, at least one of which should be from outside the Big Four. This will give challenger firms access to the largest clients, while allowing for a cross-check on quality, as each auditor reviews the other's work.

A possible alternative if concerns arise over joint audit's effectiveness is a market share cap – ensuring that a subset of major audit contracts are only available to non-Big Four firms – which would also support long-term choice.

We also propose a resilience remedy to protect against the Big Four becoming a Big Three.

- c. **A split between audit and advisory businesses.** To produce the best quality, auditors' exclusive focus should be on providing audits; and their wider business interests should not in any way compromise this. Rules are already in place at the level of individual contracts to prevent auditors from cross-selling other services to their clients; but changes at the firm level are also necessary to ensure a single-minded focus on audit quality.

This could imply a full structural split of advisory and other non-audit services away from audit, which would also ensure maximum choice among the Big Four. However, the international networks these firms belong to, and the extent to which audits draw on advisory expertise, present some difficulties. A more immediately feasible alternative would be for firms' audit and non-audit businesses to be split into clearly defined separate operating entities, with separate management, accounts and remuneration, but to remain under the same organisational umbrella. That way auditors would only be rewarded for providing good audits, but would still be able to draw on expertise from their sister firms.

- d. **Peer review** of audits, commissioned by and reporting to the regulator, could offer an additional way of enforcing standards, both keeping auditors on their toes and making quality levels more visible.

- 7. Concerns about this market are longstanding, and while some have been at least partly answered through previous interventions, serious problems persist. The package of remedies we propose in this paper should, in tandem with more effective regulation, bring about significant improvements. But if elements of the package prove not to produce the necessary effects – either following consultation, or in detailed design and implementation, or once they have been in place for a period – some of the more drastic but harder to implement remedies, like independent appointment and structurally splitting audit and non-audit services, will need to be revisited.
- 8. Many responses to our invitation to comment document highlighted the 'expectations gap' as a large part of the problem – the concern that people's expectation of what audits should do is far removed from what is currently required in the legal and regulatory framework. There is something in this: expecting auditors to prevent all company failures would be unreasonable, and even among experts there is disagreement on precisely what an audit is supposed to achieve. Clarifying this and considering how audits might best serve shareholders and ultimately the public interest is necessary, which is why we welcome the expected review on the purpose and scope of audit, announced by the government today. But the fact remains that even against



the more modest benchmark in the current standards, audits are too often falling short; pointing to the 'expectations gap' is no excuse for this failure.

9. We welcome views from interested parties on the proposed remedies as set out in this document by 21 January, before we make a final decision on any potential recommendations to the Government.

# 1. Introduction

1.1 In this section we explain why we are looking at the market for the supply of statutory audit services in the UK. We explain:

- (a) Why audit is important;
- (b) Some basic facts about the UK audit sector;
- (c) The concerns that have arisen around audits; and
- (d) How we have examined these concerns so far.

## Why audit is important

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

## The UK audit sector

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

1.4 The large auditors in the UK are part of similarly branded international networks of audit firms. Audit firms in these networks are experienced at working together to provide international companies with a seamless audit

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

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

service across borders, so a company may only need to appoint one single auditor for its global business.

- 1.5 In the UK, 97% of audits of FTSE 350 companies are undertaken by the Big Four auditors, which are PricewaterhouseCoopers (PwC), KPMG, Ernst & Young (EY) and Deloitte.<sup>3</sup> While there are many smaller audit firms that carry out audits for unlisted and smaller companies, there are several challenger firms, some of which have a small number of clients in the FTSE 350. Challenger firms include Grant Thornton, Mazars, BDO, RSM, and Moore Stephens. Many challenger firms have international networks of firms like the Big Four, although these are more limited.
- 1.6 There has been consolidation in the audit sector in the last 30 years. Before 1987, there were eight large international audit firms in the UK, and there have been four large audit firms since 2002, following Arthur Andersen's demise that year and the merger of Price Waterhouse and Coopers & Lybrand in 1998.

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

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

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<sup>3</sup> FRC, Developments in audit in 2016/17.

<sup>4</sup> See for example Deloitte, [Leaders and Shapers](#), William Welch Deloitte.

<sup>5</sup> [Enron scandal at a glance](#), BBC News, 22 August 2002.

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

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

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

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

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

#### 1.9 More recent examples include:

- (a) **BHS's demise and PwC's failings.** Both PwC and the individual audit partner admitted misconduct in their audits of BHS and the Taveta Group, which owned it, following BHS's sale to Dominic Chappell and its subsequent demise in 2016.

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<sup>6</sup> Andrew Hill, The Financial Times, [Ten years on, Enron remains an open sore](#), 17 October 2011.

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

<sup>8</sup> [Changing Banking for Good](#), Parliamentary Commission on Banking Standards, 12 June 2013, volume I, paragraph 25.

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

- (b) **Carillion's failure.** In early 2018, Carillion, a British multinational facilities management and construction services company which was at the time audited by KPMG, went into liquidation. This collapse led to project shutdowns and delays, job losses, and financial losses, including to Carillion's 30,000 suppliers, generating widespread public and political concerns. According to two House of Commons committees: 'KPMG's long and complacent tenure auditing Carillion was not an isolated failure. It was symptomatic of a market which works for the members of the oligopoly but fails the wider economy'.<sup>10</sup>
- (c) **2018 FRC Audit Quality Review (AQR) findings.** In its most recent AQR, the FRC found that there was a decline in quality for all of the Big Four, and an 'unacceptable deterioration' at KPMG, while the four challenger firms reviewed showed 'general improvements'.<sup>11</sup>
- (d) **Other FRC enforcement findings.** In May 2018, the FRC announced it had delivered formal complaints in respect of Deloitte's audit of Autonomy Corporation plc including an alleged failure by Deloitte to adequately challenge the company's accounting and disclosure of purchases and sales of computer hardware.<sup>12</sup> In July 2018, the FRC announced an investigation into the audit by KPMG of Conviviality plc, which went into administration in April 2018.<sup>13</sup> In August 2018, the FRC announced a severe reprimand and fine of £3 million for KPMG, and a separate reprimand and fine of £80,000 for one of its audit partners, after the FRC found misconduct in respect of KPMG's audit of Ted Baker plc.<sup>14</sup>
- (e) **Other international cases.** In 2016, senior staff at KPMG's South Africa division resigned following audit failures linked to a wider political corruption scandal surrounding the Gupta family. KPMG had audited various Gupta family businesses for fifteen years but its staff were found to have failed to act on warnings regarding the integrity and ethics of the family.<sup>15</sup> In India, PwC received a ban in early 2018 from auditing listed companies in the country for two years after failing to spot \$1.7 billion of fraud at Satyam Computer Services for five years from 2003.<sup>16</sup>

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<sup>10</sup> House of Commons Business, Energy and Industrial Strategy and Work and Pensions Committees, [Carillion, second joint report](#), 9 May 2018, paragraph 210.

<sup>11</sup> FRC, [Big Four Audit Quality Review results decline](#), 18 June 2018.

<sup>12</sup> FRC, [Disciplinary action in relation to Autonomy Corporation plc](#), 31 May 2018.

<sup>13</sup> FRC, [Investigation into the financial statements of Conviviality plc](#), 3 July 2018.

<sup>14</sup> FRC, [Sanctions against KPMG and Senior Statutory Auditor in relation to the audits of Ted Baker Plc](#), 20 August 2018.

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

<sup>16</sup> The Financial Times, [PwC hit with 2-year India audit ban for Satyam case](#), 11 January 2018.

- 1.10 Over the same period, regulators, governments and other authorities have made attempts to improve audits.
- (a) The Competition Commission (CC) conducted a market investigation into statutory audit services between 2011 and 2013, resulting in an Order that came into force on 1 January 2015.<sup>17</sup> The CC identified several features of the market<sup>18</sup> that were leading to adverse effects on competition and decided on a package of remedies with a number of elements. These remedies included mandatory tendering of audit contracts by the FTSE 350 companies at least every ten years, greater review of audits by the FRC, greater shareholder engagement with company management on audits, greater accountability of auditors to Audit Committees, and a recommendation for the FRC to have a competition objective.<sup>19</sup>
  - (b) In light of concerns about EU audit markets similar to those investigated by the CC in the UK, the European Commission introduced legislative change. This came into force in June 2016. This legislation closely mirrored the CC's remedies, and introduced several additional reforms including mandatory switching of audit contracts for Public Interest Entities (PIEs) (which in the UK is required at least every twenty years), and placed obligations specifically on PIEs in connection with auditor appointments.
  - (c) The Statutory Auditors and Third Country Auditors Regulations 2016 (SATCAR 2016), which came into effect in June 2016, implemented the EU legislation in the UK. SATCAR 2016 designated the FRC as the UK's Competent Authority responsible for public oversight of statutory auditors. SATCAR 2016 also amended the Companies Act 2006 to reflect the EU reforms, including the process for auditor appointments, retendering and rotation.<sup>20</sup>
  - (d) In the United States, in response to major corporate failures such as Enron, the Sarbanes-Oxley Act (2002) was passed (often referred to as SOX). The Act introduced major changes to the regulation of financial practice and corporate governance. For audit, the changes included establishing standards for external audit independence, introducing audit

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<sup>17</sup> [CMA case page for statutory audit services market investigation](#).

<sup>18</sup> These included barriers to switching; challenger firms facing barriers to entry; expansion and selection, as well as experience and reputational hurdles; company management's ability to influence auditors; and information asymmetry between shareholder and audit firm; see Statutory audit services for large companies market investigation, at paragraph 13.3.

<sup>19</sup> [Statutory audit services for large companies market investigation](#), 15 October 2013, p.7.

<sup>20</sup> FRC, [Statement from Stephen Haddrill, Chief Executive of the Financial Reporting Council, regarding the implementation of the EU Audit Regulation and Directive](#), 17 June 2016.

partner rotation, and restricting auditors from providing non-audit services for audit clients. An overarching oversight board (the PCAOB) was also established by the Act.<sup>21</sup>

- 1.11 In the last six months, public commentary on audit problems has continued. One investor has suggested: ‘many of the worries centre on audit quality... Did the auditors challenge enough? Did they actually ask whether the accounts met the higher order true and fair view test? This is not as simple as robotic adherence to accounting standards.’<sup>22</sup> Politicians have described audit as ‘a failing market’<sup>23</sup> and suggested there have been ‘structural problems over far too many years.’<sup>24</sup> A recent report for the Labour Party suggested that auditors have been ‘unable to deliver independent and robust audits and the auditing industry is in disarray, dysfunctional and stumbles from one crisis to another’.<sup>25</sup> Academics and experts have stated ‘the culture and ethics of auditing have failed miserably at too high a cost to society.’<sup>26</sup>
- 1.12 As the comments above indicate, there remain concerns despite the changes to improve audits; we explain in section two the extent to which the changes have made improvements or left issues unresolved.

## How we have examined these concerns

- 1.13 We have gathered a range of evidence and views, including from the following:
- (a) 75 responses to our invitation to comment document;
  - (b) Information request responses from nine audit firms and 31 companies; and
  - (c) Over 60 telephone calls or face-to-face meetings with auditors, investors, companies, other public authorities, and other interested parties.
- 1.14 Appendix A sets out more detail on how we have conducted the study so far.

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<sup>21</sup> More details about the Sarbanes-Oxley Act can be found at <http://www.soqlaw.com/>.

<sup>22</sup> Natasha Landell-Mills, Head of Stewardship at Sarasin & Partners, [A return to prudence – how to restore faith in accounting](#), The Financial Times, 29 August 2018.

<sup>23</sup> Rachel Reeves MP, Chair of BEIS Select Committee, [Pressure mounts on the CMA to break up the Big Four](#), City AM, 1 October 2018.

<sup>24</sup> Sir Vince Cable MP, City AM, [Pressure mounts on the CMA to break up the Big Four](#), 1 October 2018.

<sup>25</sup> Professor Prem Sikka et al, [Reforming the auditing industry](#), December 2018.

<sup>26</sup> A group of academics and audit experts including Professor Atul Shah and Richard Murphy, [Big Four warn against breaking up UK audit firms](#), The Financial Times, 13 November 2018.

- 1.15 We have focused our attention on the audits of larger companies, both listed and private, but have remained open to evidence and views on the smaller end of the market, where some different conditions may prevail.
- 1.16 We have conducted this market study in parallel to and have liaised with the independent review of the FRC led by Sir John Kingman. We also welcome the expected review into the purpose and scope of audit.

### **Structure of the remainder of this paper**

- 1.17 In section three, we give our initial views on the range of issues we have examined, taking selection and oversight of auditors, choice and competition, resilience, and firms' structures in turn.
- 1.18 In section four, we propose some improvements to the way the market operates, before setting out our next steps for the market study (section five) and how to respond (section six).
- 1.19 The paper is accompanied by three supporting appendices: two included at the end of this paper, and one published separately, on the conduct of our study to date, how we may use information provided to us during the study, and the 'expectations gap'; the purpose and scope of audit.
- 1.20 We invite views on this paper by 21 January 2019.



## 2. Market context and outcomes

2.1 In this section, we cover:

- (a) Market context, including the characteristics of the statutory audit market and changes in the market in recent years;
- (b) Audit quality, including what the different indicators of quality show; and
- (c) The 'expectations gap' and the role of audit.

### Overview

2.2 The statutory audit market has changed significantly over the past five years following the introduction of the CC and European Commission remedies. Mandatory tendering has led to a much higher rate of tendering and switching of auditors than previously. The switching process appears to have worked well, and in some cases has led to improvements in the quality of the audit process.

2.3 However, switching by the FTSE350 has been almost entirely between the Big Four auditors. The Big Four still account for over 97% of audit clients in the FTSE 350 and over 99% of audit fees. The challenger firms have won only a handful of FTSE 350 audit contracts. This is in spite of the fact that the larger challenger firms have grown their overall UK audit revenues more strongly than the Big Four and that they have similar levels of profitability.

2.4 The unanimous view of stakeholders is that the most important outcome in this market is audit quality. This means in particular that the auditor should provide sufficient professional scepticism and challenge of company accounts.

2.5 There are widespread public concerns about audit quality.<sup>27</sup> On the whole, Audit Committee Chairs (ACCs) did not share the view that there was a systemic and significant quality problem. However, the views of investors – who are the ultimate customers for statutory audit – were more mixed. Many stakeholders argued that the public concerns arise in part from an expectation gap about the role of audit, and we heard various views about how the role of audit should change in the future.

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<sup>27</sup> See paragraphs 1.7 to 1.11 above for a summary of these public concerns.

- 2.6 However, while the arguments around the role of audit are important, the evidence nevertheless suggests that audit quality is not as high as it should be in a well-functioning market. In particular:
- (a) In spite of the previous remedies put in place by the CC and the EU, there has been a persistent failure of the sector as a whole to meet the FRC's AQR targets for quality;
  - (b) There have been a number of audit failures in recent years and cases of enforcement action by the FRC reflecting concerns about lack of challenge and professional scepticism; and
  - (c) The auditors themselves accept that there is a problem that needs to be addressed. They share the view that it is important to rebuild trust in the sector.

## **Market context**

- 2.7 This section sets out background on the market for large company audits in the UK. We focus particularly on changes since the last CC report.

### ***Legal requirements***

- 2.8 The Companies Act 2006, and various domestic codes and regulations, set out legal requirements in respect of statutory audit in the UK, including reflecting elements of the European legislative framework. The key pieces of European legislation in respect of audits are the Audit Directive<sup>28</sup> and Audit Regulation.<sup>29</sup> Aspects of the legal framework particularly relevant to our study include:
- (a) A requirement that a company's accounts must be audited each financial year, unless the company is exempt;<sup>30</sup>
  - (b) A requirement that a company's auditor is selected by a vote of shareholders;<sup>31</sup>
  - (c) A requirement that, in the case of PIEs, the company's Audit Committee is responsible for the audit selection process (leading to a recommendation

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<sup>28</sup> Directive 2006/43/EC (most recently amended by Directive 2014/56/EU).

<sup>29</sup> Regulation (EU) No 537/2014.

<sup>30</sup> Section 475(1) of the Companies Act 2006. A company may be exempt if it meets certain defined terms, being: small companies, certain subsidiary companies, dormant companies, or non-profit making and subject to public sector audit.

<sup>31</sup> Article 37(1), Directive 2006/43/EC. We note that there are some exceptions to this requirement.

by management to shareholders), and specific requirements as to how that selection process must be conducted;<sup>32</sup>

- (d) Mandatory rotation of auditors of PIEs (in the UK rotation is required within 10 years of initial appointment, with the possible extension by 10 years in circumstances where a competitive tender takes place within 10 years);<sup>33</sup> and
- (e) Restrictions on the provision of non-audit services to PIEs by the statutory auditor. In particular:
  - (i) A ‘blacklist’ of services that cannot be provided by the audit firm or its network during the audit or in the financial year preceding the audit.<sup>34</sup>
  - (ii) A cap on the level of other non-audit services the audit firm may provide to its PIE audit clients. This cap limits services to no more than 70% of the average fees paid in the last three consecutive financial years for the statutory audit(s) of the audited entity (and certain other related undertakings).<sup>35</sup>

### ***Characteristics of the statutory audit market***

2.9 Total audit fees paid to auditors of UK PIEs were £2.7 billion in 2017 – an increase of 14% since the completion of the CC’s Statutory audit services market investigation in 2013.<sup>36</sup> The audit fees paid by FTSE 350 companies were around £1 billion in 2017 – accounting for 39% of the total audit fees paid by all PIEs.<sup>37</sup> By comparison, the total audit fees paid by companies in the FTSE Alternative Investment Market (AIM) were £72.9 million in 2017 and the audit fees paid by large private companies included in the Top Track 100 totalled £16.3 million in the same year.<sup>38</sup>

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<sup>32</sup> Article 16, Regulation (EU) No 537/2014. There are some exceptions to the requirement that Audit Committees take responsibility for the selection procedure.

<sup>33</sup> Article 17, Regulation (EU) No 537/2014 transposed by section 494ZA of the Companies Act 2006.

<sup>34</sup> Article 5, Regulation (EU) No 537/2014. Blacklisted services include, for example, certain tax services, payroll services, and promoting, dealing or underwriting shares in the audited entity.

<sup>35</sup> Article 4, Regulation (EU) No 537/2014.

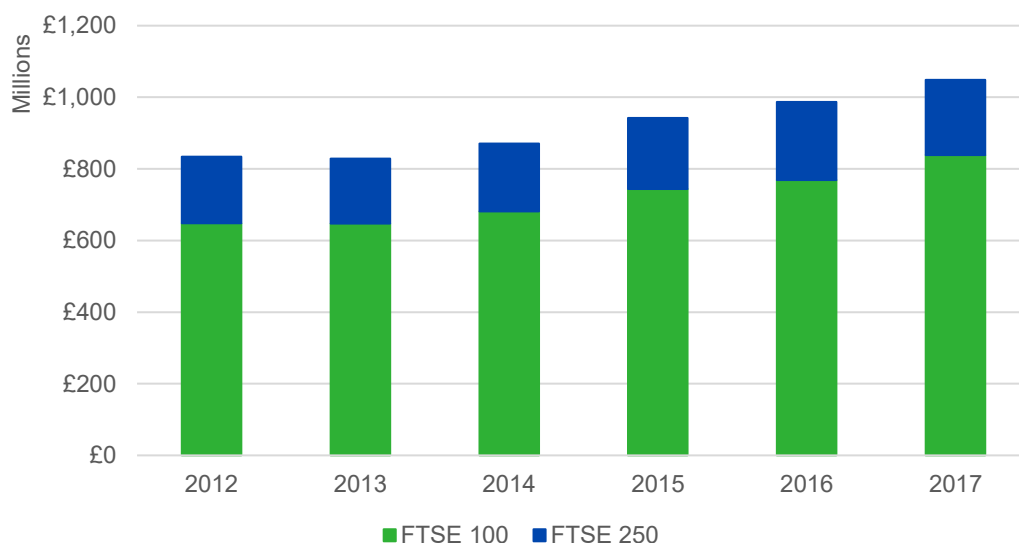
<sup>36</sup> Figures taken from the FRC’s [Key Facts and Trends in the Accountancy Profession](#) reports.

<sup>37</sup> CMA analysis of the Industry Background data set and figures taken from the FRC’s [Key Facts and Trends in the Accountancy Profession](#) reports.

<sup>38</sup> AIM figure taken from FRC *Developments in Audit: 2018* (October 2018). (The FRC used data from a survey of FTSE 350 companies published by Accountancy magazine and for 2017 it is drawn from an amalgam of FRC analysis and the Audit Analytics database.) Top Track 100 is based on CMA analysis of the Industry Background data set.

2.10 Figure 2.1 shows the trend in audit fees paid by FTSE 350 companies in the period 2012 to 2017. The total audit fees paid by companies in the FTSE 350 has increased by 25% since 2012.<sup>39</sup>

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



Source: CMA analysis of the Industry Background data set.

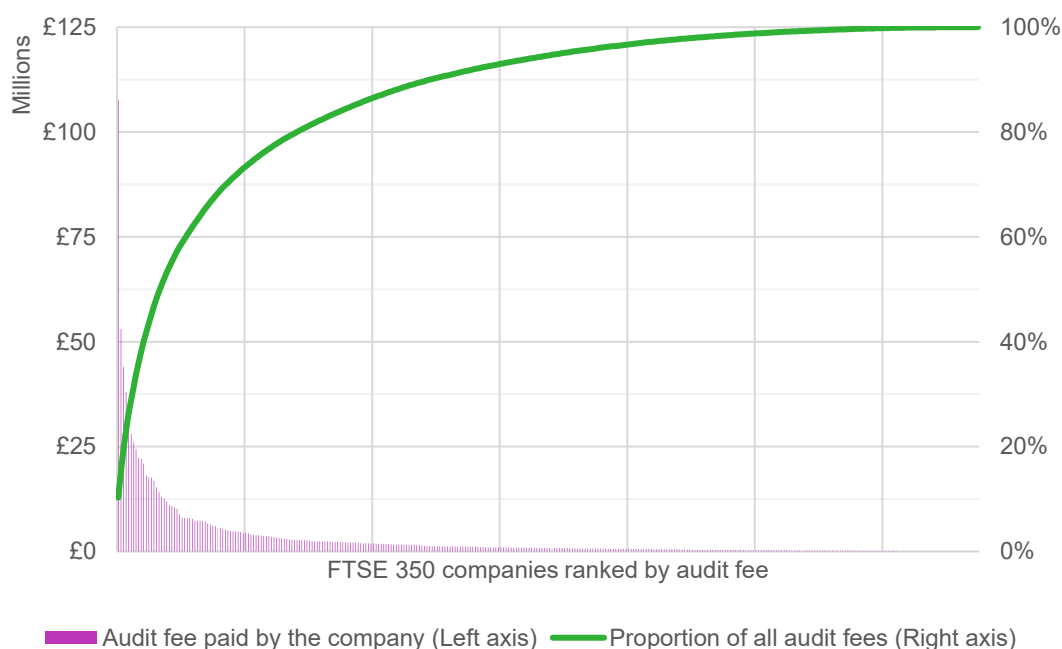
2.11 The relative size of the audit fees paid by FTSE 350 companies in each of the FTSE 100 and FTSE 250 indices is also shown in Figure 2.1. The audit fees paid by companies in the FTSE 100 have been between 77% and 80% of the FTSE 350 total in the period 2012 – 2017.<sup>40</sup>

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

<sup>39</sup> CMA analysis of the Industry Background data set.

<sup>40</sup> CMA analysis of the Industry Background data set.

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



Source: CMA analysis of the Industry Background data set.

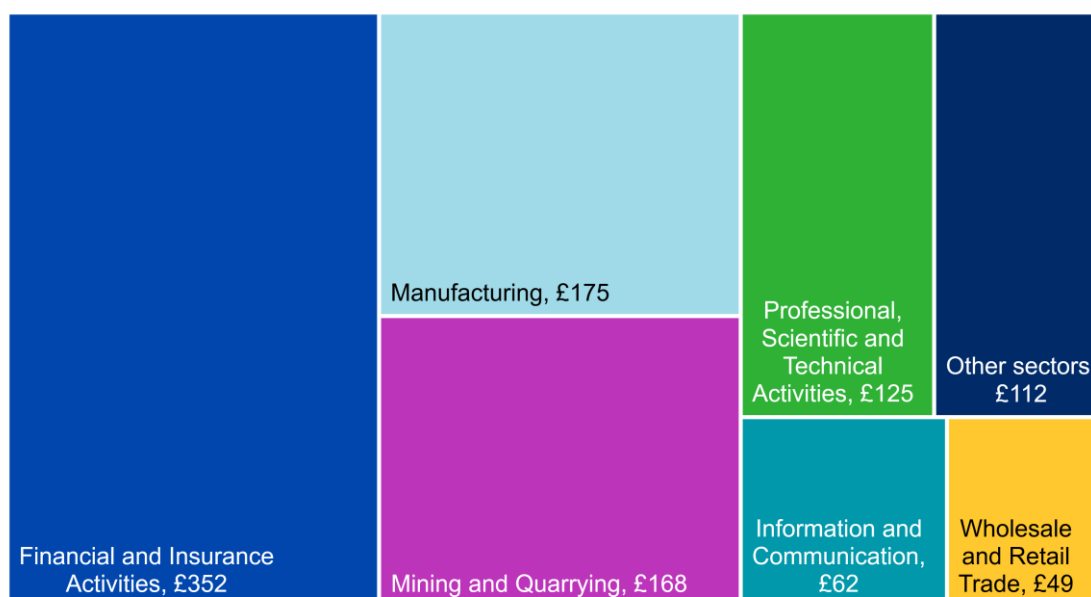
2.13 This variation in fees reflects significant differences in audit complexity within the FTSE 350. Several of the auditors suggested that there are in fact at least two audit markets within the FTSE 350: the top end, comprising perhaps 30 or 40 companies with particularly complex audits; and a longer tail of companies with relatively less complex audit requirements. This complexity can be driven, among other things, by the international scope of the business and the degree to which the audit requires specific technical knowledge and processes (for example in financial services).

2.14 Figure 2.3 shows the audit fees paid by FTSE 350 companies in the year 2017 arranged by sector.<sup>41</sup> The largest sector by audit fees in the FTSE 350 was Financial and Insurance Activities (representing around 34% of the total audit fees paid in the FTSE 350), followed by Manufacturing (17%) and Mining and Quarrying (16%). Companies from these three sectors account for 43 of the 71 companies that make up 80% of the total audit fees paid by constituents of the FTSE 350.<sup>42</sup>

<sup>41</sup> We have used the ONS's current Standard Industrial Classification (SIC) to classify businesses according to the main type of economic activity in which they are engaged.

<sup>42</sup> CMA analysis of the Industry Background data set.

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



Source: CMA analysis of the Industry Background data set.

2.15 Outside of the FTSE350 companies, we have gathered data on large private companies (the ‘Top Track 100’). Our analysis has found a similarly large variation in the audit fees paid by companies in this index – suggesting that private companies range significantly in audit complexity and scope. The largest private companies (such as Dyson and John Lewis Partnership) have audit fees that are comparable to companies listed in the FTSE 250.<sup>43</sup>

### **Market shares**

2.16 The Big Four firms were the statutory auditor for 84% of all UK PIEs in 2017, whereas the five largest challenger firms were the statutory auditor for 13% of all UK PIEs.<sup>44</sup>

2.17 This difference between the Big Four and challenger firms is starker in the FTSE 350, where the overall share of the Big Four by number of audit clients has remained stable since 2011 – increasing slightly from 95% to 97% in 2017.<sup>45</sup> The only challenger firms that audited a FTSE 350 company in 2017 were BDO and Grant Thornton, having five and four respectively FTSE 350 audit clients that year.<sup>46</sup> In comparison, these two audit firms had nine and seven respectively in 2011. Only one FTSE 100 company is audited by a challenger firm (Randgold, which is audited by BDO).

<sup>43</sup> Information taken from the Industry Background data set.

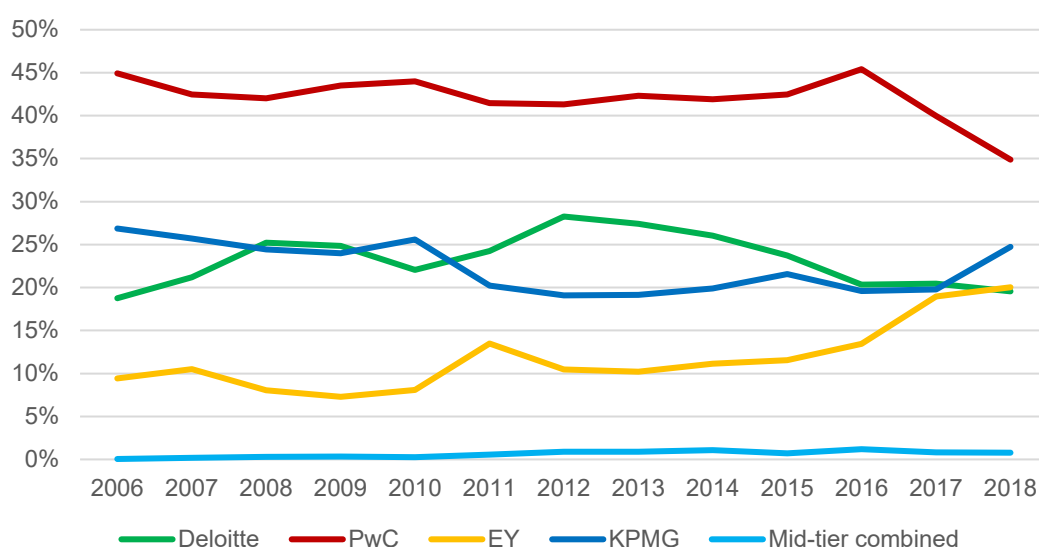
<sup>44</sup> Figures taken from the FRC’s [Key Facts and Trends in the Accountancy Profession](#) reports.

<sup>45</sup> CMA analysis of financial information submitted by audit firms.

<sup>46</sup> Information taken from the Industry Background data set.

2.18 The high combined share of the Big Four firms is also found when considering their share of audit fees paid by FTSE 350 companies. Figure 2.4 shows that, while each of the Big Four firms received between 20% and 35% of the audit fees paid by FTSE 350 companies in 2018, the challenger firms combined had less than a 1% share. Taken together with their share of audit clients in the FTSE 350, this suggests that not only do the Big Four firms carry out the more complex audits required for the top end of the index (which receive the highest audit fees paid by companies) but they also have a number of audit clients with relatively less complex audit requirements.

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



Source: CMA analysis of financial information submitted by audit firms

2.19 Outside of companies in the FTSE 350, we have gathered evidence that the Big Four firms received a sizeable proportion of the audit fees paid by smaller listed companies. A survey of the FTSE AIM 100 conducted by *Accountancy* found that the Big Four receive 86% of audit fees paid by companies in 2017, with the top 20 companies by audit fee value all audited by one of the Big Four firms.<sup>47, 48</sup> Our analysis of private companies in the Top Track 100 found that, for the years 2012 – 2017, the Big Four firms carried out the audit for around two-thirds of the companies included in the index, receiving 85% to 90% of the total audit fees.<sup>49</sup>

<sup>47</sup> *Accountancy Briefing: AIM Survey* (September 2017).

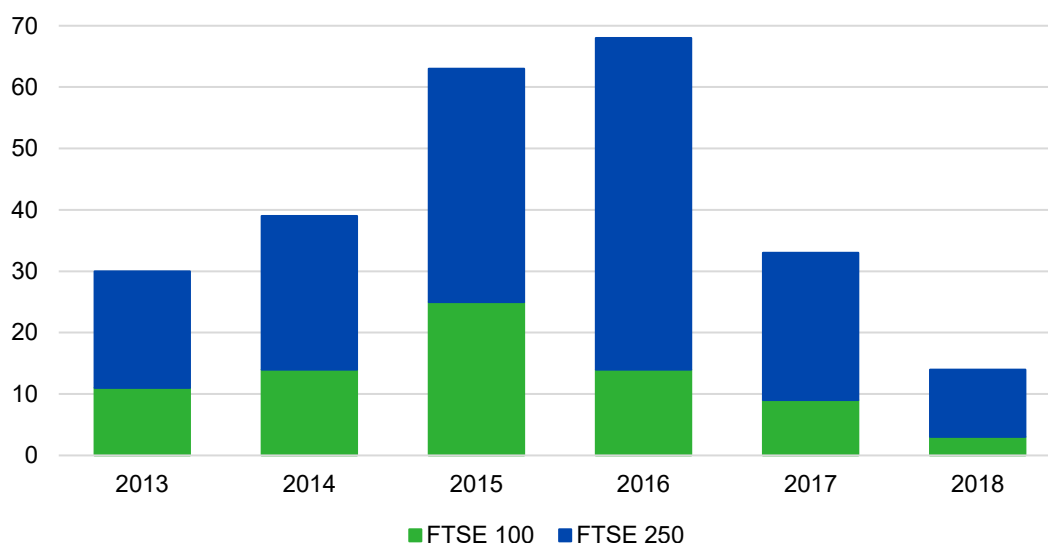
<sup>48</sup> It should be noted that only AIM listed companies with a market capitalisation higher than €200m are considered to be PIEs in the UK.

<sup>49</sup> CMA analysis of the Industry Background data set. We do not have information on all the companies in the Top Track 100 in each year (either as they are not audited or as information was not available for some companies on the FAME database). This means that the estimated Big Four share of audit clients could be an underestimate and audit fees could be an overestimate.

## Tendering and switching

2.20 Our analysis has found that over half of FTSE 350 companies have tendered their external audit since 1 January 2013. Figure 2.5 shows the number of tenders in the FTSE 350 that were completed between January 2013 and October 2018, with the increased tendering in 2015 and 2016 likely due to the transition arrangements put in place as part of the CC and then EU audit legislation.<sup>50</sup> We have identified at least 247 audit tenders in the FTSE 350 during this period,<sup>51</sup> which is a significant increase compared to the 52 included in the analysis conducted by the CC for the period 2007 to 2011.<sup>52</sup>

Figure 2.5: FTSE 350 engagements tendered per year



Source: CMA analysis of auditors' tender data.

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

2.21 Of the FTSE 350 tenders included in our analysis, around three-quarters resulted in a switch of auditor.<sup>53</sup> As shown in Figure 2.6, we found that the overall annual switching rate for FTSE 350 audits grew from 6% in 2013 to 14% in 2015, before falling to below 3% in 2018. When excluding those tenders where the incumbent auditor did not bid (a key factor being the EU rotation requirements<sup>54</sup>), we have that around 50% resulted in a switch away

<sup>50</sup> CMA analysis of auditors' tender data.

<sup>51</sup> CMA analysis of auditors' tender data.

<sup>52</sup> CC, [Statutory audit services market investigation: Final report](#), 16 October 2013, see paragraph 14 of Appendix 7.1.

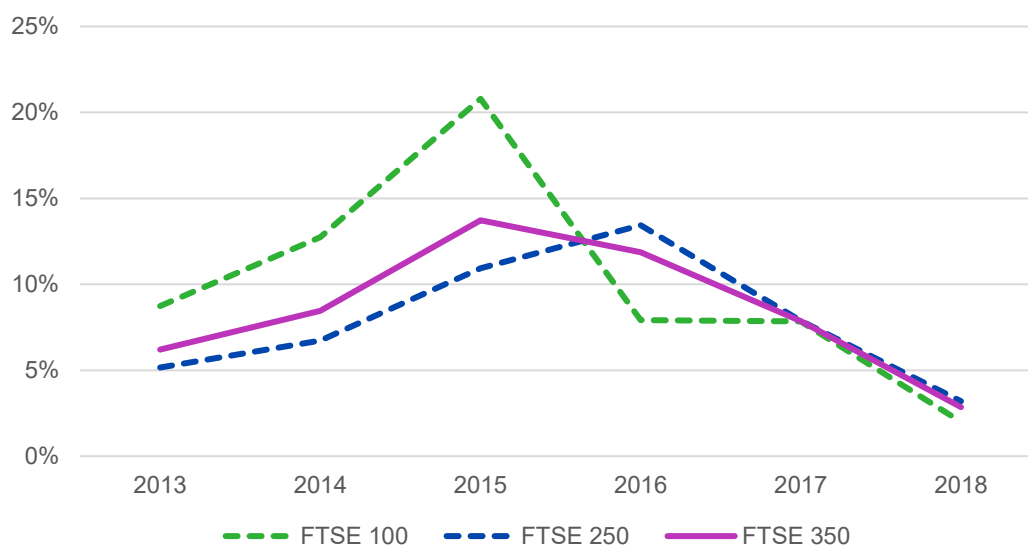
<sup>53</sup> CMA analysis of auditors' tender data.

<sup>54</sup> In over 85% of the cases where the incumbent did not participate and the incumbent provided a reason for its non-participation, the reason cited was rotation (source: CMA analysis of auditors' tender data).'



from the incumbent auditor. These results are consistent with analysis submitted by KPMG.<sup>55</sup>

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



Source: CMA analysis of auditors' tender data.

2.22 While the rate of switching has increased significantly since the introduction of the CC and EU remedies, we have found that switching has been almost entirely between the four largest auditors in the FTSE 350. This is shown in Figure 2.7, with 92% of tenders since 1 January 2013 resulting in a Big Four firm winning an audit from a Big Four incumbent for a FTSE 350 company.

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

		<i>Appointed</i>	
		Big Four	Challenger
<i>Incumbent</i>	Big Four	92%	3%
	Challenger	6%	0%

Source: CMA analysis of auditors' tender data.

2.23 Only five FTSE 350 companies (all in the FTSE 250) switched away from a Big Four firm to a challenger firm. These were: Bankers Investment Trust from PwC to Grant Thornton in 2014;<sup>56</sup> Interserve from Deloitte to Grant Thornton in 2014; Witan Investment Trust from Deloitte to Grant Thornton in 2015; JD

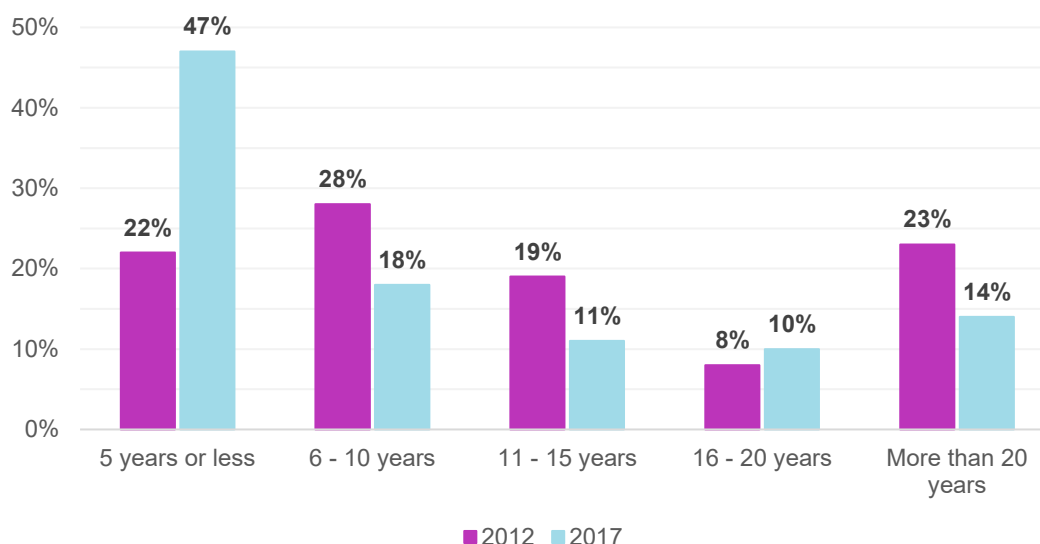
<sup>55</sup> See KPMG ITC response.

<sup>56</sup> We understand that Bankers Investment Trust subsequently switched from Grant Thornton to EY in 2016.

Wetherspoons from PwC to Grant Thornton in 2017; and Mitie from Deloitte to BDO in 2017.<sup>57</sup>

2.24 Another indicator of the increased rate of auditor rotation by companies in the FTSE 350 is the reduction in length of current auditor engagements between 2012 and 2017. This is shown in Figure 2.8, with an analysis conducted by the FRC showing a significant increase in the number of audit engagements with a tenure of less than five years – from 22% in 2012 to 47% in 2017.

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



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

2.25 A 2017 survey of the FTSE AIM 100 conducted by *Accountancy* found that 64% of companies had an audit engagement of less than 10 years, with only 3% of the AIM 100 having had the same auditor for a period of more than 20 years.<sup>58</sup> Our analysis of private companies in the Top Track 100 indicates that the proportion of companies in this index that tendered is much lower, likely reflecting the fact that these companies may not always be subject to the mandatory tendering and auditor rotation requirements.<sup>59</sup>

### **Fees from audit clients**

2.26 Figure 2.9 shows trends in total fees earned by the Big Four and challenger audit firms from their audit clients in the period 2011 to 2018. Our analysis has found that audit fees have increased in nominal terms by 34% during this

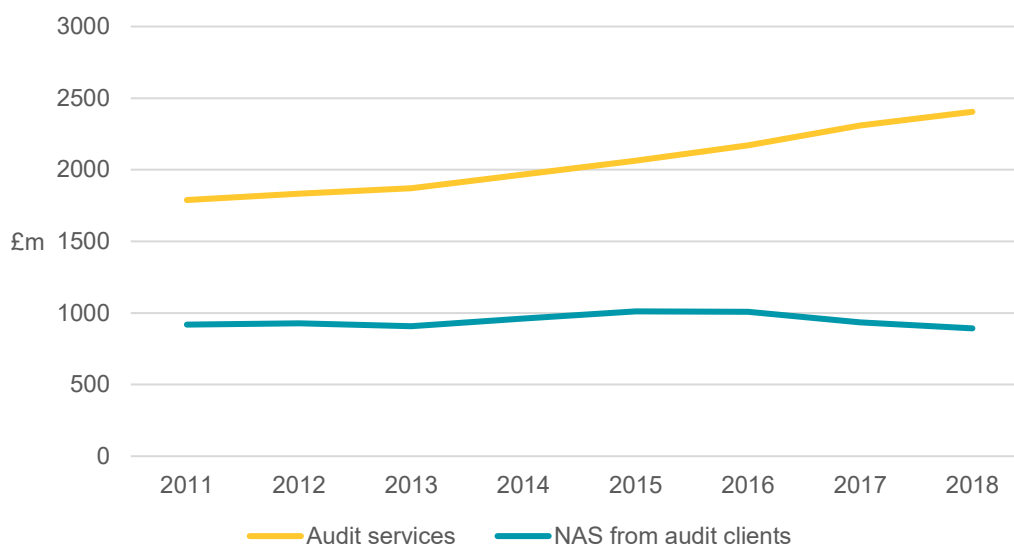
<sup>57</sup> CMA analysis of auditors' tender data.

<sup>58</sup> *Accountancy Briefing: AIM Survey* (September 2017).

<sup>59</sup> CMA analysis of auditors' tender data.

time, whereas there has been a 3% decrease in the total non-audit fees that the firms earned from services provided to their audit clients.<sup>60</sup>

**Figure 2.9: Fees received by Big Four and challenger firms from their audit clients**



Source: CMA analysis of financial information submitted by audit firms

2.27 When only considering the fees received by auditors from their clients in the FTSE 350 in the period 2012 to 2017, we found that there has been a 25% increase in the audit fees and a 35% decrease in the non-audit fees paid by companies in this index to their statutory auditor.<sup>61</sup> This observed decrease in the non-audit fees received by these firms has led the proportion of non-audit to audit fees received by audit firms from their audit clients in FTSE 350 to be 16% in 2017.<sup>62</sup> By comparison, the proportion of non-audit to audit fees received by audit firms from their audit clients in the AIM 100 was 61% in 2017.<sup>63</sup>

### **Non-audit services**

2.28 We gathered evidence from the audit firms on their total revenues from audit and non-audit services. Figure 2.10 shows aggregate total revenues from all clients for the Big Four audit firms for the years 2011 to 18.

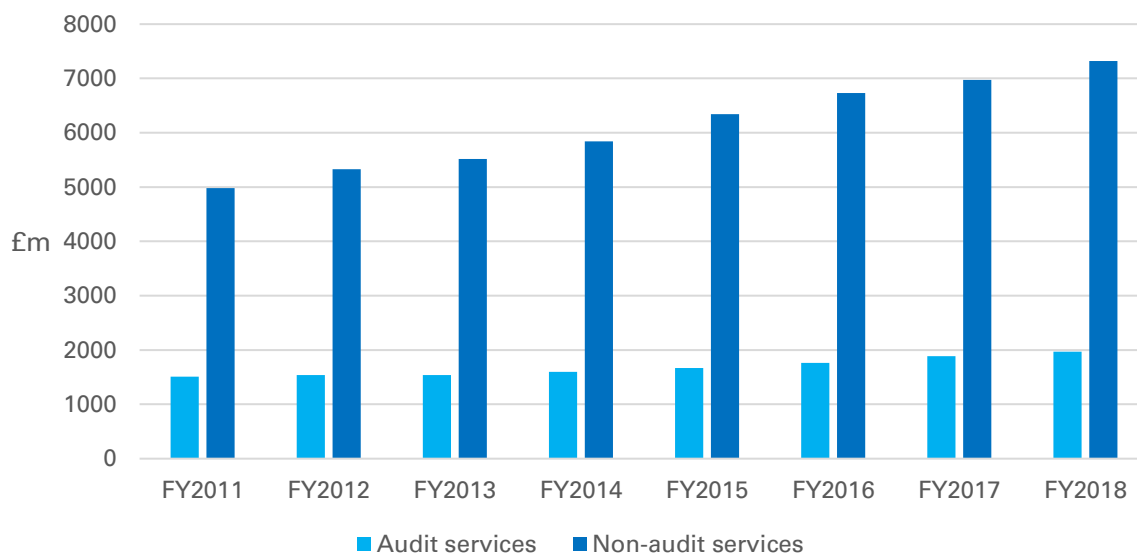
<sup>60</sup> CMA analysis of financial information submitted by audit firms.

<sup>61</sup> CMA analysis of the Industry Background data set.

<sup>62</sup> CMA analysis of the Industry Background data set.

<sup>63</sup> Accountancy Briefing: AIM Survey (September 2017).

**Figure 2.10: Aggregated audit and non-audit revenues for the Big Four 2011 to 2018 (£million)**

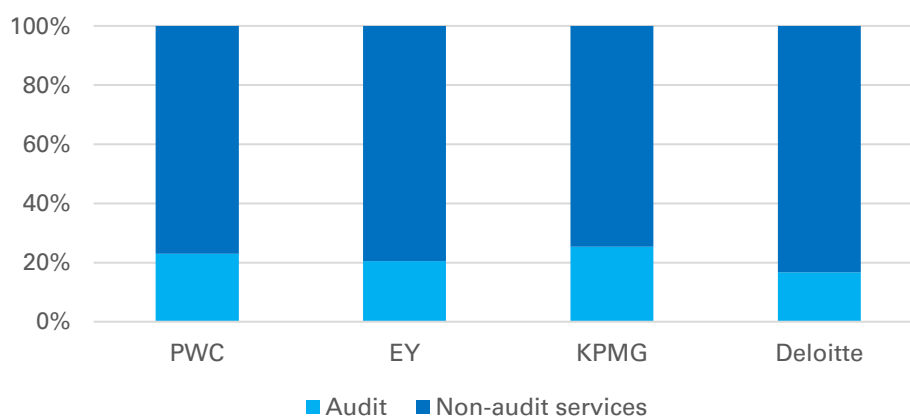


Source: CMA analysis of financial information submitted by audit firms

2.29 Figure 2.10 shows that the Big Four derive substantially more revenue from non-audit services than they do from audits. Across the Big Four as a whole, non-audit services accounted for 79% of total revenues in 2018 (a slight increase from 77% in 2011).<sup>64</sup> Revenues earned on non-audit services exceed by a factor of four those earned on audit services.

2.30 There is some minor variation between the Big Four firms, with Deloitte deriving the largest share of revenue from non-audit services (83% in 2018). However, each of the Big Four generate at least three quarters of its revenue from non-audit services as shown in Figure 2.11.

**Figure 2.11: Audit and non-audit FY2018 revenue split for each Big Four firm**

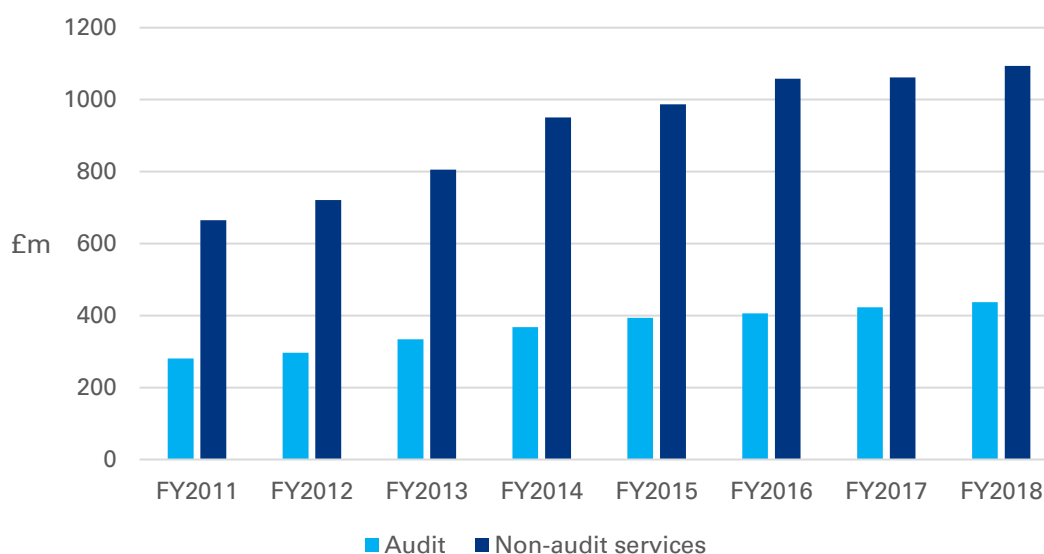


<sup>64</sup> Note that most of these non-audit fees come from clients for whom the firms do not provide audit services. As illustrated in Figure 2.9, the non-audit fees provided to audit clients have been relatively small and falling in recent years.

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

2.31 Figure 2.12 shows that the challenger firms also generate a majority of their revenues from non-audit services rather than from audits (although revenues from audit services account for a higher proportion of total revenue compared with the Big Four). The challenger firms have seen stronger growth in audit revenues than the Big Four; since 2011, total audit revenues have grown in nominal terms by around 33% for the Big Four compared with 57% for the challenger firms.

**Figure 2.12: Aggregated audit and non-audit revenues for the challenger firms 2011-2018 (£million)**



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

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

### **Profitability**

2.33 We have not carried out a full profitability analysis. However, the results set out below show the relative profitability of Big Four and challenger firms, and of audit and non-audit services, respectively.

2.34 Figure 2.13 shows, for Big Four audit firms, aggregate audit revenues and aggregate pre-exceptional items EBIT<sup>65</sup> margins for the period 2011 to 2018. While revenues have increased, margins have fallen from over [✂].

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<sup>65</sup> Earnings before interest and taxation.

### Figure 2.13: Aggregate audit revenue and aggregate EBIT margin, Big Four firms

[✂]

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

2.35 Figure 2.14 shows the same calculation for challenger firms. This shows that challenger firm revenues have increased at a faster rate than those of Big Four firms. EBIT margins have also increased over the period and are now similar to those achieved by Big Four firms.

### Figure 2.14: Aggregate audit revenue and aggregate EBIT margin, challenger firms

[✂]

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

2.36 Figure 2.15 shows, for Big Four audit firms, aggregate non-audit services revenues and aggregate EBIT margins, for the period 2011 to 2018. This shows that non-audit services revenues have increased at a faster rate than audit revenues. Again, margins have fallen from around [✂].

### Figure 2.15: Aggregate non-audit services revenue and aggregate EBIT margin, Big Four firms

[✂]

Source: CMA analysis of financial information submitted by audit firms

## Audit quality

2.37 There was unanimous agreement among stakeholders we spoke to that audit quality should be the key focus in assessing whether the market was producing good outcomes. A well-functioning market should produce high-quality audits that are in the interests of shareholders and the wider public, delivered at a reasonable cost.

2.38 Unlike in some markets where there are concerns over whether the market is working well, there seem to be few complaints here that prices are too high. We have heard views that there might be merit in prices being higher in order to secure higher quality.

2.39 There is no single agreed definition of audit quality. The CC defined quality in terms of auditors' scepticism, objectivity, integrity and independence. The ICAEW suggested that auditors provide a quality service to shareholders if they provide audit reports that are independent, reliable and supported by adequate evidence.<sup>66</sup> We agree that high quality audit must involve producing

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<sup>66</sup> See for example <https://www.icaew.com/-/media/corporate/files/technical/audit-and-assurance/audit-quality/audit-quality-forum-shareholder-involvement/audit-quality-abridged-version.ashx?la=en>

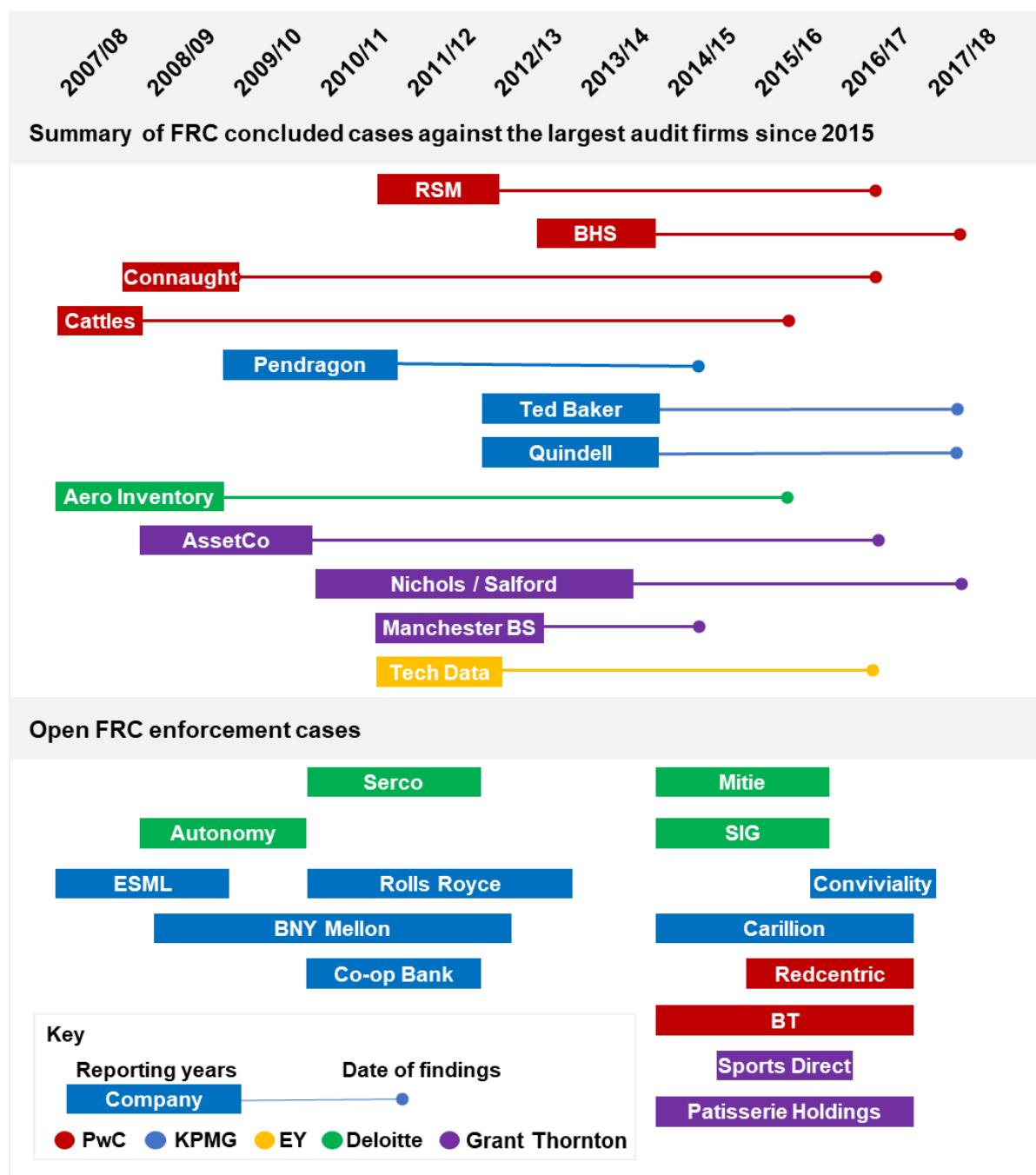
a well-evidenced, independent report. However, it is also crucially important that auditors provide appropriate independent challenge and are willing to take tough judgements, sometimes in the face of strong pressure from a company's management.

- 2.40 One of the key challenges in this market is that these aspects of quality are very difficult to observe. While it may be possible to observe whether suitable audit processes are in place and whether the audit report is properly evidenced, it is much harder to assess whether an auditor is demonstrating professional scepticism and independence.
- 2.41 In spite of these measurement challenges, several indicators suggest a persistent problem of variable and sometimes poor audit quality. These issues were identified by the CC in 2013. Despite the changes in the market since then, similar quality concerns still remain. We have come to this conclusion based on:
- (a) evidence of recent audit failures and FRC enforcement actions;
  - (b) audit quality inspections;
  - (c) international concerns over audit quality; and
  - (d) stakeholder views.

### ***Context of audit failures and FRC enforcement actions***

- 2.42 In recent years a number of high profile cases of audit failures have been exposed in the UK by corporate failures and fraud. Several of these audit failures have led to FRC enforcement actions, as summarised in Figure 2.16.

Figure 2.16: Summary of FRC enforcement findings and open enforcement cases



2.43 These failures appear not to be isolated incidents and have had significant wider impacts. For example, the Pensions and Lifetime Savings Association submitted that while there are good quality audits in the UK, 'high profile failures or even the perception of failure can be extremely damaging to investor (and public) confidence'.<sup>67</sup> The level of concern was further expressed by the United Kingdom Shareholders Association, which submitted

<sup>67</sup> Pensions and Lifetime Savings Association, Response to CMA Invitation to Comment, 5 November 2018, p. 2.



that there is a concern that ‘shareholders can no longer rely on the audit and it is a matter of sheer luck that there have not been more major audit failures recently’.<sup>68</sup> One challenger firm commented that ‘many stakeholders have reduced confidence in the assurance provided by an audit report, when of course one of the key aims of an audit is to enhance the confidence of stakeholders in the financial information that has been presented to them’.<sup>69</sup> The corporate failures have caused financial harm and distress for employees, customers, suppliers and pension schemes.<sup>70</sup>

- 2.44 Responsibility for recent corporate failures does not rest solely with the auditors. Indeed, some argue that the public commentary around audit failures reflects a misunderstanding of the role of audit – sometimes referred to as the ‘expectations gap’. We consider these arguments further below. However, had the auditors identified and exposed problems earlier, this would have provided shareholders and other stakeholders with an opportunity to make informed decisions (including decisions that might have addressed the problems or mitigated the impact).
- 2.45 In most cases, these failures came to light as a result of corporate failure or other financial problems (such as profit warnings), or instances of fraudulent or corrupt behaviour coming to light.<sup>71</sup> That these audit failures became apparent only when the companies in question collapsed (or following some other external event) must give rise to concern that there are quite likely a wider set of audit problems that never come to light.
- 2.46 We reviewed the FRC enforcement findings for the cases concluded since 2015 against the five largest audit firms set out in Figure 2.17. Based on our analysis, the most frequent reasons for findings of misconduct include:
- (a) failure to exercise sufficient professional scepticism or to challenge management (most cases);
  - (b) failure to obtain sufficient appropriate audit evidence (most cases); and
  - (c) loss of independence (three out of a total of 11 cases).

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<sup>68</sup> The United Kingdom Shareholders Association, Response to CMA Invitation to Comment, 30 October 2018, p. 1.

<sup>69</sup> Moore Stephens, Response to CMA Invitation to Comment, 30 October 2018, p. 2.

<sup>70</sup> Duncan & Toplis, Response to CMA Invitation to Comment, 30 October 2018, p. 3; 38 Degrees, Response to CMA Invitation to Comment, 30 October 2018; The United Kingdom Shareholders Association, Response to CMA Invitation to Comment, 30 October 2018, p. 1.

<sup>71</sup> Legal & General Investment Management (LGIM) stated that, while the collapse of Carillion has drawn significant attention, profit warnings from companies such as Serco, G4S and Mitie should have raised concerns with the quality of audit. Legal & General Investment Management (LGIM), CMA Invitation to Comment Response, 1 November 2018, p. 3.

2.47 The FRC told us that all its recent enforcement findings have to some extent related to a lack of sufficient professional scepticism or challenge by the auditor. This suggests to us that the enforcement cases reflect underlying quality concerns.

### ***FRC AQR results***

2.48 Each year the FRC reviews a sample of audits and related procedures supporting audit quality (firm-wide procedures) at individual audit firms. The results are published in the FRC's Developments in Audit report, which summarises the result of the audit inspections and firm-specific reports (with annual reviews and a public report for each of Big Four audit firms, BDO, Grant Thornton and Mazars). Confidential reports on individual audits reviewed are given to the relevant audit firms and ACCs.

2.49 We heard criticism from some investors and ACCs that the reports on individual audits focus primarily on the quality of the audit process rather than the underlying professional judgements. Nevertheless, the results are a key public indicator of audit quality and are used by companies in the selection of their external auditor.

### ***Individual audit inspections***

2.50 The individual audit reviews focus on the appropriateness of key audit judgements made in reaching the audit opinion and the sufficiency and appropriateness of the audit evidence obtained. All audits are graded as either good, limited improvements required, improvements required, or significant improvements required. The FRC considers whether enforcement action is appropriate for all inspections assessed as requiring improvements or significant improvements.

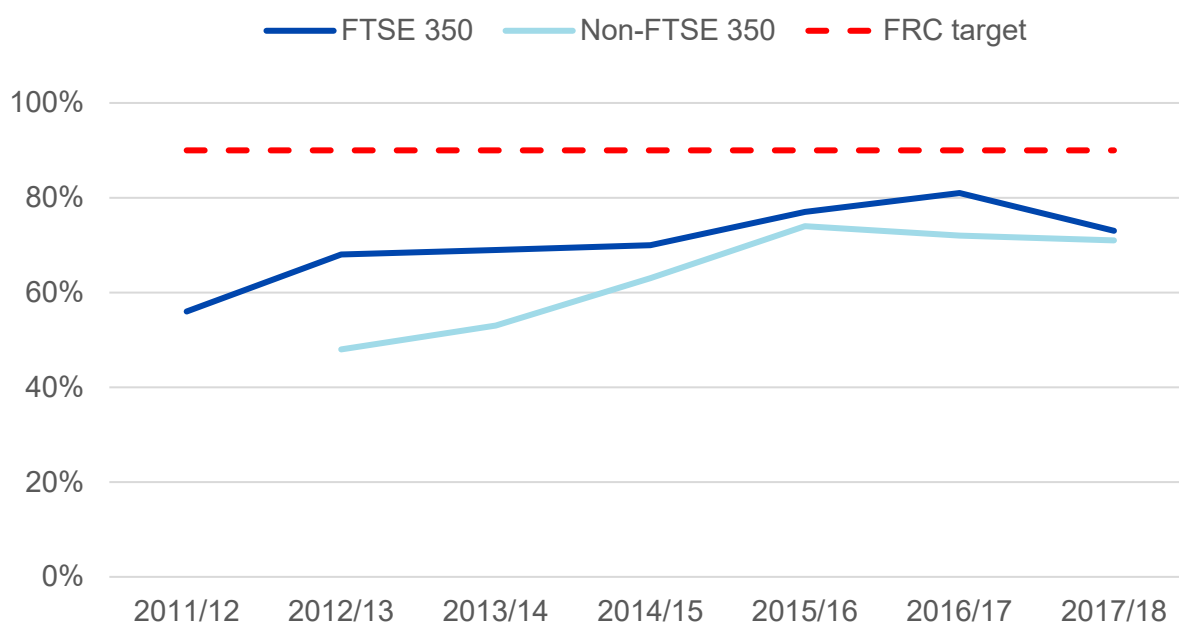
2.51 The CC recommended that the FRC inspect audit engagements on average every five years, with each individual engagement inspected at least every seven years. In any year, the selection of audits is based on a number of factors including the assessed risk in relation to the entity and particular priority sectors (i.e. it is not a random sample). This means that findings may not be representative of the population of FTSE350 audits and we need to be particularly cautious in interpreting trends over time.<sup>72</sup>

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<sup>72</sup> FRC, Developments in Audit 2018, p6, states that 'Changes to the proportion of audits falling within each category from year to year reflect a wide range of factors, which may include the size, complexity and risk of the individual audits selected for review and the scope of the individual reviews. For this reason, and given the sample sizes involved, changes from one year to the next are not necessarily indicative of any overall change in audit quality at the firm.'

- 2.52 The FRC has a target of 90% of FTSE 350 audits requiring no more than limited improvements. An audit will be assessed as requiring significant improvements where the FRC has ‘significant concerns in relation to the sufficiency or quality of audit evidence, or the appropriateness of key audit judgments, or the implications of other matters are individually or collectively significant’.<sup>73</sup>
- 2.53 The FRC has expressed ongoing concern and frustration with the failure of firms to address recurring problems. These include a lack of professional scepticism exercised by auditors when auditing key judgement areas and failure to adequately challenge management’s assumptions. The FRC identified bank audits, group audit oversight and the audit of pension balances as particular areas of concern.<sup>74</sup>
- 2.54 Figure 2.17 shows the percentage of FTSE 350 and non-FTSE 350 audits inspected by the FRC assessed as good or requiring limited improvement over the period 2011/12 to 2017/18. In 2017/18, just 73% of FTSE 350 audits were assessed as good or requiring limited improvement.<sup>75</sup> This figure is well short of the FRC’s target.

**Figure 2.17: Percentage of audits inspected by the FRC rated as ‘good’ or ‘required limited improvement’**



Source: FRC.

<sup>73</sup> FRC - Developments in Audit 2018 – p.8.

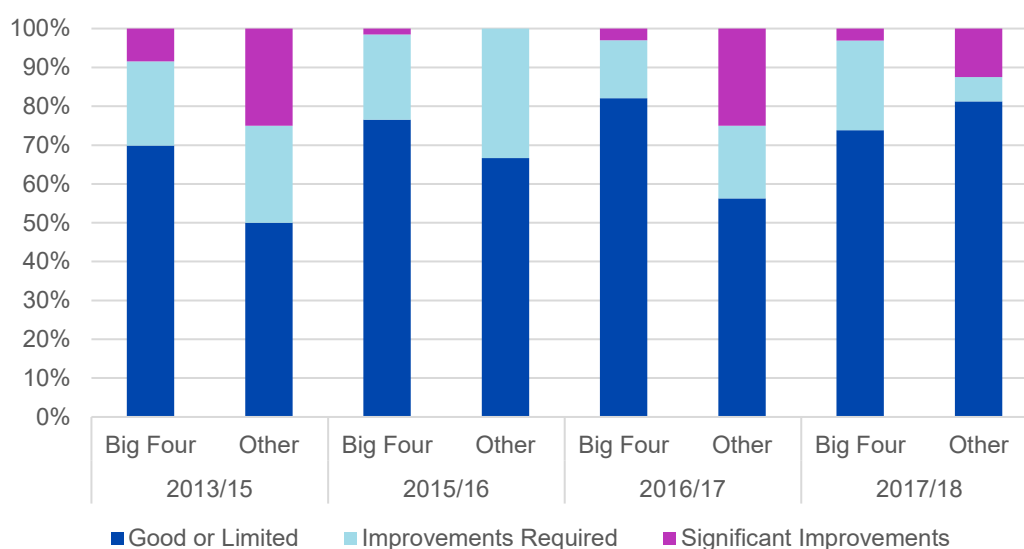
<sup>74</sup> FRC - Developments in Audit 2018 – p.9: ‘Specific Quality Issues’.

<sup>75</sup> FRC - Developments in Audit 2018 – p.4: ‘Audit Quality and Our Response’.

2.55 The FRC also provides AQR results by firm.<sup>76</sup> In 2017/18, for Big Four firms only, 23% of FTSE 350 audits required improvement and 3% significant improvement. Over the five-year period, the figures were 20% and 4% respectively for the Big Four firms and 18% and 18% respectively for the challenger firms.<sup>77</sup>

2.56 Figure 2.18 shows for Big Four and challenger firms the percentage of audits inspected rated as ‘good or limited improvement required’, ‘improvement required’ and ‘significant improvement required, over the last five years. For Big Four firms this is limited to FTSE 350 audits. For challenger firms it is all audits.

**Figure 2.18: Analysis of FTSE 350 audits inspected by the FRC, for Big Four (FTSE 350 audits) and challenger firms (all audits)**



Source: CMA analysis of FRC AQR results.

2.57 We reviewed the individual AQR reports which led to a finding of ‘significant improvements required’. In a high proportion of these, the concerns related to a lack of professional scepticism and challenge – they were not simply failures of process. This again suggests to us that there may be a systemic problem of insufficient challenge across a substantial portion of large company audits.

### *Firm-wide procedures*

2.58 Firm-wide procedures focus on the firms’ systems for ensuring compliance with professional standards and applicable legal and regulatory

<sup>76</sup> CMA analysis of AQR results in [FRC - Developments in Audit 2018](#).

<sup>77</sup> Source: FRC.

requirements.<sup>78</sup> The findings of these reviews provide further insight into areas where firms are failing to respond adequately to FRC concerns.

- 2.59 In its most recent report the FRC again identified ‘exercising appropriate scepticism’ and ‘challenging company assumptions’ as areas where improvement was required. Further areas requiring improvement included: independence, process failures,<sup>79</sup> and communication with Audit Committee/ACC as key areas for improvement.<sup>80</sup>

### **International cases**

- 2.60 Concerns about audit quality are not limited to the UK. Figure 2.19 lists some recent international examples of audit problems.

**Figure 2.19: International examples of audit problems**

<b>Company</b>	<b>Auditor</b>	<b>Country</b>	<b>Year*</b>
Abraaj Group (private equity firm)	KPMG	UAE Dubai	2018 <sup>81</sup>
BT/Italia (business telecommunication operator)	PwC	Italy	2017 <sup>82</sup>
Centro (real estate)	PwC	Australia	2012 <sup>83</sup>
Colonial BancGroup Inc (bank holding company)	PwC	USA	2018 <sup>84</sup>
Gol Intelligence Airlines (Brazilian airline)	Deloitte	Brazil	2016 <sup>85</sup>
Gupta family (Indian/South African family)	KPMG	South Africa	2017 <sup>86</sup>
Kaloti Group (precious metals services)	EY	UAE Dubai	2014 <sup>87</sup>
Lehman Brothers (global financial services firm)	EY	USA	2010 <sup>88</sup>
MF Global (commodities brokerage house)	PwC	USA	2017 <sup>89</sup>
Olympus (manufacturer of technology)	KPMG, EY	Japan	2011 <sup>90</sup>

<sup>78</sup> IFIAR - Survey of Inspection Findings 2017 – p.6: Firm Wide Quality Control Inspection Results.

<sup>79</sup> This included issues in relation to revenue recognition and loan loss impairment and the audit of accounting policies and disclosures (with particular concern in relation to the audit of pension scheme assets and liabilities)

<sup>80</sup> Source: CMA analysis of FRC reports.

<sup>81</sup> Financial News London, ‘KPMG was a key witness as investment firm Abraaj unravelled’, July 3 2018.

<sup>82</sup> The Times, ‘PwC sacked for missing ten-year BT Italia fraud’, June 9 2017.

<sup>83</sup> Financial Times, ‘Centro and PwC near record a \$200m payout’, May 9 2012.

<sup>84</sup> Financial Times, ‘PwC ordered to pay \$625m over Colonial Bank collapse’, July 2 2018.

<sup>85</sup> Financial Times, ‘US auditing watchdog fines Deloitte a record \$8m’, December 5 2016.

<sup>86</sup> Bloomberg, ‘KPMG Watched as Guptas Moved Africa Public Funds for Wedding’, June 30 2017.

<sup>87</sup> BBC News, ‘Gold market breached ‘covered up’’, 25 February 2014.

<sup>88</sup> The Telegraph, ‘Ernst and Young faces lawsuit over Lehman Brothers’ accounts’, December 21 2010.

<sup>89</sup> Financial Times, ‘PwC suggests MF Global was a risk culture run amok’, March 14 2017.

<sup>90</sup> The Telegraph, ‘Olympus scandal: KPMG quit over Gyrus accounts’, October 23 2011.

Company	Auditor	Country	Year*
Parmalat (dairy and food corporation)	Grant Thornton, Deloitte	Italy	2004 <sup>91</sup>
Petrobras (petroleum industry)	PwC	Brazil	2015 <sup>92</sup>
Satyam (IT services company)	PwC	India	2011 <sup>93</sup>
Toshiba (conglomerate company)	EY	Japan	2015 <sup>94</sup>
Tyco (security systems company)	PwC	USA	2007 <sup>95</sup>
VBS Mutual Bank (mutual bank)	KPMG	South Africa	2018 <sup>96</sup>

\* date of media coverage

Source: CMA based on media sources.

2.61 This evidence suggests that some of the same market issues present in the UK are likely to apply to auditors overseas. It emphasises the importance of ensuring that the underlying causes of poor quality are tackled.

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

2.62 Overall, the balance of views from Audit Committees and investors was that audit in the UK is generally of a high quality. Many stakeholders pointed to the fact that the UK has a high reputation internationally for the quality of its audit firms. Several ACCs also commented that switching auditor had led to an improvement in quality, as new auditors brought a fresh perspective and new processes and technologies. This positive overall view of quality is also reflected in the recent FRC survey of ACCs, which suggested that 86 per cent of respondents rated their external auditor as either 'excellent' or 'above average'.<sup>97</sup>

2.63 Nonetheless, this was not a universal view. Most customers did accept that there was at least a variation in audit quality, and that some recent cases highlighted serious quality problems. The main debate was over whether these examples reflected isolated incidents or a more systemic concern about the incentives on auditors to do a good job.

<sup>91</sup> The Wall Street Journal, 'Two Grant Thornton Officials Are Arrested in Parmalat Probe', January 2 2004.

<sup>92</sup> The Telegraph, 'Bill Gates sues oil giant Petrobras and PwC over corruption scandal', September 25 2015.

<sup>93</sup> BBC News, 'Satyam and PwC are fined in US for accounting fraud', 6 April 2011.

<sup>94</sup> Financial Times, 'EY's Japanese unit reprimanded by regulator over Toshiba audits', December 22 2015.

<sup>95</sup> Financial Times, 'PwC settles Tyco lawsuit for \$225m', July 6 2007.

<sup>96</sup> Financial Times, 'KPMG under fresh attack in South Africa over 'great bank heist'', October 11 2018.

<sup>97</sup> FRC, 'Developments in Audit 2018', p. 34.

- 2.64 Some investors expressed a view that there were significant quality problems.<sup>98</sup> Legal & General Investment Management said that they ‘feel let down by poor audit quality’ and ‘believe that trust in audit has been shaken due to the recent high profile accounting scandals’. Hermes expressed concerns in relation to auditor independence and integrity and their ability to challenge management. The Investment Association stated that ‘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’.<sup>99</sup>
- 2.65 Schroders said that there continue to be too many examples of corporate failures and poor annual report disclosures that do not adequately identify the risks of business. Audit firms can and should do more to ensure that companies clearly and unambiguously report the underlying business and financial risks that they face along with the significant estimates and judgements that have been made in preparing the financial results. Where the auditors believe that this is not the case, the auditors must be robust in fulfilling their existing responsibilities to report these matters to shareholders.
- 2.66 Others said that they had confidence in UK audit overall.<sup>100</sup> However, there was also the view that while the instances of audit failures have been relatively isolated events, when they do occur they can have serious implications.<sup>101</sup>

### ***‘Expectations gap’ and the purpose and scope of audit***

- 2.67 In response to our concerns about audit quality, respondents highlighted the importance of first understanding the purpose and scope of audit before assessing whether audit was failing to meet its designed objectives. We heard different perspectives on both what the purpose of audit was and whether it was meeting that purpose. A common theme amongst respondents’ submissions was the existence or otherwise of an ‘expectations gap’.
- 2.68 Many respondents argued that audit quality concerns arise because there is a mismatch between what the statutory framework requires of auditors and the

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<sup>98</sup>Hermes Response to CMA Invitation to Comment, 30 October 2018; LGIM Response to CMA Invitation to Comment, 1 November 2018, p1; Schroders Response to CMA Invitation to Comment, 5 November 2018, pp1-2; The United Kingdom Shareholders Association, p4.

<sup>99</sup> The Investment Association, CMA Invitation to Comment Response, 30 October 2018, p. 5. See also David Miller, Response to CMA Invitation to Comment, 19 October 2018, p. 11.

<sup>100</sup> Invesco Response to CMA Invitation to Comment, 30 October 2018; The Institute of Chartered Accountants Scotland Response to CMA Invitation to Comment, 30 October 2018, p15

<sup>101</sup> The Investment Association Response to CMA Invitation to Comment, 30 October 2018, p2.

public's expectations of what auditors do – the 'expectations gap'.<sup>102</sup> Respondents submitted a range of views on causes and solutions for this issue. Several emphasised a misunderstanding about the roles and responsibilities of auditors as compared with the company's directors.<sup>103</sup> Some said that while there might be an expectations gap for the general public, informed shareholders understand the scope and limitations of statutory audit.<sup>104</sup> Some respondents called for greater education for all stakeholders.<sup>105</sup>

- 2.69 Other respondents argued that the expectations gap was a fallacy hiding a more fundamental problem: that the industry is incorrectly interpreting and applying the existing statutory framework. They argued that, if the framework was properly applied, there would be no expectations gap.
- 2.70 Although these issues go beyond the CMA's core remit, they form important context for our assessment of whether the market is working well. As one respondent put it, unless we are clear on the scope and purpose of audit, it is difficult to comment meaningfully on the quality of audit provision.<sup>106</sup> These issues evidence the nuanced range of both the causes of, and potential solutions to, declining audit quality.
- 2.71 There is a strong case for reviewing the purpose and scope of audit to consider these issues holistically. In Appendix C we set out in more detail the range of issues that have been put to us and what questions might be covered by the expected review.
- 2.72 However, the expectations gap and discussion over the role of audit do not remove the real concerns around audit quality set out in the previous section. An effect of reviewing the purpose and scope of audit might well be to raise the requirement for what is expected of auditors, to clarify the purpose of audit, or to change the purpose. None of that would alter the fact that audits too often fall short of the current requirement. Changing the purpose and scope of audit would not alter the incentives and interests at play; whatever the purpose and scope, the market needs to operate in a way which creates the incentives to prioritise quality.

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<sup>102</sup> Legal & General Investment Management (LGIM), Response to CMA Invitation to Comment, 1 November 2018; Moore Stephens, Response to CMA Invitation to Comment, 30 October 2018.

<sup>103</sup> Standard Life, Intermediate Capital Group PLC, Daily Mail and General Trust plc., Response to CMA Invitation to Comment, 30 October 2018.

<sup>104</sup> The Institute of Chartered Accountants Scotland (ICAS), Response to CMA Invitation to Comment, 30 October 2018.

<sup>105</sup> The 100 Group, Response to CMA Invitation to Comment, 26 October 2018.

<sup>106</sup> Sarasin & Partners LLP, Response to CMA Invitation to Comment, 1 November 2018.



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

- 2.73 Audit quality is difficult to observe. This means that shareholders and other users are reliant on the oversight provided by Audit Committees and regulators. ACCs have themselves told us that it is difficult to judge quality.
- 2.74 In recent years a number of high profile cases of audit failures have been exposed by corporate failures and fraud. Poor quality is likely to be more widespread (but not exposed by other events).
- 2.75 While audit failures were not solely responsible for corporate failure, had auditors carried out their work to a higher standard it is possible that the commercial or other problems could have been identified earlier. This would have allowed those affected to have made better informed decisions. This point is not limited to the cases where poor audit quality is exposed by for example, corporate failure.
- 2.76 The potential impact of audit failures is wide. This is illustrated by the financial harm and distress to many people caused by corporate failures, including to members of pensions scheme, owners and employees of suppliers, customers. In the case of Carillion, there was harm also to the taxpayer and users of public services.
- 2.77 These cases have also undermined public trust in corporate governance and audit. Reliable financial information is essential to effective corporate governance.
- 2.78 All this means that the number of recent events, combined with the size of these companies and their importance to UK economy, cannot be dismissed as 'isolated events'.

## 3. Issues

### Introduction

- 3.1 The previous section summarised our concerns that the audit market is not currently delivering consistently high quality. This section sets out our view on what is driving these quality concerns.
- 3.2 In a well-functioning market, competition and regulation would combine to ensure the right incentives through a variety of mechanisms.
- (a) Selection and oversight of auditors would ensure that competition would be focused on quality (more than price), so that firms win more business if they deliver good quality and lose if their quality is poor.
  - (b) There would be enough opportunities to compete, and there would be sufficient choice of viable competitors over the long term, without undue barriers to entry and expansion, all to enable intense competition.
  - (c) Within firms, individual auditors' personal success would depend to a very large extent on whether they deliver high-quality audits.
  - (d) Regulation would shine a light on quality levels and punish sub-standard performance both by firms and by individuals. This would also support competition on quality because buyers would have better information on a service whose quality is otherwise hard to judge.
- 3.3 Previous interventions have attempted to make these mechanisms work more effectively. For instance, CC remedies strengthening audit committees have brought about some changes in the way auditors are selected and overseen; the CC and EU mandatory tendering and rotation remedies addressed parts of (b); regulation has attempted to improve (c), for example through bans on incentives on audit partners to cross-sell non-audit services; and the CC's recommendations for more, and more frequent AQRs related to (d).
- 3.4 But as the outcomes described in the previous section show, current incentives are insufficient to produce consistently high quality. This section considers the various possible incentive mechanisms in turn.
- (a) **Selection and oversight of auditors** is insufficiently focused on quality. Audit Committees are only a partial solution to the underlying problem that companies procure their own audits.
  - (b) **Choice**. There are limitations on choice, driven by a combination of regulatory requirements, firms' structure, and barriers to competition from

challenger firms; as well as concerns over the long-term resilience of the sector.

- (c) **Firms' structure.** The structure of accounting firms results in weaker incentives to deliver high-quality audits, because a significant majority of the firms' business is outside audit.
- (d) **Regulation.** The general quality of regulation has been considered alongside this study by the independent review of the FRC, led by Sir John Kingman, so we do not consider that subject here, beyond noting that various stakeholders have reinforced the Carillion Select Committee's view that regulation has been inadequate.<sup>107</sup>

## Selection and oversight of auditors

- 3.5 The very existence of statutory audit reflects the incentive challenges at the heart of modern corporate governance structures. Within a public limited company, the separation of ownership and control creates a 'principal-agent' problem – the owners want the managers to run the company in their interests but can only partially observe the actions of those managers. Statutory audit has evolved as a way of lessening this principal-agent problem. By appointing an independent auditor to validate the financial accounts produced by management, owners and the wider public can have confidence in the company's financial figures, which in turn gives managers a stronger incentive to act in the interests of the company's owners.
- 3.6 Within this framework, a key challenge is how to ensure that the auditors are acting in the interests of the company's owners rather than in the interests of the company's managers. Since auditors need to work closely with a company's managers on a day-to-day basis in order to carry out an audit, how can owners know whether the auditors are challenging the managers sufficiently?<sup>108</sup>
- 3.7 In the current corporate governance model for large companies, Audit Committees play a key role in representing the interests of owners (shareholders) and ensuring that incentives are aligned. According to guidance produced by the FRC,<sup>109</sup> while all directors have a duty to act in the

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<sup>107</sup> See Carillion Select Committee report, paragraphs 214 and 215  
[https://publications.parliament.uk/pa/cm201719/cmselect/cmworpen/769/76907.htm#\\_idTextAnchor168](https://publications.parliament.uk/pa/cm201719/cmselect/cmworpen/769/76907.htm#_idTextAnchor168).

<sup>108</sup> Prof Prem Sikka et al. noted that, 'Ever since the inception of modern audits there have been concerns about company directors selecting and remunerating auditors and thereby defeating the very concept of an independent audit.' *Reforming the auditing industry*, December 2018.

<sup>109</sup> <https://www.frc.org.uk/getattachment/6b0ace1d-1d70-4678-9c41-0b44a62f0a0d/Guidance-on-Audit-Committees-April-2016.pdf>.

interests of the company, the Audit Committee has a particular role, acting independently from the executive, to ensure that the interests of shareholders are properly protected in relation to financial reporting and internal control. The CC put in place a package of measures to strengthen the position of Audit Committees, to enhance the accountability of the Audit Committees to shareholders and to promote shareholder engagement in the audit process, including by promoting information flow between companies and investors in relation to the external audit.

- 3.8 We have considered the effectiveness of the current framework in creating strong incentives for high quality audit. We have found that there are limits to what we can expect from shareholders in providing oversight of the conduct of the audit committee or, directly, of the audit itself. There is little direct investor engagement in audit issues. It is very rare for investors to reject the appointment of an auditor. Investors argued that this was partly a function of lack of transparency about the detail of the audit – they argued that if there was more information available about e.g. key audit issues then they would have an incentive to be more engaged.
- 3.9 This means that the system is very reliant on Audit Committees, and ACCs in particular, in driving audit quality. We found that the CC's remedies have strengthened the role of the Audit Committee particularly in the appointment of the auditor. All the ACCs that we spoke to were clear that their duty is to provide an independent function representing the interests of shareholders and valued the professional scepticism and challenge of the auditors.
- 3.10 However, Audit Committees cannot observe directly the quality of the audit work undertaken. Rather, Audit Committees will discuss with the auditors the work performed on areas of higher audit risk and the basis for the auditors' conclusions on those areas, supplemented by their other interactions with the auditors.
- 3.11 Overall, this makes the whole system fragile, by diluting the incentives on auditors to focus on providing high quality audit based on professional scepticism and challenge.
- 3.12 There are aspects of this framework that could work better in driving good audit quality. In particular, we set out below findings in relation to the following:
- (a) The process for the selection of auditors, including the selection criteria and the role and influence of company managers in these processes.
  - (b) The variation in the resources available to Audit Committees and the approach taken by Audit Committees.

- (c) The lack of transparency for investors on the quality of audit work and the potential for more information to promote shareholder engagement.
- (d) The alignment of the interests of company shareholders in audit quality with the wider public interest in the publication of independently verified financial information.

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

3.13 We found that aspects of the selection processes could result in the selection of auditors with the interests of the company and its management rather than those of the shareholders, in mind. In particular, we examined the criteria used in the evaluation of bids and the involvement of management in the tender process.

### ***Selection criteria***

3.14 We asked a sample of companies that had recently carried out tenders to provide us with details of their selection processes.<sup>110</sup> We also collected information from the auditors on all the tenders that they had participated in over the past five years. We used this evidence to understand how companies evaluate bids.

3.15 Overall, the evidence from recent tenders suggests that quality is typically viewed as more important than price, which matches the preferences of most shareholders and other stakeholders. However, in some tenders, factors such as ‘cultural fit’ are considered to a greater extent than factors such as the degree of challenge and scrutiny that the auditor is expected to demonstrate. This calls into question the weight given in auditor selection to independence, scepticism and ability to challenge, the main attributes Audit Committees should be demanding of them.

### ***Importance of price in judging tenders***

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

- (a) experience and technical capability of the audit partner, the audit team and the firm;

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<sup>110</sup> See Appendix A for details of the approach taken to sampling.

- (b) geographic coverage of the firm's network;
- (c) understanding of the company's business and industry knowledge; and
- (d) working relations with senior management.

- 3.17 Some stakeholders have raised concerns that too much weight is attached to price as 'a company's managers may value lower pricing over a rigorous audit process',<sup>111</sup> and that competition is putting downward pressure on price to the detriment of quality. We found little evidence to support a claim that Audit Committees focus overly on price in the selection of auditors.
- 3.18 There was general agreement among the ACCs that we spoke to that audit quality should matter more than price. A number of ACCs stated that cost was not a significant determinant when selecting an auditor, with one Chair stating that in their experience 'the prime concern of the audit committee has been to ensure that the auditors perform a robust audit, unconstrained by fees'.<sup>112</sup>
- 3.19 The 100 Group, which represents the views of FTSE 100 finance directors and several large UK private companies, stated that, in its experience, Audit Committees are focussed 'on the quality and challenge provided by the audit firm. The cost of delivery is a relatively minor consideration in selecting an audit firm, with a greater weighting typically being applied to other factors such as quality, innovation, sector expertise and efficiency'.<sup>113</sup>
- 3.20 It was not always clear from the documents provided by the companies precisely how much weight was attached to price relative to quality. However, based on data provided by the auditors we observed that the winning bid was not the cheapest bid in the majority of cases (56% of the 225 FTSE 350 tenders for which we had data and where there were two or more bidders).<sup>114</sup>
- 3.21 This is supported by our analysis of the audit fees received by the auditors of FTSE 350 companies in the period 2012 to 2017. We found that the audit fee paid to a newly appointed auditor in their first year was almost as likely to be lower (44%) as it was to be higher (46%) than the fee paid to the previous auditor in the last year of their engagement.<sup>115</sup>

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<sup>111</sup> Grant Thornton, Response to CMA Invitation to Comment, 2 November 2018, p. 3.

<sup>112</sup> SD Barber, Response to CMA Invitation to Comment

<sup>113</sup> The 100 Group, Response to CMA Invitation to Comment, 26 October 2018.

<sup>114</sup> CMA analysis of auditors' tender data.

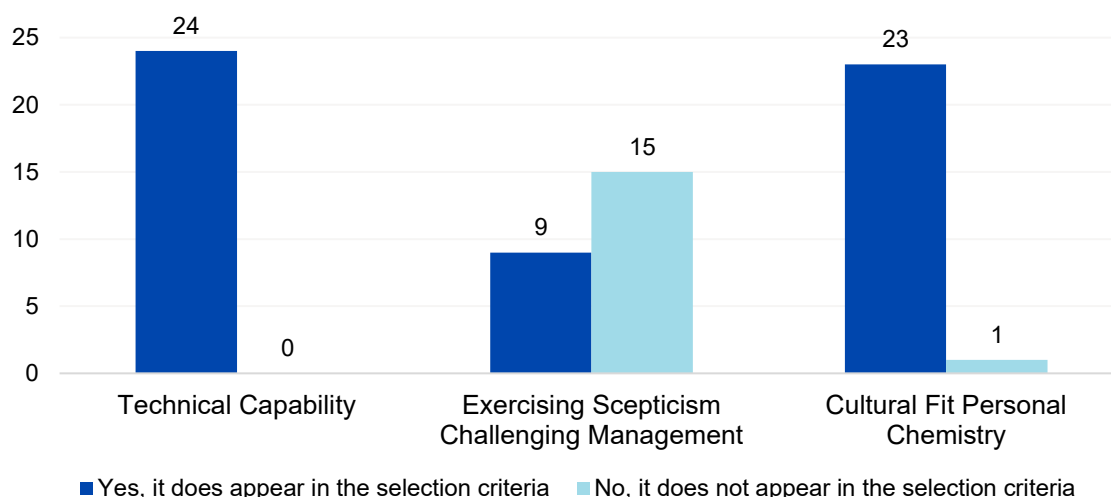
<sup>115</sup> CMA analysis of Industry Background data set based on 131 completed auditor rotations. (There was no observed change in audit fee for the remaining 10% of observations.)

### *'Cultural fit' vs audit quality*

3.22 Aside from price, the criteria used by companies are similar to those listed in the FRC 'good practice' tender guidelines<sup>116,117</sup>. The main exceptions were criteria such as 'easy to work with', 'cultural fit' and 'chemistry'. Such criteria raise concerns around independence of the auditor. The UKSA stated that when it comes to auditor appointment, large companies and public interest entities appear to take the position that 'the only real requirement for selection is that they get on well with the audit partner(s)'.<sup>118</sup>

3.23 We looked at the information provided on evaluation criteria in our sample of recent audit tenders. Figure 2.20 shows the selection criteria applied by the sample of FTSE 350 companies. We found that 23 out of 24 FTSE 350 companies explicitly included 'fit', 'cultural fit' and/or 'chemistry',<sup>119</sup> whereas only nine explicitly included 'exercising scepticism' and/or 'challenging management'.<sup>120</sup>

**Figure 2.20: Selection criteria applied in audit tenders (FTSE 350 companies)**



Source: CMA analysis of information request responses.

<sup>116</sup> [https://www.frc.org.uk/getattachment/53c85956-d712-47d2-989f-2f8eff42be29/Audit-Tenders\\_notes-on-best-practice-Feb-2017.pdf](https://www.frc.org.uk/getattachment/53c85956-d712-47d2-989f-2f8eff42be29/Audit-Tenders_notes-on-best-practice-Feb-2017.pdf)

<sup>117</sup> Industry expertise of the firm and audit team; experience and audit quality record of the lead partner and the firm; planned use of technology in the audit process; geographical coverage of the network firm; and experience in transitioning similar audits.

<sup>118</sup> The United Kingdom Shareholders Association, Response to CMA Invitation to Comment, 30 October 2018, p3.

<sup>119</sup> Includes any reference to, at least one, of the following: cultural or strategic fit; alignment with culture; and chemistry.

<sup>120</sup> Includes any reference to, at least one, of the following: robust or thorough audit; challenging management; objectivity and exercising scepticism.

- 3.24 We also found evidence that factors like ‘cultural fit’ and ‘personal relationships’ have been important in auditor selection. For example:
- (a) [X].
  - (b) One of the main reasons why [X] was not chosen by [X] was ‘the lack of chemistry between the teams both internally to [X] and with [X]’. Similarly, ‘the evaluation teams felt that [X] were too blunt in their approach and it wouldn’t be a collaborative relationship’.
  - (c) A [X] document outlining the assessment criteria states that ‘chemistry is probably the most important element’.
- 3.25 There are a variety of ways to interpret the phrase ‘cultural fit’. One ACC stated that this includes the audit partner displaying maturity in being able to deal with events in a calm and constructive manner, with the strength to make the right decisions. Interpersonal skills and an understanding of the organisation, its culture and ambitions may be relevant to an auditor’s ability to effectively question and challenge management.
- 3.26 There are also examples that suggest an interpretation and application that is contrary to what a ‘good auditor’ should be. For example, in [X]’s tender, [X] scored well on ‘challenge and tension’ but poorly on ‘culture and style’. While in terms of ‘challenge and tension’ it was positively noted that a ‘lack of relationship building meant a bigger focus on what we do and how we do it’, the same ‘lack of focus on relationship building’ negatively affected the score on ‘culture and style’. The winning bidder, [X], showed ‘not much challenge during the process’, therefore getting a low score on ‘challenge and tension’; but this was almost completely compensated by a high score on ‘culture and style’, based on (among other things), them being ‘relationship focussed’, showing ‘strong desire to work with [the company]’, and coming across as ‘personable and approachable, with good humour’.<sup>121</sup>
- 3.27 That terms like ‘cultural fit’ can be understood in different ways is also illustrated by the [X] tender. Under the title of ‘cultural fit’, the audit committee considered, amongst other things, whether the ‘Lead Partner and team bring adequate challenge, courage and integrity’. However, under the same title they also considered how the Lead Partner and key team members will ‘fit with [X]’s culture’ and whether management could ‘work with this team’. These are very different considerations.

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<sup>121</sup> [X] noted that, under "Technical expertise", the audit partner "confirmed that [X] do not agree with [the] accounting treatment of IBAs, and resisted challenge from [Finance Director] well".



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

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

- 3.29 Based on submissions received from investors and shareholder representatives, it appears that the last few years have seen an increasing involvement of Audit Committees in the appointment of auditors, with choices based more on audit quality than on price. However, some investors told us that there is still an excessive involvement of companies’ CFOs and top management in the conduct of the tender process.<sup>122</sup>
- 3.30 Based on the evidence we gathered on 24 FTSE 350 tenders, it appears that Audit Committees are now actively involved in most, if not all stages, of the tender process. This includes the design of the process, the evaluation of bids, the final presentations by short-listed firms, and the decision on the recommendation to the board. The clearest examples we found of Audit Committees delegating heavily to management were before the CC order went into force. However, we observed that management still plays a significant role in the tender process and in advising the Audit Committee.
- 3.31 Senior management involvement in the selection process provides an opportunity for them to influence auditor appointment particularly given the importance attached to factors like ‘cultural fit’ and ‘chemistry’. This is illustrated by the [X]. While we recognise that some senior management involvement is inherent to the process, confidence in the selection requires Audit Committees to have effective oversight of the process at all stages.
- 3.32 The selection process would be a more effective driver of audit quality if the criteria applied were consistently focused on audit quality, and the participation of senior management in the process were kept to the minimum necessary for an effective selection process (taking into account the constraints on the time and resources that Audit Committee members could allocate to the process).

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<sup>122</sup> Sarasin Response to CMA Invitation to Comment, 6 November 2018, p. 8.

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

- 3.33 Even if the Audit Committee appointed an auditor in a way that was completely aligned with the interests of shareholders, problems could still arise if auditors' activities are not properly monitored. This could be the case, for example, if auditors get too 'close' to the company's management and exercise insufficient scepticism or challenge. It could also simply reflect an incentive for auditors to minimise costs, given that audit quality is very difficult to observe unless things go wrong.
- 3.34 Guidance produced by the FRC<sup>123</sup> specifies that the Audit Committee should annually assess, and report to the board on, the qualification, expertise and resources, and independence of the external auditors and the effectiveness of the audit process. The Audit Committee should meet the external and internal auditors at least annually, without management. Moreover, it is expected that the Audit Committee Chair, and to a lesser extent the other members, will keep in touch on a continuing basis with the key people involved in the company's governance, including the external audit lead partner.
- 3.35 Some of the investors responding to our ITC acknowledged that Audit Committees are increasingly involved in monitoring and evaluating the activity of auditors.<sup>124</sup> However, concerns have been expressed on how independently this activity is performed.<sup>125</sup> Several 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.<sup>126</sup> In particular, it was noted that in several cases Audit Committees appear to rely on executive feedback on the auditor as the main input into annual reviews of performance, therefore assessing auditors based on the feedback from the very people whose work is being audited.<sup>127</sup> More generally, it was noted that there is no statement of what constitutes best practice in the area of auditor monitoring.<sup>128</sup>
- 3.36 Members of the Audit Committee Chairs Independent Forum (ACCIF) told us that they felt confident in their ability to assess the quality of the key aspects of the audit of their companies, in particular by discussing with the auditors

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<sup>123</sup> <https://www.frc.org.uk/getattachment/6b0ace1d-1d70-4678-9c41-0b44a62f0a0d/Guidance-on-Audit-Committees-April-2016.pdf>.

<sup>124</sup> Invesco Response to CMA Invitation to Comment, 6 November 2018, p. 3.

<sup>125</sup> Sarasin Response to CMA Invitation to Comment, 6 November 2018, p. 8; Hermes Investment Response to CMA Invitation to Comment, 5 November 2018, p. 8.

<sup>126</sup> Investment Association Response to CMA Invitation to Comment, 5 November 2018, p. 6; Sarasin Response to CMA Invitation to Comment, 6 November 2018, p. 8, Schroders Response to CMA Invitation to Comment, 5 November 2018, p. 3.

<sup>127</sup> Sarasin Response to CMA Invitation to Comment, 6 November 2018, p. 8.

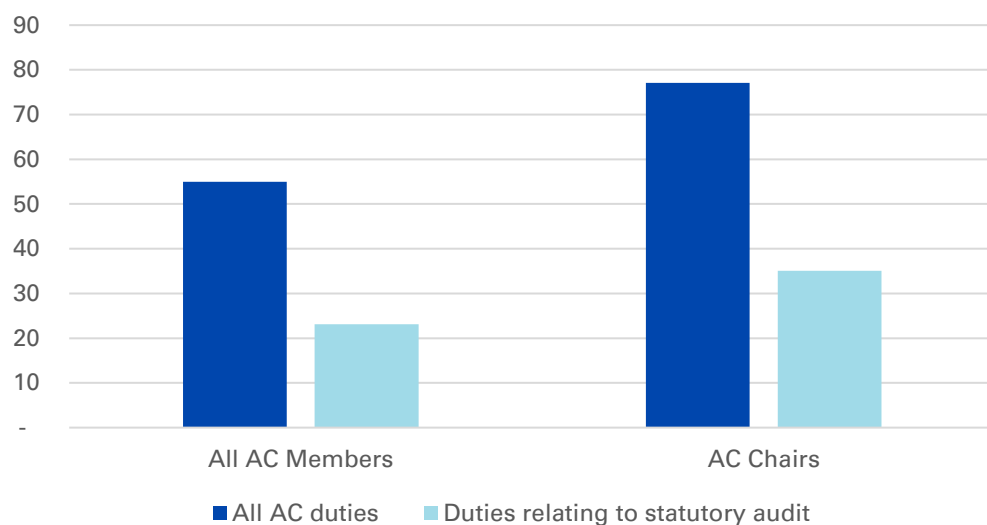
<sup>128</sup> ACCA Response to CMA Invitation to Comment, 1 November 2018, p. 2; LGIM Response to CMA Invitation to Comment, 5 November 2-

the work performed on areas of higher audit risk and the basis for the auditors' conclusions on those areas, supplemented by their other interactions with the auditors. That enabled them, for example, to gauge the depth of the auditors' understanding of the company's business. They were critical of the reviews conducted by the FRC. They felt that FRC reports are not sufficiently focussed on what matters to the quality of the audit outputs.

3.37 Like its responsibilities in appointing auditors, the extent to which the Audit Committee might mitigate the principal-agent problem in relation to the monitoring of auditors depends on the resources it is provided with and on its independence of judgement.

3.38 We have information from 18 FTSE 350 companies on the amount of time spent by Audit Committees on external audit related matters. We found that this varied significantly based on the size and complexity of the company. Figure 2.21 shows that, on average, Audit Committee members reported spending 55 hours on all their Audit Committee duties in the last financial year, and 23 hours on duties relating to the statutory audit. These figures are 77 hours and 35 hours respectively for ACC.

**Figure 2.21: Average number of hours spent by Audit Committee members in the past year**



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

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

3.40 Taken as a whole, this evidence suggests that the amount of time and resources spent by Audit Committees varies significantly between companies (including between similar companies). We found that the total audit

committee time spent on the external audit (excluding time spent on a tender), ranged from more than 400 person-hours in a year to less than 20 hours. This included several FTSE 100 companies recording less than 40 hours in a year. While this is not surprising given the variance in scale and complexity of companies within the FTSE 350, it raises a question about whether smaller and less well-resourced Audit Committees are properly able to oversee and monitor the activities of the statutory auditor.

- 3.41 For some, the hours suggest that Audit Committees cannot be taking as proactive a role as envisaged by the FRC. The FRC guidance<sup>129</sup> states that the ‘audit committee should consider key matters of their own initiative ... discuss what information and assurance it requires in order to properly carry out its roles to review, monitor and provide assurance or recommendations to the board and, where there are gaps, how these should be addressed... satisfy itself that these sources of assurance and information are sufficient and objective.’

### ***Degree of engagement by shareholders***

- 3.42 Although the Audit Committee is meant to represent the interests of shareholders, in practice most stakeholders we spoke to suggested that investors have little engagement with audit matters. Several ACCs confirmed a lack of active engagement in audit matters by shareholders and other investors.
- 3.43 Shareholders have to approve the appointment of the auditor each year, but in most cases this appears to be a formality. One recent exception was the shareholder vote in May 2018 to reject the reappointment of Deloitte as auditor of SIG. This came after SIG admitted that it had overstated its profits in previous accounts.<sup>130</sup>
- 3.44 We are also aware of instances where investors and shareholder representatives have a degree of influence on audit firm appointment, potentially encouraging an Audit Committee to appoint a Big Four audit firm.
- 3.45 The investors we spoke to told us that this lack of engagement reflected a lack of transparency and information about the audit process. They said that often little information was provided about tender processes. Also, limited information is provided about issues and concerns raised by auditors, the reasons underlying the identification of key risks, and whether the Audit

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<sup>129</sup> <https://www.frc.org.uk/getattachment/6b0ace1d-1d70-4678-9c41-0b44a62f0a0d/Guidance-on-Audit-Committees-April-2016.pdf>

<sup>130</sup> The Financial Times, [SIG shareholders reject reappointment of Deloitte as auditor](#), 10 May 2018.

Committee believe the audit has been challenging and the auditor has exercised professional scepticism. Communications to shareholders are generic and often based on answers to questionnaires drafted by audit firms.

- 3.46 Both investors and ACCs commented that the level of shareholder engagement on the external audits compares unfavourably with that on senior executive remuneration. For example, the Audit Committee Chair for National Express said that shareholders are ‘overly concerned’ with remuneration and should give more attention to the work of the audit committee and the external audit, which ultimately address greater systemic risk. Invesco Perpetual, in commenting on the scope for improvement, suggested adopting an approach similar to ‘AGM votes on remuneration reports and policies, AGM votes on audit committee reports should be considered’.<sup>131</sup>
- 3.47 On the disclosure of information to investors on appointments, FRC guidance states that: investors need to be aware at an early stage that the tender is taking place; companies should seek investor views to inform their choice of participating firms; investors should be informed on the firms being invited to tender; investors would like transparency on how potential conflicts have been mitigated and/or will be managed; and investors would like to know what factors led to the decision.
- 3.48 The lack of transparency is illustrated by our findings in relation to the information provided to shareholders on tenders of external audit engagements. We asked the sample of FTSE 350 companies to provide details of any direct communications with shareholders when the company last tendered the external audit. We found just one example of any direct communications.
- 3.49 Barclays confirmed in its 2014 Annual Report that it would be launching an external audit tender in 2015. Barclays prepared a briefing note for major shareholders covering the timetable and selection process and confirming that the Chairman of the Audit Tender Oversight Sub-Committee would be happy to discuss further with stakeholders. The tender document including the evaluation criteria was published on Barclays’ website.
- 3.50 Since 2013 external auditors have been required to prepare Extended Auditor’s Reports including information of their assessed risks of material misstatement, materiality and the scope of their audit. The intention was to enhance the level of investor confidence in audit, by providing greater insight and understanding the work of auditors. While investors have welcomed the

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<sup>131</sup> Invesco Response to CMA Invitation to Comment, 6 November 2018.

information included in these reports, many feel that more could be done. In particular, investors would like greater transparency assumptions made by management and the benchmarks used by auditors in making key judgements.<sup>132</sup>

- 3.51 Shareholders are aware that most of this information is of a confidential nature and cannot be made public. However, they argue that a mechanism should be created for allowing shareholders to have a better sense of how aggressive the accounting has been.
- 3.52 KPMG told us about its 'graduated audit' product, developed to address perceived institutional investor needs, and applied initially on a number of audits including Rolls-Royce where shareholder criticism of a lack of clarity made acceptance by the Audit Committee easier. The product provided greater disclosure and transparency for stakeholders. KPMG had tried to promote wider interest in the product with investors and Audit Committees, but had 'not gained traction'. KPMG said that, while generally positively received, there was some nervousness on the part of Audit Committees around market perceptions.
- 3.53 Some investors recognised the limited capacity or willingness to engage. The active management industry is fragmented and does not always have the in-house capacity for handling engagement with non-executive directors. It was suggested that this issue could be addressed through the FRC's review and potential strengthening of the Stewardship Code.
- 3.54 While we must be realistic about the ability and incentives for investors to be more engaged, we have received submissions from a range of investors on the case for greater transparency. More disclosure could make it easier for investors to engage.
- 3.55 The better informed and more involved they are in the auditor appointment and conduct of the audit, the more confident we, and they, can be that audits are being carried out with the interests of investors in mind. Greater disclosure should have the further benefit of providing greater visibility on the effectiveness of Audit Committees in representing the interests of investors.

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<sup>132</sup> <https://www.frc.org.uk/getattachment/02aa579b-6169-4ba5-b7c6-ac957ac9473f/Summary-for-investors-Extended-Auditor-Reporting.pdf>.

## ***Shareholder interest vs wider public interest***

- 3.56 A final issue we have considered is whether, even if audit services were delivered in the interests of company shareholders, this might still not be in line with wider interests. This might be the case for example if:
- (a) Shareholder incentives are not aligned with the interests of employees, customers and the general public. Within this we have considered whether there might be particular issues in relation to the audit of private companies.
  - (b) There are wider externalities arising from robust audit which are not internalised by shareholders.
- 3.57 The interests of existing shareholders may not always be fully aligned with those of suppliers, employees, customers and pension holders. However, the relevant question in relation to audit is whether their interests are aligned in the publication of financial statements and accounts in which they can have trust and confidence.
- 3.58 For listed companies, reliable financial reporting is essential to the shareholder ability to hold management to account and to make informed investment decisions.
- 3.59 In the case of private companies, however, ownership is sometimes more concentrated and less remote from management. This means that owners may be less reliant on independently verified published accounts for information on management performance. It is, therefore, more plausible that a company's owners could have an incentive to influence auditors to the detriment of wider stakeholders with an interest in the company.
- 3.60 The impact of corporate failures on the members of corporate pension schemes has been a particular focus of public concern. For example, when BHS failed there was a deficit in its pension scheme of £571m. As early as 2016 there was estimated to be a £900m deficit in Carillion's pension obligations and yet it made lower contributions to the pension schemes than recommended by the Pension Trustee, its advisors and the Pension Regulator.
- 3.61 This potential for divergence between the interests of shareholders in audit and the interests of a company's pension holders and the wider public suggests that, even if the all of the principal-agent issues in relation to the role of audit committees were addressed, concerns might remain. This points to a continuing need for regulation to protect these wider public interests.

## Competition and choice in the audit market

- 3.62 Competition can play a crucial role in driving higher quality only if the incentives in the market are structured in the right way so that firms compete on what matters to shareholders and wider stakeholders – i.e. high-quality audit. Given the difficulty in observing audit quality, regulation plays a key role alongside competition. Regulation is important in setting and maintaining minimum standards for audit. Competition, in turn, if focused on matters important to investors, can sharpen the incentives for auditors to deliver to a consistently high standard.
- 3.63 Choice is a prerequisite for effective competition. All things being equal, the more choice that Audit Committees have in selecting their auditor, the stronger competition will be. In turn we would expect this to drive better market outcomes under the right regulatory framework.
- 3.64 In some respects, competition appears to be working well following the previous reforms to the market. Tenders occur much more frequently than in the past. In most cases tenders involve detailed and comprehensive processes that should allow the company to make well-informed decisions. Although there are costs of tendering and switching, the switching process has generally gone smoothly.
- 3.65 The majority of companies believe they have sufficient choice. However, for a substantial minority of FTSE 350 companies, Audit Committees are faced with fewer than three credible bidders for an audit tender. Competition is, in these circumstances, fragile. If one of the bidders fails to impress, the company is left, in effect, with no choice at all. The main drivers of lack of choice in these cases appear to be:
- (a) Mandatory switching rules, which mean that the incumbent bidder cannot participate (so the Big Four becomes the big three).
  - (b) Lack of confidence that the challenger firms would have the capability to carry out a complex audit including perceptions that the international networks of the challenger firms do not have the same reach, strength and consistency as those of the Big Four firms.
  - (c) Conflicts with provision of non-audit services. In many cases auditors are willing to drop non-audit work in order to take on an audit client and the Audit Committees manage the process to allow time for the incoming auditor to become 'clean'. However, there are some cases where the company views a particular piece of non-audit work as particularly important and so does not want the firm in question to tender for the audit;



or where a tender has to be arranged quickly, for example where the company has concerns about its current auditor. In addition, for some companies and in some sectors, companies not wanting to have the same external auditor as their near competitors also reduces choice.

(d) There are also some cases where an auditor chooses not to participate. This can be for a variety of reasons including: not wanting to have too many clients in a particular sector; not wanting to exit significant non-audit work for the client; and an expectation that there is a low probability of winning.

3.66 Of these factors, the second and third are generally more significant at the top end of the market and in specific sectors. However, the last factor can also apply lower down the FTSE 350.

### ***Evidence on competition as a driver of audit quality***

3.67 There is some debate about the importance of choice and competition in driving audit quality. Some have raised legitimate concerns that competition might drive worse outcomes if it encourages too great a focus on cutting costs and too little focus on quality. Academic research evidence on the link between competition and audit quality is relatively limited and inconclusive.<sup>133</sup>

3.68 The importance of the interaction of competition and regulation was generally echoed by stakeholders we spoke to. For example, a number of parties recognised a role for both competition and regulation in driving audit quality. One challenger firm submitted that '[e]ffective competition and proportionate regulation combined are key to delivering better audit outcomes'.<sup>134</sup>

3.69 Given the parallel independent review of the FRC led by Sir John Kingman, we have not looked in detail at the regulatory framework and have instead focused on whether choice and competition are working effectively. However,

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<sup>133</sup> Recent studies of the relationship between audit competition or audit market concentration and audit quality include (i) Boone, J.P., I.K. Khurana, and K.K. Raman (2012) Audit market Concentration and Auditor Tolerance for Earnings Management, *Contemporary Accounting Research*, 29(4), 1171-1203; (ii) Dunn, K.A., M.J. Kohlbeck, and B.W. Mayhew (2013) The Impact of Market Structure on Audit Price and Quality. Available at SSRN: <https://ssrn.com/abstract=2258091>; (iii) Francis, J.R., P.N. Michas, and S.E. Seavey (2013) Does Audit Market Concentration Harm the Quality of Audited Earnings? Evidence from Audit Markets in 42 Countries, *Contemporary Accounting Research*, 30(1), 325-355; (iv) Kallapur, S., S. Sankaraguruswamy, and Y. Zang (2010) Audit market concentration and audit quality. Available at SSRN: <https://ssrn.com/abstract=1546356>; (v) Newton, N.J., D. Wang, and M.S. Wilkins (2013) Does a Lack of Choice Lead to Lower Quality? Evidence from Auditor Competition and Client Restatements, *Auditing: A Journal of Practice & Theory*, 32(3), 31-67; and (vi) Newton, N.J., J. Persellin, D. Wang, and M.S. Wilkins (2016) Internal Control Opinion Shopping and Audit Market Competition, *The Accounting Review*, 91(2), 603-623.

<sup>134</sup> Kreston Reeves, Response to CMA Invitation to Comment, 30 October 2018; The International Federation of Accountants, Response to CMA Invitation to Comment, 30 October 2018.

in analysing the sector, we are conscious of the need for competition and regulation to complement one another.

### ***Opportunities to compete: the audit tender process***

- 3.70 Competition in the audit market takes the form of periodic competition through tenders for audit engagements. Effective competition requires that audits are tendered sufficiently frequently to allow opportunities for competitors to bid for contracts, and that companies have a genuine choice of alternative auditors when they carry out a tender.
- 3.71 At the time of the CC market investigation the primary concern was infrequent tenders and low switching rates.<sup>135</sup> Now all PIEs must tender their audit at least every ten years and to switch auditor at least every 20 years. Rates of tendering and switching have now increased dramatically. Over 50% of companies in the FTSE 350 have tendered their audit since January 2013 and the overall annual switching rate for FTSE 350 audits peaked at 14% in 2015.
- 3.72 The documentary evidence we gathered from companies and auditors suggests that tenders usually involve detailed and comprehensive selection processes. A typical tender process, from Request for Proposal (RFP) to decision, takes around three months but pre-preparation time may be several months or years. Conflict checks will typically take place at an early stage in the process, as well as at later stages. There may be a 'pre-selection' of the audit partners, where firms put forward two or three partners for the Audit Committee to choose who should lead the tender process. Data rooms are widely used in the tender process and access provided to management, enabling firms to gain an understanding of the business. 'Technical' challenges are widely used in the tender process.<sup>136</sup>
- 3.73 There are risks and costs associated with switching for both auditors and companies. To date, we heard that most of these costs appear to have been largely absorbed by the audit firms. This may have contributed to some of the lack of choice, as discussed further below. However, from a company perspective the experience of switching is generally judged to have been good and in line with the ACC's expectations.
- 3.74 For example, an ACC noted the benefits of having a 'fresh pair of eyes' and new insight and challenge from the new auditor. We did come across some

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<sup>135</sup> For example, the CC found that the tenure of current auditor was more than ten years for 67 per cent of FTSE 100 companies and 52 per cent of FTSE 250 companies.

<sup>136</sup> For example, it has become normal to test a firm's technology, including its data analysis capabilities. See PwC response to the ITC, Annex.

exceptions – for example, [redacted]. However, the majority of companies appear to believe they have benefited from the switching process.

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

- 3.75 For competition for audit engagements to be effective in driving quality, there must be some degree of choice open to audit committees. Our evidence suggests that, for most FTSE 350 audit tenders, the audit committees were content with the level of choice.<sup>137</sup> However, for a substantial minority choice was limited.
- 3.76 We have been told that a choice between three bidders is generally sufficient to ensure a competitive tender. For example, [redacted] said that ‘a maximum of three firms was in line with [its] desire to execute a streamlined, efficient tender process without impacting choice or quality’. One FTSE 100 ACC noted that ‘companies needed two bidders to provide valid choice in a tender process and that three bidders would be quite sufficient to provide valid choice in a tender process’. However, more generally, ACCs have expressed concern where choice is limited to two credible bidders.
- 3.77 The FRC guidelines<sup>138</sup> state that a typical tender process should involve three or four audit firms. The legal requirement is that at least two firms are presented to the full board by the Audit Committee, with a justified preference for one firm.<sup>139</sup>
- 3.78 Most companies we spoke to that had recently tendered their audit said they felt that they had sufficient choice of auditor. However, for five of the 24 FTSE 350 companies that were asked to provide information on their recent tender, choice appears to have been limited to two firms.
- (a) [redacted] was limited to a choice between two firms ([redacted] and [redacted]). Challenger firms were not considered to have the capability or ‘global footprint’. Independence considerations meant that [redacted] was precluded from inviting [redacted] to tender<sup>140</sup> and [redacted] had decided that it wanted to switch from [redacted].<sup>141</sup> However, the audit committee felt ‘that [redacted] and [redacted] both provided compelling propositions that demonstrate very strong capability’.

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<sup>137</sup> Based on responses provided by the sample of 24 FTSE 350 companies and from meetings with ACCs.

<sup>138</sup> [https://www.frc.org.uk/getattachment/53c85956-d712-47d2-989f-2f8eff42be29/Audit-Tenders\\_notes-on-best-practice-Feb-2017.pdf](https://www.frc.org.uk/getattachment/53c85956-d712-47d2-989f-2f8eff42be29/Audit-Tenders_notes-on-best-practice-Feb-2017.pdf).

<sup>139</sup> Article 16(2) of the Audit Regulation. Also <https://www.frc.org.uk/directors/corporate-governance-and-stewardship/uk-corporate-governance-code/frc-guidance-for-boards-and-board-committees>.

<sup>140</sup> [redacted].

<sup>141</sup> [redacted].

- (b) [X] invited five firms to submit proposals ([X] – [X] was the incumbent).<sup>142</sup> Only two submitted proposals ([X]). The other three declined to submit proposals (none of them had existing non-audit services relationship with [X]). While happy with the outcome,<sup>143</sup> [X] would have liked all five firms to bid.
- (c) [X] invited five firms ([X]) to tender. [X] was the incumbent. Three firms declined to tender due to ‘being unable to confirm their independence under the new EU directive on audit independence’. An internal document suggest that [X] was content with the choice it had: ‘the decision was finely balanced but gave particular weight to the quality of the lead partner from [X], the benefits of being a [X] and their ability to deploy a “fresh pair of eyes” on the sector’.
- (d) In the case of [X], [X] as incumbent could not be reappointed. [X] declined due to conflicts of interest including the expected need to stop acting as auditor of a number of pension schemes where [X] group entities act as investment manager. The Audit Committee considered that it had sufficient choice, but would have preferred to have received a full tender response from the three firms invited to tender.
- (e) Similarly, in the case of [X], [X] as the incumbent could not be reappointed. [X] was excluded from the process [X] and potential conflicts of interest. Five firms were invited ([X]). [X] said that it had limited choice as: [X] had declined to bid due to the cost of bidding and lack of capacity to deliver. [X] declined to bid as winning [X] would further increase its exposure to [X]. [X] was also concerned about [X]’s capacity [X]. [X] has effectively been left dealing with [X].

3.79 Around 30% of the FTSE 350 tenders in our sample of 247 tenders had fewer than three competing bidders.<sup>144</sup> This is consistent with analysis submitted by KPMG.<sup>145</sup>

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

3.80 Looking across the evidence provided by companies and auditors, we identified four main reasons for lack of choice in some tenders: mandatory

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<sup>142</sup> [X] had been [X]([X]). Suggests that [X] could not participate given rotation requirements.

<sup>143</sup> Internal document states [X] will bring ‘smooth transition, ‘efficiency’, ‘robust and a challenging audit’, ‘experienced and stable audit team, ‘Clear communication to management and the audit committee’ and ‘15% saving on current audit fee’. We were told that [X] had met expectations.

<sup>144</sup> We consider this to be an upper bound as we are aware of occasions in our dataset where an auditor has not included a tender in its submission when it did in fact participate in that tender. CMA analysis of auditors’ tender data

<sup>145</sup> KPMG Response to CMA Invitation to Comment, 30 October 2018, p5

rotation rules; concerns about capability of firms outside the Big Four; conflicts rules; and choices by the audit firms not to bid.

### *Mandatory rotation*

- 3.81 The first driver of lack of choice is a straightforward consequence of the EU rules on mandatory rotation. PIEs must tender their audit at least every ten years and rotate their auditor at least every 20 years. Where auditors have reached the point where they are required to switch, they cannot take part in the tender process. For those FTSE 350 companies that perceive that only one of the Big Four could perform their audit, the best-case scenario is that they will receive tenders from the remaining ‘big three’.
- 3.82 Based on tender data provided by three of the Big Four, of those cases where they chose not to bid, around 40% were explained by the mandatory rotation rules.<sup>146</sup> These three Big Four auditors identified a total of 78 tenders between them that were affected by the mandatory rotation rules.<sup>147, 148</sup>
- 3.83 This evidence was confirmed by the information provided by companies. Several ACCs identified mandatory rotation rules as a key reason for limited choice.

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

- 3.84 A second driver is a perceived lack of capability of auditors outside the Big Four to carry out audits of FTSE 350 companies, and in some cases the reluctance of challenger firms to take part in tenders even when invited.
- 3.85 Based on data provided by the auditors, we estimate that one or more challenger firms were approached to participate in around 30% of tenders for FTSE 350 audits between 2013 and 2018. However, a challenger firm submitted a proposal in fewer than 20% of FTSE 350 tenders.<sup>149</sup>
- 3.86 Of the 24 FTSE 350 companies to whom we sent information requests, only four sent non-Big Four firms formal ‘Requests for a Proposal’. Out of the 24 tenders:

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<sup>146</sup> Based on tenders where the auditor provided a reason why it did not submit a tender proposal. CMA analysis of auditors’ tender data.

<sup>147</sup> We were unable to include the results for the other Big Four auditor because of concerns about reliability of the data.

<sup>148</sup> If anything this is likely to be an underestimate as audit firms were not in all cases able to confirm all the historical tenders in which they did not bid.

<sup>149</sup> CMA analysis of auditors’ tender data.

(a) [REDACTED].

(b) [REDACTED].

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

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

### *Conflicts issues*

3.89 Third, the multi-disciplinary nature of the large audit firms, combined with regulations to prevent conflicts between audit and non-audit work, can lead to a significant reduction in choice in some cases.

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

3.91 Several ACCs, including Go Ahead,<sup>150</sup> Pension Insurance Corporation and [REDACTED],<sup>151</sup> and Thomas Cook<sup>152</sup> all identified the rules around conflicts of interest/independence as creating a restriction on choice.

3.92 We were told that companies and audit firms can often take steps to manage conflicts of interest. In advance of the tender, a company will have discussions with potential bidders. This is an opportunity to identify potential conflicts of interests and for these be addressed. For example, [REDACTED].

3.93 However, the process of managing client conflicts can be complex, particularly as the rules apply to provision of non-audit services by any firm in the international network to the company or parent companies. In most cases the main constraint appears to come from the restricted services (where

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<sup>150</sup> Two firms decided to withdraw from the process due to conflicts of interest in the provision of related services to the Go-Ahead Group plc and its subsidiaries.

<sup>151</sup> [REDACTED].

<sup>152</sup> Deloitte was conflicted as they offered tax advisory to Thomas Cook already.

auditors need to demonstrate independence) rather than the broader cap of 70% on permitted non-audit work.

- 3.94 We also heard that companies sometimes did not want to retender non-audit work, particularly where one of the Big Four had a particular specialism and was providing ongoing advice. For example, [X] told us that [X] was providing it with advice on [X] over a number of years, and that it was not feasible to switch to an alternative provider. This meant that it did not invite [X] to tender for the audit contract. We heard several other similar examples from other ACCs.

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

- 3.95 Finally, we found that in a number of cases auditors chose not to bid for audit contracts. In many cases these reasons related to the conflicts between audit and non-audit services outlined in the previous section.
- 3.96 We received information from the Big Four and three challenger firms on a total of 151 instances where an auditor was approached, formally or informally, to a tender, but did not submit a formal tender proposal.<sup>153</sup> The reasons cited by these auditors for not submitting a formal tender proposal (ie not participating) varied considerably and in most cases it was not clear if the auditor had rejected the invitation or if the auditor did not make the final tender shortlist.
- 3.97 The information from the Big Four is consistent with conflicts of interest restricting choice to some extent. In particular, the most common reason cited by the Big Four for not participating when invited was the provision of non-audit services (roughly 57% of the time).<sup>154</sup> All other reasons were only cited by the Big Four in relation to 10% or less of tenders and included the auditor considering it had a low likelihood of success and other actual or perceived independence conflicts (eg banking arrangements).<sup>155</sup>
- 3.98 Despite non-audit services being the most common reason cited by the Big Four for not participating when invited, the Big Four still appeared to participate in most tenders where the tendering company was a non-audit services client. In particular, our data set suggests that the Big Four

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<sup>153</sup> That is, these instances are where the auditor was both invited, informally or formally, to tender and provided a reason why it did not submit a tender proposal. CMA analysis of auditors' tender data.

<sup>154</sup> Information received from the Big Four showed that, when including those they were not invited to, the most important reason cited for why they did not participate in a tender was due to rotation requirements. See paragraph [3.82].

<sup>155</sup> CMA analysis of auditors' tender data.

participated in on average 80% of the tenders they were aware of where the tendering company was a non-audit services client.<sup>156</sup>

- 3.99 However, EY told us that a factor in considering whether to participate would be maintaining a balanced audit business. It would want to avoid being overly exposed to problems that might emerge in a certain sector. Related to this, in the banking sector, the prudential regulator would be unlikely to want one auditor to dominate the audit of retail banking.
- 3.100 In contrast to the Big Four, the three challenger firms only cited the provision of non-audit services in a handful of cases. Rather, at least one challenger firm told us that in many cases they did not make the final tender shortlist for some unspecified reason. Other reasons cited, both for rejecting an invitation and not making the final shortlist, included having a lack of credentials or sector expertise and a lack of a relationship with the tendering company.
- 3.101 In addition, one of the challenger firms (Grant Thornton) told us that it did not participate in some tenders because it had decided not to bid for the audits of FTSE 350 companies.<sup>157</sup> It told us that the drivers of this decision were the time and costs associated with the tender processes combined with a bias in favour of the Big Four. In the absence of market reform, the commercial opportunities for Grant Thornton were in advisory services and in developing its audit practice in companies outside the FTSE350 and in the public sector. If the market conditions change, Grant Thornton said that it would consider again tendering for FTSE 350 audits.
- 3.102 BDO told us that it had, in recent years, declined some approaches to tender for FTSE 350 audits. BDO tended to focus on clients in certain sectors. In addition, a decision on whether to submit a proposal would be based on a number of factors including: the other firms likely to be invited to tender and their relationships with the company and Audit Committee members; potential conflicts; and BDO's previous working relationship with the company.

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

- 3.103 As identified in the previous section, one of the main constraints on choice and competition in the market for FTSE 350 audits is the difficulty faced by firms outside the Big Four in expanding their position. Challenger firms continue to have a very limited presence in the FTSE 350. They had only nine FTSE 350 audit clients and around 1% share of FTSE 350 audit fees in 2017

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<sup>156</sup> CMA analysis of auditors' tender data.

<sup>157</sup> CMA analysis of auditors' tender data.



(as set out previously), despite more frequent tendering and switching of audit contracts.

- 3.104 There appear to be both demand-side and supply-side barriers that are preventing challenger firms from building on their presence in the FTSE 350 market. These barriers reinforce each other, creating a vicious circle from which it is very difficult for the firms to escape.
- 3.105 On the demand side, there are genuine concerns about the capability of challenger firms to carry out the most complex audits, particularly those requiring large international teams. However, we also found that the challenger firms faced a 'chicken and egg' problem – they were frequently ruled out of tenders on the basis of lack of experience, but would only be able to build that experience by gaining a more substantial foothold in the market. We also saw evidence of a reluctance on the part of some investors to support Audit Committees who recommended hiring an auditor from outside the Big Four.
- 3.106 On the supply side, challenger firms appear reluctant in general to bid for FTSE350 audits. Given current market conditions, this appears to be a rational reaction to the cost of tendering, likelihood of winning, and risk for a smaller firm of taking on a large audit client. Breaking out of this cycle is likely to take significant action to reset the market.

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

- 3.107 On the demand side, we found a mix of concerns raised by ACCs and investors. Some of these related to the capability of the challenger firms, but others related more to a perception of risk in taking on a firm outside the Big Four.

### ***Capability of the challenger firms***

- 3.108 It appears to be widely accepted that challenger firms do not currently have the capability to audit the largest, most complex companies at the top end of the FTSE 350. This is in part because of the size of the audit teams required to carry out these audits and, in some cases, because the challenger firms do not have the required sector or other expertise.
- 3.109 This does not, however, explain why challenger firms have not been successful in establishing a presence in the smaller end of the market (e.g. in the FTSE 250). There is evidence that when challenger firms are given serious consideration and the opportunity to demonstrate their capability, they can win (for example the recent JD Wetherspoons and Mitie tenders). Grant

Thornton said that ‘Mid-tier firms do possess the requisite capacity and quality to deliver quality audit services to all but the largest companies’.

3.110 Even for the smaller and less complex companies in the FTSE350, several ACCs argued that the capability of the challenger firms was substantially below that of the Big Four in a number of ways. Respondents frequently cited:

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

3.111 For example, having considered the Group’s needs and the experience of audit firms in leading and coordinating global audits, the directors of RELX Group concluded that ‘It is unlikely that a firm outside the Big 3 could provide an integrated audit with suitable quality assurance’.<sup>158</sup> [REDACTED] told us that it excluded [REDACTED] due to size, capability and also their responsiveness to some of the work undertaken on the group’s smaller audits this year’. Mondi concluded that Grant Thornton and BDO, while having the international coverage, had at the time of the tender process in 2015 ‘limited FTSE100 coverage, with only 1 client each and much weaker AQRT scores’. Mondi also said that its ‘contribution to total fee income would be significant, potentially impacting independence’.

3.112 There is also some academic literature suggesting that smaller audit firms may be expected to provide, on average, lower quality audits. This may be because larger firms have more reputational capital to protect, higher litigation risk and greater regulatory scrutiny; are less financially dependent on any given client, which reduces their incentives to compromise their independence; and are able to attract and retain higher-quality human resources and expertise, therefore increasing their competence. Empirical

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<sup>158</sup> In order to meet the requirements of RELX Group’s listing in the Netherlands, the incumbent audit firm, Deloitte, could not be invited to tender.

evidence from recent studies (based on US data) supports this argument, although it is unclear how far these findings might read across to the UK.<sup>159</sup>

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

- 3.113 Aside from the objective capabilities of the challenger firms, some have claimed that firms outside the Big Four face a perception bias. For example, we heard that Audit Committees may have an incentive to hire the Big Four because they risk criticism for hiring one of the challenger firms if things go wrong.
- 3.114 The Institute of Chartered Secretaries and Administrators told us that the attitudes of the large corporates' shareholders and regulators 'inevitably play a part in this reluctance' to switch to challenger firms and there is 'much truth' in the proposition that 'no-one was ever fired for hiring IBM'.<sup>160</sup> A former audit partner at Grant Thornton and KPMG said that Audit Committees see appointing a non-Big Four a risk and '[t]he often mentioned expression of 'who ever got blamed for selecting IBM' still prevails in the selection of audit firms'.<sup>161</sup>
- 3.115 We did not see strong evidence in the tender selection processes of this 'IBM effect'. However, we found that there is a lack of objective information available to Audit Committees to validate their judgements on quality of the challenger firms, which makes it hard for them to justify appointing a challenger firm. This suggests that the challenger firms face a significant 'chicken and egg' problem – they need audit experience in order to prove their capability, but without existing experience they cannot win significant audit contracts in the first place.
- 3.116 The challenger firms highlighted these perception problems in their responses to us. For example, BDO said that 'audit committees are appropriately diligent and seek to fulfil their duties conscientiously. However an audit is a "credence good" where quality is difficult to measure and as such false proxies are used such as the size of the audit firm or a firm's current roster of clients in the

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<sup>159</sup> These studies show that, compared to non-Big Four auditors, Big Four auditors are significantly more likely to issue going concern opinions to distressed clients and are less prone to false positive and false negative errors; this is indicative both of greater independence and greater competency. Accounts audited by Big Four auditors also show lower levels of discretionary accruals (a widely used measure of 'earnings management'). See (i) Berglund, N. R., J. D. Eshleman, and P. Guo (2018). Auditor Size and Going Concern Reporting. *Auditing: A Journal of Practice & Theory*, 37(2), 1-25; (ii) DeFond, M., D. H. Erkens, and J. Zhang (2017). Do Client Characteristics Really Drive the Big N Audit Quality Effect? New Evidence from Propensity Score Matching. *Management Science*, 63(11), 3628-49.

<sup>160</sup> The Institute of Chartered Secretaries and Administrators, Response to CMA Invitation to Comment, 1 November 2018, p. 4.

<sup>161</sup> David Miller, Response to CMA Invitation to Comment, 19 October 2018, p. 6.

sector. The correlation of these factors to audit quality is weak. We believe these false proxies explain why challenger firms with better records on audit quality are consistently being unsuccessful in tenders and becoming frustrated that they are there simply to make up the numbers rather than be a real contender'.<sup>162</sup>

- 3.117 Grant Thornton said that, on the demand-side, Big Four firms are seen as 'a safe option' and that 'Audit committees have little incentive to make anything other than a conservative choice'. Also, that there is 'a bias towards Big 4 firms as a result of the professional background of audit committee and management alumni, incumbent relationships with Big 4 firms, or familiarity with the brands'.<sup>163</sup>
- 3.118 Moore Stephens said that there has 'not been a desire by companies to select non-big four firms, even when they are equally able and qualified' and that Audit Committees could not be blamed for choosing a Big Four firm 'even were something to go wrong'.<sup>164</sup>
- 3.119 RSM said that there is a 'deep-rooted resistance by UK listed companies to appointing a non-Big 4 firm as their auditor. The Big 4 firms enjoy a number of advantages of scale, size, familiarity, and a marked level of subliminal bias that act in their favour'. RSM also said that because of 'their large consulting and other non-audit activities, the dominant firms are known by, and have worked with, far more companies listed on the main market than challenger firms'. In addition, 'their alumni are in leading positions across the business and financial communities, further strengthening their brand recognition and endorsement'.<sup>165</sup>
- 3.120 This view about Big Four alumni appears to be supported by a recent survey in *Accountancy* magazine,<sup>166</sup> which found that 64% of FTSE100 ACCs had previously worked for a Big Four firm. The presence of ex-Big Four employees on Audit Committees is perhaps unsurprising given that the Big Four do employ a disproportionate share of financial professionals and therefore it is to be expected that senior staff are more likely to have links to Big Four firms than challenger ones. However, it raises questions about whether Audit Committee members' greater familiarity with the Big Four might lead them to favour Big Four firms when assessing audit tenders.

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<sup>162</sup> BDO, Response to CMA Invitation to Comment

<sup>163</sup> Grant Thornton, Response to CMA Invitation to Comment, p. 8

<sup>164</sup> Moore Stephens, Response to CMA Invitation to Comment, p. 5

<sup>165</sup> RSM, Response to CMA Invitation to Comment, Annex, p. 2.

<sup>166</sup> Published by Croner-i Ltd.

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

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

- 3.123 On the supply side, the barriers for challenger firms include: high tender costs; an emphasis during tender processes upon experience in auditing FTSE 350 companies; greater regulatory, financial and reputational risk involved in conducting audits for FTSE 350 companies; and the risk that, in securing audit work, conflicts of interest will bar a firm from securing more lucrative advisory work.
- 3.124 There are undoubtedly significant costs involved in scaling up an audit business to take on more complex audit clients. Mazars told us that 'it is unduly hard for challenger firms to recruit audit partners from Big 4 firms'. And several of the challenger firms mentioned the cost of investing in IT systems to carry out complex audit processes, although they noted that they were indeed willing to carry out this investment.<sup>167</sup>
- 3.125 However, challenger firms are currently reluctant even to compete for every tender where they are given the opportunity – some more than others. For example, Grant Thornton said in March 2018 that it only audits a small number of clients in the FTSE 350 and that 'it continues to be extremely difficult to penetrate this market'. As a result, Grant Thornton had 'taken the strategic decision to move away from tendering for statutory audit work in the FTSE 350'.<sup>168</sup> While other challenger firms are continuing to compete for some FTSE350 audits, our view is that the general reluctance to bid is a

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<sup>167</sup> For example, see Grant Thornton response.

<sup>168</sup> <https://economia.icaew.com/en/news/march-2018/grant-thornton-takes-a-bow-from-audit-market>.

rational response to their perception of the return on investment they can expect.

- 3.126 As noted above, the challenger firms are invited to fewer tenders than the Big Four. Among these invitations, they choose to bid on a smaller proportion of occasions and have a lower success rate than the Big Four (around 20% success rate for the challenger firms vs. 35% for the Big Four on average).<sup>169</sup> Given that bidding seriously for large audits is universally recognised as expensive and time-consuming, it is not surprising that the challenger firms think twice about participating in FTSE 350 tenders.
- 3.127 A further common concern raised by the challenger firms is of not wanting to take on too much risk by having a single audit client making up a large share of the auditor's total audit revenues.
- 3.128 Finally, several firms outside of the Big Four raised concerns about the regulatory costs and risks of competing for larger audits. This appears to be a particular concern for smaller firms that might be considering starting to bid for PIE audits. But it also seems keenly felt by Grant Thornton following recent fines. For recent cases, the fines resulting from enforcement action were, for the Big Four firms, in the range of 0.4% - 1.2% of UK firm audit fees in the relevant year. The 1.2% figure is the £10 million fine, discounted to £6.5 million, for BHS audit failures. Grant Thornton has been fined twice for infringements of independence rules. There was no suggestion of any audit failure and yet the fines amounted to 1.8% and 2.5% of its UK firm audit fee revenues in the relevant year.
- 3.129 A number of challenger firms have suggested that FRC enforcement activity has raised the barriers to them competing for FTSE 350 audits. Crowe cites that one of the principal supply side barriers they have observed was the 'additional risk and exposure to non-Big Four firms from being caught in litigation and also regulatory enforcement'.<sup>170</sup> The inference from its argument is that, given their relative size and financial resources, there would be a disproportionate impact on smaller firms of the reputational damage and/or fines resulting from any enforcement action which are factors that may deter challenger firms from bidding for FTSE 350 audit engagements, given the opportunity.
- 3.130 Supply-side barriers are significant, but many of them relate strongly to the demand-side constraint. In other words, if the challenger firms had a higher

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<sup>169</sup> CMA analysis of auditors' tender data.

<sup>170</sup> Crowe, Response to CMA Invitation to Comment, 30 October 2018, p. 8. Crowe was the 14<sup>th</sup>-biggest accounting firm in the UK in 2017 according to Accountancy Age.

chance of winning FTSE350 audit contracts then they would be able to invest to overcome the supply-side barriers.

## **Resilience**

- 3.131 Given the already limited choice in the market, we would be very concerned about the failure or withdrawal of one of the Big Four auditors if this led to the creation of a more consolidated 'Big Three'. With the current rules around conflicts and mandatory rotation, we would not see a market of three large auditors as being sustainable in the long run and would expect audit quality to suffer.
- 3.132 If one of the large audit firms failed, we would expect to be able to use competition tools to some extent to mitigate the consolidation of the market, including, subject to jurisdictional thresholds being met, merger review. However, there are limits on how effective these powers are likely to be in practice. It is also not clear that the challenger firms would have the capacity to take on a large number of existing Big Four audits at short notice.
- 3.133 A further concern is that resilience issues might create an incentive for the regulator not to take appropriate action against a large audit firm that was performing poorly because of the fear that this might drive the firm out of business. We have not found any evidence that this is currently affecting the approach of the FRC. However, it is possible that these concerns might increase in the future, for example if regulatory sanctions were strengthened and if the challengers failed to grow their capability to carry out complex audits.

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

- 3.134 The first concern relating to resilience is that, if one of the Big Four auditors were to fail, this would leave only three remaining large players. Given our finding that there is already very limited choice for some FTSE 350 audits, the loss of one of the four large auditors would clearly exacerbate these problems. Some companies would have no or limited choice in the appointment of their auditor, weakening competition, and we would expect audit quality to suffer.
- 3.135 We have considered first how likely it is that an audit firm might fail, and, second, whether, in the event of failure, regulators would be able to step in to limit the degree of consolidation of the market.

## *Resilience of the large audit firms*

- 3.136 Recent experience suggests that the Big Four firms appear to be resilient. They have withstood the reputational harm caused by a number of high profile cases of audit failure in the UK and elsewhere.
- 3.137 There are a number of factors likely to be contributing to this including: the regulatory requirement for listed companies to appoint an external auditor; that choice for larger and more complex companies appears to be limited to the Big Four firms; the size of these firms and the support provided by their international networks; that clients cannot switch quickly; and the ability of firms to contain the reputational harm to individual teams and partners.
- 3.138 For example, Deloitte told us that, '[they] in common with the other four largest firms, are a partnership with significant revenues in the UK. Being part of such large and balanced businesses affords a number of benefits. It offers a high degree of resilience to allow weathering of adverse events'.<sup>171</sup>
- 3.139 PwC told us that 'there are a number of reasons that a firm might fail, including reputational damage arising from audit failures', but that there is not 'a significant risk that the audit market lacks resilience'.<sup>172</sup> It said that should a firm in part of a global network fail, a new network affiliate could re-enter the national market (as has happened with PwC in Japan). There would also be the potential for other firms (including challenger firms) to take on audits of the failed firm.
- 3.140 These features have so far allowed the Big Four firms to withstand reputational damage. That it can take time for companies to switch auditor (including the time taken to manage conflicts caused by non-audit work) gives both the firm and regulators time to address concerns and restore confidence. This is helped by the weight attached by clients to the reputation, experience and capability of individual partners and audit teams, which has allowed firms to 'contain' the harm caused by audit failures. While this all increases resilience, it might contribute negatively to audit quality because of the 'moral hazard' problem, discussed further at paragraph 2.150 below.
- 3.141 However, concerns remain about the ability of the market to manage more catastrophic failure (such as that seen with Arthur Andersen in the past). The risk may be small, but it cannot be dismissed as a possibility. This could be

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<sup>171</sup> Deloitte Response to CMA Invitation to Comment, 30 October 2018, p7.

<sup>172</sup> PwC Response to CMA Invitation to Comment, 30 October 2018, p9.



triggered by audit failure(s) in the UK or another major firm in the global network.

### *Regulatory response to audit firm failure*

- 3.142 The impact of failure of one of the large firms on competition would be mitigated if it were possible to prevent the failed firm's audits from moving to the remaining three large auditors. For example, if the failed firm's audits and partners could instead be moved to one of the challenger firms (or shared between a number of them) then the concerns about the impact on choice would be significantly diminished.
- 3.143 The existing insolvency regimes applicable to audit firms are not designed to protect choice or resilience, as discussed further in the remedies section at paragraph 4.105 onwards.
- 3.144 Whether or not the merger regime would 'bite' in case of assets moving from a failed or failing auditor to a competitor would depend on whether or not such a transaction would qualify for assessment by the CMA under the merger control rules.<sup>173</sup>
- 3.145 If a merger were to qualify under the jurisdictional thresholds, the CMA would proceed to a substantive assessment of whether it would result in a significant lessening of competition (SLC). Any decision of the CMA on whether or not the SLC test is met would be context-and fact-specific.
- 3.146 In practice our view is that the merger rules would provide only limited protection against consolidation during or following failure of one of the Big Four. Although a wholesale transfer of assets could fall within jurisdiction of the merger rules, it is possible, depending on the factual circumstances, that the merger rules may not apply. It is also unlikely that the challenger firms would currently have the capacity to absorb all of the clients of one of the four large auditors.
- 3.147 Therefore, we have provisionally concluded that failure of one of the large auditors would be very likely to materially worsen the current choice problems in the market and weaken competition.

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<sup>173</sup> The jurisdictional test for the CMA to be able to assess a relevant merger situation is threefold: first, two or more enterprises (which broadly speaking would be business activities of any kind) have ceased to be distinct or that arrangements to that effect are in progress or contemplation; second, that either the turnover or the share of supply test would be met; and third that the merger either has not yet taken place (or has taken place less than four months ago). The concept of 'ceasing to be distinct' provides that any two enterprises cease to be distinct if they are brought under common ownership or common control; 'control' is not limited to the acquisition of outright voting control but may include situations falling short of it. See sections 23, 24, 26 and 33 of the Enterprise Act 2002.

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

- 3.148 The second, related concern is that fears about the impact of allowing one of the large audit firms to fail might prevent the regulator from taking appropriate action to address quality concerns. This in turn could lead to a ‘moral hazard’ problem, weakening the incentives for firms to focus on high quality audits. For example, in response to our invitation to comment document, one group of academics stated that despite regulators holding concerns about the market structure and the impact on choice, ‘the profession is likely to escape censure from either the government or regulators who fear that any crackdown will only force one or more of the firms out of business and make the situation worse’.<sup>174</sup>
- 3.149 While some commentators have referred to the Big Four as being ‘too big to fail’,<sup>175</sup> it is important to recognise that the issues in the audit market are different from those in banking, for example. In banking, there is a concern about systemic contagion, with failure of one bank affecting the viability of other banks. In audit, these systemic risks appear smaller. Although the failure of one auditor might be expected to have a systemic impact on confidence in the wider sector, companies would still need to carry out statutory audits, and it appears unlikely that failure of an audit firm would significantly increase the costs of other auditors or reduce their profitability. Instead, the main reason why regulators might be reluctant to take strong action against an auditor would be if they were concerned about the impact on competition and choice.
- 3.150 We looked at whether there was any evidence that the FRC is currently constrained by concerns about lack of resilience. We first considered the sanctions resulting from FRC enforcement action. At less than 0.5% of annual revenues of the UK firm, these have fallen well short of levels that could threaten the financial viability of firms, given our views on the overall resilience of the sector outlined above. This compares, for example, with fines of up to 10% of worldwide turnover in the case of breaches of competition law. There is, however, no suggestion that the FRC would have considered larger fines, but for concerns about the impact on the financial viability of the firms.
- 3.151 More generally, the FRC told us that it did not see concerns about resilience as constraining its ability to take action. It noted that firm failure was more likely to be triggered by litigation or a more general loss of reputation or confidence, rather than directly as a result of regulatory action. This was

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<sup>174</sup> Professor Atul Shah, Mr Brian Little, Mr Paul Moore and Professor Richard Murphy Response to CMA Invitation to Comment, 30 October 2018, p3.

<sup>175</sup> For example, see The Financial Times, [Concerns raised about ‘too big to fail’ KPMG](#), 19 July 2018.

consistent with views expressed by most of the stakeholders who commented on this issue in their responses to the launch document.

3.152 However, the Independent Review of the FRC has been considering what regulatory and enforcement powers might be appropriate in the future. If the FRC's powers are significantly strengthened, concerns about threatening the viability of the large auditors might be a more significant issue for the regulator in future.

### **Firms' structure and the culture of multi-disciplinary firms**

3.153 The final issue we have considered is whether the structure of the audit firms currently creates the right incentives to deliver high audit quality. In particular, we have sought to understand whether the very significant non-audit revenues earned by the auditors might influence the way in which they perform audits.

3.154 The core concern is that auditors might have weak incentives to challenge a company's management or exercise scepticism about the company's accounts if they are also selling substantial non-audit services.<sup>176</sup> These conflicts might play out in two ways:

(a) At a client level – for example, if there is more opportunity to sell non-audit services to audit clients (or vice versa), and the auditor fears that challenging company management could result in the loss of non-audit work.

(b) At the level of the audit firm – for example if the culture and focus of the firm is more driven by growth opportunities in non-audit services, and this affects the incentives in the audit side of the business.

3.155 Overall, we found limited evidence of conflicts between audit and non-audit work at the client level, primarily because of the restrictions in place on cross-selling. In many cases auditors now have to reduce their existing level of non-audit work in order to take on audit clients because of the independence rules and desire to avoid any perception of conflict.

3.156 However, there remains a concern that the culture of the Big Four (and other smaller auditors) is driven by non-audit services, which make up the majority of their revenue and growth).

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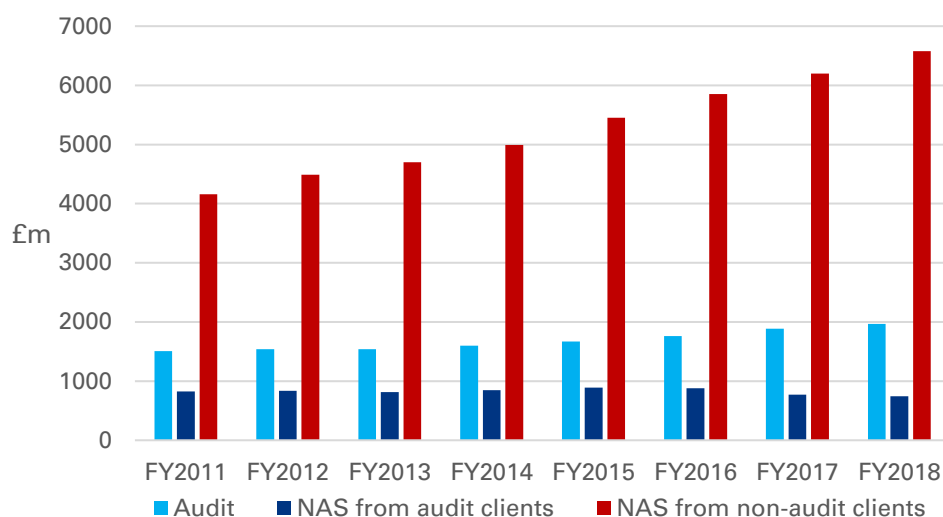
<sup>176</sup> For example, Prof Prem Sikka et al. note that 'Auditor independence is compromised by the sale of consultancy services to audit clients and is a major factor in audit failures.' [Reforming the auditing industry](#), December 2018.

### Scale and growth of non-audit services carried out by the audit firms

3.157 As set out above, both Big Four and challenger firms generate a majority of their revenue from non-audit services rather than audits (around 80% of total UK firm revenues are from non-audit services). Revenues from non-audit services have also increased faster than those from audit (over the period 2011 to 2018 non-audit service revenues increased by 46% compared with 30% for audit), and non-audit services have been consistently more profitable than audit (with EBIT margins in 2018 for non-audit services of around [redacted]% and for audit of around [redacted]%).

3.158 We found that the bulk of these non-audit services are provided to companies that are not audit clients. The average value of non-audit services provided by the Big Four firms to their all audit clients has fallen from around 55% of audit fees in 2011 to 38% of audit fees in 2018.

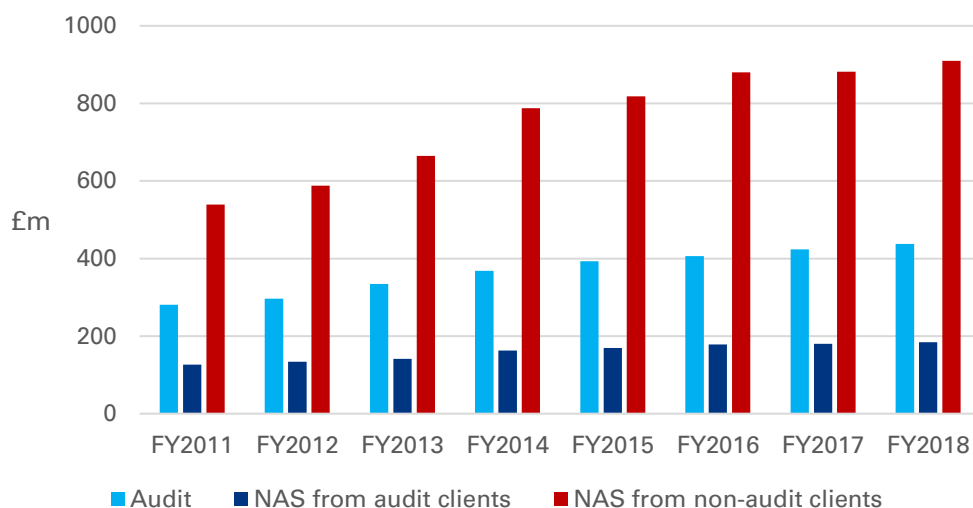
**Figure 2.22: Audit and non-audit revenues earned from audit clients, Big Four, 2011-2018**



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

3.159 Figure 2.23 shows the equivalent revenue breakdown for the challenger firms. The average sales of non-audit services to audit clients appear to be slightly higher for the challenger firms than for the Big Four – in 2018, the average value of non-audit services to their audit clients was around 42% of audit fees for the challenger firms compared with 38% for the Big Four.

**Figure 2.23: Audit and non-audit revenues earned from audit clients, challenger firms, 2011 to 2018**



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

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

- 3.160 The evidence above shows that the proportion of non-audit sales to audit clients has fallen in recent years. In large part this is due to CC and EU interventions to restrict the overall amount of non-audit services that can be provided and prohibit entirely certain types of services to audit clients.
- 3.161 Using information provided by the Big Four firms, we estimated that, in 2017/18, revenues earned from non-audit services provided to their FTSE 350 audit clients were, on average, around 20% of their FTSE 350 audit fees. This figure varies between the Big Four firms.
- 3.162 We heard that, in many cases, auditors who were successful in a tender had to exit or significantly scale back their existing non-audit work. We also found that in some cases auditors and Audit Committees were keen to go beyond the regulations to ensure that their auditor provided no non-audit services (aside from a narrow range of services that were considered to be directly related to the audit), in order to remove any perception of conflicts. This was particularly the case for the largest companies within the FTSE100. This suggests that revenues from non-audit services to audit clients could fall further in the coming years.
- 3.163 The effect of these developments in the FTSE 350 market is likely to be to reduce the short-term incentives for auditors not to challenge company management for fear of losing non-audit work.

3.164 However, in the longer term, FTSE 350 companies must rotate auditors at least every 20 years. We would therefore expect all the Big Four firms to have ongoing programmes for managing the anticipated loss of some FTSE 350 audit clients and the opportunities this creates in the provision of non-audit services. When a company switches auditor, the previous auditor is freed up to take on non-audit work. At the same time the new auditor may have to exit from or scale down its non-audit work with the client. This cycle has the same potential to weaken the incentives of the incumbent auditor to challenge a company's management or exercise scepticism if it knows that it will be in a position to sell non-audit services in the future. The risk will clearly be lower when a firm first acquires an FTSE 350 audit, when the audit term has longer left to run (or at least expected to run).

*'Cross subsidies' between audit and non-audit work*

3.165 A related set of concerns was raised with us about possible 'cross-subsidies' between audit and non-audit work. The broad concern is that audit work might be under-priced to act as a 'loss leader' in order to sell on more profitable non-audit work, and that this might then weaken the incentive to perform a high-quality audit.

3.166 The high-level profitability figures outlined previously offer some evidence that margins on non-audit work are higher than those on audit work for the Big Four auditors. This is also consistent with views we heard from the auditors and other stakeholders. However, there is no suggestion that the audit businesses are unprofitable at an aggregate level. It might also be expected that returns from audit work (which typically provides firms with a relatively low-risk revenue stream over several years) may be lower than for certain types of non-audit services where there is greater revenue risk. Therefore, we cannot draw any clear conclusions from the high-level profitability assessment.

3.167 In terms of incentives on the auditors, for the reasons set out above, the rules on conflicts and on the amount of non-audit work that can be provided to an audit client significantly reduce any incentive that the auditors might have to use audit as a loss leader at the client level. Where the Big Four win tenders for large company audits, they frequently have to reduce rather than increase their non-audit work to that client, so it is not clear why they would have an incentive to 'under-bid'.

3.168 The auditors told us that audit work has a significant wider reputational effect on the firm, including its non-audit practices. In principle, this might create some incentive to bid more aggressively for audit work as a platform from which to sell non-audit work to different (non-audit) clients. However, it is not

clear why this would materially affect the incentives to carry out high quality audit to audit clients where there are no, or limited, non-audit sales.

- 3.169 There might be a further concern if the Big Four auditors were able to use the profits from their non-audit work to under-bid the challenger firms and so make it more difficult for them to gain a foothold in the market. For the reasons set out above, it is not clear why the Big Four would have an incentive to behave in this way. Even if they did have an incentive to try to under-bid the challenger firms, the challengers also have large non-audit practices so could follow a similar pricing approach to the Big Four. In these circumstances, it appears unlikely that the Big Four would have the ability and incentive to under-bid in order to exclude competitors.
- 3.170 In order to test this further, we gathered some evidence on prices submitted by different bidders in tenders. At this stage the evidence is incomplete, and we are only able to put limited weight on it. However, the evidence so far does not suggest that the Big Four are systemically under-bidding the other challenger firms.
- 3.171 Finally, the auditors told us that one of the benefits of the multidisciplinary firm structure was that non-audit advice on audit matters could be provided at lower cost than would be the case if the audit firm had to contract for advice from a separate non-audit firm. We have not carried out a detailed assessment of whether non-audit advice is being provided to the audit side at 'below-market' rates, given the complex analysis that this would require. However, if this were the case, then it could be argued that the 'true' cost of audit is not being reflected in the audit fee. It is not clear that this would necessarily lead to worse audit quality, or to competition concerns given that all of the major auditors (not just the big four) are able to access in-house advice from their non-audit partners. However, it might reinforce the trend towards combined audit and non-audit firms, since it would be more difficult for a stand-alone audit firm to compete with the large multidisciplinary firms.
- 3.172 Overall then, we found limited evidence to support the various concerns around 'cross-subsidisation'. We acknowledge though that there are still concerns that the audit may be priced 'too low' – by which we mean that there might be benefits from a higher price if this meant higher quality. In our view, this concern is more likely to be driven by the incentives within the selection and oversight of auditors (set out above) rather than by the possibility of cross-subsidisation.

## ***Wider impacts of the Big Four and the multi-disciplinary model***

3.173 We are also concerned about the scale and reach of the audit firms and the impact this might have on audit quality. In the UK, at least 75% of revenues for the Big Four come from non-audit services. Non-audit revenues are also growing significantly faster than audit revenues. This leads to an inevitable focus of the firms' senior management on non-audit work.

3.174 We set out below:

- (a) findings from academic literature;
- (b) recent FRC findings from its Thematic Review on Audit Culture; and
- (c) our assessment drawing on various sources on the issues.

### *Academic literature*

3.175 The Enron case prompted a debate on whether the provision of non-audit services by audit firms impairs audit quality even if the services are not provided to a firm's audit clients.<sup>177</sup> In recent years the debate has intensified with a better articulation of the mechanisms through which the increasing importance of non-audit services could affect audit quality. These may fall under three categories:

- (a) The provision of both audit and non-audit services generates internal competition for resources, including both staff and investments, and distracts the attention of senior managers away from audit.
- (b) The impact on audit partners' incentives of remuneration that depends on the profitability of the whole firm, including its non-audit business. With the provision of non-audit services accounting for an increasing fraction of a firm's profits, the audit partners' interest in the success of the non-audit business has increased.
- (c) The literature has shown how the behaviour of individuals in an organisation both determines and is influenced by the social norms for the organisation.<sup>178</sup> In the context of an audit firm, the provision of non-audit services can increase the salience of a social norm emphasising cooperation with client companies' management, which contrasts with the

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<sup>177</sup> See, for example, (i) Wyatt, A. R. 2004. Accounting professionalism – They just don't get it! *Accounting Horizons*, 18(1), 45-53; (ii) Boyd, C. 2004. The structural origins of conflicts of interest in the accounting profession, *Business Ethics Quarterly*, 14(3), 377-398.

<sup>178</sup> See Fisher, P., and S. Huddart 2008. Optimal contracting with endogenous social norms, *American Economic Review*, 98(4), 1459-1475.



norms of accounting professionalism. Also, the importance of non-audit services for an audit firm may erode professional norms by increasing profit pressure.

- 3.176 These insights explain how the increasing importance of non-audit services for audit firms may impact on the firms' culture, values and professionalism in ways that are detrimental to audit quality. Non-audit services typically involve working in collaboration with the client's management. An auditor, on the other hand, is supposed to challenge management and provide an independent review of the client's business. More generally, the combination of audit and non-audit services in a multi-disciplinary firm can create tension between an advisory culture focused on profitability and short-term interests, and an audit culture based on public interest and professional values.
- 3.177 A recent study on the Big Four in the US has found empirical evidence of a negative relation between the importance of non-audit services at the firm level and audit quality.<sup>179</sup> As the study controls for the provision of non-audit services to audit clients,<sup>180</sup> the observed impact on quality can only be explained as the result of internal competition for resources, non-audit fee pressure on audit partners, reduced management attention to audit, or a change in the firms' culture.
- 3.178 Other studies have explored wider elements of the cultural relationship between audit firms and their clients. While not specifically relating to the provision of non-audit services, they indicate how the centrality of 'client service' within accounting firms may conflict with notions of independence, public service or ethical standards.<sup>181</sup> Auditors' identification with their clients has been found to affect auditors' objectivity even in the absence of financial incentives.<sup>182</sup>

### *FRC findings*

- 3.179 In May 2018 the FRC published its Audit Culture Thematic Review.<sup>183</sup> On why culture is important, the FRC said that:

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<sup>179</sup> Meckfessel, M. D., and D. Sellers (2017). The impact of Big 4 consulting on audit reporting lag and restatements. *Managerial Auditing Journal*, 32(1), 19-49.

<sup>180</sup> Moreover, the data mostly refer to a period after the introduction of the Sarbanes-Oxley Act, which prohibited the provision of many non-audit services to audit clients.

<sup>181</sup> See Anderson-Gough, F., C. Grey, and K. Robson 2000. In the name of the client: The service ethic in two professional services firms, *Human Relations*, 53(9), 1151-1174.

<sup>182</sup> See Bamber, E. M., and Iyer, V. M. 2007. Auditors' Identification with Their Clients and Its Effect on Auditors' Objectivity, *Auditing: A Journal of Practice & Theory*, 26(2), 1-24.

<sup>183</sup> <https://www.frc.org.uk/getattachment/2f8d6070-e41b-4576-9905-4aeb7df8dd7e/Audit-Culture-Thematic-Review.pdf>.

- (a) 'High quality audit is supported by fundamental principles, rigorous standards, due process and mandated quality assurance. However, auditing, by its very nature, is judgemental and based on human decisions and actions. There are many factors that influence the environment within which auditors make their decisions and act. There can be tension between these factors and auditors are faced with competing priorities.'
- (b) 'In this context, it is important that firms create a culture where achieving high quality audit work is valued and rewarded, and which emphasises the importance of 'doing the right thing' in the public interest. Auditors must also consider it their duty to serve the needs of shareholders, rather than management of the audited entity'.

3.180 Key findings included:

- (a) 'Culture has been designed (being purpose, values and encouraged behaviours) for the whole multi-disciplinary firm. There are good examples of firms keeping their cultural design current. In some firms, audit specific values such as objectivity and independence are not sufficiently prominent. All firms could do more to promote to partners and staff the purpose of an audit and the societal value that it brings.'
- (b) 'Audit remains a core service line for all firms with representation from auditors in senior leadership positions. Four of the eight firms prominently included improving audit quality within their whole-firm strategies, four did not. More could be done to promote audit specific values and make auditors feel valued for the work they do.'

### *Our assessment*

#### *Cultural pressures*

- 3.181 There are clearly significant differences in the professional culture of audit and the consultancy-based approach to many other non-audit services. For example, we saw reference in a document provided by one of the audit firms to the 'duality of purpose' between audit and non-audit services.
- 3.182 The objective in most consultancy-led services is to provide advice and support that the client wants, working closely with that client. In contrast, high-quality audit requires independence from and challenge to the client and is, ultimately, providing a product for the shareholders and wider public, rather than for the client itself.

- 3.183 Qualified auditors will have undertaken years of training, tested by rigorous examination. They will be members of a professional body. The practices and values of the profession are fundamental to audit work. By contrast, consultants will often not have formal professional qualifications or recognition.
- 3.184 External regulation and internal controls exist to protect the professionalism of the audit function within firms. We have been told, however, that there is only so much that controls and procedures can do to ensure audit quality. Ultimately, this relies on a commitment to professional standards that is embedded in the culture, the training, and the identity of professionals. This is reflected in the FRC findings from its Thematic Review.

#### *Differential growth in audit and non-audit services*

- 3.185 As set out above, audit accounts for a substantial and profitable part of the business of the Big Four firms. However, it is less profitable than non-audit services and the growth seen in recent years has been in the provision of non-audit services. Based on current trends, audit practices are likely to continue to decline in relative significance in the Big Four.
- 3.186 We have been told that, while the audit practice remains fundamental to the reputation of the Big Four firms, this situation could make it more difficult for partners in the audit practice, at the margin, to compete for resources and to make the economic case of investment. Audit is also likely to be less influential in determining the strategy and governance of the organisation.

#### *Audit partner remuneration*

- 3.187 Finally, the tensions between audit and non-audit services are also reflected in the remuneration of audit partners, which is typically linked to the overall profit earned by the firm across both audit and non-audit services. The auditors told us that they typically operate a 'points' system for partner remuneration, where the number of points is driven by audit performance, in which measures of audit quality play an important part. However, these points are then applied to the overall profit pool of the firm, covering both audit and non-audit services. This means that audit partners are incentivised to care about the overall performance of the firm (the majority of which relates to non-audit services).

#### *Conclusion on impacts of the multi-disciplinary firm structure*

- 3.188 Accounting firms have put in place a range of measures to ensure that their audit partners focus on audit quality within the multi-disciplinary firm structure.

For example, we heard that they have rigorous internal checks on quality and that partner remuneration is linked to measures of audit quality. They also argued that maintaining audit quality is fundamental to the wider reputation of the firm, including its non-audit services. We recognise that these factors all to some extent counteract the concerns outlined above.

3.189 However, our provisional view is that these measures do not remove the underlying tension created by the different objectives of audit and non-audit work. As the proportion of non-audit services increases and the nature of these services becomes further removed from the core audit function, so we would expect these tensions to increase, undermining the incentives to focus on independent, high-quality audit.

## 4. Remedies

4.1 The previous section described the various factors that lead to the market failing to deliver high-quality audits. We reiterate these factors below. The remainder of this section sets out our views on a proposed package of remedies to address the issues we have found.

- (a) **Selection and oversight of auditors.** This process is insufficiently focused on quality. Audit Committees are only a partial solution to the underlying problem that companies procure their own audits.
- (b) **Choice.** There are limitations on choice, driven by a combination of regulatory requirements, firms' structure, and barriers to competition from challenger firms; as well as concerns over the long-term resilience of the sector.
- (c) **Firms' structure.** The structure of audit firms results in weaker incentives to deliver high-quality audits, because a significant majority of the firms' business is outside audit.
- (d) **Regulation.** The general quality of regulation has been considered alongside this study by the independent review of the FRC, led by Sir John Kingman, so we do not consider that subject here, beyond noting that various stakeholders have reinforced the Carillion Select Committee's view that regulation has been inadequate.

4.2 Competition and regulation should work hand in hand to ensure that audit firms and individuals within those audit firms have the maximum incentives to carry out high-quality audits. In practice this means a combination of the following mechanisms:

- (a) Selection and oversight of auditors would ensure that competition is focused on quality (more than price), so that firms win more business if they deliver good quality and lose business if their quality is poor.
- (b) There would be (i) enough opportunities to compete, and (ii) sufficient choice of viable competitor firms over the long term, without undue barriers to entry and expansion, all to enable intense competition.
- (c) Within firms, individual auditors' personal success would depend to a very large extent on whether they deliver high-quality audits.
- (d) Regulation would (i) shine a light on quality levels and (ii) punish sub-standard performance both by firms and by individuals. Regulation would

also support competition on quality because buyers would have better information on a service whose quality is otherwise hard to judge.

4.3 The CC’s remedies have made some of these mechanisms work better, but not all. The regulatory elements have been found wanting, but the independent review of the FRC, led by Sir John Kingman, is expected to address this.

4.4 The table below explains how the package of remedies we are proposing builds on the CC’s remedies and other improvements to regulation to ensure that incentives for quality are maximised. We have included (in italics) measures outside the scope of this study, or which are already in place.

**Table 4.1: Proposed remedies and how they address the issues**

<i>Mechanism</i>	<i>Remedy</i>	<i>How does it take effect?</i>
<b>(a) Focus competition on quality rather than price</b>	<b>1. Regulatory scrutiny of Audit Committees</b>	<ul style="list-style-type: none"> <li>• Focuses appointments and management of auditors fully on quality</li> <li>• External accountability for Audit Committees</li> <li>• Minimises any barriers from bias against challenger firms</li> </ul>
<b>(b)(i) Frequent enough competition</b>	<i>Mandatory tendering (CC) and rotation (EU)</i>	<ul style="list-style-type: none"> <li>• Opportunity to compete every 10 years and guaranteed switch every 20 years</li> </ul>
<b>(b)(ii) Enough viable competitors</b>	<b>2. Mandated joint audits (or market share caps as a possible alternative)</b>  <b>3. Other measures to break down barriers to Challengers</b>  <b>4. Resilience regime</b>	<ul style="list-style-type: none"> <li>• Joint audits allow challenger firms scope to invest, acquire experience and build expertise, without sacrificing quality</li> <li>• Other measures complement this remedy e.g. through easing partner movements</li> <li>• Resilience regime reduces risk of four to three big firms</li> </ul>
<b>(c) Individual incentives for quality</b>	<b>5. Full structural or operational split between audit and non-audit services</b>	<ul style="list-style-type: none"> <li>• Full focus by auditors on audit</li> <li>• Auditors’ individual rewards rest purely on audit quality</li> <li>• Supports more choice if it allows conflict rules to be relaxed</li> </ul>
<b>(d)(i) Set standards, review firms’ work, punish for sub-standard quality</b>	<b>6. Peer review</b>  <i>Regulation to be improved following independent review of FRC</i>	<ul style="list-style-type: none"> <li>• Holds firms to account</li> <li>• Requires standards to be above a certain level</li> <li>• Makes relative quality levels between firms more visible to support competition</li> </ul>

<b>Mechanism</b>	<b>Remedy</b>	<b>How does it take effect?</b>
<b>(d)(ii) Punish individuals for sub-standard quality</b>	<i>Regulation to be improved following independent review of FRC</i>	<ul style="list-style-type: none"> <li>• Holds individuals to account</li> <li>• Deterrent effect, as individuals can be fined and / or banned if they fall short</li> </ul>

4.5 We have borne in mind the following principles to assess the remedies. The proposals need to:

- (a) address the underlying quality concerns that we have identified;
- (b) be implemented, monitored and enforced effectively;
- (c) be proportionate to the scale of the issue; and
- (d) consider the potential risks and unintended consequences.

4.6 We welcome views on whether, and how, each of our proposed remedies addresses these principles.

## **Proposed remedies**

### ***Remedy 1: Regulatory scrutiny of Audit Committees***

#### *Introduction*

- 4.7 Auditors must be properly incentivised to deliver sceptical and challenging audits. This requires auditors to be independent and, if necessary, willing to make difficult decisions in the face of opposition from company management. It is the role of Audit Committees to ensure that this happens.
- 4.8 As set out above, measures introduced by the CC and the EU Audit Regulation were designed to strengthen the role of the Audit Committee to better align the auditor's incentives with shareholders, rather than company management. However, the evidence does not inspire confidence that Audit Committees consistently prioritise quality.
- 4.9 One way to re-orient the incentives on auditors to focus on providing high quality audit based on professional scepticism and challenge would be to remove the responsibility for the audit selection processes, and audit engagement monitoring, from companies altogether. These responsibilities could instead be undertaken by an independent body. This would break the link between company management and audit firm appointment and reappointment – creating an environment where audit firms are better incentivised to provide challenging audits. An independent body could also

reduce barriers to challenger firms by ensuring that selection procedures are not biased.

- 4.10 Most stakeholders, including investors, were opposed to an independent appointment and monitoring body. We heard that this remedy would disenfranchise shareholders and that an independent body would be incapable of replicating the functions of Audit Committees.
- 4.11 We do not agree that the remedy would disenfranchise shareholders – it could be designed so that shareholders retained the final vote just as they do today. We are also unpersuaded that a well-resourced independent body would be incapable of replicating the functions of Audit Committees (as explained above; Audit Committee members on average spent less than 35 hours on matters relating to the statutory audit in the last financial year).
- 4.12 However, we have concerns at shareholders' widespread opposition to this proposal, and our current understanding is that a blanket generic removal of Audit Committees' functions and/or shareholders' rights to appoint the auditor would be inconsistent with the current EU legislative framework. Therefore, barriers exist to creating an independent audit appointment and monitoring body in the short term.
- 4.13 Nonetheless, there are substantial changes that can be made to the current Audit Committee framework to ensure that auditor incentives are appropriately aligned towards quality. These changes potentially go much further than the previous CC and EU reforms.

#### *Aims of the remedy*

- 4.14 This remedy would ensure that Audit Committees fully protect the interests of shareholders when making decisions about auditor selection and monitoring the audit engagement. In turn, this remedy will improve incentives for high-quality audits. This remedy would also ensure that challenger firms are not unfairly disadvantaged due to biases during audit selection procedures.

#### *How the remedy would work in practice*

- 4.15 The key element of this remedy is strong regulation of Audit Committees – to ensure they are all doing the job they are meant to do.
- 4.16 The type of oversight mechanisms we envisage would provide a step change in Audit Committee practice. These include:
- (a) **A requirement that Audit Committees report directly to the regulator before, during and after a tender selection process.** To strengthen this



requirement, a representative from the regulator could sit as an observer either on all Audit Committees or, for example, where process or quality issues had been identified by the regulator in the past. The Audit Committee would be required to demonstrate that it:

- (i) prioritised independence and challenge in its tender assessment;
- (ii) made its decisions independently of company management;<sup>184</sup>
- (iii) competently managed conflicts of interest so as to maximise choice at the time of the audit tender; and
- (iv) gave fair consideration to challenger firms – having an objective justification for excluding any challenger firm.

**(b) A requirement that Audit Committees report directly to the regulator throughout the audit engagement** – demonstrating how they are monitoring quality. This requirement could be monitored through the observer described above or, for Audit Committees with no observer, through the regulator having a right of inspection at any time. Audit Committees would be required to:

- (i) demonstrate that they had made meaningful interventions to assess quality beyond simply seeking management feedback; and
- (ii) provide the regulator with an account of material disagreements between the audit firm and management, including the role of the Audit Committee in these discussions.

**(c) The ability for the regulator to issue public reprimands, or direct statements to shareholders** in circumstances where it is not satisfied Audit Committees have followed proper procedures.<sup>185</sup>

4.17 It would also be helpful for the regulator to make public, as far as it is able, the results of any assessments of quality it undertakes, such as the AQRs, in order to ensure Audit Committees have maximum access to information on quality.

4.18 Our current view is that this enhanced oversight regime should apply to all FTSE 350 Audit Committees, at least initially. However, we would welcome

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<sup>184</sup> Not all companies are required to have independent Audit Committees. In circumstances where the role of the Audit Committee is performed by company management, some of these oversight mechanisms would still be applicable.

<sup>185</sup> As part of this remedy, appropriate restrictions would be put in place to prevent the disclosure by the regulator of any company's commercially sensitive information.

views on whether this should be extended to include a wider group of the largest companies, such as all PIEs. We propose a right of inspection for the regulator in respect of other large companies.

### *Views of the parties*

- 4.19 Grant Thornton supported an independent auditor appointment body on the grounds that it would promote independence and address potential bias in the procurement of audit by large companies in the UK. It added that this would balance the interests of all the various stakeholders and place the public interest at the heart of the auditor selection process.<sup>186</sup>
- 4.20 However, many other stakeholders overwhelmingly opposed replacing Audit Committees with an independent body. They told us that Audit Committees performed an important role to a high standard. For example, BDO stressed that an Audit Committee played a key role in the audit process and had a broad and deep understanding of the business and of the industry and environment that it operates in.<sup>187</sup> KPMG submitted that, in its experience, Audit Committees and members thereof generally take their responsibilities seriously and discharge them diligently.<sup>188</sup>
- 4.21 Nonetheless, there was widespread support for strengthening oversight of the existing Audit Committee framework. For example:
- (a) EY suggested closer dialogue between Audit Committees and a regulator, and providing a regulator with the power to recommend to an Audit Committee that the company's auditor be changed where it can be demonstrated through the inspection and enforcement process that there have been repeated instances of failures of professional judgment or scepticism in the auditor's audit of the company.<sup>189</sup>
  - (b) PwC suggested that Audit Committees could be required to report to an independent body on their preliminary appointment, fee and scope decisions and respond to challenges before final decisions are made.<sup>190</sup>
  - (c) Deloitte supported measures that would strengthen Audit Committees and their links to shareholders.<sup>191</sup>

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<sup>186</sup> Grant Thornton's submission to the ITC, page 3.

<sup>187</sup> BDO submission to the ITC, page 10.

<sup>188</sup> KPMG submission to the ITC, page 30.

<sup>189</sup> EY submission to the ITC, page 7.

<sup>190</sup> PwC's submission to the ITC, page 16.

<sup>191</sup> Deloitte's submission to the ITC, Appendix, page 10.

4.22 A number of parties also suggested that Audit Committees should be asked to provide better information to those they represent to enhance their role.<sup>192</sup> For example, the Investment Association stated Audit Committees should assert whether they believe the audit had been challenging, the granularity of key accounting issues and how the auditor challenged management's judgement and assertions and exercised professional scepticism.<sup>193</sup>

#### *Our assessment of the remedy*

4.23 The evidence on the performance of Audit Committees is mixed (see above). But even a few Audit Committees falling short in meeting their obligations is too many. The CC's remedies and subsequent EU Regulation were a step in the right direction but did not go far enough.

4.24 We therefore propose recommending a remedy that calls for strong regulatory oversight of Audit Committees with meaningful consequences for poor performance. This remedy would:

- (a) ensure that Audit Committees are fully incentivised to demand independence and challenge from auditors; and
- (b) create a more level playing field for challenger firms. As set out above, many selection processes we reviewed did not meet the required standards of transparency and non-discrimination.

4.25 These changes would in turn ensure that competition is focused on delivering quality audits.

#### **Summary: regulatory scrutiny of Audit Committees**

Audit Committees should be subject to specific regulatory requirements and obligations. Our current view is that this regulation should include:

- A requirement that Audit Committees report directly to the regulator before, during and after a tender selection process. The regulator would also have the ability to include an observer on all or a sample of Audit Committees.
- A requirement that Audit Committees report directly to the regulator throughout the audit engagement.
- The ability for the regulator to issue public reprimands or direct statements to shareholders.

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<sup>192</sup> Mazars' submission to the ITC, page 3.

<sup>193</sup> Investment Association's submission to the ITC, page 2.

The remedy should apply to at least all FTSE 350 Audit Committees but we would welcome views on whether this remedy should be extended to cover a wider group of companies, such as all PIEs.

## ***Remedy 2: Mandatory joint audit***

### *Introduction*

- 4.26 A joint audit would require two firms to sign off on the accounts of their audit client. Responsibility for the audit opinion, and audit liability, would rest with both auditors.
- 4.27 One version of the remedy would be to leave companies free to choose any two (or more) auditors. Another possibility would set up specific incentives or requirements designed to ensure that at least one of the two auditors was a challenger firm.
- 4.28 In our invitation to comment, we also mentioned the possibility of introducing shared audit as an alternative to joint audit. A shared audit would be carried out with one firm (the statutory auditor) taking overall control, responsibility and liability for the audit. Another audit firm would support the statutory auditor on certain aspects of the audit (e.g. carrying out audit functions on subsidiaries). As we discuss below, our current view is that shared audit would not be as effective as joint audit in achieving the remedy's aims.

### *Aims of the remedy*

- 4.29 The aim of this remedy would be to reduce the barriers to auditing large companies faced by the challenger firms. This remedy would lead, in the medium term, to improvements in the quality and capability of the challenger firms and to stronger competition in the provision of audit, and improved market resilience. Joint audit also has the potential to improve audit quality.

### *Design and implementation of the remedy*

- 4.30 The audited company would select each of the joint auditors through a separate tender. The joint auditors would be appointed at different times so their terms would not end at the same point, retaining the ongoing auditor's knowledge of the company to allow for a smooth transition.
- 4.31 Each auditor would form its own understanding of the company and assessment of audit risk. Together, the joint auditors would prepare an overall audit plan and propose it to the company's Audit Committee. This plan would

need to ensure that work is divided between the auditors efficiently, for example based along geographic lines or legal entities.

- 4.32 Each of the auditors would then conduct its respective part of the audit in accordance with the audit plan and then conduct a cross review of the relevant parts of the audit – particularly the consolidation of the component parts of the company. Following this, the joint auditors would establish a joint audit opinion.
- 4.33 Implementation of this remedy is likely to require regulatory oversight from the start: the regulator will need to set out how the regime would operate and then oversee the Audit Committees' implementation of it.
- 4.34 The remedy would include the requirement for a balanced approach in sharing audit work among the joint auditors, with regular changes in the allocation of audit procedures between the joint auditors over the years. Each auditor would therefore undertake a significant part of the overall audit procedure, from both a quantitative and a qualitative point of view. The remedy would set a minimum share of audit work to be undertaken by each of the joint auditors.
- 4.35 There are a number of possible ways this minimum share could be calculated. In any model the minimum share is likely to need to vary according to the size of the audited company, with more equal shares required for smaller companies. This would be important if the remedy mandated the presence of one challenger firm in each joint auditor pair, as challenger firms, at least initially, would not have sufficient capacity to undertake a large proportion of the audit work for very large clients.
- (a) One option would be for the share of the audit fees (which could be correlated to workload) achieved in the short to medium term to be set along a sliding scale. As an illustrative example, one way this could be achieved would be for the largest firms in the FTSE 100 to be required to have a joint auditor earning at least 10% of the total audit fee.<sup>194</sup> This percentage could then increase as the size of firm decreased so that the smallest firms in the FTSE 350 would be required to have a joint auditor earning at least 40% or 50% of the total audit fee. In the long run, the regulator could then consider increasing some of these targets. For example, the 10% minimum share for the top 50 audited companies could be gradually increased as the challenger firms build their capacity.

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<sup>194</sup> We recognise that the constituent members of the FTSE100, FTSE250 and FTSE350 change on a regular basis and any remedy will need to take account of that in its design

(b) Another alternative could be to set a minimum joint audit percentage (such as 20%, 30% or 40%) which would not initially apply to the largest companies in the FTSE 350. This percentage would increase over time and over time increasing numbers of the largest firms would be included in the requirement.

- 4.36 However, there are some types of companies, such as banks, where the challenger firms may currently not have the required skills to perform an audit. This suggests that allowing two Big Four firms to act as joint auditors could be a more appropriate option.<sup>195</sup> This would lead to greater resilience of the market for financial services and sectors that are currently audited by only some of the Big Four firms. Other than these specific examples we would expect that companies would have a challenger firm as one of their joint auditors.
- 4.37 It is likely to be necessary for this remedy to be phased in over time to avoid the immediate need for a large number of tenders, and also to allow the challenger firms to prepare for a large increase in workload both to participate in tenders and to do the work on those accounts where their bid was successful. For example, the requirement could be made applicable from the next re-tendering point or it may be appropriate to implement joint audit in respect of the FTSE 250 before the FTSE100 so that UK firms can become familiar with the new working processes before jointly undertaking the UK's largest and most complex audits.
- 4.38 There may be a need for some specific exceptions for the requirement for joint audit. There may be companies which, despite large market capitalisations, have audits that are simple and difficult to divide sensibly between two auditors – investment trusts have been cited as an example.
- 4.39 Finally, an important aspect of our joint audit remedy is that both auditors would take responsibility for a material part of the audit, with both auditors presenting their findings to the board, and both auditors having joint liability. Consolidated accounts would be audited by both joint auditors and then cross-reviewed. Some parties have proposed that liability in the case of joint audit should be proportionate, rather than auditors being jointly or severally liable. This would represent a major departure from the UK's current liability regime and would require further significant consideration.

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<sup>195</sup> Alternatively, if a mandatory requirement for one challenger auditor was implemented, there would need to be flexibility to allow for instances where two Big Four firms were necessary as the joint auditors – for example, due to capacity constraints with challenger firms, or due to particular sector circumstances.

## *Views of the parties*

4.40 The challenger firms and other stakeholders including some ACCs with direct experience of joint audits viewed them positively (with the partial exception of BDO).<sup>196</sup> The arguments put forward by the parties in favour of joint audit were that:

- (a) joint audit could create better quality audits by combining the complementary technical expertise, sector insight, experience and geographical reach of two or more audit firms;
- (b) the combination of two audit firms should strengthen the auditors' position in the event of client resistance to a particular course of action;
- (c) by allowing auditor appointments to be made on a staggered basis, joint audit could make auditor rotation smoother, striking a balance between the deep knowledge of the ongoing auditor and the fresh pair of eyes brought by the newly appointed auditor; and
- (d) the introduction of joint audit could improve resilience in the market, by allowing smaller audit firms to grow and become more competitive vis a vis the Big Four firms.

4.41 Most of the ACCs we spoke to and the Big Four expressed opposition to this remedy, while the views of investors were mixed. The parties opposed to the introduction of joint audit argued that:

- (a) there is no evidence that joint audits improve audit quality, independence or choice;
- (b) each joint auditor would only have partial oversight, or automatically rely on each other's review, which could lead to issues being missed or 'falling through the gaps';
- (c) the involvement of two firms in an audit would lead to some degree of duplication and therefore higher audit fees, and possibly delays in the process;
- (d) as both joint auditors must sign off on the same audit, liability for any problems is jointly held and an 'innocent party' to a weak audit could be

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<sup>196</sup> BDO submitted that joint audit could create a significant cost and time burden on companies that is potentially disproportionate to any benefit; however, BDO could envisage the introduction of joint audit as part of a package of measures including market share caps. BDO's submission to the ITC, page 6.

liable for all of the liability incurred; assuming liability for another firm's work may not be acceptable to some firms in some scenarios; and

- (e) joint audit implies that two audit firms, instead of one, would be precluded from tendering for an audit when they are subject to mandatory rotation, reducing choice; moreover, the presence of two auditors would reduce the choice of providers of those non-audit services that auditors are not allowed to supply to their clients.

4.42 Finally, some parties said that there should be some reform of the joint and several liability model that presently applies in joint audits in the UK, to one of proportional liability. Some parties also submitted that there could be some types of companies, such as banks, where there may not be many (potentially any) challenger firms who believe they have the requisite skills, knowledge, experience or appetite to be appointed as joint auditor.

4.43 Parties' views on shared audit were less polarised: the largest auditors were not opposed to it, while the challenger firms who expressed a view considered it a positive step, but inferior to joint audit:

- (a) Deloitte told us that it would potentially support the introduction of a shared audit (particularly in combination with another measure, such as a market share cap) to enable audit firms outside the four largest ones to develop skills and increase capacity.<sup>197</sup>
- (b) PwC argued that, compared to joint audit, shared audit may alleviate the 'falling through the gaps' issue to an extent.<sup>198</sup>
- (c) KPMG stated that it was not opposed to exploring possibilities in relation to some form of shared audit (or peer reviews) and that this option better managed some of the challenges associated with joint audit.<sup>199</sup>
- (d) Mazars, which strongly supports joint audit, recognised that shared audit may have a place in the early years of a dual appointment as the challenger firm builds up its share of the group audit undertaken to an appropriate level in order for there to be a joint audit.<sup>200</sup>
- (e) Crowe argued that, while shared audits could be part of the solution, given that the aim is to get a greater variety of auditors into the

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<sup>197</sup> Deloitte's submission to the ITC, Appendix, page 11.

<sup>198</sup> PwC's submission to the ITC, page 11.

<sup>199</sup> KPMG submission to the ITC, page 22.

<sup>200</sup> Mazars' submission to the ITC, page 18.



boardroom, there is a risk that the shared audit may not achieve this goal.<sup>201</sup>

- 4.44 Some parties, however, expressed serious concerns with shared audit, submitting that it would give rise to issues of reliance of one auditor on another and that this had been identified as an area of weakness in recent FRC audit reviews of group entity audits. Some of the strongest opposition we heard to joint audit appears to have been based on misconceptions about failings of shared audits assumed to be joint audits.<sup>202</sup>

#### *Our assessment of the remedy*

- 4.45 The lower concentration of the audit market in France<sup>203</sup>, where joint audit is mandatory, suggests that the introduction of joint audit in the UK is likely to lead to a significant increase in the share of audit fees of challenger firms.<sup>204</sup> This is supported by the results of a simulation in a recently published study.<sup>205</sup> Joint audit would result in lower market concentration even if the presence of a challenger firm in a joint audit pair was not mandated. In France, where there is no restriction on the composition of joint audit pairs, a significant minority of large firms have chosen audit pairs with one Big Four firm and one challenger firm.<sup>206</sup>
- 4.46 In contrast to a joint audit, a shared audit is less likely to be effective in promoting resilience and choice as challenger firms would be more likely to remain subordinate to Big Four statutory auditors – with the Big Four firm dictating how the audit will be carried out, and retaining overall responsibility for the engagement.

#### *Impact on choice and competition*

- 4.47 We have received less evidence with respect to the impact of the remedy on choice and competition, but overall the evidence indicates that choice of auditor should increase, as discussed below.

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<sup>201</sup> Crowe's submission to the ITC, page 11.

<sup>202</sup> [redacted] cited the cases of Bank of Credit and Commerce International and Parmalat as examples of notable failures of joint audits ([redacted]). These, however, were cases of shared, rather than joint, audit.

<sup>203</sup> Report from The Commission To The Council, The European Central Bank, The European Systemic Risk Board And The European Parliament on monitoring developments in the EU market for providing statutory audit services to public-interest entities pursuant to Article 27 of Regulation (EU) 537/2014, see Figure 3 which shows Audit firms' market share in 2015 for statutory audits of PIEs (<https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52017DC0464>).

<sup>204</sup> Where appropriate, we have followed the French model for joint audits in designing this remedy.

<sup>205</sup> Guo, Q., C. Koch, and A. Zhu (2017) Joint audit, audit market structure, and consumer surplus, *Review of Accounting Studies*, 22(4), 1595-1627. This study suggests that the introduction of joint audit would eventually result in the emergence of at least one Challenger firm of a size comparable to the Big Four.

<sup>206</sup> See Guo et al. (2017).

- 4.48 Joint audit would increase competition from challenger firms if joint audit work enabled these firms to acquire the capacities and reputation to make them able to compete for the role of 'lead' joint auditor. Should challenger firms remain confined in a role as 'junior' auditor, competition for the largest audits would effectively remain limited to the Big Four. In this regard, data from France provides mixed evidence. On the one hand, the largest companies tend to prefer joint audit pairs composed of two Big Four firms; on the other hand, a significant minority of large firms have chosen audit pairs with one Big Four and one challenger firm, and the workload in these cases is shared between the joint auditors in a fairly balanced way, with the challenger firm often receiving more than 40% of the audit fee.<sup>207</sup> This indicates that, in a significant number of cases, challenger firms are perceived as being on a par with the Big Four.
- 4.49 The evidence above, although limited, gives us some confidence that choice would increase as a result of the introduction of joint audit in the UK, with the possible exception of the largest or most complex companies in the FTSE350.
- 4.50 The impact of joint audit on competition between the Big Four depends on how the remedy is designed.
- (a) If the remedy mandates that audit pairs must include a non-Big Four auditor, then there would be no change in the relative strength of competition between the Big Four, who will continue to compete for one auditor role in a similar way to how they currently compete for the role of sole auditor.
- (b) If audit pairs were allowed to include two Big Four firms, then the remedy could reduce competition between the Big Four. When bidding for an auditor role, a Big Four firm might take into account that, if its bid was unsuccessful, it would have a chance to be subsequently selected as the other joint auditor. This chance could be particularly high in the case of the largest firms, which, as shown by the data for France, have a preference for hiring two Big Four auditors. This may give any Big Four an incentive to bid less aggressively. Such effect, however, would be counterbalanced in the long term by increasing competition from challenger firms.

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<sup>207</sup> The data has been taken from Guo et al. (2017) and covers the period 2006-2012.

### *Impact on resilience*

- 4.51 As discussed above, we expect that the remedy would lead to a significant increase in the size of some challenger firms. We would expect that this would make the audit market more resilient as, in the event of the failure of one of the Big Four, the larger size of the challenger firms would enable them to attract senior staff more easily from the failed auditor and induce large companies to begin choosing them as auditors. Given the concerns expressed, there is greater uncertainty over whether the same outcome could be achieved through a shared audit remedy.

### *Impact on audit quality*

- 4.52 As described above, parties submitted a wide range of reasons why joint audit could result in higher or lower audit quality. The arguments pointing towards an increase in audit quality have all been recognised in economic literature. In addition, it has been argued that the threat to auditor independence due to economic bonding with the audited company is likely to be lower under joint audit, as audit and non-audit fees are distributed between two different audit firms and there are therefore lower fees at stake.
- 4.53 On the other hand, the economic literature also suggests reasons why quality could instead decrease, in addition to the possibility of issues ‘falling through the gaps’. In particular, it has been argued that the smaller of the joint auditors, bearing a smaller proportion of the costs in case of audit failure (litigation risk and reputation loss), would have an incentive to ‘free ride’ on the effort of the larger audit firm; moreover, joint audit may provide an audited company with greater opportunity for ‘opinion shopping’ between the two auditors.<sup>208</sup>
- 4.54 Given the contrasting theoretical arguments, the question of whether joint audit leads to higher quality can only be answered empirically. Parties have submitted anecdotal evidence that joint audit makes auditors better able to challenge a company’s management. The Haut Conseil du Commissariat aux Comptes (H3C), the French public audit oversight body, also expressed to us its strong belief in the positive impact of joint audit on audit quality. The H3C did not share the view that issues might ‘fall through the gaps’, stating that, subject to effective communication between the joint auditors, joint audit required an appropriate cross-review of the audit work by the other auditor and would in fact increase the level of professional scepticism.

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<sup>208</sup> See Deng, M., T. Lu, D.A. Simunic, and M. Ye (2014) Do Joint Audits Improve or Impair Audit Quality?, *Journal of Accounting Research*, 52(5), 1029-1060.

- 4.55 While several empirical studies have been conducted on the impact of joint audit on audit quality, the conclusions are mixed. In particular, the literature has not established a clear link between mandatory joint audit and audit quality.<sup>209</sup> Conversely, there is no clear evidence that audit quality is lower in a joint audit regime. We therefore expect that the introduction of mandatory joint audit in the UK would not lead to a reduction in audit quality and may result in higher quality through creating incentives for greater professional scepticism.
- 4.56 Finally, we are not convinced by the argument put forward by PwC that the ‘falling through the gaps’ issue would be alleviated to an extent if shared audit, rather than joint audit, were adopted. Unlike with joint audit, the audit firm responsible for auditing certain functions or subsidiaries would not be liable for the audit opinion. This would further increase its incentive to ‘free ride’ on the statutory auditor. As noted by some parties, many examples of poor co-ordination and oversight of the work of the various component auditors, which are often required when auditing multinational enterprises, have been identified in audit inspections by independent audit regulators. The introduction of mandatory shared audit may exacerbate this issue.

#### *Impact on audit fees*

- 4.57 It is widely acknowledged in the economic literature, and recognised by many of the respondents to our invitation to comment document, that the introduction of joint audit will lead to an increase in audit fees. Estimates of the size of any increase vary significantly but the literature, based on an analysis of audit fees in Denmark before and after the abandonment of mandatory joint audit in 2005 and on comparisons between audit fees in France and in other European countries, suggests that audit fees could increase by 25-50%.<sup>210</sup> However we have also received submissions, based on bottom-up estimates, that the actual level of cost increase is likely to be lower than this, up to 20%.
- 4.58 A well-designed joint audit framework where a sector regulator sets out the principles (e.g. on division of work and fees) and the Audit Committee

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<sup>209</sup> For a literature review, see Ratzinger-Sakel, N. V. S., S. Audoussert-Coulier, J. Kettunene, and C. Lesage (2013) Joint Audit: Issues and Challenges for Researchers and Policy-Makers, *Accounting in Europe*, 10(2), 175-199.

<sup>210</sup> For a study of the Danish case, see Lesage, C., N. V. S. Ratzinger-Sakel, and J. Kettunen (2017) Consequences of the Abandonment of Mandatory Joint Audit: An Empirical Study of Audit Costs and Audit Quality Effects, *European Accounting Review*, 26(2), 311-339. Comparisons between France and other European countries can be found in Andre, P., G. Broynne, C. Pong, and A. Schatt (2016) Are Joint Audits Associated with Higher Audit Fees?, *European Accounting Review*, 25(2), 245-274.

oversees adherence to those principles would not result in unnecessary duplication.

#### *Other considerations*

- 4.59 Some parties submitted that some audit firms may be unwilling to assume liability for another firm's work. While it is uncertain whether joint audits increase the risks faced by audit firms, we do not think this issue would undermine the viability of the remedy, as shown by the operation of joint audit in France. As noted above, further consideration would need to be given as to whether a proportionate liability regime would be desirable. We note that some UK auditors already perform joint audits notwithstanding the joint and several liability regime.
- 4.60 Finally, joint audit implies the exclusion of two audit firms from the tender process when mandatory auditor rotation is required (i.e. the outgoing incumbent and the other joint auditor). However, since challenger firms are currently typically excluded from tendering for large companies' audits (by the Audit Committees), joint audit would not lead to a further reduction in choice except if a company had a strong preference for appointing two Big Four firms as the joint auditors.<sup>211</sup>

#### **Summary: Joint audit**

Our provisional view is that joint audit would increase competition without risking audit quality. Our initial views on design are:

- The main aim of this remedy is to reduce the barriers facing challenger firms. Our preferred way of achieving this would be by mandating that at least one of the audit pair is a challenger firm. We would welcome views on any alternative ways of delivering this outcome and ensuring that the remedy is effective in reducing concentration.
- This remedy should at least apply to FTSE 350 companies – perhaps with some limited exceptions where the nature of the company would not sensibly justify a joint audit. We seek views on whether this remedy should apply to other large companies or whether specific types of company should be excluded.

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<sup>211</sup> Joint audit would also imply a reduction in the number of potential suppliers of those non-audit services that auditors are not allowed to provide to their clients, as two firms would not be allowed to provide them. This, however, would cause a significant reduction in choice only for services that could be provided by a small number of firms and, most likely, only in the case of the appointment of two Big Four joint auditors.

- Each joint auditor should have to be granted a significant proportion of the audit work. The minimum proportion to be assigned to any joint auditor might vary across the FTSE 350 companies and over time to allow challenger firms to build their capacity.

## ***Remedy 2A: Market share cap***

### *Introduction*

- 4.61 As a potential alternative to mandatory joint audit, we have considered a market share cap. This remedy would involve imposing a market share cap on the Big Four firms, so that a given proportion of the market is reserved for challenger firms. There are in principle many ways in which a cap could be designed, in terms of its level, the way it is computed and the part of the audit market it applies to.
- 4.62 A market share cap could be imposed on audits of all PIEs, on audits of FTSE 350 companies, or on subsets of those categories. It would also be possible to impose multiple caps on various segments of the market, based on company size or on the industry in which they operate. In each of these cases, a cap could constrain the market share of the Big Four firms collectively or of each of them individually. Caps could be defined in terms of the number of clients that the Big Four audit, the proportion of audit fees accounted by their clients, or by weighting clients based on their capitalisation or turnover.
- 4.63 Finally, the level of the cap would have to be sufficiently low to allow challenger firms to reach the size that would enable them to compete effectively with the Big Four. The level could also be dynamically adjusted to reflect the increasing capabilities of challenger firms.

### *Aims of the remedy*

- 4.64 A market share cap would aim to reduce the barriers for challenger firms to compete with the Big Four. The underlying principle is that, by temporarily shielding challenger firms from competition with the Big Four, a market share cap would allow them to achieve greater scale and experience, so that in the long term they would become more effective competitors for the audit of large companies. In the long term, the remedy would increase the choice of auditor available to large companies and improve the resilience of the audit market.

## *Design and implementation of the remedy*

- 4.65 Any market share cap should be designed to satisfy the following conditions:
- (a) Challenger firms should not end up auditing only the smallest companies in the FTSE 350. As audit fees are very unevenly distributed across FTSE 350 companies, even a significant number of the smallest clients would be unlikely to allow Challenger firms to gain sufficient scale and experience to be able to compete for the audit of larger companies.
  - (b) Challenger firms should be given sufficient time to increase their capabilities and not be placed in a situation where they are required to audit companies for which they have not yet developed the necessary capabilities.
  - (c) The Big Four should not be allowed to 'cherry pick' their clients. As submitted by several parties, the Big Four would have an incentive to compete for the largest, most profitable and/or less 'risky' clients. This could potentially leave Challenger firms with an unattractive portfolio of clients.
  - (d) Companies should not be allowed to game the system by locking themselves into long-term audit contracts soon before the cap enters into force. Under the current tender regulations, FTSE 350 companies are required to put audit services to tender every ten years. If awareness of the future introduction of a cap led many companies to re-tender, the remedy would be largely ineffective for a long time.
- 4.66 While a system based on audit fees would be directly linked to the most relevant measure of audit firms' size, it could be difficult to implement. This design of cap would be complex to create as firms would not know the fees to be billed to companies at the beginning of any relevant reporting period and, as fees change, a cap could be broken through no fault of any one firm. In addition, apportioning fees to the UK that are agreed at a global level would involve an element of subjectivity and exchange rate fluctuations, which would introduce additional complications. Weighting clients by capitalisation or turnover would also be complex, as the weights would change from year to year, making it difficult for the parties involved to predict whether an audit firm would be constrained by the cap.
- 4.67 A cap based on the number of companies that the Big Four are allowed to audit would be easier to implement. As discussed below, it should be possible to achieve the long-term aim of making challenger firms more competitive even with a cap based on the number of clients.

- 4.68 A market share cap on individual firms would be significantly easier to implement and monitor than a collective cap on the Big Four. With a collective cap, individual Big Four firms would not know whether they would be able to take up particular tenders, because that would depend on the success of other Big Four auditors in other tenders. Conversely, with an individual cap each firm would know its position relative to the cap and could plan how to bid for future contracts. While setting individual caps requires deciding the level to apply to each audit firm, this added complexity is a minor issue compared to the difficulty of implementing a collective cap. Further consideration would need to be given to the level of the cap.
- 4.69 There are a large number of potential options on how a market share cap could be designed. In the following paragraphs, we outline two possible options by way of illustration. In the first, the Big Four are left free to choose how to bring their market shares within the cap; in the second, that freedom is removed.

*Option one*

- 4.70 One possibility would be to set a market share cap to be reached within a given time period (possibly adopting a glide path) but leave the Big Four free to determine how to reach it. Each of the Big Four would therefore decide which existing clients to retain and which new clients to bid for. Under this option, the Big Four would have a strong incentive to keep the largest, most profitable clients, leaving the smallest clients to the challenger firms.
- 4.71 The ability to ‘cherry pick’ the best clients could however be mitigated by setting multiple caps over subsets of FTSE 350 companies, based on the companies’ size and on the industries in which they operate.<sup>212</sup> Such caps might have to be introduced in different stages, to avoid challenger firms having to audit companies for which they have not yet developed the required capabilities. In particular, FTSE 100 companies might be initially excluded from the cap. This would require a regulator overseeing and managing the remedy, deciding which companies the caps should cover, and the appropriate time for introducing the various caps.

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<sup>212</sup> It is less clear whether the caps should also reflect the different level of clients’ ‘riskiness’. In a well-functioning market, we would expect higher-risk audits to command a higher audit fee. However, we have been told by parties on all sides of the market that this does not currently happen. Therefore, there is a risk that cherry picking would leave challenger firms with riskier audits. Although they might be able to negotiate higher fees for these audits, there is a concern that challenger firms would be left auditing companies where failure is more likely to occur.



### *Option two*

- 4.72 If the 'cherry picking' issue is considered particularly serious, the remedy could include a prohibition on the Big Four resigning without the audited company's approval and should be designed in a way that the Big Four are not free to choose which companies to bid for, therefore satisfying condition (c). In theory, this could be achieved by identifying groups of companies for which the Big Four would not be allowed to bid, until the capped market share levels are reached. In choosing this group of companies, it would be important to make sure that the challenger firms build sufficient capacity to take up the expected level of opportunities within the group. In order for conditions (a) and (b) to be satisfied, the relevant groups of companies could be dynamically adjusted by the regulator.
- 4.73 This option, however, would incentivise the affected companies to delay tendering or to tender immediately before the cap enters into force, in order to avoid facing a limited choice of audit firms. In order to satisfy condition (d), the regulator should be given the power to require certain firms to re-tender before the expiry of the ten-year period or to require all firms to re-tender more frequently.
- 4.74 If this was the preferred design we would need to work closely with the regulator to minimise the extent to which it led to a partition of the audit market into one market reserved to the challenger firms and one dominated by the Big Four, which could lead to a reduction of competition in the short term.
- 4.75 In practice, whatever the initial design of the cap, it might be appropriate to put in place a mechanism for the cap to be adjusted over time, for example through an independent body for example reflecting the relative capabilities of auditors over time and adjusting the cap accordingly.

### *Views of the parties*

- 4.76 The Big Four were open to the introduction of a market share cap, although they envisaged several issues with its practical implementation. The remedy was strongly supported by other audit firms such as BDO and Mazars, the latter of which suggested that it should be combined with joint audits. We received mixed views from investors, but most of those we contacted expressed opposition to a market share cap. The ACCs we talked to, or who responded to our invitation to comment, were also generally opposed to the remedy.

4.77 The parties supporting the remedy submitted that a market share cap would create a platform for challenger firms to build capacity, leading to greater choice and improving the resilience of the audit market. Some parties stressed that for this to happen it would be essential that challenger firms are encouraged to be involved in the upper end of the market as well as in the other parts of it. This would require the market to be appropriately segmented when applying the cap.<sup>213</sup> It was also suggested that the cap should be flexed over time to reflect the capability and capacity of audit firms and that a third party should be required to administer the capping process.<sup>214</sup> Finally, BDO envisaged the use of a monitoring trustee arrangement to manage an orderly divestment of clients (and staff), in order to ensure that the larger firms do not game the changes.<sup>215</sup>

4.78 Most of the parties who expressed a view on the introduction of a market share cap, including many of those who favour it, recognised that there would be challenges in its implementation. The views, however, differed widely on the significance of the challenges, and the extent to which they could be managed, and whether the potential benefits of the remedy could outweigh its costs. The main issues raised by the parties are set out below.

- (a) In the short to medium term it is likely that the choice of auditor would be restricted for some companies if an audit firm is already at its capped limit. The reduction in choice could be particularly significant in sectors where few firms have specialist knowledge, particularly in the context of mandatory rotation and independence rules that might preclude other firms with sufficient capabilities. More generally, a market share cap could blunt incentives for audit firms to compete, leading to an overall weakening of competition, and could result in audit fees increasing or quality falling.
- (b) In the short to medium term there is a risk that audit quality could decline through a lack of experience and capacity, with firms being appointed as statutory auditor that do not possess the required capabilities to address the complexities specific to individual company audits.
- (c) A market share cap could compel Audit Committees to appoint an audit firm even though they may have concerns over its ability to fulfil the role effectively, blurring responsibilities and accountabilities in the process. The repercussions in the event of a subsequent audit failure would be

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<sup>213</sup> Mazars, submission to the ITC, page 15.

<sup>214</sup> Deloitte's submission to the ITC, Appendix, page 10.

<sup>215</sup> BDO's submission to the ITC, page 6.

difficult to manage from a reputational perspective for all the parties concerned.

- (d) Caps could lead to firms 'cherry picking' clients and then refusing to compete beyond that, reducing the overall level of competition. Higher-risk audit clients would become unattractive and would be likely to find it more difficult to find an auditor.
- (e) The remedy might undermine the perceived credibility of the London Stock Exchange to international companies if companies were forced to limit the choice of auditor. Major companies might seek to move outside the UK at the holding company level to preserve audit relationships that the directors judge necessary for protection of shareholders' interests.
- (f) There is no guarantee that over time challenger firms could gradually build up capacity and quantity. It would take a lot of effort and time for other audit firms to be able to pick up Big Four work.

#### *Our assessment of the remedy*

- 4.79 The parties' views summarised above relate to either the short-term consequences of a market share cap or to the likelihood of the desired effects in the long term. These two aspects need to be assessed separately.
- 4.80 The 'short term' is here defined as the period when a lower market concentration can only be sustained through a cap; this includes a transition period, during which the caps are phased in, and the period where the audit firms are operating within or at the capped levels, but the caps still constrain their decisions on whether to bid for an audit contract. The 'long term' is defined as the period in which lower concentration becomes self-sustaining.

#### *The short-term impact of the remedy*

- 4.81 In the short term, as more companies currently prefer a Big Four firm than these firms would be allowed to serve, some of these companies would experience a reduction in choice. The impact would initially occur during the period when the caps are phased in, but would still be present as long as the caps continued to constrain audit firms' ability to bid. This would be expected to weaken competition to some extent, potentially resulting in higher fees and/or a reduction in quality.
- 4.82 Without other measures in place, weaker competition between the Big Four could lead in the short term to a reduction in the quality they provide. In addition, the reduction in choice might also result in a worse matching

between companies' requirements and auditors' expertise, with a potential negative impact on audit accuracy.

- 4.83 As we describe above, smaller audit firms do not currently have the capability to audit the larger, more complex companies in the FTSE 350. This is in part because of the size of the audit teams required to carry out these audits and, in some cases, because the challenger firms do not have the required sector or other expertise. The introduction of a market share cap might therefore reduce average audit quality to some extent in the short term as more companies would be audited by smaller audit firms. We would expect the constraints on challenger firms listed above to lessen, and likely disappear, as the firms' size grows, but this is likely to take time.
- 4.84 Some of the short-term reduction in competition discussed above is inherent in any market share cap but would be more serious under some design variants. One design option is to prohibit the Big Four firms from tendering for some sets of companies until their market shares fall below the cap. Compared to a design where the Big Four can self-select the tenders in which to take part, this design is likely to lead to a greater reduction in competition.

*The long-term impact of the remedy*

- 4.85 A market share cap would certainly lead, in a relatively short time, to the growth of challenger firms. In order for the remedy to be effective in generating actual increased choice, however, the growth of the challenger firms would need to be accompanied by a change in how they are perceived by potential audit clients. We would expect this to follow over time as clients and staff move from the Big Four to the challenger firms, and these firms are seen as effective competitors for audits of companies throughout the FTSE 350.
- 4.86 As challenger firms acquire new competencies and are increasingly perceived as effective competitors, the costs of the remedy, in terms of reduction in choice and audit quality, would reduce, until the lower market concentration becomes self-sustaining. At this point, the cap could be lifted. It would be important, however, not to remove the cap too early, as the market might then revert quickly to the original level of concentration. It is likely that, to achieve a sustainable change in the market, the market share cap would need to be in place for a number of years.
- 4.87 The positive effects on choice would be felt more quickly towards the bottom of the FTSE 350 than towards the top. We would only expect a market share cap to lead to an increase in choice for the most complex audits, e.g. companies at the top of the FTSE 100, in the very long term. The scale and

complexity of these audits would make it extremely challenging for any audit firm that is not part of one of the large global audit networks to acquire sufficient expertise and reputation to be appointed as sole auditor.

#### **Summary: Market share cap**

- Our provisional view is that a market share cap would deliver a substantial increase in the number of challenger firms auditing the largest companies in a relatively short period of time.
- However we prefer mandatory joint audit to a market share cap as a means of breaking down barriers to non-Big Four firms competing successfully for larger audits. Both remedies would provide good market access, but joint audit would do so without the risks to short-term quality and competition presented by a market share cap.
- This remedy would initially apply at least to FTSE 350 companies. We seek views on whether it should apply to other large companies that could be in the public interest.

#### ***Remedy 3: Additional measures to support challenger firms that we propose to consider further***

4.88 In our invitation to comment document, we asked for views on the possibility of providing direct support to challenger firms by reducing barriers to senior staff moving between firms and by sharing technology among audit firms. During our consultation, some parties also proposed the creation of a ‘tendering fund’.

4.89 While these measures could reduce barriers to challenger firms, our current view is that many would be largely redundant if our proposed remedy package is implemented, but that measures to reduce barriers to staff and partner switching remain important. We briefly discuss possible measures below and welcome views on their usefulness and effectiveness.

#### ***Ease of movement of staff***

4.90 The implementation of remedies within our proposed package is expected to lead to a significant increase in the volume of audit work undertaken by challenger firms. In this context, it will be important to ensure that challenger firms have access to the necessary human resources and, in particular, that they are able to attract senior audit staff.

4.91 Many of the parties responding to our invitation to comment document submitted that there are not currently significant barriers preventing senior

staff from moving between firms. KPMG told us that, other than existing notice periods, it is unclear what barriers to switching exist in practice, and whether notice periods even present a barrier to switching.<sup>216</sup> PwC observed that individuals move between firms in both directions (i.e. to and from large and challenger firms), and that it is not uncommon for directors to move from a large firm to become a partner with a challenger firm.<sup>217</sup> BDO also told us that it had not faced difficulties in recruiting senior staff from the Big Four firms.

- 4.92 On the other hand, Mazars argued that, in some Big Four firms, when partners announce they are leaving the partnership, a substantial discretionary element of their remuneration is removed for the period of their notice, which can sometimes have a duration of up to two years.<sup>218</sup> This reduces the ability of challenger firms to attract such partners.
- 4.93 As noted by some parties, there are good reasons for imposing notice periods. For example, the loss of audit partners or senior audit staff members while audit work on an engagement is ongoing would be very disruptive and be a significant risk to maintaining a high-quality audit. Reducing notice periods should be approached with caution as it might impact disproportionately on the ability of smaller firms (and small offices of larger firms) to plan their workloads reliably.
- 4.94 However, these arguments do not justify the existence of unreasonable clauses that go beyond the objectives of avoiding business disruption. We will investigate this matter further and welcome any evidence to support the claim that there are significant and unreasonable barriers to senior staff switching between firms.

### *Tendering fund*

- 4.95 Tendering for large audits is an expensive exercise and several parties submitted that the high costs of tendering constitutes an important barrier for challenger firms, particularly if they believe there is little chance of them being successful. Legal & General Investment Management<sup>219</sup> proposed the creation of an audit tendering fund. This would provide funding to challenger firms who meet certain criteria, allowing them to mitigate the costs of tendering and incentivising them to compete with the Big Four for large audit work.

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<sup>216</sup> KPMG's submission to ITC, page 25.

<sup>217</sup> PwC's submission to ITC, page 12.

<sup>218</sup> Mazars' submission to ITC, page 12.

<sup>219</sup> LGIM's submission to the ITC, page 14.

4.96 The proposed remedies already outlined in this document, such as mandatory joint audit, would substantially mitigate the issue by making it more likely for challenger firms to be selected as auditor. The higher probability of being successful would give challenger firms greater incentive to sustain the cost of participating in the tendering process. This would significantly reduce the necessity of a tendering fund.

#### *Access to technology*

4.97 Large company tenders commonly measure the relative technological strengths of audit firms as a core part of the tender process; technology has become an increasingly important competitive parameter. The Big Four appear to have an advantage compared to the challenger firms in terms of technology platforms, methodologies and processes. The challenger firms are also investing in technology, albeit at lower absolute level.

4.98 Measures to give the challenger firms access to technology could therefore, in principle, make them better able to compete for FTSE 350 audits, thereby increasing auditor choice for companies. These are two broad areas in which this could be done.

(a) Getting the challenger firms and other audit firms that wish to access better technology to pool their resources to developing a new system; or

(b) Mandating one or more of the Big Four to either:

(i) share their technology with the challenger firms by way of a price-controlled or commercially priced license; or

(ii) fund the development of a new system available through an open source platform.

4.99 Some Big Four firms expressed a willingness to offer challenger firms better access to audit technology. This could take the form of open source technology arrangements (EY),<sup>220</sup> or licensing of intellectual property including technology (Deloitte).<sup>221</sup> However, KPMG noted that the remedy could reduce market participants' incentives to invest and compete, thus weakening the competitive dynamics in audit services.<sup>222</sup>

4.100 However, some challenger firms have indicated they did not have an interest in these measures and that their technology was state of the art. We are also

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<sup>220</sup> EY's submission to the ITC, page 7.

<sup>221</sup> Deloitte's submission to the ITC, Appendix, page 11.

<sup>222</sup> KPMG's submission to the ITC, page 24.

concerned about whether technology sharing, which would result in similar systems being used across the industry, could reduce the effectiveness of joint audits. Two different audit technology systems interrogating the audit client accounting system would more likely result in the finding of potential issues.

- 4.101 One Audit Committee Chair was supportive of this remedy on the grounds that the challenger firms currently had good staff but were lacking the support systems and processes to run a large audit.
- 4.102 Given these concerns and mixed responses from challenger firms, we are not inclined to include measures promoting technology sharing in our remedy package. We have heard that technology sharing could reduce barriers to expansion to challenger firms, and if done on fair commercial terms would preserve the incentive to innovate.<sup>223</sup> Therefore, we encourage the industry to consider technology sharing further, but we are not provisionally making recommendations on this measure.

#### **Summary: Additional measures to reduce barriers to challenger firms**

We favour the prohibition or limits on the length of non-compete clauses as these make it harder for audit partners and staff to switch firms. Partner switching is necessary for challenger firms to build their capacity.

A number of other measures such as technology sharing warrant further consideration.

### ***Remedy 4: Market resilience***

#### *Introduction*

- 4.103 Audit plays a vital role in the functioning of capital markets, and other important areas of the modern economy such as credit ratings, borrowing assessments and taxation amongst others. In sectors such as banking and care homes, the regulator monitors the financial health of the sector, and the banking and retail energy sectors also have special insolvency regimes.
- 4.104 These regimes can have several objectives but generally address either:
- (a) ensuring continuity of supply of the service for customers; or

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<sup>223</sup> KPMG's submission to the ITC, page 24.



(b) maintaining the integrity of the market, for example because there are a limited number of suppliers.

4.105 There is no similar regime for the audit market. We understand that the Companies Act may help ensure continuity of supply to some extent but that it would not address concerns over the integrity of the market. Hence, the demise of a Big Four firm could lead to the 'Big Three'.

4.106 The UK insolvency framework, which currently applies to audit, places a greater emphasis on the maximisation of distributions to creditors (and then shareholders) over preserving the firm and ensuring the resilience of the market.

4.107 This remedy would create a market oversight and resilience regime in the event of a likely or actual failure of a large audit firm in the UK. It would ensure that there remains adequate choice of auditors in the market, while maintaining competition and quality both on its own and as part of a package of remedies.

#### *Aim of the remedy*

4.108 In light of resilience issues, discussed above, this remedy would seek to protect against the negative effects of further concentration in the audit market and avoid what might otherwise be the most likely outcome: the Big Four becoming the Big Three. This remedy would aid in maintaining choice and increasing the resilience of the market.

#### *Design and implementation of the remedy*

4.109 At its core, the remedy would aim to ensure that the audit clients of a failing Big Four firm are not transferred to another Big Four audit firm. The assets (including staff) are likely to follow the audit clients.

4.110 Designing the remedy would be complex. There are a number of issues that would need to be worked through.

(a) Identifying what the regulator should do if partners and clients of a distressed firm start leaving for another Big Four firm long before the firm files for insolvency.<sup>224</sup> Our current view is that the regulator should keep the market under review and take steps to prevent further concentration by:

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<sup>224</sup> For example, a situation similar to that experienced by Arthur Andersen in 2001 - 2002.

- (i) incentivising and/or mandating the movement of audit clients (and staff) to challenger firms. This could work if significant member firms in another large national market were at risk; and
  - (ii) incentivising and/or mandating that audit clients (and staff) of a distressed audit firm remain within the firm while a special administrator attempts a turnaround of the firm. This could work if the problem were isolated to the UK member firm or only a few small member firms.
- (b) Preventing moral hazard (excessive risk taking in the expectation of a 'bail-out'), while incentivising the partners and key staff to remain with the existing firm or move to a challenger firm. Our current view is that the equity within the firm relating to all (audit and non-audit) partners could be ringfenced with partner drawings coming under regulatory review. This could be used to pay the fees of the regulator and/or special administrator. A distribution to the equity partners could only be made if the turnaround was successful. A similar incentive could also be used to transfer staff (especially partners) of a distressed or failing firm to a non-Big Four firm.<sup>225</sup>
- (c) Identifying what powers the regulator and/or special administrator require, how their roles should be divided, and at what point one or other should be able to exercise executive control over a firm. This process is made more complex as an audit firm's value lies in its people and clients. Our current view is that the regulator would be well placed to keep the market under review and take steps to incentivise staff and clients not to transfer to a Big Four firm or to remain within the same firm (see above). If the firm did not respond to these incentives and it were heading towards failure in the short to medium term, the regulator could appoint a special administrator, who could take executive control over the failing firm.

4.111 Careful consideration should be given to develop a workable regime, and we are seeking feedback on how such a system could be designed. Examples from other sectors may provide a useful starting point, for example, 'living wills' as implemented by financial institutions in the US, the Bank of England's 'resolution' regime, or a special administration regime similar to those applying in certain regulated industries in the UK.

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<sup>225</sup> The counterfactual to this remedy would most likely be the failure of the firm, along with any reduction in the value of equity within the business.

## Summary: Resilience regime

This remedy warrants further consideration and we welcome parties' views on how an effective resilience regime could be designed to avoid going from the Big Four to the Big Three.

This remedy should apply to at least the Big Four. It may also be appropriate for some large challenger firms to come within scope as they grow in relative size.

### **Remedy 5: Full structural or operational split between audit and non-audit services**

#### *Introduction*

4.112 Various rules already exist to limit the effect of conflicts caused by the audit firms' combined audit / non-audit structures. The EU Audit regulation imposed significant restrictions on the provision of non-audit services to audit clients. It imposed a cap on the level of non-audit fees that can be earned from audit clients (the '70% rule')<sup>226</sup> and prohibited the provision of some non-audit services to audit clients altogether (the 'blacklist').<sup>227</sup> Ethical standards also ensure that audit partner remuneration cannot take into account cross-selling of non-audit services.<sup>228</sup>

4.113 As set out above, audit firms typically provide non-audit services to audit clients well below the 70% cap. However, we do not believe the current framework for managing non-audit services conflicts is sufficient to focus auditor's incentives on high quality audits.

- (a) Profit pooling across audit and non-audit services mean that audit partners directly benefit from the commercial success of the non-audit part of the business (including non-audit services fees from audit clients).
- (b) The significant proportion of firms' revenue derived from non-audit services means that governance and investment decisions will, understandably, be heavily driven by non-audit considerations (see above).
- (c) There are underlying cultural concerns where audit and non-audit services are provided by the one firm, given the key objective of the

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<sup>226</sup> Audit Regulation, Article 4(2).

<sup>227</sup> Audit Regulation, Article 5(1)(a).

<sup>228</sup> 2016 Ethical Standard, 4.56D.

former is to be sceptical, and the key objective of the latter is typically to be collaborative (see above).

- (d) Even when non-audit services are wound down in anticipation of accepting the audit engagement, independence and challenge could be affected by cultural considerations, for example, if the audit firm and the client have a history of working collaboratively in an advisory relationship. There may also be a risk that the selection process is not truly non-discriminatory where the audit firm and the company have a close non-audit services working relationship.

4.114 One way to address the reality and perception of non-audit service related conflicts would be to structurally separate audit and non-audit services. This would comprehensively address the issues set out above. Depending on the specific implementation, it might allow relaxation of the conflicts rules and therefore a return to greater choice among the Big Four. However, there are important practical challenges in creating audit-only firms, notably related to the international networks to which these firms are a part, and the use of non-audit experts on audits. There would also likely be substantial costs and disruption to the firms.

4.115 Therefore, we are also considering other variants of this remedy that could be effective, but less costly, in addressing our concerns with respect to non-audit services conflicts. One possible solution might be for firms to implement an operational split between the audit and non-audit parts of the firm, with separate profit pools and governance arrangements for audit and non-audit. We want to test whether an operational split could be designed in a way that would make it almost as effective as full structural separation in addressing our concerns about multidisciplinary firms (see above).

#### *Aims of the remedy*

4.116 The objectives of a remedy seeking to restrict the provision of non-audit services by audit firms are to address:

- (a) the negative effects on the **culture** of the audit practice (at a firm level) that can result from being part of a multidisciplinary professional services firm with a non-audit practice. The creation of audit-only firms would help enhance a culture of independence and professional scepticism; and
- (b) the lack of **choice** (at an engagement level) that can arise as a result of audit firms being conflicted from tendering because of the provision of non-audit services to potential audit clients.

## *Design and implementation of the remedy*

4.117 Full structural separation of the audit and non-audit parts of the business would ideally be implemented in the following way:

- (a) any audit firm over a certain size threshold would be prohibited from providing non-audit services in the UK;
- (b) the UK audit firm would then become a stand-alone firm, but could remain part of a multidisciplinary international network provided there was no common ownership and no financial subsidies from the international network to the UK audit firm;
- (c) this prohibition on non-audit services provision in the UK and to UK companies would apply to the overseas network of the UK audit firm so that no members of the network could provide these services in the UK. Likewise, an overseas member firm would also be prohibited from auditing such UK companies if it were part of a network that provided non-audit services in the UK;
- (d) the member firms would be prohibited from providing non-audit services to any group company of their UK based audit clients; this restriction could for example apply to FTSE 350 audit clients; and
- (e) audit-only firms would need to replicate in-house the non-audit expertise required to support an audit (for example, by recruiting non-audit specialists to work on audit engagements), or contract externally from an independent non-audit practice.

4.118 An operational split, by contrast, would allow for an ongoing relationship between the audit and non-audit parts of the UK firm, particularly allowing for the sharing of expertise and systems. The key features of an operational split might include:

- (a) separation of the audit and non-audit businesses, with the audit business having a separate board, chief executive, staff and assets;
- (b) separate profit and pension pools for the audit and non-audit entities;
- (c) restrictions on audit partners (but not staff) moving between audit and non-audit businesses of the same firm;
- (d) transfer pricing arrangements between the two entities, for example to support use of non-audit staff on audits; and

- (e) both the audit and non-audit businesses could share some central operations, systems, branding and know-how, and both would remain part of the same multidisciplinary network.

4.119 For both structural and operational splits, the audit practice would also be permitted to provide services closely related to statutory audits (such as quarterly or half yearly reviews).

#### *Views of the parties – full structural split*

4.120 We have heard several arguments in support of full separation of audit and non-audit firms. For example, Sarasin submitted that the creation of audit-only firms would address culture and choice concerns.

- (a) ‘Auditors need to adopt a sceptical mind-set and be comfortable challenging management. This is a very different relationship to one adopted by consultant to management. Where audit firms are undertaking both audit and consulting work, they will always struggle to reconcile these competing models. The creation of pure audit firms would eliminate this tension’.<sup>229</sup>

- (b) ‘[A]n advantage of pure audit would be an immediate increase in the number of firms competing for audit business today since none would be ruled out on conflict grounds’.<sup>230</sup>

4.121 We also heard views that, while a structural split would be complex, the challenges could be addressed.

- (a) A number of parties told us that obstacles related to the international aspect of audit networks would be surmountable. ACCA, while not supporting the audit-only firm remedy, said that it ‘do[es] not see that the international affiliations of member firms would constrain the creation of audit only firms’.<sup>231</sup> The LAPFF said that given ‘firms tend to have an affiliate relationship, rather than common international ownership, then audit only firms in one jurisdiction doesn’t seem to create barriers’.<sup>232</sup>

- (b) One ACC told us that access to non-audit expertise on audits would also not present an insurmountable challenge, as audit-only firms could hire in-

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<sup>229</sup> Sarasin’s submission to the ITC, page 9.

<sup>230</sup> Sarasin’s submission to the ITC, page 10.

<sup>231</sup> ACCA’s submission to the ITC, page 14.

<sup>232</sup> LAPFF’s submission to the ITC, page 10.

house expertise or procure third-party specialist support on arms-length terms.

4.122 However, audit firms (the Big Four, challenger firms and others), company management (e.g. 100 Group), several large companies, industry (professional) bodies, Audit Committees, investors (institutional investors and investment managers) and other stakeholders were generally opposed to the proposal to create audit-only firms. The key objections raised are listed below.

- (a) The international nature of audit networks makes the remedy impractical on a UK-only basis. Some parties submitted that both audit and non-audit businesses needed to remain part of the international network. Others told us that preventing international multidisciplinary firms from having a non-audit presence in the UK would be disproportionate.
- (b) Audit quality would suffer as audit-only firms would not have ready access to non-audit experts to support an audit.
  - (i) Parties told us that it would not be feasible or desirable to maintain all of the required non-audit expertise in-house. We heard that the range of specialists required could not all be maintained in an audit-only firm on a full-time basis, and those that were would not keep their skills sharp by practising outside the audit sphere.
  - (ii) With respect to obtaining non-audit expertise from outside the firm, we heard that challenges include ensuring that third-party advisers meet the necessary independence requirement, ensuring that advice can be obtained in a timely fashion, and risks associated with liability – all of which would likely affect the willingness of third-parties to provide these services on satisfactory terms.
  - (iii) Parties told us that either option risked a reduction in audit quality. Some parties also raised concerns that UK audit-only firms would reduce the UK's status as a leading audit jurisdiction – risking large and sophisticated companies taking steps to have their audits performed by non-UK auditors.
- (c) Audit-only firms might struggle to recruit the best and brightest talent without the ability to offer a range of work experience and varied career pathways. We were told this would lead to a reduction in audit quality.
- (d) The separation of audit and non-audit business would have a disproportionately detrimental impact on challenger firms. In particular, challenger firms would lose an avenue through which they can gain

experience in a particular sector, further raising barriers to undertaking large audits in sectors where they have no prior audit experience.

- (e) Audit-only firms would be more financially dependent on their large audit clients, risking an adverse impact on the incentives to challenge management. Some parties said this would be more acute for challenger firms than the Big Four.
- (f) Audit-only firms would have less scale for investment and would be less resilient and able to withstand market shocks. Some challenger firms told us that the lack of scale would also disproportionately affect them.

4.123 Some parties, including the major audit firms, have suggested that the CMA's concerns about the effect of non-audit services on the provision of audits would be better served by a ban on the provision of non-audit services to audit clients. We also heard that regulation such as the '70% rule', the ban on certain non-audit services to audit clients and the prohibition against cross-selling deal with non-audit services address independence concerns and that the CMA should give these measures time to take effect and then assess their impact before implementing new remedies.

#### *Views of the parties – operational split*

4.124 An operational split remedy was not expressly referred to in our invitation to comment document, though some stakeholders suggested this could be a more practical and proportionate alternative to a full structural split.

4.125 Others said that ring-fencing would be challenging. For example, Grant Thornton, said that 'ring-fencing of the audit business [would be] challenging to implement and monitor, as well as being a weak response to the concern around conflicts; one that is also unlikely to mitigate the perception of conflict'.<sup>233</sup>

#### *Our assessment of full structural split and operational split*

4.126 A complete split would address real and perceived concerns relating to culture. It would also have a positive impact on choice as firms would no longer be conflicted due to the provision of non-audit services in the UK.

4.127 Some of the objections to full separation are overstated.

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<sup>233</sup> Grant Thornton's submission to the ITC, page 15.



- (a) We are unconvinced that recruitment would be a major obstacle. Audit-only firms could continue to provide an attractive professional grounding for many graduates who may ultimately pursue a career in a related discipline; the only difference being they would now do so in a different firm, rather than merely a different team. Furthermore, the evidence that the Big Four<sup>234</sup> and the challenger firms submitted to us, ranging from 2011 to 2018, suggests that the number of audit staff that permanently moved into or seconded into a non-audit team within their firms is relatively low compared to the total number of either audit staff or graduates.
- (b) Firms could mitigate the challenges in obtaining non-audit expertise. For example, non-audit firms could be held on retainer (perhaps covering a number of years), allowing access to advice at short notice. Although the large audit firms rely on a material amount of non-audit specialist input, the non-audit partner time on an audit is low – accounting for less than 1% of the all hours spent on an audit.<sup>235</sup> In the event of a separation we would expect that audit firms would be able to contract for those non-audit services they were unable to deliver in-house.
- (c) Although audit-only firms would be smaller in scale, they would remain profitable and be capable of making necessary investments. Our analysis shows that the EBIT margins are positive for the audit parts of the business.

4.128 However, implementing audit-only firms would carry costs for the audit firms and there are risks of unintended consequences.

- (a) The lack of non-audit expertise from within the multidisciplinary firm could have a detrimental effect on efficiency and potentially quality. Audit firms rely on expert input of non-audit specialists for approximately 10% - 20% of a FTSE 350 audit, which is a material amount of expertise to outsource or retain within an audit-only firm. However, these risks to quality and efficiency could be mitigated, e.g. through running competitive tenders for non-audit services support, and keeping firms on retainers.
- (b) The remedy might see international networks break away from the UK audit arm and retain the non-audit services business. This could have a detrimental impact on the quality and standing of the UK audit profession

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<sup>234</sup> This analysis excludes KPMG, which did not submit the required information.

<sup>235</sup> Based upon CMA analysis of data submitted by audit firms, showing the hours worked by audit and non-audit staff on over 2,000 audit engagements carried out for FTSE350 and PIE companies between 2011 and 2018.

if the UK audit market becomes less attractive or if UK companies are serviced by audit firms based outside the UK.

- (c) The remedy would be likely to have detrimental effects on all audit firms within its scope, and smaller firms may be less able to source in-house the same level of expertise as the Big Four. However if the remedy was limited to the Big Four, this would give a substantial advantage to challenger firms.

4.129 As an alternative, an operational split could have the following merits.

- (a) Separate profit pools and governance arrangements would be a significant step to addressing independence concerns, because audit partners' individual financial success would be purely driven by the audit business – but this would not completely negate the culture issues discussed above.
- (b) Many of the key costs and risks associated with full structural split could be avoided – in particular, audit firms could continue to have access to non-audit expertise from their non-audit service counterpart, and international networks would in most cases be unaffected.<sup>236</sup>
- (c) Depending on design, an operational split has potential to release audit firms from the application of certain conflict regulations, which could increase choice (see below).

4.130 If the operational split was implemented in such a way that it effectively addressed the conflicts between audit and non-audit then we would expect that the separate audit firms could be relieved from at least parts of the existing conflict rules (for example the 70% rule).

4.131 This measure would increase choice and competition at the time of tendering. We would expect our proposed package of measures (and in particular the joint audit remedy) to improve the ability of challenger firms to win the largest audits, so that removing the conflict rules from the Big Four would not lead to greater concentration in the market.

4.132 However, compared to full structural split, an operational split would likely be more complex to implement in such a way that it meets our objectives, remains effective and that the remedy is not circumvented. For example, the remedy would require stringent regulatory oversight of separation arrangements, such as a robust transfer-pricing and information-sharing

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<sup>236</sup> Some firms operate a global profit sharing mechanism which would need to be considered as part of this remedy.

policy to keep the profit pools separate. Hence, this remedy carries risks of circumvention.

- 4.133 There are also some potential practical challenges around how operationally split firms would manage their conflicts, to the extent that some conflict rules would continue to apply (for example, the EU Audit Regulation restrictions on 'blacklisted' services apply at the network level, rather than the firm level).
- 4.134 Our provisional view is that the challenges to implement a form of operational split are manageable, and we welcome views on whether this is the case.
- (a) The new structure could enable sufficient interaction between the audit and non-audit businesses for the audit business to access specialist support on request, as is the case currently and as considered necessary to perform effective audits. While the services will need to be provided on third-party terms and prices, the terms could include ongoing support on an audit, rather than a specific piece of advice. We welcome views on how this could be achieved in such a way as not to reintroduce conflicts.
  - (b) An audit-only firm would be prohibited from sharing its systems, and providing back-office support, training and know-how to the non-audit business and vice versa. However, the operational split remedy would allow access to these shared services, subject to appropriate transfer pricing and cost allocations.
  - (c) It appears to us that, although it would be complex, it would be possible to segregate existing defined benefit pension schemes for the few staff that are on such schemes. Part of the scheme deficit may need to be funded upfront, depending on the magnitude of assets taken out of the existing scheme. The technical details of the pension scheme split across the entities could be overseen by the Pensions Regulator in conjunction with the audit regulator.

- 4.135 If in time it proves impossible to design and implement an operational split that achieves a sufficiently large part of the benefits of a structural split – for instance if firms game it, or if it proves impossible to overcome the cultural cohesion of the two parts of each firm – the option of pursuing the full structural split may need to be revisited, at least for the Big Four.

*Further restrictions on non-audit services to audit clients*

- 4.136 We prefer either full structural split, or an operational split, to further restrictions of non-audit services to clients because of the impact further restrictions could have on choice.

4.137 This reduction in choice would not only impact choice among the Big Four, but would also either exclude Challenger firms from many selection processes or require them to stop providing non-audit services to large clients (see above for the level of non-audit services provided by Challenger firms to FTSE 350 companies). One of our key objectives is to reduce barriers to Challenger firms – therefore, a restriction on non-audit services that would exclude Challenger firms from audit tender processes runs counter to our objectives.

**Summary: Full structural or operational split between audit and non-audit services**

Full separation would be an effective remedy. Nevertheless, we seek responses from parties on whether and how an operational split could be equally effective in addressing our objectives.

Either form of separation – full structural or an operational split – should apply to at least the Big Four. We seek views as to whether this remedy should also apply to challenger firms as well.

***Remedy 6: Peer review***

*Introduction*

4.138 We set out in the previous section the importance of a regulatory regime that sets minimum standards, makes visible the differences in quality between firms and then holds firms to account for any underperformance.

4.139 We propose that an important element of the regulator’s toolkit should be a peer reviewer who is able to identify underperformance as it happens and whose presence may actually stop any underperformance occurring. The peer reviewer should be independent, appointed and paid by the regulator, and owe a duty of care only to the regulator.

*Aim of the remedy*

4.140 The key objective of this remedy would be to improve audit quality by introducing an additional, independent quality check.

*Design and implementation of the remedy*

4.141 The peer review firm would be a third party – not connected to the statutory auditor and not having recently audited the company. The peer review could be carried out on all companies, a random selection, or specific companies

that raise particular risks. It could involve shadowing the statutory auditor on certain aspects of the audit.

4.142 To enhance independence, the peer reviewer should be appointed by the regulator. The regulator would have certain duties and objectives including to promote competition, in selecting its choice of the peer reviewer. This remedy could be funded by a levy on the audit fees of the FTSE 350 and large companies, and the sector regulator would then pay the fees of the peer reviewer using the proceeds of the levy.

4.143 The regulator would determine which companies were subject to a peer review. This could be focused on higher risk companies, or those which required additional scrutiny (for example because they were initially outside the scope of joint audit), or allocated at random.

4.144 The peer reviewer would:

- (a) review the audit file, processes and conduct financial analytical reviews;
- (b) re-perform audit tests on material and risky audit areas, which would be its area of focus;
- (c) be incentivised to identify any weaknesses that exist in the audit. The incentives for peer reviewers with a proven track record of high quality reviews could be a greater allocation of peer reviews by the sector regulator and/or financial rewards;
- (d) submit its report to the Audit Committee and the sector regulator; and
- (e) have its report used by the Audit Committee to challenge the auditors and management before the accounts are signed off.

4.145 As a result, statutory auditors would be incentivised to 'remain on their toes', which should increase their professional scepticism and audit quality.

#### *Views of the parties*

4.146 Our invitation to comment did not make it explicit that a peer reviewer would be appointed by an independent regulator. It is therefore plausible that parties commenting on this remedy could have assumed that the appointment would be made by a company's Audit Committee.

4.147 Some audit firms and other stakeholders supported peer reviews, insofar as it would be a substitute for joint audits. For example, KPMG submitted that it

was not in principle opposed to exploring possibilities in relation to some form of peer review, rather than joint audits.<sup>237</sup>

4.148 Some stakeholders supported the principles underpinning peer reviews on the grounds that it could help the challenger firms gain exposure or increase audit quality. For example, Santander told us that a peer review would be a preferable alternative to the introduction of joint or shared audits and could develop greater market access for the challenger firms to the largest audit clients, but that there would however be potential time and incremental cost constraints of this. USS told us that that peer reviews of the sections audited by each firm in the case of a joint audit could improve audit quality.<sup>238</sup>

4.149 However, parties highlighted several practical challenges with the implementation of a peer review remedy. Chartered Accountants Ireland<sup>239</sup> submitted that peer review would:

- (a) lead to significant cost increases due to duplication of work;
- (b) create challenges in establishing the sharing of responsibility and liability between primary auditor and reviewer;
- (c) require arrangements to be put in place for dealing with material disagreements between the primary auditor and the reviewer, and the reporting thereof;and
- (d) create independence issues in future tender processes for the reviewing firm and further limit the choice of statutory audit for the reporting entity.

4.150 Similarly, Deloitte submitted that the complexities in determining the scope of the peer review and the liability levels for both audit firms, together with the likelihood that a peer review will lengthen the audit process, would make the remedy less effective than shared audit.<sup>240</sup>

4.151 Finally, BDO told us that shadowing could be more effective than peer review if peer review merely took the form of reviewing the audit files. It said that such a peer review would create incentives for audit files to be well documented and would prevent inaccuracies, but this would not by itself produce good quality audits. BDO argued that the statutory auditor having

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<sup>237</sup> KPMGs submission to the ITC, page 22.

<sup>238</sup> Santander's submission to the ITC, page 5 and USS Investment Management's submission to the ITC, page 3.

<sup>239</sup> Chartered Accountants Ireland submission to the ITC, page 6.

<sup>240</sup> Deloitte's response to the ITC, page 11.

applied suitable scepticism was not necessarily captured through a peer review, whereas it could be through shadowing.

*Our assessment of the remedy*

- 4.152 Peer reviews of the overall financials (for example, the consolidated accounts) coupled with shadow audits of risky areas would be effective in keeping the statutory auditors 'on their toes'. They would do so by being performed by an 'outsider' – the peer reviewer would be appointed and paid by an external body and would thus be less susceptible to forming the cosy relationship that we have been told can develop between the Audit Committee, executive management and the statutory auditors. The peer reviewer would be expected to challenge this relationship, thereby addressing the risk that a single or joint auditor could be conflicted and as a result be incentivised not to identify the matters that they should.
- 4.153 A peer reviewer incentivised to find issues could result in inefficiencies, even on high quality audits. For example, the peer reviewer could pointlessly try and identify flaws with audit areas that by their nature will always require a certain amount of judgement. This could create uncertainty regarding the status of the audit opinion, leading to delays in the sign off and/or confusion around the status of the financial statements. However, a well-designed peer review system that focused on key audit areas could avoid significant inefficiencies.
- 4.154 This remedy would create an additional layer of activity, whereby first the work of management would be checked by the auditor, then the work of the auditor would be checked by the external peer reviewer (in addition to internal reviews), and finally the work of both would then be checked by the FRC as part of its AQR procedures. However, the levels of duplication would be minimal, as the focus of the peer review would only be on the key audit areas and, unlike AQR procedures, it would occur prior to the signing-off of the accounts. This system of checks and balances has the potential to increase audit quality.
- 4.155 However, peer reviews would not by themselves give challenger firms enough experience to become more competitive in tendering for the audits of large companies. This is because the role of the peer reviewer would be relatively minor compared to that of the statutory auditor, and would not give the same exposure to company boards as joint audit. We do not therefore consider peer review an effective way to improve choice and resilience.

### **Summary: Peer review**

Our provisional view is that peer review would be a useful remedy as part of the regulator's toolkit.

The regulator should have the ability to determine the scope of the peer review function, perhaps initially targeting this at companies that it considers high risk or which require additional scrutiny.

## **Remedies we propose not to take forward**

4.156 We consulted on some remedies in the invitation to comment document that we do not intend to pursue further. These remedies include:

- (a) breaking the Big Four into smaller audit firms;
- (b) introducing an insurance-based system;
- (c) creating an NAO-style auditor for private sector audits;
- (d) further changes to the frequency of auditor tendering or rotation; and
- (e) changes to restrictions on ownership of audit firms.

4.157 In the invitation to comment document, we highlighted the challenges of implementing these remedies. Subsequently, we reviewed the parties' submissions. In general stakeholders who responded to our document did not support these remedies.

4.158 Our provisional view is that the costs imposed by these remedies would exceed any possible benefit that they could bring. Some of the remedies could also be ineffective in achieving their aims. We therefore propose not to take these remedies forward.



## 5. Next steps

- 5.1 In this section we indicate how we might put the remedies outlined in the previous section into effect and explain our plans for the second part of the market study.
- 5.2 Our analysis of the issues, as set out in section three, gives us reasonable grounds to suspect that a combination of features of the market for statutory audit services in the UK prevents, restricts or distorts competition. These features relate to the structure of the market and the conduct of its participants, specifically in respect of incentives, choice and resilience.
- 5.3 The CMA is likely to make recommendations to the government at the end of this market study, for the following reasons.

(a) **Legislation would likely see our remedies implemented, monitored and enforced more effectively.** The CMA has only delegated authority and the limits of its order-making powers are therefore delineated by statute, namely those in Schedule 8 of the Enterprise Act 2002. This means that some of the CMA's proposed remedies would likely not be implemented as effectively by order as by legislation.

- (i) Our proposed remedies will require monitoring and adjustments over time. For example, with joint audit, the allocation of responsibilities between audit firms is likely to need adjusting as challenger firms build their capacity. While a structural split would be a mostly one-off action, any form of operational split between audit and non-audit would need oversight, for example on transfer pricing arrangements for non-audit expertise used on audits. For many of the remedies, it may be appropriate to expand or contract the class of companies to which they apply over time. In these cases, the audit sector regulator would be better placed to perform these ongoing functions, but legislation would likely be required to empower that role.
- (ii) Our proposed remedies may require legislative change in order to fully achieve their objectives or address unintended consequences. For example, several parties have submitted that a joint audit remedy should be accompanied by a proportionate liability regime, in order to incentivise challenger firms to take on the highest risk audits. We have not reached any decision on the merits of that proposal, but such reform would clearly be well beyond the scope of the CMA's order making powers.

- (iii) The audit legal framework is complex – a combination of EU directives and regulation and UK legislation, regulations, codes and the existing CC orders. Our proposed remedies would be most effectively implemented, monitored and enforced if enacted in the clearest possible way within the wider framework, rather than as a bolt-on via the order-making route.
- (b) **Legislation would enable a broader set of remedies.** The CMA’s remit is to address competition concerns. In a market investigation our specific responsibility is to identify and address any adverse effects on competition. As set out in section three, our view is that the market is not currently delivering consistent high-quality audits, and that appears to be attributable to a number of competition issues. However, we are also mindful that audit quality is strongly affected by regulation. To the extent we ultimately favoured remedies outside our competition mandate, we may not have the power to implement them by order. Government, by contrast, can take much broader policy considerations into account.
- (c) **Government has an opportunity to consider all market features and potential reforms in parallel.**
  - (i) The CMA’s proposals are unlikely to be implemented in isolation. Our work takes place alongside Sir John Kingman’s recommendations, and any recommendations from the expected review on the purpose and scope of audits. These all need to be implemented together to have the best chance of addressing the intractable problems in the market.
  - (ii) Similarly, we are in the unusual position of undertaking a market study at a time when the relevant sector regulator is also under review, with the potential for fundamental changes to the regulator and regulatory structure as a result. As a practical matter therefore, it would likely be challenging for the CMA to make specific orders when the regulatory framework is in flux, and the outcome of the regulatory review is beyond our control.

5.4 We could refer this market for a market investigation, with the potential for orders at its conclusion. At least one response to our ITC suggested that we should indeed make a market investigation reference. At this stage, however, and as a proposal for consultation, we are minded not to make a market

investigation reference, because we see recommendations to the government as a more effective route to implementation.<sup>241</sup>

- 5.5 Our consultation will run until 21 January. We will continue to gather evidence, meet with stakeholders and undertake analysis with a view to refining our proposed remedies and issuing a final report as soon as possible in 2019.

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<sup>241</sup> The CMA's guidance makes clear that, in considering whether or not to make a reference, the CMA will take into account the likely availability of appropriate remedies in the event that the suspected adverse effects on competition were found to exist. In particular, the CMA guidance states it will have regard to whether any adverse effects on competition can be addressed by the CMA in circumstances where those effects arise primarily from laws, regulations, or government policies.

## 6. Responding to the update paper

- 6.1 We welcome submissions on any of the issues we address in this update paper by no later than **5pm on 21 January 2019**. We particularly welcome responses to the questions in Box 6.1 below. Respondents are welcome to address some or all of these questions.

### Box 6.1: Consultation questions

#### A) Issues

1. Do you agree with our analysis in section two of the concerns about audit quality?
2. Do you agree with our analysis of the issues that are driving quality concerns, as set out in section three? In particular:
  - a. Issues relating to the role of Audit Committees and investors in the process of appointing and monitoring auditors;
  - b. Limitations on choice leading to weaker competition;
  - c. Barriers to challenger firms for FTSE 350 audits;
  - d. Resilience concerns; and
  - e. Wider incentive issues raised by the multi-disciplinary nature of the large audit firms.

#### B) Remedies

For all remedies:

3. What should the scope of each remedy be? Please explain your reasoning. For example, should each remedy apply to all FTSE 350 companies, or be expanded to include PIEs or large privately-owned companies that could be deemed to be in the public interest?

Remedy 1: Regulatory scrutiny of Audit Committees

4. How could the regulatory scrutiny remedy be best designed to ensure that the requirements placed on Audit Committees by a regulator are concrete, measurable and able to hold Audit Committees to account? Please respond in relation to requirements both during the tender selection process and during the audit engagement.

Remedy 2: Mandatory joint audit

5. What should the scope of this remedy be? Please explain your reasoning.
  - a) Should the requirement to have a joint audit apply to all FTSE 350 companies or potentially go wider by including large private companies?
  - b) What types of companies (if any) should be excluded from a requirement for joint audit?
6. Should one of the joint auditors be required to be a challenger firm? If so, should this be required for all companies subject to joint audit? Are there any categories of companies to which this requirement should not apply? Please explain your reasoning for each of the answers.
7. Should a minimum amount of work (and fee) allocated to each joint auditor be set by a regulator? If so, should the same splits apply across the FTSE 350? (please comment on the illustrative examples in section four). Please explain your reasoning.
8. Our provisional view is that there would be merit in the joint auditors being appointed at different times. Should this be mandated, or left to the choice of individual companies? How should companies manage (or be mandated to manage) the transition from a single auditor to joint auditors?
9. Should a joint liability framework be introduced to encourage active participation in the market by the Big Four and challenger firms? Please explain your reasoning. In the context of joint audits, what are the advantages or disadvantages of auditor liability being proportionate to the audit fee of the joint auditors, compared to the auditors being jointly and severally liable?

#### Remedy 2A: Market share cap

10. How could the risks associated with a market share cap, such as cherry-picking, be addressed?
11. Would it need to apply only to FTSE 350 companies, or also to other large companies, and if so, which?

#### Remedy 3: Additional measures to reduce barriers for challenger firms

12. We welcome evidence from stakeholders on the existence of barriers to senior staff (including partners) switching quickly and smoothly between firms. We also welcome views on how justified such barriers are, bearing in mind commercial considerations that audit firms have.

13. We welcome estimates on the costs of setting up and running a tendering fund or equivalent subsidy scheme, and views as to how this should be designed.
14. We welcome comments as to whether the Big Four should be compelled to license their technology platforms at a reasonable cost to the challenger firms, and/or contribute resources (financial, technical, algorithms and data to enable machine learning) towards developing an open-source platform. In the first scenario, we also welcome comments on how such a 'reasonable cost' might be determined in such a way that it is affordable for challenger firms but does not disincentivise Big Four firms from innovating and developing new platforms.

#### Remedy 4: Market resilience

15. How could a resilience system be designed to prevent the Big Four becoming the Big Three, not just in the case of a sudden event, but also in the case of a gradual decline? Please also comment on our initial views to disincentivise and/or prohibit the movement of audit clients (and staff) to another Big Four firm.
16. How could such a system prevent moral hazard? Please comment on our initial view.
17. What powers would a regulator and a special administrator require, and how would their roles be divided? At what point should a regulator or a special administrator be able to exercise executive control over a distressed firm? Please comment on our initial view.
18. What could be done regarding the challenges relating to the fact that an audit firm's value lies in its people and clients – which would be complicated to restrict? Please comment on our initial view.

#### Remedy 5: Full structural or operational split

19. Do you agree with the view that the challenges to implement a full structural split are surmountable (especially relating to the international networks)? If not, please explain why it would be unachievable, i.e. that the barriers to implement this remedy could never be overcome, including through a legislative process.

20. How could an operational split be designed so that it would be as effective as the full structural split in achieving its aims, without imposing the costs of a full structural split? In your responses, please also compare and contrast the full structural split to the operational split.

21. With regards to the operational split, please provide comments on:

a) implementation risks and whether they are surmountable: e.g. how any defined benefit pension schemes could be separated between audit and non-audit services;

b) risks of circumvention and how they could be addressed e.g. how audit firms could circumvent the remedy through non-arm's-length transfer pricing and cost allocations;

c) implementation timescales to separate the audit firms and how soon the remedy could be brought into effect;

d) ongoing monitoring costs for the audit firms and a regulator;

e) role and competencies of a regulator in overseeing ongoing adherence to the operational split.

22. Under an operational split, how far, if at all, should it be possible to relax the current restrictions on non-audit services to audit clients? For example through changes to the blacklist or to the current 70% limit.

23. Should challenger firms be included within the scope of the structural and operational split remedies?

24. Which non-audit services (services other than statutory audits) should the audit practices be permitted to provide under a full structural split and operational split? Please explain your reasoning.

#### Remedy 6: Peer review

25. What should be the scope (ie which companies) and frequency of peer reviews, if used as a regulatory tool?

26. How could peer reviews be designed to best incentivise auditors to retain a high level of scepticism, and thus improve audit quality?

#### **C) Next steps**

27. What are your views, if any, on our proposal not to make a market investigation reference?

## How to respond

6.2 To respond to this update paper, please make a submission by email or post to:

– **Email:** [statutoryauditmarket@cma.gov.uk](mailto:statutoryauditmarket@cma.gov.uk)

– **Post:** Statutory audit market study  
Competition and Markets Authority  
7<sup>th</sup> floor  
Victoria House  
37 Southampton Row  
London, WC1B 4AD

6.1 We intend to publish responses to this update paper in full. In providing responses:

- Please supply a brief summary of the interests or organisations you represent, where appropriate.
- Please consider whether you are providing any material that you consider to be confidential, and explain why this is the case. Please provide both a confidential and non-confidential version of your response.

6.2 If you are an individual (ie you are not representing a business), please indicate whether you wish your response to be attributed to you by name or published anonymously.

6.3 An explanation of how we will use information provided to us can be found in Appendix B.



## Appendix A: Conduct of the market study, and our data sets

1. This appendix provides a chronological description of the conduct of our market study so far and a description of the data sets we compiled.

### *Chronology*

2. On 9 October 2018, the CMA published a Market Study Notice and Invitation to Comment document, along with an administrative timetable.<sup>242</sup>
3. Since then our market study has involved various elements, as listed below.
  - We invited responses to our Invitation to Comment document between 9 and 30 October 2018 and subsequently published on our website 75 responses we received.
  - In October we sent requests for information to the Big Four and five challenger firms. We sought information on audit tenders, firms' financials, individual audit engagements, market data, audit and non-audit services, investment in technology and their internal documents relating to measures they may be considering in response to concerns about the statutory audit market.
  - Between October and November, we sent requests for information to 63 audited companies in the FTSE350 and Top Track 100 companies. Further details of the requests are set out below in the description of our data sets. We have also sought information from other companies in relation to the number of audit firms which bid for their audits.
  - Between 9 October and early December, we held telephone calls and face to face meetings with over 60 parties to discuss the issues in the audit market and potential remedies. The parties included the Big Four and challenger firms, ACCs, investors, the FRC, Prudential Regulation Authority and pensions regulator, academics, BEIS, Sir John Kingman's independent review team and relevant regulatory bodies abroad.
4. We would like to thank all who have assisted in our market study to date.

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<sup>242</sup> See the [CMA's case page for the market study](#).

## **Data sets**

5. We compiled four main data sets using data provided by companies and audit firms (supplemented by public sources).
  - (a) Industry background data set: information on the external auditor, fees paid to the external auditor and other commercial details for each company included in the FTSE 350 or Top Track 100 in the period 2012 to 2017.
  - (b) Tender data: details of tenders of FTSE 350 and Top Track 100 external audits, in the period 2013 to 2018, including the firms that participated and the fees bid.
  - (c) Company sample: for a sample of 24 FTSE 350 companies, information in relation to i) tenders for the external audits and ii) the hours spent by audit committee members of audit related matters.
  - (d) Financial data: for each of the Big Four firms and bigger challenger firms (BDO, Grant Thornton, Mazars, RSM and Moore Stephens) information on audit and non-audit fees, costs and margins, for the UK firms.

### *Industry Background data set*

6. We sent formal requests for information to each of the Big Four and bigger challenger firms (BDO, Grant Thornton, Mazars, RSM and Moore Stephens) to provide data for all their audit clients in the FTSE 350 or Top Track 100 in the period 2012 to 2017. For this information request, we defined a company to have formed part of the FTSE 350 index if they had been in the FTSE 100 or 250 for at least two quarters of any year in this period.
7. For each company identified as being part of the FTSE 350 or Top Track 100 in the period 2012 – 2017, the Industry Background data set included the following:
  - (a) the registration number of the company and the UK Standard Industry Classification (SIC) Primary code used to classify businesses according to the main type of economic activity in which they are engaged;
  - (b) the name of the company's auditor and the year of the company's first audit engagement with their auditor in each year; and
  - (c) the fees received by the audit firm from the company in each year, with these fees split into the those received for audit or non-audit services during the financial year.

8. Around 86% of the observations included in the Industry Background data set were taken from the submissions of the nine audit firms, with the remaining 14% sourced from the FAME database. The majority of the company information taken from FAME (around 61% of the observations sourced from FAME) were for companies that were included in the Top Track 100 during the period 2012 – 2017.

### *Tender data*

9. We sent formal requests to each of the Big Four and challenger firms for information on any tenders for FTSE 350 or Top Track 100 audits that they participated in since January 2013. This included tenders where there was an informal approach by or discussion with the company.
10. We merged the response to compile information on 247 FTSE 350 tenders and 23 Top Track 100 tenders which were completed between January 2013 and October 2018. In doing this we used information from the market data to identify the incumbent audit firm for each tender.
11. In compiling the final data set we:
  - (a) excluded information on tenders that occurred before 1 January 2013 and ongoing tenders;
  - (b) excluded information on tenders where there was no identified winner or date;<sup>243</sup>
  - (c) Excluded information on tenders where the tendering company was not in the FTSE 350 or Top Track 100 for at least two quarters of the year in which the tender occurred;<sup>244</sup> and
  - (d) excluded the information provided by one challenger firm due to concerns about its accuracy.
12. The information provided may not be absolutely complete. For example, we are aware of occasions in our dataset where an audit firm has not included information on a tender in its submission when it did in fact participate in that tender.

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<sup>243</sup> Where date information was missing from an individual firm's submission we first identified whether the relevant tender appeared in other firms' submissions. Where this was the case we assumed that the tender information with the missing date was for the same date as the most common date for that tendering company across other firms' submissions.

<sup>244</sup> Where necessary we standardised dates across all firms' submissions. For example, where, based on information from all firms, the same company appeared to tender in consecutive years we assumed there was only one tender.

### *Company sample*

13. We sent informal information requests to a sample of 58 companies that were included in the FTSE 350 or Top Track 100 in 2018 and had tendered their external audit in the period 2012 – 2018.
14. We took a two-stage approach to selecting the sample: First, we used the full list of 450 companies to select 45 companies that would provide a representative sample. This sampling approach used the company's total turnover, turnover from the UK, total and net assets, as well as the company's UK SIC code to ensure the sample represented the variation of companies included in the FTSE 350 or Top Track 100 in 2018. Second, we then added companies from the full list of 450 companies that allowed the sample to include companies audited by challenger audit firms or in sectors particularly important to the UK economy (such as companies that provide financial and insurance services).
15. We asked the companies to provide information on the following:
  - (a) details of the most recent tender for statutory audit services including information on tender lists, and fees bid and agreed;
  - (b) certain documents relating to the most recent tender including: the request for a proposal; score cards or other methods used by the audit committee to evaluate bids; records of the audit committee decision in relation to the selection of the successful audit firm; and any papers submitted by the audit committee to the main company board and/or shareholders;
  - (c) information on the time spent by audit committee members on audit committee and external audit related matters, details of the resources available to ACC and details of communication with the FRC on audit matters;
  - (d) key considerations in selecting the firms invited to tender, factors limiting choice, views on level of choice, switching costs and experience of switching; and
  - (e) the effects of recent technological developments in audit and financial reporting on switching auditor.
16. We received full responses from 24 FTSE 350 companies and only one Track 100 company, with some of the requested information provided by one further Top Track 100 company.

## *Financial data*

17. As noted above, we asked the Big Four firms and five challenger firms<sup>245</sup> to supply us with financial data covering the period from 2011 to date. We asked for information covering the following categories:
- (a) an analysis of total annual revenues into three revenue streams: audit services, non-audit services to audit clients, and non-audit services to other clients;
  - (b) for each of audit and non-audit services, a breakdown of annual revenues and average revenue recovery rates by specific category of client (FTSE, AIM, Top Track, etc.);
  - (c) a breakdown by the same specific categories (FTSE, AIM, Top Track, etc.) of each firm's number of audit clients and aggregated annual audit hours deployed;
  - (d) overheads, direct staff costs and profit margins associated with each of audit and non-audit services;
  - (e) amounts invested into audit IT systems, both globally and in the UK;
  - (f) the number of partners, trainees and graduates, support staff and other staff employed by both the audit and non-audit arms of each firm;
  - (g) annual average rates of staff switching from audit to non-audit teams, analysed separately for trainees and graduates and other staff; and
  - (h) average annual partner salaries and drawings, and average annual staff salaries.
18. We received responses from all nine firms that we sent requests to, although one audit firm provided partial data and has indicated that it will complete the response in January 2019.
19. We used the information received to analyse the financial performance of the firms. In particular we compared and contrasted the audit arms and non-audit arms within firms, and also collectively the Big Four firms against the challenger firms.

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<sup>245</sup> Grant Thornton, BDO, RSM, Mazars and Moore Stephens.

## **Appendix B: use of information provided to the CMA**

1. This appendix sets out how the CMA may use information provided to it during the course of this market study.

### ***Why is the CMA asking for information?***

2. The information you provide will help us better understand how well the statutory audit market is working (for further details of the issues considered see the invitation to comment document).

### ***What will the CMA do with the information I provide?***

3. Your information will inform our final market study report. The report will set out our findings and any proposed remedies to any problems we find.
4. Where appropriate, we may also use information you provide to take enforcement action, using our competition or consumer powers, against businesses operating in the statutory audit market or may share your information with another enforcement authority (such as local authority Trading Standards Services) or with another regulator for them to consider whether any action is necessary.
5. We may only publish or share information in specific circumstances set out in legislation (principally Part 9 of the Enterprise Act 2002). In particular, prior to publication or any such disclosure, we must have regard to (among other considerations) the need for excluding, so far as is practicable:
  - (a) any information relating to the private affairs of an individual which might, significantly harm the individual's interests; or
  - (b) any business of an undertaking which, if published or shared, might significantly harm the legitimate business interests of that business.
6. We will redact, summarise or aggregate information in published reports where this is appropriate to ensure transparency whilst protecting legitimate consumer or business interests.
7. If you wish to submit information either in writing or verbally that you consider confidential and therefore do not wish us to publish or share, please let us know when you contact us with your reasons.
8. Any personal data you provide to us will be handled in accordance with our obligations under the General Data Protection Regulation, the Data Protection Act 2018 and any other applicable data protection legislation. Any personal data provided to us will be processed for the purposes of this market study under Part 4 of the Enterprise Act 2002. For more information about how the CMA processes

personal data, your rights in relation to that personal data (including how to complain), how to contact us, details of the CMA's Data Protection Officer, and how long we retain personal data, see our [Privacy Notice](#).

9. Further details of the CMA's approach can be found in [Transparency and Disclosure: Statement of the CMA's Policy and Approach \(CMA6\)](#).

## Glossary

<b>The Act</b>	Enterprise Act 2002.
<b>AC</b>	Audit Committee.
<b>ACC</b>	Audit Committee Chair.
<b>ACCA</b>	Association of Chartered Certified Accountants.
<b>ACCIF</b>	Audit Committee Chairs' Independent Forum.
<b>AQR</b>	Audit Quality Review (team of the <b>FRC</b> ).
<b>AIM</b>	Alternative Investment Market.
<b>Audit-related services</b>	Services provided to clients that are of a similar nature to statutory audit.
<b>BDO</b>	BDO LLP.
<b>BEIS</b>	Department for Business, Energy and Industrial Strategy.
<b>BHS</b>	British Home Stores.
<b>Big Four</b>	Collective term for the four largest audit firms: <b>Deloitte</b> , <b>EY</b> , <b>KPMG</b> and <b>PwC</b> .
<b>Challenger firms</b>	A group of audit firms that are not the <b>Big Four</b> audit firms.
<b>CC</b>	The Competition Commission.
<b>CC investigation</b>	The Competition Commission's Statutory Audit Market Investigation.
<b>CFO</b>	Chief Financial Officer.
<b>The Companies Act</b>	Companies Act 2006.
<b>Company</b>	An audited entity.
<b>Deloitte</b>	Deloitte LLP.
<b>EU</b>	European Union
<b>EY</b>	Ernst & Young LLP.
<b>'Expectations gap'</b>	The mismatch between the role of auditors and public expectations of their role.



<b>FCA</b>	Financial Conduct Authority.
<b>FD</b>	Finance Director.
<b>Firm</b>	Generally used to refer to an audit firm, as opposed to an audited company
<b>FRC</b>	Financial Reporting Council.
<b>FTSE 100 Index</b> or <b>FTSE 100</b>	The largest 100 companies by market capitalisation which have their primary listing on the London Stock Exchange.
<b>FTSE 250 Index</b> or <b>FTSE 250</b>	Companies 101 to 250 when companies which have their primary listing on the London Stock Exchange are ranked by market capitalisation.
<b>FTSE 350 Index</b> or <b>FTSE 350</b>	A market capitalisation weighted stock market index incorporating the largest 350 companies by capitalisation which have their primary listing on the London Stock Exchange. It is a combination of the <b>FTSE 100 Index</b> of the largest 100 companies and the <b>FTSE 250 Index</b> of the next largest 250 companies.
<b>Grant Thornton</b>	Grant Thornton UK LLP.
<b>ICAEW</b>	Institute of Chartered Accountants in England & Wales.
<b>ISA</b>	International Standards on Auditing.
<b>Invitation to Comment</b>	Invitation to Comment to the Market Study Launch Document.
<b>Kingman Review</b>	The independent review of the Financial Reporting Council led by Sir John Kingman.
<b>KPMG</b>	KPMG LLP.
<b>LLP</b>	Limited liability partnership, a partnership which has been incorporated, and where the liability of the members is limited to the capital held in the company.
<b>Mandatory rotation</b>	European Union rules compelling companies to tender their audit at least every ten years and switch their auditor at least every twenty years.
<b>Mazars</b>	Mazars LLP.
<b>Moore Stephens</b>	Moore Stephens International Ltd.
<b>OFT</b>	Office of Fair Trading.
<b>PCAOB</b>	Public Company Accounting Oversight Board – the audit regulator in the United States.

<b>PIE</b>	Public Interest Entity. Broadly defined by the European Audit Directive (Directive 2006/43/EC) as any entity whose transferable securities are traded on a regulated market, credit institutions such as banks and building societies, and insurance undertakings.
<b>PRA</b>	Prudential Regulation Authority.
<b>PwC</b>	PricewaterhouseCoopers LLP.
<b>RSM</b>	RSM UK.
<b>SATCAR</b>	The Statutory Auditors and Third Country Auditors Regulations 2016
<b>SIC code</b>	Standard Industrial Classification code (a system for classifying industries using four-digit codes).
<b>SLC</b>	Significant lessening of competition
<b>Top Track 100</b>	The largest 100 private companies in the UK by sales.