Making the Audit Market Work: the case for liberalising ownership

Paul Boyle
The Centre for the Study of Financial Innovation is a non-profit think-tank, established in 1993 to look at future developments in the international financial field – particularly from the point of view of practitioners. Its goals include identifying new areas of business, flagging areas of danger and provoking a debate about key financial issues. The Centre has no ideological brief, beyond a belief in open markets.

**Trustees**  
David Lascelles (Chairman)  
John Hitchins  
Mark Robson  
Carol Sergeant  
Sir Malcolm Williamson

**Governing Council**  
Sir Malcolm Williamson (Chairman)  
Geoffrey Bell (NY)  
Rudi Bogni  
Philip Brown  
Mohammed El-Kuwaiz  
John Heimann (NY)  
John Hitchins  
Rene Karsenti  
Henry Kaufman (NY)  
Sir Andrew Large  
David Lascelles  
John Plender  
David Potter  
Belinda Richards  
Mark Robson  
David Rule  
Carol Sergeant  
Sir Brian Williamson  
Peter Wilson-Smith

This CSFI publication is available through our website www.csfi.org or by calling the Centre on +44 (0) 20 7621 1056

Published by Centre for the Study of Financial Innovation (CSFI)

Cover Illustration: Joe Cummings

Email: info@csfi.org  
Web: www.csfi.org

ISBN: 978-1-9997174-6-9

Printed in the United Kingdom by Heron Dawson & Sawyer
Contents

Foreword.................................................................................................................................................IV

Introduction ..............................................................................................................................................1

Chapter 1: The case for liberalising audit firm ownership rules ...............................................................2

Chapter 2: Critique of the CMA's findings.............................................................................................10

Chapter 3: Assessment of the CMA's proposed remedies.................................................................17

Chapter 4: Why did the CMA reject liberalisation of audit firm ownership? ...........................................29

Conclusion: Liberalising ownership is the best way to make the audit market work .........................31

Appendix................................................................................................................................................32

About the author ....................................................................................................................................34
Foreword

This is, I believe, an important paper on an important subject, by an authoritative voice. I very much hope that it prompts a wider debate on an issue that has profound implications for UK plc.

It was prompted by last year’s update report by the Competition and Markets Authority into the market for statutory audit in the UK, as well as (to a lesser extent) by Sir John Kingman’s review of the role of the FRC – of which the author, Paul Boyle, was the first Chief Executive. Like the CMA, Paul believes there are serious shortcomings in the UK audit market – but he takes issue with several of the Authority’s recommendations, and urges a rethink, both by the CMA itself and by whatever body replaces the FRC as a result of the Kingman review.

Paul’s most important recommendation is one that the CMA dismissed – in his opinion, without sufficient cause. It is that the rules on the ownership of UK audit firms should be relaxed so as to permit new capital to enter the industry – thereby permitting mid-tier audit firms to grow and new companies to be set up. (At present, a majority of an audit firm’s equity must be owned by qualified auditors.) Like the CMA, he is concerned about the lack of competition in an industry where only four firms dominate the market for FTSE350 audits – but his recommendations are significantly different.

He notes that the CMA put forward six potential remedies for the excessive concentration of the industry – but that relaxing ownership rules was dismissed at the outset, in his view wrongly. Of the six, he supports:

• providing special measures to support challenger firms, perhaps including a tendering fund to help smaller firms with the burden of bidding; and

• enhancement of market resilience – going so far as to suggest that the post-Kingman FRC should take on a role similar to that of the PRA in financial services.

However, he is sceptical of most of the other measures recommended by the CMA on the grounds that they “are either unlikely to achieve their aim or might only do so at disproportionate cost – costs that will ultimately be borne by shareholders for whose benefit audit is intended to operate”. As he puts it, “It is surprising the extent to which the CMA has concluded that the problems in the audit market are best addressed by regulating, restricting and imposing further costs on the clients”.

Paul writes with authority – and I believe that he makes a very strong case. I very much hope that his message is heard across government and in the City.

We at the CSFI are very grateful to Paul for the very considerable effort that he has put into this paper. I am also grateful to my colleague, Jane Fuller (latterly, financial editor of the FT, with a strong background in accounting issues), for the time she spent with Paul testing and fine-tuning his ideas. The result is, I think, well-worth the effort.

Andrew Hilton
CSFI

A list of the CSFI publications can be found on the Centre’s website (www.csfi.org).
Making the Audit Market Work: the case for liberalising ownership

Paul Boyle

Introduction

I was the first Chief Executive of the Financial Reporting Council, from 2004 until 2009, and led the FRC's work on Choice in the Audit Market. Since leaving the FRC I have continued to take a close interest in corporate governance, financial reporting and audit issues. I was the group internal audit director for a global systemically important insurance company and President of the Chartered Institute of Internal Auditors in 2016-17.

This paper has been prompted by the December 2018 update report from the UK's Competition and Markets Authority (CMA) on its study into the market for statutory audit services. While the CMA is to be congratulated for highlighting problems in the market for the audit of large companies (too many instances of poor quality, shortage of choice and a lack of market resilience), the package of proposed remedies will be expensive, disruptive and, probably, ineffective.

Yet one of the potential remedies rejected by the CMA – relaxing the restrictions on the ownership of audit firms – has more potential benefits, fewer downsides and a greater level of stakeholder support than the CMA acknowledges. It should be pursued as part of the long-term strategy to improve the operation of the audit market.

The table below shows the recent evolution of the UK audit market. The ratchet-like nature of the changes is clear to see. The consequences, in terms of limited choice and risks to resilience, are widely accepted. The time has come to reverse the audit market ratchet.

Paul Boyle
April 2019

<table>
<thead>
<tr>
<th>Date</th>
<th>Number of major firms</th>
<th>Firms</th>
<th>Reason for change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prior to 1989</td>
<td>8</td>
<td>Arthur Andersen, Arthur Young, Coopers &amp; Lybrand, Deloitte Haskins &amp; Sells, Ernst &amp; Whinney, KPMG Peat Marwick, Price Waterhouse, Touche Ross</td>
<td></td>
</tr>
<tr>
<td>June 1989</td>
<td>7</td>
<td>Arthur Andersen, Coopers &amp; Lybrand, Deloitte Haskins &amp; Sells, Ernst &amp; Young, KPMG Peat Marwick, Price Waterhouse, Touche Ross</td>
<td>Merger</td>
</tr>
<tr>
<td>August 1989</td>
<td>6</td>
<td>Arthur Andersen, Coopers &amp; Lybrand, Deloitte &amp; Touche, Ernst &amp; Young, KPMG Peat Marwick, Price Waterhouse</td>
<td>Merger</td>
</tr>
<tr>
<td>1998</td>
<td>5</td>
<td>Arthur Andersen, Deloitte &amp; Touche, Ernst &amp; Young, KPMG, PricewaterhouseCoopers</td>
<td>Merger</td>
</tr>
<tr>
<td>2002</td>
<td>4</td>
<td>Deloitte &amp; Touche, Ernst &amp; Young, KPMG, PricewaterhouseCoopers</td>
<td>Firm failure</td>
</tr>
</tbody>
</table>
Chapter 1: The case for liberalising audit firm ownership rules

There have been restrictions on the ownership of audit firms in the UK for many decades. The essential one is that audit firms need to be majority-owned by qualified auditors. The rules are incorporated into EU law (the Audit Directive 2006 as amended by other Directives in 2008, 2013 and 2014). The relevant provisions are in Article 3(4)(b):

“a majority of the voting rights in an entity [which is approved to be an audit firm] must be held by audit firms which are approved in any Member State or by natural persons who satisfy at least the conditions imposed by Articles 4 and 6 to 12 [relating to being fit & proper persons, education, training and experience which must be met by qualified auditors].”

The requirement is only that the majority of shares are owned by qualified auditors. This allows some ownership by others. In practice, this flexibility is used by the firms to allow non-auditors, such as economists, actuaries IT specialists, to become partners. However, I know of no significant examples of this flexibility being used by firms to raise capital from outside investors with no involvement in their management or operations. From an investor’s perspective, the prospect of becoming a minority shareholder in a firm that is majority-owned by partners, who manage the activities on a day-to-day basis, is not an attractive proposition.

The rationale for this restriction is that if audit firms were owned by other parties, the professional and ethical standards required of auditors might not be adhered to. The EU lawmakers recognised the possibility that some ownership by non-auditors presented a risk, and so the 2014 Directive includes the following (paragraph 24):

“An audit firm shall establish appropriate policies and procedures to ensure that its owners or shareholders, as well as the members of the administrative, management and supervisory bodies of the firm, or of an affiliate firm, do not intervene in the carrying-out of a statutory audit in any way which jeopardises the independence and objectivity of the statutory auditor”.

The current restrictions are anti-competitive. They are a constraint on the ability of firms to enter the market and/or grow. The intention of the restrictions is to reduce the threats to audit quality. The key public policy judgement to be made is whether the audit quality benefits outweigh the anti-competitive disadvantages.

In my opinion, the answer is “No”. This viewpoint is backed by evidence from the CMA in its latest report.

CMA evidence

The two key points are:

1. **Audit quality is not good enough**: there is a higher than desirable incidence of poor-quality audits, even among those undertaken by the largest and most reputable firms.

2. **Competition and choice in the market is not sufficient**: many companies face a limited, or in some cases non-existent, choice of new auditor.

There has been no new entrant into the audit market for decades. This lack of significant new firms compares unfavourably with other markets, such as airlines, hotels, automobiles, software and legal services. In my view, the time has come to revisit these restrictions with the aim of increasing competition while not damaging quality.
The proposal

The proposal is to relax the ownership rules by eliminating the requirement that at least 51% of the voting rights in a firm must be controlled by qualified auditors. To protect the quality of audits performed by non-auditor-controlled (NAC) firms, additional safeguards would be implemented.

Objectives

The key aim of the measure would be to make it easier for one or more new firms to enter the market with a scale and capability sufficient to compete credibly for audits of large companies. A secondary aim would be to make it easier for existing challenger firms to expand sufficiently to enhance their competitiveness.

A further aim would be to improve the resilience of the audit market. This might be achieved in two ways. First, if the above objectives are achieved, there will be more credible competitors at the top end of the market, making it easier for clients of a failing audit firm to appoint a satisfactory replacement. Second, an externally funded firm could be more easily recapitalised than one financed solely by its partners. This would increase the likelihood that at least some of the capacity provided by that firm could be retained, albeit with fresh leadership.

The combined effect would be to increase the number of credible competitors in the market for audits of large companies. This would, in turn, be expected to have a positive impact on audit quality, choice and market resilience.

The principal concern about relaxing the ownership rules is that it introduces the risk of interference in audit judgements by non-auditors, who may be motivated by profit rather than audit quality, or may have a conflict of interest regarding the firm’s clients. In my view, these concerns are over-stated and safeguards could be introduced to mitigate the risks.

Examples in other industries

Similar potential risks exist in other industries, but they are mitigated by regulation of the conduct of business and not by restrictions on ownership. Two examples will serve to illustrate the point:

Airlines: It is evident that the safety of air passengers is an important public policy issue – a matter of life and death – and, justifiably, there is extensive regulation of the industry. For example:

- Only pilots who are qualified and meet minimum standards of physical fitness are allowed to fly.
- There are limits on the length of time that pilots can fly without an enforced rest period.
- There are mandatory maintenance routines and independent inspections of the condition of aircraft.

Pharmaceuticals: The safety of medicines is also an important public policy issue – again a matter of life and death – and so, justifiably, there is extensive regulation of the pharmaceuticals industry (eg safety trials, limitations on sale without prescription by a qualified doctor, inspection of safety standards in manufacturing).

But there is no rule requiring that qualified doctors or pharmacists must own the majority of shares in drug companies – and it is almost inconceivable that anyone would propose such a rule.

But there is no regulation stipulating that qualified pilots must own the majority of shares in airlines – and it is almost inconceivable that anyone would propose such a rule.
As in the case of airlines, a theoretical risk remains that profit-seeking investors might put pressure on companies to distort trial results to boost dividends, but this would not be a rational thing for investors to request or for management to agree.

The key point is that, in both industries, it is recognised that liberalised ownership rules must be accompanied by strong regulation of operational activities. This balance would also need to be struck in the case of audit.

It should be remembered that the risk of non-auditor interference in audit judgments already exists under the current ownership rules because most of the large audit firms have owners (partners) who are not qualified auditors. Witness the CMA’s concern about the impact on audit judgments of the culture of firms in which revenues and profits from non-audit services substantially exceed those derived from audit. The Rubicon of non-auditor ownership of audit firms was crossed many years ago and so the issue is no longer one of fundamental principle but rather of degree.

Lesson from the legal profession

The audit profession is not the first to face questions about the continuing merits of restrictive ownership rules. The same issue arose more than a decade ago in relation to the legal profession. In 2003 the government asked Sir David Clementi to review the market for legal services in the UK. Sir David’s report, published in 2004, contained a key recommendation that the ownership of law firms should be liberalised. This permitted “Alternative Business Structures” to be created. At the time, a wide range of concerns were raised about the proposed liberalisation. A summary of Sir David’s responses is set out in the table below:

<table>
<thead>
<tr>
<th>Nature of concern</th>
<th>Clementi’s observations</th>
<th>Proposed mitigation</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Inappropriate owners</td>
<td>Some existing owners of law firms are unsuitable as demonstrated by the large number of disciplinary cases against solicitors</td>
<td>The regulator should apply a “fit to own” test to prospective owners</td>
</tr>
<tr>
<td>2 Outside owners would bring unreasonable commercial pressure to bear on lawyers, which might conflict with their professional duties</td>
<td>It is possible to develop a package of safeguards that would prevent outside owners pursuing their own financial interests at the expense of clients or the values of the legal profession</td>
<td>Package of measures, including designated senior management roles that could only be filled by qualified lawyers</td>
</tr>
<tr>
<td>3 New owners would cherry-pick the best business</td>
<td>It should be recognised that cherries generally grow where there are restrictions on trade. The admission of new capital is likely to increase competition</td>
<td>No additional mitigants</td>
</tr>
<tr>
<td>4 Impact on access to legal services in rural areas</td>
<td>The question of access to legal services in rural areas is not related to the source of capital</td>
<td>No additional mitigants</td>
</tr>
<tr>
<td>5 New owners would have conflicts of interest</td>
<td>The notion that for lawyers, unlike businessmen, making money is merely a happy by-product of doing their professional duty has limited resonance with the public</td>
<td>Firms should not be permitted to act for clients in which an outside owner has an interest in an adverse outcome. It should not be permitted for an owner to interfere in any client case or to have access to any client information</td>
</tr>
<tr>
<td>6 Whether some restrictions might be placed on the nature and extent of outside owners’ interests in the new firms</td>
<td>Such restrictions would limit access to capital and are not necessary given the focus of regulatory safeguards on the individuals who manage the firm and how they do so</td>
<td>No additional mitigants</td>
</tr>
<tr>
<td>7 There is no precedent for such outside ownership</td>
<td>There are such precedents in Australia and in relation to conveyancing services in the UK</td>
<td>No additional mitigants</td>
</tr>
</tbody>
</table>
The government accepted Sir David’s recommendations and they were given effect by the Legal Services Act 2007. The White Paper preceding the Act noted that Alternative Business Structures (ABS) gave rise to potential benefits for both consumers and providers of legal services. Customers would have more choice, reduced prices, better access to justice, improved service and greater convenience, all of which would increase consumer confidence. Providers would have increased access to finance, a better spread of risk and increased flexibility; it would be easier to hire and retain high-quality non-legal staff and there would be more choice for new legal professionals.

The new arrangements are overseen by the Solicitors’ Regulation Authority (SRA), which monitors compliance with the requirements relating to ABS. As of January 2019, the SRA’s register of ABS firms had 813 entries, of which 29 were quoted companies or subsidiaries of quoted companies. Interestingly, all of the Big Four audit firms – PwC, Deloitte, KPMG and EY – and several challengers have taken advantage of the liberalised ownership rules to establish ABS legal firms.

Ownership of law firms has been liberalised in a number of other countries, including the US, Canada, Australia and Singapore. A 2017 report by Thomson Reuters on the market for Alternative Legal Service Providers found that:

“…at $8.4bn and growing, ALSPs represent one of the most dynamic segments of the legal services industry and they are likely to play a role as competitors and disruptors for many years to come.”

Thomson Reuters estimated that the Big Four earned $900m of fees from providing legal services.

I am not aware of any serious suggestions that the Clementi reforms should be reversed – and, in any case, this would be likely to receive a pretty dusty response from the CMA.

The lesson from the legal profession is that relaxation of the ownership rules can attract significant amounts of new capital, leading to the emergence of strong new entrants. Many of them have developed innovative ways of serving clients, with no detriment to the quality or professionalism of the services.

Mitigating the downside risks

Despite the examples from other sectors, and the fact that the risk of interference by non-auditors in audit judgments already exists, some stakeholders might still believe that eliminating the requirement for the majority of the voting rights to rest with qualified auditors would increase the threats to audit quality.

While I do not believe these concerns to be well founded, the CMA could accompany liberalisation with measures to mitigate the downside risks associated with non-auditor-controlled (NAC) firms. These might include:

a. Limits on the maximum percentage (say, 30%) that could be owned by a single non-auditor shareholder (above that level the risks of interference might be regarded as too difficult to mitigate). I note, however, that Sir David Clementi concluded that such a measure was unnecessary for law firms.

b. The policies and procedures to prevent non-interference, which are already required for audit firms, may need to be strengthened for NAC firms. Further work needs to be done to design these procedures but strengthening the Audit Firm Governance Code, with independent monitoring of its application by the audit regulator, should be sufficient for this purpose. Indeed, respondents to the CMA’s report have pointed out that there is merit in strengthening the governance arrangements for existing audit firms, in any case.

c. It would be helpful to introduce a requirement for non-audit shareholders owning more than a certain percentage (say, 5%) to make a public statement confirming that they have not breached the “non-interference” policies.

d. There could also be a prohibition on NAC firms auditing certain clients. For example, there would be a clear conflict of interest if a NAC firm were to be appointed auditor of one of its own shareholders. However, I do not believe that this would need to extend to a prohibition on a NAC firm auditing a company in which one of its shareholders had
a low percentage shareholding. For example, if one of the major institutional investors had a 2% shareholding in a NAC firm and a 2% shareholding in a FTSE 350 company, this need not prevent the NAC firm being eligible for appointment as auditor of that company. In the context of all the other arrangements for overseeing and regulating audit quality, the risks to independence in such a situation are sufficiently low to be disregarded.

Who might invest in an audit firm?

Relaxation of the ownership rules would only have an impact on the market if outside shareholders were willing to invest. Some stakeholders might argue that the risks of investing in audit firms (e.g., uncertainty of commercial success, exposure to damages awards and regulatory fines) are so high that it is unlikely external investors would be attracted, so there is no point in relaxing the rules. However, I would argue that this is a counsel of despair, possibly motivated by a desire to maintain the status quo.

The UK financial services industry has proved over many years that it is possible to attract capital to apparently high-risk ventures, either through the public markets or via private equity. Given that the law currently prevents audit firms being majority owned by external non-auditors, it would be a waste of time to attempt to raise outside capital. However, were the ownership rules to be relaxed, the audit market would be exposed to the creativity of corporate finance practitioners.

What sort of investors might plausibly be attracted?

Three possibilities come to mind:

**Mainstream institutional investors:** Pension funds and managed investment funds would be natural owners of audit firms. Indeed, institutional investors are arguably appropriate owners of audit firms.

The role of the statutory auditor is to work in the interests of shareholders to increase their confidence in the reliability of a company’s financial statements. Ownership of audit firms by the same broad category of institution that owns the companies being audited would act as a counter-balance to the current tendency for audit firms to regard the management and directors of companies as their clients.

There would be an alignment of interests with regard to audit quality. Audit firms have often stated publicly their commitment to audit quality and institutional investors have been vocal about the importance of audit quality to them.

The cost and disruption flowing from the withdrawal of one of the Big Four from the market would be widespread, potentially affecting thousands of companies in which institutional investors have shareholdings. Given that they are among those most at risk from the current lack of resilience, they would be one of the principal beneficiaries of increased resilience resulting from the addition of well-capitalised competitors of scale.

The CMA has noted that the lack of choice of audit firms has the effect of reducing the incentives for high quality audits. Institutional investors, in particular, are disadvantaged by poor quality audits. They would, therefore, benefit the most from any improvement in audit quality that might emanate from the new competitors. The advantages would not just arise via individual investee companies experiencing better audits but would spread across entire portfolios as quality across the market edged up.

Finally, institutional investors in audit firms might well receive a positive financial return on their investment. The CMA has obtained data on the profit margins of the Big Four and challenger firms for both audit and non-audit services. The update report notes that the information is summarised in tables 2.13 to 2.15 … but all of these tables have been redacted. The decision to redact so extensively is surprising given that the largest firms publish information on their overall profitability and, at the instigation of the FRC (Choice in the Audit Market, 2006-07), on the profitability of the audit business. However, the CMA did report that the audit market is profitable at an aggregate level (paragraph 3.166). So, while a new entrant is likely to make losses in its early years, there are reasonable prospects for long-term financial returns, especially given the CMA’s
findings that low prices are not a major factor in auditor selection decisions (paragraph 3.17).

Nevertheless, the direct financial returns for institutional investors are likely to be trivial in comparison with the benefits of higher quality audits, increased choice and improved resilience across the market, which would flow from the existence of a greater number of competitors.

It is only fair to acknowledge a few reasons why institutional investors might not be appropriate owners of audit firms.

One obvious example is that it might make it more difficult for institutional investors to sue the auditors in the event of the failure of a company audited by a firm in which they had invested. While this argument may carry some weight, it is not persuasive. The number of cases in which investors have succeeded in winning damages awards from audit firms is very low because the burden of proof in demonstrating that their losses were attributable to audit failure is high. Investors would still pursue litigation against an audit firm in which they had a small shareholding if they believed they had a strong chance of success.

Institutional investors have been vocal in response to the CMA’s latest study, as they have been in previous reviews and parliamentary inquiries, about the importance they attach to improved quality and greater choice in the audit market. It would be interesting to observe whether, in a world of liberalised ownership rules, they would be willing to back their desire for audit quality with hard cash. Given the problems they are exposed to in the current market structure, it is to be hoped that many of them would be willing to invest.

From the perspective of audit committees who are considering proposing the appointment of an NAC firm, the fact that the firm was part-owned by institutional investors should give them confidence that such an appointment would receive shareholder approval.

Technology companies: The use of technology, including data analytics, is becoming an increasingly important component of the audit process. There is substantial scope for technological developments to improve the quality and efficiency of auditing. Although the audit firms have already invested heavily in technology, their investment capacity and technical capability is small in comparison with that of the largest tech companies. It is possible that some of them could make a significant contribution to the funding and technical capability of new entrants into the audit market.

Technology companies are not as promising investors in audit firms as institutional investors because they would not have so much to gain by way of increased resilience and quality in the audit market. In addition, there may be concerns over the security and potential misuse of client data. However, any new externally financed audit firms would be subject to the same restrictions on client confidentiality as the current ones, and the “non-interference” provisions discussed above could be tailored to meet any additional concerns arising from having technology companies as investors.

User-owned mutual – ‘clearing house’ model: In other industries, service providers have been established on a user-owned mutual basis. For many years clearing houses operated in this way in the financial services sector. Companies trading derivatives and commodities contracts faced a significant business problem – exposure to a high level of counter-party default risk – and they realised that the existence of a clearing house would reduce that risk and enable efficient rectification in the event of a default. Those companies subsequently established and financed a mutually-owned clearing house, which was governed and operated independently of the market participants.

In the audit market, many companies face the problem of a lack of choice in the audit market and, even more seriously, are exposed to the risk of a Big Four firm leaving. The best way to resolve these issues would be to have more audit firms of scale in the market. If no other means of funding a new firm were to be found, it might be in the interests of FTSE 350 companies to fund the establishment of one or more audit firms. These would be governed and operated on a basis that was independent of the companies.

FTSE 350 companies are not as promising investors in audit firms as institutional investors because there would
be a higher level of concern about conflicts of interest. However, the “non-interference” provisions discussed above could be tailored to meet these objections.

An externally funded audit firm could be a listed company. The potential benefits of liberalisation of the ownership rules are not dependent on the choice of public or private equity ownership.

The three models listed above do not represent a comprehensive list. If the ownership rules were relaxed, creativity and originality might generate other, more attractive models, and there may be benefits in having several new firms funded on different bases. Also, it may be possible to have a hybrid model, such as a new firm funded by institutional investors alongside one or more technology companies.

How might a new audit firm break into the market?

There is no question that a new audit firm would find it challenging to break into a market dominated by the Big Four. Some might argue that the odds against are so overwhelming it is not worth trying. However, in many other industries new entrants have faced apparently overwhelmingly dominant incumbents and yet have succeeded.

There are many ways in which such a firm might establish itself and, as developments in the legal market have illustrated, not all the growth paths could have been predicted at the outset. To show how it would be possible, albeit not easy, one approach is as follows:

i. Establish a strong independent board to give confidence to potential investors, clients and the regulators.

ii. Recruit an experienced auditor as CEO of the new firm, perhaps a senior team leader who believes that he/she will not succeed to the top role in his/her current firm. Such a person might well be attracted to the challenge of establishing an innovative new competitor with a substantial capital base.

iii. Raise capital – potential investors were discussed above.

iv. Assemble a senior management team of experienced auditors and other support staff.

v. Choose a memorable name and start raising awareness and marketing.

vi. Compete in tenders for target clients. The new firm would want to be a player in the FTSE 350 market but would start with relatively modest ambitions. It is not realistic to think that the new firm’s early clients would include the largest multinational companies, such as BP or HSBC. However, there are many examples of smaller companies whose business is primarily or exclusively in the UK.

vii. Deliver initial audits.

viii. Compete in tenders for additional target clients.

It may take many years for one or more new firms to establish themselves, and for this reform to have a meaningful impact on the market. But this extended timescale is also true of the CMA’s proposed remedies and is not a valid reason for not recommending liberalisation of the ownership rules.

Reducing regulatory barriers

There are regulatory barriers which, if interpreted literally, would make it impossible for a new audit firm to start up. The most prominent is the requirement in the Ethical Standards, published by the FRC, that seeks to guard against an audit firm being economically dependent on a client. The concern is that the firm might be reluctant to challenge its management or directors. The standards prevent firms from earning more than 10% of their income from a single public interest client. This would be impossible for a new firm to meet.

Sir John Kingman’s review of the FRC notes that other regulators have promoting competition as an objective. For example:

- The Financial Conduct Authority (FCA) must “so far as is compatible with [its other objectives] discharge its general functions in a way which promotes effective competition in the interests of consumers”.


The Prudential Regulation Authority (PRA) must “so far as is reasonably possible act in a way which, as a secondary objective, facilitates effective competition in the markets for services provided by PRA-authorised persons”.

Kingman has proposed that the successor body to the FRC should have a competition objective similar to that of the FCA: “the new regulator must… discharge its general functions in a way which promotes effective competition in the market for statutory audit services.”

Both the FCA and the PRA have taken a number of practical steps to assist new entrants. The FCA has established an Innovation Hub, a regulatory “sandbox” and, jointly with the PRA, created a New Bank Start-up Unit. Given the challenges faced by potential new entrants to the audit market, it would be helpful if the FRC’s successor were to take similar steps.

The competition objectives of financial services regulators are secondary to their principal consumer protection and market stability mandate. Tension can exist between these objectives, and the striking of an appropriate balance requires difficult trade-offs. But in a market such as audit, where shortage of choice and lack of resilience are so serious, it would be appropriate for the regulator to give considerable weight to the benefits created by new entrants.

The new audit regulator should undertake a thorough review of the technical and ethical standards and regulations applicable to auditors with a view to identifying those that might be prejudicial to new entrants. Without creating UK only standards (the UK follows International Standards on Auditing), it might consider ways of achieving the intended purpose of the ethical standards that are less damaging to new entrants.

The need for legislative change

Since the current ownership rules are set out in legislation, this measure would clearly require legislative change. While the difficulties of securing this are not to be underestimated, I do not regard this as an insurmountable obstacle to including the proposal in the CMA’s final recommendations to the government. The CMA already recognises that legislation would be the most effective way of implementing a number of its proposed remedies.

There is, of course, a particular challenge in that the current ownership restrictions are defined in an EU Directive, but Brexit may give the UK greater freedom for innovation in this respect. If that proves not to be the case, I would recommend that the UK government make the case to the EU authorities on the merits of liberalisation.

Assessment of relaxation of ownership rules against the CMA’s criteria

My proposal for the relaxation of audit firm ownership rules should be assessed against the criteria the CMA uses in considering remedies. The case runs as follows:

1. Does it address the underlying concerns identified? Yes, relaxation of ownership rules has the potential directly to address the concerns about the audit market that the CMA has identified: audit quality, choice and resilience. While the effectiveness of the proposed measure remains to be tested, there is also considerable uncertainty about the effectiveness of the remedies proposed by the CMA.

2. Can it be implemented, monitored and enforced effectively? Implementation would require legislative change, as would some of the remedies proposed by the CMA. Regulatory monitoring of the governance procedures of the new audit firms will be needed, but as the number of new firms is likely to be small, this should not involve significant cost. The measure is permissive rather than obligatory and so requires no enforcement.

3. Is it proportionate to the scale of the issue? Unlike many of the remedies proposed by the CMA, this measure will impose no new costs or other burdens on companies and it will have no adverse impact on audit choice.

4. What are the potential risks and unintended consequences? The most significant potential downside is an increased risk of interference by non-auditors in audit judgments. But this risk exists at present, and means are available to reduce the risk to an acceptable level.

In summary, relaxation of audit firm ownership rules would be a deregulatory, pro-competition measure.
Chapter 2: Critique of the CMA’s findings

The Competition and Market Authority’s update report on its study into the market for statutory audit services was published in December 2018. It performs a useful function in confirming, with an extensive evidential base, that the market is not working well. The CMA’s principal findings can be summarised as follows:

a. There are so many indicators of poor-quality audits that they cannot be dismissed as isolated examples.

b. There are deficiencies in the processes for the selection and oversight of auditors by audit committees.

c. Large companies face a very limited choice – and, in some cases, no choice – of firms with the skills and experience needed to be effective auditors.

d. Firms wishing to challenge the Big Four (PwC, Deloitte, KPMG and EY) face significant barriers, both on the demand side and supply side.

e. The market is not resilient: there is a non-zero risk of one of the Big Four exiting the market. Given the existing limitations on choice, the loss of one of those firms would be very damaging.

f. The tension between the ‘client service’ mindset, which is appropriate for the firms’ non-audit services (providing the majority of revenues and profits), and the ‘challenge’ mindset necessary for audit work means that the current structure of firms undermines incentives for audit quality.

Each of these findings is discussed below.

Widespread audit quality shortcomings

The CMA’s finding: The CMA notes that 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” (paragraph 2.37).

It adds: “Several indicators suggest a persistent problem of variable and sometimes poor audit quality” (paragraph 2.41). The indicators referenced are:

- recent FRC enforcement actions against audit failures by each of the Big Four and Grant Thornton;
- FRC Audit Quality Reports, which concluded that more than 20% of audits of large companies required more than limited improvement. These findings applied to both the Big Four and the mid-tier firms, with the performance of the latter being worse than the former over a four-year period;
- a large number of reported cases of high-profile audit failures by the Big Four and mid-tier firms in other jurisdictions; and
- widespread criticism of audit failures by politicians and investor groups responding to the CMA’s Invitation to Comment (ITC).

The CMA concluded that “the number of recent events [related to audit quality], combined with the size of these companies and their importance to the UK economy, cannot be dismissed as ‘isolated events’” (paragraph 2.78).

Observations on the finding: It is necessary to be realistic about the role of audit and the impossibility of having no audit failures, and to accept that adverse consequences would flow from having zero tolerance for audit quality deficiencies. But what is an acceptable level of tolerance? This is a matter of judgment on which reasonable, informed commentators might differ. In my view, the incidence of audit quality deficiencies is above an acceptable level.

Three aspects of the audit quality finding are particularly striking:

- The number of deficiencies identified in audits undertaken by the Big Four firms, which have reputations for being the best in the market. This is
Despite their substantial scope, including high profit margins, to invest in audit quality.

- The fact that all of the Big Four have broadly similar levels of audit quality shortcomings.

- The audit quality indicators for the mid-tier, challenger firms are generally poorer than those of the Big Four when looked at over a four-year period. This is notwithstanding the fact that, typically, they audit clients with smaller and simpler businesses than those of the Big Four.

The result is that it is difficult for the company directors responsible for auditor selection and the shareholders responsible for endorsing or rejecting those selections to make their decisions primarily on the grounds of audit quality. If, for example, directors and shareholders were to adopt a policy of refusing to appoint any audit firm that had been the subject of regulatory sanction for poor audit quality in the past five years, there would be virtually no firms eligible for appointment.

The fact that there are justified concerns about audit quality does not, however, mean that competition remedies are the most appropriate way to address them.

Deficient selection and oversight

The CMA’s finding: It has found that “aspects of the selection processes for auditors could result in the selection of auditors with the interests of the company and its management rather than those of the shareholders in mind” (paragraph 3.13). The CMA identified two main reasons for this:

- The selection criteria used in some audit tenders are insufficiently focused on audit quality and give undue weight to factors such as “cultural fit”. This “calls into question whether the current tendering approach rewards auditors for being too close to management, rather than providing independent challenge” (paragraph 3.28).

- Although audit committees appeared to have a significant role, “we observed that management still plays a significant role in the tender process and in advising the audit committee” (paragraph 3.30).

The CMA also concludes, based on an analysis of the number of hours spent on auditor matters, that some audit committees are not being as proactive as they should be in overseeing the effectiveness of the auditors. Concerns about audit committee effectiveness are exacerbated by the low level of shareholder involvement in audit matters, in comparison with their activity over executive remuneration. The CMA suggests that greater disclosure about audit matters “could make it easier for investors to engage” (paragraph 3.54).

Also noted is the “potential for divergence between the interests of shareholders in audit and the interests of the company’s pension holders and the wider public” (paragraph 3.54). The CMA concludes: “This points to a continuing need for regulation to protect these wider public interests.”

Observations on the finding: I think this finding is harsh. First, little or no weight is given to the fact that audit committee members, and other non-executive directors, have strong reasons for wanting high-quality audits. The auditor’s role is to report to the shareholders on the appropriateness of the financial statements approved by the directors. But, importantly, it is also the case that the directors pay close attention to the auditor’s views before deciding what adjustments, if any, to make to the draft financial statements prepared by management. The directors want the auditor to draw any deficiencies to their attention.

Boards are conscious of the damage that has been done to the reputations of the directors of companies where material errors in the financial statements have been identified – they really do not want the same fate to befall them. While there are cases where non-executive directors acquiesced with management in the approval of misleading financial statements, these are rare and should not be regarded as the default assumption on which the regulatory regime is based.

Second, the CMA has underplayed the contribution to audit quality of a good working relationship between the auditor and management. Although it
is necessary for auditors to retain a high degree of professional scepticism as to what management tells them, an effective audit cannot be conducted without a good working relationship. This can, for example, help persuade management not to pursue a particular accounting treatment because the auditor would raise an objection in its published audit opinion, or point out the questionable judgment in private reports to the audit committee. The CMA seems to regard the need for a good working relationship as an overly negative aspect of current selection processes.

The CMA’s point about the potential for divergence between the interests of shareholders and other stakeholders (e.g., pensioners) is an interesting one, but it should not have influenced its recommendations on what to do about the audit market, given the current responsibilities of auditors as stated in the Companies Acts. This point would be better picked up in the Brydon review of the role of audit in society.

Shortage of choice of auditors

The CMA’s finding: According to the CMA, “for a substantial minority of FTSE 350 companies, Audit Committees are faced with fewer than three credible bidders for an audit tender… If one of the bidders fails to impress, the company is left, in effect, with no choice at all” (paragraph 3.65). Around 30% of the 247 FTSE 350 tenders reviewed by the CMA had fewer than three competing bidders.

It identifies four main reasons for lack of choice: mandatory rotation rules, which eliminate the incumbent auditor; concerns about the capability of firms outside the Big Four; rules on conflicts of interest; and choices by the audit firms not to bid (paragraph 3.80). Grant Thornton, for instance, made a strategic choice no longer to bid for FTSE 350 audit appointments.

Observations on the finding: Although some audit committees have an adequate choice of firms with appropriate capabilities, there is compelling evidence that this is not true for a sufficiently large number, making it a public policy problem requiring action. This conclusion is reinforced by the finding on market resilience.

Barriers to challenger firms

The CMA’s finding: “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” (paragraph 3.103). “There appear to be both demand-side and supply-side barriers… preventing challenger firms from building their presence in the FTSE 350 market. These barriers… create[e] a vicious circle from which it is very difficult for the firms to escape” (paragraph 3.104).

On the demand side, the CMA says the barriers include:

- concerns about the capability of the challenger firms, such as smaller international networks, lack of capacity, lower AQR scores and lack of experience of auditing similar firms;
- the “chicken and egg” problem; and
- perceptions and risk for audit committees of appointing a challenger firm, including some concerns about a “pro-Big Four bias” among those committee members who are Big four alumni and some examples of adverse reactions of investors to such appointments.

On the supply side, the barriers include:

- high tender costs, coupled with a lower success rate than Big Four firms;
- reluctance to take on the risk of having a single audit client providing a large share of the firm’s revenue; and
- the higher litigation and regulatory risks of auditing FTSE 350 companies.

The CMA concludes that “if the challenger firms had a higher chance of winning FTSE 350 audit contracts then they would be able to invest to overcome the supply-side barriers” (paragraph 3.130).

Observations on the finding: There are indeed significant barriers to existing challenger firms that wish to be effective competitors in the FTSE 350 audit market.
There is a “push-me-pull-you” aspect to this finding. At one end of the beast, companies have, in some cases, genuine concerns about the present capabilities of challenger firms and so are reluctant to appoint them. At the other end, challenger firms have genuine reason to question the business case for investing in additional capabilities, given the limited prospect of success in tenders. The lack of any meaningful change in the challenger firms’ share of the FTSE 350 market illustrates the power of inertia, and something needs to be done to overcome it.

Lack of resilience of the market for statutory audit

The CMA’s finding: “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… and we would expect audit quality to suffer” (paragraph 3.134).

Although the firms have largely proved to be resilient in the face of adverse events, the CMA concludes that the risk of catastrophic failure “may be small, but it cannot be dismissed… [and] could be triggered by audit failure(s) in the UK or another major firm in the global network” (paragraph 3.141).

The CMA notes that if one of the Big Four failed, it would seek to use its competition tools to mitigate the effect, but “our view is that the merger rules would provide only limited protection” (paragraph 3.146). In the same paragraph it also notes, with considerable understatement in the light of its findings on the barriers to challenger firms, that it is “unlikely that the challenger firms would currently have the capacity to absorb all of the clients of one of the four large auditors”.

The CMA’s provisional conclusion is that “failure of one of the large auditors would be very likely to materially worsen the current choice problems” (paragraph 3.147). It also notes the potential for concerns about resilience to make the regulator reluctant to take appropriate action against a poorly performing Big Four firm.

Observations on the finding: I am supportive of this finding and think that, if anything, the CMA has understated the probability and impact of the failure of a Big Four firm.

As regards probability, the incidence of failure of audit firms is rare and so it is impossible reliably to estimate the probability. However, the table below, with an explanation on the next page, illustrates the progressive nature of the risk.

<table>
<thead>
<tr>
<th>Circumstances of the trigger event</th>
<th>Firm affected</th>
<th>Location</th>
<th>Line of business in which the event occurs</th>
<th>Time period</th>
<th>Illustrative probability (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>One specific firm</td>
<td>UK</td>
<td>Audit</td>
<td>Next 12 months</td>
<td>0.1</td>
</tr>
<tr>
<td>2</td>
<td>Any of Big Four</td>
<td>UK</td>
<td>Audit</td>
<td>Next 12 months</td>
<td>0.4</td>
</tr>
<tr>
<td>3</td>
<td>Any of Big Four</td>
<td>Anywhere in the global network</td>
<td>Audit</td>
<td>Next 12 months</td>
<td>1.0</td>
</tr>
<tr>
<td>4</td>
<td>Any of Big Four</td>
<td>Anywhere in the global network</td>
<td>Any service line</td>
<td>Next 12 months</td>
<td>5.0</td>
</tr>
<tr>
<td>5</td>
<td>Any of Big Four</td>
<td>Anywhere in the global network</td>
<td>Any service line</td>
<td>Next 5 years</td>
<td>10.0</td>
</tr>
<tr>
<td>6</td>
<td>Any of Big Four</td>
<td>Anywhere in the global network</td>
<td>Any service line</td>
<td>Next 25 years</td>
<td>50.0</td>
</tr>
</tbody>
</table>
1. The probability that a specific Big Four firm might fail in the next 12 months triggered by a problem in its audit practice in the UK (e.g., a major audit failure leading to loss of client confidence and/or substantial damages awarded in litigation and/or a loss of the licence to audit) is likely to be low, but not zero. For the sake of illustration let’s assign a probability of 1 in 1,000 (0.1%) to such an event.

2. From a public policy perspective with regard to market resilience, the relevant probability is not that of a failure of an individual firm but the probability of any of the Big Four failing. The probability of that happening in the next 12 months (attributable to a problem in their UK audit practices) may still be low, but it must be greater than that in row 1. On the assumption that the risks in each firm are similar, we could assign a probability of 1 in 250 (0.4%).

3. The Big Four firms are exposed to risks arising in other parts of their international networks. For example, the collapse of Arthur Andersen in the UK was attributable to events in the US. The Big Four networks operate in around 150 jurisdictions, including many that might be regarded as “high risk” for reasons of financial crime or tax avoidance. Although it may be possible for the Big Four to prevent issues arising elsewhere from triggering the failure of their UK audit practice, the probability of any one of them failing in the UK in the next 12 months because of a problem arising anywhere in their global audit practices must be greater than that in row 2. For illustrative purposes, let’s assign a probability of 1 in 100 (1%).

4. The Big Four are exposed to risks arising in service lines other than audit. These are the wide range of financial, regulatory and reputational risks arising from their provision of consultancy, tax and transaction advisory services. Indeed, as the firms continue to expand their services, it is arguable that the risks will increase as their ability to manage them may be stretched. So, the probability of any of the Big Four firms in the UK failing in the next 12 months attributable to a problem anywhere in the world from any one of their service lines must be greater than that in row 3. Let’s assign a probability of 1 in 20 (5%).

5. So far, we have only considered the probability of a firm failing in the next 12 months, but the probability of an event is influenced by the duration of exposure to its consequences. The dominant position of the Big Four has existed for many years and, based on current public policies, there is little reason to believe that it will not continue for, say, the next five years. This means the probability of any of them failing in the UK in the next five years, attributable to a problem arising anywhere in the world from any of their service lines, must be greater than that in row 4. Let’s assign a probability of 1 in 10 (10%).

6. Indeed, on current public policies, the duration of Big Four dominance is likely to extend well beyond the next five years – perhaps for 25 years. So, the probability of any of them failing in the UK in the next 25 years, attributable to a problem anywhere in the world from any of their audit practices and other service lines, must be greater than that in row 5. Let’s assign a probability of 1-in-2 (50%) to such an event.

As there is, of course, no reliable basis for estimating the probability of the events described in the table, the absolute values provided must be regarded with caution. However, the progressive nature of the trend of probabilities does feel intuitively correct.

And it would be unwise for public authorities to operate on the basis that Murphy’s Law (‘if anything can go wrong it will do so’) does not apply to the audit market. What probability would have been assigned on 1 January 2001 to the collapse of Arthur Andersen in the UK later that year? During 2001 the probability of collapse of that firm went from “extremely low” to “inevitable” with only a short pause in “possible”.

As regards impact, the scope of the CMA’s study is the market for statutory audits (under the Companies Acts) in the UK of large companies, both listed and private, and public interest entities (PIEs) – i.e., companies traded on a regulated market, credit institutions such as...
banks and building societies and insurance companies. However, it is worth noting that the Big Four firms also have large shares of the market for other services in which there is a public interest. Examples include the provision of audit or assurance of financial information supplied to financial services regulators, the audit of the financial statements of local government and health service organisations, the review of prospectuses and profit forecasts, and the provision of insolvency services. The large collective share means that the issues of choice and lack of resilience are relevant to those markets: the demise of a Big Four firm would have a much wider impact than just in the market for statutory audit services.

A further illustration as to why the impact of a Big Four firm’s collapse may be greater than acknowledged by the CMA relates to timing. Finagle’s corollary to Murphy’s Law states: ‘Anything that can go wrong, will do so – at the worst possible moment.’ The most popular financial year-end for FTSE 350 companies is 31 December and most of their audits are completed by the end of March. The collapse of a Big Four firm in the period from, say, November to March could leave many companies in the position where they face an even more limited choice of audit firms – they may simply be unable to find one that could complete their audit within the normal reporting calendar.

It is also worth noting that while an audit failure affecting an individual company is undesirable, its consequences are typically not spread across the economy. The collapse of any of the Big Four would cause a much greater level of detriment across a wide spectrum of the economy. The CMA acknowledges that the current range of regulatory tools is inadequate to deal with an audit firm in trouble. Things can move quickly, as in the case of Arthur Andersen, and a ‘run on the firm’ (by clients, partners and staff) may prove impossible to stop.

The public policy question is: what is the appropriate risk appetite for the collapse of a Big Four audit firm? This is a matter of judgment on which reasonable, informed commentators might differ. In my view, given the combination of non-zero probability of failure, widespread potential impact and the current absence of effective regulatory tools for dealing with the consequences, the risks are well outside what I would regard as a reasonable risk appetite.

The current position might be described as one in which the Big Four firms are both too big to fail and too complex to save. In the light of this assessment, my view is that the risks arising from a lack of resilience in the FTSE 350 audit market are even greater than those arising from audit quality failures. So, it is essential that the remedies are focused at least as much on resilience as on quality.

Structure and culture of audit firms pose a threat to audit quality

The CMA’s finding: It has established that non-audit services are very important to audit firms:

- A substantial majority of audit firms’ revenue comes from non-audit services – around 80% for the Big Four and around 70% for the challengers.
- In recent years non-audit revenue has been growing faster than audit revenue for both categories of firm.
- Non-audit services are more profitable than audit services, which are in aggregate profitable although the CMA has redacted the figures showing the profit margins.

These findings illustrate that the phrase “audit firms” is something of a misnomer.

The CMA has concluded that the selling of non-audit services to individual audit clients gives rise to limited concern about conflicts of interest. This is because tightened restrictions on cross-selling have led to a significant decline in the proportion of revenue from audit clients derived from non-audit services. Ironically, the risk of conflict increases as the date for mandatory rotation of auditors (a public policy intervention designed to enhance auditor independence) approaches.

The CMA found limited evidence to support concerns about cross-subsidy between audit and non-audit services.
services. However, it has concluded that the increasing importance of non-audit services “may impact on the firms’ culture, values and professionalism in ways that are detrimental to audit quality… 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” (paragraph 3.176). It also notes: “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 the wider public, rather than for the client itself” (paragraph 3.182). The CMA expects that these tensions will increase.

Observations on the finding: I support the finding.

The FRC’s AQR reviews and enforcement cases show that fundamental technical or ethical errors were being made in the course of audits by all the major firms, including the challengers. This suggests there may be a broader cultural problem, which could be driven by a number of factors, such as pressure to maintain or increase profit-per-partner – a key performance metric. The fact that margins on audit work are generally lower than margins on other service lines may increase the threat to audit quality.

However, as is discussed below, the remedy proposed by the CMA is only one, and possibly not the optimal, way of addressing this issue.

Overall conclusions on the CMA’s findings

The CMA has done a good job in demonstrating that there are significant problems in the market for audit services, albeit these have already been well-documented and understood over the past two decades. My overall conclusions with regard to the findings, which underpin the three main problems in the market, are as follows:

- **Audit quality**: I agree that the incidence of poor-quality audit is too widespread to be dismissed as isolated incidents, but I disagree with the assessment that a significant portion of the responsibility lies at the door of audit committee members.

- **Choice**: I agree that there is insufficient choice in the FTSE 350 market, but I think that the CMA has failed to attach sufficient weight to one of the major factors contributing to the lack of choice, namely the barriers to entry of new firms into the market.

- **Resilience**: I agree that there is a problem with regard to the lack of resilience in the market, but I think that the CMA has under-estimated the significance of the problem.

Given the vital role that audit services play in the economy, not just in relation to the capital markets but across a much broader range of activities, it would be unwise to leave these issues unaddressed – something must indeed be done. However, the fact that I do not fully agree with the CMA’s findings has a bearing on my assessment of its package of remedies, which is the focus of the next section.
Chapter 3: Assessment of the CMA’s proposed remedies

The CMA has proposed a package of six remedies to improve the functioning of the market:

1. regulatory scrutiny of audit committees;
2. mandatory joint audit, or (2A) a market share cap;
3. additional measures to support challenger firms;
4. a market resilience regime;
5. splitting audit from non-audit services (full structural or operational); and
6. peer review.

The proposed remedies should be assessed against the following criteria: Do they address the underlying concerns identified? Can they be implemented, monitored and enforced effectively? Are they proportionate to the scale of the issue? What are the potential risks and unintended consequences?

Remedy 1: Regulatory scrutiny of audit committees

The CMA concludes that audit committees do not have adequate regard to the interests of shareholders in the way they select and oversee the work of external auditors. It considered removing these functions from audit committees and transferring them to an independent body. While it believed this to be an attractive option, it decided against it because of widespread opposition from shareholders and concern that it might be inconsistent with EU law.

Instead, the CMA has proposed “strong regulation of Audit Committees” to ensure that they fully protect the interests of shareholders when making decisions about external auditors.

This remedy would have two requirements. The first is that audit committees report directly to the regulator before, during and after a tender selection process. A representative from the regulator may sit as an observer at committee meetings. The committee would be required to demonstrate that it:

• prioritised independence and challenge in the tender assessment;
• made its decisions independently of management;
• managed conflicts of interest to maximise choice at the time of the tender; and
• gave fair consideration to challenger firms.

The second is that audit committees report directly to the regulator throughout the audit engagement. Committees would be required to:

• demonstrate that they had made meaningful interventions to assess audit quality; and
• provide the regulator with an account of material disagreements between the auditors and management and what it had done in relation to these.

The regulator would be able to issue public reprimands or direct statements to shareholders, if it was not satisfied that a committee had followed proper procedures.

In support of the proposed remedy, the CMA notes that “even a few Audit Committees falling short in meeting their obligations is too many” (paragraph 4.22).

Assessment of this remedy: In my opinion this remedy is unlikely to be effective, is disproportionate, involves a significant extension of regulation and risks considerable unintended consequences:
1. The premise is that audit committees cannot be trusted to act in the best interests of shareholders when it comes to the selection and oversight of auditors. If true, this assertion would have much wider implications. Boards make many decisions with an impact on shareholders, including ones with a much greater impact than those related to auditors. Examples include the recruitment and dismissal of the CEO, whether to accept a takeover offer, whether to make an acquisition or to enter a new market. In making their decisions, directors have statutory duties with regard to the interests of shareholders and other stakeholders, and they face public and private legal risks if they disregard those duties.

Is it the view of the CMA that directors cannot be trusted to act in the interests of shareholders when they make those bigger decisions? If that were to be the case, then the entire regime of corporate governance would be called into question.

In my experience, the suggestion that company directors do not base their decisions primarily on what is in the interests of the shareholders, having regard to their duties to other stakeholders, is unfounded. Yes, it would be easy to point to certain decisions whose wisdom could be challenged, but it would be completely disproportionate to adopt a working assumption that directors cannot be trusted to act in shareholders’ interests.

2. The CMA has given insufficient weight to the incentives for audit committee members to seek high quality audits. As members of the board, they have legal obligations to make sure that the financial statements give a true and fair view and meet the relevant disclosure requirements. In deciding whether to approve the financial statements, the directors will want to know that the auditors are content to give an unqualified audit opinion. Although there may be a few examples of companies where non-executive directors have colluded with management in publishing misleading financial statements, in the majority of cases these directors are victims of poor audit quality. The publication of inappropriate financial statements causes a host of difficulties for the non-executives.

3. If an audit committee is tempted to make an auditor-related decision not motivated by audit quality, I do not believe that a requirement to report to a regulator, or having a regulator in the room, will prevent this. It is more likely that the “real” decisions and discussions will be moved to another meeting, at which the regulator is not present. The formal meeting will be stage-managed to avoid arousing regulatory suspicion.

4. The proposal to apply this remedy to all large companies, with the objective of changing the behaviour of a small number that might make inappropriate decisions, is disproportionate. The CMA's statement that “even a few Audit Committees falling short in meeting their obligations is too many” is not an appropriate risk appetite for a public authority. The aim of achieving zero failures is unachievable and any attempt to do so will impose disproportionate costs.

5. The proposal risks blurring the accountability of audit committees for auditor selection and oversight. If the involvement of the regulator is to make any difference, presumably there will be occasions on which audit committee preferences will be altered as a result of regulatory intervention. This will blur accountability. If it is not envisaged that these occasions will occur, then what is the point of having the regulator involved?

6. The impact of inappropriate or ineffective behaviour of audit committees on problems in the audit market is minimal relative to other factors affecting audit quality. As the CMA has clearly demonstrated in its study, a substantial number of audit committees face limited or no choice when it comes to auditor selection. The much more important priority is to give committees a larger number of credible and independent firms from which to choose. This would make it much easier to give greater weight to audit quality in selection decisions.

7. The proposed power for the regulator to issue a public reprimand is based on a belief that the judgment of the regulator is superior to that of audit committees. This is, in my view, incorrect. Auditor-related decisions are
complex and can be affected by many factors, some of which involve discussions in fora other than the audit committee. It is not likely that the staff working for the regulator will be more knowledgeable and experienced than the company directors.

8. The issuance of a public reprimand of an audit committee could have a substantial impact on the company and the personal reputations of committee members. Such a reprimand could only be issued after extensive due process, since the decisions are judgmental rather than objective. The number of occasions on which such reprimands might be issued is likely to be very low, further reducing the impact of the remedy on audit quality.

9. A potential unintended consequence of this remedy is to reduce the willingness of talented individuals to join boards or to serve on audit committees. Some potentially good directors might decline to take up roles that expose them to the risk of potential reprimand by a regulator.

It is surprising that the CMA’s first proposed remedy for the problem of lack of choice and competition in the audit market should be costly, intrusive – and probably ineffective – regulation of the clients, rather than of the auditors.

A more appropriate remedy would be a continuation of the trend to require greater transparency from audit committees on their efforts to ensure that the auditors are effective. The effectiveness of this alternative would be enhanced if there were a greater level of shareholder interest in matters relating to audit quality, similar to their interest in executive remuneration. The CMA should recommend that the FRC’s successor body should reflect the expectation of greater shareholder interest in audit matters in the revised Stewardship Code.

Remedy 2: Mandatory joint audits

The CMA has concluded that the barriers facing challenger firms in bidding to audit large companies would be reduced by either requiring companies to appoint two audit firms or by imposing a market share cap on the Big Four firms, individually or in aggregate. The CMA’s preference is for joint audits. It appears to believe that the most appropriate way to shift the “push-me-pull-you” beast is intervention at the companies’ end. They would be required to appoint two audit firms, rather than one, to sign off on their financial statements. The update paper leaves open a number of potentially important design questions, such as:

- Should the remedy be applied to all large companies, or are some (e.g. investment trusts) too difficult to divide between two firms?
- Should companies be free to choose any two firms, or should they be incentivised or required to ensure that at least one is a challenger?
- If companies were required to appoint at least one challenger firm, would certain entities (e.g. banks) be permitted to appoint only from the Big Four on the grounds that the challengers do not have the necessary skills?
- How should the minimum allocation of work to the smaller of the two firms be determined?
- Over what timescale should the remedy be phased in, given that smaller firms would need time to build up their capacity and capabilities?

The imposition of mandatory joint audits would be a major change. The CMA has considered some of the implications and concluded as follows:

Impact on choice: The CMA acknowledges that it “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” (paragraph 4.47). In France, where joint audit is mandatory, there is no obligation for one of the joint auditors to be a challenger firm. The largest companies tend to appoint two Big Four firms, although a significant minority have one Big Four and one challenger firm (Mazars, which is headquartered in France, is well established). The CMA notes that joint audit would increase competition from challenger firms only “if joint audit work enabled these firms to acquire the capabilities and reputation to make them compete
for the role of ‘lead’ joint auditor”. If they remain confined to a ‘junior’ role, competition for the largest audits would remain restricted to the Big Four. The CMA paper does not explain the mechanism by which the former outcome is to be achieved.

Regarding the impact on competition between the Big Four, it acknowledges that:

- if the remedy mandates that one of the auditors must be a challenger firm, there is no change in competition between the Big Four; and

- if the remedy does not require the inclusion of a challenger firm, competition between the Big Four would actually be reduced.

Only in a later section of the paper (paragraph 4.60) does the CMA note that having two auditors would reduce the choice of new ones when a company has to replace its auditors, as two firms would be excluded from the tender. This problem would be particularly acute if the company believed that only the Big Four firms were appropriate, given the scale and complexity of its operations.

Impact on resilience: The CMA believes that the remedy would increase the size of the challenger firms, which would enhance market resilience by making it easier for them to attract senior staff and induce large companies to choose them as auditors. But there is a potential adverse effect on the resilience of the market if joint audit by two Big Four firms is permitted. This would give them even more audit clients, and a larger number of companies would be directly affected if one of the Big Four exited the market.

Impact on audit quality: The CMA received a large number of representations on the impact of joint audit on audit quality, but there was no consensus. It notes that “the literature has not established a clear link [in either direction] between mandatory joint audit and audit quality”. Nonetheless, the CMA concludes: “We…expect that…mandatory joint audit…would not lead to a reduction in audit quality and may result in higher quality through creating incentives for greater professional scepticism.”

Impact on audit fees: The CMA paper notes that the remedy would increase audit fees, probably by around 20%.

Assessment of this remedy: The most important open question is whether the design of the remedy should mandate that the audit pairs include a non-Big Four firm. The CMA’s stated aim is “to reduce the barriers to auditing large companies faced by the challenger firms”. This focus is confirmed by the statement that “we expect that the remedy would lead to a significant increase in the size of some challenger firms”.

In the light of this, it is surprising that the CMA regards mandatory inclusion of a non-Big Four firm as an open question. The introduction of mandatory joint audit permitting the appointment of two Big Four firms would have the effect of increasing their size (and the gap between them and the challengers), especially given the preference of FTSE 350 audit committees to choose Big Four firms. So, I assume that the CMA will conclude that the remedy must mandate the inclusion of a non-Big Four firm.

Where would this leave companies for which the challenger firms may not have the required skills? In addition to banks, examples that readily come to mind include insurers, companies utilising complex commodity, currency or interest-rate hedging strategies as part of their risk management, and those with extensive international operations.

There will be considerable scope for debate as to which companies fall into this category. The CMA’s proposed approach is to permit the appointment of two Big Four firms. But, bearing in mind the potentially perverse outcome described above, it may revise this and accept that this category of company will not be required to appoint joint auditors. In view of the additional costs to be borne by companies with joint auditors, this is likely to increase the incentives for companies to argue that they fall into the “too complex for joint audit” category.

The main implications of this remedy would be to impose additional burdens, while the emergence of the hoped-for benefits would be highly uncertain.
The main burdens would be:

- increased audit fees, since both audit firms would need to do enough work to take full responsibility for the audit opinion;
- increased costs of managing the rotation of the joint auditors across the company, especially as the CMA envisages regular changes in the allocation of audit procedures between them;
- increased audit tender costs. The CMA has proposed that the two auditors be appointed in different years with unmatched appointment periods, so that they would normally leave one at a time under mandatory rotation. This would allow some knowledge and experience to be retained by the remaining firm, but for the company, it doubles the frequency of tenders;
- increased costs of the final stages of the audit through having to work with two audit firms to arrive at an unqualified audit opinion;
- greater complication of the tender process caused by a reduced choice of auditors; and
- increased regulatory fees for the extra tasks of overseeing the introduction of joint audits and determining whether a company qualifies for exemption from this requirement.

The realisation of hoped-for benefits is very uncertain for both supply and demand reasons. On the supply side, the effectiveness of the CMA’s remedy will be dependent on the reaction of the challenger firms. At first glance, one might think that they would jump at the opportunity being presented to them by the CMA, but for the company, it doubles the frequency of tenders.

The challengers will have to reflect on whether they can fund the necessary investment and whether they will see an adequate return on that investment.

Second, the required rate of return will need to reflect the level of risk, including additional exposure to litigation and the enhanced regulatory scrutiny associated with auditing much larger and more complex clients than they have experience of.

A further open question is the reaction of the Big Four firms. The CMA’s hope that mandatory joint audit will give an opportunity for challenger firms to boost their capabilities is dependent on the Big Four’s co-operation. Under joint audit arrangements both firms are jointly liable for the entire audit. The Big Four will have to take a view on their willingness to accept liability for audit work done by challenger firms that, at least in the early years, will not have had much experience of auditing large companies. They will, no doubt, be aware of the results of the FRC’s AQR inspections, which show that the quality of audits undertaken by the challenger firms is lower than that of the Big Four, even though they are auditing smaller and less complex clients.

On the demand side, it remains to be seen how many companies will be able to secure exemption from the requirement to appoint joint auditors. This may, in turn, have an adverse impact on the willingness of the challenger firms to invest. The “push-me-pull-you” beast may well prove to be more stubborn than the CMA hopes.

The appointment of joint auditors is already legally permissible in the UK, but there are almost no examples of it in practice, from which it is reasonable to conclude that companies believe that its potential advantages are outweighed by its disadvantages. For this reason, it would be a major market intervention to make the appointment of joint auditors mandatory.

My overall assessment is that the cost-benefit trade-off of this remedy is unattractive and that it should not be pursued. As with remedy 1, it is surprising that a proposed remedy for lack of choice and competition in the audit market should be costly, intrusive – and potentially ineffective – with the burden falling on the clients rather than the auditors.
Remedy 2A: Cap on market share

Market share caps are proposed as an alternative way of allowing challenger firms to “achieve greater scale and experience, so that in the long term they would become more effective competitors for the audit of large companies” (paragraph 4.64). The CMA notes that the design should take into account several factors:

- Challenger firms should not end up auditing only the smallest of the FTSE 350 companies as those clients “would be unlikely to allow [them] to gain sufficient scale and experience to...compete for the audit of larger companies.”

- Challenger firms need “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.”

- The Big Four should not be allowed to ‘cherry pick’ their clients, leaving the challenger firms to audit less profitable and/or riskier clients.

- Companies should not be allowed to game the system by retendering their audits before this remedy comes into force, thereby avoiding the need to retender for 10 years.

The questions relating to the design of this remedy include:

How should market share be measured? The CMA believes that audit fees are the most relevant measure, but some factors (eg exchange rates) complicate this in practice. Similar difficulties would affect metrics such as the market capitalisation or turnover of clients. In the end, the CMA considers that a cap based on numbers of clients would be easier to implement.

Should the cap apply to the Big Four in aggregate or to individual firms? The CMA prefers individual caps rather than an aggregate cap, in which case the question of whether a Big Four firm was eligible to compete for a new audit would be dependent on the success of the other three.

At what level should the cap be set? The CMA is silent on this.

The CMA has proposed two potential methods of introducing the cap:

1. The Big Four would be set a cap and given a timeframe within which they had to reach it. They would be free to decide which clients to retain or resign from, and which new audits to compete for. This option gives rise to a clear risk of ‘cherry picking’. The CMA notes that this could be mitigated by setting multiple caps for subsets of the FTSE 350. These would be introduced in stages to allow for the evolving capabilities of the challenger firms. Given the complexity, this would “require a regulator overseeing and managing the remedy”.

2. If the ‘cherry picking’ risk was considered particularly serious, the remedy might be designed to prohibit a Big Four firm resigning without the approval of the client and the regulator, designating which specific companies the Big Four firm would be prohibited from bidding for. The CMA notes, however, that these restrictions would increase the incentive for companies to game the remedy by retendering before the cap comes into force. To mitigate this, the regulator would have the power to require certain firms to retender before the end of the currently permitted 10-year period. The CMA acknowledges the potential drawback of segmenting the market into one part reserved for challenger firms and another for the Big Four, which would reduce competition.

The introduction of market share caps would reduce the choice of auditor for companies currently audited by the Big Four (ie nearly all of the FTSE 350) for as long as the Big Four were constrained in their ability to compete for new audits. This might result “in higher fees and/or a reduction in audit quality”.

The CMA notes, however, that 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... the growth of the challenger firms would need to be accompanied by a change in how they are perceived by potential audit clients” (paragraph 4.85).
Assessment of this remedy: Again, significant design decisions are left open in the update paper. And, again, additional burdens would be imposed on companies. The main ones would not be costs but rather:

• reduced choice for firms that would like to appoint a Big Four auditor but are unable to do so;

• a potential reduction in audit quality because it may be difficult for audit committees to assess whether or not a smaller firm has the capacity to deliver a high-quality audit; and

• the involvement of the regulator in decision-making over the appointment of joint auditors is likely to blur the accountability of audit committee members, especially where the committee’s preferences are altered by regulatory intervention.

As in the case of the joint audit remedy, the realisation of the hoped-for benefits is uncertain. Much depends on the response of the challenger firms, which will have to recruit additional skilled and experienced staff. They will need to reflect on whether they will see an adequate return on their investment, bearing in mind the additional litigation and regulatory risks they will be exposed to.

My overall assessment is that this remedy should not be pursued. It has similar drawbacks to remedies 1 and 2, and places burdens on the clients rather than the auditors.

Remedy 3: Additional measures to support challenger firms

An increase in the market share of the challenger firms will necessitate the movement of partners and staff from the Big Four to them. Most of those making submissions on this point believe that there are no significant barriers at present. However, Mazars commented that the remuneration penalties imposed on partners leaving the Big Four can make it harder for a challenger firm to recruit such individuals. The CMA is in favour of a prohibition or limits on the length of non-compete clauses, but is looking for further evidence on the extent of the problem.

It also considered a “tendering fund” to incentivise challenger firms to compete, as well as incentives for the Big Four to share their audit technology with challengers, but did not include these measures in the proposed remedies.

Assessment of this remedy: “Liquidity” in the market for experienced auditors will be essential if there is to be a change in the competitive positions of the firms, and the proposed remedy relating to non-compete clauses is to be welcomed. However, constraints on personnel moves between firms is a minimal contributor to the problems of quality, choice and resilience in the market and so this remedy is unlikely to have much impact.

I think the CMA should reconsider the merits of a tendering fund and of sharing the Big Four’s technology. At the margin, they could be helpful.

Remedy 4: Market resilience regime

In certain sectors, there are mechanisms in place to ensure the continuity of services regarded as vital to the economy or citizens (e.g. banking, care homes). Although the CMA regards the audit sector as playing a vital role in the economy, there are, at present, no such arrangements in place.

Its proposed remedy aims to ensure that the audit clients of a failing Big Four firm are not transferred to another Big Four firm. The design of such a remedy would be complex and raises important issues, which include (paragraph 4.110):

• What should the regulator do if partners and clients of a distressed Big Four firm start to leave for another Big Four firm before the distressed firm files for insolvency? The CMA’s provisional view is that the regulator could incentivise or mandate the movement of clients and staff to challenger firms.

• How best to prevent excessive risk-taking in firms in the expectation that they would be ‘bailed out’? The CMA’s provisional view is that partners should only be able to withdraw equity with the approval of the regulator.
• What powers should the regulator and/or a special administrator be given and at what point should they be able to exercise executive control of a firm? The CMA’s provisional view is that the regulator would be well placed to keep the market under review and to incentivise staff and clients not to transfer to another Big Four firm, or to appoint a special administrator.

Assessment of this remedy: I am supportive of this remedy and think it should be developed further. Helpful lessons can be drawn from financial services regulation, where there is a distinction between conduct of business regulation and prudential (or safety and soundness) regulation.

Conduct of business regulation is concerned with customer outcomes: do they receive products and services that meet their requirements? The regulator sets the rules, monitors compliance and makes interventions, including enforcement action.

The broad equivalent in the audit market is audit quality regulation, which has become more independent and intensive over the years, for instance, through the extension of the FRC’s role in 2004 and EU audit regulation. Sir John Kingman’s review of the FRC (published in December 2018) includes recommendations that would further enhance audit quality regulation.

The aim of prudential regulation has been to protect the resilience of the market and the interests of individual consumers in the event of the collapse of a financial services firm. The prudential regulator also sets rules, monitors compliance, makes interventions and carries out enforcement action. Notably, it has specific duties in relation to failed firms, including the power to “resolve” them.

In the audit market, there has never been any form of prudential regulation. The FRC has taken some tentative steps in this direction since its designation, in 2016, as the competent authority for audit regulation under the latest EU audit directive. But its remit falls well short of a full-scope prudential regulator.

In light of the risks associated with lack of resilience in the market, I believe the CMA should recommend that the remit of the FRC, or its successor body, should be extended to take on prudential responsibilities similar to those of the Prudential Regulation Authority. The objectives would be:

• to ensure that the audit firms are governed and managed in a way that reduces, but does not eliminate, the possibility of an unplanned collapse of the firm; and

• to ensure that arrangements are put in place to ensure that a failing audit firm can be resolved in an orderly way.

The Kingman review has already recommended that the FRC’s successor should have a competition objective similar to that of the FCA. The interaction of prudential objectives with the competition objective would require further consideration.

Remedy 5: Full or operational split of audit firms

The CMA has concluded that the nature and scale of non-audit services provided by audit firms is culturally inconsistent with the need for scepticism and challenge in the conduct of audits. It also reduces choice of auditors because of restrictions on providing non-audit services to audit clients. The CMA is considering two potential remedies: full structural separation of audit and non-audit services into separate firms, or an operational split of these services within a firm.

Full structural separation

Any audit firm over a certain size would be prohibited from providing non-audit services in the UK, although audit-related services (eg half-year reviews) would still be permitted. Such an audit firm could remain part of a multidisciplinary international network provided there was no common ownership and no subsidies from the network, and no member of the network could provide non-audit services in the UK. The audit-only firms would need to recruit or buy in the non-audit expertise needed for their audits, which would previously have been provided by the non-audit part of the firm.
The CMA received a wide range of views on this option, with the majority being opposed. It believes some of the objections (eg challenges in obtaining non-audit expertise and reduced financial capacity to invest) were overstated and could be overcome. However, it recognises that the measure would impose costs on the audit firms and could have unintended consequences:

- The lack of non-audit expertise from within the multi-disciplinary firm could have a detrimental effect on audit efficiency and, potentially, quality.
- The international networks might break away from the UK audit firm and retain the non-audit services business, harming the quality and standing of the UK audit profession.
- The remedy might be more damaging to challenger firms than to the Big Four.

Assessment of this remedy: The CMA has concluded that this option would be disproportionate relative to other options and should not be pursued. I am supportive of this conclusion.

Operational split of firms

This alternative would have the following features:

- separate boards, CEOs, staff and assets for the audit and non-audit parts of the firms;
- separate profit and pension pools;
- restrictions on partners (but not staff) moving between the two parts of the firm;
- transfer pricing arrangements between the parts; and
- sharing of central operations, systems, branding and international network.

The CMA believes that an operational split has a number of merits (paragraph 4.128). Audit partners’ success would be purely driven by the audit business. The firms would continue to have access to in-house non-audit expertise and the international networks would be unaffected (unless they had global profit sharing). Conflict-of-interest rules relating to non-audit services could be eased, which would increase competition and choice.

However, compared with a full structural separation, an operational split is complex and could be circumvented, thus requiring stringent regulatory oversight. If it did not deliver the intended benefits, the full-split option would be revisited. The CMA regards both these alternatives as preferable to further restrictions on non-audit services, which it believes would further reduce choice.

Assessment of this remedy: I agree that the size and nature of the non-audit services provided by the major “audit” firms result in cultural tensions that may be prejudicial to audit quality. However, I think this remedy is unlikely to be effective and should be replaced by an alternative.

Both the Big Four and challenger firms have adopted multi-disciplinary service lines. I believe that, with one major exception, the multi-disciplinary business model operates in the interests of clients and the audit firms. Specifically, the ability to access the services of specialists who are not primarily engaged in audit work can make a positive contribution to audit quality.

The firms clearly have a multi-disciplinary business model and culture. The range of services provided has expanded over time and is likely to continue to do so. A regulatory intervention seeking to ‘cut across’ this business model is unlikely to be effective.

The CMA recognises that an operational split would be complex to operate and require stringent regulatory oversight. It has been likened by some to the “ring-fencing” arrangements separating UK retail banks from investment banking activities – viewed as “casino banking”. However, there is a clear distinction between the objectives of “ring-fencing” in banking and the operational split envisaged for audit firms.

Bank ring-fencing has a specific financial objective: to ensure that the safety of customers’ deposits is not put at risk by potential losses in investment banking. In the case of splitting audit firms operationally, the objective...
is to achieve cultural change to ensure the sceptical and challenging mindset required to deliver high-quality audits. There is a well-known phrase that “culture eats strategy for breakfast”. If the partners remain owners of the entire firm and service provision continues to cross the audit/non-audit boundary, I think the multi-disciplinary firm culture will eat regulation for breakfast.

A more promising approach would be to accept the multi-disciplinary nature of the firms but to require strengthened management and governance arrangements to reinforce the importance of audit quality. Applicable to the entire firm, these arrangements would be predicated on the need for all partners and staff to acknowledge the public interest nature of audit assignments and to commit to meeting expectations of independence, objectivity and integrity.

This proposal might, understandably, meet with a degree of scepticism, but the values of independence, objectivity and integrity would also serve the firm well in relation to tax, corporate finance and other professional services. It would build on the Audit Firm Governance Code, instigated by the FRC during its work on Choice in the Audit Market in 2006-07. The most recent version was published in 2016. Its principal objectives are very relevant to the CMA’s market study:

• to promote audit quality;

• to help the firm secure its reputation more broadly, including its non-audit business; and

• to reduce the risk of firm failure, which in relation to the largest firms would be of systemic significance.

It would be fair to conclude that the Code has so far been insufficiently effective and would benefit from strengthening. Interestingly, a number of the published responses to the CMA’s December 2018 update report contain proposals for action that could be taken to improve the governance of audit firms. The proposals have come not only from the audit firms but also from institutional investors such as Hermes and Legal & General.

Ideas to strengthen governance arrangements could include:

• increasing the number of independent non-executive directors (INEDs) on the firm’s governing body, possibly to the extent that they constitute a majority;

• extending their role by requiring the establishment of audit and risk committees comprising INEDs only;

• giving the INEDs a specific obligation to have oversight of audit quality; and

• strengthening the independence of the risk, compliance and internal audit functions within the firms.

Companies’ compliance with the UK Corporate Governance Code is designed to be monitored by shareholders, who have the right to vote on key motions (eg appointment of directors, remuneration policy) at annual general meetings. In the case of audit firms, the owners (ie the partners) are also its managers, and so shareholder monitoring is insufficiently effective to protect the public interest. For this reason, the new audit regulator should have responsibility for monitoring and reporting publicly on the implementation of the Audit Firm Governance Code.

**Remedy 6: Peer review**

The CMA has concluded that the regulatory regime should be more effective in making visible the differences in quality between firms. The key objective of this remedy “would be to improve audit quality by introducing an additional, independent quality check” (paragraph 4.140). It proposes that the regulator’s toolkit should include “a peer reviewer who is able to identify underperformance as it happens and whose presence may actually stop any underperformance happening”. The reviewer should be independent, appointed and paid by the regulator, to which they would owe a “duty of care” (paragraph 4.139).
The CMA envisages that the peer reviewer would:

- review the audit file, processes and conduct analytical reviews;
- re-perform audit tests on material, risky areas;
- be incentivised to identify any weaknesses in the audit;
- submit its report to the audit committee and regulator; and
- have its report used by audit committees to challenge the auditors and management before the accounts are signed.

The CMA notes that the role of peer reviewer would be relatively minor. It would not improve choice or resilience as, by itself, it would not give challenger firms enough experience to make them more competitive in audit tenders.

Assessment of this remedy: There is one striking omission from the CMA’s explanation of how this remedy might work in practice: no acknowledgement of the impact it would have on the already limited choice of auditors faced by FTSE 350 firms. It would impose additional burdens on companies, including payment for the review and higher costs in the final stages of the audit due to interaction with the reviewer. As with some of the other remedies, the involvement of the regulator in the appointment of peer reviewers is likely to blur the accountability of audit committees for appointment decisions.

Peer review as envisaged by the CMA might identify poor audit quality in real-time and nip it in the bud, but the additional costs are likely to be significant – even more so if this remedy is implemented alongside mandatory joint audits. This could result in three audit firms reviewing a company’s financial statements before they are published. It is hard to see how this remedy could pass a cost-benefit assessment.

Overall assessment of the proposed remedies

There is a real danger that the package of remedies proposed by the CMA will cause more harm than good. It should, therefore, reconsider its proposals. While all three aspects of the problem – audit quality, choice and market resilience – are important (and to some extent inter-related), it is surprising how much emphasis the CMA has put on quality. Its remit and expertise are as a competition regulator (the clue is in the name), not as a regulator of audit quality.

Some of the remedies directed at quality are either unlikely to achieve their aim or might only do so at disproportionate cost – costs that will ultimately be borne by shareholders for whose benefit audit is intended to operate. The development of proposals directed at raising audit quality, as opposed to enhancing choice and market resilience, is better left to the FRC’s post-Kingman successor.

On choice, it may be the case that in the long-term the proposals will enhance the capabilities of the challenger firms, but the causal connection between the remedies and a significant enhancement is tenuous. The effect could take many years to emerge, during which time there will be less choice in the market. In other words, the problem of lack of choice will be aggravated.

An important point is that the CMA’s proposals involve a substantial increase in the scope and intensity of regulation. This includes requiring the regulator’s staff to make tricky judgements on issues for which company directors, who are likely to be more knowledgeable and experienced, are accountable. For example, remedy 1 involves regulators arriving at real-time views on the quality of decision-making by audit committees. It is surprising the extent to which the CMA has concluded that the problems in the audit market are best addressed by regulating, restricting and imposing further costs on the clients.

My recommendations on the six remedies proposed by the CMA are summarised on the next page.
The CMA has decided against five options:

- breaking the Big Four into smaller audit firms;
- introducing an insurance-based firm;
- creating an NAO-style auditor for private sector auditors;
- further changes to the frequency of auditor tendering or rotation; and
- changes to restrictions on ownership of audit firms.

The CMA explains:

“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.

“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 aim.”

Next steps

The CMA is likely to make recommendations to the government. It says:

- Legislation would be a more effective mechanism for implementing and enforcing the remedies than the limited powers which the CMA has.
- Legislation would enable a broader set of remedies to be implemented, encompassing the CMA’s remit (competition) and other issues (eg regulation).
- Government has an opportunity to consider all market features and potential reforms in parallel (eg the Kingman recommendations).

The CMA could instigate a formal “market investigation”, but it prefers not to “because we see recommendations to the government as a more effective route to implementation”.

---

Summary of recommendations on the CMA’s proposed remedies

<table>
<thead>
<tr>
<th>Description of Remedy</th>
<th>Recommendation</th>
<th>Key reasons</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Regulatory scrutiny of audit committees</td>
<td>Reject and replace with additional transparency by audit committees and additional engagement by shareholders</td>
<td>Unlikely to be effective, is disproportionate and risks considerable unintended consequences</td>
</tr>
<tr>
<td>2 Mandatory joint audit</td>
<td>Reject</td>
<td>Costs significant and certain; benefits uncertain. Trade-off is unattractive</td>
</tr>
<tr>
<td>2A Market share cap</td>
<td>Reject</td>
<td>As with 2, cost:benefit trade-off is unattractive</td>
</tr>
<tr>
<td>3 Additional measures to support challenger firms</td>
<td>Accept and enhance</td>
<td>Potentially useful at the margin but not likely to have significant impact on market structure</td>
</tr>
<tr>
<td>4 Market resilience regime</td>
<td>Accept and enhance</td>
<td>Market resilience risks are very high. A formal prudential regulatory regime is needed for major audit firms</td>
</tr>
<tr>
<td>5 Split between audit and non-audit services: full structural or operational</td>
<td>Reject and replace with enhanced audit firm governance code and monitoring by the regulator</td>
<td>Remedy is targeted at culture but cuts across fundamental multi-disciplinary business model and so unlikely to be effective</td>
</tr>
<tr>
<td>6 Peer review</td>
<td>Reject</td>
<td>May contribute to audit quality but only at disproportionate cost and with significant adverse effect on choice</td>
</tr>
</tbody>
</table>

---

Remedies that the CMA does not propose to take forward

The CMA is likely to make recommendations to the government. It says:

- Legislation would be a more effective mechanism for implementing and enforcing the remedies than the limited powers which the CMA has.
- Legislation would enable a broader set of remedies to be implemented, encompassing the CMA’s remit (competition) and other issues (eg regulation).
- Government has an opportunity to consider all market features and potential reforms in parallel (eg the Kingman recommendations).

The CMA could instigate a formal “market investigation”, but it prefers not to “because we see recommendations to the government as a more effective route to implementation”.

---

CSFI – 73 Leadenhall Market, London EC3V 1LT – Tel: 020 7621 1056 – E-mail: info@csfi.org – Web: www.csfi.org
Chapter 4: Why did the CMA reject liberalisation of audit firm ownership?

I believe that the package of remedies could be improved by reinstating one of the remedies rejected by the CMA: relaxing the restrictions on ownership of audit firms, specifically by allowing audit firms to be majority owned by external shareholders (see Chapter 1). This should be accompanied by additional measures to address potential risks to audit quality.

I would like to make two main points about the way in which the CMA has dealt with this option in its market study.

First, in its ITC document (October 2018), the CMA gave signals that it had attached low importance to this potential measure from the outset. It did not adequately explain either the potential benefits of relaxing the ownership rules or how the potential downsides of such a relaxation might be mitigated.

The relevant section is paragraph 4.26:

“Some stakeholders have suggested that current restrictions requiring most voting rights in audit firms to be held by qualified auditors should be relaxed. This could affect the market in two ways:

a. it could broaden the owners (equity holders) of audit firms, and thus increase the quantum of capital invested in the mid-tiers. The mid-tiers could then invest this capital to take on audits of larger listed companies. However, some stakeholders have highlighted that this measure could risk reducing the independence and objectivity of auditors from commercial pressures; and

b. it could facilitate entry by non-audit firms. We note, however, that these new entrants would still face regulatory barriers that auditors need to comply with.”

The CMA does not ask a specific question in the consultation about this potential measure, but rather includes it within a general question (Q14). Through the structure of both the ITC and the consultation questions, it is evident that the CMA attaches greater weight to some measures than others. Given this, it is not surprising that respondents to the ITC had less to say about restrictions on ownership than the measures on which specific questions were asked.

This impression is reinforced by the CMA’s comments in the update paper:

“[in the] invitation to comment document, we highlighted the challenges of implementing [this] remedy” (emphasis added) (paragraph 4.157).

Second, in its update paper, the CMA has inappropriately rejected the option of relaxing ownership rules. Its summary of the views of those who responded to the ITC is surprising. Notwithstanding the absence of a specific consultation question on ownership rules, 22 of the 75 published responses commented on the option.

The CMA’s summary of the responses is as follows (paragraph 4.157):

“In general stakeholders who responded to our document did not support this remedy” (emphasis added).
I have analysed the responses commenting on ownership restrictions and consider that they fall into the categories shown in the table below (the detail underpinning this categorisation is set out in the Appendix):

<table>
<thead>
<tr>
<th>Category</th>
<th>Count</th>
</tr>
</thead>
<tbody>
<tr>
<td>Broadly supportive, even if some reservations</td>
<td>12</td>
</tr>
<tr>
<td>Broadly neutral</td>
<td>5</td>
</tr>
<tr>
<td>Broadly negative</td>
<td>5</td>
</tr>
</tbody>
</table>

Based on my analysis, a fairer summary of the comments received by the CMA would be:

‘A clear majority of the stakeholders who commented on the ownership rules governing audit firms were supportive or neutral, although they did identify some potential downsides that would need to be addressed. A minority believed that the downsides were sufficiently significant that the measure should be rejected, although some of those respondents might be expected to be competitively threatened by the entry into the market of a well-capitalised new firm.’

In addition, the basis for the CMA’s provisional conclusion that “the costs imposed by th[is] reme[d]y would exceed any possible benefit” is questionable given its very brief exploration of the potential benefits and means of mitigating the downsides.

The CMA’s update report describes its decision not to take forward the option of liberalising the ownership rules as a “provisional view”. However, the 27 consultation questions did not include one on whether this “provisional view” was appropriate, so stakeholders might have formed the impression that the decision was actually final rather than provisional. Nevertheless, about 10% of the 90 or so published responses to the update report did refer to the option of encouraging new entrants to the market through wider access to capital – and did so in positive terms.

In addition, some other respondents, while not specifically referring to the ownership rules or access to capital, did remark on the desirability of measures to encourage new entrants and/or the growth of the challenger firms.
Conclusion: Liberalising ownership is the best way to make the audit market work

The CMA has done a good job of demonstrating that there are significant problems in the market for audit services, albeit problems that were already well documented and understood. My overall conclusions with regard to the CMA’s findings are as follows:

- **Audit quality**: I agree that the incidence of poor-quality audit is too widespread to be dismissed as isolated incidents, but I disagree with the level of blame attached to audit committees.

- **Choice**: I agree that there is not enough choice in the FTSE 350 market, but I think that the CMA has failed to attach sufficient weight to one of the major contributory factors: barriers to the entry of new firms into the market.

- **Resilience**: I agree that the lack of market resilience is a problem; indeed, in my view, the CMA has under-estimated the significance of this.

Given the vital role that audit services play in the economy, not just in relation to capital markets but across a broad range of activities, it would be unwise to leave these issues unaddressed. Something must indeed be done. However, there is a real danger that the package of remedies proposed by the CMA will cause more harm than good and it should reconsider them for three main reasons.

First, it is surprising how much emphasis the CMA has put on quality. This is not to understate the importance of this factor, but to point out that the CMA’s remit and expertise are as a competition regulator (the clue is in the name), not as a regulator of audit quality. Some of the remedies directed at quality are either unlikely to achieve their aim or might only do so at disproportionate cost. The development of proposals directed at raising audit quality, as opposed to choice and market resilience, is better left to the FRC’s post-Kingman successor.

Second, on choice, it may be the case that the proposals will enhance the capabilities of the challenger firms in the long-term, but the causal connection is tenuous. Any effect could take many years to emerge. Meanwhile, the problem of lack of choice will be aggravated, which means that resilience will not be bolstered either.

Third, the CMA’s proposals involve a substantial increase in the scope and intensity of regulation. This includes requiring the regulator’s staff to make tricky judgements on issues for which knowledgeable and experienced company directors are accountable. For example, remedy 1 involves regulators judging, in real-time, the quality of decision-making by audit committees. It is surprising the extent to which the CMA has concluded that the solutions to problems in the audit market are best addressed by regulating, restricting and imposing further costs on the clients.

In finalising its proposals to the government, the CMA should reconsider some of its remedies and reinstate the rejected remedy of relaxing the rules on audit firm ownership. Over many decades there has been a one-way ratchet of increasing concentration in the audit market. Liberalisation of the ownership rules has genuine potential to reverse this.

Liberalisation will not, on its own, solve all the problems in the audit market and it may take many years to have a material effect. But opening up the audit market to the forces that have improved market outcomes in other sectors of the UK economy must be a better way forward than a substantial increase in the regulatory burdens on our largest public companies – at a moment in history when the competitiveness of UK companies could be more important than ever.
Appendix

I have analysed the responses that commented on the ownership restrictions and consider that they fall into the following categories:

<table>
<thead>
<tr>
<th>Category</th>
<th>Count</th>
</tr>
</thead>
<tbody>
<tr>
<td>Broadly supportive, even if some reservations</td>
<td>12</td>
</tr>
<tr>
<td>Broadly neutral</td>
<td>5</td>
</tr>
<tr>
<td>Broadly negative</td>
<td>5</td>
</tr>
</tbody>
</table>

In the following extracts from responses to the Invitation to Comment, the comments classified as “broadly supportive” of relaxation of audit firm ownership rules are:

“This is a critical measure in case the CMA recommends the introduction of audit-only firms. Audit-only firms would need capital to build the capacity to be better placed to take on audits of larger listed companies.”

Mr Filip Lyapov

“There could be potential benefit here in terms of increased investment.”

Association of Practising Accountants

“Significant investment is required to help mid-tier firms to scale up their operations to meet the demands of FTSE audits. Audit firms should consider how their business model and ownership structure can be adapted to achieve better access to finance.”

Confederation of British Industry

“To encourage more entrants into the FTSE 350 market, we believe that the CMA should at least explore whether allowing outside capital to invest in audit firms would help bridge the large gap in size.”

Johnston Carmichael

“There would be some merit across the entire profession for such a move, particularly at smaller firms …”

Kreston Reeves

“We think that this is worth considering and we are prepared to discuss potential changes to the current legal requirements on ownership of audit firms.”

PwC

“… this could facilitate new entrants into the audit market (or provide incentive for consolidation of those firms outside the four largest) …”

Deloitte

“There is the potential benefit of increased investment …”

Duncan and Toplis
“Wider ownership structures will not necessarily reduce quality. Quality depends on the governing body of the auditing company.”

Intermediate Capital Group

“Wider ownership structures will not necessarily reduce quality. Quality depends on the governing body of the auditing company.”

Standard Life

“… we believe there is a market resilience issue arising from the partner ownership structure of audit firms and how they are incentivised.”

Legal & General Investment Management

The comments classified as “broadly neutral” are:

“We do not think that the other suggestions such as … relaxing restrictions on audit firms’ outside equity would individually have a significant impact …”

Lloyds Banking Group

“In the longer term could bring investment to support non-Big 4 to grow” but “Will be resisted by the firms.”

Grant Thornton

“It is unclear how this would meet the objectives since it would not change the regulatory barriers.”

Moore Stephens

“It is not without its challenges, and whilst it might enable firms to invest for the future, it might also pose risks to firm culture and behaviours.”

Institute of Chartered Accountants of Scotland

“The IA [Investment Association] is not convinced that changes to the ownership rules would necessarily result in new players entering the audit market.”

Investment Association

The comments described as “broadly negative” are:

“We are particularly concerned that bringing in external investors may create pressures from those investors to prioritise commercial returns over audit quality.”

Association of Chartered Certified Accountants

“We would agree with the comments in the consultative document about the risk to independence and objectivity arising from commercial pressures.”

Chartered Accountants Ireland

“We do not believe this is a relevant causal factor …”

BDO

“KPMG … considers that the complexities … would likely outweigh any benefits of the measure.”

KPMG

“… there would be risks to audit quality in reducing the current requirements requiring most voting rights to be held by qualified auditors.”

Mazars
About the author

Paul Boyle OBE is Chairman of the whistleblowing charity, Protect, and a Non-Executive Director of Mogo Holdings Ltd and of the Government Internal Audit Agency. He is also a Senior Adviser with Alvarez & Marsal.

He retired from Aviva, a global systemically important insurer, in 2017, having been Chief Internal Auditor since 2010 and a member of the Group Executive Committee. In 2016-17, he was President of the Chartered Institute of Internal Auditors (UK & Ireland). He served as Chief Executive of the Financial Reporting Council from 2004 to 2009, prior to which he was Chief Operating Officer of the Financial Services Authority. He has also worked for WH Smith and Cadbury Schweppes in senior finance roles. He qualified as a chartered accountant in 1983 with Coopers & Lybrand.
Supporters

The CSFI is an educational charity. It has no endowment income. It receives financial and other support from a wide range of public and private bodies, as well as from individuals. Among the institutions that have provided the Centre with financial support are:

Accenture  
Arbuthnot  
Citi  
City of London  
Deloitte  
EY  
HSBC  
JPMorgan  

ACCA  
Association of British Insurers  
Aviva  
Bank of England  
Bank of Italy  
Brunswick Group  
Building Societies Association  
Eurex  
Eversheds  
Financial Conduct Authority  
Financial Reporting Council  
Fujitsu  
FTI Consulting  
Gate One  
ICMA  
IHS Markit  
Investment Association  
Japan Post Bank  

Absolute Strategy  
AFME  
Association of Corporate Treasurers  
Bank of Japan  
Brigade Electronics  
Chartered Banker Institute  
C. Hoare & Co.  
CISI  
CMS  
Cognito Media  
EBRD  
Embassy of Switzerland  
Endava  
ETF Securities  
Euro IRP  
EVIA  
Fairbanking Foundation  
Farrer & Co  
Finance & Leasing Association  

London Stock Exchange Group  
Moody’s  
PwC  
Royal Bank of Scotland  
Ruffer  
Swiss Re  
Tradeweb  

Jersey Finance  
KPMG  
Legal & General  
LendInvest  
Lloyds Banking Group  
Meiji Yasuda  
Morgan Stanley  
Nomura Institute  
Orrick  
Oxera Consulting  
PIMFA  
Schroders  
The Share Centre  
Triple Point  
UK Finance  
Wipro  
World Federation of Exchanges  

Greentarget  
Hardman & Co.  
HM Treasury  
Intrinsic Value Investors  
Ipsos MORI  
Kreib Gavin Anderson  
MacDougall Auctions  
Meritus Consultants  
Money Advice Service  
NM Rothschild  
Nutmeg  
OMFIF  
Raines & Co  
Sapience Communications  
Skadden, Arps, Slate Meagher & Flom  
Taiwan Financial Supervisory Commission  
TheCityUK  
Zopa  
Z/Yen  

The CSFI has also received support in kind from, *inter alia*

Allen & Overy  
Burges Salmon  
Charles Russell Speechlys  
Clifford Chance  
Dentons  
DLA Piper  

Financial Times  
The London Institute of Banking & Finance  
Kemp Little  
Linklaters  
Norton Rose Fulbright  
Standard Life Aberdeen