

Statutory audit market

Invitation to comment
9 October 2018

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1. Summary

- 1.1 Most people will never read an auditor's opinion on a company's accounts. But often without realising it, tens of millions of ordinary people depend in some way on independent audits to help ensure that companies report truthfully on their performance. Unreliable numbers can lead to the wrong investment decisions, which in turn risk people's jobs, their pensions or their savings. The availability of trustworthy financial information on the performance of companies is important to providing the confidence that is necessary for the proper functioning of a market economy.
- 1.2 Despite all the past efforts of regulators and governments, events such as Carillion's demise and recent poor results from reviews of audit quality have raised concerns over whether audits are delivering what is needed. Similar concerns have been raised in a number of other countries.
- 1.3 We are carrying out a market study to consider whether the market for the provision of statutory audit is working as well as it should. We are focusing on three sets of issues:
 - (a) choice and switching;
 - (b) the long-term resilience of the sector; and
 - (c) the incentives between audited companies, audit firms and investors.
- 1.4 We will focus on what might be the most effective and proportionate remedies. We will consider a variety of ideas, but will look particularly at three groups:
 - (a) ideas to improve incentives;
 - (b) further separating audit and non-audit services; and
 - (c) reducing barriers to entry and expansion of non-Big Four firms.
- 1.5 Regulation and competition should work hand in hand to deliver quality; we therefore look forward to working closely with Sir John Kingman as he concludes the independent review of the Financial Reporting Council (FRC). We are also aware of planned work by the accounting profession to consider 'the future of audit', and would encourage it to consider issues around the audit framework – the internationally-agreed scope and purpose of an audit.
- 1.6 Given considerable past work by the CMA and our predecessor, the Competition Commission, we intend to consult on provisional views by the end of the year and complete our work as soon as possible thereafter.

2. Background

2.1 In this section we set out the context for our market study. This includes details of the statutory audit market, relevant work by our predecessor bodies, and recent developments that have prompted us to look again at this market.

Role of audit and overview of statutory audit market in the UK

2.2 All companies in the UK are required, under the Companies Act, to have their annual accounts audited externally, unless exempt.¹ There are many audit firms in the UK that can carry out these statutory audits, but few such auditors currently audit the largest publicly listed companies, including those listed on the FTSE 350.²

2.3 The large auditors in the UK are part of similarly branded international networks of audit firms. Audit firms in these networks are experienced at working together to provide international firms with a seamless audit across borders, so a company may only need to appoint one auditor for its global business.

2.4 In the UK, 97% of audits of FTSE 350 firms are undertaken by the Big Four auditors, which are PricewaterhouseCoopers (PwC), KPMG, Ernst & Young (EY) and Deloitte.³ While there are many smaller audit firms that carry out audits for unlisted and smaller firms, there are several mid-tier auditors, some of which have a small number of clients in the FTSE 350. Mid-tier auditors include Grant Thornton, Mazars, BDO, RSM, and Moore Stephens. Some mid-tier auditors have international networks of firms like the Big Four, although these are more limited.

2.5 There has been consolidation in the audit sector in the last 30 years. Before 1987, there were eight large international audit firms in the UK, and there have been four large auditors since 2002 following Arthur Andersen's demise that year and the merger of Price Waterhouse and Coopers & Lybrand in 1998.

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

² The FTSE 100 and 250 collectively are referred to as the FTSE 350.

³ FRC, Developments in audit in 2016/17.

Competition Commission (CC)'s investigation

- 2.6 Our predecessors, the Office of Fair Trading (OFT) and the Competition Commission (CC), previously examined the statutory audit market. Following its work, the OFT referred the market for statutory audit of large companies to the CC in October 2011 for a market investigation.⁴ The CC reported in October 2013 with an Order that came into force on 1 January 2015.⁵
- 2.7 The CC identified several features of the statutory audit market that were leading to adverse effects on competition. These features were:
- (a) barriers to switching, including company management facing significant opportunity costs in the selection and education of a new auditor, benefits of continuity in the existing relationships, and companies' inability to calculate accurately the benefits of tendering and switching;
 - (b) barriers to entry, expansion and selection of mid-tier audit firms in the FTSE 350 statutory audit market. The mid-tiers faced experience and reputational hurdles which, together with the infrequency and unpredictability of opportunities to tender, affected their incentives;
 - (c) the ability of executive management to influence external auditors in how they conduct and report their audit; and
 - (d) the information asymmetry between shareholders and audit firms, so that shareholders had little information regarding the investigation carried out by the auditor.⁶
- 2.8 In order to address these features of the market, the CC decided on a package of remedies that included the following elements:
- (a) Mandatory tendering of audit contracts. FTSE 350 companies must put their statutory audit engagement out to tender at least every ten years;
 - (b) Greater review of audits. The regulator (the FRC)'s Audit Quality Review (AQR) team should review every audit engagement in the FTSE 350 on average every five years and the AQR team should review and report on the firms in its scope annually;
 - (c) Prohibitions of provisions in loan agreements which restrict a company's choice of auditor;
 - (d) Greater shareholder engagement with company management on matters relating to audit;

⁴ Larger companies were defined as members of the FTSE 100 and 250 indices.

⁵ [CMA case page for statutory audit services market investigation](#).

⁶ [Statutory audit services for large companies market investigation](#), 15 October 2013, p16.

- (e) Greater accountability of auditors to audit committees and extended reporting for audit committees; and
- (f) A recommendation for the FRC to have a competition objective.⁷

2.9 The CC expected this package of measures to lead to greater competition to win audit mandates, particularly between the Big Four, and an increase in audit quality. As part of this package of remedies, the CC also aimed to expand choice by improving the position of mid-tier auditors – the tendering remedy provides a more frequent opportunity for mid-tier firms to be included in bids for larger audits, and the loan agreements remedy sought to remove some of the reputational barriers to entry, expansion and selection for mid-tier auditors.

Developments since the CC’s investigation

2.10 During 2010, the European Commission began consideration of potential legislative change to address concerns in the audit markets in the EU that closely mirrored the concerns in the UK. The OFT liaised closely with the Commission on this work. The CC’s analysis of the audit market fed into the debate in the EU. The resulting legislative change in the EU, which came into force in April 2014, closely mirrored the remedies implemented in the UK, with the addition of mandatory switching of audit contracts every 20 years.

2.11 Following the CC’s investigation, there has been work to implement the remedies, align them with EU and UK legislation, and assess their impact, as well as work by the FRC to improve audit quality.

2.12 At the same time, there have been ongoing concerns about the market. These concerns have intensified over the last year following the linking of high-profile business failures to audits conducted by the Big Four. In turn this has resulted in calls for the CMA to investigate the statutory audit market, including most recently by the Secretary of State for Business, Energy and Industrial Strategy.

2.13 The evidence available to us indicates that, despite having had only three years in force, the CC remedies have generated some positive change in the operation of the audit market, with increases in both tendering of audit contracts and switching. Alongside this, the FRC has reported broad increases in quality, albeit sampling means we should be cautious in interpreting a trend over time. The overall proportion of a sample of audits deemed ‘good or only requiring limited improvements’ via Audit Quality

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

Reviews (AQRs) was 58% in 2012/13, rising to 77% in 2016/17. However, in its most recent AQR, there was a decline for all of the Big Four, and an “unacceptable deterioration” at KPMG, while the four mid-tier firms reviewed showed “general improvements”.⁸

- 2.14 We have also seen greater rivalry in some sectors with more of the Big Four competing for clients in areas where they did not previously – for example in banking where all Big Four auditors now have FTSE 350 clients, compared to three previously. Other sectors which now seem to have more choice of auditors include food and drug retailers,⁹ construction and materials and healthcare equipment and services.
- 2.15 However, the CC’s remedies do not appear to have helped mid-tier firms to expand their presence in auditing FTSE 350 companies, with the proportion of FTSE 350 audits undertaken by Big Four auditors increasing slightly from 95% at the time of the CC report to 97%.¹⁰ In fact, one of the main mid-tier firms, Grant Thornton, announced publicly in March 2018 that it would no longer bid for audit contracts at FTSE 350 companies.¹¹

The collapse of Carillion and BHS

- 2.16 In early 2018, Carillion, a British multinational facilities management and construction services company, went into liquidation. This collapse led to project shutdowns and delays, job losses, and financial losses, including to Carillion’s 30,000 suppliers, generating widespread public and political concerns. These concerns resulted in parliamentary inquiries including into the conduct of Carillion’s management, its auditors and the role of the FRC. Similar concerns about auditors were raised following the high-profile liquidation of the retailer, British Home Stores (BHS), in 2016.

Public comments on the audit sector, and other reviews

- 2.17 Since the collapse of Carillion, there have been various calls for further review of the statutory audit market. Some other reviews are also under way.
- 2.18 In early 2018, Stephen Haddrill, Chief Executive Officer of the FRC, stated that “there should be more competition in the major accounting and audit area” and called for the CMA to look at the sector again.¹² Subsequently other commentators and media have suggested that an investigation of the audit

⁸ FRC, [Big Four Audit Quality Review results decline](#), 18 June 2018.

⁹ In 2014, only PwC and Deloitte audited these, now all four do.

¹⁰ FRC, [Developments in audit in 2016/17](#).

¹¹ [Grant Thornton exits audit market for big UK companies](#), Financial Times, 29 March 2018.

¹² [Probe urged into break-up of Big Four accountants](#), Financial Times, 16 March 2018.

sector would be valuable. Some of these, including the Rt. Hon Sir Vince Cable MP, have sought the break-up of the Big Four auditors as the outcome. In May, the Joint Select Committees investigating the collapse of Carillion stated that:

“Waiting for a more competitive market that promotes quality and trust in audits has failed. It is time for a radically different approach. We recommend that the Government refers the statutory audit market to the Competition and Markets Authority. The terms of reference of that review should explicitly include consideration of both breaking up the Big Four into more audit firms, and detaching audit arms from those providing other professional services.”¹³

2.19 Most recently, the Secretary of State for Business, Energy and Industrial Strategy has asked the CMA to consider looking again at what can be done to improve the audit sector. He was quoted as saying: “there are questions about the competitiveness of the market and there are questions about conflicts of interests.”¹⁴

2.20 The various public comments reflect concerns about the following issues:

- (a) the regulatory oversight of the audit sector (including perceived problems with the quality or role of statutory audit and whether the FRC’s structure and role is appropriate); and
- (b) a lack of choice of auditor, conflicts of interest and resilience of the market (including the unwillingness of larger corporates to appoint the mid-tier auditors combined with formal conflicts of interest among the big four and concerns about whether the Big Four are now ‘too big to fail’).

2.21 In light of these concerns, some reviews are now under way or being considered.¹⁵

- (a) An independent review of the FRC led by Sir John Kingman.¹⁶ This is examining the structure and governance of the FRC including its standard setting, investigative and regulatory roles. The review is expected to complete by the end of 2018.

¹³ [Joint report into Carillion.](#)

¹⁴ [UK to press for shake-up of Big Four auditors](#), The Financial Times, 29 September 2018.

¹⁵ The Labour Party announced on 20 May that it is “commissioning an independent review of the entire corporate auditing and accounting regime”. Labour’s review of the industry will be led by Prem Sikka, professor of accounting and finance at the University of Sheffield.

¹⁶ [FRC Review 2018.](#)

(b) A possible review of the ‘future of audit’, organised through the Audit Quality Forum and the Institute for Chartered Accountants in England and Wales (ICAEW).¹⁷

2.22 Alongside these broader reviews into the sector, the FRC is conducting an investigation into the audit of Carillion. This will focus on whether KPMG breached audit standards. Following BHS’s failure, the FRC investigated PwC in relation to its audit for the retailer. The FRC is also investigating KPMG’s audit of Conviviality, a failed drinks wholesaler, and has accused Deloitte of misconduct over its audit of Autonomy.

Audit market outcomes

2.23 Widespread public concerns indicate that the audit sector is not meeting expectations. A well-functioning market should deliver good outcomes for both businesses and their shareholders, and also other stakeholders with an interest in audits.

2.24 Most of the concerns focus on audit quality rather than price. This is indicated by the AQR results referred to above, as well as by the high-profile cases where audits have been judged to have fallen short – Carillion and BHS,^{18,19} but also others such as KPMG’s audit of Ted Baker.²⁰

2.25 Unlike in some markets where there are concerns over whether the market is working well, there seem to be few complaints here that prices are too high. Indeed quite the opposite; we have heard views that there might be merit in prices being higher in order to secure higher quality. Separately we have heard from some mid-tier firms that the links between audit and non-audit services of the Big Four firms may make it difficult for mid-tier auditors to win audit contracts with FTSE 350 clients if the Big Four price their statutory audit offer relatively low.

2.26 Another aspect of stakeholder views of quality manifests in what is known as the ‘expectation gap’. Stakeholders’ expectations of statutory audit may differ from what it is required to provide by law. Sources of this gap may include expectations some stakeholders have of auditors in providing assurance on the business’s future viability.

¹⁷This review has been reported by the media e.g. The Times, ‘No one wants to chair ‘toxic’ Project Flora audit review’, 25 June 2018.

¹⁸ BEIS and DWP Select Committee report, Carillion, 16 May 2018.

¹⁹ FRC, Particulars of fact and misconduct, 10 August 2018.

²⁰ <https://www.frc.org.uk/news/august-2018/sanctions-against-kpmg-and-senior-statutory-audito>

2.27 In the next section we discuss five themes as a way to structure our analysis of the audit market. Our summary of the issues in Section 3 and of ideas to resolve them in Section 4 builds on the CC's work, and on a number of informal discussions we have had with interested parties in recent months.

3. Themes we propose to investigate

- 3.1 In this section, we outline the themes we plan to explore, as a way of structuring our analysis of the concerns that we have heard, drawing on the background discussed above, the CC's market investigation and subsequent developments.
- 3.2 We first set out some key characteristics of audit that affect how the market works. We then describe each of our themes in turn.

Characteristics of the audit market

- 3.3 The way audits are delivered is a function of the particular characteristics of the sector. These characteristics frame the themes that we plan to explore in our study.
- 3.4 The demand for independent external audit arises from shareholders' need for reliable information about the performance of companies that they invest in. Shareholders do not know as much about the financial health of a company as the firm's managers – a problem sometimes referred to as 'asymmetric information'. Audits can help address this problem by providing assurance about the financial results a company presents.
- 3.5 The publication of independently verified company accounts has an economic value beyond the private benefits to the shareholders and the management of a company. The availability of financial information on the performance of companies which users trust is widely perceived to be important to providing the confidence that is necessary for the proper functioning of a market economy.
- 3.6 The way the sector has developed over time reflects a number of key characteristics, many of which follow directly from the underlying purpose of conducting audits.
- 3.7 First, the **audit framework**, largely set at an international level, defines the scope of a statutory audit. This framework has evolved over time, for example recently through the implementation of the EU Audit Regulation and Audit Directive in 2016 which included changes for auditors relating to personal independence and mandatory rotation requirements for public interest entity (PIE) audits. The International Auditing and Assurance Standards Board (IAASB) has also issued refinements to the International Standards of Auditing (ISA), most notably in 2009 following a comprehensive review. The current scope says that the auditor should give an opinion on whether the numbers are a 'true and fair view' of the company, on a 'going concern' basis -

i.e. an expectation that the company will be in business for the following 12 months.

- 3.8 Second, there are a particular set of **incentives** at play, reflecting the relationships between the audited company, the auditor, and shareholders. The information provided by an audit is intended for shareholders, but the auditor is selected and paid by the company, through the audit committee. Company managers' incentives may be for low prices, but shareholders are more likely to want high quality. As well as this apparent misalignment of incentives, shareholders are likely to find it **difficult to judge audit quality**, because quality may take the form of intangibles such as auditor scepticism and challenge of management's opinions.
- 3.9 This sets up a 'principal-agent' problem for shareholders – how do they ensure that audits provide sufficient reassurance on the accuracy of the information about a firm?
- 3.10 Market outcomes are driven by the interplay of competition and regulation. Strong **competition** between audit firms (through periodic tenders for audit contracts) can play an important role in driving good outcomes by giving customers choice and enabling new entry, expansion and innovation. **Regulation** is used to hold auditors to standards of conduct and to soften the effects of the incentives at play; as well as realising the network benefits from common audit standards across companies.
- 3.11 However, while effective regulation is required to ensure that competition is focused on the outcomes that are in stakeholders' interests, there may be trade-offs between the two – for example, increases in regulation might add cost or make it harder for firms to compete. In analysing the sector, we are conscious of the need to strike an appropriate balance between competition and regulation.
- 3.12 There are issues throughout the chain described above, which may in combination undermine quality and / or perceptions of quality. We have identified five themes considering the concerns we have heard from stakeholders so far, the CC's report and our initial view of how the market functions.

Theme 1: The scope and purpose of audit

- 3.13 The scope and purpose of audit is determined by an international framework of rules. This framework sets the standards within which audit firms operate.

- 3.14 In relation to the standards themselves, there has been a broad shift over time from an approach based on historic cost accounting to that based on fair value accounting. The key principle is that assets and liabilities should be valued on market prices, based on the idea this would make the financial statement more 'useful to users'. Some commentators have argued that fair value accounting has led to greater risk because of the difficulty, and subjective nature, of valuing and auditing certain assets and liabilities.²¹
- 3.15 Related to this is what is sometimes known as the 'expectation gap': the difference between what the public and financial statement users believe auditors are responsible for and what auditors' actual responsibilities are.²² Commentary on Carillion in particular suggests that public expectations are for audits to do more to consider risks to the future viability of a company than is provided for in the current standard 'going concern' approach.
- 3.16 Since the accounting framework is in large part determined internationally, and the issues raised go significantly beyond the CMA's focus on the operation of the market, we are not intending to carry out a detailed assessment of these standards and rules.
- 3.17 However, we will be interested to hear views on how the accounting framework impacts on competition and outcomes in the market. We will examine the existing scope of UK and international standards of statutory audit and we will gather views from stakeholders on whether the regulatory scope is delivering or hindering the outcomes that customers and stakeholders in the wider economy expect.

Theme 2: Incentives

- 3.18 Audit is a service for shareholders, but is commissioned by company management. This misalignment of incentives (a 'principal-agent' problem), and its effect on the way audits are procured, has long been recognised, including by the CC in its investigation.
- 3.19 Some of the CC's remedies sought to address this issue, for instance through strengthening audit committees. We want to assess how effective these reforms have been and whether and how these incentive issues continue to affect the way the market works. We will also consider whether the wider public interest in ensuring high quality audit might diverge from shareholders' interests, and what implication this might have for possible market reforms.

²¹ [Reform accounting rules to restore trust in audit](#), Financial Times, 2 August 2018.

²² [KPMG's audit of HBOS shows why the public expects so much more](#), Financial Times, 19 September 2017.

- 3.20 We will gather views from stakeholders on the incentives of different parties in the market and how this affects competition. We will also analyse the impact of the CC's remedies, including strengthening the role of audit committees.
- 3.21 Evidence discussed for the other themes will also be relevant to our assessment including the data on audit quality collected by the FRC's AQR team. We will consider what may drive changes in these measures including change in regulatory oversight. In discussion with the FRC, we will consider both high and low profile regulatory interventions in audit quality.

Theme 3: Choice and switching

- 3.22 Our third theme relates to the process of exercising choice in the audit market and whether it works well to deliver good outcomes including price, quality and innovation for shareholders, and the wider stakeholders in the economy and society. The key question for us is whether a lack of competition and choice means that there is not enough pressure on auditors to provide a good service, leading to worse outcomes in terms of quality, price or lack of innovation.
- 3.23 The CC identified a number of competition issues in the audit market and further issues have been raised with us by stakeholders, which lead us to believe that the market continues not to work well in a number of ways. We will use the CC's analysis as a starting point and focus on understanding what has changed since the CC report. We may also consider wider aspects of competition if these are raised with us. We plan to examine the impact that the CC remedies may have had on competition, to the extent practicable given the relatively short period they have been in place.
- 3.24 Based on the CC's analysis, alongside the developments and views described in the Background section, we expect to focus our analysis on three sets of issues.
- 3.25 First, we will consider whether the market currently delivers **sufficient choice of auditor** for large companies (e.g. FTSE 350 companies) in order to drive effective competition. A lack of choice might stem from several market features:
- (a) The statutory audit market is relatively concentrated. The Big Four auditors accounted for 97% of FTSE 350 audits by volume in 2016/7.²³ While they have consistently accounted for similarly high proportions, this

²³ [FRC, Developments in audit in 2016/17.](#)

reflects a slight increase in concentration by volume.²⁴ On the demand side, we have heard that some large, complex companies believe that their choice is restricted to the Big Four auditors for reasons we explain below.

- (b) The relationship between audit and non-audit activities of the Big Four appears to limit effective choice further. For example, if an audit firm provides extensive non-audit services to a company it could create actual or perceived conflicts of interest if that firm were also to appoint them as auditor. We will explore the extent to which audit market choice has been affected by changes to the FRC's Ethical Standard, which prohibit an auditor from providing some non-audit services.²⁵
- (c) Some companies may be reluctant to choose an auditor that also audits a close competitor, because of perceived conflicts of interest.
- (d) Finally, the CC found that some sectors (such as financial services, pharmaceuticals and oil and gas) may require specialist knowledge which can only be provided by the Big Four firms or a subset thereof.

3.26 Second, we will consider the extent of **demand-side barriers to switching** (particularly to non-Big Four firms) that might reduce the degree of competitive pressure on audit firms. We will focus on assessing whether there have been any changes to the demand-side barriers identified by the CC. The CC found a number of barriers to switching including:

- (a) the majority of audit committee chairs for FTSE 350 companies would not consider a mid-tier firm to be a credible auditor for the scale and complexity of their businesses. In particular, for FTSE 350, or other large companies, with significant international operations, there is a perception that only the Big Four have sufficiently developed international networks to service such accounts.
- (b) audit committees and other aspects of the audit process may be influenced by the involvement of alumni of the Big Four firms, giving rise to a bias in favour of the appointment of Big Four firms.
- (c) the limits on shareholder capacity to appraise auditor performance (even with the audit committee acting on their behalf), having appointed an auditor, reduce their incentive to switch supplier given uncertain benefits.

²⁴ The CC found that the Big Four consistently accounted for 95 per cent in the supply of FTSE 350 audits and over 99 per cent of FTSE 350 audit fees.

²⁵ FRC [Revised Ethical Standard](#), 2016.

- (d) the costs to businesses of switching auditor (including the tender process, loss of relationship, educating the new auditor and uncertainty in the performance of a new auditor) reduce the incentive to switch compared with uncertain benefits.
- 3.27 As part of its remedies package, the CC introduced mandatory tendering of audit contracts. Starting in 2015, FTSE 350 companies must put their statutory audit engagement out to tender at least every ten years; and as a result of EU legislation, companies must rotate auditors at least every 20 years. We will consider the impact of these changes on the demand-side responsiveness of the market.²⁶
- 3.28 Third, we will explore whether **supply side barriers to entry and expansion** limit the degree of competitive pressure faced by the Big Four. As with demand-side barriers, we will focus on what has changed since the CC report, and assess the impact of the CC's remedies so far.
- 3.29 The CC found that mid-tier firms lacked experience of auditing sufficiently large and complex businesses and thus did not have sufficient reputation for their capabilities to convince a FTSE 350 business to award an audit contract.
- 3.30 From what we have heard to date, this does not appear to have changed significantly for the better. For example, Grant Thornton announced earlier this year that it will no longer compete for audit contracts for FTSE 350 firms due to 'market structures' and Big Four dominance, which it claimed was preventing it from winning contracts when competing with Big Four firms.²⁷ Moreover, we have heard that mid-tier auditors are less likely and willing to enter the FTSE 350 sector due partly to the low probability of winning the bid where the demand side may be biased towards the Big Four.
- 3.31 We will examine the scope for new or disruptive business models to enter the market, for example, by data analysis firms that may be developing technological replacements for some aspects of audit.
- 3.32 The CC also identified a number of potential barriers for which it did not find evidence to conclude that they were significant. These included mid-tier auditors' ability to invest in sunk costs such as IT, strategic behaviours by the Big Four auditors (such as aggressive pricing to win business cross-subsidised by consultancy revenues) and the impact of the regulatory framework on barriers (such as its impact on the ability of mid-tiers to signal

²⁶ The CC remedies, implemented in 2015 and listed above, are expected to have long term impacts on competition, switching and quality. Early indications suggest that mandatory switching has led to an increase in switching between the Big Four firms but have not facilitated entry from the mid-tier.

²⁷ [Grant Thornton exits audit market for big UK companies](#), Financial Times, 29 March 2018.

their quality as noted above or on the behaviours of the Big Four as noted in theme 5 below). We may consider whether these factors have become more significant since the CC report.

- 3.33 In assessing each of these three issues (choice, demand-side and supply-side barriers), we will need to take account of the interactions between competition and regulation (see theme 5). Regulation plays an important and complementary role in competition and market outcomes, especially in this sector where the regulation addresses a number of market failures. But regulation can also form a barrier to entry; for example, smaller firms may find it difficult to comply with regulation or to influence the development and implementation of regulation. As part of this we will consider whether regulation affects competition and the market structure by, for example, making it more difficult for mid-tier auditors to signal their quality, or by for example offering certain incumbents advantages such as access to, and membership of important regulatory committees or decision-making bodies.
- 3.34 We intend to focus our analysis on what has changed since the CC report.
- (a) To understand the market structure and its dynamics, we intend to update the CC's evidence on the market structure including historic data on the number of firms and their shares, churn and rates of entry and exit.
 - (b) To understand the tendering process and which auditors win contracts and which do not and why, we plan to collect data on tenders to identify which auditors bid (and which did not bid and why), how they were ranked and why. This will also help us to understand what the impact of the CC's mandatory tendering remedy has been, as well as the European Commission's mandatory auditor rotation rules.
 - (c) To understand the market dynamics, we plan to collect evidence and views from both customers of audits and auditors to explore how they view the market, who are their main rivals and their views on regulator barriers and other barriers.
 - (d) To understand how competition affects quality we plan to explore what quality means in this market, building on the CC's report that quality involves scepticism, objectivity, integrity and independence. We intend to examine whether the market process and regulation is delivering quality using the FRC's AQRs and from discussing with stakeholders their view of quality.
- 3.35 We may also seek to learn lessons from how competition and regulation works in other countries.

Theme 4: The resilience of the audit market

- 3.36 Our fourth theme relates to the long-term sustainability of competition between auditors – the ongoing resilience of the market. This relates closely to the previous theme of competition, but it raises specific concerns that have featured in some of the recent public debate.
- 3.37 Even if there were currently judged to be sufficient choice of auditor to drive competitive outcomes, some commentators have expressed concerns that the Big Four may be ‘too big to fail’. This could reflect two related concerns:
- (a) first, competition for the biggest audits would become even more limited if any of the Big Four were allowed to exit the market. This would exacerbate the concerns around lack of choice outlined in theme 3 above; and
 - (b) second, lack of a deep field of audit firms may prevent the regulator taking tough action against a firm if doing so could threaten its viability – something it would have fewer qualms about doing if there were more firms in the market.
- 3.38 We propose to consider a number of aspects under this theme, including the following:
- (a) What resilience means in this market. For example, resilience could mean the ability of other auditors to take on the clients of an existing auditor following exit. Resilience could also involve processes to facilitate the orderly exit of a failing auditor while its clients and staff transfer to third party auditors. We will explore with stakeholders what might occur in the event of the exit of a significant auditor.
 - (b) Whether present levels of market concentration could compromise the effectiveness of the regulatory oversight of the market. In particular, the possibility that the regulator might not be willing to impose significant sanctions for fear of driving one of the small number of major players out of the market (what we have termed ‘too big to regulate’). We will consider what impact this could have on the incentives and behaviour of audit firms, their clients and other stakeholders including regulators. For example, we are interested in whether large auditors may have implicit incentives to take greater risks or reduce quality in the belief that they are considered ‘too big to regulate’.
 - (c) Whether present levels of market concentration have implications for the sustainability of competition in the future. From the supply side, we will explore whether large firms are relatively susceptible to shocks that could

raise concerns about future audit provision. From the demand side, we will explore the views of businesses and shareholders about their ability to switch to non-Big Four auditors.

Theme 5: Regulation of audit in the UK

- 3.39 The final theme is regulation of audit in the UK. As described above in the discussion of characteristics of the sector, competition and regulation interact very closely in this market. Given the principal-agent dynamic and information asymmetry that are inherent in the provision of audit services, competition can only deliver good outcomes within a regulatory framework which ensures that competition is targeted at delivering sufficient robust and high-quality audit services.
- 3.40 However, we have heard that the implementation and oversight of the regulatory framework may not adequately deliver outcomes stakeholders expect. The users of the audit information are not able to verify the quality of the audit. This is known as a credence good (which means that the users of an audit may not know that the audit is low quality until something goes wrong, at which point it may be too late to make improvements). Thus effective and proportionate enforcement of regulation is necessary to satisfy clients and stakeholders that audits are carried out diligently and to agreed standards.
- 3.41 Where there are doubts about the robustness and independence of enforcement there may be doubts about the quality of the audit. This may have knock on effects for wider stakeholder confidence in capital markets. As noted above (see paragraph 3.26), the CC found that the influence of alumni of the Big Four firms – for example, with former Big Four partners sitting on audit committees – may create barriers to entry. We have also heard that alumni influence of regulators as employees of the FRC may affect the actual or perceived robustness of enforcement.²⁸
- 3.42 The independent review of the FRC, led by Sir John Kingman, is currently examining the enforcement and oversight of audit regulation. For this reason, we are not proposing to analyse closely the way in which regulatory standards are enforced in the UK.
- 3.43 However, we will consider the appropriate balance between competition and regulation, and the interaction between the two. Given the importance of

²⁸ [Auditing watchdogs should remind the Big Four of their public duty](#), Financial Times, 3 July 2018.

regulation in this market we expect to contribute our views to the review as appropriate.

- 3.44 We expect to include this theme in our research via the methods described in themes 1 and 2.

Market study scope

- 3.45 All companies as defined by the Companies Act 2006²⁹ must prepare audited accounts unless exempt.³⁰ Some of the concerns we have heard, for example on concentration, focus on the statutory audit of larger companies and particularly the FTSE 350; but others, for example on incentives, are likely to apply to a variety of types of company.
- 3.46 The scope of the market study will be the supply of statutory audit services in the UK to large companies, both listed and private, and public interest entities (PIEs).

Proposed focus of our research

- 3.47 We plan to focus on themes 2 (Incentives), 3 (Choice and switching) and 4 (Resilience). We do not expect to focus our work on theme 1 (Scope and purpose of audit) and theme 5 (Regulation) because the former is furthest from our focus and expertise in the operation of markets, and the latter is to be addressed by the ongoing review of the FRC led by Sir John Kingman.
- 3.48 The overall objective of our work should be to ensure that the market works in a way that delivers audits at a high enough quality, at a reasonable price. Whether that happens in practice depends on the interaction between all the themes above.
- 3.49 Themes 2, 3 and 4 in particular are inextricably linked. For example, competition can only take place as part of the tenders that companies run. Whether they tender, whom they invite to bid, how they evaluate those bids, whom they select, and how they interact with the selected auditor during the contract, are subject to regulatory standards, but are all driven by their incentives – whether they want a low-price, low-scrutiny audit or the opposite. Whom they invite to bid is also affected by the available choice of auditors, which in the long term can be expressed in terms of resilience.

²⁹ <https://www.legislation.gov.uk/ukpga/2006/46/contents>

³⁰ <https://www.gov.uk/government/publications/life-of-a-company-annual-requirements/life-of-a-company-part-1-accounts>

4. Potential outcomes

- 4.1 If we find that there continue to be problems in this market despite the changes brought about by the CC and the EC, we will consider what new measures might make the market work more effectively.
- 4.2 As a regulated sector with a history of problems, we are unlikely to find one complete solution. The issues identified above are multi-faceted; and the range of ideas we have heard to address them is similarly varied. Most measures could generate unintended consequences, and any idea is likely to have both proponents and critics.
- 4.3 At this stage of our work, all options remain open, whether identified in this section or not; but with the OFT and CC's work behind us, and subject to the evidence that we will obtain, we can, on a preliminary basis, identify three groups of measures which are likely to hold the most promise in addressing the issues described in Section 3. These groups of measures could seek to:
- (a) increase competition between the Big Four, for instance by creating audit-only firms (paragraphs 4.7 to 4.10);
 - (b) increase competition from non-Big Four audit firms, for instance through a market share cap and / or joint / shared audits (paragraphs 4.11 to 4.29); and/or
 - (c) address the incentives arising in audits, for instance by moving responsibility for appointing auditors away from audited companies, in certain circumstances, to an independent body (paragraphs 4.30 to 4.45).
- 4.4 Each of these three groups of ideas relates to different sets of issues: the first would seek to address the issues of choice and conflicts; the second would seek to address choice, barriers to expansion and resilience; and the third would seek to address the underlying incentives in the audit sector. But just as the issues are all interlinked, so are potential remedies. For instance, changes to governance arrangements would also have an effect on competition through the operation of tenders. As a result, combinations of the three groups of measures above could be implemented together; and the summary above is not exhaustive.
- 4.5 Some of the ideas below would be quite significant changes in their own right, whereas others would be more incremental. Given the history of intervention in this market and the continued level of public concern, it is likely that the main role of incremental changes would be to complement the bigger potential measures, rather than there being an expectation that such changes would be capable of achieving significant improvements in isolation.

- 4.6 We would like to hear views from stakeholders on these, and on any other measures we should consider.

Increase competition between the Big Four

- 4.7 One way to promote more effective competition among the Big Four would be to restrict audit firms from providing non-audit services to at least some companies.

Restrictions on audit firms providing non-audit services

- 4.8 Measures under this heading could either aim to limit firms' ability to develop potential conflicts between audit and non-audit services ((a) and (b) below), or aim to remove any scope for conflicts altogether ((c) below):

- (a) greater partial, or complete, restrictions on audit firms providing non-audit services to their audit clients;
- (b) prohibit audit firms from providing non-audit services not only to their audit clients, but also to any other large company or PIE; or
- (c) split the UK arms of major accounting firms into audit-only and non-audit services practices.

- 4.9 Options (a), (b) and (c) above could all further increase the actual and / or perceived independence of auditors, by reducing conflicts of interest for the auditors from the provision of non-audit services to their audit clients. However, options (a) and (b) could have a further negative impact on choice in future tenders. This is because audit firms may be conflicted from having already provided non-audit services and/or having the incentive to continue to provide non-audit services.

- 4.10 In contrast option (c) could increase choice, by removing the possibility that major firms could be conflicted out of bidding for audit work as a result of their non-audit practices. However, drawing on the CC's work and on recent informal discussions with stakeholders, it appears that such a measure could face challenges:

- (a) the international nature of these firms complicates the exercise of splitting UK firms. A UK audit-only firm would likely need to remain connected to the international network in order to service global clients, leaving questions over the non-audit services business.
- (b) it could reduce audit quality if specialist in-house non-audit staff were not as easily available or as skilled in advising the audit teams on complex

areas; although examples elsewhere, such as in merger transactions, suggest that there are ways for separate firms with different specialisms to work together successfully for a single client;

- (c) it could reduce audit quality if it proved significantly harder to recruit high-quality staff into audit-only firms; a frequently-raised concern with this idea, although the likely scale of such an effect is unclear;
- (d) it might negatively affect the mid-tiers more than the Big Four, as the former are less likely to have the scale and resources to employ in-house specialists in audit only firms; and
- (e) audit-only firms could be more financially dependent on their large audit clients, which could impair their independence.

Increase competition from non-Big Four firms

4.11 The Big Four audit a considerable proportion of large companies and PIEs, measured by the number of audit clients and audit fees, as set out in Section 2. This has raised concerns about lack of choice and resilience.

4.12 Measures to increase competition from non-Big Four audit firms could include:

- (a) reducing the barriers for non-Big Four firms to build their capacity; and/or
- (b) breaking up the Big Four into smaller firms.

Measures to reduce the barriers for non-Big Four firms to build their capacity

4.13 We plan to consider the following measures to reduce the barriers for non-Big Four to build their capacity and increase the likelihood of them winning audit tenders for large companies and PIEs:

- (a) market share cap on the Big Four;
- (b) variations of joint and shared audits;
- (c) direct support to the mid-tiers by the Big Four and professional bodies;
- (d) reducing the barriers for senior staff to switch between audit firms; and/or
- (e) changes to the restrictions on the ownership of audit firms.

Market share cap

- 4.14 One way of reducing the barriers to non-Big Four firms expanding their presence among audits for the largest firms would be a market share cap. This would set a limit on the proportion of large companies and PIEs that the Big Four could audit.
- 4.15 This would be a direct way to increase the number of audit firms in the market. It would give non-Big Four firms an opportunity to invest in the market and tender for audits in the knowledge they are likely to win a proportion of the mandates.
- 4.16 These audit firms would gain experience on complex audits. In the medium to long term, they could potentially build up their capacity (knowledge, staff and assets) to win tenders competitively for audits without the cap. If this were to happen, it could:
- (a) promote greater competition by increasing the choice of auditors; and
 - (b) improve the resilience of the audit market to external shocks, regulatory interventions or the potential failure of an audit firm.
- 4.17 However, until the potential benefits noted above materialise, this measure would have some costs:
- (a) the audit committees of a proportion of companies would be restricted in their choice of auditor. This could reduce the accountability of audit committees. It might also affect audit quality in the short term if alternative auditors were unable to provide the same level of service, for instance in terms of geographic coverage; and
 - (b) there is a risk that some audit firms could increase their audit fees for a proportion of the market due to weaker competitive constraints.

Joint or shared audits, or peer review

- 4.18 Another way to ensure greater market access for non-Big Four firms would be various forms of joint or shared audit. We propose considering three possible variations where more than one audit firm is involved in the audits of large companies and PIEs:
- (a) a mandatory joint audit that requires two audit firms to sign off on the accounts of their audit client. Responsibility for the audit opinion, and audit liability, would rest with both auditors;

- (b) a shared audit where one audit firm (the statutory auditor) takes overall control, responsibility and liability for the audit. Another audit firm would support the statutory auditor on certain aspects of the audit; and
- (c) a peer review, where an independent audit firm (not the company's statutory auditor) reviews the audit file and assesses the accuracy of the audit opinion before it is signed off by the statutory auditor.

- 4.19 Countries that mandate joint audits, such as France, appear to have less concentrated audit markets, with some mid-tier audit firms having larger market shares than they do in the UK. For example, the Big Four audited approximately 85% and 42% of PIEs in the UK and France respectively in 2015.³¹ As with a market share cap, lower concentration could promote increased competition and improve the resilience of the market.
- 4.20 In addition to possible effects on choice and long-term resilience, some have expressed the view in informal discussions that joint or shared audit can directly increase quality, by adding to the level of scrutiny of the accounts. If appointed on separate dates, the two audit firms would not have to be rotated at the same time, which has the potential to reduce disruption during auditor rotations.
- 4.21 Potential downsides of any of the variants above include duplications and increases in audit fees. The scale of any duplication is likely to vary depending on the design. We have also heard worries about issues 'falling between the cracks' between two auditors; but conversely advocates of joint audits say that these worries can be resolved through careful design.
- 4.22 The effectiveness of these measures is also uncertain. Stakeholders have told us that the audit committees of large companies and PIEs have been unwilling to appoint a non-Big Four firm. It is unclear whether this measure would increase their propensity to do so in the long term beyond any minimum requirement. Also, two audit firms might hesitate to take on a joint audit of a risky company; risks arising from one audit firm's work could make both firms liable for potential losses.

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

- 4.23 We propose considering measures under which the Big Four and/or professional bodies could support the mid-tiers and any new entrant that expressed an interest in tendering for the audits of large companies and PIEs.

³¹ Figure 3, European Commission Report dated 7.9.2017. See <https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:52017DC0464&from=EN>

This could build their capability with regards to technical know-how and knowledge base. In principle this could assist non-Big Four firms to expand, but there are various questions of how this would work in practice.

Reducing the barriers for senior staff to switch between audit firms

- 4.24 Another possible way to improve non-Big Four firms' ability to compete effectively at the top end of the market is in ensuring better access to top audit staff. We propose considering measures to reduce the barriers that partners and senior staff currently face to switch between audit firms – for instance from a Big Four firm to a mid-tier. Examples of such barriers include long notice periods and their associated costs that are often borne by the audit firm hiring the new staff.
- 4.25 This measure could allow the mid-tiers to hire experienced staff (who have audited large companies and PIEs) from the Big Four, and thus build their capacity. The key risk with this measure is that the Big Four staff switch among the Big Four only, and not to the mid-tier auditors.

Changes to restrictions on ownership of audit firms

- 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 audit 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 build the capacity of their audit practices to be better placed 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.

Break-up of the Big Four into smaller audit firms

- 4.27 A direct way to increase choice and resilience would be to impose structural changes in the biggest existing firms, forcibly to increase the number of firms in the market. This measure would split the audit practices of the Big Four in the UK into separate businesses. Each of the separated businesses could continue to provide audit and non-audit services.

- 4.28 The discussions that we have had with stakeholders so far suggest that the design and implementation of this measure would pose significant and potentially insurmountable challenges, some of which include:
- (a) one of the separated businesses would be likely to lose its affiliation to the international network of the previously consolidated firm. Only one of the two (or more) separated businesses could reasonably have access to this international network. This is because affiliating more than one of these separated businesses to the same international network would be complex to implement and may undermine the intended separation;
 - (b) the separated business without an international network could be placed at a competitive disadvantage, even compared to the mid-tiers with international networks. An international footprint is often a pre-requisite to tender for large companies with international operations; and
 - (c) the measure could be circumvented as staff might move between firms after a break-up. It would be challenging to restrict staff from moving between firms or leaving the industry altogether, which would raise concerns about the sustainability of those separated businesses.
- 4.29 Overall, (and to avoid an un-level playing field) this measure would need to be introduced on an international basis to be most effective. If the UK were to implement this measure in isolation, then it could significantly impair the capability of UK-registered audit firms to audit global companies.

Measures to improve incentives

- 4.30 As described in Section 3, the incentives between auditors, company management and shareholders have strong effects on the way competition operates in this market. There are two broad types of change that could be considered here: to mitigate the effects of this principal-agent problem by setting further rules on how the various parties behave, or to attempt to address the problem head-on by breaking the link between company management and auditors.

Mitigate the effects of current incentives

- 4.31 Ideas under this heading would seek to build on existing regulation by strengthening further the independence of auditors from management, and / or making them more answerable to shareholders. Possible measures include:

- (a) improving the transparency around the tendering process;

- (b) reforming mandatory tendering and auditor rotation; and
- (c) further strengthening audit committees and / or their links to shareholders.

Measures to improve the transparency around the tendering process

- 4.32 We propose considering measures to increase the transparency around the tendering process. If implemented, they could require a body such as the sector regulator to:
- (a) publish data on an annual (historic) basis on tender participants and their outcomes;
 - (b) publish the names of large companies and PIEs that will tender their audits over the forthcoming 12 months;
 - (c) implement blind tenders so that the names of audit firms and/or audit fees are not disclosed; and/or
 - (d) publish non-confidential examples of winning tenders so that audit firms interested in tendering for the audits of large companies and PIEs can gauge what a good tender looks like.
- 4.33 These measures might increase the intensity of competition. However, the body would incur some costs to implement and oversee these measures.

Measures to reform mandatory tendering and auditor rotation

- 4.34 We propose considering potential measures such as increasing the frequency of both mandatory tendering and mandatory auditor rotation. These measures would aim to reduce the tenure of audit firms.
- 4.35 These measures could interrupt the close relationship that may develop among management, audit committees and the audit firms, over a long audit tenure. This could increase the independence of auditors, and could also promote greater competition.
- 4.36 However, more frequent audit tenders and auditor rotation would increase the costs for the audit firms and companies, and this might increase the audit fees. Also, increased switching of auditors could reduce audit quality if recently appointed audit firms did not fully understand the businesses of their audit clients.

Measures to further strengthen audit committees and / or their links to shareholders

- 4.37 It would be possible to seek to increase the extent to which audit committees deliver against the requirements of shareholders and other stakeholders. This could take the form of increasing their independence from management, for instance by ensuring they have greater resources available to them which are not dependent on company management; increasing the role of shareholders in selecting auditors, for example by giving the AGM a choice of auditor rather than a single option to ratify or veto; and/or increasing companies' accountability on audit to stakeholders outside the company, for example, requiring audit committee appointments to be cleared by the sector regulator.
- 4.38 Measures to strengthen audit committees may offer benefits, but there are questions as to the scale of those potential benefits.
- 4.39 Any idea involving concerted shareholder action faces difficulties, such as the transient nature of share ownership; the diffuse nature of shareholdings in many companies and therefore the limited influence of any single shareholder; or conversely the wide range of shareholdings held by many investors and the resulting limits to their capacity to influence the audit arrangements of every company in which they invest.

Break the link between company management and auditors

- 4.40 Some stakeholders take the view that no amount of regulation of behaviour can ever ensure effective competition in the interests of quality while the roles and responsibilities remain as they are – i.e. company employees, whether management or, as now, audit committees, appointing auditors despite their product being for the benefit of shareholder and wider interests.
- 4.41 This view leads to ideas for more significant change – for instance transferring the powers, partially or wholly, to appoint audit firms and manage their performance away from audit committees, to:
- (a) shareholders directly;
 - (b) shareholders indirectly through shareholder groups; or
 - (c) other independent institutions or bodies such as a sector regulator or stock exchange.
- 4.42 The idea behind this type of proposal would be to put these decisions, for certain companies, in a body with a broader public interest mandate, and a focus on quality. It would make the auditor accountable to a body other than

the company, making it more independent and more able to challenge management's judgements.

- 4.43 Some detractors from this type of idea have suggested that any institution other than the audit committee would be less good at making the best choice for the company in question, and that to do this would be to disenfranchise shareholders.
- 4.44 An alternative view is that even if audits were delivered in line with shareholders' interests, shareholders might not take full account of the wider public interest in audit (and other aspects of the company's management) – for example through the impact on companies' future shareholders, employees and consumers. This might point towards the benefits of giving an independent institution that is external to the company the responsibility to appoint and manage auditors, rather than audit committees on behalf of shareholders.

Invitation to comment on measures to improve the incentives and governance of audits

- 4.45 Some of the potential measures discussed above are similar to, albeit more stringent than, those implemented by the CC in its 2013 market investigation (mandatory tendering) or which result from EU legislation (mandatory auditor rotation) in this area. Some measures could also complement each other. For example, greater frequency of mandatory tendering could be one way to potentially implement measures aimed at reducing market concentration, such as a market share cap. Other measures such as transferring the responsibility for the management of audits to independent institutions or bodies would be a significant departure from the status quo.

Wider reforms of the audit sector

- 4.46 Some stakeholders have suggested that the issues in the audit market cannot be solved by measures such as those listed above. Instead, they have called for radical measures to reform the market. These include the creation of:
- (a) an insurance-based system for audit; or
 - (b) an 'NAO-style' national auditor.

Insurance-based system

- 4.47 A more radical alternative model could involve creating different, more direct lines of accountability for auditors. For example, as an alternative to a

mandatory audit, companies could be given the option to buy insurance against any diminution in value of shareholders' invested capital. Insurers would in turn need to obtain assurance on the level of risk to that capital, which they could procure from auditors.

- 4.48 Audit firms would be accountable to the insurers, potentially to a greater degree than they are currently to the audit committees and shareholders. The insurers would appoint the audit firm, set the scope of their work and have the incentive and capability to monitor their performance. The aim of this would be to improve the quality of audits.
- 4.49 We understand that there are no significant regulatory barriers for insurers from currently providing such products. An insurance market could develop, if shareholders (or management on their behalf) were mandated to take out insurance policies.

'NAO-style' national auditor

- 4.50 There might be other ways of resolving the misalignment of incentives between company management, auditors and shareholders. For example, an independent 'NAO-style' national auditor could replace the auditors of some or all of the large companies and PIEs. This could in principle increase the directness with which wider public interests could be reflected in audits.
- 4.51 The discussions that we have had with stakeholders suggest challenges in building, staffing and operating a national auditor:
- (a) the national auditor might lack the incentive to innovate and improve audit quality because it would be a monopoly service provider, not subject to any discipline from competition;
 - (b) it might lack expertise, because it would be a public sector entity, remote from the specific structures and issues affecting private companies;
 - (c) the technical expertise to audit large companies and PIEs primarily sits within the Big Four. It is unclear whether their staff would work for a national auditor, perhaps at lower salaries; and
 - (d) the national auditor would have to sub-contract the audits of companies with international subsidiaries, or establish new audit firms in foreign jurisdictions that must be permitted by law to audit companies in those local jurisdictions.

Oversight of the audit sector

- 4.52 We are not proposing to consider detailed remedies relating to regulation of the sector because these are the subject of the parallel independent review of the FRC. However, we will need to consider the impact of the regulatory framework on any potential remedies. There are two broad areas relating to the oversight of the sector that may warrant our input and/or commentary:
- (a) implementation of the above measures; and
 - (b) the audit framework.
- 4.53 Several of the measures discussed above would be complex to implement, and would involve ongoing monitoring and enforcement, with effective penalties to incentivise compliance. Where there are existing regulatory bodies in the sector with relevant expertise, the CMA would expect them to be well-placed to carry out such activities, with additional powers where necessary. Given the overlap in this work with the regulatory regime, we will work closely with Sir John Kingman's review team in this area.
- 4.54 The second area concerns the audit framework. As set out in section 3, of the five themes this is furthest from our focus and expertise on the operation of markets. However, the audit framework is a significant determinant of actual and perceived audit quality. Therefore, if ideas emerge during our work, then we may pass comment on these topics.

5. Next steps

- 5.1 We intend to move as quickly as possible to a conclusion, mindful of parallel work going on elsewhere, particularly the independent review of the FRC, which is due to finish by the end of the year.
- 5.2 It should be possible to do this more quickly than in other market studies, because we will be starting with a significant weight of past material and analysis, including from the CC's work, building on and updating this as appropriate.
- 5.3 Many of the measures explored in this document would require legislation to be implemented. Similarly, legislation may well be required to implement recommendations coming from the independent review of the FRC. We intend to consult on provisional views by the end of the year and complete our work as soon as possible thereafter.
- 5.4 If on the other hand, following this market study, we are minded to make a reference, the statutory deadline for doing so is 12 months from the date of publication of our market study notice – which accompanies this document – i.e. by 8 October 2019.
- 5.5 We welcome responses, including relevant evidence where appropriate, to this invitation to comment. Further details of the particular issues where we welcome responses and how to respond are set out in section 6.
- 5.6 We will add information and updates about this market study to the case page on the CMA website on a regular basis.

6. Consultation questions

Invitation to comment on our market study notice

6.1 We welcome written submissions on the market study from interested parties by no later than 30 October 2018. In addition to general submissions, we particularly welcome responses to the following key themes and issues.

Box 3: Consultation questions

A) Issues

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

Theme 1: The audit framework

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

Theme 2: Incentives and governance

3. To what extent do the decisions made by audit committees support high-quality audits, whether through competition for audit engagements or otherwise?
4. How has this changed following the Competition Commission's intervention?

Theme 3: Choice and switching

5. Is competition in the audit market working well? If not, what are the key aspects hindering it?
6. In particular, how effective is competition between the Big Four and between other firms and the Big Four?
7. How has this changed following the Competition Commission's intervention?
8. What is the role for competition in the provision of audit services in delivering better outcomes (i.e. consistently higher quality audits)?
9. In practice, how much choice do large companies and public interest entities have in the appointment of an external auditor?
10. What are the key factors limiting choice between auditors?
11. What are the main barriers to entry and expansion for non-Big Four audit firms?

Theme 4: Resilience

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

Theme 5: Regulation

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

B) Potential measures

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

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

Restrictions on audit firms providing non-audit services

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

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

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

Market share cap

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

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

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

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

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

Incentives and governance

24. Should the auditors and those that manage them (e.g. audit committees, or an independent body as described in section 4) be accountable to a wider range of stakeholders including shareholders, pension fund trustees, employees, and creditors, rather than the current focus on shareholders?
25. If yes, should audit committees (in their current form) be replaced by an independent body that would have a 'public interest' duty, including for large privately-owned companies? Should this body be responsible for selecting the audit firm, managing the scope of the audit, setting the audit fees and managing the performance of the audit firms?
26. Please describe the benefits, risks and costs of such an independent body replacing audit committees.
27. Should companies be required to tender their audits and rotate their auditors with greater frequency than they currently are required to do? What would be the costs and benefits of this?

6.2 To respond to this invitation to comment, please make a submission by email or post to:

- **Email:** statutoryauditmarket@cma.gov.uk
- **Post:** Statutory audit market study
Competition and Markets Authority
7th floor
Victoria House
37 Southampton Row
London WC1B 4AD

6.3 We intend to publish responses to this launch document in full. In providing responses:

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

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

6.5 An explanation of how we will use information provided to us can be found in the annex to this document.

Annex – use of information provided to the CMA

1. This annex sets out how the CMA may use information provided to it during the course of this market study.

Why is the CMA asking for information?

2. The information you provide will help us better understand how well the statutory audit market is working (for further details of the issues considered see the invitation to comment document).

What will the CMA do with the information I provide?

3. Your information will inform our final market study report. The report will set out our findings and any proposed remedies to any problems we find.
4. Where appropriate, we may also use information you provide to take enforcement action, using our competition or consumer powers, against businesses operating in the statutory audit market or may share your information with another enforcement authority (such as local authority Trading Standards Services) or with another regulator for them to consider whether any action is necessary.
5. We may only publish or share information in specific circumstances set out in legislation (principally Part 9 of the Enterprise Act 2002). In particular, prior to publication or any such disclosure, we must have regard to (among other considerations) the need for excluding, so far as is practicable:
 - (a) any information relating to the private affairs of an individual which might, significantly harm the individual's interests; or
 - (b) any business of an undertaking which, if published or shared, might significantly harm the legitimate business interests of that business.
6. We will redact, summarise or aggregate information in published reports where this is appropriate to ensure transparency whilst protecting legitimate consumer or business interests.
7. If you wish to submit information either in writing or verbally that you consider confidential and therefore do not wish us to publish or share, please let us know when you contact us with your reasons.
8. Any personal data you provide to us will be handled in accordance with our obligations under the General Data Protection Regulation and any other applicable data protection legislation. Any personal data provided to us will be processed for the purposes of this market study under Part 4 of the Enterprise Act 2002. For more information about how the CMA processes personal data, your

rights in relation to that personal data (including how to complain), how to contact us, details of the CMA's Data Protection Officer, and how long we retain personal data, see our [Privacy Notice](#).

9. Further details of the CMA's approach can be found in [Transparency and Disclosure: Statement of the CMA's Policy and Approach](#) (CMA6).