

Monday, 21 January 2019

Statutory audit market study  
Competition and Markets Authority  
7th floor Victoria House  
37 Southampton Row  
London  
WC1B 4AD

Dear Sir or Madam

## **STATUTORY AUDIT MARKET – UPDATE PAPER**

### **1. Introduction and overall recommendation**

#### *Objectives and context of the CMA study*

- 1.1 Thank you for the opportunity to comment on your Update Paper on the issues facing the statutory audit market and the potential remedies to address them.
- 1.2 We support the CMA's policy objectives to increase choice in the listed audit market, ensure that the market structure and competition incentivises the delivery of high quality audits and improve market resilience.
- 1.3 You have highlighted the need to rebuild trust in the audit profession and address perceptions of conflicts within multidisciplinary firms and the alignment of incentives between company and auditor. We understand these concerns, and whilst we believe these are more perception than reality, we believe the package of remedies we propose will build on the CMA's provisional recommendations to address these concerns.
- 1.4 The CMA's study is closely aligned with two other reviews:
  - The Kingman Review, which has considered how to deliver more effective regulatory oversight. We support the objectives of this review and the majority of its recommendations; and
  - The Brydon Review, which has the potential to fundamentally change the audit product, materially increase the reliance on emerging technologies and deliver on an increasing range of stakeholder expectations which is in our view at the heart of the loss of trust in audit referred to above.
- 1.5 The recommendations of the Brydon Review need to be available before the CMA concludes on the appropriate remedies it is to recommend; increased competition and choice around the wrong audit product might make things worse and stifle innovation.
- 1.6 The conclusions of the CMA, Kingman and Brydon reviews need to be considered in aggregate. Collectively, they offer a unique opportunity to restore trust and confidence in audit and corporate reporting and maintain the UK's position as a world-leading financial market. It is particularly important that at a time that the UK is leaving the EU any changes do not put the UK out of line with global norms or add significant costs and complexity for companies, their shareholders or auditors. Such changes could materially damage the UK's competitive position and particularly London's place as a leading capital market. This is one reason why the CMA should seriously consider whether a

market investigation reference is appropriate, contrary to the preliminary view set out in the update report.

## *Summary of our submission*

- 1.7 The CMA has proposed a set of radical proposals to transform the market. We are supportive of some of these measures but we have strong reservations about joint audits, structural separation and in the proposed current form of operational separation because they may have severe unintended consequences. We believe they will both be detrimental to audit quality and reduce resilience.
- 1.8 Instead we have put forward alternative measures that we believe, in aggregate with the other related recommendations from Kingman and subsequently Brydon, will meet the CMA's objectives and make a significant positive difference to the audit market. Together these reviews represent a unique opportunity to transform the UK corporate reporting and audit environment, support the business environment in the 21st Century and strengthen the UK's competitiveness. In particular:
  - 1.8.1 Our proposed measures to deal with increasing choice can generate participation of challenger firms in about 75 FTSE 350 audits within five years versus 11 today and pick up a meaningful share of audit work within the FTSE 100 market. Challenger firms would potentially receive over 25% of FTSE 350 audit fees excluding the FTSE 30. We estimate that over 5 years, these firms would need to recruit c.1,000 audit practitioners (net, in the UK). This would be achieved without requiring those firms to transform at such a rate that would threaten audit quality and the resilience of the audit sector; and
  - 1.8.2 We propose an alternative to the CMA's structural or operational separation remedy. This separate governance and performance management structure will address any actual or perceived cultural issues resulting from a multidisciplinary structure. To support this we still propose a ban on non-audit services<sup>1</sup> being provided to FTSE 350 and large private entities in recognition of the challenging public perception of conflicts in the UK at present. The latter will demonstrate that there is no possibility of any conflict of interest.
- 1.9 We believe that these measures referred to in paragraph 1.8.1 above and in more detail in paragraph 11.3 in the Appendix will make a significant impact on the audit market place within a five year period. At that time, we would recommend that an appropriate body examines their impact. If the results are as expected, then the measures should be sunsetted and normal competition rules would apply.
- 1.10 We concur with the CMA's view that there is no clear evidence that joint audits enhance audit quality (paragraph 4.55 in the Appendix) and they are unproven in the UK. In fact, some countries have actively moved away from joint audits. There is no evidence that they improve choice and encourage new entrants capable of leading large listed audits into the market. In the only market where joint audits are used extensively, France, the vast majority of audit mandates in the CAC 40 are held by Big Four firms.
- 1.11 They cause significant increases in cost and complexity and do not appear to be welcomed by many companies, investors or other stakeholders.
- 1.12 A joint audit system will require the challenger firms make a very significant investment in hiring, training and developing 3,600 net new staff within their UK audit businesses over five years (according to our estimates), all capable of auditing FTSE companies. At the same time, the challenger firms will assume unlimited and joint liability at all companies in the FTSE 350 and both the challenger firms and the four largest networks will be grappling with how to perform a joint audit in practice.

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<sup>1</sup> A clear definition of non-audit services would need to be developed. We would suggest that as well as the annual audit, this definition includes closely-related services that, for reasons of time and cost, are best carried out by the auditor.

- 1.13 Having joint audits that only involve Big Four firms for the more complex sectors (e.g. Financial Services) does not help meet the CMA's objectives of increasing choice and improving the capabilities of challenger firms. It would also significantly reduce choice in this segment at the time of re-tendering, moving in all likelihood from two of the Big Four to the other two Big Four firms.

*Structural or Operational Splits*

- 1.14 We do not support a structural separation. It will not achieve the CMA's aims of increasing choice by removing conflicts and improving culture. It is also detrimental to resilience and will have a negative impact on audit quality potentially separating the UK audit business from both the rest of the UK multidisciplinary firm where it draws significant specialist audit support from and potentially from the international network required to support the audit of the UK's leading multinational companies.
- 1.15 Structural and operational separation as contemplated will reduce resilience and investment capacity. For example, the audit practice of Deloitte in the UK is part of a £3.5bn business. Were it standalone, it would have revenues of c. £500m or less and would be substantially reduced in overall strength, resilience and investment capacity.
- 1.16 Any separation will also damage audit quality. We have over 2,000 practitioners outside of the audit practice in the UK who act as specialists on audits and who share the same culture and training as our audit practice of delivering audit quality. The CMA have agreed that the use of specialists is vital to audit quality, but a structural separation will place these specialists in another firm. Structural separation could also result in the UK audit business being separated from the international network which will further damage audit quality as the ability to draw on audit colleagues in other jurisdictions and the basis on which they would be engaged would change.
- 1.17 Operational separation as currently proposed by the CMA also has material negative unintended consequences. Those downsides, while slightly less than structural separation, will have negative impacts on both audit quality, resilience and investment capacity. It will make the relationship with specialists less seamless, more contractual and less culturally-aligned in the delivery of quality audits. Specialists outside the operationally separate audit business may have less of a focus on our public interest audit responsibility over time.
- 1.18 An operational separation will neither reduce conflicts nor increase choice. The audit business will remain within the same network as the non-audit business and be subject to the multiple UK, EU and international regulations that govern auditor independence and will remain in place.
- 1.19 Instead, we believe that separation achieved by a new and robust separate governance and performance management structure for the audit business will achieve the CMA's Policy Objectives. This will provide far reaching and fundamental enhancements to the current governance model, will provide independent and transparent oversight and the enforcement of the culture and incentives required to drive quality audits. It will address any perceived cultural issues resulting from a multidisciplinary structure. It will preserve the financial resilience of audit in a multidisciplinary firm and will importantly retain the cultural alignment of auditors and specialists. To avoid market distortion we believe that this measure should apply to all audit firms and not just the Big Four.
- 1.20 In addition, we continue to propose a ban on non-audit services being provided by a firm to companies it audits, for UK FTSE 350 and large UK private companies. We concur with the CMA that there is limited evidence of conflicts between audit and non-audit work at the client level, but such an unequivocal position will address public perceptions about conflicts of interest.

## **2. Our principles to assess your proposed remedies**

- 2.1 In our response to your Invitation to Comment we set out three overall principles to guide the design of remedies:
- a) Audit quality should be the overriding objective of any remedies pursued by the CMA. An essential element of the ability to deliver audit quality and innovate the audit approach is the ability to draw on a wide range of skills within a multidisciplinary firm.
  - b) An increase in the choice of providers of audit services to the UK's largest companies is in the public interest.
  - c) Restoring trust is essential but any remedy must work within the international context, given the requirements of investors and stakeholders in large UK listed and large private public interest companies.
- 2.2 We have used these principles in considering the remedies you have proposed.

## **3. Remedy 1: Regulatory scrutiny of audit committees**

- 3.1 We believe that this remedy could generate greater assurance that the process to appoint auditors and oversee their work is rigorous, unbiased and fair. Care will be needed to ensure that additional regulatory scrutiny adds to the effectiveness of the UK corporate governance structure rather than merely creating further bureaucracy, and does not damage the attractiveness of audit committee membership in such a way as to deter the most able candidates from joining.
- 3.2 Implementing this remedy will require close cooperation with the Kingman Review and BEIS to ensure that the powers of the Audit, Reporting and Governance Authority (the new regulator proposed by the Kingman Review) are proportionate and aligned appropriately.

## **4. Remedies 2 and 2A: Mandatory joint audit and market share caps**

- 4.1 The CMA has recognised the risk of asking challenger firms to develop scale, skills, insights and experience, and their international networks, too quickly. Mandatory joint audits and market share caps are both mechanisms to help build the market share of challenger firms, and are considered by the CMA as alternatives. Both will require an increase in the scale, skills, experience and international network of the challenger firms. We have considered both to assess which is preferable. Since our conclusions about joint audits are different from the CMA's, we have sought to explain our position on this remedy in greater detail than for other remedies.

### *Joint audits*

- 4.2 Both joint and shared audits will create more "slots" for firms outside the Big Four to build experience and capability. Where challenger firms work alongside Big Four firms, there is also likely to be increased transfer of skills and knowledge to challenger firms, and a "four eyes" approach could reduce the perception that audit firms have too close a relationship with the companies they audit.
- 4.3 The most significant difference between the two is that with joint audits, both firms and both engagement partners have to sign the overall audit opinion and both accept overall responsibility for the whole audit. In shared audits there is a clearer distinction between the lead firm and the secondary firm, and only the lead firm and lead engagement partner takes responsibility for the overall audit report. This has three important consequences:
- 4.3.1 Building the level of capacity to be an effective joint auditor is much harder than to be an effective shared auditor. Ideally, joint auditors should carry out balanced shares of the audit work, including the higher risk areas, and both auditors should have the skills and reach to be able to properly review and challenge the work of the other. Working on the principle that

challenger firms would be one of the joint audit pair in most cases, this places significant pressure on challenger firms to develop capacity, industry experience, technical skills and international networks in a timescale that may not be possible.

- 4.3.2 Auditor liability is unlimited and under UK common law and statute, both firms are jointly and severally liable for errors in the audit opinion. A proportional liability regime would be more attractive to all participants, where the risk and fees were more closely aligned, but this will require an amendment to the Companies Act. Without liability reform there could be significant threat that an audit failure could lead to the collapse of a challenger firm and a resulting reduction of choice<sup>2</sup>.
- 4.3.3 Since both audit firms need to interact much more under a joint audit system, revised auditing standards will be required. Such standards do not currently exist in the UK and would need to be developed. Joint audits will introduce additional cost and complexity also putting the UK out of step with international practice.
- 4.4 We do not believe that it is workable for either firm to have a joint audit arrangement whereby one party takes a significantly lower share, creating the sense of a "senior" and "junior" party in the audit. This concurs with CMA's view in its boxed comment after paragraph 4.60. Joint audits are not an effective mechanism to help challenger firms build up their scale and capability gradually.
- 4.5 There is limited empirical evidence that mandated joint audits have a positive effect on audit quality, and indeed may damage it. A meta-study carried out in 2013<sup>3</sup> considered 20 separate studies carried out between 2007 and 2012 on joint audit in markets where it has operated, including France and Denmark. Among its findings, the study notes the difficulty in allocating work between the firms and that uneven distributions in the split of work can lead to one firm becoming dependent on the other, limiting the effectiveness of the "four-eyes" review.
- 4.6 The lack of popularity of joint audits with companies, investors and audit firms reinforces their unattractiveness. Companies and investors in the UK can currently choose to appoint joint auditors but they do not. The CMA has pointed to France as a market where joint audits operate successfully, but the circumstances of the French market – where auditors are appointed for a period of six years and where an industrywide fund for auditor liabilities exists – are significantly different from the UK. Even in France, where there is more than 50 years' practical experience of joint audit, only one national challenger firm has gained a foothold in the CAC 40 audit market.
- 4.7 We do not understand the suggestion that requires two Big Four firms to take on the joint audits of the largest, most complex companies. This measure does not help challenger firms build capability or increase choice in any way. Indeed, it would actually reduce choice. Consider, for example, joint audits involving Big Four firms at the UK's four largest retail banks. Each bank would be audited by two firms and when the audit was rotated, they would have to appoint the other two firms – they would have no choice at all.

#### *Joint audit vs market share caps + shared audit*

- 4.8 The CMA believes that joint audits generate a similar benefit to market share caps in increasing the participation of challenger firms in large audits, but without the risks to short-term quality that come with market share caps and concludes, therefore, that joint audits are preferable. We disagree.

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<sup>2</sup> We understand that in France there are profession-wide insurance arrangements, and that this helps encourage cooperation between different firms involved in a joint audit. Such arrangements do not exist in the UK.

<sup>3</sup> Ratzinger-Sakel et al, 2013 "Joint Audit: Issues and Challenges for Researchers and Policy Makers".

- 4.9 In practice, implementing either market share caps or joint audits will carry significant challenge. Both remedies carry the danger of giving challenger firms responsibility for complex audits before they have the necessary capability.
- 4.10 Under market share caps, though, we think the phased introduction of the remedy can be controlled more carefully (for example using different levels of cap depending on the industry and size of companies) to ensure that the market share of challenger firms grows in step with their capacity. In addition, market share caps could be introduced without the need for new auditing standards or a revision of auditor liability, and without significant opposition from stakeholders.
- 4.11 Rather than using joint audits, an equivalent change in the structure of the market can be achieved more effectively with a combination of shared audits and market share caps. Such an approach would:
- 4.11.1 Allow challenger firms to build up their skills over time more easily. The second auditor in a shared audit could start with a lower share of audit hours, say 10-20%, and build up over time (with the split potentially overseen by the new regulator). This could apply to all companies including banks;
  - 4.11.2 Be flexible to the existing industry skills and geographic networks of the challenger firms. The initial share of work could be designed to reflect where the challenger firms are already strong and with planning for the evolution of this share over time, this gives the firms time to develop the reach and expertise they will need to carry out a larger share;
  - 4.11.3 Be capable of being introduced more quickly, because it does not need to align with or interfere with the overall group auditor appointment;
  - 4.11.4 Be carried out under existing audit standards and liability arrangements, reducing the need for lengthy processes to develop, consult and endorse new standards and statute; and
  - 4.11.5 Be more compatible with peer reviews (Remedy 6). This would help challenger firms develop their capabilities through engagement quality control reviews.
- 4.12 We estimate that if challenger firms were to be joint auditors for all FTSE 350 companies, in a five year period they will need to grow their revenue from FTSE 350 audits from their current level of £5 million to approximately £400 million, with a corresponding increase in headcount. FTSE auditing requires some different and additional skillsets.
- 4.13 The challenger firms will be required to make a very significant investment in hiring, training and developing up to 3,600 net new staff in the UK over five years (according to our estimates). At the same time, these firms will assume unlimited and joint liability on all companies in the FTSE 350 whilst simultaneously grappling with how to perform a joint audit in practice.
- 4.14 The CMA has raised concerns that market share caps will allow firms to cherry pick the companies that they audit. We understand these concerns and believe that they can be carefully managed by temporarily excluding Big Four firms from participating in FTSE 250 audit tenders within certain sectors. This would include industries that are not high risk and where the challenger firms already have a market presence. This could be coupled with increased scrutiny of the tender process akin to the mechanisms outlined in Remedy 1. We understand that this will not be popular with companies as it reduces choice in the short term but it will provide increased choice in the longer term.

## **5. Remedy 3: Additional measures to support challenger firms**

### *Ease of movement of staff*

- 5.1 Employment contracts should be designed to avoid significant business disruption, but should not act as an unreasonable barrier to prevent people switching firms. We do not believe contract restrictions are a significant and widespread issue, but agree that there is merit in the CMA investigating the issue further.
- 5.2 Our own hiring data suggests that there is no restriction on movement of people between accounting firms.

### *Tendering fund*

- 5.3 The use of other remedies – particularly market share caps and shared audits – should reduce the need for such a fund, since they will give greater opportunity to challenger firms, who in many cases will not be competing against Big Four firms. The CMA has also acknowledged that audit prices are likely to increase and this will provide an additional incentive for challenger firms to compete. We would suggest that the CMA to keep this under review and revisit it if other remedies do not increase tendering activity by challenger firms.

### *Access to technology*

- 5.4 We recognise that access to large firms' proprietary technology platforms might help challenger firms to compete and could reduce the risks of poor quality. However, our technology platform is owned at a global level so providing access would require global approval. Alternatively challenger firms should either develop their own proprietary systems or come together to develop a shared platform.

## **6. Remedy 4: Market resilience**

- 6.1 We agree that the market would benefit from a greater resilience regime that would protect against the effects of a catastrophic failure or voluntary withdrawal of a large audit firm.
- 6.2 It will be challenging to develop such a regime that keeps a failing firm together because the firm's main assets – its experienced partners and staff – cannot be prevented from leaving, and nor can companies be prevented from switching audit firm. Nevertheless, we agree that there is merit in the CMA considering this further through, for example, plans for a regulator and other appointees temporarily taking over failed firm to ensure its stability while a long-term plan is invoked.
- 6.3 In recent years the FRC has encouraged firms to develop their own contingency plans to manage a catastrophic collapse. Any contingency plans need to consider not only the collapse of a large firm in the UK, but also the effect of a large network collapse precipitated outside the UK.

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

- 7.1 A full structural separation or an operational separation as defined by the CMA would not achieve the CMA's policy objectives of removing conflicts nor will it increase choice. We believe that any cultural or incentive issues are best dealt with by the alternative separation approach of a new and robust separate governance and performance management structure which we outline below in further detail.
- 7.2 A full structural separation faces unsurmountable challenges. We have over 2,000 practitioners who act as specialists on audits, and who share the same culture as our audit practitioners of delivering audit quality. The CMA have agreed that the use of specialists is vital to audit quality. For Deloitte all of our FTSE 350 audits required the use of specialists from outside the audit practice and over 55% of the key audit matters – the most significant audit risks - required the use of specialists. Separating these specialist from the audit business creates in our view unsurmountable challenges to audit quality. In addition to the significant challenges of contracting for these specialist services from the structurally

separate non audit firm, we believe the potential loss of the full cultural alignment over time from these specialists to deliver quality audits as part of the same firm will create a new audit risk. Any separation will make the relationship less seamless, more contractual and less culturally-aligned in the delivery of quality audits.

- 7.3 Separation of any kind will reduce resilience. For example, the audit division of Deloitte in the UK is part of a £3.5bn business. Were it standalone, it would have revenues of less than £500m would be substantially reduced in overall strength and resilience to withstand financial shocks, loss of large audits, economic cycles or any other similar events.
- 7.4 Under an operational split, the audit business will remain within the same network (as defined for independence purposes) as the non-audit business and subject to the multiple UK, EU and international regulations that govern auditor independence that will remain in place. An operational separation as defined by the CMA will not address conflicts nor increase choice.
- 7.5 In terms of the CMA's culture objective, we believe that Deloitte has an extremely strong set of governance principles and procedures that mean that audit partners' incentives are aligned with audit quality and have not seen evidence that our culture harms audit quality in any way. But we are proposing a separate audit governance and performance management structure as set out below.

#### *A separate audit governance and performance management structure*

- 7.6 The proposed separate governance and performance management structure has significant and far-reaching enhancements that will:
- Create a separate, transparent, independent governance and management structure for the audit business with an overriding responsibility to act in the public interest, an overarching performance management structure aligned solely with the delivery of audit quality and management process and systems to reinforce that;
  - Maintain the audit business' ability to readily access overseas auditors and specialists of requisite experience, to avoid jeopardising audit quality; and
  - Underpin resilience.

This structure would in our view address the concerns of culture and conflicts without the significant unintended negative consequences of structural or operational separation in its current proposed format. We have explored a range of organisations where some form of separation or ring-fencing exists, including the ring-fenced banks in the UK, BT Openreach and the recently-introduced enhanced governance regime for audit firms in the Netherlands<sup>4</sup>.

- 7.7 Our proposal will demonstrate to external stakeholders that a culture of quality, independence and objectivity is pervasive within the audit business and that such a business operates separately, independently and without undue influence from the wider (non-audit) business. It would have the following attributes:
- An audit business with its own CEO, overseen by a new separate governance board and a completely independent Chairman;

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<sup>4</sup> Effective from 1 July 2018 and enacted in Dutch law through the Act on Additional Measures for Audit Firms (*Wet Aanvullende Maatregelen Accountantsorganisaties*), which amended the Audit Firms Supervision Act (*Wet Toezicht Accountantsorganisaties*)(*Wta*) and introduced mandatory independent (internal) oversight over audit firms who audit Public Interest Entities.

- The Audit Governance Board would have a majority of Independent Non-Executives. It would have clear terms of reference including maintaining a culture of audit quality within the audit practice;
- Clear reporting obligations to external stakeholders by the Audit Governance Board, including the new Audit, Reporting & Governance Authority;
- Oversight and enforcement of clear, transparent policies that link partner and staff remuneration to audit quality, overseen by the governance board;
- Oversight of scope of services restrictions for the audit practice that seek to prevent conflicts but also allow the skills of audit practitioners to be developed;
- A firm-wide strategy and budget set at a firm level, with the level of investment in audit agreed by the Audit Governance Board, to ensure investment levels are consistent with its aims of safeguarding audit quality;
- Financing and investment provided at a firm level; and
- Disclosures akin to a listed company together with an annual report and an AGM.

Such a separate governance and performance management structure in combination with an appropriate ban on non-audit services provided by audit firms to FTSE 350 and UK large private entities that they audit (as set out in our original response to the CMA's ITC document) provides a clear mechanism to address the perceptions around culture and incentives.

## **8. Remedy 6: Peer review**

- 8.1 We can see merit in a peer review process as a mechanism to enable challenger firms to develop skills.
- 8.2 However, we see little need for extensive peer reviews to be introduced in conjunction with joint or shared audits, unless the reviews were carried out by one or other of the joint or shared audit firms. Otherwise three firms would be involved in every company's audit, which would be cumbersome and further restrictive of choice.
- 8.3 Alternatively the peer review could be carried out after the audit opinion had been signed which would address concerns around any associated liability and disruption to the audit process and timetable.

## **9. Conclusions**

- 9.1 We are committed to playing our role in delivering change that embraces audit quality, improves choice in the market and restores trust, particularly in the way our firm's multidisciplinary structure is perceived by wider society. We have assessed your proposed remedies and built on these to suggest a basket of measures that we believe will deliver effective and sustainable change in the public interest.

Issue addressed					
Components of the Deloitte proposal	Choice	Resilience	Alignment of incentives	Culture	Deloitte comment
1. Regulatory scrutiny of audit committees			✓		We agree this proposal is worth exploring
2. Market share caps + shared audits	✓				Market share caps + shared audits provide the most effective and low risk option for increasing choice.
3. Additional measures	✓				We agree the proposal is worth exploring
4. Market resilience		✓			We agree the proposal is worth exploring
5. Refined audit governance and management structure + ban on NAS		✓	✓	✓	This will address the perceived cultural and incentive concerns and serve to increase audit quality
6. Peer review	✓				We agree this proposal is worth exploring

9.2 Our responses to the 27 questions in Section 6 of your paper are covered in the appendix.

We look forward to continuing to work constructively with you and others on this crucially important study. Please do not hesitate to contact us if you would like to explore any of the points set out in this letter.

Yours faithfully



**David Barnes**  
Deloitte LLP