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Statutory Audit Market Study
Competition and Markets Authority
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Dear Sir or Madam

Statutory Audit Market – Invitation to Comment

Introduction

Deloitte is grateful for the opportunity to respond to the Competition and Markets Authority's ("CMA") Invitation to Comment.

We recognise the considerable thinking that has gone into producing this paper, and we share the CMA's objective of delivering a UK audit sector that works well for the UK and international companies, their shareholders and the wider stakeholder community served by the audit market.

The CMA's Invitation to Comment is understandably focused on the issues of choice and switching, resilience and incentives.

As the CMA acknowledges, these matters cannot be considered in isolation. It is important that these matters are considered in the broader context and in conjunction with adjacent ongoing reviews of the financial reporting ecosystem. We highlight three points.

1. The UK audit profession contributes over £17 billion to UK GDP and employs over 150,000 people, providing for the efficient operation of the UK financial markets. The six largest firms recruit a young person every two hours of every day, and five of the six firms are ranked in the top 10 list of social mobility employers. Accountancy is one of the UK's success stories and is widely respected internationally. It is clear, however, that trust and confidence in the role of the profession has been damaged and change is required. Care needs to be taken that any remedies are focussed on the UK but do not damage the international competitiveness of the UK, particularly in a post Brexit world.

2. Recent events have highlighted the expectation gap and demonstrated the need to reconsider the role and purpose of an audit and examine whether it is still meeting the needs of 21st century stakeholders. Audited financial statements continue to provide the bedrock of trust and confidence for the capital markets. Today tough financial insight is mainly generated from an abundance of real time, forward looking financial and operational information.

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We support an independent review that examines the question "*what is the very nature of audit?*". It needs to explore how artificial intelligence and technology can reinvent audit and look at expectations around the business model, future viability, fraud and the front half of the annual report. This review needs to be established quickly and report no later than June 2019 so that any conclusions can be considered alongside other changes that are required to improve audit regulation and to drive more choice in the listed audit market. The review needs to be forward looking and reflect the fact that changes to the audit product may well in itself lead to major disruption, opportunities for new entrants (subject to independence considerations) and increased competition.

3. Changes are also required more broadly in the financial reporting ecosystem. All participants have a role to play in improving the overall quality of financial reporting.

   The primary responsibility for the quality and integrity of financial reporting rests with the company's management and board. We support the introduction of a proportionate UK Sarbanes-Oxley equivalent type regime for the largest listed companies in the UK. This will place appropriate accountability on companies' boards and management to ensure the quality of their financial reporting. Data[1] shows that restatements in the US spiked in the years following the introduction of Sarbanes-Oxley, as a result of the new requirement to report on the effectiveness of internal controls over financial reporting.

Guiding principles for reform on choice, resilience and incentives

We are clear that there is no one simple or quick solution that addresses all of the CMA's concerns. A small number of the solutions that have been discussed, such as breaking up the largest four firms, would not solve the question of choice and will undoubtedly impair audit quality. Consequently a constructive, aligned and complementary set of remedies is required. We acknowledge that no effective group of remedies is likely to be challenge-free or have no potential for negative consequences. We have used the following principles to guide our response:

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 is the ability to draw on a wide range of skills within a multi-disciplinary firm;

b) An increase in 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 private public interest entities.

Our remedy proposal

We do not want to be in the same position in five years' time. We have put forward below a cohesive and comprehensive package of proposals that combined with substantive changes to the financial reporting ecosystem and the audit product, will deliver significant and lasting positive change. These proposals will be challenging for Deloitte and other market participants to deliver, but we believe this package of measures are most likely to address the concerns around choice and switching, long-term resilience and incentives. In the time available we have carefully considered the mechanisms that can make these remedies practicable and avoid, to the extent possible, negative collateral consequences. We do not have all the answers but would welcome engagement with the CMA on this issue.

We believe that the following measures will be the most effective:

a) A market share cap or caps, for particular segments or subsets of the market, which would over time seek to address choice and competition issues, reducing barriers to entry as well as concerns around resilience of the audit market;

b) A stronger, fully accountable governance structure around the audit practice, which seeks to address issues around incentives and conflicts and increases resilience; and

c) A ban on non-audit services provided to FTSE350 and large unlisted public interest entity audit clients, which seeks to address issues around incentives.

We provide more details on each of these proposals below.

1. <u>Increasing choice: from four to more</u>

1.1 The FTSE 350 audit sector in the UK is fiercely competitive, and has been made more so by the remedies put in place following the Competition Commission's market investigation. However, it is undoubtedly highly concentrated, with 98% of FTSE350 companies audited by the four largest firms. Recent regulatory interventions in the UK and the EU aiming to reduce concentration have not led to a decrease in the proportion of companies audited by the four largest firms – in fact, the opposite has occurred.

Considering the listed company market as a whole

1.2 In the US, the Fortune 500 has similar levels of concentration to the UK FTSE 350 market. This is not surprising. Big international companies require big international audit firms with sufficient global coverage and capabilities, expertise and scepticism to challenge management.

1.3 However, there are significant differences between the UK and US when the entire listed market is considered. In the US, the four largest firms audit between 45-50% of the entire listed market, compared with 75-80% in the UK.

1.4 With this in mind, we believe that the CMA's remedies should take into account the entire listed market. This will allow firms outside of the four largest firms to build their skills and capacity over time.

1.5 We also recognise that greater choice over time within the FTSE 350 market is in the public interest. In a mandatory rotation environment, at the top end of the market, the choice of auditor is currently limited to three firms which have the expertise and international footprint and, in some cases, fewer than that. We support changes that increase choice and reduce concentration.

Splitting up the largest firms would be very damaging for all stakeholders

1.6 Splitting the four largest firms into a smaller eight would not address this issue. We strongly oppose any such proposal.

1.7 This proposal would not substantively increase choice. Only four of the newly-created UK firms could remain as part of an international network. The choice of firms with an international footprint would not change.

1.8 The proposal would potentially undermine audit quality. Deloitte in the UK is currently a Partnership with over £3bn of revenues. Being part of such a large and balanced business affords a number of benefits. It offers a high degree of resilience to allow weathering of adverse events. Its size and scale mean that it is not reliant in any way, actual or perceived, on even the largest clients as they individually represent a very small proportion of the overall revenues. This independence allows the firm to make entirely objective judgements on all client matters.

1.9 Scale also provides an ability to invest in the people, methods, infrastructure and quality required to identify risks and challenge management.

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Measures to improve incentives will not have a material impact on market share

1.10 We do not believe that any of the remedies suggested around incentives would have a material impact on market share and many of them run counter to and perhaps reduce board accountability and responsibility. We are not supportive of an independent body to appoint auditors. However measures that will improve the transparency of the audit appointment and reappointment decision and that will stimulate greater investor involvement in the tendering process and indeed strengthen the links between audit committees and investors are welcome. We would also suggest that audit committees are required to manage their relationships with suppliers of audit services such that they have a choice of at least three credible suppliers at the time of any audit tender.

Supporting the emergence of new players

1.11 The only durable solution is the emergence of at least one other large firm as a major competitor to the four largest firms, with a significant share of listed (and, in time, FTSE 350) company audits. We would welcome a discourse with the CMA on this issue. A target of 20% of the FTSE 350 companies audited by a firm outside of the four largest firms in five years' time would represent a sevenfold increase from the current position.

1.12 However based on our analysis a firm outside of the largest four firms would need to win 60% of all tenders in the next five years, to reach the 20% FTSE 350 target by 2023/4 and wait for another one to two years before these audits go live. If this share was to be spread between the firms it is arguable that they may continue to have insufficient scale to compete effectively, leading to an outcome that may never be self-sustaining. We note that prior to its collapse in 2002 Arthur Andersen only had a market share of 8% of FTSE350 audits.

1.13 Market based changes on their own are therefore unlikely to lead to a significant durable change in concentration; some intervention is required.

A market share cap remedy is most likely to be effective

1.14 On balance we believe that market share caps, if introduced for a set period of time and judiciously planned and monitored, are the only effective mechanism for moving 'from four to more', within an acceptable timescale. In the time available Deloitte has considered this issue carefully. It seems clear that at least currently, there are some companies that, due to their size and complexity, will continue to require an auditor from among the four largest firms. We have therefore considered the possibility of applying different caps to different segments of the market and flexing the level of those caps over time. These caps should be applied by number of companies to the entire listed market as well as a FTSE 350 subset. We would welcome the opportunity to discuss with the CMA in more detail how this might work in practice, and, in particular, how we think this would be consistent with the principles we have set out above.

1.15 Market share caps on the four largest firms will provide a guarantee of other large firms being able to win work in segments in which they have not been able to make sufficient progress to date. However, two related issues need to be addressed:

a) we note that the leading firms outside the four largest firms consider that they already have the capabilities to audit large listed companies and other public interest entities (PIEs) (as they explained to the Competition Commission) but more is needed to build skills, capacity and scale; and

b) the economics of the marketplace need to be attractive for these firms. The returns from investment in top-end audit capability are uncertain and long-term, and the risk environment is challenging.

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Additional support measures

1.16 Consequently, we believe a package of additional measures is required to support the market share cap and help other large firms to compete effectively and sustainably, while maintaining or improving audit quality. These measures should be understood as transitional in nature: we would propose that they have an agreed five-year sunset clause.

1.17 To address skills and capacity we support measures such as:

a) shared audits, where the four largest firms would partner with a firm outside this group to audit a particular component but retain overall responsibility for signing off the group accounts. This is distinct from joint audits which we do not support. They add cost and are detrimental to audit quality;

b staff secondments to the four largest firms from firms outside this group and or the provision of training by the four largest firms or the Institutes on particular technical topics; and

c) the licencing of technology platforms between the four largest firms and firms outside this group in the context of delivering a shared audit.

1.18 We are confident that the market can support more than four large players, but we recognise that some additional support may be necessary for a transitional period to support investment. Consequently, for a five year period we support measures such as:

a) an appropriate and proportionate sanctions regime for all firms that acts as a catalyst for an improvement in audit quality rather than acts as a deterrent and barrier to entry for firms into the FTSE 350 and PIE audit market; and

b) additional funding from the four largest firms to a third party that can be used to support and develop skills, training, and technology across the audit market.

Conclusion on a market share cap remedy

1.19 We acknowledge that market share caps are not an easy solution. Feedback we have received suggests that caps may not be popular with companies, some of whom feel that their choice may be restricted further rather than improved for a period of time. We acknowledge these concerns, but believe that they can be managed. In particular, the caps should reflect the capability, capacity and credibility of the relevant firms as these develop over time. It may therefore be necessary to introduce caps gradually over time and flex them accordingly.

2. <u>Stronger governance around the audit practice</u>

2.1 We understand the concerns voiced when conflicts of interest arise between the firms' public interest audit responsibilities and the advisory services provided to non-audit clients. We believe that these conflicts arise very infrequently.

2.2 The CMA will be aware that conflicts of interest may arise in any company or firm that is not a monoline operator, and the key is in ensuring that any such conflicts are appropriately minimised and managed.

The benefits of a multi-disciplinary firm

2.3 The careful management of potential conflicts of interest is all the more important because there are clear benefits to audit quality of a multi-disciplinary model. The scope of international standards on auditing requires the extensive use of specialists and high quality audits require high quality specialists. On complex audits we regularly use specialists from across corporate tax, transfer pricing, actuarial, IT and cyber risk advisory, data analytics, valuations and financial instruments together with industry specialists to identify risks and challenge management.

2.4 Auditors are required to communicate Key Audit Matters ("KAMs") in their report in the financial statements. Communicating KAMs provides additional information to users of the financial statements to assist them in understanding those matters that, in the auditor's professional judgment, were of most significance in their audit. It also provides users of the financial statements a basis to engage further with management and those charged with governance about certain matters relating to the entity and the audited financial statements.

2.5 We have analysed the KAMs included in all of the audit reports for the FTSE 350. Over 55% of all reported KAMs require specialist input from the broader multi-disciplinary firm outside of Audit. Only 7% of such audit reports contain no KAMs that require the input from a specialist.

2.6 Specialists are drawn from across the Firm but are subject to the same quality, ethical and independence standards. In the year to May 2018, over 2,100 people from service lines outside of audit worked on statutory audits contributing particular expertise and specialisation. This need for specialist input is only likely to increase as the audit product develops, particularly in areas such as cyber risk, artificial intelligence and blockchain. A potential outcome of the current debate around the scope and purpose of audit is more rather than less specialist input being required e.g. in respect of providing assurance over a company's viability. A multi-disciplinary firm helps to futureproof audit quality against a backdrop of these areas of emerging importance and may well in itself prove a significant catalyst for disruption.

2.7 The multi-disciplinary model also provides the best opportunity to attract the highest quality talent and provide for their rounded development. It provides the scale, financial resources and skills needed to innovate and invest in artificial intelligence and technology to continually improve quality and evolve the audit product to meet the needs of 21st century stakeholders. This can only be achieved if there is full financial consolidation across the firms to support investment in quality and innovation.

2.8 For these reasons, we are strongly opposed to any measures that split the audit practice from the rest of the firm (or as posited at 4.8b to prohibit or limit audit firms from providing non-audit services to any large company or PIE irrespective of whether they audit the company). We believe it would be enormously detrimental to audit quality and would not improve choice. We are clear that those remedies are not necessary to achieve an effective answer to concerns about conflicts of interest - to say nothing about the risk they pose of unintended adverse consequences.

An effective governance remedy

2.9 We believe long-term resilience can be improved by strengthening the existing governance structure around the audit business and by developing a clearer separation of the governance frameworks that are in place for both the audit and the advisory businesses.

2.10 The current audit governance framework is strong, but we believe it can be improved. We support the creation within each firm of a separate, independent, governance body with clear public interest reporting responsibilities. Such a body would:

a) be required to monitor and report publically on any potential conflicts and how they have been dealt with to ensure there are no actual or perceived conflicts with the firm's public interest responsibilities. They could be required to ratify certain types of appointments; and

b) have a dedicated focus on audit quality with an emphasis on root cause analysis and a requirement to report publically on audit quality metrics.

2.11 Appointments to this independent body and other key appointments within the firm would need to be approved by the audit regulator.

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3. Ban on non-audit services to audit clients

3.1 Non-audit services were a key focus of the EU audit reforms, which introduced a raft of prohibitions and other limits on the non-audit services that auditors can provide to the public interest entities they audit. As a result, the proportion of revenues that auditors earn from such services have declined in recent years[2].

3.2 However, we recognise that in the UK there are still concerns around auditor independence. These concerns are not generally held elsewhere around the world, but given the UK environment we support a ban on all non-audit work by a firm to those FTSE 350 companies and large public interest entity private companies which it audits.

3.3 This will require a clear definition of large public interest private companies as well as a clear definition of 'audit services'. We would suggest that as well as the annual audit, this includes the half-year review, bond offerings, grant applications, reporting on historical financial information, work on offering circulars and similar services. All other services, with no exceptions, would be banned.

Conclusion

Deloitte is committed to achieving a UK audit sector that works for its stakeholders. While the Competition Commission's market investigation and other reforms that have taken place since then have further increased competition among the four largest firms for audits of the UK's largest companies, we believe that more needs to be done to alleviate the concentration issue.

We believe that any remedy seeking to split up the largest audit firms, whether vertically or horizontally, is not workable and would lead to a deterioration in audit quality. Neither of these proposals would address the issues identified in the Invitation to Comment nor would they be consistent with the principles set out at the start of this paper. We strongly believe that they would not be effective in improving audit quality or increasing effective competition or resilience in the market. On the contrary, both would damage audit quality.

However, we do acknowledge that to improve choice, mere incremental changes would not be effective. A remedy package with a market share cap (or caps) at its heart would over time bring about more choice. A set of supporting measures would help to ensure its effectiveness by allowing firms outside the current largest four firms to invest with confidence in their capabilities. However, all of these measures needed to be considered in the context of changes required in the broader financial reporting ecosystem.

We look forward to further engagement with the CMA in support of its goal of bringing the right set of changes to the UK audit sector.

Our views on potential remedies that have not been explicitly referenced above are dealt with in our response to the detailed questions in the appendix.

Yours faithfully

David Barnes

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[1] In 2006, companies filed 1,859 restatements after a rise to 1,632 the year before. The numbers have dropped dramatically since.
[2] https://www.frc.org.uk/getattachment/27725654-8bd9-4623-a410-ef1661a69649/Key-Facts-and-Trends-2018.pdf FRC data shows that the percentage of fee income of the four largest firms derived from non-audit services provided to the entities they audit was 9.7% in 2017, down from 12.0% in 2014; and was 48.7% of the audit fees in 2017, down from 56% in 2014.