

21 January 2019

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Dear Andrea,

The FRC welcomes the CMA's update paper on the audit market. We have reviewed the paper and wanted to set out our own reflections on the proposed remedies.

Sir John Kingman's recent review of the Financial Reporting Council made a series of recommendations, including more statutory powers, to address issues of quality and resilience in the UK statutory audit market, and to create a more powerful and better resourced regulator. It is important for these recommendations and yours to be considered together to ensure that the final proposals are coherent and proportionate.

Kingman's recommendations could also provide an impetus for greater international regulatory co-ordination which would contribute to successful implementation of your final proposals given the global nature of the key players in the audit market. Such international cooperation will also help reduce the risk that the UK is perceived to be pushing its own "solutions" on the rest of the world which will damage our influence. We are willing to develop this dialogue with other audit regulators who are members of the International Forum of Independent Audit Regulators (IFIAR), and with other global regulatory bodies through the Monitoring Group.

We have considered your proposed remedies against the criteria set out in the report, namely whether they: (i) address the underlying quality concerns; (ii) can be implemented, monitored and enforced effectively; (iii) are proportionate to the scale of the issue; and (iv) consider the potential risks and unintended consequences.

We very much welcome the focus on the importance of high-quality audit that runs through the report; high-quality audit is vital to underpin the confidence of users in reported financial information. However, as the report identifies, currently the selection and oversight of auditors is not always sufficiently focused on quality. This, alongside very real limitations on choice, results in a situation where the UK statutory audit market does not deliver *consistently* high-quality work.

Your report also rightly focuses on increasing the capacity of challenger audit firms, so that over time they will prove able to take on a greater proportion of audit work on the largest and most complex audit engagements with minimal risk to audit quality. Such challenger firms are very few in number and will require levels of growth in resource and expertise that will be hard to secure and sustain through organic growth alone. In addition, this high level of growth, necessary both in the UK and globally to compete on more equal terms with "the Big Four",

carries with it considerable risk. To move to a UK statutory audit market with five or six comparable major market participants will therefore take time.

Remedy 1 – Regulatory scrutiny of auditor appointment and management

We believe that there are two existing regulatory requirements which could strengthen the impact of the current proposal set out in the update paper:

- The EU Audit Regulation introduced a requirement for member states to report to the European Commission on audit committee effectiveness. It did not, though, set any framework for making such an assessment, but simply made information requests in this respect. A clear and well understood regulatory assessment of the effectiveness of audit committees, which includes their effectiveness in leading and providing oversight for any audit tender and providing oversight of and challenge to the relationship between audited entity and audit firm, would support your proposal. The update paper's recommendations provide an opportunity to develop further arrangement for oversight of how Audit Committees discharge their duties; and
- There is a requirement (also in the Regulation) for audit committees to report publicly on how they have run a tender for audit services. The matters covered by that report could be expanded to include how the tender was run to deliver high audit quality and could also include how the audit committee satisfied itself that there had been appropriate competition and choice through the process. This could be supplemented by more granular reporting requirements through the UK Corporate Governance Code to report annually on how the audit committee has addressed quality through its ongoing oversight and would align well with Sir John Kingman's recommendation that his proposed new regulator have oversight of the entire annual report.

We believe these matters would better support oversight and evaluation of audit committees, focusing on risk and addressing poor practice. It is important, in our view, that the regulator does not determine the outcome of the auditor selection process. Direct participation would run contrary to the need to encourage greater investor involvement in holding audit committees to account. To support investor engagement, the CMA might consider recommending that the audit committee chair be required to report to the general meeting of a company on the work of the committee, and also be subject to questions and challenge.

Remedy 2 – Mandatory joint audit

This remedy offers a mechanism to support the growth in capacity of challenger audit firms to take on additional FTSE 350 audit engagements. It is clearly a medium to long term remedy, which is predicated upon the desire and capacity of challenger firms to develop over time to be credible competitors for larger and more complex audit engagements. It is important that such expansion is sustainable in the long term and supports the delivery of high-quality audit work, recognising that there is a mobilisation and investment period that firms will need to prepare for this on any significant scale. We share the CMA's assessment that this would not be feasible under a shared audit model, and that a rigorous joint audit may mitigate the risks to audit quality.

We think it would be helpful in this respect to require challenger firms to prepare a three to five-year capability action plan, setting out: their plans for growth in resource and expertise (e.g. by sector); how they plan to fund the necessary investment; how they will secure the high-quality resources necessary to deliver consistently high-quality work (e.g. by investing in technical capacity and sector expertise); and how they manage their own risks in relation to the levels of growth required. This will provide a shorter-term mechanism to monitor progress

towards meeting the objectives of this remedy, which otherwise could move slowly over a five to ten-year period. It would provide a framework to assess preparedness on the part of challenger firms to take on additional, more challenging work, and to manage any associated risk to quality, and would focus the challenger firms on the size of the task, and the effort and resources required. Requiring the development of such plans and monitoring against them fits well within the FRC's enhanced Audit Firm Monitoring and Supervision approach (AFMAS) and will give insight as to the speed with which the market can transition to new arrangements. We would like to discuss this further with you.

Although we do not have an evidence base that supports the use of joint audit as a way to deliver consistently high-quality audit of large and complex organisations, we do support some staged introduction of joint audits as a means to an end (i.e. a means of bringing the challenger firms up to the level where they can compete effectively). We believe that it would be helpful to develop a stronger evidence base to support the contention that joint audits are associated with high audit quality and are happy to support the CMA in this respect with evidence-based research.

In finalising this remedy, we would encourage the CMA to consider making available supporting evidence and analysis to make the case more strongly. Although the French example provides a case study for mandatory joint audit being implemented in practice, even there the Big Four firms still earn 85 per cent of total audit fees from the largest listed audit clients. There is also no clear evidence that the model used in France has had a positive impact on audit quality.

We are also aware that in Denmark, Sweden and Canada there has been a move away from mandatory joint audit. Addressing the risks that led to decisions in these jurisdictions should be built into the final proposal. Further analysis might also usefully include the CMA's assessment of which audit engagements best lend themselves to high quality joint audit, the relative strength of the global networks of challenger firms (covering locations and capacity by sector), and the impact on audit cost which will be important in determining how to expand the work undertaken by challenger firms in a managed way.

Remedy 2A– Market share caps

We note the CMA's clear preference for mandatory joint audit set out in the update paper. We agree with the assessment that because challenger firms need to build up their capability and capacity, the market share cap remedy on its own could pose significant short-term risks to quality and competition. However, included in this proposed remedy are a number of measures which are helpful to avoid the risk of any sort of arbitrage over audit engagements, whereby the largest firms seek to trade smaller engagements for larger and more lucrative ones. These measures could be added as hybrid measures to Remedy 2 to strengthen it.

Remedy 3 – Additional measures to support challenger firms

The measures set out could well be incorporated within the capability action plans proposed in our response to Remedy 2. In developing those plans, we recommend that challenger firms are encouraged to articulate further additional measures which they believe should be considered to provide them with the support to expand their capability to take on more challenging audit engagements.

Remedy 4 – Market resilience

We welcome and endorse the CMA's proposed remedy, which would greatly assist in making the FRC's work more effective in the event of a UK audit firm failing. The FRC has pressed

audit firms to develop resolution plans, similar to those required in financial services, which would provide the basis for a managed transition in the event of a UK audit firm failing. Whilst such plans should not allow a further concentration of the statutory audit market, and should support greater competition and choice, it is important that they are also grounded in measures that will protect and enhance audit quality.

Under our AFMAS programme of work, we have reviewed and recommended improvements in the contingency plans which the large audit firms have in place, with a view to making the UK audit market more resilient. We have established a joint forum with other regulators to ensure close oversight and to learn from best practice in other regulated markets. Sir John Kingman's report recommends the regulator should have the statutory powers to enforce these requirements.

Remedy 5 – Full structural or operational split between audit and non-audit services

We note the CMA's comment that regulatory measures that restrict competition and choice are undesirable. This needs to be balanced against the need to ensure that the independence of auditors is not undermined by conflicts of interest, or the provision of services that pose a threat to independence, which lies at the core of the FRC's Ethical Standard. These measures are necessary to underpin stakeholder confidence, and to comply with current UK and EU legal requirements they cannot be waived. This does have competition and choice implications, because independence requirements are applicable not just to the audit firm, but also to its global network. We believe, however, that by taking steps to remove such conflicts, by not permitting auditors to provide services that pose a threat to independence, we can ensure greater participation in tenders by market participants, as fewer audit firms will be conflicted.

However, more can be done to provide a strong ring-fence around the audit business of audit firms (and if challenger firms are to be seen as serious challengers to Big-Four firms, they should be treated the same). Requiring the governance and leadership of an audit firm to focus on the needs of the audit business, rather than being distracted by the needs of other, sometimes larger service lines is to be encouraged. A firm which has fewer external conflicts and distractions is better placed to focus on the delivery of high-quality work. One of the ways that this could be done is by ring fencing revenues from non-audit services so that they form no part of the remuneration of members of the audit practice, ensuring there is no incentive to sell services other than the statutory audit, and related assurance work where there is a clear need for the auditor to undertake it (e.g. interim reports and reporting on regulatory returns).

Such measures, which we are looking at strengthening through our revisions to the FRC Ethical Standard, but which this remedy could also support, would lead to a better assessment of what the cost of audit should be. Firms need properly to consider how to capitalise their audit business so that it is able to invest the resources required to deliver consistently high-quality work, and that investment should not have to rely, in part, on a wider subsidy from the firm's network and other service lines. If the CMA concludes that such a ring fence should be part of the final remedy, then the financial resilience of ring-fenced audit firms would need to be modelled and tested rigorously.

Remedy 6 – Peer review

We welcome the CMA's acknowledgment that there should be consideration of additional regulatory measures which might be used to drive enhanced quality and accountability. Peer review, though, may not be the most effective way of achieving this, in the context of the existing requirements on auditors and audit firms under current international (and UK) audit quality control standards. Peer review is also likely to impact on the timetable for reporting

results to market and bring with it challenging liability and duty of care considerations. The CMA might instead wish to consider the following measures in finalising its remedies:

- Audit committees are allowed to commission additional work or advice to support their work in overseeing audit quality; however, we understand that this is rarely taken up. This could be more widely encouraged, and the committee's consideration of whether this is merited could be included in the committee's annual report; and
- Quality control measures applied by audit firms including internal hot and cold reviews, engagement quality control reviews, root cause analysis, and responses to regulatory action should be made available to the audit committee before the financial statements and auditor's report are signed. The committee should also report on their assessment of this material and conclusions drawn from it.

The FRC remains ready to provide the CMA with any further assistance, including discussing our observations in more detail, to support the conclusion of the review.

Yours sincerely,

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