



Department for  
Business, Energy  
& Industrial Strategy

# MARKET STUDY ON STATUTORY AUDIT SERVICES

Initial consultation on recommendations by  
the Competition and Markets Authority

Closing date: 13 September 2019



**OGL**

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Any enquiries regarding this publication should be sent to us at: [auditmarketconsultation@beis.gov.uk](mailto:auditmarketconsultation@beis.gov.uk)

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# Foreword



In October 2018, I asked The Rt Hon Lord Tyrie, Chair of the Competition and Markets Authority (CMA), to consider what can be done to improve competition in the audit sector. I took this action because I want the UK to continue to benefit from a high quality, competitive and resilient audit services market. Good governance underpins the Government's Industrial Strategy and audits are a vital contributor to the trust and confidence required in a modern economy.

In reviewing this important sector we need to make sure that we recognise and value the critical contribution audit makes to the UK economy and the wider financial ecosystem, of which the UK can be rightly proud. As well as providing an oversight function to investors and the wider economy, our audit sector provides a proving ground for financial and corporate leaders in the UK and across the world. This is why it is right that we continuously review our audit regime to maintain the UK's world-leading position.

I am most grateful to The Rt Hon Lord Tyrie and his colleagues for their thorough, ambitious and comprehensive study, which captures evidence and views from a wide variety of stakeholders. The CMA identifies a series of challenges for the market and makes a number of wide-reaching and ambitious recommendations, including proposals for the joint audit of FTSE 350 firms and an operational split between audit and non-audit practices. I believe the CMA's analysis provides a strong foundation to increase quality and competition in the market and their study complements a wider body of work being undertaken to enhance the UK's world leading corporate reporting regime. Most importantly, the Government has endorsed Sir John Kingman's recommendation to replace the Financial Reporting Council with an independent statutory regulator with stronger powers. We will establish the new body as soon as Parliamentary time allows and I am confident this robust regulator will build on the UK's status as a world leader in audit services, ensuring that the market is fit for the future and works for investors and the wider public.

The Government is committed to acting on the CMA's findings to create a fit-for-purpose and proportionate regulatory regime that delivers a competitive and resilient audit market. There are no easy solutions to the problems identified in the CMA's report and the Government would welcome views on the CMA's final proposals, as developed since their interim report in December 2018. We also strongly encourage proposals from the sector outlining what they believe could be done to address the CMA's concerns on a voluntary basis prior to legislation. The Government will then develop a full set of proposals for reform taking account of both the recommendations from the CMA and the outcome of Sir John Kingman's Review of the Financial Reporting Council.

A handwritten signature in black ink that reads "Greg Clark". The signature is written in a cursive, slightly slanted style.

**The Rt Hon Greg Clark MP**

**Secretary of State, Business, Energy & Industrial Strategy**

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# General information

## Why we are consulting

The consultation seeks views on recommendations made by the Competition and Markets Authority to improve competition and resilience in the statutory audit services market.

## Consultation details

**Issued:** 18 July 2019

**Respond by:** 13 September 2019

**Enquiries to:**

Audit Reform and Regulation Team  
Department for Business, Energy and Industrial Strategy  
1<sup>st</sup> Floor, Victoria 1  
1 Victoria Street  
London  
SW1H 0ET

Email: [auditmarketconsultation@beis.gov.uk](mailto:auditmarketconsultation@beis.gov.uk)

**Consultation reference:** Market Study on Statutory Audit Services – Initial consultation on recommendations by the Competition and Markets Authority

**Audiences:**

The Government would welcome views of users of accounts, investors, asset owners, others who rely on audited accounts, business stakeholders, regulated firms, companies, and other regulatory bodies including professional associations.

**Territorial extent:**

The territorial extent of matters in this document is the whole of the UK. The Companies Act applies UK wide.

Company law is a reserved matter in relation to Scotland and Wales. Previously, the Northern Ireland administration has agreed that, while the operation and regulation of audit and corporate reporting matters remains a transferred matter within the legislative competence of the Northern Ireland Assembly, amendments to the Companies Acts 2006 and legislation regulating audit and corporate reporting matters should be made in the same terms for the whole of the United Kingdom.

## How to respond

**Respond online at:** <https://beisgovuk.citizenspace.com/strategy/statutory-audit-services-cma-recommendations>

**Email to:** [auditmarketconsultation@beis.gov.uk](mailto:auditmarketconsultation@beis.gov.uk)

**Write to:**

Audit Reform and Regulation Team  
Department for Business, Energy and Industrial Strategy  
1<sup>st</sup> Floor, Victoria 1  
1 Victoria Street  
London  
SW1H 0ET

When responding, please state whether you are responding as an individual or representing the views of an organisation.

Your response will be most useful if it is framed in direct response to the questions posed, though further comments and evidence are also welcome.

## Confidentiality and data protection

Information you provide in response to this consultation, including personal information, may be disclosed in accordance with UK legislation (the Freedom of Information Act 2000, the Data Protection Act 2018 and the Environmental Information Regulations 2004).

If you want the information that you provide to be treated as confidential please tell us, but be aware that we cannot guarantee confidentiality in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not be regarded by us as a confidentiality request.

We will process your personal data in accordance with all applicable UK and EU data protection laws. See our [privacy policy](#).

We will summarise all responses and publish this summary on [GOV.UK](#). The summary will include a list of names or organisations that responded, but not people's personal names, addresses or other contact details.

## Quality assurance

This consultation has been carried out in accordance with the government's [consultation principles](#).

If you have any complaints about the way this consultation has been conducted, please email: [beis.bru@beis.gov.uk](mailto:beis.bru@beis.gov.uk).

# Introduction

On 9 October 2018, The Rt Hon Greg Clark MP wrote to The Rt Hon Lord Tyrie, Chair of the Competition and Markets Authority (CMA), asking the CMA to consider what can be done to improve competition in the audit sector. The CMA published its interim conclusions in December 2018 before publishing its final study on 18 April 2019.<sup>1</sup> The Government is grateful to the CMA for this broad and ambitious study and welcomes its efforts to compile a wide range of evidence and views from stakeholders. The CMA's analysis is far reaching and thoughtful, providing a strong foundation for reforms to increase competition and quality in the UK audit market.

In particular, the Government would like to thank the CMA for its analysis of the opportunities and challenges facing the UK audit sector. The UK has a world leading audit and corporate reporting sector and it is right that we continually seek opportunities to enhance this global position. The CMA's analysis has significantly aided this effort, and we agree with their conclusion that more can be done to strengthen quality, competition and resilience in the audit market. The Government is committed to reform of the statutory audit market and we share the CMA's concerns regarding the uneven quality of information provided to investors.

It is important to note that CMA's study represents one pillar of the Government's broader efforts to strengthen and improve quality and regulatory oversight of the audit market. Sir Donald Brydon has been asked to conduct a review of the purpose and quality of audit to ensure that UK audits require the highest standards and are focussed on the right questions.<sup>2</sup> Sir Donald is currently seeking views from stakeholders and we look forward to his findings in due course.<sup>3</sup> The Government has also endorsed the core recommendations of Sir John Kingman's Independent Review of the Financial Reporting Council, published in December 2018 and we share Sir John's vision of a new regulator with a strong statutory footing.<sup>4</sup> We will take forward a set of proposals which draws on all three of these important pieces of work, to build a coherent and rigorous new regulatory framework for the statutory audit market in the UK, maintaining our global pre-eminence in this important sphere in line with the aims of our Industrial Strategy.

In this document, we seek views on the effectiveness and impact of the CMA's final recommendations, as developed following the CMA's interim study in December. The CMA's central recommendations are to:

- enhance regulatory oversight of audit committees;
- mandate 'Joint Audits' of FTSE 350 companies;

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<sup>1</sup> CMA, 'Statutory Audit Services Market Study: Final Report', 18 April 2019, accessible at [https://assets.publishing.service.gov.uk/media/5cb89b2bed915d74fed24206/CMA\\_final\\_audit\\_market\\_report\\_A.pdf](https://assets.publishing.service.gov.uk/media/5cb89b2bed915d74fed24206/CMA_final_audit_market_report_A.pdf). The update paper was published on 18 December 2018 and can be found at [https://assets.publishing.service.gov.uk/media/5c17cf2ae5274a4664fa777b/Audit\\_update\\_paper\\_S.pdf](https://assets.publishing.service.gov.uk/media/5c17cf2ae5274a4664fa777b/Audit_update_paper_S.pdf)

<sup>2</sup> The terms of reference of Sir Donald Brydon's review can be found at <https://www.gov.uk/government/publications/the-quality-and-effectiveness-of-audit-independent-review>

<sup>3</sup> Sir Donald Brydon, 'Independent Review into the Quality and Effectiveness of Audit: Call for Views'. The call for views can be accessed at <https://www.gov.uk/government/consultations/the-quality-and-effectiveness-of-audit-call-for-views>

<sup>4</sup> Sir John Kingman, 'Independent review of the Financial Reporting Council (FRC) 2018: Final Report'. The report can be accessed at <https://www.gov.uk/government/publications/financial-reporting-council-review-2018>

- give the regulator powers to design an ‘operational split’ between the audit practices and non-audit practices of the ‘Big Four’ firms; and to
- require a five-year review of progress by the new regulator.

Collectively, these recommendations represent a wide-ranging and ambitious set of proposals. These proposals would be administered by the new regulator and it is therefore important that the Government understands how best to make them work and how they would interact with Sir John Kingman’s proposals. Following this consultation, we will bring forward detailed proposals later in the year in addition to further consultation on the detailed FRC review recommendations.

## Structure of this Document

This document is divided into the following chapters, which summarise and seek views on each of the CMA’s recommendations:

- Chapter 1 focuses on the CMA’s proposals for enhanced regulatory oversight of Audit Committees.<sup>5</sup>
- Chapter 2 focuses on the CMA’s proposals regarding mandatory joint audits of FTSE 350 firms, as well as proposals for peer reviews of audits conducted for firms not in scope of the joint audit proposals.<sup>6</sup>
- Chapter 3 focuses on the CMA’s proposals to mitigate the effects of the distress or a failure of a ‘Big Four’ firm.<sup>7</sup>
- Chapter 4 focuses on the CMA’s proposals to mandate an operational split between audit and non-audit practices of ‘Big Four’ firms.<sup>8</sup>
- Chapter Five seeks views on other possible proposals that were not part of the CMA’s core package of remedies.<sup>9</sup>

We recommend that this document is read alongside the CMA’s full study, which provides additional detail regarding the rationale behind each recommendation.

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<sup>5</sup> CMA, ‘Statutory Audit Services Market Study’, pp. 132-43.

<sup>6</sup> CMA, ‘Statutory Audit Services Market Study’, pp. 144-76.

<sup>7</sup> CMA, ‘Statutory Audit Services Market Study’, pp. 177-86.

<sup>8</sup> CMA, ‘Statutory Audit Services Market Study’, pp. 187-198.

<sup>9</sup> CMA, ‘Statutory Audit Services Market Study’, pp. 142, 175, 203.



# 1. Audit Committee Scrutiny

- 1.1. The CMA's first recommendation highlights the important role that audit committees play in appointing, supporting and challenging auditors. The CMA recommends that the role and effectiveness of audit committees should be subject to greater scrutiny by the new regulator to ensure that they select auditors based on quality of audit rather than any other criteria. The CMA argue that this will increase the accountability of audit committees to shareholders and create greater focus on quality. By focussing on audit quality this will help to mitigate bias against non-Big Four firms during tendering processes.
- 1.2. This recommendation is based on the CMA's conclusion that there is significant variation in the performance of audit committees within the FTSE 350, and that selection of auditors is not sufficiently focused on quality. The CMA also concludes that:
  - it is difficult for audit committees directly to observe the quality of audit work undertaken;
  - there is a lack of transparency in relation to the information provided to shareholders on tendering of external audit engagement; and
  - investors are not sufficiently informed of audit appointment matters, either due to a lack of information, limited capacity or willingness to engage.

## Design of the Remedy

- 1.3. To address these concerns, and to increase the effectiveness of Audit Committees, the CMA recommends that the regulator should be given powers to scrutinise Audit Committees in relation to both the appointment and oversight of auditors. Various standards for audit committees are already in place, but the CMA concludes that its recommendation would give the regulator a clearer set of powers to set and enforce standards which do not currently exist.
- 1.4. In particular, the regulator would have powers to mandate minimum standards for the appointment and oversight of auditors; monitor compliance with minimum standards; and take remedial action where necessary. The CMA recommends these powers should be cast broadly to allow flexibility and that the regulator should initially apply greater regulatory scrutiny to FTSE 350 audit committees, with a view of expanding scrutiny at a later stage. The CMA also notes that the regulator would need to act judiciously to balance the need to avoid undue bureaucracy with the need to maintain audit quality.

- 1.5. In addition, it makes initial suggestions about the standards the new regulator could set in relation to audit tenders, the actions it could take to monitor compliance and the actions it could consider when taking remedial action:
- **Standards for Audit tenders:** the new regulator should draft new standards that would encourage and require audit committees to prioritise independence and sceptical challenge over cultural fit, avoid management influencing audit committees on their recommendation of auditor, encourage non-Big Four firms to participate in tenders, and manage conflicts of interests arising from auditors' provision of non-audit services.
  - **Compliance:** the regulator should request information and reports from audit committees and, if necessary, place an observer on an audit committee or another part of the audit process in order to oversee compliance with the standards described above.
  - **Remedial action:** the regulator should publish its findings (or summaries of findings) on poor-performing and high-performing Audit Committees; write to audit committees to highlight deficiencies; and write to shareholders to give them the information they need to challenge audit committees and auditors.
- 1.6. Finally, the CMA is of the opinion that an alternative proposal for the selection of auditors to be moved to an independent body should be kept under consideration in the long term. If this proposal were implemented, the CMA notes that shareholders should have the right to vote on the selection proposed by the independent body.

## Government Response

- 1.7. The Government welcomes the CMA's analysis of the issues in this area. We agree that the audit committee plays an extremely important role and that there should be clear expectations and standards for audit committees to ensure they deliver the best results for shareholders, and that there should be a role in this for the regulator. We would welcome your views on the following questions:
1. **Do you agree that the new regulator should be given broad powers to mandate standards for the appointment and oversight of auditors, to monitor compliance and take remedial action? What should those powers look like and how do you think those powers would sit with the proposals in Sir John Kingman's review of the Financial Reporting Council?** <sup>10</sup>
  2. **What comments do you have on the ways the regulator should exercise these new powers?**
    - For instance, do you have any comments on the conditions that should be met for the regulator to exercise its powers to take remedial action?

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[https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/765547/auditor-appointment-letter-to-greg-clark-december-2018.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/765547/auditor-appointment-letter-to-greg-clark-december-2018.pdf)

- Are there particular events (such as a poor audit quality review, early departure of an auditor or a significant restatement of the company's accounts) which should trigger the regulator's involvement?
- 3. How should the regulator engage shareholders in monitoring compliance and taking remedial action?**
  - 4. What would be the most cost-effective option for enabling greater regulatory oversight of audit committees? Please provide evidence where possible.**

## 2. Mandatory Joint Audit and Peer Review

- 2.1. The CMA's second group of recommendations are designed to improve audit quality and increase the number of viable competitors for complex audit tenders.

### Joint Audit

- 2.2. Under the CMA's first recommendation, a joint audit would require two audit firms to sign off the accounts of an audited entity. The two audit firms would divide the necessary fieldwork between them, and both firms would audit areas that are highly material and/or involve a high level of judgment. Under this model, responsibility for the audit opinion, and audit liability, would rest with both auditors.
- 2.3. The CMA's joint audit proposal is designed to address their concerns regarding a lack of choice and competition within the audit market. While competition is working more effectively than it has done in the past, the market has consolidated considerably over the past 30 years, with some companies lacking viable alternatives to the four largest audit firms. In the UK, 97% of audits of FTSE 350 companies are now undertaken by the Big Four auditors. This lack of choice means that incumbent audit firms would be unlikely to lose market share even if their audit quality was relatively low.
- 2.4. The CMA's proposals are therefore designed to remove barriers to challenger firms and to increase the number of credible audit firms in the statutory audit market. According to the CMA, challenger firms face a 'chicken and egg' problem, with demand-side and supply-side barriers preventing them from building a presence in the FTSE 350 market. On the demand side, there are concerns about the capability of challengers carrying out complex audits due to a lack of experience. This concern is reinforced on the supply side: challengers appear reluctant to bid for FTSE 350 audits, where bidding costs are high and the likelihood of winning is perceived to be small.

### Design of the Remedy

- 2.5. The aim of the joint audit recommendation is to break this cycle by providing greater opportunity for challenger firms to participate in the market. Under these recommendations, the Secretary of State would give the new regulator powers to implement a joint audit regime and adapt it over time. The regime would apply to audits of FTSE 350 companies, with exemptions:
- for the audits of the largest and most complex companies, where there may be insufficient capacity from challenger firms to participate in joint audits;
  - for the audits of investment companies and companies that do not prepare consolidated accounts; and

- for audits where an audit committee has appointed a challenger firm as its sole auditor.

2.6. In addition, the CMA recommends that:

- the regulator should have the power to grant specific exemptions to the proposed joint audit requirement in exceptional and limited circumstances;
- each FTSE 350 company within the scope of joint audit should appoint a joint auditor no later than when it next re-tenders its audit engagement; and that
- no joint auditor should be allocated less than 30% of the total audit engagement fees.

2.7. Finally, the CMA does not recommend making changes to the UK's current liability regime, meaning that both firms within a joint audit would be jointly and severally liable for the overall audit. There are two reasons for this. First, the CMA awaits the conclusion of Sir Donald Brydon's review, which may consider proposals and suggestions for proportionate liability in a joint audit regime. Second, the CMA is unconvinced by stakeholder responses to their interim study that suggest a joint and several liability regime presents too great a risk for audit firms. The CMA's rationale for this position is set out in its study, alongside stakeholder views of the impacts of joint liability on industry and audit firms.<sup>11</sup>

## Peer Review

2.8. Supplementing its proposals on joint audit, the CMA also recommends that the regulator should have the power to appoint peer reviews of the audit engagements of those companies not subject to the joint audit requirement. The peer reviewer would be appointed from a challenger firm in order to improve audit quality by introducing an additional, independent quality check. It may also provide additional experience to challenger firms.

## Design of the Remedy

2.9. The main features of the CMA's peer review proposal are as follows:

- peer review would only apply to companies who are not in the scope of the joint audit proposal;
- the reviewers should not be one of the Big Four apart from in exceptional circumstances;
- the peer reviewer should not sign the audit opinion, and should not be liable for the accuracy of the accounts;
- the regulator should consider how to select which companies to peer review;

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<sup>11</sup> CMA, 'Statutory Audit Services Market Study', pp. 151-52, 165-66.

- the regulator should consider whether and how to make the results of peer reviews public.

## Government Response

- 2.10. The Government is grateful to the CMA for these innovative proposals to address the problems faced by challenger firms in building their capacity and expertise in relation to the most complex audits.
- 2.11. We also recognise the importance of providing meaningful and effective competition and choice for audit clients in the statutory audit market, both as a stimulus to quality and efficiency, and as a bulwark to market capacity and resilience. Previous reforms have not significantly enhanced competition, and more needs to be done to create a more competitive market both in the short and long term as part of a strategy that connects to the market for audit clients beyond the FTSE 350. The CMA's proposals are designed to achieve sustainable progress towards that aim in a reasonably short period of time, without depriving audit clients of choice in their selection of auditor.
- 2.12. In addition, we are aware of the finely balanced arguments between a joint audit and a shared Audit. We note the CMA's view that a shared audit may cement preconceptions that challenger firms are less capable and may limit opportunities for them to gain experience on more complex audits.
- 2.13. Finally, the Government notes the CMA's concerns that market share caps could lead to the Big Four audit firms 'cherry picking' audit clients for retention, leading them to shed the highest risk and lowest profit clients. It could also have a significant impact on audit clients, who might find their choice of auditor constrained and their reputation affected by a perception that they were higher risk than others.
- 2.14. We would welcome views on the following questions:
- 5. Do you agree with the CMA's joint audit proposal as developed since its interim study in December?**
  - 6. Do you agree with the CMA's proposed exemptions to the joint audit proposals? How should the regulator decide whether a company should qualify for the proposed exemption for complex companies?**
  - 7. Do you agree that challenger firms currently have capacity to provide joint audit services to the FTSE350? If a staged approach were needed, how should the regulator make it work most effectively? If not immediately, how quickly could challenger firms build sufficient capacity for joint audit to be practised across the whole of the FTSE350?**
  - 8. Do you agree with the CMA's recommendation that the liability regime would not need to be amended if the joint audit proposal were implemented?**
  - 9. Do you have any suggestions for how a joint audit could be carried out most efficiently?**

- 10. The academic literature cited in the CMA's report suggests the joint audit proposal would lead to an increased cost of 25-50%. Do you agree with this estimate?**
- 11. Do you agree with the CMA's assessment of the alternatives to joint audit, including shared audit?**
- 12. How strongly will the CMA's proposals improve competition in the wider audit market, and are there any additional measures needed to ensure that those impacts are maximised?**
- 13. Do you agree with the CMA's proposals for peer review? How should the regulator select which companies to review?**
- 14. Are any further measures needed to ensure that the statutory audit market remains open to wider competition in the long term?**

### 3. Measures to Mitigate the Effects of the Distress or Failure of a Big 4 firm

- 3.1. As we have seen, the CMA's joint audit proposal is designed to increase the number of audit firms with the capability to compete for complex tenders. In so doing, this proposal would also increase market resilience.
- 3.2. The CMA's third recommendation builds on this proposal by suggesting that the regulator should be given powers to obtain the information it needs to monitor the health of audit practices and intervene where a firm is likely to fail. With these powers, the regulator would aim to maintain competition in the event of the failure of a major firm.
- 3.3. These proposals are based on a broad acceptance among stakeholders that the failure of a major firm could be extremely damaging for the audit market. While there is no suggestion that the Big Four are likely to suffer a failure in the foreseeable future, the CMA concludes that it would be prudent for the new regulator to hold powers for that eventuality.
- 3.4. It is also important to note that this recommendation does not aim to prevent a failure of an audit practice at all costs - failures arising from systematic and firm-wide poor-quality audits must not be prevented in a competitive market. Instead it aims to enable the regulator in that situation to moderate the impact on the market.

#### Design of the Remedy

- 3.5. Under the CMA's proposals, the regulator would be responsible for monitoring the health of the audit firms and intervening when necessary. The CMA therefore recommends that the regulator should be given powers to:
  - obtain timely and periodic submissions from the Big Four firms and possibly the large non-Big Four firms on their financial health;
  - require audit committees to inform it of upcoming tenders and any other information that the regulator considers necessary;
  - obtain, and then review, the modified contingency plans from large audit firms, which should encompass their turnaround plans;
  - require non-Big Four firms to draw up plans for how they could if required take on migrating auditors and/or audit clients from a distressed Big Four.
- 3.6. The CMA's recommendations would provide the regulator with freedom to determine how it would detect whether a firm is in distress. However, as an initial suggestion the



CMA recommends – among other things – that the regulator obtains periodic submissions on key metrics and uses information it obtains from audit firm contingency plans under the AFMA (Audit Firm Monitoring Approach).

3.7. Similarly, the CMA’s recommendations give the regulator flexibility to determine what action to take once it has identified signs of distress. The CMA suggests a range of options, which the regulator may wish to consider depending on the circumstances of the failing firm. These include:

- requiring the audit practice to identify the source of the problem;
- requiring audit firms to modify their contingency plans;
- taking measures to discourage audit contracts transferring to Big Four firms;
- taking measures to incentivise audit teams to move to non-Big Four firms along with their existing audit clients;
- using regulatory reliefs for audit practices to help retain or move staff; and
- providing certainty to the markets and transparency to staff to prevent a ‘run’ on a distressed audit practice.

3.8. In addition, the CMA suggests that the regulator should:

- consider the possible benefits of requiring large audit practices to ringfence a proportion of audit partners’ equity;<sup>12</sup> and
- consider whether and how a power to intervene in executive decision-making could be used. For instance, the CMA suggests that the regulator may wish to consider a) whether it or an appointee may have a seat on the executive board with the power to exercise veto; and b) whether the regulator (or its appointee) might require the option of taking executive control of the audit practice.<sup>13</sup>

## Government Response

3.9. We are grateful to the CMA for these recommendations and we agree that there is more that the regulator could do to monitor and act on the health of audit firms, particularly while the statutory audit market remains so concentrated. Implementing solutions in this area will need careful consideration in order to avoid the moral hazard risks highlighted by the CMA in their report. The Government is keen to implement a monitoring function that can support the market in an effective and competitive way. We would welcome your views on the following questions:

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<sup>12</sup> The CMA suggests the ringfenced equity could be used to pay the fees of a regulator to administer the distress process, and may be used to incentivise audit partner movement, by approving audit partner distributions of salaries at the distressed audit practice.

<sup>13</sup> These proposals may require a special or modified insolvency regime for large audit practices that prioritise the resilience of the market.

**15. What factors do you think the regulator should take into account when considering action in the case of a distressed statutory audit practice?**

**16. What powers of intervention do you think the regulator should have in those circumstances, and what should be their duties in exercising them?**

## 4. Operational Split between Audit and Non-Audit Practices

- 4.1. The CMA's fourth recommendation would require the 'Big Four' firms to put in place a strategic and operational split between their audit and non-audit services. The aim of this recommendation is to ensure that auditors focus on conducting high quality audits, without their incentives being affected by the much greater revenue and profits which may accrue from the non-audit side of the firm.
- 4.2. The CMA's recommendation is based on its observation that audit firms are increasingly dominated by non-audit work. More than three quarters of revenues come from non-audit activities and the CMA concludes that tensions can arise between a firm's non-audit activities and its audit functions.
- 4.3. In coming to this recommendation, the CMA acknowledges that recent changes have mitigated concerns that audit firms are incentivised to use audit services to sell advisory and consultancy work. For instance, three of the Big Four firms have committed to stop providing non-essential non-audit work to the FTSE 350 companies they audit. However, the CMA concludes that the underlying tensions remain between audit and non-audit functions, for the following reasons:
  - audit partners share in the profits earned by non-audit services, giving them a stake in the profits of the whole business rather than those exclusively arising from audit;
  - firms continue to use sectoral expertise of audit partners to help sell non-audit work to clients, drawing on partner time and risking audit quality;
  - there is a 'one firm' culture in multidisciplinary firms, with shared values and goals. Although there are benefits to this shared culture, the CMA conclude that audit requires a distinct set of values centred on objectivity and challenge; and
  - conflict rules exacerbate internal tensions between audit and non-audit work, as firms will take into account the potential loss of current or future non-audit work when considering whether to bid for audits.

### Design of the Remedy

- 4.4. The CMA's recommendation is designed to mitigate the risks to audit quality posed by tensions they identify between audit and non-audit work. Under the CMA's proposal, the Secretary of State would empower and require the regulator to establish an operational split and refine it over time. The CMA recommends that the split initially applies to the Big Four and that the regulator should consider extending elements of

the split to challenger firms. This is because the tension between audit and non-audit functions applies across the Big Four and challenger firms.

4.5. The CMA also explains that key elements of the operational split are likely to be:

- (a) a separate CEO and board for the audit practice, populated by a majority of independent non-executives, who would be accountable to shareholders of audit clients, and to the public interest (subject to the conclusions of the Brydon review) via the regulator;
- (b) the audit board should be responsible for all remuneration and career progression decisions within the audit practice, including recommendation to promotion to partnership;
- (c) remuneration and career progression should be strongly linked to audit quality, with the audit board setting and overseeing quality standards;
- (d) the audit board should conduct an annual general meeting and produce an annual report, with disclosures to be determined by the regulator, but including reporting on audit quality measures;
- (e) separate financial statements for the audit practice, consisting of an income statement;
- (f) transparent transfer pricing, checked by the regulator, e.g. for the use of non-audit specialists on audits;
- (g) no profit-sharing between the audit practice and the non-audit practice;
- (h) the audit practice for the purposes of this remedy includes audit and essential non-audit services closely related to audit.

4.6. In coming to this recommendation, the CMA opted against an alternative proposal that would mandate a full structural separation between audit and non-audit functions. CMA explains that conflict of interest rules apply to the international network, so separation would not improve choice if the structural separation was only applied on a unilateral basis in the UK.

## Government Response

4.7. The Government is grateful for the CMA's ambitious recommendation. We recognise the high risk of actual and perceived conflicts of interest that can occur where audit firms provide non-audit services to their audit clients. This is why in 2016 the UK implemented EU's Audit Directive to increase restrictions on provision of non-audit services by audit firms to public interest entities.<sup>14</sup> These restrictions exist in order to

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<sup>14</sup> 'The Statutory Auditors and Third Country Auditors Regulations 2016', available at <http://www.legislation.gov.uk/uksi/2016/649/contents>

prevent perverse incentives arising for audit firms, and to remove the risk that an auditor will be asked to 'mark their own homework' by auditing other work they had previously conducted for the firm.

- 4.8. Going forward, the Government is determined to identify and implement a powerful and proportionate package of measures to increase choice and capacity in the audit market. We recognise that the multi-disciplinary nature of the Big Four audit firms means that they can be prevented from tendering for a company's audit because of past consultancy work they have undertaken. This further reduces choice for clients and we are therefore committed to increasing meaningful and effective competition, while addressing the conflicts that the CMA identifies between audit and non-audit practices. We recognise that the CMA has considered the balance between these issues very carefully and we would be grateful for stakeholder views on the following questions:

- 17. Do you agree with the CMA's analysis of the impacts on audit quality that arise from the tensions it identifies between audit and non-audit services?**
- 18. What are your views on the manner and design of the operational split recommended by the CMA? What are your views on the overall market impact of such measures?**
- 19. Are there alternative or additional measures which would meet these concerns more effectively or produce a better market outcome?**
- 20. Do you agree with the CMA's proposal to keep a full structural separation in reserve as a future measure?**
- 21. What implementation considerations should Government take into account when considering the operational split recommendations? Please provide reasoning and evidence where possible.**

## 5. Other Possible Measures

- 5.1. The CMA proposes several additional measures in its report that do not form part of its core package of remedies.

### Five-year review

- 5.2. To supplement the proposals described in Chapters 1 to 4, the CMA recommends setting a specific point at which progress can be reviewed, and the effectiveness of the overall package of remedies assessed. It suggests that the regulator should be required to do this five years from full implementation, in addition to its continuing oversight of the implementation and maintenance of the remedies.
- 5.3. In addition, the CMA recommends that the review should return to the following questions:
- (a) The merits of moving to independent appointment of auditors, depending on the effectiveness of the regulatory scrutiny of audit committees.
  - (b) The merits of a requirement for a structural split between audit and non-audit services, depending on the effectiveness of the operational split, and on the level of international engagement in this question.
  - (c) How to fine-tune the joint audit remedy to adapt to market developments.

### Other Measures

- 5.4. The CMA recognises that other measures have been brought to its attention, which do not form part of its central recommendations, but may merit further consideration. These are outlined in pages 18 and 19 of the CMA's summary report and include:<sup>15</sup>
- (a) **Remuneration deferral and clawback.** Whereby awards to partners could be deferred, with a portion of the award vesting in subsequent years. The retained amounts could be subject to a clawback provision, giving the option to the Audit Board to reduce payment. This would aim to discourage irresponsible risk-taking, lack of effective oversight and short-termism, in a similar way to the framework introduced in the financial services sector in 2015.
  - (b) **Audit firm ownership rules.** This suggestion involves reconsidering the requirement for audit firms to be majority owned by qualified auditors. Liberalising

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<sup>15</sup> CMA, 'Statutory audit services market study: final summary report', 18 April 2019, available at [https://assets.publishing.service.gov.uk/media/5cb74577e5274a7416b64f01/final\\_summary\\_report.pdf](https://assets.publishing.service.gov.uk/media/5cb74577e5274a7416b64f01/final_summary_report.pdf)

the ownership rules could encourage greater capital investment allowing entrants and challengers to scale up more quickly, but would need to be weighed up against potential impacts on independence.

- (c) **Technology licensing.** Cross-industry technology licensing, potentially facilitated by the regulator, could remove barriers to competition in the future. The Big Four firms could be required to share their audit technology with challenger firms, for example.
- (d) **Measures to improve information for shareholders,** and increasing transparency of audit committees, especially during tendering. Possible measures include disclosing audit staff hours and fee breakdowns, and a requirement to provide a public database of audit partners and firms. This database could be similar to the one maintained by the US regulator, the Public Company Accounting Oversight Board, to make it easier to identify all audits for which a partner was responsible.
- (e) **Notice periods and non-compete clauses.** The CMA received suggestions that barriers to the growth of challenger firms could be reduced if notice periods for partner and senior staff in Big Four firms were reduced, and non-compete clauses were limited in scope. In response, the CMA suggest that the regulator should consider whether Big Four firms should limit their notice periods to six months.
- (f) **Requirements on tendering and rotation periods.** The current requirement on Public Interest Entities is to carry out an audit tender at least every ten years and to change audit firm at least every twenty years. The BEIS Select Committee recommended revisiting this, moving to a fixed term of seven years, in order to disrupt the ‘familiarity’ that can arise between auditor and audited company.<sup>16</sup>

## Government Response

5.5. We will consider these recommendations alongside the CMA’s core recommendations.

**22. Do you agree with the CMA’s other possible measures? How would these suggestions interact with the main recommendations? How would these additional proposals impact on the market?**

**23. Do you agree with the CMA’s suggestions regarding remuneration deferral and clawback?**

**24. How would a deferral and clawback mechanism work under a Limited Liability Partnership structure?**

**25. Do you agree that liberalising the ownership rules for audit firms would reduce barriers for challengers and entrants to the market?**

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<sup>16</sup> CMA, ‘Statutory Audit Services Market Study’, p.175.

- What positive and negative impacts would this have?
- Do you have any specific proposals for a reformed ownership regime?

**26. Do you agree with the CMA's suggestions regarding technology licensing?**

- What changes would you like to see made to the current licensing framework?

**27. Do you agree with the CMA's suggestions to provide additional information for shareholders? Do you have any observations on the impact of the Public Company Accounting Oversight Board's database on the US audit market?**

**28. Do you agree with the CMA's suggestions regarding notice periods and non-compete clauses? Do you agree that the regulator should consider whether Big Four firms should be required to limit notice periods to 6 months?**

**29. Do you agree with the CMA's suggestions regarding tendering and rotation periods?**

**30. Do you have other proposals for measures to increase competition and choice in the audit market that the CMA has not considered? Please specify whether these would be alternatives or additional to some or all of the CMA's proposals, and whether these could be taken forward prior to primary legislation.**

**31. What actions could audit firms take on a voluntary basis to address some or all of the CMA's concerns?**

**32. Is there anything else the Government should consider in deciding how to take forward the CMA's findings and recommendations?**



## Annex A – Consultation Questions

1. **Do you agree that the new regulator should be given broad powers to mandate standards for the appointment and oversight of auditors, to monitor compliance and take remedial action? What should those powers look like and how do you think those powers would sit with the proposals in Sir John Kingman’s review of the Financial Reporting Council?** <sup>17</sup>
2. **What comments do you have on the ways the regulator should exercise these new powers?**
  - For instance, do you have any comments on the conditions that should be met for the regulator to exercise its powers to take remedial action?
  - Are there particular events (such as a poor audit quality review, early departure of an auditor or a significant restatement of the company’s accounts) which should trigger the regulator’s involvement?
3. **How should the regulator engage shareholders in monitoring compliance and taking remedial action?**
4. **What would be the most cost-effective option for enabling greater regulatory oversight of audit committees? Please provide evidence where possible.**
5. **Do you agree with the CMA’s joint audit proposal as developed since its interim study in December?**
6. **Do you agree with the CMA’s proposed exemptions to the joint audit proposals? How should the regulator decide whether a company should qualify for the proposed exemption for complex companies?**
7. **Do you agree that challenger firms currently have capacity to provide joint audit services to the FTSE350? If a staged approach were needed, how should the regulator make it work most effectively? If not immediately, how quickly could challenger firms build sufficient capacity for joint audit to be practised across the whole of the FTSE350?**
8. **Do you agree with the CMA’s recommendation that the liability regime would not need to be amended if the joint audit proposal were implemented?**
9. **Do you have any suggestions for how a joint audit could be carried out most efficiently?**
10. **The academic literature cited in the CMA’s report suggests the joint audit proposal would lead to an increased cost of 25-50%. Do you agree with this estimate?**

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[https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/765547/auditor-appointment-letter-to-greg-clark-december-2018.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/765547/auditor-appointment-letter-to-greg-clark-december-2018.pdf)

- 11. Do you agree with the CMA's assessment of the alternatives to joint audit, including shared audit?**
- 12. How strongly will the CMA's proposals improve competition in the wider audit market, and are there any additional measures needed to ensure that those impacts are maximised?**
- 13. Do you agree with the CMA's proposals for peer review? How should the regulator select which companies to review?**
- 14. Are any further measures needed to ensure that the statutory audit market remains open to wider competition in the long term?**
- 15. What factors do you think the regulator should take into account when considering action in the case of a distressed statutory audit practice?**
- 16. What powers of intervention do you think the regulator should have in those circumstances, and what should be their duties in exercising them?**
- 17. Do you agree with the CMA's analysis of the impacts on audit quality that arise from the tensions it identifies between audit and non-audit services?**
- 18. What are your views on the manner and design of the operational split recommended by the CMA? What are your views on the overall market impact of such measures?**
- 19. Are there alternative or additional measures which would meet these concerns more effectively or produce a better market outcome?**
- 20. Do you agree with the CMA's proposal to keep a full structural separation in reserve as a future measure?**
- 21. What implementation considerations should Government take into account when considering the operational split recommendations? Please provide reasoning and evidence where possible.**
- 22. Do you agree with the CMA's other possible measures? How would these suggestions interact with the main recommendations? How would these additional proposals impact on the market?**
- 23. Do you agree with the CMA's suggestions regarding remuneration deferral and clawback?**
- 24. How would a deferral and clawback mechanism work under a Limited Liability Partnership structure?**
- 25. Do you agree that liberalising the ownership rules for audit firms would reduce barriers for challengers and entrants to the market?**
  - What positive and negative impacts would this have?
  - Do you have any specific proposals for a reformed ownership regime?
- 26. Do you agree with the CMA's suggestions regarding technology licensing?**

- What changes would you like to see made to the current licensing framework?
- 27. Do you agree with the CMA's suggestions to provide additional information for shareholders? Do you have any observations on the impact of the Public Company Accounting Oversight Board's database on the US audit market?**
  - 28. Do you agree with the CMA's suggestions regarding notice periods and non-compete clauses? Do you agree that the regulator should consider whether Big Four firms should be required to limit notice periods to 6 months?**
  - 29. Do you agree with the CMA's suggestions regarding tendering and rotation periods?**
  - 30. Do you have other proposals for measures to increase competition and choice in the audit market that the CMA has not considered? Please specify whether these would be alternatives or additional to some or all of the CMA's proposals, and whether these could be taken forward prior to primary legislation.**
  - 31. What actions could audit firms take on a voluntary basis to address some or all of the CMA's concerns?**
  - 32. Is there anything else the Government should consider in deciding how to take forward the CMA's findings and recommendations?**

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This consultation is available from: [www.gov.uk/government/consultations/statutory-audit-services-initial-consultation-on-the-competition-and-markets-authority-recommendations](https://www.gov.uk/government/consultations/statutory-audit-services-initial-consultation-on-the-competition-and-markets-authority-recommendations)

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