Annex B

Summary of CMA Statutory Audit Services Market Study

Overview

The CMA's statutory audit services market study has recommended that firms' audit and advisory businesses be split into clearly defined separate operating entities, with separate management and accounts and remuneration, but stopping short of full structural separation. It also proposes more accountability for those appointing auditors, with the aim of strengthening their independence and a "joint audit" system, with a Big Four and a non-Big Four firm working together on an audit.

In more detail

The CMA wants to change the dynamics of the market so that competition is focused on quality, and that there is sufficient choice of viable competitors over the long term.

The CMA has identified the following issues that it wishes to address:

- **Selection and oversight of auditors** – the process is insufficiently focused on quality. Audit Committees are only a partial solution to the underlying problem that companies procure their own audits.
- **Choice** – there are limitations on choice, driven by a combination of regulatory requirements, firms' structure, and barriers to competition from challenger firms; as well as concerns over the long-term resilience of the sector
- **Firms' structure** – the structure of audit firms results in weaker incentives to deliver high-quality audits, because a significant majority of the firms' business is outside audit.
- **Regulation** – the CMA leaves Sir John Kingman's review to speak for itself, but notes stakeholder opinion that regulation has been inadequate.

Of most relevance to us is the relationship between audit and non-audit services given that each of the Big Four has an ABS licence and has ambitious plans for legal services. While the 70% rule – an EU regulation – already places a cap on fees for non-audit services from audit clients, the CMA considers this does not deal sufficiently with its central concern that audits are insufficiently challenging due to conflicts caused by firms' combined audit and non-audit structures. Its specific concerns are that: audit partners directly benefit from the commercial success of the non-audit part of the business; the significant proportion of firms' revenue from non-audit services means governance and investment decisions will be driven by non-audit considerations; underlying cultural concerns where the two types of services are provided by one firm, given the objective of audit is to be sceptical but the objective of non-audit services is to be collaborative; and incentives around the selection of audit firms.

The CMA proposes the following remedies:

- **Regulatory scrutiny of auditor appointment and management**. The CMA also considered taking appointments away from audited companies, but felt that EU rules preclude this and acknowledged some practical issues.
- **Breaking down barriers to challenger firms** – mandatory joint audit for the FTSE350 with at least one of the auditors being outside the Big Four. Should this

prove ineffective, a possible alternative is a market share cap. A resilience remedy is also proposed to protect against the Big Four becoming a Big Three.

- **A split between audit and advisory businesses** – into clearly defined separate operating entities, with separate management and accounts and remuneration. For now, the CMA is not recommending full structural separation, but this remains on the table. Even if this were introduced, it is likely that any prohibition on audit firms providing non-audit services would apply to their FTSE350 audit clients only.
- **Peer review of audits** – commissioned by, and reporting to the regulator.

There could be concerns if the remedies would unduly impinge on the ambition or ability of audit firms to provide legal services within multidisciplinary practices. However, the proposed structural changes would be unlikely to have this effect, while audit firms would still have the scale and revenues to invest in a sector which they view as potentially highly profitable.

The proposed package, in tandem with regulatory reform (see Kingman Review) is expected to bring about significant improvements. However, if not, the CMA promises to come back to more 'drastic but harder to implement remedies'. The CMA also makes clear that legislation would likely see its remedies implemented, monitored and enforced more effectively.

The CMA is inviting comments on its update paper by 21 January. It plans to issue a final report 'as soon as possible in 2019', although the statutory deadline is not until October.

Summary of Sir John Kingman's Independent Review of the FRC

Overview

This government-commissioned but independent Review recommends the abolition of the FRC as soon as possible, and its replacement with a new independent regulator with clear statutory powers and objectives named the Audit Reporting and Governance Authority. It should be accountable to Parliament, its Board composition should not seek to be representative of stakeholder interests and the current self-regulatory model for the largest audit firms should end.

In more detail

The Review was commissioned in the wake of several major corporate collapses, including Carillion, in which the quality of audit reports on the financial position of those firms was called into question.

The Review uses direct language to highlight the deficiencies of the FRC and call for a fundamental overhaul of the regime for assuring audit quality and independence to rebuild public and investor confidence.

The key criticisms of the FRC include:

- The FRC has no direct regulatory purchase on the major audit firms, meaning they were still effectively being regulated by their own trade association.
- The FRC has failed to make the case (or not persuasively enough) for change to its powers, even though its powers are clearly deficient.
- The FRC has taken an excessively consensual approach to its work.
- The FRC's own governance (eg recruitment of Board and council members which is described as 'inappropriately informal', managing conflicts of interest, leaking of key decisions in advance) has been inconsistent with the public importance of its work and its role in championing governance in the corporate world.

- It is inappropriate for a body such as the FRC which receives no tax payer funding to be subject to certain Public Sector financial controls, particularly the Public Sector Pay Guidance structures.

The Review recommends that the new regulator should (amongst other things):

- Have a strategic objective "to protect the interests of investors and the wider public interest by setting high standards of corporate governance, corporate reporting and statutory audit, and by holding to account the companies and professional advisors responsible for meeting those standards".
- Be levy funded
- Recruit more partner-level staff to add weight to its work and command more respect with firms
- Have a budget and CEO salary set by Ministers, but make other pay decisions itself, subject to proper transparency and within the overall budget set by Ministers.
- Be firmly driven by the interests of consumers and users of audited figures, not producers or the audit profession.
- Be able to recommend to shareholders that they consider a change of CEO, CFO, chair or audit committee chair, or that they reconsider the payment of dividends.

The Review emphasises that it has **not** recommended major structural change, such as merger with another regulator or splitting standard-setting from enforcement. It also makes a number of more detailed recommendations around the arrangements for local authority audit, the role of the regulator in quality-assessing all the NAO's financial audit work and interim steps that could be taken (given that primary legislation will be required to implement many of the Review's recommendations) to improve the functioning of the FRC in the meantime.