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1 Introduction

ICAS is a professional body for more than 21,000 world class business men and women who work in the UK and in more than 100 countries around the world. Our members have all achieved the internationally recognised and respected CA qualification (Chartered Accountant). We are an educator, examiner, regulator, and thought leader.

While ICAS has many members who work in both practice and across business and industry sectors, and who will be affected by any change to the accountancy, audit and PIE regulatory regimes, we work primarily in the public interest. It is this public interest that has driven our proposals. We welcome the opportunity to respond to the CMA Invitation to Comment.

The expectation is that increased choice in the audit market will improve audit quality, and that this would help safeguard against future corporate failures. That may not necessarily be the case. It is important to recognise that increased choice and quality will not eliminate the risk of future corporate failures – that is a part of corporate life as markets change and some companies fail to adapt, overstretch themselves or make poor decisions.

Increased choice should always be encouraged, and as part of this response we have sought to identify potential ways in which choice, within the audit market, could be improved. However, the primary overarching objective has to be to seek to ensure audit quality. Any measures which could impact negatively on audit quality will not be in the public interest.

If audit quality is the prevailing issue, then the optimum outcome is likely to be a combination of several initiatives, including a review of corporate reporting, scope of audit, enhanced corporate governance, and creating opportunities for increased choice. Therefore, the CMA needs to contribute to this wider programme of reform.

The escalated timescale of this market study is very tight, almost unreasonable, and stakeholders are unlikely to have had sufficient time to provide meaningful evidence to the CMA. Over the last few weeks, to shape and inform our response, ICAS has mobilised its resources and engaged with members and non-members, investors, directors of Public Interest Entities (PIEs) and large private companies (including audit committee chairs) and auditors (including beyond the Big Four) to seek out views on the CMA document and the questions posed.

External audit does not operate in a vacuum. It forms part of the wider governance framework that oversees larger corporates, i.e. boards of directors, audit committees, investors and regulators. ICAS members across the various stakeholder groups have highlighted to us that there is a willingness to identify and to embrace positive changes, for the benefit of the public and business. They have also shared their concerns over the unintended consequences of certain proposed reforms.

In the public interest, ICAS seeks to not only suggest a way forward, but also offer constructive challenge to some of the current CMA assumptions and proposals, all with a view to bringing clarity to the current debate.

Beyond the submission date, ICAS will look to see what further enquires and activities it may reasonably pursue to help inform the continuing debate on the future of assurance.

If you would like to discuss any of the matters in this response then please feel free to contact me.

Bruce Cartwright
Chief Executive
ICAS
2 Key Messages

We have identified the following areas for focus.

- A Government supported multi-stakeholder review into the UK corporate governance and corporate reporting frameworks including assurance should be instigated. This would encompass a review of the role and purpose of audit and consider whether it needs to evolve to better meet current and evolving stakeholder expectations. The objective of this review would be to address the core issues that we believe the public (and Government) want to see addressed. These are to improve the level of quality and trust in audit and its role in supporting the viability of Public Interest Entity (PIE) companies. It is however important to recognise that audit change alone will not eliminate the risk of future corporate failures. Part of the Review ought to consider whether it is reasonable to rely on the current scope of audit to provide the assurance required by stakeholders for protection of their interests. This would include looking at whether non-GAAP measures should be brought into the scope of a more formal assurance process and also whether assurance is required on other corporate information that is reported by the company e.g. investor briefings. Consideration might also be given to the US requirements on the effectiveness of an entity’s internal control over financial reporting (and the integrated audit approach). It will only be by giving due consideration to the role and purpose of statutory audit in the context of the broader corporate governance and corporate reporting environment that significant changes can be identified for consideration and, if supported, implemented.

- Any review of the market for audit in the UK should consider both the “demand” as well as the “supply” side. Looking alone at who is supplying audit services will not be sufficient to fully understand the market, and there are several potential demand-led initiatives which we believe could encourage increased competition within the audit market.

- It is incumbent upon shareholders to engage with audit committees of their investee companies. Many board directors have commented that while investors engage on matters relevant to the remuneration committee, there is little or no engagement on the matters addressed by the audit committee which arguably go to the heart of the quality of their investments. We have highlighted this point in our response to the Review of the FRC. Likewise, audit committees need to be mindful of their wider role and responsibilities.

- There should be increased transparency of the audit committee tender process and this should be communicated well in advance of the actual process commencing. In particular, this should include disclosure of the audit committee’s key criteria for assessing the qualities they expect of their statutory auditors. This should be at a sufficiently detailed level to enable all firms including those outside of the Big Four to assess their own capabilities to audit a particular PIE company and if necessary to close any gaps in capability. Audit committees already publish their tender requirements (FRC Audit Tender Best Practice Notes, February 2017) but it is not being reported at a sufficiently detailed level to enable all firms including those outside of the Big Four to assess their own capabilities to audit a particular PIE company, or if necessary the level of investment required to close any gaps in capability. Any improvement in supply side choice will, we believe, require such investment (and we understand that firms are willing to invest).

- We would support a complete prohibition on audit firms providing non-audit services to their PIE audit clients (at least the FTSE 350), subject to a small agreed list of permitted assurance related services. The assurance and audit related services that could be allowed to be provided to PIE audit clients should be reviewed and clarified, and a list of permitted services prepared accordingly.

- The current auditor liability regime concentrates the audit of the most complex PIE companies within a very small group of firms who have the capacity to invest in the training and technology required to manage this risk and who have the diversification and scale to absorb liability for failings should these arise. We believe the CMA will need to engage with the FRC to address this particular challenge. Consideration may need to be given to whether or not the existing auditor liability regime should be adapted.
- There is also a need for more constructive dialogue between the FRC and CMA to ensure the respective objectives of both bodies are aligned. The FRC has an established KPI that 90% of FTSE 350 audits should not require more than limited improvements; we support this. If this KPI is met through existing audit arrangements this acts as a constraint to making a change given that the risk of audit quality falling below the FRC threshold may be elevated in the period of transition from one auditor to another. The regulator would need to find ways to support the audit market through this process, if enhanced choice is to be a realised outcome.

- We note the CMA’s proposed measure that the professional bodies, such as ICAS, could assist audit firms outside the Big Four to build capability and capacity, with a view to tendering for PIE audits in the future. ICAS is committed to working in the public interest and thus would look forward to exploring with the CMA what those initiatives might be, and the role we might play.
The purpose, scope and future of audit

Audit quality is receiving global attention, with public trust in business and the audit profession needing to be improved. However, the issues are broader than just audit and need to be considered in this wider context. At the heart of this debate is the overall corporate governance and corporate reporting arrangements for PIE companies.

Audit serves its many stakeholders well, and every year thousands of companies, both public and private, are audited without any material issues. This reflects generally high quality financial reporting, supported by the rigour of the accounts having to be independently audited. Our capital and financial systems depend upon reliable financial information and external confidence in our stock markets and financial system more generally, is evidence of broad-based trust in the information reported.

Whilst we do not believe that the current audit model is broken, we do accept that the public perception of audit has changed, and the time is ripe for a holistic review of the purpose and role of the audit of PIE companies to ensure that the audit remains fit for purpose. Against a background of changing public expectations, there still remains a level of confusion over the current role and purpose of audit, what it does and does not do.

In this section we reflect on the purpose and statutory scope of an audit, and the need for a review of the wider corporate governance and corporate reporting framework.

3.1 Purpose of Audit

Historically, the requirement for an audit of the financial accounts arose out of the increased separation of ownership from management following the industrial revolution in the 19th century, coupled with a series of corporate scandals in which the quality and sometimes the veracity of the documents provided by company directors were questionable. The response was to enshrine in law the need for external assurance of these financial statements – an audit – to be carried out by a suitably qualified professional – the auditor. This requirement has over the years gone through many and varied iterations in both law and regulation.

Ultimately, the purpose of the audit is to provide independent assurance that management has, in preparing the financial statements, presented a "true and fair" view of a company’s financial performance and position. Audit underpins the trust and obligation of stewardship between those who manage a company, its shareholders and wider stakeholder groups.

3.2 Audit Scope

The current statutory audit is governed by the requirements of UK primary legislation, International Standards on Auditing (ISAs) (UK) and Ethical Standards. While true that the ISAs (UK) set out the “way” the audit should be conducted, the fundamental objective of the audit is firmly grounded in Section 495 of the Companies Act 2006.

Audit Scope

The longer form of an audit report which requires the identification of key audit matters now provides considerably more information for investors and other stakeholders to assess the work of the auditors, but at its core, the work undertaken by the statutory auditor is restricted to an opinion on the financial statements (made up of GAAP defined measures), associated notes and parts of the remuneration report. Other parts of the company’s annual report, including the use of non-GAAP measures, are nonetheless reviewed for consistency and included within the auditor’s comments where there are “material” inconsistencies with the financial statements and/or conflict with the auditor’s knowledge gained during their audit work.

While the auditor does consider the future viability statements, they are not “audited” to the extent that the public might think; nor are they capable of being so without considerable further work, akin to that needed to report within a prospectus document. This is at the core of the now widely recognised “audit expectation gap”. It is in no one’s interest that this “gap” persists, alleviation of which can only be achieved through increased public awareness of the restricted scope of the audit, and/or some change to align the audit scope with society’s expectations. This task should be at the core of the proposed future multi stakeholder review into the UK corporate governance, corporate reporting and assurance framework.
**Impact of increasing judgement**

The CMA has made reference to the evolution towards “fair value accounting”. By way of clarification, we would highlight that this relates to financial reporting standards, and not auditing standards. Fair value accounting has notably increased the level of complexity and judgement and the application of assumptions, in some cases without verifiable external inputs, both required for measurement and reporting of some material balance sheet and income statement accounts. These judgements and assumptions are the responsibility of directors, but are subject to audit. In particular, the measurement of the carrying value of goodwill, long term contracts, financial instruments and pensions involves complex accounting processes based on underlying assumptions.

Measurement outcomes naturally fall within acceptable but challengeable ranges rather than precise numbers. As well as necessitating companies to improve the expertise within their own accounting functions and governance arrangements this has, in turn, required auditors to enhance their in-house capabilities and specialist expertise in order to review assumptions and models and audit these account balances; this has further driven the consolidation of complex technical skills within a small number of firms - the market we know today.

This increased level of judgement has also naturally led to greater subjectivity in the financial information published as accounts move away from historic cost to measurement bases that incorporate modelled assumptions about future events. This more forward-looking accounting basis has also led to greater transparency, for example in terms of displaying a company’s defined benefit pension scheme liabilities on balance sheet, as well as measuring the fair value of certain financial instruments which would not have been required under a historic cost model. So, accounting standard setters have increasingly opted to favour value-based accounting with increased transparency versus the objective but less relevant certainty of historic cost accounting. This obviously makes the auditor’s role much more challenging, due to management’s increased use of modelling in preparing the financial statements (with inputs based on judgement versus observable facts).

While in all cases the judgments, models and assumptions remain the responsibility of the company directors (and experienced audit committee members will challenge these bases), considerable time and expert resources is also engaged in the audit of these areas of judgement. They are also key items for discussion with audit committees and will receive due attention. In addition, the enhanced audit committee report and the longer auditor report generally comment on the work done to assure that the final conclusions are appropriate. These disclosures are there for shareholders and other stakeholders to read and interpret; it is likely, however, that only the most sophisticated stakeholder will have the skill to do so. It is incumbent on those stakeholders to positively engage with the audit committee on any matter arising. Additionally, reviewing audit reports, and indeed audit committee reports, over a number of years could enable stakeholders to better identify any change in the risk profile of a company.

**Audit Tenders and Statutory Auditor selection**

The ultimate clients of a statutory audit are investors not companies, and audit committees act on their behalf. Significant shareholders are therefore interested in a transparent tender process. Audit committees are required to disclose in their annual report that a tender is taking place.

In compliance with their obligations under the UK Corporate Governance Code, the audit committee of a PIE company (which is a subcommittee of the UK unitary board and not a separate entity) has to consider the company’s particular needs and circumstances when they make a recommendation to the board and shareholders to change/appoint a Statutory Auditor. An audit committee and its members have a fiduciary duty to find and select the highest quality audit service firm to meet their specific needs.

Audit committees have the time and resources to understand fully the audit requirements of the company and the audit planning and scope proposals being made by the respective audit firms that participate in the tender process. They are in an unrivalled position to make an informed assessment about: the needs of the company; whether the tender selection criteria are met; the proposed engagement team; and to ultimately make a recommendation to the board and to the shareholders as to which audit firm should be appointed.

The members of the audit committee are exclusively non-executive directors, with statutory and fiduciary duties. They do not discharge these duties lightly. The tender is a complex process, which is conducted in compliance with best practice guidance (the FRC and ICAS both issue guidance for audit committees).
3.3 Responsibility for the Financial Statements (including UK Corporate Governance Code Disclosures)

The annual report and financial statements are, by law, the sole responsibility of the directors of the company.

In addition, the UK Corporate Governance Code requires that directors should explain in the annual report their responsibility for preparing the annual report and accounts, and state that they consider the annual report and accounts, taken as a whole, are fair, balanced and understandable and provide the information necessary for shareholders to assess the company’s position and performance, business model and strategy. Liability remains with the company and its directors and it is essential to emphasise that these are not the auditor’s financial statements.

To help provide clarity on this point International Standard on Auditing 700 (Revised June 2016) ‘Forming an Opinion and Reporting on Financial Statements’ requires in the inclusion of the auditors’ report:

(i) A section on management responsibilities, which includes outlining the directors’ responsibilities for preparing the financial statements and assessing the company’s ability to continue as a going concern; and
(ii) A section on the auditor’s responsibilities, which include obtaining sufficient and appropriate audit evidence regarding the financial information of the entities or business activities within the group to express an opinion on the group financial statements.

3.4 Future of Audit

The current conversations about the future scope of audit are not new.

Following the financial crisis in 2008/9 ICAS looked to the role of assurance in the capital markets and published in 2010 “The Future of Assurance”. A copy of this report is included at Appendix 2.

We introduced this work with the following statement:

“Effective capital markets need trust: trust in the integrity, skill and competence of a company’s directors and management and trust in their reporting. The role of assurance is to inspire trust in corporate reporting. But assurance is more than external audit - it is a process which begins with the company itself”.

We believe that statement was true then and it is equally relevant today as the CMA examines the external audit market in the UK. Indeed, looking back on the ICAS Future of Assurance work today we can see that many of the recommendations made then have since been adopted in one form or another.

3.5 Corporate Failures

The core issues that we believe the public and government want to see addressed are, how to ensure fewer unsignalled corporate failures and also improve the quality of audit.

The public needs to have trust and confidence in the operation of the capital markets and the companies that make up those markets, but it is important to recognise that external audit does not operate in a vacuum. Whilst the current debate is placing considerable focus on the role of the auditor, the wider holistic governance framework has a greater role to play. Audit forms part of the wider governance framework that oversees the governance and reporting of larger corporates. This involves many participants including: directors; audit committees; standard setters (financial reporting, auditing and ethics, including auditor independence); regulators; shareholders; auditors and Government.

Audit is not designed to prevent corporate failures. Companies fail for many reasons unrelated to audit, often involving one or a combination of the following factors (not exhaustive):

- Inadequate, weak, or breakdowns in, internal controls;
- Lack of liquidity/solvency leading to Going Concern, viability issues;
- Raising false expectations through focussing on selective Non-GAAP measures when reporting in public pronouncements;
- Poor corporate governance;
- Flawed business model;
• Fraud;
• Poor ethical culture; and
• Poor/weak management.

We also need to consider the ever-increasing complexity and speed of change of business, and the related increase in the complexity of corporate reporting, despite best endeavours to make this fair, balanced and understandable.

There is no disputing that Society’s expectation of audit is changing, and we believe the public interest test is changing with it. However, it is only by properly considering the purpose and role of audit in the wider corporate reporting environment that we can properly consider what changes are required.

3.6 Holistic review of governance and reporting framework

If the shared aim is improving trust in capital markets and corporate reporting, then the wider context of the UK governance framework and the role that audit/assurance plays should not be overlooked.

The focus of the CMA’s market review: improving competition and choice in the audit market, will not, of itself, resolve the challenges of audit and audit quality.

The optimum outcome is likely to be a combination of several themes (including the role and purpose of corporate reporting, a review of the scope of audit, improved audit regulation, enhanced corporate governance and increased choice and competition in the audit market).

ICAS would endorse the establishment of a Government supported multi-stakeholder forum to review the corporate governance and corporate reporting framework. As part of this review, the role of audit would feature prominently and this would provide the opportunity to properly address any issues and seek to close the audit “expectation gap”. For example, due consideration should be given to whether the current scope of audit is suitable for the modern world and further, whether extending the scope would give greater protection and assurance to stakeholders, at a proportionate cost. It could also include consideration of the US requirements on the effectiveness of an entity’s internal control over financial reporting, including the audit of management’s assessment of this, where this is integrated with the audit of the financial statements. Finally, consideration could be given to bringing assurance on non-GAAP measures into the scope of the audit as well as whether there is a need for assurance to be provided on other corporate reported information, such as investor briefings.

This forum should comprise representatives from each of the main stakeholder groups i.e. investors, business, the audit firms, the professional bodies, standard setters and regulators.

We acknowledge that any change in the definition, scope and extent of audit will require a change in law and regulation. It is important that the Government is involved in this multi-stakeholder review, not only so that it can lead on any legislative and regulatory reform, but its participation will be key to ensuring public trust.
4 Audit Market Considerations

A holistic review of the corporate governance and corporate reporting framework will take time and the outcomes may require legislative change, but it is key to restoring public trust in business.

Beyond this review, if increased choice within the audit market can be achieved, then it should be encouraged.

In this section, ICAS seeks to not only suggest ways to help increase choice, but also offers constructive challenge to some of the current CMA assumptions and proposals, all with a view to bringing clarity to the current debate.

4.1 Demand Side Considerations

Any review of the audit market should consider both the “demand” as well as the “supply” side. Looking alone at who is supplying audit services will not be sufficient to fully understand the market.

There are several potential demand-led initiatives which we believe could encourage increased competition within the audit market.

**Transparency of FTSE 350 audit requirements**

The requirements of the “demand” side for audit merit attention from the CMA, particularly as there appears to have been little research to date, to establish what PIE companies and their audit committees require from their auditors (such as scale, geographical scope and sector/specialist expertise).

We believe that particular attention should be given to the FTSE 350 in any market study; this is an important group which we anticipate might demonstrate the individual and varying requirements that they would present to any prospective auditor, including specialist expertise and sector knowledge, access to technology, global capability and individual engagement team characteristics.

We also consider that there is scope to require FTSE 350 companies in future to be more open and transparent about the qualities they expect of their prospective auditors, enabling firms to assess their suitability at an early stage of the tender process (and to invest in and address any areas of weakness for the future). Whilst audit committees are reporting in compliance with the FRC’s current guidance, there is scope for more specification and detail. This should not be to the extent required under procurement rules, but the ability for firms outside of the Big Four to assess their own competitiveness to audit a FTSE 350 company well in advance of any planned audit tender, could be greatly enhanced by increased transparency of the characteristics that audit committees are looking for in their prospective auditor.

Increased transparency and improved accessibility to the tender process will be key factors in encouraging firms to make any necessary investments (and we understand that firms are willing to invest).

**Enhanced Investor Engagement**

Today’s enhanced reporting and the encouragement for further shareholder engagement with company boards, through the Stewardship Code and the other incentives, should allow for shareholders to actively seek out explanations on issues that concern them, including those of perceived audit quality. Ultimately it is the investors who will appoint the auditors of the company at the Annual General Meeting. It is the clear responsibility of board members including non-executive directors, to respond positively to such approaches.

However, as we highlighted in our response to the Review of the FRC, there is an apparent lack of willingness for investors to engage with audit committee chairs; this is in stark contrast to the engagement with remuneration committee chairs, yet the risk impact is considerably higher in matters of audit. ICAS has called for greater focus to be placed on the role of investors in promoting corporate governance (which we consider could be mandated if necessary). This needs to be addressed, at the very least by making provision to this effect in any forthcoming revisions to the Stewardship Code. Indeed, any such provision should take on board recommendations that were made by ICAS in its 2010 Future of Assurance report.
This ICAS report proposed that investors should:

- Seek to satisfy themselves that the reporting of the company is sufficient for their needs as Investors;
- Where that reporting is not sufficient, seek to challenge the Board to improve its reporting;
- Seek to engage with the audit committee on the sufficiency and quality of the assurance provided on the annual report, including the financial statements and any other assurance provided.

ICAS remains of the view that these initiatives remain relevant.

4.2 Supply Side Considerations

Supply Market Size

Whilst there are over 5,500 audit firms in the UK, not all can conduct the audit of a FTSE 350 or a large private company. There is a fundamental difference between being “registered” to carry out audit work, and being “fit and competent” to carry out the audit of a large listed company. Less than 1% of these firms are presently undertaking the audit of a FTSE 350 or large private company, and the proportion of firms reduces as the complexity of the company increases.

The capabilities of the top 50 firms will be different. Some audit firms may be able to very quickly challenge the Big Four for some of these audit engagements, and some audit firms may never want to (the required levels of investments and increased risk will outweigh any perceived benefits). Other audit firms may take longer to build the capacity and capabilities.

This is why we consider there is a real need to understand the “demand” side requirements, as it will be critical to determining the level of potential competition that certain reforms can deliver within the audit market, and the likely timescale of those reforms being realised.

4.3 Observations on CMA Themes

The invitation to comment identifies five relevant and appropriate themes that the CMA propose to investigate (but later restricts the focus of its research to incentives, choice and resilience). For the reasons outlined earlier in this response, scope and purpose of audit may not be within the CMA’s expertise, but it needs to form part of the wider programme of reform.

Before exploring the potential outcomes, we would wish to comment on the following CMA assumptions and proposed considerations.

Incentives

There are significant governance arrangements for the appointment of auditors, enshrined in legislation and the UK Corporate Governance Code. There is no evidence that the audit process is incentivised by company management at present.

The selection of auditors is today made through a generally publicly disclosed process by the audit committee of the board of directors, who then recommend their appointment to the full board and to the shareholders. It is the shareholders who ultimately approve the appointment of the auditor, at the Annual General Meeting.

The audit committee, in UK public companies, is a sub-committee of the board and is made up wholly of non-executive directors who are appointed annually to represent the shareholders. There is no reason to believe, nor do we know of any empirical evidence to suggest, that there are cases where non-executive directors who make up the audit committee did not act in the shareholders’ and wider public interest. Indeed, statements being made through public company enhanced audit committee reports would suggest that these committees, and its members, are primarily looking for high quality audit and not the lowest cost, and that company management (who support but are not part of this decision-making process) incentives are not a consideration.

Choice

Since the last Competition Commission review, mandatory retendering and rotation has resulted in a number of FTSE 350 companies switching auditors. This was intended to increase competition which it has, although we acknowledge the result so far has been to increase the dominance of the Big Four in the FTSE 350 audit market.
(as we have explained above). Despite this, mandatory retendering and rotation remain a good lever to encourage competition over the long term. Although still relatively new these requirements have resulted in considerable switching of auditors which has, it is generally accepted, seen an improvement in audit quality.

Nevertheless, the CMA considers that mandatory retendering and rotation have not been as successful as expected due to other emerging issues, such as demand side barriers to switching, influence of alumni of the large firms on audit committees, limited shareholder capacity to appraise auditor performance, cost to business and access to technology.

To inform the CMA research, we offer the following comments:-

• **Demand side barriers to switching**
  Directors have a fiduciary duty to ensure that the company obtains audit services from a firm that can fully and effectively deliver the full scope of the audit. The current capability of a number of firms outside the Big Four may as yet be untested in certain specialist sectors. This could have been a determining factor in the selection of auditors, as lack of demonstrable experience does create a potential risk to audit quality, and understandably, many audit committees (and audit firms) will be reluctant to tolerate such risks in the current political, legal and regulatory environments.

• **Influence of alumni of the Big Four on audit committees**
  The major professional services firms are a key training ground for the FTSE 350. A number of employees within the Big Four audit firms will leave each year, to translate their skills into a business environment. Mobility of talent needs to be encouraged, and should not be presented or perceived as a negative factor. In the particular context of audit, there are a number of measures to safeguard against threats to auditor independence and objectivity, and these requirements must be followed. The FRC Ethical Standard sets out strict independence rules which prevent former audit partners from joining their audit client as an officer or employee for a prescribed period of time. The UK Corporate Governance Code also reinforces the need for the audit committee to review and monitor the external auditor’s independence and objectivity each year, as well as the effectiveness of the audit process. We also highlight that the independence of the chair of the audit committee in the tender process is important. As has been seen in practice, where an audit committee chair has recently been part of one of the firms tendering for the audit, they should recuse themselves from chairing the selection panel. As this process requires to be disclosed in the Annual Report, highlighting such matters should provide confidence to users of the independence of the selection panel.

• **Limits of shareholder capacity to appraise auditor performance**
  As outlined above, the obligations of the audit committee are enshrined in the UK Corporate Governance Code. The responsibility to appraise the auditor’s performance and report on that appraisal lies firmly with the audit committee. Incentives to enhance investor engagement with the chair of the audit committee need to be encouraged. The issue could be characterised as limited shareholder engagement, rather than limits of shareholder capacity. We refer you to our earlier comments on how the Stewardship Code could be enhanced to help facilitate greater engagement between institutional shareholders and audit committees.

• **The costs to businesses of switching auditor … reduce the incentive to switch compared with uncertain benefits**
  Admittedly, there is an opportunity and real cost attached to retendering, but rotation is mandatory. Barriers are more likely to take the form of audit committees’ safeguarding against a risk to audit quality, or firms not yet being able to meet the key requirements. This is why it is so important for audit committees to better articulate early what they are looking for, thereby allowing audit firms to address any real or perceived shortfalls and confirm to any target companies why they could effectively provide a high-quality audit. Equally, the audit committee should be open with unsuccessful firms so that they can address areas of weakness for the future. Firms need to know what is expected of them, or the level of future investment required to close any gaps in capability.
• **Liability Regime**

The current auditor liability regime acts to concentrate the audit of the most complex PIE within a very small group of firms who are perceived to have the capacity to invest in the training and technology required to manage this risk and who have the diversification and scale to absorb liability for failings should these arise. If increasing audit choice is a key objective, consideration is required as to how the existing auditor liability regime could be reformed. We believe the CMA will need to engage with the FRC to address this particular challenge.

We would also point out that for any disruptive business model provider to enter the audit market they would have to be able to navigate the regulatory landscape to prove they have the expertise and structures to be registered as an auditor. Sustaining audit quality into the future will require continuing regulation and registration in some form.

• **Resilience**

It would be an unfortunate backward step should one of the Big Four audit firms exit the FTSE 350 audit market, reducing further choice for companies in this market. Such an event could be triggered by a number of factors including (but not exclusively);

- a loss of economic viability in the service provided occasioned through tighter market pricing and/or higher costs of regulation;
- a gradual and increasing imposition of personal liability on individual statutory auditors, which would render the role unattractive to high quality individuals (thereby impacting on the firm’s access to people and talent);
- Regulatory action that results in the same outcome;
- Audit partners and other staff are subject to ongoing pressure and criticism from regulators with their judgements constantly being questioned, even though the vast majority of audits are performed well and without incident. Continuation of the ‘expectation gap’ makes auditing an unattractive professional career for future entrants, and could lead to long term succession challenges.

These factors could equally apply to all firms that carry out audits as they are all subject to the same regulatory regime and external factors. Indeed, the financial and regulatory risks attaching to PIE company audit should not be underestimated. There are few firms who could tolerate the reputational risk of public reporting of a poor inspection by the FRC Audit Quality Review Team, or the added financial risk of possible enforcement proceedings.

ICAS is not suggesting that regulation should not be in place and operating effectively, but the current regulatory landscape is not creating a constructive environment for firms outside the Big Four to challenge their larger competitors. ICAS has made some considered recommendations to the Kingman review on how audit regulation may be enhanced, while ensuring that the quality and effectiveness of audit is sustained. This will require careful choreography of a package of reform.
5 Reflections on potential outcomes

We have reviewed the potential outcomes. If audit quality is the prevailing issue, then the optimum outcome, is likely to be a combination of several initiatives. The changes being considered by the CMA must be supported by a fundamental review into the UK corporate governance and corporate reporting frameworks including assurance. This review would include within its scope: what an audit is, and what it is intended to achieve, having regard to the requirements of business and changing public expectations.

The suggested potential outcomes all have unintended or indirect consequences, and we would encourage the CMA to give proper consideration to them, as well as any direct consequences. The CMA should therefore carefully assess the impact of each proposal they wish to bring forward. We would draw attention to several key considerations.

5.1 Restriction on audit firms providing non-audit services.

Prohibition on the auditor providing non-audit services to FTSE 350 audit clients

We believe this issue is as much about perception as reality, as along with regulatory requirements, significant processes and procedures are already in place inside audit firms to ensure there are appropriate conflict avoidance and independence safeguards (which go beyond the UK boundaries).

Nevertheless, the profession needs to be receptive to the wider public interest, and challenge the status quo. We therefore believe that there would be merit in introducing a complete prohibition on the auditor providing non-audit services to a PIE audit client (at least in the FTSE 350), subject to a small agreed list of permitted assurance related services. This proposal would help address the perception that management is “too close” to the audit firm. Further consideration would need to be given to the range of audit related assurance services that should be best provided by the auditor. These might include capital raising comfort letters and reports; and assessment of cyber-security frameworks etc. The ability to access such services is essential to help directors in the effective assurance of their business on behalf of shareholders, and would not only help audit to evolve but also ensure it is fit for purpose in the 21st century.

Complete prohibition on audit firms providing non-audit services not only to their audit clients, but also to any other large company or PIE

A complete prohibition on audit firms supplying non-audit services to a large company or PIE would be a severe restriction of choice for the companies concerned. PIE and large companies already face restriction of supply in some service areas and to add to this could be detrimental to their effective operations. As mandatory retendering and rotation continues to create opportunities for increased competition, the environment is already challenging for companies who are forced to find new suppliers for their non-audit services. This is expensive and time consuming, and anything that increased this challenge without any tangible benefit would likely not be desirable or effective. Furthermore, even when there are service providers beyond the audit firms who can advise on certain specialist areas there remain challenges with independence and choice. For example, pensions and actuarial service. Generally, three parties in a corporate environment need such services to carry out their respective duties – the company, the pension fund trustees and the auditor - and for conflict avoidance reasons one party cannot choose the service provider of the other. A total ban would render the situation more complex for companies and could further reduce market choice for such services. This would not be desirable.

Likewise, the split of UK arms of major accounting firms into audit only and non-audit service practices, would require overcoming considerable challenges, including those presented by the CMA. To suggest that there can be a UK only solution is misguided. There are global dimensions, both in relation to the scope of the audit, and the operations of the audit firm. Additionally, there are currently calls for more expertise both within companies and audit firms. To force audit only firms will reduce the level of expertise for the most complex audits where the firm may only have one audit client in that sector. The provision of expert services to non-audit clients enables the firms to gain the necessary level of expertise that helps within the audit environment.

Measures that result in an absolute prohibition on non-audit services, or audit-only/non-audit firms, could perversely reduce market choice.
We would suggest that the key test of the effectiveness of such a major disruption to the operation of service provision in this area is whether it would address the fundamental question raised about the quality and effectiveness of audit in the UK.

We believe it would not.

5.2 Increased competition from non-Big Four firms

Increased choice will require increased competition from non Big Four firms. The CMA has set out a number of proposals which it considers will promote change in the FTSE 350 audit market. We would encourage the CMA to give proper consideration to these proposals, not only the benefits but also any consequences.

Market share cap on the Big Four
This is a supply solution and if properly constituted could create opportunities for mid-tier firms. However, considerable obstacles would need to be overcome in the design of any quota system. Such considerations would include the scope of the market and the basis on which any market cap is set. Whilst basing the cap on numbers of companies would be the easiest way this would not ensure an appropriate allocation of the true value of the marketplace. Therefore, consideration would probably need to be placed on audit fees as a surrogate for the market capitalisation of the entity concerned, although this is likely to prove extremely fluid and problematic.

Additionally, any market cap is likely to leave some audit committees in an untenable position. A restriction of market choice for certain audit committees when tendering, and where appropriate rotating their auditors is our key objection. An example, might be where a FTSE 350 company has a requirement for audit services that can only realistically be supplied by the capability and capacity of one of the Big Four. Such requirements might include a global geographical spread of activities requiring local audit presence; specialist business activities (i.e. insurance or oil and gas) and challenging balance sheet attributes such as capital leasing all in multiple countries. An audit committee and its members have their fiduciary duty to find and select the highest quality audit service firm to meet their specific needs and, in this situation, they may not be able to meet this if the widest choice of service providers were not available to them. This would in effect be a restriction of market choice and it is something that investors in the company concerned would not likely welcome.

We are aware that audit firms and stakeholders favour a market cap, but we would encourage the CMA to fully consider all of the benefits and risks of adopting this approach.

Joint audits, shared audit or peer review
Joint audits are not widely adopted across the world and indeed in the EU only France adopts such a position. Some firms, but not all, that carry out or have carried out joint audits would support their operation as being effective, but there remain issues notably with accountability, liability and cost. Specifically, with regards to the auditor liability regime we would highlight that a major disincentive to non-Big Four firms is that as joint signatories to the audit report they would be subject to the joint and several liability regime.

We are of the view that joint audits (or shared audits) will present difficult challenges for both the auditors and for the audited company and its audit committee. Considerations will include increased costs, potential impact on audit quality, investor confidence and ownership of risk. The latter is particularly important in the current legal and regulatory environment.

Peer review as described in the Invitation to Comment would also provide considerable obstacles to its introduction. These include but are not limited to the other firm’s capability to undertake this task prior to the audit report being signed. Audit firms have detailed internal procedures which ensure there has been appropriate peer review and challenge. These include the need to appoint an Engagement Quality Control Reviewer for audits of listed entities and other entities as appropriate (ISA 220 ‘Quality Control for an audit of Financial Statements’). The Engagement Quality Control Review is a process designed to provide an objective evaluation, on or before the date of the auditor’s report, of the significant judgments the engagement team made and the conclusions it reached in formulating the auditor’s report. Any peer review would be subject to significant terms and conditions, including obligations of confidentiality and measures to protect the audit firm’s methodology.
Direct Support by the Big Four and/or professional bodies to the mid-tiers

We note the CMA’s proposed measure that the professional bodies, such as ICAS, could assist audit firms outside the Big Four to build capability and capacity, with a view to tendering for PIE audits in the future. ICAS is committed to working in the public interest and thus would look forward to exploring with the CMA what those initiatives might be, and the role we might play.

Changes to restrictions on ownership of audit firms

This approach has been adopted in relation to other sectors, most notably in relation to the provision of legal services. It is not without its challenges, and whilst it might enable firms to invest for the future, it might also pose risks to firm culture and behaviours.

Audit firms are presently required to be owned and controlled by a majority of individuals who hold the audit qualification, and are therefore members of a professional body, subject to meeting the highest level of technical, ethical standards and behaviours. To dilute their influence on the firm would need very careful consideration. The CMA could not consider this initiative without close involvement of the Financial Reporting Council, as the Competent Authority for audit in the UK.

5.3 Interface of competition and current review of audit regulation and oversight

ICAS has made a considered response to the Kingman Review to the FRC and we would encourage the CMA to consider the interface of its proposals, with the wider review of audit regulation and oversight. In particular, corporate governance, audit regulation and enforcement are of relevance to the CMA market study. In the context of audit quality, the Audit Quality Review Team, and the FRC’s future approach to audit quality, is a priority. We would encourage you to consider our comments.

ICAS will be responding to Sir John Kingman’s recent call for submissions on the audit appointment initiatives that are under consideration, including the independent appointment of auditors.

ICAS does not support an independent appointment process for a company’s auditor. To go down this route fundamentally disenfranchises the audit committees of PIE company boards and leaves them with the accountability for performance and outcome of an audit whilst not having any direct control over the selection and appointment. Such a situation is neither equitable nor sustainable. In addition, while this regime has operated in recent years in the context of Local Authority audit, the Audit Commission was dismissed in favour of open competition. In our experience, the entities being subjected to audit are very different. Local Authorities and large trusts are broadly similar in their requirements; the FTSE 350 and large private companies are not homogenous. The auditor selection process undertaken by an audit committee is substantive. Even if the practical barriers could be overcome, the Competent Authority has an operational inspection role which would preclude it from engaging in any appointment process.