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The Quoted Companies Alliance is the independent membership organisation that champions the interests of small to mid-size quoted companies.

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To whom it may concern,

[Market Study on Statutory Audit Services: Initial consultation on recommendations by the Competition and Markets Authority]

We welcome the opportunity to respond to your initial consultation on recommendations by the Competition and Markets Authority.

The Quoted Companies Alliance *Financial Reporting Expert Group* has examined the proposals and advised on this response from the viewpoint of small and mid-size quoted companies. A list of Expert Group members can be found in Appendix A.

Overall, we welcome the CMA's intentions to improve the quality of audit, as well as competition and resilience within the statutory audit market. Notwithstanding this, we have the following concerns to raise:

1. Any of the recommendations introduced must not be overly burdensome on listed entities, and, in particular, must not disproportionately impact smaller entities.
2. The government needs to bear in mind the size and resource constraints of smaller companies when considering an extension of the regulators powers outside the FTSE 350.
3. The issue with joint liability needs to be addressed before it is implemented in order to ensure it is proportionate.
4. We believe the government should consider an initial staged audit approach.
5. A full structural separation should not be kept as a reserve option and the government needs to carefully consider the practicality of implementing an operational split.

If you would like to discuss our response in more detail, we would be happy to attend a meeting.

Yours sincerely,

Tim Ward
Chief Executive

Audit Committee Scrutiny

Q1 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?

Whilst it is generally accepted that a set of principles for the appointment and oversight of auditors would be useful to Audit Committees, we are opposed to proposals that would introduce mandated standards. The implications of any such proposals are twofold: not only will they increase the burden on listed entities, but they are also likely to reduce the attractiveness of listing. As such, the proposals have to be mindful of the burden they will impose on companies. In particular, the Government needs to bear in mind the capacity of smaller companies, who typically have fewer resources, especially if a decision is made to expand the scrutiny powers at a later stage to companies outside the FTSE 350.

On that note, we are of the opinion that if the new regulator is given powers to scrutinise Audit Committees, in line with the CMA's recommendations, they should not be imposed on the FTSE 350. Rather, and whilst we believe that FTSE 350 companies should be subject to more rigorous standards and requirements, we see benefit in the new standards and requirements being limited to the FTSE 100 in the first instance. This will allow a cost-benefit analysis of the new standards and requirements to be conducted and analysed accurately, which would ensure that any extension to the FTSE 350 is appropriate and benefits the wider public interest.

Furthermore, and from the perspective of the small and mid-size companies we represent, we are wary of any proposals being cascaded on to smaller companies outside the FTSE 350 and particularly to those on AIM and the NEX Exchange. This is because the proposals and the burden they place on these companies would be disproportionate to the public interest threat.

Q2 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?**

In terms of the ways the regulator should exercise its new powers, and, in particular, the ways the regulator exercises its power to take remedial action, we believe that it should take a measured and progressive approach. That is, rather than look to take remedial action at the earliest opportunity, the regulator should be pragmatic and give time for the entity in question to ameliorate the issues signposted to it by the regulator. If, upon receipt of a query by the regulator, the Audit Committee can demonstrate that they have taken the necessary steps to address the query made by the regulator, both now and going forward, remedial action should not be warranted.

Additionally, if there is an extension of the powers held by the regulator to take remedial action beyond the FTSE 350, consideration has to be given to smaller entities. Typically, smaller entities have fewer resources and will be less able to make adjustments in a timely manner, when compared to larger entities. Having more limited resources makes it difficult for these entities to respond to the regulator's publications and/or communications. As well as this, the consequences of the regulator writing to a smaller entity's shareholders "to give them the information they need to challenge audit committees" can have significant consequences. Not only may smaller entities struggle in their response to their shareholders, but this also has implications

on hindering their ability to attract funds and thus limit their growth. Therefore, consideration needs to be given to the most appropriate and proportionate approach to take when the regulator exercises its 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?**

Yes, there are events, such as those listed above, that should indicate the need for the involvement of the regulator. However, depending on the extent of damage a particular event could cause, a letter from the regulator would often suffice, as opposed to more weighty public involvement, such as remedial action.

Moreover, the regulator needs to carefully consider certain events. For instance, there may be valid reasons as to why there was an early departure of the auditor or restatement of a company's accounts. As well as this, the regulator will also have to determine what is meant by "significant". Currently, the accounting standards dictate what a restatement is, but it hinges on the word 'material', rather than 'significant'. Thus, the Government and the regulator should provide further clarification on what it means by 'significant restatement'.

Q3 How should the regulator engage shareholders in monitoring compliance and taking remedial action?

The Financial Reporting Council has often struggled with its engagement with shareholders in monitoring compliance, and this is an area that the new regulator needs to improve its effectiveness in. An immediate action that could be taken would be for the Audit Committee to disclose in its annual report to the shareholders – either separately or within the annual report and financial statements – on how it has complied with any issues of concern. Doing so would enable shareholders to query a situation and, if required, raise this with the regulator directly.

Q4 What would be the most cost-effective option for enabling greater regulatory oversight of audit committees? Please provide evidence where possible.

The most cost-effective option for enabling greater regulatory oversight of audit committees would be for the company to pay a levy to the regulator which would cover these costs. That said, any costs established that are to be borne by the company need to be proportionate to the size of the company, so as not to disproportionately impede them from participating in the market.

Mandatory Joint Audit and Peer Review

Q5 Do you agree with the CMA's joint audit proposal as developed since its interim study in December?

Yes – we agree with the CMA's joint audit proposal. Notwithstanding this, we believe that the issue with joint liability should be addressed before the joint audit proposal is implemented, as the current recommendation is unfair and disproportionate. A challenger firm, which has far less funds than a Big Four firm, should not become jointly liable for the work of a Big Four firm. Recent evidence suggests that the fines and sanctions that are currently charged against the likes of the Big Four would existentially threaten smaller challenger firms. As such, we urge the Government and the regulator to consider a proportionate liability regime within

the joint audit proposal. The larger firm and the smaller firm should not attract the same level of sanctions or fines; everything should be proportionate to the size of the practice.

Q6 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?

We agree, but only to a partial extent, with the CMA's proposed exemptions to the joint audit proposals.

In regards to the investment company and single entity accounts exemption, we believe that this should be revisited. Under most circumstances, these could be more easily accommodated by challenger firms alone. Perhaps the proposal could be re-oriented so that these are exempted only when a challenger firm is seriously considered for appointment alone in the tender process.

Prime examples of what could be considered a complex entity lie within the Banking and Financial Institutions sector. However, if challenger firms were exempted from conducting these audits, this would contradict the intended purpose of the proposal of a joint audit – that is, to enable a challenger firm access to the more complex entities in order to obtain the required experience for such entities. Complexity, therefore, should be assessed as more than just the sector the entity operates within.

For example, it could be determined by the cost and level of resources required by the audit firm to successfully perform the audit. Factors to consider could include: the amount of people required; the expected period of time to complete the audit; and whether any specialists or experts are required. In order to ensure that challenger firms are not exempt in this regard, they could be afforded a smaller percentage of the less complex aspects of the audit, whilst simultaneously injecting knowledge and experience into the firm by working in conjunction with the larger audit firm.

Whatever criteria are applied should be subject to significant scrutiny, and the regulator should be open and transparent in the criteria it has used to determine whether or not a company is complex.

Q7 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?

In terms of whether challenger firms have the capacity to provide joint audit services to the FTSE 350, it is unclear if this can be concluded upon in a definitive manner. Other than reviewing the size of the audit fee, it is difficult for challenger firms to accurately assess the capacity required to jointly audit a FTSE 350 company. If, however, this information is published it will allow challenger firms to consider the possibility of jointly providing an audit service to the FTSE 350.

Whilst the CMA rejected the notion of a staged approach to joint audit, we see merit in this. For example, if, in the first year or two, the Big Four firm takes the lead in the audit, this will allow knowledge, experience and capacity to be ingrained into the challenger firm, thereby ensuring that a joint audit approach can be adopted thereafter.

Finally, without the knowledge of the capacity and resources needed to conduct a FTSE 350 audit, it remains difficult to determine how quickly a challenger firm could build sufficient capacity for joint audit to be practised across the whole of the FTSE 350.

Q8 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?

No – we do not agree with the CMA's recommendation that the liability regime would not need to be amended if the joint audit proposal was implemented. Please see response to Q5 for the reasons why we do not agree with the CMA's recommendations on the liability regime.

Q9 Do you have any suggestions for how a joint audit could be carried out most efficiently?

For a joint audit to be carried out most efficiently, it would be particularly beneficial if the Big Four firms were to share their audit tools, methodology and expertise with the challenger firms, such as their software and data analytic tools. Not only will this ensure a consistent approach throughout the joint audit regime, it will also give both firms comfort in terms of their joint liability on the audit work performed by each other for the purposes of the audit report being issued for a FTSE 350 company.

Q10 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?

We have no comments.

Q11 Do you agree with the CMA's assessment of the alternatives to joint audit, including shared audit?

In regards to shared audit, we do not agree with the CMA's assessment. As stated above in Q7, we believe that an initial staged audit approach would be beneficial, whereby the Big Four firm takes the majority of control over a one to two year period whilst sharing its knowledge and experience that will allow the challenger firm to enhance and develop its capacity. At the end of this period, there should be a transition to a joint audit approach.

Q12 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?

In order to ascertain whether and to what extent the CMA's proposals will improve competition in the wider audit market, it first needs to be determined whether FTSE 350 companies will actually entertain the prospect of a joint audit with a challenger firm. Moreover, if the audit committee standards are in place, which set the grounds for appointment and oversight of audit, this will help assist in this regard. It is also important to note that, for any joint audit recommendation to work, there must be a sufficient number of willing challenger firms from which companies can make a selection.

Q13 Do you agree with the CMA's proposals for peer review? How should the regulator select which companies to review?

The process the regulator must take to decide on which companies to review is an intricately difficult one as it must not restrict the number of firms it chooses from. Whilst the regulator should not default to the Big 6 firms, but expand outwards to the other challenger firms in the market, selection should be based on length of time and knowledge, such as that of the sector, company and market. However, in so doing, the regulator must ensure that the number of firms it is able to select are not restricted, as it has the potential to reinforce the pre-existing restrictions in opening the audit market to more entrants.

Q14 Are any further measures needed to ensure that the statutory audit market remains open to wider competition in the long term?

Yes – we believe that there are further measures needed to ensure that the statutory audit market remains open to wider competition in the long-term. First, it should be a mandatory requirement for the Big Four to share their audit tools, methodology and expertise with challenger and mid-tier firms. Doing so, will ensure that audits are consistently of high quality throughout the market and create sufficient competition in the market between firms of all sizes.

Second, restrictions should be placed on the Big 6 firms acquiring new audit firms (mergers/acquisitions) to a certain level. The proposals, as currently manifested, would likely see a concentration of audit firms whereby small and mid-tier firms will merge in order to obtain the required capacity to perform joint audits as challenger firms. Whilst it is important that this is not restricted for smaller firms, larger firms should be subject to the restriction. If there are no restrictions in place, the audit market could soon become more heavily concentrated within the "Big 8 to 10" firms. Under such circumstances, the only firms left within the market will be so small that they would never be able to be considered as a challenger firm. This has dual connotations – that is, the audit market will remain highly concentrated, and the risk to the market of audit firm failure will still prevail. As such, sensible restrictions should be in place to ensure that the audit market is competitive in the long-term.

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

Q15 What factors do you think the regulator should take into account when considering action in the case of a distressed statutory audit practice?

When considering action in the case of a distressed statutory audit practice, we believe the regulator should take into account the following:

- Audit quality monitoring reports; and
- The level of fines being levied for poor performance against the ability of those firms to pay the fines without having a detrimental impact on their operational costs.

Further to this, and whilst not mentioned within this section of the consultation, we urge the Government to consider what they define as "large non-Big Four firms". We are of the opinion that these proposals should not be automatically cascaded down to all large non-Big Four firms. If an overburdensome approach was taken this would inadvertently act as a barrier to the market, thus limiting the choice of firms and the competition between them. For the present, near and short-term future, we believe that the risk is limited to the Big Four, which was echoed within the CMA's report where the risk associated with the potential failing of one of the firms was highlighted. If, in the medium to long-term, the proposals are effective and successfully open up the audit market to new entrants, then the need to expand these requirements down to the next-tier increases. However, at present, it remains that the risk is primarily concerned with the Big Four, especially as the size of these firms in terms of their financial status far outstrips the large non-Big Four firms.

Q16 What powers of intervention do you think the regulator should have in those circumstances, and what should be their duties in exercising them?

We believe that the regulator should be able to deploy a team within the audit firm in order to correct the audit practice or take the necessary steps to force it to dismantle.

Operational Split between Audit and Non-Audit Practices

Q17 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?

Yes – we agree with the CMA's fourth recommendation that would help to ameliorate the tensions identified between audit and non-audit services and drive up audit quality. In spite of this, and as referred to in both the consultation document and CMA report, the UK has already adopted and implemented the EU's Audit Directive which limited the provision of non-audit services to public interest entities (PIEs). In addition to this, the FRC is currently conducting a post implementation review of the 2016 Ethical Standard, which further reduces the provision of non-audit services, thus making the likelihood of a Big 4 firm providing anything other than an audit service even smaller.

Q18 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?

It is agreed that a full structural separation between audit and non-audit functions will not improve choice and address the issues raised within the CMA review due to the conflict of interest requirements that apply to the international framework. We believe that an operational split appears to be the better option, however, the practicality of firms applying this operational split should not be overlooked.

We also believe that the Government and the regulator should not seek to impose an operational split on challenger firms in the short to medium-term. Doing so would act as a barrier to expanding the audit market. Challenger firms will be less inclined to introduce such a split without seeing the benefit of conducting audits within the FTSE 350 market.

Q19 Are there alternative or additional measures which would meet these concerns more effectively or produce a better market outcome?

We have no comments.

Q20 Do you agree with the CMA's proposal to keep a full structural separation in reserve as a future measure?

No – we do not agree with the CMA's proposal to keep a full structural separation in reserve as a future measure. As stated in our response to Q18, due to the international conflict of interest requirements, a full structural separation would not improve choice within the audit market.

Q21 What implementation considerations should Government take into account when considering the operational split recommendations? Please provide reasoning and evidence where possible.

We have no comments.

Other Possible Measures

Q22 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?

In terms of the CMA's other proposed measures, we believe that the majority of the proposals seem reasonable. Notwithstanding this, we have the following points to raise regarding some of the other measures:

- We agree with the notion of the five-year review approach and this should remove all consideration of a full structural split, as per our concerns raised in our response to Q18 and Q20.
- The audit firm ownership rules should be relaxed in order to encourage and help build greater competition within the market.
- The technology licensing approach should be escalated. Doing so will directly impact the ability of challenger firms to effectively enter the market and contribute to the joint audit proposals.

In regards to how these suggestions should interact with the main recommendations, we believe that their application should be holistic, as opposed to being on a piecemeal basis.

Q23 Do you agree with the CMA's suggestions regarding remuneration deferral and clawback?

In order to answer this question, the Government needs to first consider how it would work in practice and who would monitor compliance with it.

Q24 How would a deferral and clawback mechanism work under a Limited Liability Partnership structure?

We have no comments.

Q25 Do you agree that liberalising the ownership rules for audit firms would reduce barriers for challengers and entrants to the market?

Yes – we agree that liberalising the ownership rules for audit firms will reduce barriers to entry for challenger firms and new entrants to the market.

- **What positive and negative impacts would this have?**

Positive

- It would help to encourage greater competition and choice within the market.
- Liberalising the rules creates more potential for new entrants and challenger firms to scale up at a greater speed.
- Market resilience will be emboldened as there will be more credible competitors at the top end of the market, which makes it easier for smaller audit firms to recruit and appoint high quality auditors.

Negative

- The rules do not apply outside of the UK as the EEA restricts ownership. This means that there will be a different approach for EEA audit firms and the non-audit owners could detrimentally impact the focus and strategic direction of the audit practice if they still offer non-audit services.
    - However, it may be the case that the proposals to restrict this could negate this issue.

- **Do you have any specific proposals for a reformed ownership regime?**

We have no comments.

Q26 Do you agree with the CMA's suggestions regarding technology licensing?

Yes – we wholeheartedly agree with the CMA's suggestions regarding technology licensing. If the Big Four firms are required to share their audit technology, this has major implications for both the quality of audit

and competition within the market. Furthermore, it will also enable smaller challenger firms to actively and effectively contribute to the joint audit proposals.

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

We have no comments.

Q27 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?

We agree with the CMA's suggestions to provide additional information for shareholders. That said, it is first necessary to establish the extent to which this is a worthwhile undertaking. For instance, it needs to be established whether shareholders are likely to engage with, as well as understand, the information provided.

Q28 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?

Yes – we agree with the CMA's recommendations regarding notice periods and non-compete clauses. However, this will not change the limitations of those audit partners being involved in an audit engagement that is transferred. As the rotation rules are set in the Ethical Standard/EU Audit Regulation and Directive, if the Government seeks to apply the notice periods and non-compete causes, then it will need to consider this issue as a pre-requisite.

As for whether Big Four firms should be required to limit notice periods to 6 months, we believe that this should be applied comprehensively across all firms in order to ensure consistency.

Q29 Do you agree with the CMA's suggestions regarding tendering and rotation periods?

Whilst we agree that moving the tendering period to a fixed term of seven years seems reasonable, we do not see the need for the audit firm rotation period to be set at the same time period. The ethical framework already requires the audit partner to be rotated off the engagement before the ten- and twenty-year periods are up. Therefore, whilst there is still familiarity with the firm and the client, the audit partner is no longer engaged and has a period away before they can act again. As such, there is little to no benefit in reducing the audit firm rotation period.

Q30 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.

We have no comments.

Q31 What actions could audit firms take on a voluntary basis to address some or all of the CMA's concerns?

We have no comments.

Q32 Is there anything else the Government should consider in deciding how to take forward the CMA's findings and recommendations?

In deciding how to take forward the CMA's findings and recommendations, the Government should consider how these recommendations align with those from Sir John Kingman's review of the FRC and the current review led by Sir Donald Brydon into the quality and effectiveness of audit before taking any definitive action. Any decisions should be made in conjunction with the above two reviews in order to eradicate the potential consequences of a disjointed approach, so as not to result in the duplication of effort or excessive additional regulatory burden.

Appendix A

The Quoted Companies Alliance *Financial Reporting Expert Group*

Matthew Howells (Chair)	Smith & Williamson LLP
Rochelle Duffy (Deputy Chair)	PKF Littlejohn LLP
Edward Beale	Western Selection PLC
Matthew Brazier	Invesco Asset Management Limited
Elisa Noble	BDO LLP
Anna Hicks	Saffery Champness LLP
Mark Hodgkins	Trackwise Designs LLP
Clive Lovett	Bilby PLC
Laura Mott	Haysmacintyre
Claire Needham	KPMG LLP
Matthew Stallabrass	Crowe UK LLP
Jon Wallis	Grant Thornton UK LLP
Peter Westaway	Deloitte LLP