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CMA Launches Market Study into the Audit Sector

Back in June 2018, we published an article (Auditing the Auditors – Potential Review by the CMA?)[1] at a point when the need for a review of the audit market was being hotly debated following the collapse of Carillion and the issuance of a Parliamentary report. Subsequent to that, the Competition and Markets Authority ("**CMA**") announced on 9 October 2018 that it will commence an immediate review of the audit sector. This will be the second study of the market in eight years, with the first conducted by the CMA's predecessors, the Office of Fair Trading ("**OFT**") and the Competition Commission ("**CC**")[2].

The market study by the CMA will focus on three specific aspects: (i) choice and switching; (ii) long-term resilience of the audit sector; and (iii) incentives between the company management, auditors and shareholders/investors. Numerous potential outcomes after the market study are also outlined by the CMA.

Commencement of CMA's Market Study

The CMA's announcement on 9 October 2018 stated that its aim was to determine whether the sector is competitive and resilient enough to maintain high quality standards. Interested parties including the so-called "Big Four", the largest firms in the sector (i.e. Deloitte, KPMG, EY and PwC), have until the end of this month to submit initial comments to the CMA on the CMA's market study in general, as well as to respond to particular questions for consultation raised by the CMA. Whilst the statutory deadline for the review is October next year, the CMA has indicated that it plans reach a conclusion "*as quickly as possible*", with the aim of publishing a provisional report by December this year, and to complete its work as soon as possible thereafter.

The launch of the CMA market study has been prompted by a series of high-profile events – the compulsory liquidation of Carillion, calls from Parliament and the Government, general criticisms of poor audit quality, and an independent review of the Financial Reporting Council's ("**FRC**") role and powers. Further, the CMA's announcement came one day after the FRC published its annual report, "*Developments in Audit 2018*", which highlighted key challenges faced by the audit sector and proposed a strategic programme to improve quality of work, including potentially banning accountancy firms from conducting consultancy work for the firms which they audit.

Focus of CMA's Market Study

The CMA's market study will focus on the following areas, all of which the CMA considers are interlinked:

- *Incentives*: Auditing is a service for shareholders with the intention of providing an assurance to them, the ultimate owners of the company, that the accounts of a given company represent a true reflection of that company's financial performance. The CMA is of the opinion that there is currently a misalignment of incentives, since the auditors are in fact chosen and paid by the company, as opposed to by the shareholders. The CMA wishes to assess the effectiveness of the reforms introduced by the CC after its market investigation which sought to address this issue of misalignment. It will also consider whether the wider public interest in ensuring high-quality audit might diverge from shareholders' interests and implications arising from this for possible market reforms.
- *Choice and switching*: The CMA will consider whether the audit market offers a competitive choice of auditors, especially for larger FTSE 350 companies, 97% of which are audited by the Big Four auditors. Given this statistic, the CMA is concerned that the Big Four are the major, if not the only, players in the audits of the largest companies. The CMA also notes that consolidation in the sector in the past 30 years has been a contributory factor in this.

[1] https://www.shlegal.com/insights/auditing-the-auditors-potential-review-by-the-cma

[2] The first review was opened in 2011. The CC published its report in 2013. The remedies order was issued in September 2014.

- The key question for the CMA is whether a lack of competition means that there is not enough pressure on auditors to provide a good service. The CMA will use the CC's analysis on this point and focus on what has changed since the CC's report. It expects to focus on three elements here: (i) sufficient choice of auditor; (ii) demand-side barriers to switching (particularly to non-Big Four firms); and (iii) supply-side barriers to entry and expansion.
- *Resilience*: The CMA will examine the sustainability of competition between audit firms and the role played by the Big Four in the market. In particular, it is concerned that the Big Four may be "too big to fail". There is a concern that, as competition would be even more limited if any of the Big Four firms were allowed to exit the market, regulators may be prevented from taking tough action that could threaten the viability of one of these firms.

Two additional issues that the CMA identified as relevant to its considerations are: (i) the scope and purpose of audit; and (ii) the regulation of audit in the UK. However, these will not be the focus of its research. The former is said to be outside the scope of its expertise, while the latter will be covered by an independent review of the FRC by Sir John Kingman. This latter review is taking place concurrently, and Sir John Kingman is expected to report on his findings by the end of the year.

Key concerns

The CMA has noted that the majority of concerns about the audit market focus on quality rather than price. This is indicated by high-profile cases where audits have come under the regulatory spotlight, as is the case with the 2014, 2015, 2016 and 2017 audits of Carillion, and where audits have been judged to fall short as well, as with the 2014 audit of BHS (and an associated company). In addition, a number of mid-tier firms have complained that the links between the audit and non-audit services of the Big Four firms make it difficult for the mid-tier firms to win audit contracts for FTSE 350 clients, if the Big Four price their statutory audit offer relatively low. Finally, the CMA has identified that shareholders' expectations of statutory audit may exceed what auditors are required to do by law, for example in relation to assurances on businesses' future viability.

Potential Remedies

At the current stage, the CMA proposes three groups of possible remedies: (i) ideas to improve incentives; (ii) further separating audit and non-audit services; and (iii) reducing barriers to entry and expansion of non-Big Four firms.

In particular, the CMA is considering the following:

- *Requiring firms to split their audit services from their non-audit services*: In order to maximise choice among the Big Four, these firms may be prohibited from providing their client with non-audit services, which will need to be provided by a separate entity. This measure aims to limit the potential conflicts of interests between auditing and non-auditing businesses;
- *Introducing a market share cap on the Big Four*: Potentially, this could be a market cap on the maximum number of FTSE companies that the Big Four can audit. This would decrease the market share of the Big Four directly, albeit arbitrarily. Non-Big Four firms would then have an opportunity to enter the market which is currently dominated by the Big Four;
- *Mandating joint/shared audits*: The CMA will look into three variations: mandatory joint audit, which requires two audit firms to conduct the audit of a single company together and both to sign off the audit report; shared audit, where one auditor will take up the control and liability of the audit while the other will be in a supporting role; and peer review, where the audit of the statutory auditor is further "audited" by another independent auditor;
- *Implementing measures providing for direct support by the Big Four and/or professional bodies to the mid-tier firms;*
- *Reducing barriers for senior staff to switch between audit firms;*
- *Changing restrictions on ownership of audit firms*: This could broaden the owners of audit firms and thus increase the quantum of capital invested in the mid-tiers;
- *Reforming mandatory tendering and auditor rotation*: Possible reforms considered by the CMA include increasing the frequency of mandatory tendering and changing auditors;
- *Strengthening audit committees*: This may involve lowering a committee's dependence on the management by providing it with resources independent from the management, and increasing participation of shareholders in selecting auditors; and/or
- *Breaking the link between company management and the auditors*: This aims to mitigate the mismatch of accountability between company management, shareholders and auditors. Proposed changes include having the shareholders, shareholder groups or independent institutions appoint auditors directly.

Breaking up the Big Four was also addressed as one of the potential outcomes by the CMA. However, it seems that the CMA earlier indicated that it would not be willing to go as far as to break up the Big Four into smaller audit firms. It has pointed out various downsides of doing this, in particular noting that any break-up would not be at all effective if it is to occur in the UK market only.

Would the measures work?

Concerns have already been expressed in relation to some of the CMA's potential measures as to whether they would cause any positive change to the audit market:

- The CMA itself acknowledges that splitting the audit and non-audit services may not be very effective given the international nature of most FTSE 350 companies. The mandatory split into UK audit-only firms may impact the firms' international connections, which are essential to service multinational clients. Members of the Big Four have also expressed concerns that splitting services in this way could negatively impact the quality of audit, as audits can often benefit from the multiple competencies of the auditors;
- The arbitrary market share cap could pose problems for those companies which cannot use the Big Four as auditors. There are worries that the non-Big Four firms would not be able to match the quality of work provided by the Big Four in the time frame required;
- Mandatory joint audit may cause an increase and/or duplication in audit fees which will be borne by the audited companies. The effect of the measure is also unclear as some have suggested that large companies are hesitant to engage a non-Big Four firm as auditor; and
- The benefits of increasing the frequency of mandatory tendering and rotation of auditors are also in doubt given the lessons learned from the previous measures introduced by the CC.

Context of CMA's Market Study

The launch of the market study by the CMA has come just three years after an order of its predecessor, the CC, following a two-year long investigation into the audit sector.

The CC introduced various measures in its order back in 2015, hoping to increase the competitiveness of the audit sector. Remedies proposed included, most significantly, a mandatory tendering of audit contracts at least once every ten years by the FTSE 350 companies and a greater number of audit reviews by the FRC.

Various events subsequent to the CC's investigation seem to indicate that the CC's measures did not bring about the positive effects that were hoped for – the increase in market share of the Big Four in FTSE 350 audits from 95% at the time of the CC report to 97% in 2016/17; the fact that the FRC itself is also under criticism and that there is an independent review into its effectiveness; as well as the collapse of large UK corporations which has led to questioning of the auditors' role in these companies.

In light of the questionable impact of the CC's order, and the fact that the CMA's market study will be built on the investigation conducted by CC, it will be interesting to see the provisional results of the CMA's study by the end of this year and its proposed measures, if it decides to introduce any.

Representations to the invitation to comment on the CMA's market study should be made to the CMA by no later than 30 October 2018.

Contact us

If you would like any further information, or if a brief discussion on any of the issues arising in this briefing would be helpful, please do not hesitate to get in touch.

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