

Disruption in the Audit Market: The Future of the Big Four
By Krish Bhaskar and John Flower with Rod Sellers
Online companions volume
Current CMA and Kingman reports September 2019 Audit Market
Post Publication Comments

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This includes
CMA update report
The Kingman report
Operation of the audit market: letter from Rt Hon Greg Clark to Sir John Kingman

Events on 18th December 2018

CMA issues its interim verdict on 18 December 2018:

The Competition and Markets Authority said that the time is ripe for more competition in the market. The Big Four sign off the accounts of 97 per cent of large British companies. However, the quality of audits is “diluted” because auditors reap three quarters of their revenues from consulting and other services, according to the CMA¹.

Officially the CMA’s (Competition and Markets Authority) has published an update paper outlining serious competition concerns and proposing changes to legislation to improve the audit sector for the benefit of savers and investors alike. It is now putting these proposals out for public consultation².

Three events occurred on the 18th December 2018 and one event assumed to occur did not.

- 1) The event that did not occur was the Kingman report on the audit area and the FRC which was supposed to be released before Christmas. This has not occurred. Instead a series of overlapping investigations have occurred.
- 2) The CMA released its report and its desire to go to public consultation – discussed later but briefly:

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¹ Simon Duke, 2018, No more madness from big auditors, *The Times*, 18 December 2018.

Available at:

<https://www.thetimes.co.uk/article/no-more-madness-from-big-auditors-3xshvk0bf>

Accessed December 2018.

² Government press release. 18 December 2018, CMA proposes reforms to improve competition in audit sector: Improvements to the independence and the quality of audits are the focus of the CMA’s market study update.

Available at: <https://www.gov.uk/government/news/cma-proposes-reforms-to-improve-competition-in-audit-sector>

Accessed December 2018.

auditors reap three quarters of their revenues from consulting and other services, according to the CMA³.

Officially the CMA's (Competition and Markets Authority) has published an update paper outlining serious competition concerns and proposing changes to legislation to improve the audit sector for the benefit of savers and investors alike. It is now putting these proposals out for public consultation⁴.

- 3) Donald Brydon (outgoing Chairman of the London Stock Exchange and Chairman of the accounting software group Sage Group, will head up the review of UK audit standards⁵; appointed by the Department for Business, Energy and Industrial Strategy.

The independent review will look at the quality of standards delivered by UK auditors and what more can be done to make them "more effective and reputable" as well as how better to meet public, shareholder and investor expectations⁶.

This is called Project Flora⁷ and the Brydon review will build on the work of the:

The Brydon review will build on the work of the Kingman and CMA reviews by considering: how far audit can and should evolve to meet the needs of investors and other stakeholders; how auditors verify information they are signing off; how to manage any residual gap between what audit can and should deliver; and what the public's expectations are from audit⁸.

In the press release the review is far reaching. Brydon Review into UK Audit Standards will consider⁹:

³ Simon Duke, 2018, No more madness from big auditors, *The Times*, 18 December 2018.

Available at:

<https://www.thetimes.co.uk/article/no-more-madness-from-big-auditors-3xshvk0bf>

Accessed December 2018.

⁴ Government press release CMA, 18 December 2018, CMA proposes reforms to improve competition in audit sector: Improvements to the independence and the quality of audits are the focus of the CMA's market study update.

Available at:

<https://www.gov.uk/government/news/cma-proposes-reforms-to-improve-competition-in-audit-sector-and-the-actual-paper-can-be-downloaded-via>

https://assets.publishing.service.gov.uk/media/5c17cf2ae5274a4664fa777b/Audit_update_paper_S.pdf

Accessed December 2018.

⁵ Government press release Brydon, 18 December 2018, Government takes next step in improving standards of UK audit market with new independent review into audit standards: Donald Brydon, outgoing Chair of the London Stock Exchange Group, appointed to lead new independent review of the quality and effectiveness of the UK audit market.

Available at:

<https://www.gov.uk/government/news/government-takes-next-step-in-improving-standards-of-uk-audit-market-with-new-independent-review-into-audit-standards>

Accessed December 2018.

⁶ Julia Irvine, 2018, Brydon to head Project Flora, *Economia*, 18 December 2018.

Available at:

<https://economia.icaew.com/news/december-2018/brydon-to-head-project-flora>

Accessed December 2018.

⁷ The Brydon review, or Project Flora, as it was originally known, was conceived in November 2017 by the Audit Quality Forum.

⁸ Op. Cit. Irvine 2018'.

⁹ Op. Cit. Government press release Brydon, 2018.

- how far audit can and should evolve to meet the needs of investors and other stakeholders, putting the UK at the forefront;
 - how auditors verify information they are signing off;
 - how to manage any residual gap between what audit can and should deliver; and
 - what are the public's expectations from audit.
- 4) Earlier, the FRC laid out a series of reforms to tackle what it admitted was the underlying falling trust in business and the effectiveness of audit. This included a separation of the audit business from the audit business. The FRC would conclude cases more quickly. Finally they would increase their fines. Accepted that this was made in October but it became relevant in December 2018¹⁰. So these opinions indicating what the FRC will change direction to, are germane as of Christmas 2018.

The CMA report proposals¹¹

In principle the CMA report argues for

- a) Strengthening of the audit committee and approved by or monitored closely by a new FRC and
- b) joint audits to bolster the challenger firms.

The CMA wants to rely on Government action and not their competition mandate: "At this stage, however, and as a proposal for consultation, we are minded not to make a market investigation reference, because we see recommendations to the government as a more effective route to implementation¹²." The CMA updated report as it is called does not want to go for a competition mandate but argues for the Government to enact new legislation to achieve the joint audit and upgraded FRC or replacement, to monitor the appointment of auditors and the work of the audit committee.

The CMA used its own collected evidence (as we did in the Audit Market) book, They relied on 75 responses to invitation to comment, 9 audit firms comments, 31 companies, and over 60 telephone calls or face-to-face meetings with auditors, investors, companies, and other

¹⁰ Patrick Collinson, 2018, Accounting watchdog could ban auditors from consultancy work: FRC also rebukes KPMG over auditing of collapsed construction firm Carillion, *The Guardian*, 8 October 2018.

Available at:

<https://www.theguardian.com/business/2018/oct/08/accounting-auditors-consultancy-frc-kpmg>

Accessed December 2018.

¹¹ CMA 2018, The CMA report: Statutory audit services market study, Update paper, *Competition Markets Authority*, 18 December 2018

Available at:

https://assets.publishing.service.gov.uk/media/5c17cf2ae5274a4664fa777b/Audit_update_paper_S.pdf

¹² Ibid. Page 130-131.

interested parties. The CMA's statutory audit market study^{13,14} makes for interesting reading but we do not agree with all its finding.

The CMA's list of remedies is limited and does not consider all possibilities. Re-categorising their remedies and mapping into ours it comes down to just three possibilities with a fourth which we dismissed early on – the failure of one or more of the Big Four:

1. Greater regulatory and other control
This includes two of their remedies:
Remedy 1: Regulatory scrutiny of Audit Committees
Remedy 6: Peer review
Sir John Kingman in his letter¹⁵ cautions (like us) against relying too heavily on these remedies.
2. Bolster challenger firms
Build the challenger (for us the mid-tier) firms into rivals to the Big Four.
Remedy 2: Mandatory joint audit
Remedy 2A: Market share cap (the CMA seems against this option)
Remedy 3: Additional measures to support challenger firms.
3. Split of the Big Four
Remedy 5: Full structural or operational split between audit and non-audit services
The CMA does not go into further possible splits. KPMG has already announced it will only do audit work for its FTSE 100 audit clients. This in essence is a self-imposed partial (and incomplete) operational split.
Our analysis shows that this does not solve the choice issue which we think is essential to solving a number of the issues highlighted by the CMA.
4. Failure of one or more of the Big Four
Remedy 4: Market resilience

In principle the CMA report argues for

- c) strengthening of the audit committee and approved by or monitored closely by a new FRC and
- d) joint audits to bolster the challenger firms.

We are extremely disappointed that they have dismissed, more or less, any split of the Big Four. They category ruled out breaking the Big Four into smaller audit firms. They also did not recognise the need for more choice, 'the insufficient numbers of audit firms' as we call it. We placed greater reliance on competition between firms, independence, and choice. The CMA whilst recognising the current failures of the audit process. In the end they put great store on seeing the challenger firms grow in size to compete with the Big Four. We found this an event that was more or less impossible.

¹³ Government website. 18 December 2018.

Available at:

<https://www.gov.uk/cma-cases/statutory-audit-market-study#update-paper>

Accessed December 2018.

¹⁴ The actual CMA study can be downloaded from the above website and is entitled: Statutory audit services market study. Update paper 18 December 2018.

¹⁵ Ibid.

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CMA faces corporate backlash over audit plans

A group representing the FTSE100 finance heads opposes proposals for a system of joint auditors, which they argued would drive up the cost of auditing company accounts without any assurance of quality improvement. The backlash to the CMA has started.

We found that our continental experience¹⁶ showed that either the small, tiny or even sole auditor was just paying lip-service to the statutory requirement for joint auditors

Our collected evidence found that often there was a deterioration in audit quality (although not all studies confirmed this) but on balance including our own evidence, this was our conclusion. One of the reasons was the differences in culture and the need to disseminate to two different groups of audit staff with differing managements (including differing styles and structures of management). Then the second reason that made us reject this as a viable solution was the increased cost of that additional communication and the duplication of resources which inevitably leads to higher audit fees. This charge of higher audit fees is the primary concern of the backlash above by the FTSE100 CFOs.

¹⁶ JF lives in Germany. RS had many of his subsidiaries at his FTSE250 company audited with the joint auditing requirement. KB has lived in France for more than 15 years.

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The Big Four responses

These can be viewed:

The Big Four

Deloitte

https://assets.publishing.service.gov.uk/media/5bec3d1aed915d6a1c35ff2a/Deloitte_response.pdf

EY

https://assets.publishing.service.gov.uk/media/5bec3d29ed915d6a283efa13/EY_response.pdf

KPMG

https://assets.publishing.service.gov.uk/media/5bec3d4ee5274a08354b4885/KPMG_response.pdf

PwC

<https://assets.publishing.service.gov.uk/media/5bec32bc40f0b667a46ce0c4/pwc.pdf>

Mid-tier/Challenger firms

BDO

https://assets.publishing.service.gov.uk/media/5bec3cdbed915d6a105b79ec/BDO_response.pdf

Grant Thornton

https://assets.publishing.service.gov.uk/media/5bec3d40ed915d6a283efa14/Grant_Thornton_response.pdf

RSM UK

https://assets.publishing.service.gov.uk/media/5bec332f40f0b667adfd3f21/rsm_uk.pdf

The Kingman Report¹⁷

By and large we agree and support all the Kingman recommendations. Their summary is reproduced below:

Summary of the main recommendations of the Kingman report

The FRC should be replaced as soon as possible with a new independent regulator with clear statutory powers and objectives. It should be named the Audit, Reporting and Governance Authority.

The new body should be accountable to Parliament, with the Chair and Chief Executive subject to a pre-approval hearing with the BEIS Select Committee, and appearing annually in front of the Select Committee. The Government should issue a remit letter to the regulator, at least once each Parliament, as it does for the FCA and PRA.

¹⁷Kingman Report, 2018, *Kingman Report: Independent Review of the Financial Reporting Council*, Government, December 2018

Available at:

<https://www.gov.uk/government/publications/financial-reporting-council-review-2018>

The regulator should have an overarching duty to promote the interests of consumers of financial information, not producers. It should also have a duty to promote competition; a duty to promote innovation; and a duty to apply proportionality to all its work.

A new board should be appointed. This should have some, but limited, continuity with the existing board. It should be significantly smaller than the FRC's. It should not seek to be "representative" of stakeholder interests.

The board should cease to be self-perpetuating. All appointments to the new board should be public appointments. All appointments to both the board and committees of the new regulator should be advertised, and headhunters should be used. The regulator's sub-board structure should be simplified.

The board of the new regulator should exercise significantly stronger ownership and oversight of the regulator's investigation and enforcement functions.

The regulator should be better equipped to ensure that its work and decision-making is informed by market analysis, particularly the dynamics of the audit market. It should have a view on the economics of audit and whether audit work is being properly resourced and priced.

The current self-regulatory model for the largest audit firms should end.

The Government should review the UK's definition of a Public Interest Entity (PIE).

The new regulator should work towards a position where individual audit quality inspection reports, including gradings, are published in full upon completion of Audit Quality Reviews (AQRs). This will, however, be a major step, requiring a high level of confidence in the AQR process. For the present, as a first and interim step, the Review recommends publication of AQR reports on an anonymised basis.

The regulator's corporate reporting work should be extended from its current limited scope to cover the entire annual report. It should be given stronger powers to require documents and other relevant information in order to conduct that review work. The regulator should be given the power to require restatements promptly (rather than requiring a Court Order).

The Government, working with the FCA and the new regulator, should consider whether there is a case for strengthening qualitative regulation around a wider range of investor information than is covered by the FRC's existing corporate reporting work, to ensure that disciplines to drive up the quality of companies' disclosures in the UK are at least as demanding as best practice internationally.

The Government, working with the new regulator, should develop detailed proposals for an effective enforcement regime in relation to PIEs that holds all relevant directors, not just members of professional bodies, to account for their duties to prepare and approve true and fair corporate reports and to deal openly and honestly with auditors.

The regulator should ensure that a consistent approach is taken in enforcement action against auditors, accountants, and responsible non-member directors by putting in place schemes that are equivalent to the Audit Enforcement Procedure (AEP).

The Review recommends that CRR findings are reported publicly by the regulator. The regulator should publish full correspondence following all CRR reviews, and the findings should be published in a set timeframe following closure of a review. The new regulator should develop a new capability to offer pre-clearance on interpretation of relevant standards.

BEIS should monitor closely the speed and effectiveness of the regulator's performance on enforcement to ensure that previous long delays do not recur. The regulator should report annually to Parliament on its enforcement performance.

In relation to the regulator's oversight of professional accountancy bodies, the Government should put a backstop statutory power in place, that would require action to be taken by a professional body if there was a need in the public interest.

The regulator should be required to promote brevity and comprehensibility in accounts and annual reports, to engage meaningfully with investors and asset owners about their information needs, and to ensure the proportionality and value of reports. At least once in every Parliament, the regulator should report on its assessment of the extent to which the statutory reporting framework is serving the interests of users of company reports.

The new regulator should be more sparing and disciplined than the FRC in promulgating guidance and discussion documents. These documents should only be issued if they are genuinely useful, and their utility clearly exceeds the considerable costs they impose through users having to read and check them.

A fundamental shift in approach is needed to ensure that the revised Stewardship Code more clearly differentiates excellence in stewardship. It should focus on outcomes and effectiveness, not on policy statements. If this cannot be achieved, and the Code remains simply a driver of boilerplate reporting, serious consideration should be given to its abolition.

The regulator needs to engage at more senior level in a much wider and deeper dialogue with UK investors, both fund managers and representatives of end-investors.

The regulator should not be funded on a voluntary basis. BEIS should put in place a statutory levy.

The regulator must be able to recruit staff of the calibre, expertise and seniority necessary to hold those regulated to account. It should recruit more partner-equivalent staff, adding weight and commanding more substantial respect in conversations with firms. The regulator should also develop a pool of 'grey panthers' whose expertise could be drawn on when needed.

The regulator is a market-facing body which, like other financial regulators, is funded **by** those it regulates, not the taxpayer. Accordingly, the control arrangements on pay for the new regulator should mirror those of other financial regulators such as the FCA, PRA and Ofcom which are not funded by the taxpayer. The regulator's budget should be set by Ministers, as

should the CEO's pay, but other pay decisions should be made by the regulator subject, of course, to proper transparency, and within the overall financial budget set by Ministers.

For the foreseeable future, the new regulator should not allow staff, or board or committee members ever to work on any regulatory functions relating to a past employer, removing themselves and/or delegating to others as necessary.

The regulator should engage closely with the proposed work on the future of audit and help ensure that its conclusions are put into effect. This work should be firmly driven by the interests of consumers and users of audited figures, not producers or the audit profession.

Operation of the audit market by Sir John Kingman¹⁸

Sir John Kingman wrote independently from his review of the FRC on the matter of the audit market. His views were aligned to our views.

Sir John Kingman¹⁹ concludes:

- a) First, he suggests that you should give the new regulator the right to appoint an auditor, in the case of PIEs, in several specific circumstances – all concerned to improve audit quality.
- b) Second, he suggests you should give the new regulator the right, in the case of PIEs, to approve audit fees, where it sees a case for doing so in the interests of quality. We call this remedy scale fees. This is where the audit fee would be governed by a scale and subject to allowances for complexity and other factors, and to be approved or mediated by the regulator.

Business Secretary Greg Clark seems to have accepted Sir John Kingman's report²⁰:

The UK has a world leading business environment making us one of the most attractive places to invest, start and grow a business but it is right we continuously keep our corporate governance regime under review to maintain that high competitive standard. The government will take forward the recommendations set out in the Review to replace the FRC with a new independent statutory regulator with stronger powers. This body will build on our status as a great place to do business and form an essential part of the government's continued efforts to grow trust and public confidence in business and the regulations that govern them.

¹⁸ Kingman Letter, 2018, Operation of the audit market: letters to the CMA and Sir John Kingman, Letters from Greg Clark to Lord Tyrie, Chair of the CMA, and Sir John Kingman, FRC review lead, Sir John Kingman, December 2018.

Available at:

https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/765547/auditor-appointment-letter-to-greg-clark-december-2018.pdf

¹⁹ Ibid.

²⁰ Available at:

<https://www.gov.uk/government/news/independent-review-of-the-financial-reporting-council-frc-launches-report>