Disruption in the Audit Market: The Future of the Big Four
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Online companions volume
Post Publication Comments: Current 2019 Audit Market comments and updates

Online companion volume

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Cases

For updates on:
Autonomy, Barclays, Patisserie Valerie, Steinhoff, Tesco, Wirecard and others see:
http://www.fin-rep.org/which-book/financial-failures-scandals-from-enron-to-carillion/

For our critique of the CMA (Competition and Markets Authority) Final Report

Please see: http://www.fin-rep.org/which-book/disruption-to-the-audit-market/

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October/September 2019 events

Big Four increase UK market share as audit reform concerns grow

Tabby Kinder[1] again had her finger on the pulse. The Big Four increased their domination of the FTSE companies and at the same time, reform of the audit market seemed to be slipping away. The domination is such that the Big Four, PwC, Deloitte, EY and KPMG, audited all of the companies in the blue-chip FTSE 100 index in 2018, up from 96 in 2017 (according to the FRC).

The Big Four auditing fees of PIEs climbed to, including those from consulting work, £11 billion in 2018. That is up almost 5 per cent from 2017. Tabby Kinder went on to say:

> The tightening of the Big Four's grip on FTSE 100 companies comes as Sir John Kingman, the architect of planned sweeping audit reforms, earlier this month attacked the government for failing to legislate to create a new accounting watchdog with more powers.
> Senior industry figures have also privately voiced concerns about a possible shift in attitude among some ministers to separate reforms recommended by the UK competition regulator that are aimed at breaking the control of the Big Four. In July, Andrea Leadsom took over as secretary of state for business from Greg Clark, who had spearheaded a string of reviews into auditing.
> The FRC's figures also revealed that the Big Four have failed to significantly cut the amount of non-audit work they do for the companies they audit.
> Total fees for non-audit services provided to audit clients fell from £1bn to £930m in 2018. Last November, KPMG pledged to stop providing non-audit services to big listed companies after coming under pressure over the potential for conflicts of interest. EY and PwC followed suit with similar pledges in January.

The actual FRC's annual report titled *Key Facts and Trends in the Accountancy Profession*, October 2019, is available on the FRC website:
https://www.frc.org.uk/getattachment/109373d4-abc2-424f-84d0-b80c2cec861a/Key-Facts-and-Trends-2019.pdf

/Continued

[1] Kinder, T., Big Four lift UK market share as audit reform concerns grow, *Financial Times*, 28 October 2019.
Available at:
https://www.ft.com/content/96d4b090-f973-11e9-a354-36acbbb0d9b6
Accessed October 2019.

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Joint audits

Not surprisingly, Paul England, the managing partner of BDO, the fifth largest accountants and a mid-tier challenger firm, said he expects ministers to force FTSE 350 companies to appoint two firms to audit their accounts. Mandatory joint auditing, where Britain's biggest listed companies are audited by both a "Big Four" firm and a smaller rival, was among proposals set out by the CMA in April 2019 to spur greater competition in the market[2].

We now believe that this is unlikely with the government being headed by Boris Johnson and the business minister, Andrea Leadsom.

BDO growing but argues that Audit is broken

BDO, after its merger with Moore Stephens, boosted growth and allowed the firm to leapfrog GT. The details are reported as[3]:

> BDO saw a 25 per cent jump in revenues last year as the accountancy firm swallowed a smaller rival and narrowed the gap with the UK's Big Four.
> In results released on Monday, BDO said that its revenues increased to £578m in the year to July 5, boosted by the merger with Moore Stephens in February that allowed it to leapfrog Grant Thornton and become the UK's fifth largest accountancy firm. Net profits climbed 26 per cent to £134m.
> Average profits per partner increased 8.7 per cent to £602,000. That follows PwC awarding partners their biggest payday in a decade after improved revenues.

However, Paul England the head of BDO, also said that audit is broken[4]:

> Paul Eagland, managing partner of BDO, said the audit market was "clearly broken and trust needs to be restored. At the moment it's not clear how that will be [done]."
> The audit profession has come under extreme pressure from politicians and regulators over the past 18 months as a series of accounting scandals, including Goals Soccer Centres, Patisserie Valerie and Carillion have shaken confidence in the industry.
> Mid-market firms such as BDO, Grant Thornton and Mazars were viewed as best placed to benefit from a shake-up of the audit market as the government seeks to loosen the grip of the Big Four and improve audit quality.

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[2] Clarence-Smith, L., Mandatory joint auditing is on its way, says BDO, The Times, 7 October 2019.
Available at:
https://www.thetimes.co.uk/article/mandatory-joint-auditing-is-on-its-way-says-bdo-hp35rjsz6
Accessed October 2019.

[3] Pooley, C., R., BDO narrows gap with Big Four but warns audit is 'broken', *Financial Times*, 7 October 2019.
Available at:
https://www.ft.com/content/d5b3f894-e5d1-11e9-9743-db5a370481bc
Accessed October 2019.

[4] Ibid.

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Brydon unhappy about the current stance on audit

Economia reported that[5]:

> Speaking publicly for the first time since he began the review, Sir Donald said, "It is not auditors that cause companies to fail, that's the result of the actions of directors. "I'm a little troubled by the current mood that reaches for a shotgun aimed at auditors every time there's a corporate problem.
>
> "Audit needs to be an attractive profession that attracts the brightest and the best who can have confidence that a good piece of professional work will not be misdescribed in times of stress", he said according to a report in the Financial Times.
>
> Sir Donald added he was "seeking for audit to become more informative and not just a compliance-checking function, and one which helps to maintain and grow trust in business as a whole".

A good point.

/Continued

[5] Doherty, R., "Shotgun aimed at auditors", says Brydon, *Economia*, 7 October 2019. Available at: https://economia.icaew.com/news/october-2019/shotgun-aimed-at-auditors-says-brydon Accessed October 2019.

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Criticism of EBITDA

The FT Lex column reports6 that the International Accounting Standards Board (IASB) plans to clamp down on EBITDA:

> … "What do you want profits to be?" Ebitda has the flexibility bosses crave, but which statutory profits lack. It has become a ubiquitous measure of corporate earnings.
> Companies calculate earnings — for which, read operating profits — in different ways. They may then chuck in adjustments. Some businesses deduct a one-off charge for restructuring that recurs every year. Exotic variants have included WeWork's "community-adjusted ebitda".
> Adjusted ebitda belongs to a befuddling slew of bespoke benchmarks. US accounting blogger Drew Bernstein calls these "the numbers management talks about once the auditor leaves the room". He argues these "management performance measures" are generating earnings upgrades troublingly absent from statutory results.
> The US Securities and Exchange Commission has issued reproving technical guidance for chief financial officers. Wholesale reform is in the sights of the IASB, rule-maker for much of the rest of the world. It is planning to standardise operating profits. A consistent earnings measure derived from this — "opbda" — would then supersede shifty ebitda.

OPBDA, standardised operating profits before depreciation and amortisation, would have the following benefits:

> Companies would have to reconcile any fancy-schmancy earnings measures they clung on to with statutory numbers at the back of their accounts. Auditors, nudged awake by recent scandals, would have to police accuracy.
> It is a good plan. Investors should support it — while keeping a close eye on real, but excluded, cash costs. Any measure that ignores interest flatters companies with hefty debts. The ability to pay dividends is reduced, all the same.

/Continued

[6] Lex, Accountants: lies, damn lies and ebitda, *Financial Times*, 7 October 2019.
Available at:
https://www.ft.com/content/05e00eb2-4d4a-3498-b1a8-3a4304116e7f
Accessed October 2019.

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KPMG eyes cost cuts with 'Project Zebra' plan

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KPMG cost cutting attempts

The news began to trickle out from KPMG after a series of adverse criticism in 2018 and 2019[7]:

> KPMG has drawn up plans to save £100m in costs in a profit-boosting exercise codenamed "Project Zebra".
> The Big Four accounting firm has started stripping out expenses from its UK business ahead of its 2019 financial results, which will be published in December.
> KPMG told the Financial Times that it was "resetting its cost base across the firm". The savings could increase its UK profits by almost a third.
> One insider close to Project Zebra said that about 150 cost-cutting measures were being considered, adding to initiatives already under way that include recalling hundreds of employees' corporate mobile phones and making about a third of its 630 personal assistants redundant.
> The person said the project had been commissioned by KPMG's leadership and drawn up by a restructuring partner who specialises in advising the firm's clients on "zero-based budgeting", a means of stripping out costs whose initials are the basis for the code name.

As part of its cost cutting news has spread that KPMG mulls plans to shut down its private members' club as well as move staff to Reading as part of efforts to trim £100m in costs. The KPMG club is a five-storey townhouse at 20 Grosvenor Street, which boasts a rooftop terrace, restaurant and private meeting rooms. As well KPMG will also transfer most of its marketing department from Canary Wharf to Reading and make around 50 roles were placed at risk of redundancy as a result of the restructure[8].

/Continued

[7] Kinder, T., KPMG eyes cost cuts with 'Project Zebra' plan, *Financial Times*, 21 October 2019.
Available at:
https://www.ft.com/content/9b46c17a-f1aa-11e9-ad1e-4367d8281195
Accessed October 2019.

[8] Mkandawire, V., and Gill, O., KPMG mulls plans to shut down its private members' club, The Telegraph, 27 October 2019.
Available at:
https://www.telegraph.co.uk/business/2019/10/27/kpmg-mulls-plans-shut-private-members-club/
Accessed October 2019.

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KPMG cost cutting attempts/Continued

This FT articles argues that it may be counter-productive and hit morale[9]:

> KPMG has breathed new life into the phrase "petty bean-counters" with a recent decision to cancel work mobile phones for hundreds of junior and back office employees.
> The move by the British arm of the Big Four accountancy firm is part of a larger cost-cutting drive that will include letting go about 200 secretaries and personal assistants and telling partners to file their own expenses claims.
> There are also firm specific reasons to trim spending: KPMG, under pressure after a series of scandals, has told employees that the costs of the UK business were higher than others in its global network as well as UK rivals. The firm argues that the phone cull will encourage staff to separate working hours from personal time and says that employees who travel a lot or need to be contacted out of hours will not be affected.
> ….
> Penny-pinching also backfires when it involves erecting new hurdles for costs — postage, local travel, etc — that used to be routinely approved. Bedding down new expenses procedures eats money and time, and distracts employees from core activities. This might be worth it if companies stuck to their guns, but often they drop the strict scrutiny once immediate savings goals are met.
> ….
> The underlying problem for managers may be that the burdens of cost-cutting are rarely shared evenly, as a 2012 study published in the American Sociological Review revealed. It found that efforts to automate, reduce bureaucracy and eliminate waste have historically been associated with rising numbers of managers and increased manager pay.
> Rather than fostering solidarity, symbolic cost-cutting all too often translates into something far more divisive: employees feel the pain while executives and managers reap the profits.

/Continued

[9] Masters, B., Pinching pennies is all too often pound-foolish, *Financial Times*, 8 October 2019.
Available at:
https://www.ft.com/content/22552c6c-e8da-11e9-a240-3b065ef5fc55
Accessed October 2019

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GT also cutting costs[10]

Grant Thornton has parted ways with a dozen UK partners in a restructuring designed to reverse a five-year financial decline.

The accounting firm informed its top echelon that about 12 partners — 6 per cent of the total — were leaving as it attempts to improve profits and recover from a difficult year for the business, which has faced scrutiny over its audits of Patisserie Valerie and after the controversial departure of Sacha Romanovitch, its former chief executive.

The internal announcement about the partners, some who have worked at Grant Thornton for 30 years, was made ahead of its financial results, which are due to be published in December

FRC chairman steps up plans for stronger UK accounting watchdog[11]

The new chairman of Britain's accounting watchdog is speeding up plans to create a new regulator with stronger powers to discipline audit firms and company directors.

Simon Dingemans, who became chairman of the Financial Reporting Council this week, said he will run a "very different" regulator to his predecessor, Sir Win Bischoff, who stepped down following a damning report into the regulator's effectiveness.

Mr Dingemans takes over at the FRC seven months after the UK government said it would follow the recommendations of the report, which was written by Sir John Kingman, chairman of Legal & General, by giving a new watchdog significantly greater oversight of the Big Four accounting firms.

"I want to see much greater challenge, focus and pace from the FRC as we move to establish [the new regulator] and deliver this important reform programme," said Mr Dingemans. "Success will also need delivery at pace of the legislation to give us the powers we need. We will be working closely with the department for business to achieve this."

Now this tells us two interesting issues:

1) The FRC as the watchdog seems to be continuing under a tighter and more aggressive stance.
2) ARGA, FRC's replacement as recommended by the Kingman review, seems as if it may not go ahead. Lack of political will in the Boris Johnson post-Brexit world where regulations may be rolled back.

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[10] Kinder, T., Grant Thornton cuts partner numbers as it seeks improvement, *Financial Times*, 8 October 2019.
Available at:
https://www.ft.com/content/f8f21d7c-e914-11e9-a240-3b065ef5fc55
Accessed October 2019

[11] Kinder, T., FRC chairman steps up plans for stronger UK accounting watchdog, *Financial Times*, 8 October 2019.
Available at:
https://www.ft.com/content/e762d018-e9d4-11e9-a240-3b065ef5fc55
Accessed October 2019.

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John Kingman hits out at drift in reform of UK accountancy

The fact that the changed government under Boris Johnson may not want to continue with the previous changes to the FRC and the direction of any future changes to the governance codes[12]:

> The architect of sweeping audit reforms has hit out at the UK government for failing to legislate to create a new accountancy watchdog with more powers.
> John Kingman, who led a review that recommended replacing the Financial Reporting Council with a new regulator to help restore trust in the scandal-hit audit market, said it was "disappointing" that his proposals had not been included in Monday's Queen's Speech.
> In a letter to a parliamentary select committee on Tuesday, Sir John said he was "concerned about the risk of letting the FRC drift on, half-reformed and lacking the teeth that only legislation can give it".
> The Legal & General chairman and former civil servant, who published his damning review last year, pointed to the "unequivocal consensus around the need for change".
> A string of accounting controversies and corporate collapses in recent years including Carillion, BHS, Patisserie Valerie and most recently, Thomas Cook has intensified disquiet about regulation of the UK audit market.

This more or less confirms that ARGA will not go ahead though a beefed up FRC probably will.

/Continued

[12] Binham, C., and Pickard, J., John Kingman hits out at drift in reform of UK accountancy, *Financial Times*, 15 October 2019.
Available at:
https://www.ft.com/content/42e27cee-ef6c-11e9-ad1e-4367d8281195
Accessed October 2019.

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PwC's retired partners share £100m windfall

Tabby Kinder reported[13]:

> More than 1,000 former partners of PwC, including one who is now a senior member of the accounting industry's regulator, have shared a windfall of £100m after a record year for profits at the business.
> The payout, which was more than 10 per cent of PwC UK's total profit last year, was made through the firm's annuities system. This is a longstanding arrangement offered by each of the Big Four accounting firms through which a share of annual profits is paid out to certain retired partners.

Lex of the FT was also rather scathing about these Huge PwC payouts[14]:

> Accountancy has found the gift that just keeps on giving. More than 1,000 former partners in PwC UK have shared £100m paid out in annuities this year. Such largesse raises ticklish questions. Accountancy firms are underpinned by auditing, which companies have to pay for as a public service. Real public servants sometimes receive gold-plated pensions. But their pay is modest. You cannot say the same of accountants: profits per partner were
> £765,000 at PwC UK in 2018-19.
> PwC UK's plutocratic pensioners evidently get their annuities as a kind of profits share from practices they ran before they retired. The cash stops rolling in five years after they leave. You could argue this rewards them for helping make PwC the UK's most successful large accountancy firm.
> But, as any accountant knows, an annual payout may also be a liability. This, we can surmise, would be something just under £500m for PwC UK. The scale would depend on how obligatory the distributions were. PwC UK says payouts drop when profits do, but does not say how. Indeed, annuities are described as a private arrangement. That conveniently takes the matter off the balance sheet.

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[13] Kinder, T., PwC's retired partners share £100m windfall, *Financial Times*, 14 October 2019.
Available at:
https://www.ft.com/content/d679ceee-ec33-11e9-85f4-d00e5018f061
Accessed October 2019.
[14] Lex, PwC annuities: go audit that, *Financial Times*, 14 October 2019.
Available at:
https://www.ft.com/content/fd62ffdd-acc4-4195-a2ff-a1e1c6eda1d7
Accessed October 2019.

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FRC strengthens Going Concern audit standard

This has come straight after the collapse of Thomas Cook which went straight into liquidation as being too big and complicated to run by an administrator. See our separate analysis of the case in:
https://www.fin-rep.org/wp-content/uploads/2019/09/11-Thomas-Cook.pdf
And it has announced there will be an investigation[15]. This FRC action[16] would put the work of two Big Four audit firms, EY and PwC, under the spotlight once again[17]. This is the new ISA standard ISA (UK) 570.

The revised standard requires:

- greater work on the part of the auditor to more robustly challenge management's assessment of going concern, thoroughly test the adequacy of the supporting evidence, evaluate the risk of management bias, and make greater use of the viability statement;
- improved transparency with a new reporting requirement for the auditor of public interest entities, listed and large private companies to provide a clear, positive conclusion on whether management's assessment is appropriate, and to set out the work they have done in this respect; and
- a stand back requirement to consider all of the evidence obtained, whether corroborative or contradictory, when the auditor draws their conclusions on going concern.

A copy of the revised standard can be found here:
https://www.frc.org.uk/getattachment/13b19e6c-4d2c-425e-84f9-da8b6c1a19c9/ISA-UK-570-revised-September-2019-Full-Covers.pdf

A copy of the feedback statement can be found here:
https://www.frc.org.uk/getattachment/d0922877-903c-4566-940b-d60dcd2165f5/Going-Concern-Feedback-Statement-2019-Full-Covers.pdf

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[15] FRC, Investigation in connection with the financial statements of Thomas Cook Group plc, 1 October 2019.
Available at:
https://www.frc.org.uk/news/october-2019/investigation-in-connection-with-the-financial-(1)
Accessed October 2019.
[16] FRC, FRC strengthens Going Concern audit standard, 30 September 2019.
Available at:
https://www.frc.org.uk/news/september-2019/frc-strengthens-going-concern-audit-standard
Accessed October 2019
[17] Davies, R., and Topham, G., Thomas Cook directors could have bonuses seized, suggests Shapps, *The Guardian*, 25 September 2019.
Available at
https://www.theguardian.com/business/2019/sep/25/thomas-cook-directors-could-have-bonuses-seized-suggests-shapps
Accessed September 2019.

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The rationale for the regulators actions

Such moves won't happen. But the FRC investigation is more serious especially the impact on the two Big Four who audited the group – EY and PwC. The Thomas Cook accounts are claimed to have reported historic exceptional charges that flattered profits, as well as its treatment of goodwill writedowns and under-reporting debts. The problem for EY is that in October signed off on the travel group's 2018 accounts as a going concern, meaning it had judged that the business could survive another 12 months[18].

EY may also be criticised because in the half-yearly review of Thomas Cook's interim results in May 2019, that there was a "material uncertainty related to going concern" linked to a new financing agreement. The company disclosed that month that it had agreed a new £300m lending facility[19].

Not only have the FRC now releases (as of October 2019) new godliness for the evaluation of going concern, but they are tightening up other regulations as well.

This quote provides some idea of the direction the regulators are going in (according Bob Moritz, global chairman of PwC)[20]:

> "The expectation of the market [for an audit] is above the regulatory requirement," said Bob Moritz, global chairman of PwC. "When big failures happen, it is not necessarily an audit failure. The controls might be appropriate, but the continuation of the business, its financial position and long-term sustainability can still be in question."
> The gap between what a company's shareholders, employees and pensioners expect from an audit and the reality of an auditor's legal responsibilities is a core part of the government review led by Sir Donald Brydon.
> At a minimum, Thomas Cook is an example of what is the relevance of the audit opinion," said Mr Moritz….

This is long overdue. The fact that auditors took the narrowest viewpoint of the existing regulations shows that either the audit regulations required revision long ago or the common interpretation favoured by all auditors was too narrow in today's world. Failures were bound to fall between the cracks.

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[18] McCormick, M., and Kinder, T., Accounting regulator launches probe into EY audit of Thomas Cook, Financial Times, 1 October 2019.
Available at:
https://www.ft.com/content/41fdd630-e412-11e9-9743-db5a370481bc
Accessed October 2019.

[19] Ibid.

[20] Kinder, T., Thomas Cook collapse will intensify UK audit debate, PwC says, *Financial Times*, 1 October 2019.
Available at:
https://www.ft.com/content/1e3aeabc-e34a-11e9-9743-db5a370481bc
Accessed October 2019.

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Auditors get tough new rules after high-profile collapses

The Times analysis of this was[21]:

> The Financial Reporting Council has published a new set of rules for auditors when deciding whether a business is a "going concern " and able to trade for another 12 months. Audit firms will have to test "more robustly" the evidence provided by managers to demonstrate a company's viability.
>
> The rules are in response to the collapses of companies such as BHS and Carillion, which received clean audits months before going bust. Auditors were criticised for failing to question management assessments that the companies were "going concerns". The FRC was lambasted for its perceived light-touch approach and is being replaced by a new watchdog called the Audit, Reporting and Governance Authority.
>
> Under the new framework, auditors will have to take much more responsibility over the "going concern" judgments and will not be allowed to take directors' assurances at face value. Audit firms operating in Britain will follow "significantly stronger requirements" than those required in other developed economies, according to the FRC.
>
> The new rules will require auditors to challenge management's assessment of "going concern" and "thoroughly test" the adequacy of any supporting evidence they put forward.
>
> Audit work will have to be more transparent and firms will need to provide a "clear, positive" statement explaining why they have deemed a company to be a "going concern". They will have to say whether they agree with directors' assertions that a company could stay in business for the foreseeable future and set out the work done to reach this conclusion.
>
> The enhanced standards will apply to listed and large private companies.
>
> "High-quality audit protects the public interest, meets the needs of users of financial statements and underpins investor confidence. Recent corporate failures have, for good reason, adversely affected that confidence." said Stephen Haddrill, FRC chief executive.
>
> "Our own enforcement work has demonstrated a need to strengthen existing going concern standards, which is a fundamental aspect of audit, so that investors can have confidence in audited financial statements and businesses' financial prospects," he added.

[21] Duke, S., Auditors get tough new rules after high-profile collapses, *The Times*, 30 September 2019. Available at: https://www.thetimes.co.uk/article/auditors-get-tough-new-rules-after-high-profile-collapses-zdbkdzjgq Accessed October 2019.

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Big Four accountants facing changing times

Tabby Kinder of the FT argued a more general point which we agree with[22]:

> The Big Four accountants have enjoyed an oligopoly over the audits of the largest listed companies in the UK and US, with some relationships dating back more than a century.
>
> But amid increasing scrutiny from politicians and regulators in the wake of high-profile corporate collapses, structural change, at least in the UK, looks certain.
>
> This week the FT revealed that Deloitte has asked the UK government whether the Big Four could head off regulatory intervention with the introduction of a self-imposed cap on the number of FTSE 350 entities it can audit.
>
> The proposal, which it would introduce only if rivals followed suit, could open the door to more mid-tier firms in the audit market for FTSE 350 companies, all but 13 of which are audited by the Big Four. Under the plans, each firm could be restricted to 20 per cent of the market.
>
> The UK competition watchdog has instead recommended that each large listed business is audited by both a Big Four firm and a smaller rival. Companies will be exempt from mandatory joint auditing if they appoint a mid-tier firm as their sole auditor.
>
> Structural changes are almost certain to happen. The Big Four accountancy firms have enjoyed a monopoly auditing the largest listed companies. In some cases those relationships have lasted more than a century. But change looms: pressure from politicians and regulators could threaten their future by allowing more m d her players in the sector.

Continued

[22] Kinder, T., Big Four accountants facing changing times, *Financial Times*, 27 September 2019. Available at:
https://www.ft.com/content/a7a6aa80-e137-11e9-9743-db5a370481bc
Accessed September 2019.

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KPMG cutting costs – paying the price for poor audits?

KPMG has probably been involved in more cases that have drawn public and press attention than any of the other Big Four. They took action. They were the first that changed the pay structure away from earnings to audit quality. They were the first to separate audit from consultancy – though closely followed by the other two except for Deloitte. But the reputational damage must have resulted in lower income because KPMG are in the throes of a severe cost-cutting program – to get back the partners salaries to where they were perhaps?

It is reported that KPMG UK is to cut hundreds of admin roles in cost-saving drive[23]. Partners asked to file their own expenses. And KPMG staff told to hand back work mobile phones[24]. Expect more announcements as part of this cost saving drive.

We think this cost-saving is a mistake,. In the competition to obtain, the best recruits if KPMG offer less than other firms. Who wants to join a firm where perks are being taken away. Whilst the etch giants are offering even more perks as well as a present environment and sleep pods and more flexibility.

Continued

[23] Kinder, T., and Marriage, KPMG UK to cut hundreds of admin roles in cost-saving drive, *Financial Times*, 19 September 2019.
Available at:
https://www.ft.com/content/4eecbbc4-da2e-11e9-8f9b-77216ebe1f17
Accessed September 2019.
[24] Kinder, T., KPMG staff told to hand back work mobile phones, , *Financial Times*, 29 September 2019.
Available at:
https://www.ft.com/content/ae2d4f70-e142-11e9-b112-9624ec9edc59
Accessed September 2019.

Online companion volume

October/September 2019 events/Continued

KPMG reorganises ahead of Government regulations

This continues the KPMG reactions (they were the frist off the starter's gun) to move to a better structure more fit for purpose. These new measures are all part of this reorganisation. Tabby Kinder again broke this latest news[25]:

> KPMG has moved 800 staff and about 20 partners from its advisory division into its audit department in preparation for a possible forced break-up.
>
> Any consultant who spends more than 10 per cent of their time advising auditors will now sit within the audit department in a move towards a "more separate future", according to a person briefed on the firm's internal communications.
>
> The job moves in recent months, ahead of an expected overhaul of the sector by politicians and regulators, put KPMG ahead of Big Four accounting rivals Deloitte, EY and PwC, which have lobbied against enforced structural changes and are yet to implement their own.
>
> KPMG told the Financial Times that rather than waiting to be "forced into action", it was "working on creating a model which gives our audit practice greater independence from the rest of the business, while ensuring our auditors have access to the benefits a multidisciplinary firm brings".
>
> KPMG, whose UK turnover was £2.3bn last year, is trying to save its reputation after the collapse of Carillion, the government outsourcer it audited for 19 years, and scandals in America and South Africa.
>
> The restructuring, to be completed by the end of the firm's financial year on October 1, is expected to boost the finances of the audit practice, which received £572m in fees last year and audited 91 of Britain's 350 largest companies.

Continued

[25] Kinder, T., KPMG switches 820 UK staff from advisory to audit, *Financial Times*, 26 September 2019, Available at:
https://www.ft.com/content/a5a84da8-df69-11e9-b112-9624ec9edc59
Accessed September 2019.

Online companion volume

October/September 2019 events/Continued

PwC UK considers giving external body oversight of auditors' pay

Meanwhile as Tabby Kinder again reports PwC is not sitting idly by[26]:

> PwC UK is considering an overhaul of how its auditors are paid to reduce the risk of conflicts of interest between audit and consulting and head off a possible forced break-up.
> The report by Oxford university Professor Karthik Ramanna, which was published on Friday, said such a committee was needed for audit firms to "credibly signal" that partners were being rewarded for challenging company directors on their accounts.
> PwC will also review the use of client feedback when reviewing the performance and pay of its auditors after the report said the practice discouraged auditors from criticising a company's accounts.
> Prof Ramanna further recommended that audit firms' non-executive directors launch an annual review of the degree of cross-dependence created by profit sharing across audit and advisory divisions of the firm. "The independent assessment must be made public . . . to adjust audit partner compensation in ways that safeguard the audit firm's public responsibilities," he wrote.
> "High margin consulting services by audit firms are creating conflicts of interest for auditors' mission to challenge," Prof Ramanna wrote. "The audit firms must credibly signal that partners are being rewarded for skills in scepticism rather than in selling."
> He told the Financial Times that an external monitor of auditor pay was the "only way" that the firms could show they were serious about creating a "culture of challenge".

This is another move to try to sure up greater independent. It still does not alter the fact that the cosy relationships between client and audit exists and that the client pays the auditors fees. The client chooses the auditor. These are not changed. Within this context it is difficult to see how Professor Karthik Ramanna is anything more than tinkering with the system. It may help at the margin but it fundamentally changes nothing.

And PwC was fined $8m in the US to settle improper conduct claims where consultancy and audit work were not kept sufficiently separated[27].

> PwC has agreed to pay US regulators $7.9m to settle charges of improper conduct during its audits of over a dozen companies, another setback to attempts by the Big Four accountancy firms to restore their reputations following a series of controversies.

[26] Kinder, T., PwC UK considers giving external body oversight of auditors' pay, *Financial Times*, 27 September 2019.
Available at:
https://www.ft.com/content/d0c2c5f0-e07b-11e9-9743-db5a370481bc
Accessed September 2019.

[27] Stacey, K., and Kinder, T., PwC pays $7.9m to settle improper conduct claims, *Financial Times*, 23 September 2019.
Available at:
https://www.ft.com/content/b56d4f0c-de21-11e9-b112-9624ec9edc59
Accessed September 2019.

Online companion volume

Summary and overview (August 2019)

The recent game changing events (August 2019)

Given that:

- Consultancy and audit are being split operationally – only Deloitte is holding out. However, one way (voluntary and peer group pressure) or another (legislation, rules) this will happen in the UK.
- The FRC and its replacement ARGA, are steadily ratcheting up their rules and regulations for auditing. These and other regulatory bodies (FCA etc) are steadily increasing their fines and are much more likely to open an investigation than before. The whole climate had dramatically shifted and for tightening audit more in in term of public perception and less in terms of the legal framework of acts. Nowhere is this more apparent than in the going-concern and viability statements.

Then this has changed the audit market in a major way.

1) Auditors are becoming more circumspect[28]. The resignation of Sports Direct is a major change. Then KPMG resigned from Eddie Stobart Logistics (but PwC took-over). However, there or will be continuing rankles about auditors with the FTSE 100 and also in the US. GE and Disney are the latest discussions where whistleblowers claimed there were massive misstatements or worse[29].
2) Higher audit fees: There is now pressure on higher audit fees. Partly due to an increased awareness of what we say as missed opportunities to detect problems and issues but also the higher fines being levied and the mood of politicians and the public. Pressure is also exerted now that the consulting and audit divisions are split. Consultancy cannot subsidise low margin audit work. Anymore. Audit work has to produce better returns or there will be no wish to conduct audits.
3) Reputational damage. The astute Oliver Shah summarises this as not being a fees concern but[30]:

> Ashley's character. A man who tells a newspaper he has "balls of steel" and a court he is a "power drinker" is not, in their opinion, someone whose word you want to rely on for marginal calls. "Everyone's afraid to touch him — you're going to get FRC'ed," says one, referring to the Financial Reporting Council, which has belatedly discovered a set of teeth.

Continued

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[28] Kingsley, S., (one of my former students?), Auditors are becoming more circumspect, Financial Times, 13 August 2019.
Available at:
https://www.ft.com/content/4c5a2236-b551-11e9-bec9-fdcab53d6959
Accessed August 2019.

[29] See:
http://www.fin-rep.org/which-book/financial-failures-scandals-from-enron-to-carillion/

[30] Shah, O., Ashley effect poses new problem for auditors, *Sunday Times*, 25 August 2019.
Available at:
https://www.thetimes.co.uk/article/oliver-shah-ashley-effect-poses-new-problem-for-auditors-0xttvnb32
Accessed August 2019.

Online companion volume

Summary and overview (August 2019)/Continued

The recent game changing events (August 2019)/Continued

4) Fines and legal costs might persuade a smaller audit firm to be wary. The current favourite according to Shah is:

    > That has left Sports Direct scrabbling around in accounting's lower leagues, reportedly holding talks with MHA MacIntyre Hudson — a member of Baker Tilley International, and auditor to the iron ore pellet-maker Ferrexpo, but hardly a household name[31].

    A smaller firm, not this one necessarily, may be worried about regulatory fines (now becoming considerable), legal costs and the possibility of being sued.
5) Insufficient numbers of large auditors still remains an insurmountable problem. Even with the Big Four and a group of mid-tier challenger firms, there are not enough auditors for there not to be a conflict of interest, or insufficiently attractive. With the resignation of the mid-tier challenger firm GT from Sports Direct (Mike Ashley), this difficult to fathom and rapidly expanding retail group is presenting a problem. After GT, the Big Four and other have refused to tender as an auditor. Just Mazars remain and they may well say no. In which case an auditor will be appointment by the Department of Business. But the audit fees are currently too low for a mid-tier firm to take the risk of fines and litigation, and the reputational risk if governance has been shown to be weak and the business has already run into problems.

Continued

[31] Ibid.

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Summary and overview (August 2019)/Continued

Recent events, opinions, and commentary (August 2019)

The Shah dilemma

This is beautifully penned:

> All of which makes you think that many of the current reviews into the industry, inspired by BHS, Carillion et al, are coming from the wrong direction.
>
> Lord (Andrew) Tyrie of the Competition and Markets Authority thinks the overwhelming problem is competition (perhaps unsurprisingly, given the old rule that if you're holding a hammer, everything looks like a nail). He wants to enforce joint audits on the FTSE 350, split audit and advisory businesses, and possibly bring in market share caps.
>
> Such thinking assumes the economics of auditing are so compelling that firms will always scramble over each other to win clients. The Ashley situation may be an outlier for now, but it is a glimpse of a world where that is no longer the case. Firms are waking up to the reputational risks of wheeler-dealer customers and wondering whether they're worth it.
>
> In fact, competition is a red herring. What we need is higher audit fees and more focus on quality, plus bigger fines from the FRC to keep everyone in line.
>
> Ashley may be a rougher and more unappealing version of Goldsmith, and he may well deserve to be ostracised, but a world where the big accountants shrug their shoulders and walk away from difficult jobs is not a safer one[32].

The old and new Government have made promises and appear tough on auditing Yet their entire bandwidth on making decisions is taken up with Brexit, relations with the US and other affairs (as of August 2019). The new Prime Minister, Boris Johnson, is not particularly keen on pursuing the auditors, or if he is, it is earmarked as a low priority item. Andrea Leadsom who replaces Greg Clark, has not made her views known. They are, in Krish's view, likely to be tamer than the outgoing business minister.

Meanwhile the auditors have shifted their position. Most, with the notable exception of the Deloitte, have begun to split their audit and consultancy divisions. The verdict is out as to how successful this will be; and how separate and independent these splits will be. KPMG have made audit quality their basis for rewarding partners – perhaps a step forward rather than ranking partners on their total client earnings. That said the consultancy side of the business still dwarfs the audit side for all the Big Four and their challenger mid-tier firms (and the handful of up and coming [through mergers] smaller firms).

[32] Ibid.

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Summary and overview (August 2019)/Continued

Recent events, opinions, and commentary (August 2019)

Audit, Reporting and Governance Authority

Rod reports, (being close to the ICAEW), that ARGA (the Audit, Reporting and Governance Authority), the replacement for the FRC, is proceeding and appointments have been made. This is reinforced by press reports of the head appointment being made[33]. Krish was more pessimistic and believed that ultimately this replacement for the FRC will be put on hold or the timescale of its implementation delayed or postponed. That seems to be changing than the end result may be a watered-down version of ARGA - along with the lower salaries on offer[34]. Press reports as of May 2019[35], indicate that the adverts for the new head jobs at the new ARGA being advertised (at a lower rate than the FRC which goes again the logic of the Kingman report. Hence Krish's view that ARGA is either delayed, or will be watered down… or worse.

Currently though the FRC has taken on a new aggressive stance.

Continued

[33] Clarence-Smith, L., Sir Jonathan Thompson to head new audit watchdog, The Times, 19 July 2019.
Available at:
https://www.thetimes.co.uk/article/sir-jonathan-thompson-to-head-new-audit-watchdog-bpvphw0sl
Accessed July 2019.
And
Thomas, D., Strauss, D., and Beioley, K., HMRC's Thompson chosen to overhaul accounting watchdog, The Times, 18 July 2019.
Available at:
https://www.ft.com/content/102efec6-a980-11e9-b6ee-3cdf3174eb89
Accessed July 2019.

[34] Something that goes against the Kingman recommendations.

[35] Ball, F., CEO of ARGA to be paid less than FRC leader, *Economia*, 22 May 2019.
Available at:
https://economia.icaew.com/news/may-2019/ceo-of-arga-to-be-paid-less-than-frc-leader
Accessed July 2019.

Online companion volume

Summary and overview (August 2019)/Continued

The most important August events are:

1) **No to risky audits**. UK accountancy firms prepare to cull risky clients and this follows GT's resignation as auditor of Sports Direct (Mike Ashley's expanding retail group [just taken over Jack Wills August 2019]). The Big Four and just about all of the mid-tier and challenger firms have made it clear that they do not want to audit Sports Direct. This supports our contention that there are insufficient numbers of the Big Four and now even the mid-tier challenger audit firms.

2) **Increasing regulations**. Even before the creation of ARGA, the FRC had become much more aggressive and firm, tightening its regulations wherever possible and fining in volumes, frequency, and amounts never heard before. So effectively the rules and regulations over financial reporting. There were two further sub-effects:
   a) The boards of the larger companies are becoming more are – not sufficiently – but they are taking note.
   b) The audit firms are now being much more careful. As demonstrated by GT resigning as the auditor of Sports Direct. This followed a tax bill of £605m liability from Belgium – the likelihood of paying this amount or some of it being in question among a host of other factors (such as a dismal performance from the House of Fraser [recently taken over]).
   c) Public expectations and the users of reports have, if anything, increased the expectations gap between what is expected by the public and what the auditors actually deliver.

3) **Higher audit costs**. Increasing regulations, auditors not willing to take on risky sectors and clients, a separation on audit and consultancy division are a price worth paying for the Big Four. See the next few sections.
   a) The EU regulation for tendering regularly. Tendering cost money – at least £500,000 for a FTSE 100 company. Getting to know a new client possibly adds costs, and shorter contracts mean investments in new people and technology can't be spread over many years. That's aid we found that audit quality actually increases with such a change - effectively every 5 years.
   b) As above, UK regulators and international accounting standards setters are demanding that auditors 'up their game' by providing more sophisticated modelling of risks, as well as more documentation of what they have done to challenge management assumptions.
   c) As firms split auditing and consulting, they must ensure audit businesses are profitable on their own, rather than subsiding the audit division or being a loss-leader for the consultancy diviiosn of the larger firm.

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Summary and overview (August 2019)/Continued

Important August events/Continued

Companies penalise auditors who are more critical [US] (August 2019)

No prizes for guessing what is probably common sense. But this is a scientific study that proves the point, albeit using US data[36]:

> We examine whether the audit market penalizes auditors for providing investors with value-relevant information that is critical of management (i.e., internal control material weakness (ICMW)). While prior research has examined how the receipt of an ICMW increases the likelihood that a client leaves their auditor, we examine the reputational impact of an office issuing ICMWs by focusing on clients that receive clean internal control opinions. We predict and find that audit offices that issue more ICMWs experience lower client and fee growth. We also find that the decrease is stronger when the ICMW is associated with a more visible client and when the ICMW is more severe. In supplemental analyses we find evidence consistent with clients avoiding auditors with a reputation for issuing ICMWs in their auditor selection decisions. Our results indicate that, on average, the market for audit services penalizes auditors for disclosing information critical of management in their audit opinions, which undermines the value of direct-to-investor auditor communications and provides insight into potential longer-term implications of the recently enacted expanded auditor's report.

In the UK after the current round of EU regulations have been implemented, internal control systems are not the province of the external auditors. IT is explicitly banned. But the sentiment still exist as we have found in our interviews. Auditors who are more critical are like less. This argues for a) greater auditor independence and b) separation of the fees and c) perhaps the appointment of an auditor through some other system than the tendering where personal relationships seem to be mantra for a winning formula in the tendering process.

[36] Cowie, E>, N., and Rowe, S., P., Don't Make Me Look Bad: How the Audit Market Penalizes Auditors for Doing Their Job, 7 August 2019.
Available at:
https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3228321
Accessed August 2019.

Online companion volume

Summary and overview (July 2019)

CMA's recommendations

The CMA's recommendations are in turmoil. Joint audits are probably out permanently (only the CMA seems to favour this). None of the FTSE 350 are particularly enamoured with them. Neither is the FRC particularly keen. Our research shows a) little evidence of an improvement in audit quality, b) costs increase, c) duplication increases, and d) responsibility for an audit is diluted. The separation of audit and consultancy has taken place by most of the Big Four. Deloitte's will eventually bow to this split. The CMA device for increasing the revenues of the challenger firms disappears with the demise of joint audits. Their other recommendations such as beefing up audit committees and a review process will probably be woven into new FRC rules and regulations – probably diluted from the original recommendations.

So the CMA's recommendations have either fallen by the wayside of pressing political concerns or have been swept into an enhanced FRC, a watered-down ARGA, or may be the full as intended ARGA. Meanwhile the Big Four have managed (just) to show willingness in splitting their audit and consultancy divisions. Though, unfortunately, audit quality continues to be suspect.

FRC's new management

Meanwhile the newly aggressive FRC, under new management, will issue new guidance and rules on independence. That will be welcomed. However as against that audit quality has not improved and 2018 saw another decline in audit quality (as judged by the FRC – who we admit have probably - and rightly - moved the goal posts).

Insufficient numbers problem

That still leaves the insufficient numbers problem. There are not enough of the Big Four, or whatever, to cover all the audit, tax consultancy and other advisory work for the largest listed and private companies.

As one CEO of the audit firms admitted there is not sufficient degrees of freedom in choosing an auditor among the Big Four – even with a measure of some conflicts of interest acknowledged. Not employing the Big Four leaves open the question to shareholders and stakeholders of 'why not'. The performance of the mid-tier audit firms, as found by Valerie Patisserie and others has not been encouraging. Whatever the outcome of current investigations in this case, the chairman was unaware of the financial performance, a black hole of £40m, and unauthorized bank loans of £10m or so. Neither were the auditors.

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Summary and overview (July 2019)/Continued

Private companies and SMEs

With the growth of private equity and an increasing number of companies angling not to be listed and suffer the rigours and regulations that a stock market brings, we feel that private companies should be more tightly regulated.

On the other hand that although SMEs should be regulated, the extent should be less than that for a PIE. At present, little attention has been paid to this though there are increasing rumblings about this.

Public interest test

The FRC wants to introduce a public interest test requiring a firm to consider whether stakeholders such as consumers would view a proposed action as likely to affect its independence, instead of considering only what another auditor might think. The acid tests for this[37] was probably the Staffline case (PwC were the auditors).

As the FT reported:

> The Big Four accounting firm's relationship with Staffline — one of the UK's largest recruitment firms — has come under scrutiny after it delayed publishing its results in January and admitted to potential accounting irregularities involving "invoicing and payroll practices".

Independence of the auditors

The other big issue apart from insufficient numbers of the big audit firms continues to be the independence of the auditors from the firm being audited. The tendering process is all about social easiness and the relationship between management and the auditors – as shown by empirical evidence of the auditing process. The FRC may well tinker with the rules but the fundamental issue of the tendering process and the fact that it is the firm being audited that pays the auditor cannot change the relationship of purchaser and seller. The buyer has most of the cards up his or her sleeve.

Ending note

Will scandals continue to occur? Of course. Will audit quality improve? It may but not sufficiently for our liking. More needs to be undertaken to solve the insufficient numbers issue and the independence of the auditors.

[37] Beioley, K., Accounting watchdog moves to beef up audit independence rules, *Financial Times*, 15 July 2019. Available at:
https://www.ft.com/content/49e57c9e-a705-11e9-b6ee-3cdf3174eb89
Accessed July 2019.

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Other July 2019 events

UK accountancy firms prepare to cull risky clients (August 2019)

This was reported by a well-researched article from the FT. The Big Four and the smaller mid-tier and challenger firms are reviewing their audit books as costs and regulation increase. The risk both reputationally and legally (as KPMG have found out with Carillion where they are being used in the US). As Scott Knight, head of audit at BDO reported saying[38]:

> Some audits are becoming so unattractive that audit firms will not want to take the appointment regardless of the fee.

Sports Direct (see section a few pages later) has already found the all of the Big Four and most of the mid-tier/challenger firms do not want tot audit the growing Mike Ashley's/Sports Direct growing portfolio of retail outlets and new acquisitions. The same FT article argued[39]:

> The UK's largest accountancy firms are preparing to purge risky or unprofitable audit clients after a string of corporate collapses and scandals have increased regulatory scrutiny of the sector.
> Big Four firms EY, KPMG, Deloitte and PwC and mid-tier accountants Grant Thornton and BDO have launched sweeping reviews of clients to weed out those they consider potentially problematic. Auditors warned that companies in volatile sectors, such as retail or outsourcing, and businesses that have faced criticism over their financial controls and governance were the most likely to be dropped.
> PwC started a review of its audit book in June. Hemione Hudson, its head of audit, said it would "ensure we achieve a return that allows continual investment in and focus on quality". The process would lead to an increase in fees and there would "undoubtedly" be some instances where PwC walked away from audit clients, she added.
> "We need to make sure we are only working with organisations that put quality corporate reporting at the top of the agenda," Ms Hudson said.
> EY wrote to its large listed clients, which include Royal Bank of Scotland, Standard Chartered and Vodafone, to warn them it would be increasing audit fees because of "unprecedented market forces". Hywel Ball, head of audit at EY, said the firm expected to part ways with some clients as part of the process.
> KPMG has already shed a number of building society audit contracts because of comparatively low fees and the high cost of compliance.
> Meanwhile, Grant Thornton is expected to quit as auditor of Sports Direct, one of its largest listed clients, next month, following criticism over the retailer's corporate governance and concerns about the non-disclosure of a €674m tax bill.
> Grant Thornton has separately started a "line by line" review of its audit book, which also includes Neil Woodford's quoted Woodford Patient Capital Trust, in recent weeks, according to a senior partner.

[38] Kinder, T., UK accountancy firms prepare to cull risky clients, Financial Times, 7 August 2019.
Available at:
https://www.ft.com/content/cc0579ba-b775-11e9-96bd-8e884d3ea203
Accessed August 2019.
[39] Ibid.

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Some observers have flagged the risk to the stability of UK financial markets if accounting firms begin to quit tricky audits. Andrew Tyrie, chairman of the

Other July 2019 events/Continued
UK accountancy firms prepare to cull risky clients (August 2019)/Continued

Competition and Markets Authority, said in December, as the watchdog published its inquiry into the audit market: “Tens of millions of people depend on robust and high-quality audits. If a company’s books aren’t properly examined, people’s jobs, pensions or savings can be at risk.”

The auditors claimed the reassessment of clients was triggered by higher costs from increased regulation and the potential risk of large fines for poor quality work. The Financial Reporting Council, the industry regulator, last year levied a record £43m of fines on the profession, almost triple the amount of the previous year.

However, critics have accused the largest firms of trying to subvert far-reaching reforms to their businesses.

Continued

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Other July 2019 events/Continued

Higher audit costs are a price worth paying for the Big Four (Aug 2019)

This is an interesting argument for higher audit fees. With increasing regulation and a wider coverage of the audit, this seems inevitable. The split of the audit division from the consultancy division indicates that consultancy can no longer subsidise the lower margin audit work. They bot h have to stand on their own feet. That is probably good for the combined (audit and consultancy) audit firms. All this is argued by[40]:

> European bank failures in the financial crisis sparked a further spate of new rules, and now the Carillion collapse has prompted the UK to consider going further still and forcing firms to split auditing from consulting. Concerns about rising costs are already starting to roll in.
> This month EY sent letters to all of its FTSE 350 clients warning that it would be boosting its audit fees due to "unprecedented market forces", while KPMG is scaling back its exposure to the building society sector partly out of concerns that smaller lenders cannot afford to pay for the additional work that now needs to be done.
> Auditors say there are three main drivers of higher fees.
> First, the EU decided to require companies to tender their audits once a decade and change auditors at least every 20 years. Tendering and getting to know a new client adds costs, and shorter contracts mean investments in new people and technology can't be spread over many years.
> Second, UK regulators and international accounting standards setters are demanding that auditors up their game by providing more sophisticated modelling of risks, as well as more documentation of what they have done to challenge management assumptions.
> Third, if firms do have to split auditing and consulting, they must ensure audit businesses are profitable on their own, rather than being loss-leaders for the larger firm.
> Most of the Big Four firms, and Grant Thornton, which is number five, have announced or carried out big hiring pushes as they seek to bulk up on experienced auditors and modelling experts, as well as invest in artificial intelligence and machine learning
> At EY, that has led to the letters warning of higher fees. Head of audit Hywel Ball explains that the increases "reflect the significant investments we have already made in new technology, regulatory compliance and talent, plus recognising the tendering and switching costs. This is about delivering sustainable, high-quality audits."
> KPMG isn't sending out formal letters, but it is also warning clients about the cost impact of tougher standards and rethinking its fees. The firm, which used to audit half of all UK building societies, has dropped about a dozen clients in the sector. Part of this is due to mandatory rotation, but there is also a financial motive. "We are making sure that we are getting paid appropriately when more work is done," says Michelle Hinchcliffe, who heads audit at KPMG.

[40] Masters, B., Higher audit costs are a price worth paying for the Big Four, Financial Times, 30 July 2019. Available at:
https://www.ft.com/content/6862b468-b1da-11e9-8cb2-799a3a8cf37b
Accessed August 2019.

Online companion volume

Other July 2019 events/Continued

Investors are core to bridging the audit gap (August 2019)

Economia reported the ICAEW beliefs in an influential article influencing Sir Brydon's views on his forthcoming review of auditing[41]. Basically the ICAEW argues that shareholder engagement through better communications and user-driven assurance is the key to finally closing the expectation gap.

> In its response to Sir Donald Brydon's call for views on the future of audit, ICAEW sets out its "innovative and transformative" vision of a "radical new three pillar model", geared to the needs of the primary user – the shareholder – and covering a range of assurance outputs delivered on demand by multiple providers, not just auditors.
> It goes on to say that the new model will require significant effort to develop and implement but it believes it could be an effective way of meeting the needs of all users – and "finally and fully closing the expectation gap".
>
> 1) The first pillar would be an improved version of the statutory audit: this would aim to avoid "disorderly" failure, bring fresh thinking on fraud and improve audit reporting. In this context, ICAEW says that the core product of statutory audit remains essential but there are other things that can be done to make it more fit for purpose.
>
> Suggestions include auditing internal controls over financial reporting, making the CEO and CFO directly responsible to the regulator for the accuracy and fairness of the financial statements, more robust and focused risk reporting and assurance, and an improved capital maintenance regime.
>
> 2) The second pillar would comprise a range of assurance engagements, as happens now, such as skilled person reviews for the City regulators.
>
> 3) As for the third pillar, ICAEW wants to see "a significant empowerment of shareholders through new voting rights, enabling them to require the commissioning of assurance on a flexible and discretionary basis".

[41] Irvine, J., Investors are core to bridging the audit gap, *Economia*, 14 June 2019.
Available at
https://economia.icaew.com/news/june-2019/investors-are-core-to-bridging-the-audit-gap
Accessed July 2019

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Other July 2019 events/Continued

Restoring Trust in audit (August 2019)

The President of the ICAEW has called for a number of revaluations including[42]:

> In making changes, though, we must not lose sight of proportionality. Let us not forget that as well as those PIE audits, there are several thousand more being successfully carried out for small and medium-sized businesses. Regulation must always be risk-based and closely aligned to the nature of a business. So a small business that chooses to have an audit should not have to face the same hurdles as a bank .There is recognition now internationally that auditing standards are not fit for purpose for less complex entities and I welcome the International Auditing and Assurance Standards Board's discussion paper on the matter. They are asking for input from a wide range of people .ICAEW will certainly be responding and I would urge all auditors of SMEs and not-for-profit entities to do the same

The question of not treating all companies alike and varying the degree of audit and assurance is, we believe, important.

Continued

[42] Wilkinson, F., 2019, From the top/Restoring Trust in audit, *Economia*, July/August 2019, 17 July 2019. Available at:
https://economia.icaew.com/opinion/july-2019/restoring-trust-in-audit-fiona-wilkinson
Accessed July 2019.

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Other July 2019 events/Continued

FRC moves to set up more independence of auditors (July 2019)

The FT reported:

> The UK's audit watchdog has proposed more stringent ethical rules requiring firms to be independent from their clients following a series of high-profile accounting controversies at UK companies, including retail chain BHS and outsourcer Carillion.
>
> The Financial Reporting Council on Monday launched a consultation on "important changes" to rules designed to tackle conflicts of interest among auditors and limit the non-audit services firms can provide to clients.
>
> The rules, if passed, could result in fines for audit companies that breach them and come after calls to break up the "Big Four" accounting firms amid escalating criticism over the quality of their audits.
>
> The FRC said it would introduce a public interest test requiring a firm to consider whether stakeholders such as consumers would view a proposed action as likely to affect its independence, instead of considering only what another auditor might think[43].

The official FRC site provides this under the guise of a consultation paper on enhanced Ethical and Auditing Standards[44]. Our view is that this is very welcome but it does not go far enough.

[43] Ibid.

[44] FRC, FRC consults on enhanced Ethical and Auditing Standards, 15 July 2019, Available at: https://www.frc.org.uk/news/july-2019/frc-consults-on-enhanced-ethical-and-auditing-stan Accessed July 2019

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Other July 2019 events/Continued

Multi-firm (not joint audits) audits can break the Big Four's oligopoly (July 2019)

Joseph Smith, a partner in an accounting firm relates experiences from the US[45]. He argues not for joint audits but for something rather different. He comes from this position:

> The predominance of PwC, KPMG, EY and Deloitte has stunted the development of rivals, to the point that the UK has proposed forcing its biggest businesses to hire two auditors, one from outside the Big Four. Independent auditors are crucial to the operation of capital markets and to public trust in companies generally, so stifling competition and the benefits that come with it is a serious problem.

He was to monitor five court settlements between the US and 49 state governments on the one hand, and the five largest home mortgage servicers (Bank of America, JPMorgan Chase, Wells Fargo, Citi and GMAC) on the other. He was charged with validating that the banks were granting relief to distressed borrowers and complying with conduct rules for handling distressed loans. He was authorised to hire professional firms to perform the required validation work. But the court judgments also prohibited conflicts of interest between these professionals and the banks. So he had to find firms that had the capacity to do the work but that did not have prohibited conflicts, which ruled out the entire Big Four[46].

This is what he did[47]:

> After reviewing a lot of proposals, I selected six smaller firms to help me: one to oversee the project and five others to focus on individual banks. I then set up a not-for-profit corporation to co-ordinate our work and organise common training and regular interaction.
>
> For three years, we supervised mortgage servicing operations accounting for more than half of the US market. Our work together wasn't always smooth. That was the good news. We benefited from a diversity of outlooks, approaches and independent opinions. We worked through our differences and were better for having done so.

The author thinks this arrangement could compete with the Big Four on the audits of global corporations. The evidence of duplication is there – appointing one firm to overview. And there has to be an additional not-for-profit company to coordinated all the work. This is indeed a high costs solution. One that would only work where there is a court appointewd overall head and overall control. Our view is that this would only work in special monitoring situations but is totally impractical for everyday audits. Nevertheless it adds to the debate.

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[45] Smith, J., Multi-firm (not joint audits) audits can break the Big Four's oligopoly, *Financial Times*, 23 July 2019.
Available at:
https://www.ft.com/content/bc5afbc4-a3fd-11e9-a282-2df48f366f7d
Accessed July 2019.

[46] Ibid

[47] Ibid

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Other July 2019 events/Continued

New Heads of FRC who is dismissive about joint audits (July 2019)

Sir Jonathan Thompson, the head of the HMRC has been chosen as the CEO of the FRC to replace the Stephen Haddrill, the outgoing chief executive of the accounting watchdog[48].

Simon Dingemans, former chief financial officer of Glaxosmithkline and the government's preferred candidate to lead the Financial Reporting Council, was asked how he would oversee reform of the audit market during a hearing with the business, energy and industrial strategy committee[49]. Interestingly he is against join audits. The same article reported[50]:

> Simon Dingemans, former chief financial officer of Glaxosmithkline and the government's preferred candidate to lead the Financial Reporting Council, was asked how he would oversee reform of the audit market during a hearing with the business, energy and industrial strategy committee.
> He said that he was "not convinced personally at this stage whether joint audit for instance is the answer".

That said he was equally forthright about going for radical change[51]:

> He said that he would bring radical change with a more empowered board, a simpler committee structure and a "proactive and challenging" approach to the reviews of audit quality and corporate reporting, with "a lot more transparency".
> He pledged to shake up the leadership of the regulator to create a team with a very different range of skills, capabilities and backgrounds. The regulator is appointing a new chief executive to replace Stephen Haddrill, who has been in the post for nearly ten years.
> Mr Dingemans said that he would create a regulator with "powers and teeth that it's prepared to use" that serves "the end users of accounts as opposed to the preparers of accounts".
> He said that he was ready for the personal scrutiny that comes with a public sector role. "Being the CFO of a company like Glaxosmithkline is not short of scrutiny and press interest, and certainly being a banker at Goldman Sachs isn't short of press interest from time to time. But I recognise this is a very different league."

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[48] Thomas, D., Strauss, D., and Beioley, K., HMRC's Thompson chosen to overhaul accounting watchdog, *Financial Times,* 18 July 2019.
Available at:
https://www.ft.com/content/102efec6-a980-11e9-b6ee-3cdf3174eb89
Accessed July 2019

[49] Clarence-Smith, L., Favourite to lead Financial Reporting Council questions joint audits, *The Times,* 18 July 2019.
Available at:
https://www.thetimes.co.uk/article/favourite-to-lead-watchdog-questions-joint-audits-025nkb9tw?region=global
Accessed July 2019

[50] Ibid

[51] Ibid

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Other July 2019 events/Continued

Audit quality slips again but is this fault of fair value rules? (July 2019)

Kate Burgess[52] points out that:

> Just three-quarters of FTSE 350 audits the FRC inspected last year were either good or needed only trivial improvements. That means a full 25 per cent were smothered in red ink.
> Hardly a stellar outcome in the year in which auditors were supposed to hit the sunlit uplands, achieving the watchdog's 90 per cent target for good quality audits. But no matter; onward and upward. Next year, the FRC is expanding the target from the FTSE 350 to all audits. And for 2020-21, it is looking for a 100 per cent hit rate. Good luck with that.
> The watchdog thinks one reason for the stubborn shortfall is "scepticism" — or rather its absence. Auditors just aren't challenging management enough. And surveying a scene in which the accounts of cake chain Patisserie Valerie were wildly overstated, it's a plausible theory.

However she blames the standard setting rules rather than the auditors. Her view is that the auditing rules against which the FRC judges auditors make it harder for bean-counters to take a prudent view.

She claims:

> Fair value" accounting may have been designed to give investors more useful information about a group's valuation. But in practice it has created a highly prescriptive system where accounting standards allow asset values to be marked up in value, and future profits anticipated. This not only creates powerful incentives for bonus-hungry bosses to push for an aggressive view; it is also very rule-bound — and the enemy of the prudent approach.Take Capita, the UK outsourcing company. It ended 2016 with net assets of almost £500m, and £566m of cash. Yet a change in the IFRS accounting standard the following day lopped £1.2bn off net assets and meant all of its cash belonged to clients. Capita survived the shock — but at the cost of a £700m rescue rights issue. The stock lost 55 per cent of its value in two days.Under company law, accounts must reflect a "true and fair" view of a company's financial position. But how can that have been true for Capita both at 11.59pm on December 31 2016 and at one minute past midnight on 1 January 2017? And how do we know the latest standard for valuing long-term outsourcing contracts is genuinely prudent, rather than just less imprudent than the last one? Given the reliance on rules rather than principles, we can't. Auditing would work better if the incentives to anticipate profits were removed and more space given to auditors to fulfil their legal duty to exercise judgment. Rubbish auditors may not be the only problem. The FRC should worry about rubbish accounting standards too.

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[52] Burgess, K., 'Fair value' rule does little to boost audit standards, *Financial Time*s, 10 July 2019.
Available at:
https://www.ft.com/content/6352dfc0-a258-11e9-974c-ad1c6ab5efd1
Accessed July 2019

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Other July 2019 events/Continued

Big Four and GT fail to meet audit quality targets (July 2019)

Press reports, including that by the Independent reported continuing failures among the Big Four audit firms and the fifth largest, GT where:[53]

> Just half of a sample of audits carried out by Patisserie Valerie's auditor Grant Thornton in 2017 were assessed as "good" by the Financial Reporting Council, the latest figures show. The UK's fifth-largest accountancy firm is already under the microscope for its role in the chain's collapse.

These reports make it clear that this is not an isolated example:

> All of the UK's top auditors have failed to hit quality targets for checking companies' books, a damning report has revealed.
> None of the so-called Big Four – EY, KPMG, Deloitte and PwC – managed to surpass the 90 per cent target of its audits being assessed as good quality, the accountancy watchdog said.
> The results come after a string of high-profile cases in which auditors missed potential financial problems or fraud – including signs of trouble at Carillion, BHS and Patisserie Valerie.[54]

Continued

[53] Chapman, B., PwC, KPMG, Deloitte and EY all fail to meet audit quality targets after string of high-profile failures, *Independent,* 10 July 2019.
Available at:
https://www.independent.co.uk/news/business/news/pwc-kpmg-deloitte-and-ey-audit-quality-failure-frc-report-a8998321.html
Accessed July 2019

[54] Ibid.

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Other July 2019 events/Continued

Latest FRC audit inspections (July 2019)

The latest FRC audit inspections show that[55]:

> Audit is vital to investor confidence in UK companies. Poor quality audit work remains unacceptably common.
> The latest audit inspections for 2018/19, which relate principally to audits of companies' December 2017 year-ends, found 75% of FTSE 350 audits reviewed were good or required no more than limited improvements, compared to 73% in 2017/18. No firms achieved the FRC's audit quality target for 90% of FTSE 350 audits to meet this standard. Looking across all audit reviews completed at the largest seven firms, the outcome was 75% compared to 74% in 2017/18. In the reports published today, each firm has committed to specific actions to enhance audit quality including, for the worst performers, detailed audit quality improvement plans. The FRC will assess the success of these initiatives and secure further action if necessary.
>
> The FRC found cases in all seven firms where auditors had failed to challenge management sufficiently on judgemental issues. This has been a recurring finding over a number of years and it can have many contributory factors. These include the mind-set of audit teams, especially an absence of professional scepticism in evaluating evidence presented by company management, tight reporting deadlines and the complexity of the judgements involved. Familiarity is also a factor arising from long-standing audit relationships, particularly if the company comes to be considered as "the client" for the auditor, rather than the shareholder or investor. The audit firms need to work harder to solve this problem. The FRC is undertaking detailed work to assess how the audit firms are responding to this.

The individual and sometime very damning reports are made for each of the audit companies investigated include the Big Foyr, GT and BDO, Moore Stephens, Baker Tilly, Crow, Clark Whitehill, Mazars, and PKF[56].

The audits investigated include some of the largest as well as some of the budding unicorns and problem companies. Over 150 audits were named by the FRC as part of their investigation[57].

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[55] FRC, Latest FRC Audit Inspections, FRC, 10 July 2019.
Available at
https://www.frc.org.uk/news/july-2019/latest-frc-audit-inspections
Accessed July 2019

[56] Available at:
https://www.frc.org.uk/auditors/audit-quality-review/audit-firm-specific-reports
Accessed July 2019.
[57] Available at:
https://www.frc.org.uk/auditors/audit-quality-review/aqr-audit-reviews/aqr-2018-19-reviews
Accessed July 2019.

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Other July 2019 events/Continued

Latest FRC audit inspections (July 2019) [Continued]

The FT cited earlier slammed the Big Four but it is not just the FT. The Times was equally damning in its reporting[58] and [59] with headlines such as: Big Four firm censured as audit score Worsens: PWC ordered to take swift action by industry watchdog.

Continued

[58] Clarence-Smith, L., Biggest auditors fail their annual exams, *The Times,* 10 July 2019. Available at:
https://www.thetimes.co.uk/article/biggest-auditors-fail-their-annual-exams-3g23jkqw9
Accessed July 2019

[59] Clarence-Smith, L., Big Four firm censured as audit score, *The Times,* 10 July 2019. Available at:
https://www.thetimes.co.uk/article/big-four-firm-censured-as-audit-score-worsens-mphtmvs5f
Accessed July 2019

Other July 2019 events/Continued

GT tries to move on from calamitous year (July 2019)

The FT reported:[60]

> In a nondescript meeting room in the firm's City of London headquarters, Mr Dunckley conceded it had been a testing period. "[There is] a huge amount of scrutiny for our industry at the moment, and we are probably feeling it at least as much as everyone else, if not more," he said.
>
> Grant Thornton has been hit by a series of disasters since last August, undermining confidence in its audit work. It has been a sharp fall from grace for a group that just 12 months ago was widely regarded as the best placed "challenger" capable of breaking the stranglehold of the Big Four accountancy firms — KPMG, EY, PwC and Deloitte — over Britain's audit market

Cryptocurrency can no longer hide anonymity

According to recent press reports the whole idea and importance of anonymity for block chains and cryptocurrencies might have been blown wide open[61]. PwC has updated its Halo auditing suite to establish crypto asset ownership and gather information about transactions and balances from blockchains. That seems to indicate the big advantage for some users of cryptocurrencies of being anonymous now disappears. We are not sure how or if it can be achieved. But this is what is being reported. Block-chains just becomes another database system and cryptocurrencies, including Bitcoins, Ethers, Ripples and Banks' cryptos, such as J P Morgan's Coin and any offerings from the FAANG giants, will just become another currency.

Continued

[60] Marriage, M., Grant Thornton CEO keen to move on from calamitous year, *Financial Times*, 21 June 2019. Available at:
https://www.ft.com/content/5fca5aba-9117-11e9-aea1-2b1d33ac3271
Accessed July 2019

[61] *O' Neal, S., Will PwC's New Software Solve the Cryptocurrency Auditing Problem?, CoinTelegraph*, 22 June 2019.
Available at:
https://cointelegraph.com/news/will-pwcs-new-software-solve-the-cryptocurrency-auditing-problem
Accessed July 2019

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Other July 2019 events/Continued

Areas for audit to evolve according to PwC paper (July 2019)

PwC collected insights and opinions from individuals and organisations who have stakes in the effectiveness of audit, including academics, investors, audit committee chairs, CFOs and politician as reported by Accountancy Age[62]. Essentially PwC in a paper entitled *The Future of Audit: Perspectives on how the audit could evolve*, found that Just under a third of investors think that audit is effective at meeting the needs of wider stakeholders, such as employees, customers and suppliers, according to a report by PwC**.** It spells out a raft of changes the firm intends to make to regain public trust and meet expectations.

Key findings are[63]:

> By speaking to various audit stakeholders, there were a number of key findings in the report.
> Just 32% of the investors surveyed believed that audit is effective at meeting the needs of wider stakeholders, such as employees, customers and suppliers, and 41% of investors feel audit meets their needs.
> This suggests a lack of confidence in audits when it comes to investors and will be a key concern to businesses reading this report looking for investment.
> The majority of investors and businesses (72% and 78% respectively) are in favour of more information about a company's future prospects as well as their future risks and feel this should be a central focus of a statuary audit.
> There was also a broad backing to strengthen the quality of reporting and ensuring a company's internal controls are also in the scope of the audit.

There are a number of ways in which audit can evolve:

1. Strengthen the clarity and relevance of corporate reporting
2. Enhance the reporting and auditing of a company's internal controls
3. Develop better engagement between the audit profession, company management, shareholders and other stakeholders
4. Create a single, coherent piece of company reporting that provides more insight into the future prospects of the company—including the scenarios in which the business model could fail
5. Provide more insight about the material uncertainties facing a company
6. Consider the need to provide assurance over other forms of risk
7. Reporting and assurance need to expand to cover critical performance measures
8. Provide additional assurance over the companies that need it, without expanding the statutory audit

[62] Jewers, C., Areas for audit to evolve according to PwC paper, Accountancy Age, 22 July 2019. Available at:
https://www.accountancyage.com/2019/07/22/areas-for-audit-to-evolve-according-to-pwc-paper/
Accessed July 2019
[63] Ibid.

Other July 2019 events/Continued

Areas for audit to evolve according to PwC paper (July 2019)/Continued

9. Continue to develop and roll out new technologies to improve the effectiveness of audits
10. Continue to invest in the training, technology and people required to conduct consistently high-quality audit
11. Help stakeholders better understand the risks of fraud
12. Strengthen the culture of challenge