Disruption in the Audit Market: The Future of the Big Four
By Krish Bhaskar and John Flower with Rod Sellers
Online companions volume
Post Publication Comments: Current January-June 2019 Audit Market comments & updates

Online companion volume

Current January-June 2019 Audit Market comments and updates
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Cases

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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/

Online companion volume

Ireland also had a Big Four audit failure (June 2019)

In case the UK had not enough woes over audit quality and accounting issues concerning company failures, Ireland add to this concern by its financial watchdog has raised serious concerns about two audits undertaken by one of the country's largest accountancy firms last year. The Sunday Times reported[1]:

> The Irish Auditing and Accounting Supervisory Authority (IAASA) said that it was keeping the unidentified firm under tighter supervision. Audit quality deteriorated across the board in 2018, according to the state watchdog.
> Its inspections cover nine firms that audit 1,000 so-called public interest entities, broadly defined as banks, insurance companies and businesses listed on the stock market.
> About 84% of these entities are audited by the Big Four: Deloitte, EY, KPMG and PwC.
> "Two audits from the same firm were referred by the audit quality team for investigation," said IAASA chief executive Kevin Prendergast. "This reflects serious concerns about these audits, and they are the first such referrals under the authority's direct inspection regime."
> The IAASA said the shortcomings did not suggest that the accounts being audited had been misstated.
> Firms whose work is not up to scratch face being named in future under plans by the IAASA to offer public grades on the quality of work undertaken by the auditors of public interest entities.

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[2]. 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.

[1] Brady, N., Audit watchdog issues alert on accountants, *The Sunday Times*, 23 June 2019.
Available at:
https://www.thetimes.co.uk/article/audit-watchdog-issues-alert-on-accountants-52fn26hdt?region=global
Accessed June 2019

[2] *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

Online companion volume

Big Four dominate the FTSE 250 (June 2019)

Accountancy Daily have conducted their audit statistics for the 101 to 250 FTSE listed companies by market valuation:[3]

> The total audit fee bill for the FTSE 250 rose by 6% (2018: £192m), and when non-audit fees are included, the overall total paid by audit clients to their auditors was £274m, despite an overall drop in non-audit service fees.
>
> The FTSE 250 audit market, like the FTSE 100, is dominated by the Big Four firms – Deloitte, EY, KPMG and PwC, with less than 5% of listed audits – 12 companies – at this level being audited by mid-tier firms. Here again only BDO and Grant Thornton have any audits and the business is worth less than £4m. When considered by value, 98% of audit revenue is earned by the Big Four.
>
> More than half of the companies (57%) pay £600,000 or less for their audits, suggesting a market that is well within the reach of the challenger firms, which also include Mazars, the firm recently appointed to audit the international operations of US-listed banking giant Goldman Sachs.
>
> Some 24 FTSE 250 companies switched their auditor ahead of their 2018 year end, with a further 15 due to swap auditor ahead of their 2019 year ends. 148 companies have changed auditor since 2010.

Accountancy Daily, and the former Magazine undertakes these surveys every year. This is the 2019 update and it shows that if anything the Big Four have increased their stranglehold of the smaller FTSE 250 companies.

Continued

[3] Smith, P., FTSE 250 audit fees exceed £200m for first time, *Accountancy Daily*, 3 June 2019.
Available at:
https://www.accountancydaily.co/exclusive-ftse-250-audit-fees-exceed-ps200m-first-time
Accessed June 2019
And
[3] Smith, P., FTSE 250 Auditors Survey 2019, *Accountancy Daily*, 3 June 2019.
Available at:
https://www.accountancydaily.co/ftse-250-auditors-survey-2019
Accessed June 2019

Online companion volume

FT's Lex thinks splitting audit from consultancy is enough (June 2019)

We think that splitting audit and consultancy divisions of the Big Four is not enough. With the benefit of computer modelling the remaining choice improves but still only provides a small degree of freedom for nearly all of the FTSE 100 and with less rigour the FTSE 250. The FT Lex column disagrees after pointing out that too little attention has been paid to their audit divisions[4]. This was in the context of PwC planning additional investment into its audit division:

> Auditors expect the accounts they review to balance. After a number of UK company collapses, however, the Big Four accountancies must prove the worth of their audits to financial watchdogs. PwC was on Thursday fined £4.55m in relation to its audit of Redcentric, an IT services company. A broader issue is whether the Big Four have the right balance between their external audit teams and the rest of their partnerships.
>
> …
>
> While the direction of travel looks right, some will ask whether the move removes conflicts of interest that worry policymakers.
>
> …
>
> If audits once provided the hard foundations of the Big Four — PwC, KPMG, EY and Deloitte — some subsidence appears to have set in. In the case of PwC, audit provides only about a fifth of global revenues. Until last week's announcement, audit had not even been one of the group's key divisions, sitting within assurance, which included risk assessments. In the UK, PwC plans to change that, making audit a completely separate unit. Spending will increase by £30m annually. That is less than 5 per cent of the UK audit team's revenues last year.
>
> To be fair, PwC's partners will all contribute to this investment. Plans to hire more than 500 experienced auditors should eat up a fair bit of this additional spend. That may put more pressure on UK audit's operating margin of 17 per cent. We can surmise this is much lower than for the consulting division.
>
> …
>
> Partners at PwC have made a calculated bet. Separating audit internally will reduce external pressure to split up the business. This more radical solution would have the virtue of simplicity. But in UK politics, as in accounting, compromises must sometimes suffice.

We disagree but it is an arguable viewpoint and one that might rule the day with the Government rowing back on the Kingman and CMA reports and delays being inevitable as Brexit dominates the decision making bandwidth of the current government and Parliament.

[4] Lex, Audits: go figure, 13 June 2019.
Available at:
https://www.ft.com/content/96535616-87a5-11e9-97ea-05ac2431f453
Accessed June 2019

Online companion volume

Government 'kicking audit reforms into the long grass' (June 2019)

Pat Sweet of Accountancy Daily put the view as of mid-June as[5]:

> MPs have accused the government of dragging its feet over reforms to the audit market, with the Business, Energy and Industrial Strategy (BEIS) committee calling for faster action, warning of the risks of becoming bogged down in further consultations with three major reviews already in hand. [Kingman, CMA and Brydon].

Our view is that with the focus on Brexit and the election of the next PM, it is unlikely that any new legislation is going to be agreed upon leave alone be enacted. We think that there will be some hesitation. And then the 'consultations' will lead to an inevitable watering down of the recommendations. Meanwhile the Big Four, somewhat reluctantly in our view, have been forced to re-consider the splitting of their audit and consultancy division – but on their own terms rather than being forced to by new legislation. We feel that this will lead to a less than complete separation that may have been recommended by the CMA report and others (including us). The new ARGA (FRC replacement) will probably go ahead but may be delayed for some time.

One in four audits need improvement, say ICAEW inspectors (June 2019)

Meanwhile the monitoring of the audits has led to the ICAEW reporting that their inspectors reviews showed that one in four audits needed improvements[6]:

> In the latest round of ICAEW audit reviews into audit practice at nearly 600 firms, a quarter of audits fell below expectations, with 16% of audits requiring some improvement, and 10% flagged as needing significant improvement, up from 8% in last year's inspection cycle. The worst audits were described as inadequate by inspectors.
> Only one in four audits (25%) were of a satisfactory standard (24%: 2017), which is the top rating, while 49% (51%: 2017) were deemed of an acceptable standard, the level two rating.

Continued

[5] Sweet, P., Government 'kicking audit reforms into the long grass', *Accountancy Daily*, 11 June 2019. Available at:
https://www.accountancydaily.co/government-kicking-audit-reforms-long-grass
Accessed June 2019
6 White, S., One in four audits need improvement, say ICAEW inspectors, *Accountancy Daily*, 17 June 2019. Available at:
https://www.accountancydaily.co/one-four-audits-need-improvement-say-icaew-inspectors
Accessed June 2019

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KPMG slammed with £40m fine for changing audit results in US (June)

This is the largest fine ever for the US and worldwide[7]:

> The Securities and Exchange Commission has charged KPMG LLP in the US with altering past audit work after receiving stolen information about inspections of the firm that were conducted by the Public Company Accounting Oversight Board (PCAOB).

An alternative view of what went wrong

Emile Woolf in Accountancy Daily blamed regulations for the current problems in the audit market. We do not entirely agree but he has a point[8]:

> Auditors will never be able to fulfil their responsibilities until regulators ensure accounting rules are fit for purpose, while pressure from client companies has led to legacy misstatements and the Big Four audit firms simply set aside contingency for multimillion pound fines, says Emile Woolf FCA.

He blames the switch from the old rules:

> Compliance with the accounting principles referred to would, on its own, have gone a long way towards affirming truth and fairness. Those principles, after all, determine that:
>
> i. revenues and costs have been allocated to the correct accounting period;
> ii. the amounts at which assets and liabilities have been stated assume the company will continue in operational existence for the foreseeable future;
> iii. assets have been included at the lower of cost and net realisable value, while liabilities and expected losses have been prudently determined; and
> iv. only realised profits are available for dividend payments

This has been replaced by an ever evolving and complex set of rules and standards:

> Audit reports now inform readers that the accounts have been prepared ‘in accordance with International Financial Reporting Standards (IFRS)’. Compliance with IFRS has enabled the technocrats in standard-setting bodies to expand the length of the average annual report by 50% over the past 10 years.
>
> These are now, typically, 140 pages long, and living proof of form triumphing over substance. No wonder that stock exchanges around the world are pleading for the decluttering of published accounting reports.
>
> These abstruse concoctions are beyond human comprehension, and probably beyond audit too. Technical departments in audit firms are stuffed with wizards of cryptology rather than clear expression.

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[7] White, S., KPMG slammed with £40m fine for changing audit results in US, *Accountancy Daily*, 3 June 2019.
Available at:
https://www.accountancydaily.co/kpmg-slammed-ps40m-fine-changing-audit-results-us
Accessed June 2019

[8] Woolf, E., Woolf: no improvement in standard of audit work, *Accountancy Daily*, 6 June 2019.
Available at:
https://www.accountancydaily.co/woolf-no-improvement-standard-audit-work
Accessed June 2019

Online companion volume

PwC to split audit practice and hire 500 experienced staff

The FT reported that PwC has joined KPMG to restructure and enhance its audit division:[9]

> PwC will spend £30m a year to overhaul its audit business and split the practice in two in response to rising criticism of the accounting industry from politicians and regulators. The Big Four accounting firm on Wednesday announced a drive to strengthen audits, including hiring an additional 500 experienced audit professionals.
>
> …
>
> Hemione Hudson, head of audit at PwC, said: "There has been a lot of debate and scrutiny of our profession for many months, so we have spent many months thinking about what is the right response.

This initiative comes after the CMA report and a series of heated criticisms about The Big Four. Reports claim that PwC plans to split in two its audit practice, which currently houses 5,500 auditors. Again it is reported that one business would focus on traditional "external" audits. The second separated business would carry out "internal" audits for management, alongside cyber security and technology risk reviews. PwC will also double the amount of time its experienced auditors spend in face-to-face training programmes annually, and increase by two-thirds the number of specialists in its audit quality control team.

Now just two of the Big Four to go. But we believe this is not enough to solve the insufficient numbers of auditors issues.

Continued

[9] Marriage, M., PwC to split audit practice and hire 500 experienced staff, *Financial Times*, 5 June 2019, Available at:
https://www.ft.com/content/47f89a82-86e0-11e9-97ea-05ac2431f453
Accessed May 2019.

Online companion volume

Goldman moves beyond Big Four by selecting Mazars as auditor

In the second move against the Big Four (see Carmakers' talks with smaller auditors threaten grip of Big Four on page 6), Goldman Sachs has selected Mazars (one of the smaller mid-tier challenger firms) to audit its European operation. As we discussed in the book, this illustrates to the lack of choice and the insufficient numbers of auditors. This is the first, possibly of many, where US bank have not chosen (gone beyond) a "Big Four" to audits its accounts and reports[10]:

> The decision is a coup for Mazars, the UK's eighth-largest auditor by revenues, which has struggled to break into Britain's prestigious FTSE 350 audit market.
>
> Goldman was forced to look beyond PwC — which has audited the bank for almost a century — after becoming ensnared by tough new European audit rules that came into force in 2016. The rules — which aimed to break the stranglehold of the Big Four over the listed audit market and to improve audit quality — also apply to US and Asian companies that are considered "public interest entities" in Europe.
>
> "It is a step forward," said Erik Gordon, professor at the University of Michigan's Ross School of Business. "Mazars has the opportunity to dispel the myth that only the Big Four are capable of auditing the largest, most complex companies."
>
> Mazars will become the European auditor for Goldman Sachs International, which encompasses the bank's London and Frankfurt businesses, from 2021. Goldman will retain PwC as its group auditor.
>
> Goldman's move comes after concern over the dominance of PwC, EY, KPMG and Deloitte prompted Britain's competition regulator to call last month for legislation to force the firms to split their operations by separating their audit businesses from their consultancy arms.
>
> Goldman paid PwC $63.1m in audit fees in 2018, according to a company filing. Mazars is expected to earn up to $5m from the European audit contract. Goldman was unwilling to consider another Big Four firm because they all provide consulting services to the bank.
>
> Grant Thornton — until recently the UK's fifth-largest accounting firm — was last year considered the frontrunner to take on Goldman's European audit but pulled out of the race following a series of controversies involving its leadership and audit work.
>
> That narrowed the competition down to Mazars and BDO, which leapfrogged Grant Thornton to become the UK's fifth-largest accounting firm last year.

Continued

[10] Marriage, M., and Morris, S., Goldman moves beyond Big Four by selecting Mazars as auditor, *Financial Times*, 20 May 2019.
Available at:
https://www.ft.com/content/e8f94c50-7af7-11e9-81d2-f785092ab560
Accessed May 2019.

Online companion volume

KPMG loses veteran female partners over male colleague's conduct

KPMG in trouble again, this time because of bullying (denied by the firm)[11]:

> Two of KPMG's high-flying female partners have quit their jobs in response to the way the Big Four accounting firm has dealt with concerns about alleged bullying by a senior male partner in the UK.

Though the said male senior partner at the centre of a bullying dispute has left his role and taken a leave of absence from KPMG after fresh allegations about his conduct surfaced[12]. You might have thought that was the end of the affair, but no.

As reported in the FT the case seems as if it will continue for some time[13]:

> KPMG has been reported to Britain's accounting watchdog by a former employee who has urged the regulator to investigate how the Big Four firm responded to complaints about a top partner accused of bullying.
>
> KPMG said last week that the partner in question, Sanjay Thakkar, head of its deal advisory unit, had stepped down from his role and taken a leave of absence after new allegations about his conduct were brought to its senior leadership team.
>
> The firm decided not to take disciplinary action against Mr Thakkar in December after deciding that his behaviour at a meeting in September 2018, which was reported internally via KPMG's formal whistleblowing hotline, had not amounted to bullying.
>
> However, several current and former KPMG employees have since told the Financial Times that complaints about the 50-year-old's behaviour raised as far back as 2017 had been repeatedly ignored by top executives.
>
> One former employee, who quit the firm last year, said: "There will be people there who think it's great. But I know so many people who talk about this permissive culture that allows this bad behaviour to continue. There are so many of these stories where revenue and seniority is king. You are untouchable if you are senior and the shit just flows downhill."

Continued

[11] O' Connor, S., and Marriage, M. Two of KPMG's high-flying female partners have quit their jobs in response to the way the Big Four accounting firm has dealt with concerns about alleged bullying by a senior male partner in the UK, *Financial Times*, 30 May 2019
Available at:
https://www.ft.com/content/37ae6eae-8221-11e9-b592-5fe435b57a3b
Accessed May 2019.

[12] O' Connor, S., and Marriage, M. KPMG partner at centre of bullying claims quits role, *Financial Times*, 4 June 2019.
Available at:
https://www.ft.com/content/8990f14e-86ac-11e9-97ea-05ac2431f453
Accessed June 2019.

[13] Marriage M., KPMG reported to accounting watchdog by ex-employee, *Financial Times*, 10 June 2019.
Available at:
https://www.ft.com/content/49a5c52c-8aa9-11e9-a24d-b42f641eca37
Accessed June 2019.

Online companion volume

CMA news – May 2019

Economia had an opinion piece recognising the importance of the debate and that the audit industry would need to listen and change:[14]

> Serious questions are being asked at government level about the future of audit. It is essential that we engage properly with them, recognising the issues while seeking the highest standards
> The UK is a global leader in professional services of which audit is a key element. I believe it's right that questions should be asked of us at the moment. Perhaps our halo has slipped a bit. But if we want to put that halo back where it belongs – on top of our heads – we've got to engage

It seems likely that nothing will happen at all soon. The Government seems to be rowing back on the Kingman and CMA reports and delays being inevitable as Brexit dominates the decision making bandwidth of the current government and Parliament.

GT may scupper CMA joint audit proposals

GT may not play ball and ruin the CMA's proposals[15]

> CMA's audit revolution hinges on Grant Thornton decision: David Dunckley has told rival big six audit firms that it is yet to decide whether to resume bidding for work, Sky News learns.
>
> Regulators' plans to overhaul Britain's audit sector risk unravelling before they get under way after the sixth-biggest accountant told rivals it might not re-enter the market. Sky News has learnt that Grant Thornton UK's chief executive told fellow bosses at a meeting this week that the firm had not yet decided whether it would resume tendering for FTSE-350 audit clients in the wake of a key report by the Competition and Markets Authority (CMA).
> Senior audit figures and finance chiefs believe the joint audit rule would be "a non-starter" without Grant Thornton's presence in the market.

Continued

[14] Opinion, 2019, Engaging with the future of audit, *ICAEW Economia*, 2 May 2019.
Available at:
https://economia.icaew.com/opinion/may-2019/engaging-with-the-future-of-audit
Accessed May 2019.

[15] Kleinman, M., CMA's audit revolution hinges on Grant Thornton decision, Sky News, 3 May 2019.
Available at:
https://news.sky.com/story/cmas-audit-revolution-hinges-on-grant-thornton-decision-11710071
Accessed May 2019.

Online companion volume

Big Fours reactions to the CMA proposals – early April 2019

We thought that the Big Four were going to challenge the ruling the CMA's conclusions[16]. That seemed to be a logical reaction. However, the more recent reports seem to indicate that just EY will challenge the CMA through legal channels[17]:

> Slaughter and May is advising the audit giant on whether it can challenge recommendations made by the competition watchdog, which are designed to overhaul the disgraced sector following a string of corporate scandals, sources told the Telegraph.
>
> The auditor is the only one of the Big Four that is prepared to do battle with the Competition and Markets Authority (CMA). It is understood that EY's rivals KPMG, Deloitte and PwC are not planning to follow suit and are prepared to adopt the CMA's recommendations.

This is surprising as we though the Big Four would be more resistant to these changes. That said they will no doubt be lobbying the Government hard not to accept the CMA recommendations in full.

Continued

[16] Shah, O., 2019, Big four accountancy firms consider legal challenge to audit shake-up, The Sunday Times, 28 April 2019.
Available at:
https://www.thetimes.co.uk/article/big-four-accountancy-firms-consider-legal-challenge-to-audit-shake-up-xkftvvb0g
Accessed May 2019.
Ball, F., 2019, Big Four considers challenging CMA review, Economia, 29 April 2019.
Available at:
https://economia.icaew.com/news/april-2019/big-four-considers-challenging-cma-review
Accessed May 2019.

[17] Burton, L., 2019, EY hires magic circle law firm in bid to fight back against audit reforms, The Telegraph, 2 May 2019.
Available at:
https://www.telegraph.co.uk/business/2019/05/02/ey-hires-magic-circle-law-firm-bid-fight-back-against-audit/
Accessed May 2019.

Online companion volume

Ireland’s watchdog’s plans to issue public grades criticised for going beyond EU norm

Meanwhile Ireland’s equivalent of the FRC has taken its own action where the Irish Auditing and Accounting Supervisory Authority (IAASA) wants to group the audit firms into three tiers, giving a red warning for significant deficiencies; an amber warning where improvement is required; and a yellow light for minor deficiencies. The regulator also proposes to grade the firms’ audits of PIE where grades would range from one, for a satisfactory audit, to four, meaning that significant improvements are required. The Big Four are not happy[18]:

> Leading accountancy firms are warning of a potential for widespread confusion if the industry watchdog presses ahead with plans for public grades on the quality of their audit work.
> The so-called Big Four — Deloitte, EY, KPMG and PwC — also claim that a proposed “traffic light” warning system, intended to facilitate comparisons of one firm against another for audit quality, goes far beyond what has been attempted in other countries in the EU.
> The Irish Auditing and Accounting Supervisory Authority (IAASA) wants to group the shortcomings of individual audit firms into three tiers, giving a red warning for significant deficiencies; an amber warning where improvement is required; and a yellow light for minor deficiencies.

Continued

[18] Taylor J., 2019, Big Four accountants see red over traffic light grading system, The Sunday Times, 5 May 2019.
Available at:
https://www.thetimes.co.uk/article/big-four-accountants-see-red-over-traffic-light-grading-system-mtcp5ff2f
Accessed May 2019.

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Carmakers’ talks with smaller auditors threaten grip of Big Four

Whatever the rights or wrongs of the CMA final report (and we think it better than the update report but falls short of solving the problem and is likely to add cost and not solve any of the prevailing problems. That said let’s look at what is actually happening on the ground in the UK and Europe because of the rotation directive brought into play in 2016.

As the FT reported:[19]

> Ford and several leading car manufacturers are in talks with smaller accounting firms about auditing their European financing operations, threatening the Big Four’s stranglehold over the automobile sector.
> EU rules that force large companies to switch auditors every 20 years mean that Ford, which has been audited by PwC since 1946, has to find a new auditor for its European financing arm by 2021.
> An audit partner at a challenger firm, speaking privately, said: “This is a big opportunity for firms like ourselves.”
> The rules, which came into force in 2016, were intended to break the cosy ties between large companies and their auditors, and strengthen financial stability in the wake of the financial crisis.

Those rules may have been intended to break those ties but certainly, up to now, they have merely strengthened those ties and cause the insufficient numbers problem leading to a lack of choice. This report may be the first signs that this cosy relationship may be at risk. We shall see. However, in the UK there has been no sign that such a relationship has been disturbed. Quiet the reverse to date.

Continued

[19] Marriage, M., and Campbell, P., Carmakers’ talks with smaller auditors threaten grip of Big Four, *Financial Times*, 24 April 2019.
Available at:
https://www.ft.com/content/8abbb2bc-3138-11e9-ba00-0251022932c8
Accessed April 2019.

Online companion volume

CMA Final report (April 2019)

See our separate analysis of the CMA final report in
http://www.fin-rep.org/wp-content/uploads/book1/CMA-Final_Report_April-2019.pdf

The first news broke with the FT[20] with a headline signalling the end of the dominance of the Big Four. The two remedies the FT emphasised were a) operational split between audit and non-audit and b) joint audits with one of the non-Big Four.

> The UK's competition watchdog called …for rapid legislation to end the dominance of the big four accounting firms and address problems of poor working practices and conflicts of interest in the scandal-hit audit sector.
>
> The Competition and Markets Authority stopped short of demanding a full break-up of Deloitte, EY, KPMG and PwC following strong criticisms of the firms after a series of auditing failures, including of BHS and Carillion. However, it recommended that the firms split their operations by separating their audit businesses from their consultancy arms.
>
> And, in an effort to increase competition in the audit sector, the CMA also said that UK-listed companies should be required to use two audit firms to check their accounts, with one being from outside the big four.
>
> Andrew Tyrie, chair of the CMA, said he had lost patience with repeated reviews of the accounting sector. "Just carrying on doing more reviews is not going to take us very far," he told the Financial Times. "We now have to make a start and that's going to require legislation."
>
> The CMA recommended that the government bolster impending legislation to create a new accounting regulator by giving it powers to oversee the splitting of accounting firms' audit businesses from their consulting arms, and to supervise the joint auditing of listed companies.

Reuters in its report[21] concentrated on on the separation and ring-fencing of the audit businesses of the Big Four.

[20] Giles, C., 2019, Regulator urges laws to end UK dominance of Big Four audit firms, *Financial Times*, 18 April 2019.
Available at:
https://www.ft.com/content/4219750e-612a-11e9-a27a-fdd51850994c
Accessed April 2019.

[21] Jones, Huw, 2019, UK watchdog orders ringfencing of Big Four audit business, *Reuters Business News*, 18 April 2019.
Available at:
https://uk.reuters.com/article/us-britain-accounts-competition/uk-watchdog-orders-ringfencing-of-big-four-audit-business-idUKKCN1RT2PJ
Accessed April 2019.

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CMA update (April 2019)/Continued

> Britain's "Big Four" accounting firms must ringfence auditing from their consultancy work, the country's competition watchdog said on Thursday in a response to book-keeping failures such as at construction company Carillion and retailer BHS.

The actual press release from the CMA[22] reorders the report's recommendations by placing the operational split first whereas it is the fourth in the CMA report:

1) **Operational split**

Auditors should focus exclusively on producing the most challenging and objective audits, rather than being influenced by their much larger consultancy businesses. Given the difficulties with an immediate global structural split, the CMA is – at this stage – recommending an operational split of the Big 4's UK audit work. This will require separate management, accounts and remuneration: a separate CEO and board for the audit arm; separate financial statements for the audit practice; an end to profit-sharing between audit and consultancy, and promotions and bonuses based on the quality of the audits.

2) **More choice to increase resilience: mandatory joint audit**

More choice and competition for the audits of big businesses can and should drive up their quality, but the barriers to entry for 'challenger' audit firms are currently large. The CMA recommends mandatory joint audit, to increase the capacity of challengers, to increase choice in the market and thereby drive up audit quality. Challenger firms should work alongside the Big 4 in these joint audits and should be jointly liable for the results. There should be initial limited exceptions to the requirement, based on criteria set by the regulator, focused on the largest and most complex companies. In addition, any company choosing a sole 'challenger' auditor should be exempt. Audits of exempt companies may be subject to rigorous, real-time peer reviews commissioned by and reporting to the regulator. The joint audit requirement should remain in place until the regulator determines that choice and competition have improved enough to address the vulnerability of the market to the loss of one of the Big 4.

3) **Regulation of UK companies' audit committees**

It is essential that audit committees choose auditors by seeking those likely to provide the most robust and constructive challenge to the accounting practices of their companies. The CMA recommends that the regulator should hold audit committees more vigorously to account. This may include ensuring that committees report their decisions as they hire and supervise auditors, and that the regulator issues public reprimands to companies whose committees fall short of adequate scrutiny of their auditors.

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[22] Competition and Markets Authority, CMA recommends shake-up of UK audit market: The Competition and Markets Authority (CMA) has published its final report with recommendations to address serious competition problems in the UK audit industry, 18 April 2019.
Available at:
https://www.gov.uk/government/news/cma-recommends-shake-up-of-uk-audit-market
Accessed April 2019.

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CMA update (April 2019)/Continued

4) **A 5 year review of progress by the regulator**

The regulator should review the effects of these changes periodically, in the first instance five years from full implementation. This should consider in particular: the merits of moving to independent appointment for auditors; whether to go beyond the operational split already proposed; and how to fine-tune the joint audit remedy to adapt to market developments.

The full report[23] is available together with a summary[24].

Apart from our criticism, there are, not unnaturally many criticisms including from the Big Four (but not KPMG). However, there are many other criticisms from industry and the financial sector. Professors Sikka and Shah also demonstrate strong views against the the CMA. Overall we think that the CMA did a much better join, though the joint audit proposal could add cost, confusion and lower quality. Their data sets and interpretation are slightly mistaken. See :
http://www.fin-rep.org/wp-content/uploads/book1/CMA-Final_Report_April-2019.pdf

[23] Competition and Markets Authority, Statutory audit services market study: Final report, 18 April 2019. Available at:
https://assets.publishing.service.gov.uk/media/5cb7855d40f0b649e47f2972/CMA_final_audit_market_report.pdf
Accessed April 2019

[24] Competition and Markets Authority, Statutory audit services market study: Final summary report
Available at:
https://assets.publishing.service.gov.uk/media/5cb74577e5274a7416b64f01/final_summary_report.pdf
Accessed April 2019

Online companion volume

Continued

Breaking-up the Big Four (April 2019)

"Industry voices hostility to 'operational' split plan, as chair of commons committee prefers full break-up" = this is the subtitle of the FT article[25]. This was before the CMA Final report was published.

Just when you thought that The Big Four were moving in what we think is the right direction, reaction sets in. Up to now there has been:

1) Ban on consulting work for the large audit clients – all except Deloitte's have made noises of moving towards this action.
2) KPMG, having had a bad year in 2018 has gone further in terms of motivational aspect of partners and has recently also seemed to have let rumours of a possible plan to have the audit arm breakaway from the rest of the consulting and legal part of the firm. (Law becoming an increasingly expanding part of the Big Four's operations).

That said this seems to have been countered by the FT article which does not quote the Big Four directly but is sure to have depicted accurately their views.

The FT article reported primarily on Rachel Reeves select committee's views and reaction from that:

> In front of a densely packed crowd at the headquarters of the UK's largest accounting body, the Labour MP's blunt criticism of various industry practices drew several collective gasps, as well as sporadic applause.
>
> Her message was clear: the only way to fix the myriad problems that have blighted the sector — including conflicts of interest, weak audit quality and regulatory capture — is to break up the four largest firms.
>
> The UK's reforms are being closely watched internationally amid active debates in countries ranging from the Netherlands to South Africa on how best to address serious audit failings by EY, Deloitte, KPMG and PwC.
>
> Ms Reeves' cross-party committee of MPs published a report last week when they unanimously agreed that forcing the Big Four to spin off their audit arms into legally separate businesses would create a more robust and trustworthy audit industry.
>
> Despite Ms Reeves' ominous message — delivered just weeks before Britain's competition authority is due to deliver its final verdict on how best to reshape the audit market — many industry insiders appeared unperturbed by the latest call for a break-up.
>
> The view among many in the sector is that politicians are pushing for the most extreme option to reform the market only to put pressure on the Competition and Markets Authority not to soften its stance.

Our views are continued on the next two pages. We thought that the voluntary split by the Big Four and BDO, would be the best way forward from the point of view of Big Four as opposed

[25] Madison, M., Breaking-up the Big Four: EY, Deloitte, KPMG and PwC protest at UK reform, Financial Times, 9 April 2019.
Available at:
https://www.ft.com/content/e0cdfc4c-57b6-11e9-a3db-1fe89bedc16e
Accessed April 2019

to being broken up by legislation – which now seems likely. We shall have two wait to see what KPMG's real view is.

KPMG plans a breakaway audit arm (April 2019)

In the this book, Volume 1: Disruption in the Audit Market: The Future of the Big Four, our conclusions was that we thought the Big Four might decide to jump before they were pushed. The CMA report has not been well received, Rachel Reeves and the select committee on business, many of her MP colleagues are all up in arms over the rather tame conclusions of the CMA report – also heavily criticised by us. But as the FT (see below) points out it is better if the Big Four and mid-tier firms set their own agenda rather than being forced to some sort of split. The same article opines (and we have agreed in the book) that an operational split or restructuring would demonstrate to the world that UK the accounting/auditing profession is competitive and transparent; and a global leader. This would certainly spark a trend within the EU (we believe) and ultimately a decade or so later the US. What the West decides will, of course, migrate to the vibrant Asian and Chinese market eventually (Singapore and Hong Kong probably earlier than later).
See:
http://www.fin-rep.org/wp-content/uploads/book1/5-Our-response-to-the-CMA-update-paper.pdf

There has been no official announcement but the Times[26] and the FT[27] (also the Daily Telegraph) all reported that KPMG is planning to create an independent audit firm, regardless of any decision by the CMA or Government.

The subtitle of the FT is very apt: "With UK politicians calling for businesses to be split, firms should try to set the agenda". The FT goes on:

> A succession of UK corporate scandals, including the collapse of Carillion, a government contractor, threaten the profession. Politicians — when not debating Brexit — call for the splitting of auditing functions from consulting businesses. A competition authority report, due soon, is likely to hew to the politicians' demands.
>
> Some have taken pre-emptive action. KPMG, Carillon's auditor and one of the Big Four with large global practices, is reportedly mulling splitting its business. BDO, the UK's fifth-largest accountant, has detailed contingency plans for a similar move.

The FT article reports that the CMA's requirements are:

> An operational split — likely to be the competition authority's minimum requirement — could improve transparency and better align incentives. Formal transfer pricing would block cross subsidies.

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[26] Kinder, T., KPMG plots breakaway audit arm, *The Times*, 8 April 2019.
Available at:
https://www.thetimes.co.uk/article/kpmg-plots-breakaway-audit-arm-nkdqz0wj7
Accessed April 2019

[27] Lex, KPMG/Big Four auditors: trial separations, *Financial Times*, 8 April 2019.
Available at:
https://www.ft.com/content/01424268-59ff-11e9-939a-341f5ada9d40
Accessed April 2019

Online companion volume

KPMG plans a breakaway audit arm/Continued

Of course this is not a done deal. These are plan and this may start, according to the Times article earlier as soon as early 2020:

> KPMG is plotting an overhaul of its British business to create an independent audit firm, regardless of any decision by the competition regulator to force a break-up of the Big Four accountants.
> The plans would mean the business pulling away from Deloitte, EY and PWC, its rivals that have lobbied against enforced structural changes being made to their operations.
> KPMG, whose turnover in the UK was £2.3 billion last year, is trying to save its reputation after the collapse of Carillion, the outsourcing firm that was its audit client, and scandals in South Africa and America.
> It could separate its audit division at the start of its next financial year on October 1. The division received £572 million of fees last year and audited 91 of Britain's 350 largest companies. KPMG's audit practice has 200 partners and about 5,000 staff, who could move to a standalone entity or to a subsidiary of KPMG if the plans go ahead, The Times understands. The plans have not been finalised and no decision has been made, a person close to the firm said. KPMG declined to comment.

Will the other Big Three follow? We think so ultimately, if not forced then political and business pressure. May be event he threat of government action. The Times articles also reported:

> A senior executive at a Big Four rival said that the move would be "game-changing" for accounting in Britain, adding that "it would not be welcomed by the other three firms".

But an independent audit division would need to increase its fees and so The Times reported:

> An auditor close to KPMG said that the firm had increased some of its fees to ensure a sustainable audit practice that could survive as an independent business. They said that KPMG was reviewing the profitability of its audits to prepare for changes to the division.

Continued

Online companion volume

Big Four expanding into law (April 2019)

The Times put the issues distinctly as[28]: "Big Four auditors have eyes on the law".

> The bean counters may be squirming under the spotlight of public and political disapproval of the cartel-like domination of the audit market by Deloitte, EY, PwC and KPMG, but it is predicted that any regulatory crackdown in that field will only hasten their expansion into law. Ominous signs are apparent that the accountants are revving up their tanks to encroach farther on to the lawns of traditional law firms.
>
> On the same day this week that MPs called for the Big Four to break up their British audit businesses, EY was revealed to be in talks to buy a legal outsourcing business from Thomson Reuters. Its acquisition of Pangea3 was confirmed yesterday. That move comes after it purchased Riverview, a so-called new model legal practice that launched seven years ago offering clients fixed-fee deals, last year.
>
> All four of the global behemoth accountancy practices have obtained alternative businesses licences from the Solicitors Regulation Authority, entitling them to provide more or less the same legal services in England and Wales as traditional law firms.

This echoes a move already made in other EU countries and especially France where takeovers and expansion into law has already been established.

Interestingly this makes it even more difficult for the Challenger firms to follow the Big Four – at least in size. Financially although fees in audit are lower than consultancy, the big Four still command a much higher fee than the mid-tier/challenger firms.

Continued

[28] Ames, J., Big Four auditors have eyes on the law, *The Times*, 4 April 2019.
Available at:
https://www.thetimes.co.uk/article/big-four-auditors-have-eyes-on-the-law-vhrxrz6fr
Accessed April 2019

Online companion volume

Professor Bhaskar believed that the Big Four were already resilient

The CMA asked me to comment on this attribution. We suggested modification to:

> Professor Bhaskar believed that the Big Four would be financially resilient under a wide variety of assumptions though an Arthur Andersen type failure can never be ruled out – however unlikely. In addition, UK law is prone to be more partial to auditors than US law. That said Professor Bhaskar believed that the Big Four European or US audit networks would aid any equivalent failure in the UK because of the nature of cross-country subsidiaries and business relationships entangled in today's complex business world. Also any setback in reputation, as seen in 2018, has proven to be short-lived and has not affected the client base to any great extent. In fact quite the reverse with KPMG (external auditor to Carillion).

This clarifies our view. Though others as outlined in the book disagree. Especially in the US where auditors can be more easily sued. See for example[29]. However, we stand by our view defended to the CMA as above. We think essentially it is unlikely that the Big Four could or would be allowed to fail (by the international networks). The expansion into law and consultancy provides a dilution of the exposure to audit risk.

Continued

[29] Brooks, R., 2018, 'The financial scandal no one is talking about: Accountancy used to be boring – and safe. But today it's neither. Have the 'big four' firms become too cosy with the system they're supposed to be keeping in check?', *The Guardian*, 29 May 2018.
Available at:
https://www.theguardian.com/news/2018/may/29/the-financial-scandal-no-one-is-talking-about-big-four-accountancy-firms
Accessed June 2018.
See also:
Brooks, R., '*Bean Counters: The Triumph of the Accountants and How They Broke Capitalism*', Atlantic Books, 2018. Theme runs throughout the book.

Online companion volume

Big Four accounting firms accused of 'anti-competitive' behaviour

The Big Four allegedly have deliberately undercut small rivals on audit work[30]:

> The chair of the House of Commons business select committee has accused the Big Four accounting firms of "anti-competitive" behaviour by routinely under-pricing their audit work.
>
> The chair of the House of Commons business select committee has accused the Big Four accounting firms of "anti-competitive" behaviour by routinely underpricing their audit work.
>
> Rachel Reeves, the Labour MP who oversaw the committee's review of the accounting market published on Tuesday, said the deliberate underpricing of audit work by the Big Four — 7EY, PwC, KPMG and Deloitte — had made it "very difficult for challenger firms to compete".
>
> Speaking at a packed event at the headquarters of Britain's largest accounting body, the ICAEW, Ms Reeves set out the committee's final recommendations for reforming the audit market following a series of high-profile scandals that have undermined confidence in the profession.
>
> Ms Reeves noted that data submitted to her committee by the Big Four showed that 37 per cent of their audits of large listed companies "ended up costing significantly more than originally budgeted". In 73 per cent of these circumstances, a higher fee for the audit was subsequently negotiated.
>
> "Just as a builder might give you a good quote for an extension, but then double it when he discovers complications, so it is with audit," she said. "The Big Four are both cross-subsidising audit and underpricing in their tender bids. This is anti-competitive and it must stop."

Rachel Reeves again! In the Volume 1: *Disruption in the Audit Market: The Future of the Big Four*, we found similar evidence. First year fees were kept low. Second year figures had a double digit growth as audit firms realised the complexity of the audit and/or decided that they had priced the audit too low. Subsequent years also had higher rate of increased fees.

Continued

[30] Marriage, M., 2019, Big Four accounting firms accused of 'anti-competitive' behaviour, *Financial Times*, 2 April 2019.
Available at:
https://www.ft.com/content/3343b274-5559-11e9-91f9-b6515a54c5b1
Accessed April 2019

Online companion volume

Big Four should be broken up to restore faith in audits, say MPs
The Times was more aggressive in its reporting[31]:

> In a report being published today, the Commons business committee, chaired by Rachel Reeves, says that the competition watchdog should order Deloitte, PWC, EY and KPMG to separate their audit and consulting businesses. According to Ms Reeves, 40, the four firms, which audit 97 per cent of Britain's largest listed companies, have "fostered a precarious market which shuts out challengers and delivers audits which investors and the public cannot rely on".
>
> The criticism comes after corporate collapses at Carillion, BHS and Patisserie Valerie that called into question the quality of audits and raised concerns that the financial culture at accountancy firms may encourage their staff to prioritise advising companies, rather than properly auditing their results.
>
> The MPs' report urges the Competition and Markets Authority to issue the harshest measures possible to crack down on conflicts of interest in auditing. In December the authority suggested that it could demand a less severe "operational split" of the Big Four firms that would require them merely to ringfence, but not completely separate, their audit practices.
>
> "The Big Four may not like it, they may seek to undermine the case for reform, but vested interests should not be allowed to get in the way of positive change. We must not wait for the next corporate collapse," Ms Reeves said.
>
> The CMA is expected to issue its final recommendations for overhauling the audit market shortly. It has been reviewing competition and resilience in the auditing market since October.
>
> The Big Four firms made about £2.1 billion from audits last year, which represented 18 per cent of their £11.6 billion combined turnover. PWC has the largest audit practice, which made £673 million last year, or 18 per cent of its total UK revenue, while Deloitte has the smallest, generating £417 million, or 13.5 per cent of revenue.
>
> The firms have rejected a structural break-up of their businesses, claiming that it would lower audit quality. The committee has made several other recommendations, including a cap on the number of FTSE 100 and FTSE 250 companies that any one firm may audit.
>
> KPMG also said that the Financial Reporting Council, the audit watchdog, had commissioned Allen & Overy, the law firm, to conduct an assessment of its audit practice.

Rachel Reeves is at it again. And, like us, she wants to see some break-up of the Bog Four. Our analysis is to increase the number of large audit firms at a stroke and because of this to improve audit quality.

[31] Kinder, T., 2019, Big Four should be broken up to restore faith in audits, say MPs, *The Times*, 2 April 2019. Available at:
https://www.thetimes.co.uk/article/big-four-should-be-broken-up-to-restore-faith-in-audits-say-mps-nr9zv08l2
Accessed April 2019

Online companion volume

Whistleblower accuses PwC of failings over private jet trip (US)

The FT reported[32]:

> A PwC whistleblower has accused the Big Four accounting firm of serious independence failings after it allowed its auditors to fly in a private jet owned by a major audit client, US-listed chipmaker Micron.
> [This was to attend a private party given by the client].
> Mauro Botta, a former PwC auditor who is suing the firm in the US for wrongful dismissal, alleged that a photo of the Micron audit team standing in front of the private jet was singled out for praise during a meeting in California in 2016.
> The incident is one of several alleged audit lapses involving a handful of PwC's Silicon Valley clients that were highlighted in a document sent by Mr Botta to the US Securities and Exchange Commission as part of a whistleblowing complaint against his former employer in 2016.

One might say 'much ado about nothing' except that this is a number of US issues where the auditors seem just a little too close for comfort.

FRC Personnel changes (March 2019)

Mike Suffield (acting executive director of audit and actuarial regulation) has resigned just days after Greg Clark, Secretary of State for Business, Energy and Industrial Strategy, confirmed plans to replace the audit regulator[33] with a new body called ARGA (Audit, Reporting and Governance Authority). He is expected to remain in his current post "for some months yet as the process for recruiting to the executive director of supervision role at the FRC, which is well underway, proceeds"[34].

In both the first two volumes of the series, we wrongly referred to Mike Suffield's boo, or rather the person he reports, to, Stephen Haddrill, as ex-CEO. That is a mistake. Stephen Haddrill, remains the current CEO but will depart by the end of the year.

Continued

[32] Marriage, M., Whistleblower accuses PwC of failings over private jet trip, *Financial Times*, 19 March 2019.
Available at:
https://www.ft.com/content/5def9f62-4e22-11e9-b401-8d9ef1626294
Accessed March 2019

[33] Kleinman, M., FRC audit chief to exit as watchdog prepares for abolition, *Sky News*, 18 March 2019.
Available at:
https://news.sky.com/story/frc-audit-chief-to-exit-as-watchdog-prepares-for-abolition-11669673
Accessed March 2019

[34] Ibid.

Online companion volume

PwC Regains top spot (March)

KPMG was the top firm with the most audit clients. However, PWC has replaced KPMG as the auditor with the most cleats. This is not a ranking by fees, just number of clients. And this is why the newly merged BDO and Moore Stephens in in third place – ranked by number of audit clients – ahead of Deloitte and EY.

PwC has also regained its number one position among the FTSE 100. This is slightly surprising as we had imaged earlier that PwC had concentrated more on consultancy. But obviously not. Of all the Big Four, we had found, in our collection of evidence phase, that PwC had the best tendering tools to in the tender process.

Continued

Online companion volume

Update on the Brydon audit review (Feb)

According to the FT[35], the extent to which auditors should be expected to detect fraud will form a crucial part of a government commissioned review of the audit market that is being led by London Stock Exchange (and Sage Group) chair Sir Donald Brydon. This contrasts with the FT's reports of what GT said:

> Sir Donald highlighted a heated House of Commons committee session last week — where Grant Thornton chief executive David Dunckley raised eyebrows after telling MPs that an audit "is not designed to look for fraud" — as a clear indication that this issue requires clarification.
>
> He said: "The evidence was very interesting because it showed the need for greater clarity...There is no doubt that if there is material fraud, that does fall inside the auditor's scope otherwise they can't say the accounts are fair, reasonable and balanced. There is an issue there.

This is also in sharp contrast to the other statements made by Dunckley (GT CEO):

> Mr Dunckley told MPs at last week's hearing: "We are not doing what the market thinks. We are not looking for fraud and we are not looking at the future and we are not giving a statement that the accounts are correct. We are saying they are reasonable, we are looking at the past, and we are not set up to look for fraud."

However, Scott Knight of BDO disagreed:

> Knight said: "You look for material frauds. If they are sizeable and material then I think you do have to look for them. In a large organisation there will be petty frauds and that is not something an audit is designed to wheedle out. But if they are material to the financial statements and of relevance to the shareholders, then you should be expected to find them."

Continued

[35] Marriage, M., UK audit review will focus on fraud, *Financial Times*, 4 February 2019.
Available at:
https://www.ft.com/content/7814183a-28a9-11e9-a5ab-ff8ef2b976c7
Accessed February 2019

Online companion volume

Kingman on the Carillion (January 2019)

As we know Kingman, responsible for reviewing the performance of the UK's FRC said that the body should be wound up and replaced with new regulator led by a "credible" leadership team. In an article[36] Kingman claimed that:

> "It will take time… because building credibility does take time, but we have seen other regulators in this country come on that journey, so I see no reason why this one cannot."
> Sir John added that the political appetite to deal with the issues highlighted in his report at the FRC was strong.
> He said: "I have had very positive engagement with the Secretary of State in particular. He took a very close interest in the review as it progressed… The sense I have from him is that he wants to make really serious progress in this area; he wants to see a new and more effective regulator."
> Quizzed about the future regulation of the audit profession following the Carillion collapse, Sir John said any new regulator must have the power to "go in and have a look" where there were concerns about the financial health of a company.
> The call for a more proactive regulator effectively signals the end of the era of self-regulation by the audit and accounting profession in the UK.

Update on FRC investigations in relation to Carillion[37] (January 2019))

The bottom line is that this report is going to take some time to complete –even under the FRC's new faster rules. The FRC says it has obtained and is analysing very significant quantities of documents relating to this case. They go on to claim that detailed interviews have been conducted with audit team members and Carillion senior executives and further interviews are planned for 2019.

Continued

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[36] Bouvier, S., Accounting roundup: Kingman on the FRC; Carillion audit report, *Investment Pensions Europe*, 1 February 2019.
Available at:
https://www.ipe.com/pensions/pensions/pensions-accounting/accounting-roundup-kingman-on-the-frc-carillion-audit-report/10029283.article
Accessed February 2019

[37] FRC, Update on FRC investigations in relation to Carillion, 22 January 2019.
Available at:
https://www.frc.org.uk/news/january-2019-%281%29/update-on-frc-investigations-in-relation-to-carill
Accessed February 2019

Online companion volume

KPMG suspends Carillion audit partner and three others (Feb & Aug 2019)

To some extent this reinforces our conclusions in this volume of the series.

As reported in Accountancy Age38 KPMG has suspended Peter Meehan, the audit partner for Carillion, and three other members of staff after discovering issues with documentation provided to the FRC's audit quality review (AQR) of the company in 2017:

> A KPMG spokesperson said: 'Over the past year, we have been performing a thorough review of the firm's audit of Carillion. Our investigation included the audit team's response to the FRC's AQR undertaken during 2017, which looked at aspects of the 2016 audit.
>
> 'Concerns were identified in connection with a small number of documents provided to the FRC's team during the routine AQR. On discovery of this information, we immediately reported our findings to the FRC.
>
> 'It is important to note that this took place after the signing of the audit opinion and we have not identified any evidence or indication that it had any impact on the audit conclusions of Carillion.
>
> 'We are taking this matter extremely seriously and have engaged outside legal counsel to conduct an independent investigation into the circumstances of the AQR and the conduct of the individuals involved.
>
> 'We acted swiftly and decisively and will continue to take all necessary steps to deal with this, including cooperating fully with the FRC.'

This was not the end of the story. In August 2019, at least one more senior resignation followed[39]:

> KPMG has forced out the head of one of its core businesses in Britain after an investigation into his conduct involving messages sent on WhatsApp.
>
> Tim Howarth, head of UK financial services consulting at KPMG, is the third senior partner to be investigated by the firm this year over claims of misconduct.
>
> KPMG convened a disciplinary panel on Friday and then ousted Mr Howarth, whose profile was removed from the firm's website over the weekend. Two people briefed on the matter said it related to messages sent via the WhatsApp service.

Continued

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[38] Sweet, P., KPMG suspends Carillion audit partner, *Accountancy Age*, 21 January 2019.
Available at:
https://www.accountancydaily.co/kpmg-suspends-carillion-audit-partner
Accessed January 2019

[39] Kinder, T., KPMG ousts head of UK consulting unit after conduct probe, Financial Times, 12 August 2019.
Available at:
https://www.ft.com/content/52cd234a-bce8-11e9-b350-db00d509634e
Accessed August 2019.

Online companion volume

The PCAOB (US) Needs to Just Beat the Sh*t Out of KPMG Already (Jan)

This is the title of an article.[40] The US watchdog, the PCAOB, has criticised KPMG (auditor of Carillion) and other issues. The article comments:

> While its Big 4 counterparts have been making strides in audit quality over the years, KPMG has somehow managed to get worse at this auditing thing. And this after they got busted poaching PCAOB talent in order to cheat on PCAOB inspections.
> The wait for KPMG's missing 2016 PCAOB inspection report is over. As proselytized by former PCAOB member Dan Goelzer last September, the delay was directly due to the PCAOB learning about KPMG getting tipped off to which clients were up for inspection, poisoning 11 of the initial audits.

The full 2017 report on KPMG can be found:
https://pcaobus.org/Inspections/Reports/Documents/104-2019-002-KPMG-LLP-2017.pdf

Economia puts this rather more elegantly but it is still worrying for the troubled Big Four KPMG firm[41]:

> The US Public Company Accounting Oversight Board (PCAOB) has revealed that further audit inspections following the KPMG inspection leaking scandal showed that the quality of banking audits carried out by the US firm was shockingly bad.

Accountancy Daily[42] provides the details. Of the 52 audits examined 26 had deficiencies. In 17 audits, KPMG's failure to sufficiently test the design and/or operating effectiveness of controls that included a review element. In 13 audits evidence of failure to identify and test any controls that addressed the risks related to a particular account or assertion, and the same number demonstrated a failure to perform substantive procedures to obtain sufficient evidence as a result of relying too heavily on controls (due to deficiencies in testing controls. For 10 audits, KPMG was found to have failed to sufficiently test significant assumptions or data that the issuer used in developing an estimate. The three most common areas for audit deficiencies were identified as revenue, including allowances (11 audits); loans, including the allowance for loan losses (six audits); and Inventory, including related reserves (five audits).

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[40] Gonzalez, A., 2019, The PCAOB Needs to Just Beat the Sh*t Out of KPMG Already, *Going Concern*, 30 January 2019.
Available at:
https://goingconcern.com/the-pcaob-needs-to-just-beat-the-sht-out-of-kpmg-already/
Accessed January 2019

[41] Irvine, J., 2019, Two more bad audit inspection reports for KPMG US, *Economia*, 29 January 2019.
Available at:
https://economia.icaew.com/news/january-2019/two-more-bad-audit-inspection-reports-for-kpmg-us
Accessed January 2019

[42] Sweet, P., 2019, PCAOB faults half of KPMG US audits inspected, *Accountancy Daily*, 29 January 2019.
Available at:
https://www.accountancydaily.co/pcaob-faults-half-kpmg-us-audits-inspected
Accessed January 2019

Online companion volume

The Rachel Reeves promise (Jan): Ban on audit fees.

As reported by the FT[43], Rachel Reeves, the business committee chair, had invited David Sproul (Deloitte), Steve Varley (EY), Bill Michael (KPMG) and Kevin Ellis (PWC) to give evidence on audit reform. Her references to accounting scandals at Carillion, BT in Italy and Patisserie Valerie suggested there was plenty to give. Her allusion to reform proposals from the CMA, the Kingman review of regulation and the Brydon review of audits showed there were plenty of people to give it to.

> What two of those bosses actually gave, however, was a commitment: to stop providing non-essential consulting services to companies they audit, by 2020. Messrs Varley and Ellis said this would improve public trust in the sector — acknowledging concerns over cosy fee-earning relationships. With Mr Michael's firm making the same pledge in November, and Mr Sproul saying he supported the policy, it sounded like a cartel of the converted.

And the opinion given by Mathew Vincent in the same article was rather critical. Promises were not going to be enough to satisfy the critics and lead to solutions.

Reuters put this rather more neutrally[44]:

> PwC and EY told a panel of British lawmakers they would mirror a change already underway at another Big Four firm, KPMG, in a bid to end a "perception" of conflict between selling audit and consulting work to the same customer. Consulting is better paid than audit work, raising concerns that an accountant won't challenge a company's management properly regarding an audit for fear of losing more lucrative advisory work. KPMG said last November it would phase out advisory work for its British accounting clients as the Big Four faced calls from lawmakers to be broken up after the collapse of construction firm Carillion, which KPMG audited.

Though sadly, Kevin Ellis, chairman and senior partner of PwC UK told parliament's business committee said: 'It would not improve audit quality, however'.

This normally applies to the FTSE 305, but not necessarily to companies listed on AIM or to private companies. What it does do as outlined in the book and simulation modelled, it puts greater strain on 'insufficient numbers' of Big Four audit firms. That is not the only problem, though this is one of the most important criteria. Only Deloitte's has yet to commit to this policy switch.

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[43] Vincent, M., 2019, Big Four accountants aim to become a cartel of the unconflicted: Promises made will not be enough to satisfy critics, *Financial Times*, 30 January 2019
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Ban on consulting for audit clients (February 2019)

Forcing the existing consultancy load on to a Big Four firm who is not an auditor, reduces choice by one degree of freedom. So if there are no conflicts of interest or blacklisted work, then the consultancy proportion of the current auditors workload has to be spread among the other three of the Big Four firms. However, there are always conflicts of interest, or an audit tendering process being undertaken, so in practice the choice may be limited to just two of the b|Ig Four,. Worse, some of the FTSE 100 use more than one of the Big Four for consultancy, so the actual choice is reduced to just one of the Big Four. This is the insufficient umbers problem/

Ban = higher fees (Feb)

Splitting audit and consultancy into separate pockets places one more additional strain on the Big Four. Given our contention that consultancy is much more profitable than audit work there are two impacts of this policy switch of not mixing audit and consultancy work for the FTSE 350.

a) The hiring of quality staff. If the salaries are higher in consultancy then this could mean that the best staff are drawn to consultancy rather than audit.
b) The audit work of the Big Four becomes the poor relation, so the Big Four will want to concentrate on consultancy rather than audit work.

The implication is that fees would either have to increase probably by more than a third and possibly more. Or that there must some equalisation of fees between the two pockets: audit and consultancy.

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A point of view – Rodger Hughes[45] (January 2019)

A good auditor seeks evidence to validate their client's assumptions. It is being assumed that the perceived decline in audit quality is due to a lack of competition and conflicts of interest (January 24). But the evidence conflicts with this. The Herfindahl-Hirschman index of market concentration for FTSE 100 audits, as well as non-audit fees as a share of audit fees, have fallen over the past 20 years. The key driver of audit quality is the ability and attitude of audit partners and managers. There appears to be no evidence of lower-quality recruits or training at the big firms. What might have worsened attitudes then? Here are three contenders.

First, the increased complexity and rigidity of accounting and auditing standards encourages a "tick-box" mentality. This undermines the exercise of professional judgment. Some auditors may have got lost among the trees of compliance and not spotted that the forest is on fire.

Second, the reduced security of tenure from the risk of having to retender (and the fewer questions that changing auditor now triggers) may have made auditors more not less likely to go along with management's views.

Third, when audit partners were responsible for all the services delivered to their client they developed a broader view of the state of the business and its risk profile. They also had more to lose from an audit failure.

Has regular retendering and restriction on providing non-audit services therefore perversely caused a decline in audit quality? There is certainly a strong correlation in timing. What is lacking and urgently needed is an authoritative study of audit failures and the underlying causes. Perhaps we need a good auditor to look at this?

Continued

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Why audit changes may fail? (Jan)

This was an interesting article in Economia[46] that makes the point that:

> the accounting profession must embrace the reality that focusing on financial capital as the foundation for materiality and audit scope is no longer acceptable when over 80% of a shareholder's investment value is no longer on the balance sheet. If the profession is unable to embrace this scope, regulators must expand the role of audit to others who can address non-financial aspects of risk and the business model, as a determinant of both materiality and corporate sustainability.
>
> Using an auditor's statement to shareholders about "…relying on the opinion and representations of management" is a bit of a "cop out" as is pointing to the management discussion and analysis; both are valid and useful but do little to ensure that an audit is adding value? Some potential progress was being made in the revisions to the UK Companies Act but sadly the suggestions that made it in to the final legislation were limited. Maybe there remain too many influential voices in maintaining the status quo?

Business Matters: The future of audit (Feb)

PwC's North West regional chairman Iwan Griffiths says the auditing profession is at a watershed moment and that's why PwC are asking the public to join the debate on the future of audit[47]. In a meeting at Old Trafford with a collection of senior management from audit and businesses, they cantered their discussions on:

- Who should the audit be for?
- What should the audit cover?
- Should the focus continue to be on a binary "true and fair view"?
- Does one size of statutory audit fit all organisations?
- How will technology enhance the future of the audit?
- How does the profession continue to drive

> Conversations explored culture, risk metrics, how an organisation is actually approaching risk, where does it sit - is it just at the top or throughout a business? Does everyone understand risk appetite? Do people in the organisation understand and live by it?
>
> Discussions also centred on the relationship between auditors and senior management. It was felt that the auditor should be close to the board, to important decisions, to the business model and where auditors had a good relationship they were able to challenge in a good way.

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Defence Department and investigations (Feb)

> The Defense Department will soon force accounting firms it hires to disclose investigations they face, a requirement that chips away at federal protections that have long helped keep flawed audits of public companies under wraps[48].

Audit reform update (Feb)

Emeritus Professor Ruth Bender of Corporate Financial Strategy from Cranfield School of Management discussed the next steps following the CMA and Kingman reviews[49]. She agreed with us, more or less on joint audits and the enhancing of the audit committee.

> …one of the chief proposals, joint audits, could be made to work – we have seen that elsewhere – but they will not necessarily build up the capacity of mid-tier firms to undertake the premium audits by themselves, and certainly not in the short run. However, none of the Big Four firms is in favour of joint audits, and as David Sproul of Deloitte said at the committee – there is no evidence that they will necessarily improve quality of audits.
>
> Another interesting proposal is to put more on an onus onto audit committees to ensure the quality of audits. However, although it will provide a useful regulatory backstop, and give more backbone to audit committees, we should remember that the practice of putting more and more governance matters onto a few non-executives must have some practical limit.

Continued

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BDO merger with Moore Stephens (Feb)

City AM first reported this[50]:

> The announcement arrives alongside new audit contract figures for the Alternative Investment Market (Aim) clients, which show the accountancy firm has expanded its junior market dominance.
> The new firm – which will operate under the BDO moniker as part of the company's international network of firms – says it will focus on "mid-sized, entrepreneurially-spirited businesses".

The merger was originally confirmed in December 2018. It gives the firm a combined workforce of 5,000 staff members and 350 partners working in 17 locations across the UK.

But the bottom line is that[51]:

> The firm is expected to deliver revenues of £590m – taking it ahead of competitor Grant Thornton – although it still remains only a quarter the size of the smallest Big Four firm KPMG.
> The merger means the expanded BDO will supplant Grant Thornton – which was hit with an unprecedented £21m fine last week for failures in its audit of Assetco – as the UK's fifth-largest accountancy firm, with combined revenues of around £590m.
> That will place it top of the so-called challenger firms, but still a long way behind KPMG, the smallest of the sector's Big Four, which had UK revenues of around £2.3bn last year.
> Grant Thornton and BDO have divergent approaches to audit clients, with the former having a strong focus on public sector audits and the latter targeting mid-sized firms.

Boosting the challenger firms is still going to take many more mergers, and the new merged BDO strategy is not to bid so much for the FTSE clients but AIM clients. Of course AIM clients may grow into FTSE companies.

Continued

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Company secretaries view post Carillion (Jan)

This survey was reported in Accountancy Age[52]. Essentially more than half of company secretaries surveyed by ICSA, the Government Institute and recruitment specialist said the industry has learned little from the collapse of the construction giant

> A survey has revealed that just 9 per cent of company secretaries surveyed think that the audit process has improved since **the collapse of Carillion**. Over half (51 per cent) feel that it has failed to advance with many believing that the industry has learned little from the collapse. The survey was conducted by ICSA: The Governance Institute and recruitment specialist The Core Partnership.
>
> Some of the opinions voiced about the current state of the audit process were:
>
> - Auditors have become lazier. Instead of sourcing their own documents and reconciling their work they have set up portals to collate documentation in a specific format and push it through an algorithm. This is more efficient from their point of view, but clients are forced to work harder. Some saw this as outsourcing their role to clients
> - The relationship between management and auditors is still too close. Need to find a more appropriate balance between auditors being familiar with the company's business and the ability to remain inscrutably independent
> - Audit is not taken seriously by the Big Four firms. It is a loss leader and seen as a way to access better paying non-audit work
> - The gap between what auditors are required to do and what the public think they do is large and this needs to be addressed.

Continued

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Company secretaries view post Carillion (Jan)/Continued

Splitting consultancy from audit work

The same survey threw some interesting insights:

> When asked the best way for the Big Four accountancy firms to reform, 45 per cent called for audit and advisory businesses to be split within the Big Four. Big Four firms themselves have suggested this as a way forward. However, it is not a straightforward solution.
>
> One respondent to the survey said: "Splitting audit and consultancy firms could materially impact the quality of the pipeline to the audit firms as consultancy firms will look more attractive and can generate fees from a more diversified base. It could also result in a significant increase in audit fees as the firms seek to retain talent.'
> Many said new regulation and monitoring are needed. Responses included the following:
> Audit firms need to raise their standards to ensure audits are conducted properly and the FRC needs to monitor performance better and intervene earlier.
> Tighter registration and regulations. There is a conflict of interest in providing the audit opinion and seeking reappointment as the auditor.
> "While there is much good work already done that should not be overlooked, it will take time to establish a step change in independence, rigorous challenge and culture. Even then, we need to have shared expectations of what audit is for and what it can achieve. Audited accounts can only provide a level of assurance, they do not mean a company cannot fail," said Peter Swabey.

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Advanced Technologies Audit (Feb)

Forbes reported[53] in a survey:

> When looking at which technologies auditors leverage the most, the cloud comes out on top at 91%. Data and analytics is the second-most-cited technology (73%), followed by visualization (62%), AI (56%) and workflow automation (55%). Others include natural language processing and robotic process automation, cited by 45% and 30%, respectively.

The FRC's Financial Reporting Lab has released a report into how artificial intelligence (AI) could be deployed in financial reporting[54].

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