

**Reply to the CMA from the authors of:
Disruption to the Audit Market: The Future of the Big Four. Routledge. 2019.**

6. Responding to the update paper

Summary of interests or organisations: academic research (summary of credentials below)

Version of response: non-confidential

Attribution: Professor Krish Bhaskar

Krish Bhaskar, together with my colleagues Professor John Flower and with contributions from Rod Sellers, are about to publish a book entitled *Disruption to the Audit Market: The Future of the Big Four*, Routledge. 2019. This book is one in four of a series on disruption in financial reporting¹. The first volume entitled as above deals with all the subject matter of the CMA's updated report. Our evidence and views in some cases supports the CMA's views and conclusions, and in other cases sharply disagree. As indeed, Sir John Kingman concludes in his separate letter² - so we are not alone in our critique of the CMA report.

The four volumes of the *Disruption in Financial reporting* series are:

Volume 1: *Disruption in the Audit Market: The Future of the Big Four*

Volume 2: *Financial Failures & Scandals: From Enron to Carillion*

Volume 3: *Disruption in Financial Reporting*

Volume 4: *Disruption in Auditing: Subtitle TBC*

In addition, the websites fin-rep.org and fin-rep.com are companion volumes and contain new material.

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

1. Greater regulatory and other control
This includes two of their remedies:
Remedy 1: Regulatory scrutiny of Audit Committees
Remedy 6: Peer review
Sir John Kingman in his letter³ cautions (like us) against relying too heavily on these remedies.
2. Bolster challenger firms
Build the challenger (for us the mid-tier) firms into rivals to the Big Four.
Remedy 2: Mandatory joint audit
Remedy 2A: Market share cap (the CMA seems against this option)
Remedy 3: Additional measures to support challenger firms.
3. Split of the Big Four
Remedy 5: Full structural or operational split between audit and non-audit services

¹ The book (*Disruption in Financial Reporting and Auditing*) was originally over 500,000 words but has been cut down to 4 volumes each of less than 50,000 words – with a further 3 longer volumes to come. The companion online website has additional material and references online (<http://www.fin-rep.org/>). There is also a blog and other material in www.fin-rep.com. We started writing this book in 2012 and have been researching the subject area since then.

² Kingman Letter, 2018, Operation of the audit market: letter from Sir John Kingman to Rt Hon Greg Clark. *Government*, December 2018.

Available at:

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

³ Ibid.

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The CMA does not go into further possible splits. KPMG has already announced it will only do audit work for its FTSE 100 audit clients. This in essence is a self-imposed partial (and incomplete) operational split.

Our analysis shows that this does not solve the choice issue which we think is essential to solving a number of the issues highlighted by the CMA.

4. Failure of one or more of the Big Four
Remedy 4: Market resilience

Sir John Kingman⁴ concludes:

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

We consider all the above but do not detail all the possibilities we explored in the Audit Market book (volume 1 of the disruption series). To explain who we are, we supply an extract from Chapter 1.

The Authors' and Contributor's Credentials

Professor Krish Bhaskar is the principal author of this book. He has published more than 50 books and many refereed articles. He has also worked in the IT, consulting, investment banking, automotive and forecasting sectors. He has experience of running companies, preparing reports and auditing – though mainly computer auditing as it used to be called.

Krish has been aided and abetted by Professor John Flower whose major role is as an auditor and researcher into multinational financial reporting. John would probably classify himself as left of centre and leaning towards anti-capitalism and environmentalism. He has published scholarly critiques of the profession including Global Financial Reporting, with Dr Gabi Ebberts, Palgrave, 2002 and two more radical books by Routledge: Accounting and Distributive Justice (2010) and The Social Function of Accounts: Reforming accountancy to serve mankind (2017). He has undertaken substantial research on financial reporting and standard setting. He also introduced modern auditing methods for the EU's Common Agricultural Policy and undertook a number of innovative techniques in auditing what were and are massive-scale mega audits.

Finally, Rod Sellers OBE, FCA has spent almost 50 years in senior financial and corporate roles in industry. Rod has given his time, written material, and given his views relentlessly, unstintingly and without complaint. But he does not want to be regarded as an author – just a contributor. He is deemed part of the auditing establishment (as he sat on the advisory board of one of the Big Four accounting/auditing/consulting firms) and was financial director and then chief executive of a FTSE 250 company. For the last 20 years he has been a portfolio

⁴ Ibid.

Available at:

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

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NED/Chairman with a dozen companies – from private family businesses to PIE entities. His role has often included serving on audit committees and working closely with the financial departments. He defends the accounting and auditing profession and, although he realises the impact of disruption, he does not believe that very much has gone wrong or usually requires anything more than evolutionary change. Though in terms of solutions and scenarios to correct problems facing the audit market, he appreciates that something more radical might be appropriate. He also believes that, in most cases, management is basically honest and trustworthy. His motivation to be involved in this series of books is to make sure his viewpoint and that of the profession is taken into account. Rod came to many of the interviews and collected considerable amounts of written evidence (emails etc.).

All three of us have extensive and varied experience in the [accounting and audit] profession as listed in the table below [not provided – too bulky]. All of us have had preparer, auditing and consulting experience. Two of us have an academic background. One has undertaken the largest of scale audits imaginable. Two of us have had extensive publications. All three of us have experience both from the reporting viewpoint and audit experience. One of us has had a lifetime career in industry with preparer experience including audit committees and shareholders. Two of us are broadly pro-Big Four in some shape or form and one of us is against. But we all agree that the current disputes between the FRC, the users of reports, the Government and the Big Four has to lead to a re-evaluated audit experience, not least because of the gap between what the public expects and what the auditors actually currently deliver. This expectations gap is currently widening and unstable, especially after the plethora of failures in 2018.

The Big Four

The three of us are not against the Big Four. We think the UK networks of the Big Four, the ICAEW and the other UK accounting bodies have been pioneering and a major global force. We think that the Big Four, despite current issues, remain important world-wide and a force that brings pride to the UK. However, one can see that the watchdogs, Parliament, the informed public, the City (despite the CMA evidence), at least one of the Big Four (KPMG for the FTSE 100), a string of academics (including John Flower, one of the authors) all think that audit only is a good idea, whatever the evidence for or against. Krish Bhaskar and Rod Sellers are, in principle, against breaking the Big Four up having lived through Arthur Andersen and Andersen Consulting. That said and in reality, that process has already started and probably can't be stopped. So the break-up of the Big Four into audit only is probably inevitable. (If this occurs this leaves an audit only division with relatively low margin work and this may lead to a re-evaluation of whom sets the audit fees). One of the driving forces which we examined for further options was the insufficient numbers of large audit firms. To provide more choice, more competition, and more audit quality (our view), we believe that there would have to be a larger number of internationally recognised auditors of sufficient scale. In some ways, the Big Four are so globally dominant that any increase in audit firm numbers has to have links to those famous Big Four brand names. We think the international network issues are not insurmountable.

Computer modelling

In this reply, we refer to our computer simulation modelling. The results of such modelling are critically dependent on the starting point (which Big Four is working for whom and on what) and the meaning of 'conflict of interest' (which would cause a company to drop consultancy work to accept audit work, or conversely not bid for an audit tender). Our results about the choice for companies for audit or consultancy work from the Big Four (or equivalent) were not

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sensitive to a broad range of assumptions. However, different interpretations could yield differing results.

I prefix my replies with the initials KB (standing for Krish Bhaskar) below. Additional comments are made by Rod Sellers (RS) [who, from his experience of joint audits, is also dubious about the viability of joint or shared audits]. We have tried to include elements of John Flower's (JF) views⁵.

Box 6.1: Consultation questions

A) Issues

1. Do you agree with our analysis in section two of the concerns about audit quality?

KB: We agree that audit quality has dropped but then we think that the baseline set by statute was too low and that the regulatory bodies failed in their duties. We have four axioms on audit quality. These were supported by academic studies and our own collected evidence. These are:

- 1) Axiom 1: Size is linked to higher audit quality. Larger firms are capable of higher quality audits.
- 2) Axiom 2: Higher audit quality is linked to shorter length of audit tenure.
- 3) Axiom 3: Greater competition leads to better audit quality. An increase in the number of firms competing leads to higher audit quality especially in turbulent periods. The CMA provided evidence of the academic literature that provided a different view. We think that there is contradictory evidence and the conclusions of many of these studies were misinterpreted⁶. Despite the CMA conclusions, we stand by our axiom as it pertains to the

⁵ Professor John Flower's more radical views are expressed in John Flower, 2010, *Accounting and Distributive Justice* (Routledge Studies in Accounting), 2010. And in John Flower, 2017, *The Social Function of Accounts: Reforming accountancy to serve mankind* (Routledge Studies in Accounting), 2017.

⁶ We did review other articles on joint audits but felt that the weight of the evidence was not applicable to the UK. However, the CMA report disagreed. So we provide our reasons in brief here. The references are listed below the footnote. Five of the six studies quoted deal with the US and are often concerned with the geographical distribution of audit fees and results and the evaluation of city data. One deals with cross-country data. Many of the studies quoted use restatements as a measure of audit quality. Whilst we believe that other factors, as well, go towards the measurement of audit quality. The geographical distribution in the city level and metropolitan statistical area level is distinctive to the US. The audit market structure in the US is, we believe, very different from the market structure in the UK. The study by Francis et al (2013) showed that concentration within the Big Four appears to be detrimental to audit quality in a country – though this was reversed when their country differences were taken into account. Less developed countries cannot be compared with the UK audit rules and procedures. In another study, Newton et al (2016), their primary concern was internal controls and a task that is blacklisted in the UK for auditors. The Newton et al (2013) study dealt with restatements mainly from smaller non-Big Four audit firms in the US. The data from the Kallapur et al (2010) paper relates back to the Arthur Andersen period. Dunn et al (2013) concentrates on city data. The Boone et al (2012) study seems to support our axiom. One of their major conclusions is that: "oligopolistic dominance of the audit market by the Big 4 fosters complacency among auditors resulting in a more lenient and less skeptical approach to audits and lowers service quality".

Boone, J.P., I.K. Khurana, and K.K. Raman (2012) Audit market Concentration and Auditor Tolerance for Earnings Management, *Contemporary Accounting Research*, 29(4), 1171-1203.

Available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1926875

Dunn, K.A., M.J. Kohlbeck, and B.W. Mayhew (2013) The Impact of Market Structure on Audit Price and Quality.

Available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2258091 (mis-referenced in the CMA paper).

Francis, J.R., P.N. Michas, and S.E. Seavey (2013), Does Audit Market Concentration Harm the Quality of Audited Earnings? Evidence from Audit Markets in 42 Countries, *Contemporary Accounting Research*, 30(1), 325-355.

Available at: <https://onlinelibrary.wiley.com/doi/abs/10.1111/j.1911-3846.2012.01156.x>

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UK, geographical area and the current market structure. This does not mean smaller firms (as of now) provide higher audit quality. But it could mean that if the Big Four audit divisions were split, audit quality might improve.

- 4) Axiom 4: Greater independence leads to higher audit quality.

We used the word axiom, meaning a self-evident truth, rather than the more conventional ‘hypothesis’, to represent our belief that these represent something more than the many (especially US) papers proving via an econometric model that the Big Four are or are not the casual factor in a higher quality audits, and/or lower audit fees. The references made to joint audit studies are a typical example (see footnote 6).

The CMA report also examined the academic literature in regard to whether the provision of non-audit services by audit firms impairs audit quality. This also included an examination even if the services are not provided to a firm’s audit clients.

Our conclusion is that whatever the academic evidence, the FRC’s reports on the BHS audit show that, where permissible, non-audit services can dominate audit and therefore affect audit quality. However, for listed companies falling within the scope of the Audit and Regulation Directive (ARD), this is cannot now take place – at least in a similar manner. CMA quotes one US study⁷ where the conclusion was that “the loss of Big 4 professional focus – not simply conflicts of interests – is a major factor affecting the audit quality”. We are not certain that this conclusion can translate to the current regulatory environment in the UK. However, we believe that conflict of interest are important.

The evidence quoted by the CMA on their own collected data we believe probably carries some bias – only those sufficiently interested may have participated. We did not respond to your earlier invitation as we had thought the first volume would be out in October or November. However, illness and staff shortages have taken their toll.

2. Do you agree with our analysis of the issues that are driving quality concerns, as set out in section three? In particular:

- a. Issues relating to the role of Audit Committees and investors in the process of appointing and monitoring auditors;
- b. Limitations on choice leading to weaker competition;
- c. Barriers to challenger firms for FTSE 350 audits;
- d. Resilience concerns; and
- e. Wider incentive issues raised by the multi-disciplinary nature of the large audit firms.

Kallapur, S., S. Sankaraguruswamy, and Y. Zang (2010) Audit market concentration and audit quality.

Available at SSRN: <https://ssrn.com/abstract=1546356>

Newton, N.J., J. Persellin, D. Wang, and M.S. Wilkins (2016) Internal Control Opinion Shopping and Audit Market Competition, *The Accounting Review*, 91(2), 603-623.

Available at: https://digitalcommons.trinity.edu/cgi/viewcontent.cgi?article=1039&context=busadmin_faculty

Newton, N.J., D. Wang, and M.S. Wilkins (2013) Does a Lack of Choice Lead to Lower Quality? Evidence from Auditor Competition and Client Restatements, *Auditing: A Journal of Practice & Theory*, 32(3), 31-67.

Available at: <https://pdfs.semanticscholar.org/6a2c/b8338898ad1ca1449aa68a88e680535978a5.pdf>

⁷ The paper is Meckfessel, M. D., and D. Sellers (2017). The impact of Big 4 consulting on audit reporting lag and restatements. *Managerial Auditing Journal*, 32(1), 19-49.

Available at:

https://www.researchgate.net/publication/312143315_The_impact_of_Big_4_consulting_on_audit_reporting_lag_and_restatements

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KB: We differ in the approach and the paradigms assumed. Our approach has been reinforced by a separate letter from Sir John Kingman letter. So there is no single correct paradigm to take this subject area forward. Our approach began from a different starting point. In the PwC reply already published⁸, the introduction mentions quality, independence and choice. We agree but with differing conclusions. Broadly, we see the lack of choice as a much larger problem than considered by the CMA. We also modelled this extensively using computer simulation models. We think the 75/9/31/60 sample of evidence were self-interested parties and therefore may be slightly biased. Examination of professional magazines and serious press reports would also offer ample evidence of lack of choice and conflicts of interest being a much greater problem than that relied upon by the CMA⁹.

We made a number of suggestions to beef up the role of NEDs (non-executive directors) as well as the audit committee's chairperson. It is the NEDs on the audit committee which could differ sharply from the board members on the audit committee. The trouble, we often found, is they do not. Our view was also supported by Sir John Kingman in his separate letter to Greg Clark – discussed in several places in that letter¹⁰.

Audit committee and investors: Our evidence suggested that the bulk of investors listened to possible takeovers by private equity, or hedge funds, or the proxy advisers. Management pay and their appointment of auditors apart, we found there was little appetite to be more actively involved. Limited time and other objectives were often cited.

Choice: We gained our impression of the importance of choice when we talked to both the Big Four, the mid-tier audit firms (the CMA report call them challenger firms), the investment community, Bank of England, proxy advisers, hedge funds, the companies themselves and the shareholders. Press reports¹¹ also indicate and support what we found: choice (or as we called it 'the insufficient numbers problem') was indeed a significant and a major problem made worse

⁸ See these references and many more for example:

Available at:

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

⁹ See for example:

<https://www.ft.com/content/2085cab2-9af3-11e8-9702-5946bae86e6d>

Jones, H., 2018, 'Bank of England says worried by lack of auditor choice for banks', *Reuters*, 11 July 2018.

Available at:

<https://uk.reuters.com/article/uk-boe-banks-accounts/bank-of-england-says-worried-by-lack-of-auditor-choice-for-banks-idUKKBN1K12GN>

Jones, H., 2018, 'Goldman Sachs : Bank of England says worried by lack of auditor choice for banks', *4-Traders*, 11 July 2018.

Available at:

<http://www.4-traders.com/GOLDMAN-SACHS-GROUP-12831/news/Goldman-Sachs-Bank-of-England-says-worried-by-lack-of-auditor-choice-for-banks-26911141/>

Marriage, M, McLannahan, B., and Gray, A., 2018, 'EU rules force US banks to overhaul ties with auditors: Goldman, Citi, and Morgan Stanley among lenders that will need to alter arrangements', *Financial Times*, 16 October 2017.

Available at:

<https://www.ft.com/content/e66db868-aff6-11e7-beba-5521c713abf4>

¹⁰ Op. Cit. Kingman Letter, 2018,

Available at:

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

¹¹ See references from footnote 9.

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by the recent EU ARD reforms. That exacerbated the problem, as more firms had to bid for the existing business on the banned non-audit work.

Barriers: We confirm that we found large barriers to entry for the challenger firms. Much of this is the perceptions held by management and what they believe the institutional and other shareholders want.

Resilience: We found resilience concerns to be overstated. We do not think the Arthur Andersen failure (when there was a Big Five) will reoccur. That level of behaviour would not be tolerated today. Even if it were, examining the world markets, the Big Four have ceased operation in many major markets for a period of time (Japan, India and South Africa are recent examples). The US networks would not allow one of the Big Four to cease trading within Europe. If a UK company went under, we believe that the European arm would come to its rescue in one form or another. We concluded that resilience was not as big a problem as the CMA report assumed. What we noted was that challenger firms are beginning to withdraw from the FTSE 100 market and may not be willing to tender for what we think is now up to or over £500,000 expenses for the audit tendering process. Could a Big Four fund to help the challenger firms help? Maybe.

Wider incentive issues raised by the multi-disciplinary nature of the large audit firms:
To us this involved the concept of independence (among others) which we stress and which seems to be given a lower priority by the CMA paper. The other major observations were the split of the consultancy and audit divisions which is one of the CMA remedies, and the possible further splitting up of the audit divisions. One area which we examined is the growth of the challenger firms into a reasonable size to match the Big Four. We did model this but did not dwell on this as being a realistic possibility within a reasonable timeframe; and perhaps never – depending on assumptions. The CMA cites the Guo et al paper¹² as evidence. This paper does not specify the amount of time required for the challenger firms to grow, and the paper does not allow for growth of the Big Four during that period. Their modelling was not of a dynamic simulation model as ours. The issue is that the Big Four will continue to grow, so that it becomes much more difficult for the challenger firms even with multiple mergers, to grow to anything like the size in terms of personnel and revenue of the Big Four. Whilst we also urge the bolstering of what we call the mid-tier firms, we do not believe that this is a viable solution sufficient to solve all our and the CMA issues (which differ slightly in weight, priority and importance). This is further discussed below.

B) Remedies

For all remedies:

3. What should the scope of each remedy be? Please explain your reasoning. For example, should each remedy apply to all FTSE 350 companies, or be expanded to include PIEs or large privately-owned companies that could be deemed to be in the public interest?

KB: Our remedies differ from those of the CMA. So we briefly mention some of our remedies. After considering many alternatives including all those the CMA considered and many more, but

¹² Guo et al (2017) study suggests that the introduction of joint audit would eventually result in the emergence of at least one challenger firm of a size comparable to the Big Four. This paper focussed on consumer surplus and used an econometric model based on historical data. Our evidence disagrees with their findings. We think we are not comparing like-with-like.

Guo, Q., C. Koch, and A. Zhu (2017) Joint audit, audit market structure, and consumer surplus, *Review of Accounting Studies*, 22(4), 1595-1627.

Available at: <http://ifas.xmu.edu.cn/ueditor/net/upload/file/20161130/6361609590704158026956261.pdf>

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with different weights and nomenclatures, we came down to the following choices and combinations. We also argued for greater independence (which might be a proxy factor among the CMA's issues). Lastly, we found the lack of choice to be important in creating an oligopoly that led to decreasing the importance of audit quality. So for us choice was an issue in itself and also created a business environment where audit quality would suffer. We also dismissed enhancing the role of the audit committees: we thought that their ability to be totally independent of senior board members was limited (see below).

Our list of shortened remedies concentrated on:

- Splitting the Big Four: evaluating by modelling, analysis and discussions, splitting the Big Four into audit only or Big Eight (splitting the audit into, for example, PwC A and PwC B audit divisions, and a consulting division). This is the only solution we found from modelling and other analyses that satisfied the insufficient numbers choice of audit firms within a whole variety of assumptions and sensitivity analyses. Using modelling and other analytical tools, we found that if the challenger firms were to grow and become of reasonable size, this would take a decade or two to achieve and therefore would not solve the insufficient numbers or choice problem for some time.
- Bolstering the challenger firms with or without sharing of resources with the Big Four.
- Rather than monitoring the audit committees, we concentrated on someone else choosing the auditor. (as per the Kingman letter but in all cases [not just his specific three sets of circumstances]). We did not ultimately trust the audit committee. Carillion and the CMA's other examples in paragraph 2.42 shows the inadequacy of the audit committee in those cases. They are part of and influenced by senior board members who can sway the audit committees decision. (This was our findings and can be discerned from the cases you mention if analysed in detail).
- We also paid more attention to litigation and insurance. Whatever the CMA thinks, this is prevalent in the US and is bound to influence (ultimately) developments in the western world.
- To promulgate independence (which we found has a major impact on audit quality), we considered and advocated that audit fees should be the subject of scale fees. (Sir John Kingman suggests that audit fees should be set by the regulatory body – our suggestion could be said to be similar to his proposal). Unlike the CMA findings, we found a significant rise (often 20% or more) of audit fees in the second year following a tender. First year fees often fell. But second year fees rose. This indicates that the tendering process did not adequately judge the complexities - or lowered the fees to win the tendering process. Though we agree that audit fee was not the prime reason for winning a tender, we put this as a higher ranking in importance than the CMA report.
- Someone else chooses the auditor and together with scale fees. This increases the degree of independence. Our view was supported by a separate letter from Sir John Kingman¹³ though for just specific circumstances.
- We also considered the functions and actions of the FRC and one of our conclusions was that the fines levied were really too small, even in the BHS case, to have anything more than a pinprick on the Big Four. However, we found that there was a significant peer group pressure (from within the Big Four firm) and impact on promotion/remuneration prospects for the named auditor signing off the annual report.

¹³ Kingman Report, 2018, Kingman Report: Independent Review of the Financial Reporting Council, December 2018.

Available at:

https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/767387/frc-independent-review-final-report.pdf

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- That said we support, in principle, the broad conclusions of the Kingman report on the FRC¹⁴.
- We also considered other issues such as conflict of interest waivers, relaxation of the blacklist to allow tax, valuation and other services.
- We also analysed the likely impact of future technology such as AI, levelling the playing field between the Big Four and the challenger groups. This seemed a realistic possibility but not in the short run - within the next decade or so. There is a difference between neural networks playing games with itself and learning (a closed system), from being wise to a new situation such as auditing a firm where history may be no guide to the current or future.

Remedy 1: Regulatory scrutiny of Audit Committees

4. How could the regulatory scrutiny remedy be best designed to ensure that the requirements placed on Audit Committees by a regulator are concrete, measurable and able to hold Audit Committees to account? Please respond in relation to requirements both during the tender selection process and during the audit engagement.

KB: We investigated ‘What determines the winning formula for an audit tender?’ This section draws upon interviews, various documents provided by audit firms, our own research and survey data, several confidential papers. The most important conclusion is that the personal relationships of the lead auditor partner and his or her team is probably the biggest influence in deciding who wins the audit tender. See Chapter 4 of our volume 1.

This confirms the CMA’s verdict of the importance of chemistry and cultural fit. However, we dismissed the greater involvement of investors (as already outlined) and we thought that the role of NEDs was often an abject failure with little time and resources given to their NED responsibilities with many of the NEDs having full-time and time-consuming jobs elsewhere leaving little room for them to fulfil their duties. Given that stance, we found that the audit committee’s chair was often limited by the ability of the audit committee members, and/or his or her other responsibilities.

We also doubt that anyone is willing to fund the much larger budget for the FRC, or equivalent, to enable them to adopt the close scrutiny of audit appointments in the tendering process and after. What we did propose was that the monetary element be taken away by scale fees with a complexity adjustment factor to allow for complexities and then adjudicated by a regulator.

Along the lines of the CMA’s enhanced monitoring of the audit committee, we also considered taking the decision away from management in total or jointly. This and the one above were two concepts were supported to some extent by the Sir John Kingman letter¹⁵.

We also agree with the EY reply¹⁶ that there should be changes and broader reporting in financial reporting. This is discussed in volume 3: Disruption in Financial Reporting, Bhaskar and Flower, Routledge, 2019.

¹⁴ Kingman Report 2018 op. cit.

Available at:

https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/767387/frc-independent-review-final-report.pdf

¹⁵ Op. Cit. Kingman letter, 2018.

Available at:

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

¹⁶ Available at:

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

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Remedy 2: Mandatory joint audit

5. What should the scope of this remedy be? Please explain your reasoning.

KB: We considered joint audits (and shared audits) as well the sharing of the Big Four resources (especially IT, AI and audit software) with the mid-tier firms. JF lives in Germany and I have spent more than 15 years in France. So two of us are very familiar with joint audits. We have also reviewed the evidence and contrary to the CMA we found that often there was a deterioration in audit quality (although not all studies confirmed this) but on balance including our own evidence, this was our conclusion. One of the reasons was the differences in culture and the need to disseminate to two different groups of audit staff with differing managements (including differing styles and structures of management). Then the second reason that made us reject this as a viable solution was the increased cost of that additional communication and the duplication of resources which inevitably leads to higher audit fees.

Size: if you take BDO or GT and then add the next 25 firms to them (excluding RSM), you would still have a company that would be the size of KPMG – the smallest of the Big Four. But we feel that during the process the political and cultural differences would make such a challenger firm difficult to compete with the Big Four.

RS found that the second joint audit firm was, sometimes, a tiny company or even an individual just paying lip service to the mandatory joint audit requirement. In general, our experience was that the junior partner in the joint audit was just used more as a lip-service partner to meet statutory requirements whilst not having any real say in the audit. Where there was more of a joint approach, then the liability when things do go wrong seemed to slip through the cracks. Neither of the two firms in the audit would admit responsibility blaming the other.

a) Should the requirement to have a joint audit apply to all FTSE 350 companies or potentially go wider by including large private companies?

KB: We disagree with the adoption of joint or shared audits (see above). But if any action is to be taken then this should apply to the FTSE 350 (may be in varying degrees for size and complexity) and we also believe that the larger (say top 100) private companies should be included. The alleged behaviour (as per the FRC report) of the auditors in the case of BHS (private company) was unforgivable. Take John Lewis, Swire, Arcadia, Iceland, IT, Specsavers, Clarks, Dixon Carphone, Boots UK, and the next 70 companies – you are dealing with a UK employment of close to 1 million UK staff.

b) What types of companies (if any) should be excluded from a requirement for joint audit?

KB: see above.

6. Should one of the joint auditors be required to be a challenger firm?

KB: we had assumed this to be the case to help build expertise and size of the challenger firms. But it is difficult to regulate. In France often the joint auditor is a tiny audit firm. The danger has to be that the junior partner plays a much smaller less important role, with a knock-on effect to audit fees.

If so, should this be required for all companies subject to joint audit?

KB: Yes - again to help bolster the challenger firms and to spread expertise. But I would advocate this as part of sharing resources.

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Are there any categories of companies to which this requirement should not apply? Please explain your reasoning for each of the answers.

KB: Apart from those not requiring statutory audit, probably not.

7. Should a minimum amount of work (and fee) allocated to each joint auditor be set by a regulator?

KB: A 50:50 split might help to prevent the lip-service issue.

If so, should the same splits apply across the FTSE 350? (please comment on the illustrative examples in section four). Please explain your reasoning.

KB: We did not analyse this in any great detail. Our view is that scale fees are desirable so we probably would advocate some formula for joint work – but not set by the firms involved. See our sections on how scale fees would be applied in the book referenced above.

8. Our provisional view is that there would be merit in the joint auditors being appointed at different times. Should this be mandated, or left to the choice of individual companies? How should companies manage (or be mandated to manage) the transition from a single auditor to joint auditors?

KB: Our view is that left to the companies there would be few takers.

9. Should a joint liability framework be introduced to encourage active participation in the market by the Big Four and challenger firms? Please explain your reasoning.

KB: Audit liability needs an overhaul. For joint auditors, legislation would be needed to alter precedence (which is ambiguous) and to allocate who is liable and for what. Falling through the gap as discussed in some of the CMA replies would also be a real problem. This might lead to the problem of no one being liable (as we have found).

In the context of joint audits, what are the advantages or disadvantages of auditor liability being proportionate to the audit fee of the joint auditors, compared to the auditors being jointly and severally liable?

KB: At the moment liability in the UK is ambiguous unlike in the US. So this represents what we believe is badly needed change in general. Within the context of joint audits, we did not analyse this. However, it this requires careful thought and depends on what functions each do in the joint audit. For example if an audit firm only does a subsidiary then their liability may be limited to just that subsidiary.

Remedy 2A: Market share cap

KB: We were against market share cap as a remedy because it might distort the markets too much. We dismissed this as being unworkable and probably bad for those companies whose audit had relatively low audit fees.

10. How could the risks associated with a market share cap, such as cherry-picking, be addressed?

KB: One way or another, unless someone else chooses the auditor and imposes a duty to audit, cherry-picking could be the result.

11. Would it need to apply only to FTSE 350 companies, or also to other large companies, and if so, which?

KB: Whatever action is taken we want to include the larger private companies.

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Remedy 3: Additional measures to reduce barriers for challenger firms

12. We welcome evidence from stakeholders on the existence of barriers to senior staff (including partners) switching quickly and smoothly between firms. We also welcome views on how justified such barriers are, bearing in mind commercial considerations that audit firms have.

KB: This is a question for the audit firms to answer. We have no knowledge nor did we investigate this topic.

13. We welcome estimates on the costs of setting up and running a tendering fund or equivalent subsidy scheme, and views as to how this should be designed.

KB: We did not consider the setting up of such a fund. We believed that scale fees was the best way forward. Such a scheme if contributed to by the Big Four could help to cover the cost of tendering which the challenger firms find too expensive.

14. We welcome comments as to whether the Big Four should be compelled to license their technology platforms at a reasonable cost to the challenger firms, and/or contribute resources (financial, technical, algorithms and data to enable machine learning) towards developing an open-source platform.

KB: Although we did not go into great detail on the allocation of cost, in essence, we think that sharing resources with challenger firms would be good for the challenger firms. We had highlighted IT systems as being particularly relevant.

In the first scenario, we also welcome comments on how such a 'reasonable cost' might be determined in such a way that it is affordable for challenger firms but does not disincentivise Big Four firms from innovating and developing new platforms.

KB: These resources should be viewed as a tool. It is how the tool is used that is the most important element. However, allowing the challenger firms to use these tools avoids duplication of effort and spreads the technology among more firms. In terms of cost and resources we consider this further in volume 4 (Disruption in the Auditing Process). However, we do not think that the AI audit tool will come from the Big Four. We argue that it is the tech firms that capture the imagination and can pay the highest salaries for the best IT and AI brains. We argue that it will either be Google's Deep Mind/Amazon/Microsoft, etc., or a unicorn, or an unknown start up or an emerging firm that will develop the AI tool or tools that will be used eventually by all the audit firms. The competition here is not just Big Four versus themselves, but Big Four versus the giant tech companies and other smaller tech firms. It was outsiders who developed the most widely used accounting packages – not the Big Four. We see AI going the same way.

RS felt that another adjacent area (dealing with challenger firms) that might be given more prominence is the possible input/involvement of the tech companies in the developing AI world, together with challenger firms. The tech companies might be encouraged to move into the audit market, perhaps in conjunction with a mid-tier or challenger company, as the combination of their tech with radical and innovative thinking alongside a good mid-tier audit firm could help bring about major changes in the audit market, and help the challenger firm.

Remedy 4: Market resilience

15. How could a resilience system be designed to prevent the Big Four becoming the Big Three, not just in the case of a sudden event, but also in the case of a gradual decline?

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KB: We do not think this is a big issue. See our earlier comments answers. If any of the Big Four should have experienced a decline one might have posited that it would be KPMG. However, KPMG has just overtaken PwC as the firm with most audits within the FTSE 100. PwC's previous fines have hardly dented its business¹⁷. We do not think it has influenced the tendering process. In fact, we think the PwC tendering process is extremely efficient. In any case most staff have an insurance indemnity contract (as do most health staff) to cover any personal fines. So often, the actual monetary impact is not that great. However, we recognise the importance of peer group pressure (within a firm), the impact on promotion prospects, and the possible severance or inability to be employed by any firm in the future.

So in summary:

- a) we do not think that an Arthur Andersen type situation will reoccur
- b) the international networks will help or takeover an ailing UK or European network
- c) periodic retreat from markets do occur from time to time but do not seriously harm the international network – rebranding or re-entry has always been relatively easy in the past (although the UK would be the largest western market to experience such a withdrawal).

Whilst the CMA believes that market resilience may be an issue, we have given this possibility a low priority in our weighting of possible events.

Please also comment on our initial views to disincentivise and/or prohibit the movement of audit clients (and staff) to another Big Four firm.

KB: The ease of barriers of staff moving between firms – so far we had not found any evidence of this as an issue. However, it is notable that staff once in the Big Four tend to stay in the same firm. Switching between the Big Four or even the challenger firms does not seem to be common place. We have no real systematic evidence so this is just an observation. There may be restrictive clauses in staff/partners' contracts – we have no evidence of this. Differences in culture and procedures may create artificial barriers.

16. How could such a system prevent moral hazard? Please comment on our initial view.

KB: The thought that in some way that one of the Big Four would always be saved by the other Big Three, or a safety mechanism, or the Government, is not an action we would support. There has to be a realistic prospect of failure (even if remote) to concentrate management minds. If there was a support mechanism then that might disincentivise management or make them take outrageous risks.

17. What powers would a regulator and a special administrator require, and how would their roles be divided? At what point should a regulator or a special administrator be able to exercise executive control over a distressed firm? Please comment on our initial view.

KB: This is the context of the resilience remedy and dealing with a distressed firm. We did not think that this was relevant for the Big Four. Mergers and takeovers of the smaller firms are already occurring but would still not make for a challenger (in size) to the Big Four. We thought that the role and powers of an enhanced FRC or a replacement would be the major debate.

18. What could be done regarding the challenges relating to the fact that an audit firm's value lies in its people and clients – which would be complicated to restrict? Please comment on our initial view.

¹⁷ This may be, of course, PwC deliberately chose to reduce its reliance on low margin audit work.

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KB: We confirm that currently the values lies in people. But we would add IT resources and systems. We would note that increasingly IT systems (including advanced AI and machine learning systems) will make the role of people less important through the use of the these AI audit tools, But these will always rely on the abilities of those humans working those tools¹⁸. We also think the machine learning via neural networks has to have a quantum leap (which we predict will be forthcoming) in order to be relevant to auditing. Neural networks are supreme in closed systems where the machine learning element can learn through trial and error – often repeated millions of times. That type of action is not available within auditing. There can be no trial and error and then evaluation. It is a one-off play (so-as-to-speak). It has to be right first time. But this will come. It just requires a modified view of machine learning. The current advances using backpropagation and reinforcement learning need to be enhanced. It may even be that only an AI system will be capable of creating and programming such a suitable audit system or AI audit tools. And such a system would have to be parallel run for a period of years. More likely, and sooner, is specific sub-tasks in the audit process would initially be used to undertaken well defined roles – such as sorting through contracts to identify outliers or abnormalities.

Remedy 5: Full structural or operational split

KB: We concentrate on solutions in this area more heavily. Although controversial, we found that this was the only way to solve the insufficient numbers or choice issue within the audit market.

19. Do you agree with the view that the challenges to implement a full structural split are surmountable (especially relating to the international networks)?

KB: a) Evidence of what has happened in other countries and b) the history of where firms have split in some way and the partners in one country have chosen to move in a way that their international colleagues did not agree with.

There are two types of structural split:

- 1) Split of the audit and consulting divisions which provides greater independence but does not fully solve the insufficient numbers problem for the audit market. The joint audit or bolstering of challengers firms would take time and, we think, a decade or so rather than years.
- 2) The second degree split is to then split each audit division to create eight audit only divisions.

Now in our remedy we envisaged all three businesses to be split into clearly defined separate operating entities, with separate management, accounts, and remuneration, but to remain under the same organisational umbrella. However, this would need careful monitoring and we need to ensure that active competition of all three would remain. In this scenario, we could conceive that the two audit firms would be able to draw on expertise from the sister consulting division for IT resources, but there would have to be strict limits on such cooperation. If the degree of separation was not sufficient then the consulting division may be prohibited from work on any audit cases though they could provide and maintain IT services.

On the demise of Arthur Andersen, the network went in a number of different ways depending on geography with Deloitte picking up the main share. When Deloitte and Touche Ross merged in 1989 the network split in at least 2 ways with the UK Deloitte not wanting to join Touche unlike the rest of the international network. Instead, they joined Coopers & Lybrand (which then joined PwC). So historically, each region has had its own peculiarities.

¹⁸ With Chess 4.0 which one of the authors had a hand in developing (but is now totally outmoded) but then beat the then world champion (Bobby Fischer), the most important aspect was the humans setting up the parameters to which the machine system would rely on, and make decisions constrained by those parameters.

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The makeup of the network is secure in its present form. However, if anything disturbs it, then the partners in each country's partnership will have their own say as to how to proceed. There is no necessary uniform outcome. Any breakup in the UK will have ramifications elsewhere. So the ripples from any UK reorganisation may have far reaching international affects, many of which are unpredictable. That said the international network would not want to lose too many clients in any advanced western country because of the knock-on effects of its clients who have subsidiaries in many countries.

So we think the challenges to implement a full structural split are surmountable. The easiest split would be like the Arthur Andersen and Andersen Consulting. It appeared that the organisational split was completely separate despite (in the UK) being in adjacent buildings. KB, as the providers of employees to both the Andersen firms, found the fact that there was a separate and viable consulting division added kudos and choice to potential candidates. As a result, he often found this firm was the preferred choice for the brighter students. So for an audit/consulting split we see no insurmountable problems. There might be a few shared resources, and the audit division may use the resources of the consulting division to help them in some cases – subject to certain safeguards. With the UK Andersen example, we believe that the two divisions were run as separate division both culturally and in business terms, but under one umbrella.

Now the more difficult question is a split of the audit division into two firms. As before we gave the example of PwC Audit A firm and PwC Audit B. Of course A and B would need to be changed to be neutral so that no unintended ranking was involved. We outline in volume 1 book in Chapter 7 to 10 how these divisions might be split with a small coordinating head office. We believe they could compete and share IT resources. The winning proposal in a tender process, as noted, depends on the personal relationships of the lead audit partner and his or her teams. As long as the name is PwC, the team and the name is all that matters. Now we do not wish to trivialise this but we do think it is feasible and possible.

However, we attach a much higher priority to choice and the insufficient numbers of audit firms issue than the CMA report. We relied on our evidence. But just a review of press cuttings¹⁹ (referenced in volume 1) by the serious papers, Accountancy Age, Accountancy, Economia and others show that this is indeed a much greater concern than the CMA reported. These references are also online as of now on www.fin-rep.org under the above heading and see the endnotes where the online references are directly accessible. The fact that the Bank of England and institutional investors believe that only the Big Four are 'acceptable' in their view speaks volumes. Perceptions are going to take decades to overturn.

The KPMG voluntary ban on non-audit work²⁰ for their largest listed companies is not something we advocated. In the past (as evidenced by BHS) the Chinese walls have been broken by many of the Big Four (our view). Consistently? JF would say yes. Despite valiant attempts and partly because of the reward structure (explicit or implicit), the greater profitability of the consulting services will always swamp the audit services. Hence we developed the scale fees concept.

Also we found that the definition of audit work was fluid and flexible among the Big Four. Even the extent of statutory audit work is subject to interpretation and ambiguity. So the definitions of

¹⁹ See footnote 9 for some examples.

²⁰ Also advocated by Deloitte in their letter to the CMA, among other actions.

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non-audit work could become an exercise in stretching definitions and work instructions. So again, we did not dwell on this remedy.

However, the largest problem for us was the insufficient numbers problem. Throwing out the non-audit work of the Big Four places additional strain on sharing that work among the other Big Three. A quick simulation attempt on the KPMG solution via modelling showed a rapid deterioration in the insufficient numbers due to conflicts of interest. In total, it just added to the problem. Bans on non-audit work just exacerbated the problem of only having the Big Four. Joint audits in our models took a decade or two to develop. Splitting the audit firms seemed to be the only viable method achievable within a realistic timeframe.

We also think if this is advanced and unlike the KPMG/Deloitte proposals, it should also cover all the top 100 (or so) private firms. This is to avoid behaviour as found in the BHS, MG Rover and other cases.

If not, please explain why it would be unachievable, i.e. that the barriers to implement this remedy could never be overcome, including through a legislative process.

KB: We believe that the Big Four will resist any attempt to break them up. In their submissions to the CMA, all the Big Four say they are not surmountable. Our attitude is that they would say that. However, an examination of history and other geographical areas show the Big Four are very agile and can adapt to all sorts of structures and organisations including partnership among themselves. Each country has its own management and partnership and can determine how it operates. We think the only issue would be the retention of an element of the name. For example, Deloitte's Audit Xray, Deloitte Assurance Oscar and Deloitte Consulting would be real possibilities in our view.

20. How could an operational split be designed so that it would be as effective as the full structural split in achieving its aims, without imposing the costs of a full structural split? In your responses, please also compare and contrast the full structural split to the operational split.

KB: We have discussed this above. Our solution is to have somewhere between the CMA's structural split and their organisational split. For us there would be separate management, accounts, remuneration, and name. There may be a common head office but that would only be used to organise any shared resources and to liaise with the international networks. This separation and split would be enshrined in law (for the UK) and monitored by one of the enhanced regulatory bodies (a la Kingman²¹). Existing audit clients would be randomly split but would try to achieve a 50:50 balance of the two audit firms if they equitably split staff, resources and clients.

Continues

²¹ Op. Cit. Kingman Report, 2018.

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In the table below, we compare and contrast the full structural split to the operational split. That said we believe that an organisational split with enforcement and a strict separation regime that is monitored could be close to a structural split.

	Audit Quality	Sufficient size	Increased competition	Greater independence
Audit & Consultancy split a) Structural split	Possible slight increase	Little change	Little impact	Some
Audit & Consultancy split b) Operational split	May lose some quality	As above	As above	Danger of losing some independence
Split into 2 audit divisions and a consultancy divisions a) Structural split	Possible substantial increase (our view)	Still large enough but smaller in size	Big increase in competition	Would be improved if scale fees and/or someone else choose the auditor.
Split into 2 audit divisions and a consultancy divisions b) Operational split	Any increase in audit quality is dependent on the degree of competition and independence achieved.	Still large enough but smaller in size	Depends on the degree of separation and the ability of each audit division to compete with its sister firm.	Would be improved if scale fees and/or someone else choose the auditor.

21. With regards to the operational split, please provide comments on:

a) implementation risks and whether they are surmountable: e.g. how any defined benefit pension schemes could be separated between audit and non-audit services;
KB: Maybe this is something that would be held at the UK head office.

b) risks of circumvention and how they could be addressed e.g. how audit firms could circumvent the remedy through non-arm's-length transfer pricing and cost allocations;
KB: Whatever arrangement is made it would need monitoring and enforcing. The split would require legislation and safeguards. The more onerous split of separating the audit divisions would need to be more carefully monitored by a new regulatory body proposed by Kingman²².

c) implementation timescales to separate the audit firms and how soon the remedy could be brought into effect;

KB: There would have to be a period of preparation and then a sharp split with close monitoring for a two or three years. However, a degree of monitoring would be necessary in the long run but perhaps at a lower level. Whistleblowers would need to be protected by law. The Big Four will raise many hurdles, problems and issues but we think they may be over-stating these.

²² Op. Cit. Kingman Report, 2018.

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d) ongoing monitoring costs for the audit firms and a regulator;

KB: This depends on the type of split. The worst case is, we think, that our estimated costs would be modest (perhaps less than £5m to £7m per year²³) but we are still determining the exact costs over time. We think that such a cost should help the public in general and therefore should be partly if not fully or partially provided for by the government.

e) role and competencies of a regulator in overseeing ongoing adherence to the operational split.

KB: We think that a body as proposed by Kingman and with enhanced powers as identified there is a solution. However, we advocate an aircraft-style early warnings of failure or issues and would need to be much pro-active with fines up to £100m or more and with a much shorter timescale for concluding investigations. Their powers would require legislation. There is also an overlap between the various (ten or so²⁴) watchdogs:

The FRC has been found to be weak (as reported by the Kingman report). Pensions, BEIS and the SFO arguably have been inefficient or weak, and/or rarely take any action or have not been successful in the past. Though we note that the Kingman report argued cogently for no major structural change, for instance merger with another regulator or splitting standard-setting from enforcement.

22. Under an operational split, how far, it at all, should it be possible to relax the current restrictions on non-audit services to audit clients? For example through changes to the blacklist or to the current 70% limit.

KB: Assuming we have to keep to the EU ARD framework, we think the blacklist should be kept and that the 70% cap should be reduced to zero. At one point we argued for a slight relaxation of the blacklist for some tax and valuations services. However, we need to identify a framework and that is an area on which we are currently working. If the UK, via Brexit, feels the need to move away from ARD then this raises many new concerns.

23. Should challenger firms be included within the scope of the structural and operational split remedies?

KB: No. This would limit their ability to grow in sufficient size. This decision would need to be revisited once the challenger firms grow to 80% of the manpower or revenue of at least one or two of the smaller entities in the newly split Big Four.

24. Which non-audit services (services other than statutory audits) should the audit practices be permitted to provide under a full structural split and operational split? Please explain your reasoning.

KB: We are still working on this. But one area that should be included in a statutory audit is a test of the auditee's accounting system (as in the US). Then tax and valuation were two areas we identified that could be considered for some relaxation from the current black list. We also think that comments on poor internal controls could be a by-product of the audit process but once initiated should then be reviewed by a separate auditor - or a consultancy division if a

²³ KB estimate.

²⁴ FRC, FCA, PRA, The Pensions Regulator, The Equality and Human Rights Commission – for the Gender gap info, BEIS, Insolvency Service, SFO, Information Commissioner's Office, Select Committees – not a regulator but becoming more prominent as an external check.

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systems issue. We also are not sure how much consultancy work should be undertaken by a sister consulting division. Such decisions depend on the type of split and the safeguards put in place.

Remedy 6: Peer review

25. What should be the scope (ie which companies) and frequency of peer reviews, if used as a regulatory tool?

KB: Given the state of the FTSE 350, top AIM companies, and the top 100 private firms, we think that these firms could be categorised into several types depending on certain risk factors. Such categorisation would depend on profitability, gearing, loans coming due, intangibles and the state of the economy and market sectors. This is gone into greater detail in: *Disruption in Financial Reporting*, Bhaskar and Flower, Routledge, 2019. Those companies in the worst categories would require more careful and extensive monitoring. Companies in clear profitability may be the subject of less scrutiny. UK listed companies relatively strong in profitability include such FTSE 100 companies as BHP, British Land, BP, Riot Tinto, Legal & General, Berkeley Group, Schroders and so on. However, a housing collapse could place Berkeley Group²⁵ in a riskier category and so on. Other companies less well off are those hit by online competition and a slowing down of consumer UK spending. These include such companies as all the large UK supermarkets, tourism companies, service and outsourcing companies. This more problematic category would require greater supervision and this is discussed in volume 3 in detail.

26. How could peer reviews be designed to best incentivise auditors to retain a high level of scepticism, and thus improve audit quality?

KB: In terms of motivation and behaviour, we believe that peer review pressure has not and cannot work in the audit environment. The FRC already examines senior promotions. What we believe is necessary is there to be an active monetary reward system, within a firm, for a) audit quality, b) collection of evidence and the degree of scepticism, and c) the performance of analytical tools including financial modelling, sensitivity analysis and stress test for the longer run - all applied to the entity being audited.

C) Next steps

27. What are your views, if any, on our proposal not to make a market investigation reference?

KB: We agree with your conclusion in 5.3 (b): "...our view is that the market is not currently delivering consistent high-quality audits, and that appears to be attributable to a number of competition issues". We would just add independence issues. The remedies we advocated do fall within the competition arena, but we also think that the Government needs to be fully involved to repair the damage and make the City a place of excellence for the future whatever that holds. The one area we would not wish you to take forward is the joint audit. Also we believe that choice and the insufficient numbers of large audit firms is an area that we believe you should not ignore within the competition mandate.

On a note of realism, we doubt the Government has much appetite to do more than some fine tuning at the current time. This applies to any CMA recommendations as well as the recommendations from the Kingman report (though accepted by Greg Clark) and any from the forthcoming Brydon report. Even if the probability is small, if Brexit happens in a harder option, and the Singapore model is used as a strategy/policy coupled with a move to deregulate,

²⁵ Of course, the Berkeley group have protected themselves by placing each property development in its own limited liability company.

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then controls may very well be relaxed and not tightened. That would be a pity in our view. In this event all that may be available in practice could be the competition mandate.

So we would like to see a market investigation reference and recommendations to the Government. We do not see this as being mutually exclusive. The break-up of the Big Four would require a market investigation reference, though we appreciate that your "... proposed remedies would be most effectively implemented, monitored and enforced if enacted in the clearest possible way within the wider framework, rather than as a bolt-on via the order-making route".

Our recommendations²⁶

KB:

- 1) We think that independence is important (for audit quality) and that scale fees with an adjustment for complexity could improve independence. We still believe that greater independence will improve audit quality. Taking the decision of who to appoint as auditor by an independent body would be an added plus but, we appreciate, raises some difficult questions²⁷.
- 2) We think that the split of audit and consultancy should be evaluated along with the split of the audit divisions as discussed above.
- 3) We think that growing the challenger firms is a positive development and should occur and be encouraged despite our misgivings. The preferred method is via resources sharing plus encouraging mergers between what we term the mid-tier firms with the smaller practices. This is already occurring. A fund to help mergers might be considered.
- 4) We are not in favour of joint or shared audits (shared audits less so than joint) a) because of the liability and falling through the gaps issues, and b) because of the increased cost of communication and duplication for no improved audit quality. (We acknowledge that some academic studies dispute whether audit quality is improved but we believe that at best it is neutral).
- 5) Finally, we disagree with the FRC (or any equivalent regulatory body) policy of charging for quoting any of their regulations or press releases. Charging for what should be a publicly transparent body we feel, is wrong. Such bodies should be concerned with the widest dissemination of their material.

²⁶ We think that shorter tenure should be reviewed but this was not our highest priority. Any international firm operating in Poland is limited to 7 years rotation. So for international companies with operations in Poland (together with an existing audit team change at five years in the UK), the audit firms' rotation period may already be reduced.

²⁷ But partially supported by Sir John Kingman in the Kingman Letter 2018, op. cit.

Available at:

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