

Update and comments on the CMA Final Report April/May 2019

Statutory audit services market study

Disruption to the Audit Market: The Future of the Big Four. Routledge. 2019.

By Professor Krish Bhaskar, Professor John Flower with contributions from Rod Sellers.

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Introduction

Please see our earlier critique of the update report from the CMA:

<http://www.fin-rep.org/wp-content/uploads/book1/5-Our-response-to-the-CMA-update-paper.pdf>

The one thing which has changed between the update report and the CMA's final report is in their remedy detailing an operational split of the audit division.

The full CMA final report (18 April 2019)¹ is available at:

https://assets.publishing.service.gov.uk/media/5cb89b2bed915d74fed24206/CMA_final_audit_market_report_A.pdf

A summary of the report can be found:

https://assets.publishing.service.gov.uk/media/5cb74577e5274a7416b64f01/final_summary_report.pdf

The press release:

<https://www.gov.uk/government/news/cma-recommends-shake-up-of-uk-audit-market>

The report contains much data and analysis and is better than the update report issued in December 2018 with mostly careful reasoning and interpretation of data. The report claims a full set of tendering data in the FTSE 350 or Top Track 100 from 2012 to 2019. We have no reason to doubt this but if so it seems doubtful (but possible) that this was a 100% sample. What is more telling is that the CMA surveyed the FTSE 350 and the Top track 100² and only received 24³ sets of data relating to information in relation to i) tenders for the external audits and ii) the hours spent by audit committee members of audit related matters. However, there is some doubt over the accuracy and/or completeness of this data⁴.

That said we were impressed with the logic and thought that went into the final report. Since its publication, the final report has undergone much criticism. We will come to that shortly.

¹ CMA, 2019, Statutory audit services market study: Final report, *Competition and Markets Authority*, 18 April 2019

Available at:

https://assets.publishing.service.gov.uk/media/5cb89b2bed915d74fed24206/CMA_final_audit_market_report_A.pdf

Accessed April 2019.

² It is not clear exactly how many responses were received. Because on Page 209, it seems there was 100% sample. Then on page 210 it talked about 250 and 23 data sets. Then on page 211 the report declares:

The information provided may not be absolutely complete. For example, we are aware of occasions in our dataset where an audit firm has not included information on a tender in its submission when it did in fact participate in that tender.

So this casts doubt on the accuracy of the data sets of the firms responding can choose what data they gave to the CMA under the pretense of all data. There were also many exclusions for a variety of reasons.

³ It transpires they only asked 58 firms to respond/ How was the 58 chosen? In our experience the FTSE 100 would give very different form the bottom end of the FTSE 250 companies. Were the 24 that did respond (a 50%) response rate self selecting and therefore introduce a bias.

⁴ See above.

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CMA Recommendations

These consists of the five remedies outlined below the one new one over the update report is the operational split. These are called a package of remedies (page 8 of the summary report) to reform the audit market:

- Recommendation 1 – audit committee scrutiny
- Recommendation 2a – mandatory joint audit, including at least one non-Big Four firm, for most large companies; peer reviews for the largest;
- Recommendation 2b – measures to mitigate the effects of a Big Four failure
- Recommendation 3 – an operational split between the audit and non-audit practices of the biggest firms
- Recommendation 4 – a five-year review of progress by the new regulator

This package is justified through this reasoning⁵:

1. The market, supported by the right regulation, needs consistently to reward high-quality audits above all else, and penalise poor quality.
2. Previous attempts to improve the situation have helped, for instance through mandatory tenders following the Competition Commission's 2013 investigation, which create more opportunities to compete. But not enough has changed as a result, and the deep-seated characteristics of the market mean we can have little confidence that, left to its own devices, the market, or the firms within it, will self-correct.
3. Our recommendations are intended to achieve the following objectives, which follow on from the problems we see in the market:
 - a. Increase the effectiveness of audit committees across the FTSE350, ensuring that the selection and oversight of auditors is focused on quality – in the form of scepticism and challenge as well as technical expertise.
 - b. Increase long-run resilience and choice in the market. We need to arrive at a position where more than the current four big firms can and do audit the UK's biggest companies.
 - c. Address the problems in terms of focus on quality, and choice, caused by the firms' combined audit / non-audit services structures.
4. The difficulty of bringing about these changes should not be underestimated. The resilience problem, in particular, is reflected the world over, and has been entrenched following regulatory decisions and Andersen's failure 15-20 years ago. It will take time to get the market to a better position; and it would be misplaced confidence to imagine we can predict exactly how the process will play out over that period.
5. The changes will need concerted action by the Government. They will also need to be overseen by the regulator, which we expect to become increasingly effective as it is reformed and given new powers following the independent review led by Sir John Kingman. There would be value in the regulator starting work on our recommendations before it is fully re-shaped following the Kingman changes, for instance on scrutiny of Audit Committees.

⁵ CMA Final Summary Report. Pages 7-8.

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CMA Recommendations/Continued

6. The changes recommended here should in time also be complemented by what emerges from the review by Sir Donald Brydon into the quality and effectiveness of audit. But as Sir Donald himself indicated to the BEIS Select Committee, making progress with changes to the regulator and to the market need not wait for the final outcome of his review.

Criticisms of the CMA final report

Prem Sikka has the strongest critique in the Guardian⁶ concludes: “The near-collapse of BHS, Carillion and the bailed-out banks wasn’t spotted. The CMA’s remedy shows it is not fit for purpose”. He goes on to say:

.....these firms [the Big Four] collected huge fees and delivered little of any public value. Their failure to spot the fragility of those businesses resulted in the loss of jobs, savings, pensions and tax revenues.

Yet the victims of these failures have no legal recourse to seek compensation because auditors owe a “duty of care” only to the company that hires their services, not to any individual stakeholder or creditor.

Another critique is given by Professor Shah in the FT⁷ and is even more vitriolic than the Sikka article. His view is:

But it avoids tackling directly the monopoly power of the Big Four and the urgent need to break them up to preserve competition and independence.

A more measured FT article⁸ reports on a cross-section of opinions with the question?:

At a time when the accountancy firms are awaiting a new regulator to replace the Financial Reporting Council, often criticised as ineffectual, and the publication of the Brydon review into the quality and effectiveness of the audit market, the question is whether the CMA’s proposals will help to prevent a repeat of the recent collapses or merely bring added cost and complexity.

⁶ Professor Sikka, P., 2019, The near-collapse of BHS, Carillion and the bailed-out banks wasn’t spotted. The CMA’s remedy shows it is not fit for purpose, The Guardian, 18 April 2019.

Available at:

<https://www.theguardian.com/commentisfree/2019/apr/18/big-four-auditors-failing-watchdog-not-fit>

Accessed April 2019.

⁷ Shah, A., and Grimstone, G., 2019, Do the CMA auditing proposals make sense?, *Financial Times*, 19 April 2019.

Available at:

<https://www.ft.com/content/c9c4bf50-61d3-11e9-9300-0becfc937c37>

Accessed April 2019.

⁸ Thompson, B., and Thomas, D., 2019, Watchdog’s plans for audit reform get mixed reception, *Financial Times*, 18 April 2019.

Available at:

<https://www.ft.com/content/40f12080-61d6-11e9-a27a-fdd51850994c>

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Criticisms of the CMA final report/Continued

Individual criticism of the recommendations will be made shortly. The Guardian⁹ made a more general criticism which continues the themes already made but summarises the overall negative position (not everyone is against the CMA proposals):

Timid is the best description of these proposals, because only a separate audit industry, cut free from tax and management consultancy work, can ever be truly independent. Beefing up smaller firms is something the government needs to be actively involved in facilitating, because expecting auditors to treat the idea of joint working with anything other than disdain is naive.

So the CMA's efforts amount to little more than the kind of window-dressing the audit industry has managed to maintain ever since Arthur Andersen perished following the collapse of Enron in 2002.

From that point onwards, auditors have repeatedly told ministers that imposing too many rules will only lead to another accountancy firm dying under the weight of unjustified compensation claims (Arthur Andersen was cleared of wrongdoing by the US courts¹⁰).

Should we expect any better from Brydon, given that his report will be from the perspective of shareholders and shareholder representatives, with only Alison Hopkinson, the chief operating officer of Oxfam, to represent the interests of wider society? Not really.

Only a more fundamental shake-up will prevent managements from sinking companies, like they did at Carillion. Business minister Greg Clark should take note.

Accountancy Age had an article from the CEO of MGI Worldwide¹¹ (a group of independent auditing/accounting firms) questioned the basis of independence (as we did in our book) *Disruption in the Audit Market: The Future of the Big Four*. The article attacks the basis of audit independence claiming it is non-existent:

⁹ Business leader, 2019, Modest proposals will not make the audit process any more watertight, *The Guardian*, 21 April 2019.

Available at:

<https://www.theguardian.com/business/2019/apr/21/cma-audit-competition-report-tyrie-carillion>

Accessed April 2019.

¹⁰ This requires comment. Initially Arthur Andersen was found guilty. In 2002, the firm voluntarily surrendered its licenses to practice as Certified Public Accountants in the United States after being found guilty of criminal charges relating to the firm's auditing of Enron, an energy corporation based in Texas, which filed for bankruptcy in 2001.^[11] In 2005, the Supreme Court of the United States unanimously reversed Arthur Andersen's conviction due to serious errors in the trial judge's instructions to the jury that convicted the firm.

¹¹ Bennett, C., V., 2019, The madness of audit independence, *Accountancy Age*, 18 April 2019.

Available at:

<https://www.accountancyage.com/2019/04/18/the-madness-of-audit-independence/>

Accessed April 2019.

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Criticisms of the CMA final report/Continued

Unfortunately, the huge independence edifice is built on quicksand because auditors are paid directly by the companies they audit. The extraordinary fact is that companies pay experts to pronounce publicly on their probity and viability. On top of that, the paying company is usually not even the constituency needing the audit. Shareholders and wider stakeholders depend on the reliability and transparency of financial statements but, unless the company is owner managed, get no effective say in the choice or control of auditors.

We would never travel with an airline that paid inspectors to issue its safety certificates, so why, other than habit, do we entrust our financial safety to auditors paid for by the companies they audit?

This is not only about money; it is about culture. The assumption is that audits can be made of such high quality that auditors will never fail to call out unsustainable or corrupt businesses. But the client-supplier relationship, the antithesis of independence, is at the core of any firm – great companies in all sectors rightly put their customers' interests at the heart of their strategy.

And

Auditors are only human. Admonishing clients, let alone disciplining or firing them, when they represent a good percentage of fee portfolios, not to mention bonuses, is commercial torture. Auditors are not corrupt, their silence is not bought by evil clients: the significant independence they honestly achieve is, rather, a heroic stand against business logic. Obsessively detailed independence rules are made mockery by the most basic maxim – he who pays the piper calls the tune.

Auditors are terrified of putting a client at risk by publicly questioning the reliability of accounts with a “qualified” or “adverse” audit opinion or the future viability of a client company with a “going concern disclosure”. They worry that even hinting at such issues will cause a catastrophic crash in the client's share price or creditworthiness or be a self-fulfilling prophecy and destroy its future. Such commercial considerations should never be the concern of an independent auditor – as they would not be for an air safety inspector – yet they frequently are.

So, in audit, the deepest foundation of independence is not just made of sand, it does not exist. It truly is madness. It is dangerous madness because the ever-growing thousands of pages of regulation give a false sense of security to investors and stakeholders.

Bennett who made these points and who is the CEO of an auditing firm, has a valid view which we mostly endorse in our book *Disruption in the Audit Market: The Future of the Big Four*. If the fees are paid by the management to the auditor they appoint and negotiate the said fees, there is little independence. Bennett viewpoint has legitimacy and is an important issue not fully resolved by the CMA or many of the other suggestion. Only if someone else appointed the auditor and there were scale fees would there be true independence.

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Criticisms of the CMA final report/Continued

The CBI and other bodies have been critical of the CMA report in a Times article¹²:

Britain's biggest lobby group has defended its criticism of proposed reforms of Britain's accountancy industry.

The CBI warned that proposals by the Competition and Markets Authority (CMA) to force large companies to appoint smaller audit firms could "undermine confidence in corporate Britain", provoking criticism yesterday.

We need to examine the individual recommendations and critiques thereof.

Big Four fight back

It is reported that the Big Four may be taking legal advice as to whether they could challenge the CMA's final report on auditing, "which was handed to ministers this month. The government has three months to respond"¹³. The article also reported:

The market share of the big four, which audit 97% of the FTSE 350, is in the spotlight after a series of blow-ups and fines. Rachel Reeves, Labour chairwoman of the Commons business committee, has called the market "broken".

A senior accounting source said a judicial review of the CMA's report would be a "nuclear option", but added: "The analysis is not deep enough and it's quite a political document."

Oliver Shah also went on in his editorial to make comments¹⁴:

Continued

¹² Griffiths, K., 2019, CBI stands by attack on audit reform, *The Times*, 19 April 2019.

Available at:

<https://www.thetimes.co.uk/article/cbi-stands-by-attack-on-audit-reform-w3sjn6vt9>

Accessed July 2018.

¹³ Shah, O., 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-xkftvzb0g>

Accessed April 2019.

¹⁴ Shah, O., The competition watchdog slips his leash, *The Sunday Times*, 28 April 2019.

Available at:

<https://www.thetimes.co.uk/edition/business/the-competition-watchdog-slips-his-leash-v7v8v8h8h>

Accessed April 2019.

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Big Four fight back/Continued

The watchdog was seen as sleepy and wonkish. No longer. Under the chairmanship of Lord (Andrew) Tyrie, the former Tory MP and Treasury committee inquisitor, it has fired a blunderbuss at the accounting industry and a torpedo at the £14bn merger of Asda and Sainsbury's. Tyrie may protest that as chairman he stays aloof from the fine detail, but his fingerprints are all over both cases, and the CMA's change of tone since he arrived last June has serious implications for big business.

That might help to explain why the CMA has pushed ahead with proposals to enforce joint audits of FTSE 350 companies and an operational split between audit and non-audit parts of accountancy firms, despite howls of protest from many of the companies and investors it is trying to protect.

and¹⁵

While it's difficult not to admire the absence of dithering, the overwhelming feeling is that Tyrie and friends are shooting from the hip based on his preconceptions. The appendix to the audit market study mentions that the CMA received 24 proper responses from the FTSE 350, and just one from a big private company. It's hardly exhaustive. Some of the big four accountants — Deloitte, PwC, EY and KPMG — are now thinking of demanding a judicial review

With the ultimate conclusion¹⁶:

There is speculation that the new chairman wants to use the CMA as a springboard to the creation of some kind of super-regulator along the lines of the US Securities and Exchange Commission, with jurisdiction over other watchdogs such as the Financial Conduct Authority. If that's the case, the City had better brace itself. In the meantime, big firms need to bear in mind that the CMA is now eager to pick fights — and willing to do so quickly.

Continued

¹⁵ Ibid

¹⁶ Ibid

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Recommendation 1 – audit committee scrutiny

Our principle criticism of the recommendations probably lies in the joint audits. We regard any tinkering with the audit committees as ineffective.

We had regarded this as ineffective because the recent failures all had well experienced and qualified NEDs who failed to undertake their duties in our opinion. In Volume 2: *Financial Failures & Scandals: From Enron to Carillion*, the NEDs at Carillion were:

Box 7.3 Carillion's NEDs

Alison Horner From December 2013

Pensions expert, Chief People Officer of Tesco

Alison Horner: a non-executive director and chair of Carillion's remuneration committee for four years, Alison Horner presided over growing salaries and bonuses at the top of the company as its performance faltered. In her evidence to us, she sought to justify her approach by pointing to industry standards, the guidance of advisors, and conversations with shareholders. She failed to demonstrate to us any sense of challenge to the advice she was given, any concern about the views of stakeholders, or any regret at the largesse at the top of Carillion. Ms Horner continues to hold the role of Chief People Officer of Tesco, where she has responsibilities to more than half a million employees. We hope that, in that post, she will reflect on the lessons learned from Carillion and her role in its collapse. SC Page 35.

That said Alison Horner's role at Tesco has changed from HR to operational. She will become chief executive of Tesco's Asia business after spending seven years as chief people officer at the supermarket¹⁷. Reported as a promotion though.

Keith Cochrane: Scottish Chartered Accountant with finance experience; former chief executive of the Weir Group and of the Stagecoach Group. From July 2015 to July 2017 then became CEO.

Andrew Dougal: also Scottish Chartered Accountant with finance experience; former chief executive of Hanson PLC. From October 2011.

Ceri Powell: Vice-President of Royal Dutch Shell. From April 2014

All of the four NEDs held top positions in the FTSE 100 and were well-qualified financially and had much experience in the most senior positions.

Continued

¹⁷ Uttley, H., 'Pay chief who helped dish out huge bonuses to bosses at Carillion is given a promotion at Tesco', *This is Money*, 22 May 2018.

Available at:

<http://www.thisismoney.co.uk/money/markets/article-5754637/Reward-failure-Pay-chief-dished-huge-bonuses-Carillion-bosses-given-promotion.html>

Accessed July 2018.

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Recommendation 1 – audit committee scrutiny/continued

From *Financial Failures & Scandals: From Enron to Carillion*,

The four NEDs were all experienced (see Box 7.3) and all four were on the five sub-committees of the board: Remuneration Committee, Nominations Committee, Business Integrity Committee, Sustainability Committee, as well as the Audit Committee. It would appear challenging for them to devote sufficient time and effort to fulfilling their responsibilities on each of these committees, especially considering that they were essentially part-time. For example Alison Horner was the Chief People Officer of Tesco and Ceri Powell Executive Vice-president of Global Exploration, Royal Dutch Shell. Was Carillion expecting too much of its non-executive directors? There is a fundamental paradox in the position of the non-executive director: if he or she is given too many responsibilities, they become part of the management team and are no longer able to provide the outside independent control that is desired, but if given too little, they provide insufficient control. It's a delicate balance.

Non-executives are there to scrutinise executive management . They have a particularly vital role in challenging risk management and strategy and should act as a bulwark against reckless executives. Carillion's NEDs were, however, unable to provide any remotely convincing evidence of their effective impact. The SC¹⁸ page 31.

The SC concluded that the various board committees were ineffective or had failed. They were especially critical of the Remuneration Committee and Alison Horner, its Chairperson whose priority was salary boosts and extra payments as described by the SC Page 33. But that is not an isolated example. In all the recent failures and in many of the examples we examined in detail we found the same evidence of ineffective input.

Sikka¹⁹ is also critical:

The CMA washes its hands by saying that it wants to empower audit committees, consisting of non-executive directors, to deal with the appointment and oversight of auditors. It neglects to note that all the bailed-out banks, along with Carillion and BHS, had such committees. They failed, and the CMA does not ask why.

Continued

¹⁸ SC, 2018, House of Commons. Business, Energy and Industrial Strategy and Work and Pensions Committees. Carillion

Second Joint report from the Business, Energy and Industrial Strategy and Work and Pensions Committees of Session 2017–19. HC 769. Published on 16 May 2018. by authority of the House of Common.

Available at:

<https://publications.parliament.uk/pa/cm201719/cmselect/cmworpen/769/769.pdf>

Accessed July 2018.

¹⁹ Op. Cit. Professor Sikka 2019.

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Recommendation 1 – audit committee scrutiny/continued

Shah and Grimstone²⁰ are also sceptical about audit committees:

The other major contributor to audit failure is the UK's system of corporate governance. My research into the 2008 collapse of HBOS, the largest corporate failure in British history, shows that the bank's board and audit committee failed to adequately question the business strategy and risk-taking or to police the quality and conduct of audits.

Most non-executive directors rarely challenge the executives they ostensibly oversee. Instead, they have become habituated to rely on auditors to provide them comfort, and the auditors have in turn relied on management.

Everyone has been far too comfortable for far too long, and this CMA review does not change that in the slightest. Since the financial crisis, the UK has quite rightly revamped its system of regulating banking, but powerful corporate interests continue to capture the regulation and governance of accounting.

CMA adaptation

What the CMA does to mitigate this ineffectiveness is as follows²¹:

- a) The regulator should have the power and a requirement to mandate minimum standards for both the appointment and oversight of auditors.
- b) The regulator should have the powers and a requirement to monitor compliance with these standards, including the ability to require information and / or reports from Audit Committees, as well as placing an observer on a Committee if necessary.
- c) The regulator should take remedial action where necessary, by for example issuing public reprimands, or making direct statements to shareholders in circumstances where it is unsatisfied with Audit Committees. The more severe measures proposed by Sir John Kingman might complement our remedy

We liked the placing of an observer. This would certainly add to how those committees worked. That said the CMA also suggested greater shareholder participation with the audit committee. This is an absolutely 'no-no' unless there is some concern over directors' fees or bonus payments.

Of greater interest is the CMA's suggestion that the regulator (ARGA) or some other body take the more radical step of moving responsibility for selecting auditors to that independent body. They did not recommend this but they concluded that this would be worth considering in the long term²².

However, our conclusion tends to verge on the negative. Despite the above safeguards we think it will not be that effective. The NEDs are drawn from a small pool of fellow directors with their own high profile and extremely busy jobs. They do not have time to devote much time for their NED responsibilities. ARGA cannot police 500 or more audit committees. That said we do acknowledge that the CMA attempted to bring more realism into this process. We just do not think it will work. Our evidence supports this.

²⁰ Op. Cit. Shah and Grimstone 2019.

²¹ CMA summary report, Page 9.

²² Ibid, page 9

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Recommendation 2 joint audits, peer reviews, and resilience

Previously the CMA relied on joint audits almost exclusively to other remedies. This has now changed with the CMA realising that this may take some considerable time²³:

In order to ensure both acceptable choice and improved resilience of the audit sector, we need five, six or even seven firms auditing the largest companies in the UK, in the medium to long term, rather than the current four. The existing market structure is heavily entrenched, so this will not be easy, and will take time – perhaps some considerable time; but it will certainly not happen if the market is left unchanged.

Mandatory joint audit for most large companies is designed to address choice and resilience problems. The effect of this remedy should be to break down the barriers to expansion for non-Big Four firms, enabling them to build capacity, capability and reputation over time, as they gradually start to carry out substantial portions of audits for some of the UK's biggest companies, and as a result to increase long-term quality.

The new safeguards to this proposal include²⁴:

- 1) At least one joint auditor should be a non-Big Four firm.
- 2) Most FTSE350 companies should be required to appoint joint auditors with some exemptions overseen by ARGA.
- 3) The regulator should establish criteria on which companies may need initially to be exempted.
- 4) Any company that would otherwise fall within the scope of the remedy should also be exempt if it appoints a non-Big Four firm as its sole auditor (and that seems a little unfair).
- 5) Other circumstances for exemption by the regulator should be limited – for example where all firms outside the Big Four firms are unable to provide a service.
- 6) The introduction of joint audit should be gradual, enabling adaptation over time, as suggested by the BEIS Select Committee; companies should make the transition to joint audit no later than when their next tenders arise (rather than all companies in scope having to make the change immediately), but could do so earlier if they choose.
- 7) Other than the existing mandatory rotation requirements, individual audit committees should be free to arrange the respective timings of each joint auditor's appointment as they see fit.
- 8) There should be a presumption that Audit Committees should ensure that the work of each of the two joint auditors is substantial and relatively equal, starting with each audit firm ordinarily receiving at least 30% of the audit fee.
- 9) No changes should be made to the existing UK audit liability framework, meaning that the joint auditors will have joint and several liability for the engagement.
- 10) The regulator should be empowered to adapt this remedy over time, for instance increasing or decreasing the coverage of the joint audit or peer review requirements, or changing the requirements on the balance of fees between joint auditors.

²³ CMA summery report page 10

²⁴ Ibid Pages 11-12

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Recommendation 2 joint audits, peer reviews, and resilience/Continued

The CMA concluded that:

...the best route for early action lies with joint audit, plus the option for Audit Committees to choose between joint audit or a sole challenger auditor. This offers many of the potential benefits of a share cap, as highlighted by the BEIS Select Committee, without many of the risks. It serves the purpose of breaking down the barriers to non-Big Four firms, allowing challenger firms to build their market presence at a sustainable rate, while maintaining maximum choice for Audit Committees²⁵.

In our book, *Disruption in the Audit Market: The Future of the Big Four*, we analysed joint audits and were not enthusiastic about joint audits. The insignificant lip-service partner problem has been solved. But there remains the increased cost, the duplication, the different cultural and audit approaches from two very different organisations. This is what we said to the response to the CMA update report²⁶:

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/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.

However, we are not alone in criticising joint audits. There was much discussion among the FTSE 100 and FTSE 250. The increased cost albeit small is dismissed by the CMA. On that we are inclined to agree with the CMA. However, we can see no benefit in audit quality and the growth of the challenger firm to become close to the Big Four will take too long (decades in our simulations studies).

²⁵ CMA Final report 2019, page 146

²⁶ See:

<http://www.fin-rep.org/wp-content/uploads/book1/5-Our-response-to-the-CMA-update-paper.pdf>

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Recommendation 2 joint audits, peer reviews, and resilience/Continued

Thompson and Thomas²⁷

“[Auditors] have no duty of care to any individual stakeholder so it is hard to see without any liability why they would want to improve,” he said. “At best, the joint audit approach might make some difference in 25 years, but there is no proposal on audit quality at all.”

And²⁸

“I have had my own criticisms of the accounting industry and there is a need to recognise independence, but joint audits are not going to solve anything. The smaller firms do not necessarily have the capability or desire to take on the extra work, while the quality gap between the big four and the tier below is absolutely huge. Most of the firms are already operationally separate between accounting and audit.”

Sir Mike also highlighted the problems of forcing through changes in a single country for businesses that operate across the world.

Also²⁹:

Some executives said they were concerned about the impact of the proposals. One FTSE 250 executive said having two auditors could prove more costly and confusing, replicating roles with little obvious improvement in audit quality.

And in answer to the question of whether smaller firms have the capacity to audit big companies?³⁰

Michael Izza, chief executive of the ICAEW accountancy body, said joint audits “could both drive out incumbents and discourage new entrants”.

BDO’s Mr Knight said there needed to be “a lot of investment in the challenger firms” before they were to be able to service the FTSE 350 audit market, as they could face capacity and experience problems.

“I would be surprised if any of the challenger firms had audited a utility company, for example,” he said. “Equally, they will have limited experience of financial services institutions.

Mr Knight also predicted that audit staff from the big four would seek to move to challenger firms as the latter would represent the growth side of the market. “But hiring those teams requires big investment by the challenger firms,” he added.

But the strongest criticism of joint audits comes from Shah and Grimstone³¹:

Continued

²⁷ Op. Cit. Thompson and Thomas 2019. Quote from Professor Prem Sikka

²⁸ Ibid, Quote from Sir Mike Rake, former chairman of KPMG as well as companies including BT and Worldpay

²⁹ Op. Cit. Thompson and Thomas 2019

³⁰ Op. Cit. Thompson and Thomas 2019.

³¹ Op. Cit. Shah and Grimstone 2019.

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Recommendation 2 joint audits, peer reviews, and resilience/Continued

I am sceptical as to how joint audits will improve audit quality, given the fundamental failure of the profession to reform the way audits are conducted. Today's accounting standards and policies have been significantly influenced by the Big Four firms, so audits are based on weak, compromised and inconsistent rules that make failure "normal". If we are not careful, joint audits can lead to a division of blame and responsibility, making it harder to hold firms accountable in the case of audit failure.

And

Quite simply, joint audits and the potential for further separation of audit practices risk increasing the cost and complexity of doing business in Britain and are out of sync with other major economies, particularly the US, which is our major competitor as a financial centre.

And³²

The move to force joint audits is intended to bring new entrants into the market and to allow smaller players to carry out more work. The intention is good, but is hard to see how doubling auditor involvement does not lead to a vast increase in bureaucracy, cost and time. This will not be welcomed by any business.

The proposals would also force smaller firms to share the joint liability, something that seems an unfair burden and risk. The CMA itself acknowledges enforced joint audit would not be appropriate for the "largest and most complex" businesses given the relative lack of expertise and experience.

Introducing these measures in the UK would put us out of step with other markets and make us a less favourable environment. Providing more onerous and potentially less effective audit services in the UK will reduce our pulling power for businesses and companies that would once have plumped for Britain.

Professor Sikka is also critical of joint audits³³:

The CMA proposes joint audits for most FTSE 350 companies by a big four and a mid-tier firm. This may make a marginal difference to the market.....

Continued

³² Op. Cit. Shah and Grimstone 2019.

³³ Op. Cit. Professor Sikka 2019.

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Joint audits: a deeper analysis

Rod and Krish have identified some problems with joint audits. At the moment the definition of a joint audit is ill-defined. There are question of how the work is shared, the legal responsibility of each partner in the joint audit, and some insurance coverage considerations.

- a) The CMA do make exemptions possible³⁴:

Most FTSE 350 companies should be required to appoint joint auditors. The regulator should establish criteria on which companies should be exempted, covering the largest and most complex companies; companies with very simple, single-entity accounts such as investment trusts are also likely to need exemption from the requirement.

We think that within the FTSE 100 the complexity and the nature of the audit will be such that many of the challenger firms may not have the ability to be a junior partner. So exemptions may be asked for a much larger group of the larger companies than envisaged by the CMA. This may render joint audits unworkable for many of the FTSE 100.

- b) The first definition. Let's call one of the Big Four the senior partner with more than 50% of the audit fees, and one of the mid-tier challenger firms as the junior partner with more than 30% of the audit fees (the minimum recommended by the CMA). It could mean that the senior partner (one of the Big Four) sets the junior partner (a mid-tier challenger) specific tasks within the minimum of 30% fees split. However, the senior partner takes overall responsibility for the audit. In which case the senior partner (one of the Big Four) would have to check the junior partner's work in order to sign off the total audit. That means duplication – the Big Four checks the challenger firm's work. Meanwhile the challenger firm may have to understand and partially implement the Big Fours' audit work practice. Additional cost could be significant.

We would probably think that margins on audit should be raised in any case by at least 10% to 25%. Then the additional costs of duplication probably adds around 25% to 33% of additional cost. Then add the addition insurance costs and one can portray a scenario where audit fees basically double or more than double.

But the major point we make is that the responsibility for 'things going wrong' lies with the senior partner – one of the Big Four. That divide of the work, although problematic, may work with the disadvantages of additional costs (and we believe no improvement in audit quality at best)..

- c) Second definition. Or it could be defined and mean that both firms (the senior and the junior partner) jointly review and sign-off the audit. Perhaps a junior/senior split of the work is closer to a 50:50 split. In which case both firms take responsibility for the audit. That raises the question of liability and who checks the totality of the audit. Would the challenger firm really be able to have the force and authority to call of the Big Four to account? Then it has to be agreed as to how the senior partner or equal partner checks the other partner's work and then justifies the joint signing of the audit. This would seem operationally to be more problematic in practice.

³⁴ Op. Cit. CMA Final report 2019, Page 144,.

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Joint audits: a deeper analysis/Continued

In the third point, the smaller/junior partner, we think, might have trouble obtaining insurance cover. Rod is particularly worried that this raises major questions over insurance cover. A large excess might be charged and, 'if things go wrong', this might threaten the survival of the challenger firms – in cases such as Carillion or Patisserie Valerie³⁵. For the challenger firms the risk of undertaking audits for the FTSE 100 cannot be understated and the possible loss if a problem does arise. In either case insurance and audit liability are both going to be a problems. Such problems and the issues arising are going to need clarification and will be further discussed over the next few years.

Peer group review

Most of the critiques do not comment much on the **peer group review**. We think this is basically neutral. Undertaking the same auditing approach is unlikely to throw up much without undertaking the full evidence gathering approach. Forecasts and evaluating values are probably beyond the remit of the peer group reviewer. Ticking boxes is more likely and that was missed in all the recent failures. It is always a question of scepticism and undertaking an auditors own forecast and value calculations independent of that of management.

So we see no harm in this remedy but along it may not make much difference.

Recommendation 2 joint audits, peer reviews, and resilience/Continued

The CBI reported³⁶

The CMA's most controversial suggestion was that Britain's largest companies either run joint audits with a smaller accountancy firm alongside one of the Big Four or appoint a smaller firm as sole auditor.

The CBI said that forcing companies to introduce joint audits would "add cost and complexity for business with no guarantee of better outcomes".

The same Times article said³⁷:

Other groups also challenged the joint auditing proposal, including the Investment Association, which represents the interests of shareholders.

Continued

³⁵ Still under investigation.

³⁶ Op. Cit. Griffiths, K., 2019

³⁷ Ibid

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Measures to mitigate the effects of a Big Four failure

The second part of this recommendation concerns the ways to prevent or mitigate the failure of one of the Big Four. That said their solution is to adopt the same measure as for Arthur Andersen³⁸. That would see the Big Four become the Big Three. Not so good for choice.

The CMA asked Professor Bhaskar to comment on the Big Four resilience. 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).

Though others as outlined in our book [*Financial Failures & Scandals: From Enron to Carillion*] disagree. Especially in the US where auditors can be more easily sued. See for example³⁹. 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

³⁸ Which failed after the Enron scandal. The consulting division became Accenture.

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.

³⁹ 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.

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Recommendation 3 – an operational split between the audit and non-audit practices of the Big Four

The CMA in its Summary of the Final Report⁴⁰ explains:

As explained above, the multi-disciplinary structure of the firms creates two types of problems – a potential diminished focus on audit quality, and a reduction in choice and competition. The only way to remove both problems entirely would be to separate the firms’ audit practices from their non-audit practices – in practice forcing them to divest one side or the other. This was the route proposed by the BEIS Select Committee.⁴¹ If auditors’ only financial interest was in their audit practices, their focus on delivering good audits would be strengthened; and the absence of non-audit services-related conflicts would free more firms to compete in tenders.

The CMA goes on to discuss the problems of a full structural split – namely the international networks. We dealt with this in our book - *Disruption in the Audit Market: The Future of the Big Four*. We do not think it a problem. There are as before criticism of the proposed operational split as opposed to a full structural split.

Thompson and Thomas report⁴²:

“An operational rather than fully structural split of audit from non-audit services is wise as it allows the audit firms to have a chance to enhance audit quality without a major disruption of their activities. If this doesn’t work, stronger action may be necessary.”

The justification being:

...it was “absolutely critical for there to be less concentration in the audit market to provide market resilience should one or more fail and to enhance audit quality”.

He stressed that the board of an auditor should be “fully independent and accountable for the public service it provides”, and able to explain how remuneration structures and outcomes incentivised partners to put audit quality over profit.

Professor Sikka comments⁴³:

The CMA calls for an “operational split” of the big firms, that is, audit and non-audit arms need to be separated internally by Chinese walls. The idea is that this would somehow dissuade auditors from selling non-audit services to big corporations and reporting on the very transactions that they themselves have created. But this will not work: the lure of profits is too strong. Big firms claim to have Chinese walls to prevent their tax divisions from targeting their audit clients

for the sale of tax-avoidance schemes, but court cases have shown otherwise.

Continued

⁴⁰ CMA Summary report 2019. Page 15.

⁴¹ BEIS Select Committee, [The Future of Audit](#), 2 April 2019, paragraph 141.

⁴² Op. Cit, Thompson and Thomas, 2019. in a quote from Leon Kamhi, head of responsibility at Hermes Investment Management.

⁴³ Op. Cit. Professor Sikka 2019.

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Recommendation 3 – an operational split between the audit and non-audit practices of the Big Four/Continued

He goes on to question and to ask for a dismantling of the barriers for entry:

The CMA ... shies away from removing barriers to entry to that market: the government requires that all auditing firms need to be under the ownership and control of licensed auditors. This prevents technology and other companies from entering the market and challenging the big accounting firms' dominance. Despite a brief to promote competition and choice, the CMA has totally ignored the issues.

Licensed auditors

Rod and Krish in discussing Professor's Sikka critique came to the conclusion that this may be an important issue. We did argue this in detail in our book *Disruption in the Audit Market: The Future of the Big Four*. By licensing auditors to just three of the accounting professional bodies⁴⁴ may exclude some new IT and unicorn entrants. As such licensed auditors might be viewed as a restrictive practice. This is especially true as dark data, grey data and Big Data take over with high speed 5G and 6G allowing the IoT to flourish with many billions of devices connected via internet. AI and the use of smart intelligence may be the way forward - ultimately. It may be that the like of Microsoft, Alphabet and others who are the only parties with enough resources capable of developing a new generation of audit systems, and the ability to implement and run them. They may need adequate training and may need to take accounting body controlled exams, but they may not need to be formally part of a professional accounting association. This may prevent the advent of such companies joining the innovative audit process. Of course this sweeps under the carpet a whole plethora of issues but it is a thought worth pursuing and one that was ignored by the CMA.

Shah and Grimstone⁴⁵ have a slightly different viewpoint:

As for the operational split that the CMA recommends, we have already lived through the costly experience of the failure of such "Chinese walls" in banking. Why should we still believe they can and will work here?

The heart of the audit problem is that the Big Four have highly commercial cultures, which will not be transformed if they continue to operate as one firm. As an example, if audit partners continue to profit from their consultancy arms, can their judgment and reporting be truly independent and robust when both sides are selling services to the same large companies? Furthermore, how can society rely on their timely and trenchant challenge of excessive risk-taking by those corporations?

We are not sure about the operational versus the full structural split. To us it seems like a spectrum and the operational split falling some way along towards full structural split. The devil will be in the detail and any monitoring.

⁴⁴ ICAEW, ACCA and CIPFA.

⁴⁵ Op. Cit. Shah and Grimstone 2019.

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Recommendation 4 – a five-year review of progress by the new regulator

The CMA summary report explains this recommendation⁴⁶:

This review should examine the effectiveness of the remedies. It should return to the following questions in particular:

- a) The merits of moving to independent appointment of auditors, depending on the effectiveness of the regulatory scrutiny of Audit Committees.
- b) The possible need for a structural split between audit and non-audit services, depending on the effectiveness of the operational split, as well as on the level of international engagement in this question.
- c) Joint audit will almost certainly take longer than five years to bring the desired effects, but the regulator should consider how to fine-tune the remedy to adapt to market developments, to the extent it has not already done so.

We have no quarrel with this recommendation. It is a sensible review process.

Competition and in the audit market

The Final Report made the following point⁴⁷:

A second condition for the audit market to work effectively is that there is sufficient choice between auditors available to Audit Committees to drive effective competition. All things being equal, the more choice that Audit Committees have in selecting their auditor, the stronger competition will be. In turn we would expect this to drive better market outcomes, including higher audit quality, under the right regulatory framework.

Deloitte, KPMG and PwC claim that there is little direct evidence of competition and choice as drivers of audit quality⁴⁸. The CMA report also casts doubt on the academic research that provides evidence on the link between competition and audit quality claiming it is relatively limited. They also claim that this reflects the difficulties in measuring audit quality on a consistent basis⁴⁹.

Our computer simulation studies show that for the FTSE 100 and FTSE 250 there is a wide range of assumptions where there is limited choice. The tendering process and mandatory rotation, and the ban of non-audit work for audit clients all makes the choice more limited. The CMA both agrees and disagrees.

Continued

⁴⁶ CMA Summary report 2019. Pages 17-18

⁴⁷ CMA Final report 2019. Page 76. Paragraph 3.82

⁴⁸ CMA Final report 2019. Page 79. Paragraph 3.95

⁴⁹ Ibid

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Competition and in the audit market/Continued

Our axiom 3 from the book *Disruption in the Audit Market: The Future of the Big Four* is together with some (but not all) of our evidence:

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 misinterpreted⁵⁰.

⁵⁰ 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 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>

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_fac

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Competition and in the audit market/Continued

Despite the CMA conclusions, we stand by our axiom as it pertains to the 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.

The CMA collected their own evidence from a sample of 35 FTSE 350 companies with 24 responses. They also collected evidence from the audit firms. The CMA concluded that:

For competition to be effective in driving quality, there must be some degree of choice open to audit committees. Our evidence suggests that, for the majority of FTSE 350 audit tenders, audit committees were content with the level of choice⁵¹. However, for a substantial minority choice was limited⁵².

This was then qualified by the CMA. We think that the CMA has mistakenly drawn the wrong conclusions from the evidence:

Based on the information provided by the audit firms, we found that around 25% of the 250 FTSE 350 tenders in our dataset had fewer than three competing bidders. This was consistent with analysis submitted by KPMG⁵³.

This is the first area where the result is biased. The FTSE 100 has an entirely different set of choices from the FTSE 250 where the challenger firms have a small but significant market share. Perhaps we should have emphasized in our simulations that it is necessary to stratify the results.

The CMA concluded:

Evidence from the sample of companies we spoke to was also consistent with the data provided by the audit firms. The majority of companies said they felt that they had sufficient choice of auditor. However, for five of the 24 FTSE 350 companies that were asked to provide information on their recent tender, choice appears to have been limited to two firms. These examples illustrate the circumstances in which choice might be limited⁵⁴.

First this conclusion would be radically different if the CMA had stratified this result between the FTSE 100 and FTSE 250. Even the CMA noted⁵⁵:

[ulty](#)

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>

⁵¹ Based on responses provided by the sample of 24 FTSE 350 companies and from meetings with ACCs.

⁵² CMA Final report. Pages 80-81. Paragraph 3.100

⁵³ CMA Final report. Page 81. Paragraph 3.103

⁵⁴ CMA Final report 2019. Page 81. Paragraph 3.104

⁵⁵ CMA Final report 2019. Page 81. Paragraph 3.101

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Competition and in the audit market/Continued

We have been told by ACCs that a choice between three bidders is generally sufficient to ensure a competitive tender. For example,said that ‘a maximum of three firms was in line with [its] desire to execute a streamlined, efficient tender process without impacting choice or quality’. One FTSE 100 ACC noted that ‘companies needed two bidders to provide valid choice in a tender process and that three bidders would be quite sufficient to provide valid choice in a tender process’. However, more generally, ACCs have expressed concern where choice is limited to two credible bidders. The FRC guidelines state that a typical tender process should involve three or four audit firms.

Most FTSE 100 have at least one of the Big Four as an auditor. Then they have at least another one of the Big Four on several consulting projects. Many of the FTSE 100 will employ two of the Big Four on consultancy projects. So even if there is only one that they need to continue with a consultancy project, and they want one of the Big Four (mainly for size, experience, and shareholder opinion), that still leaves a choice of two (the outgoing auditor who would be one of the Big Four, and the ongoing IT project conducted by another one of the Big Four). That said, in a number of FTSE 100 cases, there will be a long term IT project conducted by one of the Big Four and a another project enduring over a number of years. In that case there is a choice of just one of the Big Four.

In some cases we found that one of the challenger firms were asked to tender just to make up the numbers with no real intention of the mid-tier firms being appointed. The CMA also confirmed that in some cases some of the firms being invited to attend declined to tender due to ‘being unable to confirm their independence under the new EU directive on audit independence’⁵⁶.

So we stand by the results of our simulation studies. Separation of audit and non-audit increases choice if there is a full split. However, the big increase in choice is if you split the audit division of each of the Big Four into eight competing audit firms. Then the difference in size between the mid-tier challenger also become smaller. The increase in choice to each of the FTSE 100 increases by at least 100% under a wide variety of assumptions.

The CMA classify the bigger challenger firms, after the current round of mergers, as BDO and GT (the two biggest) and Mazars, Moore Stephens, and RSM

Continued

⁵⁶ CMA Final report 2019. Page 81. Paragraph 3.101

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Selection process for audit tenders

There is one other area that we found our data was in sharp contrast to that found by the CMA. This is in the selection process of audit tenders and the criteria used. We go into detail in *Disruption in the Audit Market: The Future of the Big Four*. Here we just note our differences and where we concur:

- 1) We agree that price is not important in short-listing the tender process. Though we did find some haggling over price once the selection has been made. We also found that this pricing reduction was reclaimed in the second year of the audit.
- 2) Audit quality: this we found was difficult to judge. All of the Big Four, when tendering, represent and portray the highest standards. So it is difficult to judge differences in audit quality in what is seen as very similar processes. One fact is that KPMG was judged the poorest in audit quality during 2018 yet it increased its share of the large audit market in 2019. So ostensibly, previous history of audit quality has little impact. What is more important is what is promised in the future.
- 3) Another area of difference is the final decision making. Audit committees were outflanked by the CEO, CFO and the ACCs. Often it was the CEO and/or the CFO who took the final decision. That at least was our evidence.
- 4) The CMA disagreed with our evidence in that we found ‘personal chemistry’, ‘easy to work with’, ‘cosiness’, ‘cultural fit’ and so on to be one of the most important criteria between the audit team and the appropriate management team in the selection process. The CMA correctly said that such criteria raise concerns around independence of the auditor⁵⁷.

Continued

⁵⁷ CMA Final report 2019. Page 63. Paragraph 3.27

Update and comments on the CMA Final Report April/May 2019

Statutory audit services market study

Disruption to the Audit Market: The Future of the Big Four. Routledge. 2019.

By Professor Krish Bhaskar, Professor John Flower with contributions from Rod Sellers.

Overall assessment of the CMA Final Report

The CMA collected and amassed an enormous amount of data which is very useful. It analysed much of this correctly. Where we disagree it is because of bias in the data sets collected or misinterpretation, partly because they were swamped by submissions from interest parties.

On the remedies and recommendations, we applaud the fact that the CMA change their mind and went for an operational split. But they may not have gone far enough. We maintain that the audit committee and joint audit indicatives will be largely ineffective. The joint audit is the most worrying in that it can cause confusion and obfuscation. It may also be harmful to audit quality as well as adding incremental cost.

Overall there are some other viewpoints:

Suren Thiru, head of economics at the British Chambers of Commerce, said there was support for improvements to the audit industry. But, he added, government and regulators “must tread carefully to avoid unintended consequences, including adding to the unrelenting cost burden on business and undermining the UK’s hard-fought reputation across the world as a great place to do business”⁵⁸.

Also:

This is the third unsuccessful attempt by the UK’s competition authorities to tackle the dysfunctional auditing industry. Under the weight of lobbying and political interventions, previous reports in 2006 and 2013 shelved the long overdue reforms. Now, despite a stream of audit failures, meaningful reforms are once again being taken off the agenda. It is time to ask whether the CMA itself is fit for purpose⁵⁹.

Finally Professor Shah has the strongest observation⁶⁰:

The heart of the problem rests with the Big Four accounting firms — KPMG, Deloitte, EY and PwC — and their near total dominance of the auditing of FTSE 350 companies. In my view, research by Prem Sikka, professor of accounting at Sheffield university, and others shows that they are neither professional nor independent and, instead of policing corporate conduct, they have been doing exactly the opposite and have made it easier for multinational corporations to rip off governments, taxpayers, the environment and society.

But the recommendations have shown the CMA is spineless and captured. The watchdog recommends requiring large companies to hire two auditors, including one firm that is not in the Big Four; seeks to strengthen the role of audit committees; and sets up greater oversight of the audit process. It also recommends that firms be split operationally between audit and consulting to reduce conflicts of interest.

⁵⁸ Op. Cit. Thompson and Thomas 2019

⁵⁹ Op. Cit. Professor Sikka 2019.

⁶⁰ Op. Cit. Shah and Grimstone 2019.

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Overall assessment of the CMA Final Report/Continued

What is surprising is that the Big Four have reacted so strongly against the splitting of the audit and consulting divisions. The Daily telegraph, for example headlines “Big Four vent fury at watchdog's plan to split audit and consulting divisions”⁶¹. Something that three of the Big Four had said they would do so voluntarily (Deloitte was the odd one out). Obviously this fury must have meant that this was intended more as a cosmetic split and not a real operational or structural split – we hypothesise.

However, KPMG, seems to have softened its view. Despite its earlier issues, KPMG has shown to be the one firm of the Big Four that has exhibited the desire to change more⁶²:

Notably, “Big Four” member KPMG welcomed “many aspects” of the Competition and Markets Authority’s final recommendations published on Thursday, in particular that firms should do more to separate their audit and consulting services. It said it recognised the need “to rebuild public trust in our sector”.

The last word before more reports are released goes to Michael Izza again⁶³:

Michael Izza, ICAEW chief executive, said, “While we support the CMA’s focus on reinforcing the independence of auditors, we are now concerned that some of the measures they propose could prove counter-productive, pushing up costs for businesses and consumers while doing little to improve quality or increase choice. For example, we question the CMA’s confidence that mandatory joint audit with joint liability will make the market more resilient. As proposed, this looks like a very complex intervention, and there is a high risk that it could both drive out incumbents and discourage new entrants. We have long argued that a segmented market share cap would be a better and faster way of extending competition.

“The CMA’s report does contain a number of other ideas which are realistic and pragmatic, and do go to the heart of rebuilding trust in audit. These will need to integrate with the outcomes of the Kingman and Brydon reviews to deliver a comprehensive and coherent programme of reform. We look forward to working with all parties to produce effective recommendations for regulation and legislation which will ensure that audit meets the future needs of the British economy and wider society.”

⁶¹ Burton, L., 2019, Big Four vent fury at watchdog's plan to split audit and consulting divisions, Daily Telegraph. 18 April 2019.

Available at:

<https://www.telegraph.co.uk/business/2019/04/18/big-four-vent-fury-watchdogs-plan-split-audit-consulting-divisions/>

Accessed April 2019.

⁶² Thompson, B., 2019, KPMG softens opposition to planned audit market reforms, *Financial Times*, 18 April 2019.

Available at:

<https://www.ft.com/content/774f6534-6135-11e9-a27a-fdd51850994c>

Accessed April 2019.

⁶³ Doherty, R., CMA proposes radical reshaping of UK audit, *Economia*, 18 April 2019