Statutory Audit Market Study
Competition and Markets Authority
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[redacted]

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Dear Sirs

Statutory Audit Market Study

I am a member of the Institute of Chartered Accountants in Scotland and am a former audit partner in Grant Thornton and, previously, KPMG. I retired from the accounting profession at the end of June 2017 having spent my career largely in statutory audit.

I very much welcome the Competition and Markets Authority's study of the audit market and I hope that the study will deliver results which are successful in taking the auditing market forward and towards rebuilding confidence in the service.

I look forward to reading the outputs from the study and I have enclosed my personal observations and responses in the meantime.

Yours faithfully

[redacted]

David F Miller BA CA

A) Issues

1. How well is the audit sector as a whole serving its stakeholders?

Undoubtedly, there are issues in the audit sector which need addressing and which may need reform. There have been numerous corporate failures and financial reporting frauds or material errors over the last decade. Of course, financial and corporate reporting failures did occur before the financial meltdown in the period around 2008 but there have been a number of highly significant cases in the period since that date. Many of these, unfortunately, went un-noticed or unreported by the statutory auditors and the audit committees of the relevant entities.

It is inevitable that there will be corporate failures and, on some occasions, there may be fraud which is collusive and therefore unlikely to be discovered through normal statutory audit procedures. However, there have been numerous cases where the going concern basis of financial reporting has been proven to be incorrect or there have been highly material errors or frauds in the financial statements. It therefore can only be concluded that statutory audit is currently not fully meeting its stakeholders' requirements.

This view is supported by the frequent reports in the financial media of a loss in confidence in financial reporting, statutory audit and in audit committees and non-executive directors. There is a need for change to begin to restore confidence in this critical market and service.

Theme 1: The audit framework

2. How well does the audit framework support the interests of both direct shareholders and also wider stakeholders in the economy?

The audit framework is driven largely by International Auditing Standards which are, in my view, comprehensive and clear. The Financial Reporting regulators across the Globe review the quality of the audit work in the context of the auditing standards and report their findings based on whether the audit work is carried out in accordance with those standards. There are occasions where the FRC may interpret standards in a slightly different manner from the interpretation of firms and therefore practice may evolve over time to reflect the interpretation of the FRC alongside the standards themselves. On the whole, auditing standards are fit for purpose and are a robust and solid base for professional and high quality auditing.

The International Financial Reporting Standards ("IFRS"), by way of contrast, are complex, rules based and lead to the use of fair value accounting in many areas of corporate balance sheets. It is frequently commented by users of annual reports (including experts) that these are now incomprehensible and lack clear reporting of the critical performance measures of business such as cash generation and cash resources for the future. It is increasingly difficult for experienced practitioners to exercise professional judgement and make clear disclosures on those judgements. It is likely that the complexity and lack of clarity in reporting arising from IFRS has been a contributory factor to failures in corporate reporting and in auditing.

An example is in the treatment of Goodwill arising on acquisitions, Under IFRS Goodwill arising on acquisitions is generally capitalised onto the balance sheet as an Intangible Asset and then subject to annual impairment reviews. The FRC has made it known for many years that this is an area of interest for the inspections of audit firms and therefore auditors may expend a disproportionate amount of time reviewing management's forecasts of future business performance to support the continued carrying of the asset. This may distract attention from other areas of the audit which are, in fact, more critical and riskier by nature. Given the nature of business and the fast changing climate in which global businesses operate, this is crystal ball gazing in all but name. It is noteworthy that many of the businesses which have collapsed in recent years have reported balance sheets which are replete with goodwill and other intangible assets and which were therefore most likely carried at overstated amounts. It is difficult for management to produce solid and reliable business forecasts to support goodwill and therefore, by its very nature, it is almost impossible to audit to the level of comfort one would want for reporting as an asset in the financial statements.

I believe a further question on goodwill is about whether it is an asset at all. It is evident that most goodwill arises from the excess paid by management over the net assets acquired when they buy businesses. Highly acquisitive companies therefore have very substantial amounts of goodwill and other intangibles on their balance sheets (Carillion being a clear example) and this tends to cloud the issue of the worth of the company in balance sheet terms. Another perhaps pessimistic way to look at goodwill might be that goodwill is how much has been overpaid to acquire a business and the amount which needs to be funded in the future to justify the cost. This does not feel like an asset for balance sheet reporting but has been treated as such under IFRS. The treatment is controversial at best.

Other key measures such as net current assets are not immediately highlighted in IFRS balance sheets and, in the case of Carillion, these were in fact net current liabilities which can be an indicator of financial weakness and which, at the very least, would merit proper explanation in the context of funding and going concern.

In my view, there is a need for a major overhaul of IFRS, including the treatment of goodwill and, indeed, of the use of fair value reporting in so many areas. I do not believe IFRS is fit for purpose and I believe there is a strong groundswell of opinion confirming this view. I believe audit focus is diverted as a result of the complexity of IFRS and I do not believe the best use of resources is being made as a result.

Theme 2: Incentives and governance

3. To what extent do the decisions made by audit committees support high quality audits, whether through competition for audit engagements or otherwise?

Audit committees are, by their nature, made up of directors of other large corporate entities either present or past. It is arguable that they are not truly independent as they are appointed by management of the company with little reference to shareholders except for reappointments which are normally a formality.

Audit committees are involved in setting the scope and agreeing the fees and reports of the auditors but there is almost certainly a lack of true independence. It would be interesting to note from case history in recent years to what extent audit committees have supported the auditors in difficult discussion with management on accounting judgements including the carrying of goodwill and income recognition.

My own view is that audit committees are still not sufficiently robust and independent. I believe that, in order to improve independence, the appointment and remuneration of those on audit committees needs to be carried out through a body which is independent of management.

4. How has this changed following the Competition Commission's intervention?

The changes which have resulted from the previous intervention have resulted in more tendering of audits and, indeed, in more changes of auditors. This is probably a step forward but the issue remains that the market is obsessed with "the big 4". In my view the term "big 4" should not be used or appear in the reports of any regulator or documents of government bodies as its very nature is anti-competitive and akin to an alternative brand.

The tendering of audits has resulted in a reshuffling of the pack of large corporate audits amongst the giant firms but has not opened the market to new participants. In fact, Grant Thornton disappointingly removed itself from that market very recently having previously been pushing very hard for the market to be opened up to it and other mid-tier firms.

Theme 3: Choice and switching

5. Is competition in the audit market working well? If not, what are the key aspects hindering it?

Competition is clearly not working well from the perspective of the market needing to deliver reliable and high quality audits and from only considering there to be four serious contenders. There have been too many failures and quality remains an area of concern. The most recent findings of the FRC on the inspection of the major audit firms confirms that view. There are too few players (perceived or actual) in the market to deliver a properly competitive market. There is undoubtedly competition on pricing but the market is most probably not competitive in delivering the required quality.

6. In particular, how effective is competition between the Big Four and between other firms and the Big Four?

See comments above. I do not believe there is much competition outside the giant firms for audits in the large corporate sector in the UK. There is also significant bias in those involved in audit committees towards the giant firms and this almost precludes other firms from winning work in the sector. The often mentioned expression of "whoever got blamed for selecting IBM" still prevails in the selection of audit firms.

7. How has this changed following the Competition Commission's intervention?

See comments above.

8. What is the role for competition in the provision of audit services in delivering better outcomes (i.e. consistently higher quality audits)?

This is a complex question and, in my view, delivering better quality depends to some extent in changing the corporate reporting environment and making substantial changes to IFRS. Auditors are focusing significant amounts of time on the crystal ball gazing numbers in accounts and are probably missing some of the more basic and essential areas of focus as a result.

There are also issues about the structure of audit firms and about the composition of audit teams which need to be considered. For instance, does it really make sense that the majority of those involved in audit fieldwork are trainees or near qualified accountants? If we want audits to detect management fraud, errors or manipulation of results does a new model needs to be contemplated, with all of the structural and pricing implications this would bring. This is probably another topic but I sense is one which is worthy of consideration for the long term improvement of audit.

In the ideal world, competition would be a factor in driving quality but I sense the competition to date has largely been about pricing and perhaps a perception of quality but it is very difficult for audit committees to get beneath the surface to understand how to judge quality.

9. In practice, how much choice do large companies and public interest entities have in the appointment of an external auditor?

See comments above. There is a perceived lack of choice and a natural inclination for audit committees to continue to select the giant firms. They continue to judge any decision to appoint a firm other than one of the giant firms as a risk and one which could be counted against them if there is a reporting problem.

In some cases, the choice is not even across all of the giant firms and certain markets may have fewer than four very large players or conflicts of interest may prohibit one or more of the firms. This is a very major issue for the large corporate market.

10. What are the key factors limiting choice between auditors?

See comments above.

11. What are the main barriers to entry and expansion for non-Big Four audit firms?

The barriers to entry are both perceived and real. There is a perception that audit committees and Finance Directors of large corporates are obsessed with appointing giant firms and therefore the chances of success are limited and not sufficient to pursue the market opportunity.

There is a perception that firms outside the giant firms do not have the international reach to service the largest corporates. This may be true for some but for many large corporates there are firms with major international networks which could deliver the service.

Audit pricing has probably fallen significantly in real terms over the last decade and it is likely also that it is difficult to justify the investment for uncertain returns in the large corporate market.

The attractiveness of the auditing profession is also a matter which needs to be contemplated. Audit is a highly regulated sector and, taking a role in auditing the larger public entities, puts auditors into the public eye (being named on audit reports for example). There are comments frequently in the auditing firms that staff do not see the attractiveness of taking on the role of the Responsible Individual and this is a real threat to quality in the medium to longer term.

Theme 4: Resilience

12. Is there a significant risk that the audit market is not resilient? If so, why?

This has to be considered to be a significant risk. Four players in a market with no clear challenger emerging cannot be satisfactory. No firm can be considered to be too big to fail and yet there is a perception that this may be the case.

Some of the failures in recent years have been pursued extensively by the FRC and others but other failures seem to have dropped out or fallen off the radar screen. For example, how it is possible that no audit firm has been taken to task over the bank failures and the fact that they could not have been going concerns when the financial statements and audit reports were published. How can it be the case that there was insufficient evidence to pursue the auditors of Tesco when it was clear there was a material financial reporting fraud which cost shareholders many millions?

At the same time as failing to pursue those high profile cases (always involving one of the giant firms), the FRC has pursued other cases where I believe there has been no loss to shareholders or to other stakeholders. This seems like an uneven use of resources and an inconsistent approach to pursuing the public interest.

These failures to pursue and the speed at which investigations are carried out and concluded have undermined the credibility of the FRC as a regulator and no doubt will be topics for the current review of the FRC and its future.

Theme 5: Regulation

13. What is the appropriate balance between regulation and competition in this market?

Ultimately, accountancy and auditing are a professional activity and therefore the standard demanded is that of professionals. However, regulation is required to give assurance that high professional standards are being maintained. Competition should have a role but the lack of players in the market and the lack of criteria on which audit committees presently are able to judge auditors put competition in a weak second place. Regulation is therefore likely to be the key driver of quality for the foreseeable future.

B) Potential measures

14. Please comment on the costs and benefits of each of the measures in Section 4 and how each measure could be implemented.

See comments below

15. Are there any other measures that we should consider that address the issues highlighted in section 3? If so, please describe the following: a) aim of the measure, b) how it could be designed and implemented, and c) the costs and benefits of each such measure.

See comments below.

Restrictions on audit firms providing non-audit services

16. One way to create audit-only firms would be through separate ownership of the audit and non-audit services practices of the UK audit firms. Could this be effective, and what would be the relative scale of benefits and costs?

This has long been cited as a possible solution. However, the audit firms would counter this with the argument that audit only firms would be less likely to attract and retain the highest calibre of staff required for audit. There is probably a degree of truth in this as the audit market currently stands but, as indicated above, there is a need to consider the structure of firms and the composition of audit teams to ensure that these are sufficient for the complexity of businesses being audited and to include the experience required to be robust and truly independent.

I cannot comment on the costs but I do believe that there will have to be a market price adjustment to audit costs if there is a genuine desire for improvement and to attract new participants.

17. How do the international affiliations of member firms affect the creation of audit only firms? What is the extent of common ownership of audit firms at the international level?

This is a major barrier to such fundamental change. The structure of firms would need to be looked at on a territory by territory basis and it is unlikely that one global solution would be available.

18. What should be the scope of any measures restricting the provision of non audit services? For example, applying to the Big Four only, the Big Four and the mid-tier audit firms, or any firm that tenders for the audits of large companies and PIEs?

I do not believe that the provision of non-audit services is a major problem now as there are many restrictions on these. The greater concern is probably about independence and robustness of audit firms in taking a sufficiently robust stance with management.

Market share cap

19. How should the market shares be measured? - number of companies audited, or audit fees or some other measure?

I am not able to comment on this proposal.

20. Could the potential benefits (greater choice, and resilience) of a marketshare cap be realised?

I am not sure that a market share cap would deliver greater quality. A greater number of players in the market would probably help to drive quality but that quality would need to be capable of identification and measurement which would probably require a new way of appointing and measuring audit performance.

21. What do you consider to be the relative scale of the costs of a market sharecap, such as increased prices and potentially reduced competition, and potential benefits?

I am not able to comment on this proposal.

22. What should be the appropriate level of such a cap, collectively for the Big Four for the measure to achieve its objective? For example, 90%, 80%, 70%?

I am not able to comment on this proposal.

23. Could a joint audit be an effective means of implementing a market sharecap?

I do not believe that joint audits would lead to an improvement in audit quality and, in fact, may be counterproductive. My view is that it is important that responsibility for audit is clearly defined and joint audits would reduce such clarity.

Incentives and governance

24. Should the auditors and those that manage them (e.g. audit committees, or an independent body as described in section 4) be accountable to a wider range of stakeholders including shareholders, pension fund trustees, employees, and creditors, rather than the current focus on shareholders?

I believe this is an area which deserves due attention and consideration. There is a perception that there is a lack of independence and that auditors are too closely aligned with management. This is evident even in conversations when audit team members will describe the management of the company as "the client" forgetting that the client is the shareholder base.

In my experience over many years in audit, when there is a major disagreement with management on an accounting treatment, level of provisioning or valuation of an asset, there is frequently a change of Responsible Individual or audit firm shortly after such a disagreement. This may be a deterrent to audit firms taking the robust position required of them.

I also believe that audit committees are not sufficiently independent to be able to make the robust challenges of management which are required on the key areas of judgement in financial statements. It was my experience in such situations that audit committees would, in the vast majority of cases, side with management in concluding matters of contention.

Independence in terms of selection, remuneration and reporting lines on audit is vital to audit quality, both perceived and real, and I believe change is required in this area to allay concerns and, hopefully, provide audit firms with greater, independent support.

25. If yes, should audit committees (in their current form) be replaced by an independent body that would have a 'public interest' duty, including for large privately-owned companies? Should this body be responsible for selecting the audit firm, managing the scope of the audit, setting the audit fees and managing the performance of the audit firms?

Ideally audit committees and their activities should be reformed at the same time as appointment and remuneration of auditors. Audit committees are generally comprised of past or present directors of large corporate entities and are appointed by management. I believe there are questions about the degree of independence of audit committees arising from several of the recent high profile cases.

The independence question on auditors is equally relevant to audit committees and therefore by reforming both, there would be a perceived or real greater degree of independence.

26. Please describe the benefits, risks and costs of such an independent body replacing audit committees.

I would prefer to see reformed audit committees with a much greater degree of independence than a fully independent body but I do support the consideration of both alternatives.

27. Should companies be required to tender their audits and rotate their auditors with greater frequency than they currently are required to do? What would be the costs and benefits of this?

I think there is now sufficient audit tendering. The need is for more market participants to help drive quality and competition. The alternative is the less desirable move to a NAO style body assuming the role. This would be unlikely to deliver the quality required in the longer term but there could be a role for a NAO style body being introduced to provide competition on quality.