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Statutory Audit Market Study  
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## **Dear Sirs**

I am James Michael Deakin, a life member of the Institute of Chartered Accountants in England & Wales, a Fellow of the Institute of Management (Chartered Management Consultant), and a former Fellow of the Association of Corporate Treasurers. I also hold the academic qualification BA(Com)(Distinction) (University of Manchester)

My 50 years of experience as an adviser in Commercial Risk Identification and Assessment has included risk identification, risk management structures and processes, risk measurement and monitoring and risk mitigation. I have managed projects with and on behalf of UK Corporates; UK Banks; Government departments (British & Commonwealth Office); Governments of UK Overseas Territories; Sovereign Investment Funds; Global Investment Managers & Corporate Finance Due Diligence.

This response to the CMA's Update Paper is made in my personal capacity, and does not reflect the views of my past employers or clients.

## **Scope and Objectives of the Consultation**

- 1.** It appears that the Competition & Markets Authority ("the Authority") has conducted a Consultation that lacks defining Terms of Reference or a Scoping Statement. Such a fundamental flaw is alarming, as it reduces the potential for industry consensus on agreed key issues, which diminishes the value of thoughtful contributions by interested parties.
- 2.** In the Update Paper and Appendix C, the Authority acknowledges the breadth of issues that respondents addressed, and notes a shortfall of core expertise. Against this admission, it seems inappropriate for the Authority to hazard "remedies" to "improve" the working of an ephemeral market.
- 3.** In the absence of disciplining scope, each respondent appears to have aired its own vested interests on any broad topic that could fall under a general heading "audited statutory accounts"

4. The resulting Update Paper (& its Appendices) is an interesting tour through many historically obvious and some less-known foothills of a long-established chimera.
5. The following paragraphs are offered to illuminate fundamental issues; to separate contribution from institutional hubris & ambition and to recommend a disciplined approach to serving a needful “wider public”.

### **Context of the Market for Statutory Audit Services**

6. The Statutory Audit Services Market Study Update paper, published 18 December 2018, states (at para 2)

*“Independent audits should ensure that company information can be trusted; they provide a service which is essential to shareholders and also serves the wider public interest”*

This statement misleads the wider public.

7. It seems essential that consideration of the nature and use of statutory audit services should be set on a secure base.
8. A “company” is a statutory legal construct, historically based on a Joint Stock company approach that can be traced to the Song Dynasty in China (c.960 – 1279). The legal construct has a continuous development in England from 1553. A “company” is a legally independent entity, which can incur legal liabilities & has legally enforceable rights.
9. The conduct of a “company” is the legal responsibility of its “directors”, who are accountable to their shareholders. The identification and duties of “directors” are specified from time to time by Companies Acts and statutory instruments. Additionally, all directors have legal rights and obligations that apply to any member of the public.
10. “Financial records” must be maintained by all “companies”. Formal codification of financial recording for companies in England was led by professional accountancy bodies, from c. 1750, due to development of financial record keeping for the growing number & size of companies during the “Industrial Revolution”. Various UK accountancy bodies cooperated from c.1976 to create a common rule book, of increasing complexity & size, leading eventually to the introduction of the first common accounting standards in April 1980 (following a two-year consultative period).
11. “Statutory audit” is relatively recent legal construct: the practice of audit was introduced in England in the Middle Ages, possibly based in land agent aural reviews of tenancy stewardship. Until 2004, “statutory audit” referred to a statutory requirement for a “company” to have its published financial records audited, & did not refer to a specific process.
12. In 2004 the Auditing Practices Board (a company, initially a committee of the Consultative Committee of Accountancy Bodies) issued standards for use in all UK company audits from 15 December 2004.

13. The 2004 standards were replaced by International Standards on Auditing - developed by the International Accounting & Auditing Standards Board, an independent rule-setting body.
14. The audit standards currently in force were issued through the Auditing Practices Board, now part of the FRC, which is funded by the accountancy profession and accountable to the Secretary of State for Business, Energy & Industrial Strategy. They apply from 15 December 2010.

### **Observations**

15. The market for statutory audit services is based on a long-established and incrementally- developed body of law and regulation, which certifies the accuracy and completeness of a company's financial records within narrowly specified rules (*emphasis added*)
16. The quality of "financial records" & "audit" is such that they have become accepted as a factual basis for levying tax, measuring size, and holding accountable, as well as being included as metric input to complex economic events such as lending and stock trading.
17. The rules framework relates only to an auditor's duty when reporting to the shareholders of the audited company. The limitations to the context of financial reports and audit certification are clearly set out in specific wording, which is included in all published accounts.
18. There is no obligation to a "wider public interest". The Authority misleads a "wider public" by indicating that - other than as reports to a company's members (shareholders) - reliance on audited accounts may be justified or reasonable.

### **Limitations of Financial Accounts**

19. The statutory & professional standards base for financial accounting and auditing is large and complex. As a result, published annual accounts - more frequently presented in summarised forms - have been adopted as the source of data for key commercial activities beyond the investor / shareholder / director accountability relationship that is their priority objective. These additional relationships expose the output of the service to uses where rules-based certification of financial accuracy and completeness is inadequate or inappropriate.
20. Significantly, financial accounts focus on the historic financial transactions of a "company" over an identified period and measure their impact as at a specified date. Preparers and auditors are not required to address or certify non-financial transactions, nor transactions outside the dates specified.
21. The operating "management structure" of a commercial enterprise need not (and frequently does not) mirror its legal "company" form(s). Separate bodies of law and regulation deal with these non-financial matters under general descriptions such as "governance", "market conduct", "employment", "health & safety", "building regulation", and many others; each of which has its own accountability structures and reporting.

22. Operating reports (sometimes referred to as “management accounts”) are used by most directors to monitor the day to day affairs of a commercial enterprise. There are no standards for the keeping of such records, which lie outside statutory review. Such records may include non-financial metrics that the “directors” use to manage key risks effectively. There is no requirement for “directors” to reconcile “management accounting” records with financial accounting records, and the company’s “statutory audit” has no duties to review or report on such management records

### **Observations**

23. The Authority may feel that it is appropriate to assist the wider public to realise the fundamentally limited scope of statutory audited accounts, and may wish to encourage adoption of more appropriate reporting vehicles and metrics from a wider regulatory universe.
24. It is of the essence of financial accounts that they are a limited retrospective of financial transactions. Not only is this a “rear-view mirror”: in the real world of multiple risks, it is a fatally limited rear view
25. The Authority may wish to advise the “wider public” that looking in the direction of travel is an essential aspect of a controlled journey.
26. The Authority may also agree that changes to the design of a rear-view mirror, and to the way in which rear-view mirrors are procured, can never be an adequate substitute for looking vigilantly in the direction of travel.

### **Impact of Carillion**

27. It appears that the current Consultation was triggered by parliamentary and public media reviews of the failure of the Carillion group of companies.
28. The usefulness of Carillion plc’s published financial accounts can be compared to the usefulness of a report describing a 12-month long journey - undertaken by a group of more than 300 vehicles (“companies”), which had at least 169 individual drivers (“directors”) - derived exclusively from a list of credit card receipts that were collected along the way (“financial records”). All delivered after the convoy has moved on for a further three months.
29. Such a report might contain useful information: it might reveal where & when fuel was purchased, which could be used to extrapolate a route taken. The drivers could be asked to confirm that they had visited those places, and even be asked to identify where they were at the end of the period, and whether they intended to continue moving on. Closer perusal of the credit card receipts might indicate whether the drivers had been compliant with traffic laws, through the presence or absence of payments to enforcement authorities. In fact, the report might generate confidence that a purposeful journey had been completed.
30. But it would not confirm that the journey had been more than a peregrination between two points over a limited period: it would not be any guide to the efficiency or purpose of the journey undertaken, nor to the journey that the

vehicles were on currently. And it would be necessarily silent as to the beneficial or destructive impact of the convoy's journey on the roads and communities that it had passed. Perusal of past financial records could offer no intelligence as to the current or future condition of the 300 vehicles, nor of the drivers' quality.

31. It seems clear that no matter how closely the credit card receipts list was examined, nor by whom: the report of old credit card receipts would be fundamentally useless for predicting the quality of the completed journey, or of the destination, purpose or safety of any ongoing or future journey.

### **The Dog That Didn't Bark**

32. It appears that many of Carillion's customers & suppliers may have acquired credit exposures through acquisition of long-standing independent companies by Carillion during its period of rapid expansion. As a result, any due diligence that they completed at tendering or contract finalisation stages was overtaken by imposition of the aggressive income recognition & profit booking of the new Carillion group management. Such a pattern of short-term profit realisation by close reinterpretation of contractual obligations, followed by aggressive identification and pricing of "variations" has been a feature of short-lived "supermanagements" in the past.
33. It is difficult to identify increased "market consolidation" risk, and to assess the impact of changes in management policies following ownership change. While use of an acquiring group's consolidated financial statements may play a part, typically "new group" accounts contain high value one-off adjustments (such as changes in accounting dates and accounting principles, including, but not limited to, goodwill accounting), which make the data even less useful as a basis for assessing future risk exposures.
34. The Authority may wish to contribute further to the "wider public interest" by considering whether its Competition & Markets remit includes awareness of "consolidation" risk when company expansion increases the concentration of supply- or demand-side exposures. The Authority may wish to assist the "wider public" by publishing the results of informed analyses and providing observations on changes in exposures surrounding acquisitions.

### **Conclusion & Recommendations**

35. It appears that the outcome desired by a "wider public" is to identify failing companies more effectively: the Authority may wish to address this issue directly, rather than encouraging further bureaucracy around a fatally limited legal & professional construct.
36. The Authority may wish to guide the "wider public" by reconsidering the appropriateness of each and every reference to "the wider public" in the Update Paper.

37. Specification of a clear framework of definitions & objectives would enable the Authority to consolidate Responses into practical forward action. The quality of Consultation output would be improved.
38. Highlighting of issues relating to focussed improvements in dynamic risk impact data - within a clearly defined and relevant “market” - and identification of the participants that the recommendations address, would improve the result of the Consultation.
39. The Authority may wish to consider advising the “wider public” of routes to greater awareness of the multiple risk exposures that challenge all commercial activities; sources of experience-based risk analysis and advice could be suggested.
40. The Authority may wish to make a major contribution to the quality of commercial risk management by warning the “wider public” of the danger of focussing inappropriately on historical financial data.

#### **“Why Companies Fail”: Educational Seminars**

41. The Authority may wish to enhance the wider public’s awareness of risk exposure by introducing a series of educational seminars that explain risk exposure, risk identification, risk inception, risk measurement and monitoring, and risk management at market level, and explore implications for contract procurement (aimed at local government & public authorities) and private sector companies (aimed at customers and suppliers).

#### **Submission Statement**

I welcome this opportunity to input to an improved understanding of the contribution of audited statutory accounts to the identification and management of risk, and will be pleased to clarify any of the above issues if required.

I give permission for my identity to be revealed in the event that the Authority wishes to publish this submission.