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Competition and Markets Authority
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BY POST AND EMAIL

Dear Sirs

CMA - RESPONSE TO UPDATE PAPER 18 DECEMBER 2018 - STATUTORY AUDIT SERVICES
MARKET STUDY

This is my response to the issues raised in your update paper.

My main conclusion is that I have not been able to find a problem to be solved but rather numerous expressed concerns and difficulties.

The market is expressed as that for statutory audit within which are sub-markets for audit needs of specific entities, a term I shall use rather than company. Legislation and regulation that creates and defines the markets is not wholly within the legislative control of the UK. Control structures for operations of entities continue the tradition of often inert group of equity investors (owners) in an entity and a control group of management with few investor imposed controls on limits of authority coupled with weakened demands for full quality audit opinion not derived from owner but from legislative requirements. General demand for independent audit services is almost wholly based on requirements of legislation and regulation. Audit committees are an element of internal control within management control structures and owners' appointment of independent auditors is not adequately controlled by them. Supply of independent audit services to entities is not universally required by statute, audit opinion requirements are (but this is arguable) based on an assumption that financial statements and other required reports show a true and fair view before audit; and the opinion is essentially concerned with these statements and other reports not with either full independence of opinion forming based on independently determined and adequate verification of control systems and practices. Service supply is based on limitation of choice of audit service providers who may themselves have little if any confidence that an adequate number of skilled and highly qualified independent auditors will replace those available now. Service providers may lack certainty of their relationship to all service demand and whether it should or can be met by them and others perceptions of them are of a lack of the skills and understanding that service demands can be met. Education and training of highly qualified auditors may require change and much improvement to meet market needs.

An alternative conclusion is that ineffective efforts of successive legislative and regulatory actions to determine rules to be met and supervisory investigative powers coupled with significant changes in the financial and structural changes have allowed a more liberal but less secure system for management of public and private entities to develop.

I have attempted to identify elements of the problem that has resulted in many of the matters described in the update paper and for my own purposes I concluded that the essential elements of the problem are as follows:

a) Requirements of legislation and regulation that allow entities to use other than most effective internal control arrangements and a less than adequate means for owners to effectively ensure sound management of operations. Coupled with this independent auditor requirements based on a restrictive true and fair view opinion requirement further lessen assurance requirements of reported outcomes. A significant increase of assumption of powers over an entity's assets and operations by managers who generally have limited personal exposure to the outcome from failure allow for less than best control as do the limited adverse effects of legislative and regulatory action. And it is with circumstances that practical authority of owners to effect improvements using adequate unrestricted action is less than adequate.

b) Reliable and accurate information to assure entities and others that present education and training means and bases will allow for there to be available a sufficient number of individuals to provide future quality audit services. The demands for an ill defined independent quality audit service coupled with a lack of clarity by both professional and other bodies of service providers on their objects and public service obligations. A demand for independent audit increasingly based on

legislation and regulation with few demands for effective and accurate recording by management of entity operations and with greatest concentration of requirements on presentation of results and opinions based on selective reporting standards.

c) Lack of a clear agreement that independent audit is not the provider of financial and other information but an element only of provision of reliable results from entity operations. Increased and greater assumption by government of the ultimate responsibility for information to be produced and presented by entities and the extent to which and how reliance on them is to be judged; and consequently a lowering of the reliability of the extent to which strength and effectiveness of basic control systems of an entity may be understood. The acceptance of unchallengeable limitation of responsibility of an independent auditor based on testing rather than on in depth verification and the possible misuse of the true and fair view concept used to confirm presentation rather than substance.

d) The reliance by regulators and legislators on conformity of presented accounting auditing and information with standards that are optional and that allow for financial results of entity operations to be shown on other than factual results amended and restricted when need and appropriateness of doing so may be questionable but reporting not required.

My conclusions as to actions that might be advised to some extent and in differing ways are those already set out in your paper. However I put forward the following suggestions for consideration:

Legislation and regulation: Rather than concentrate efforts on the creation of a new regulator perhaps action should be to achieve the following results.

1. Amend reporting requirements to separate those related to annual and other financial statements from those of other matters and lessen the content of the financial statements to matters essential to their understanding. Change reporting and audit opinion requirements so that (dependent on changes suggested in 2):-

a) Annual and other financial statements be required to provide confirmation that basic records accurately and correctly reflect an entity's operations with financial outcome also accurately and properly recorded in accounts

b) where estimates or assumptions are used for presenting the items and amounts in financial statements whether permitted by standards used or otherwise the affect of such presentation bases is properly and fairly set out as a part of the statements; and that information that clearly describes the reasons for such alternatives and the methods used for them can be clearly understood

c) A required or elected independent auditor's opinion will be based on the annual and other financial statements and deal with the outcome of the audit results as follows:

i) Confirmation that the auditor's examination allowed the confirmation that the internal control structures and systems in use were such that reliable and accurate records of operations and of financial outcomes have been recorded and to the extent that the examination revealed concerns or weaknesses these have been separately reported to the "Investor Committee". If such confirmation is not given the auditor must reflect the affects of findings in the body of his opinion.

ii) confirmation that the financial statements as presented and at the date given for them using bases for presentation used (about which the auditor will state that no opinion no comment or positive agreement can be given) together with other information accompanying and stating how items in the financial statements were arrived and the accounting records and assumptions and methods of presentation used taken as a whole provide a true and fair view of the financial condition of the entity at the date given and of the results of activities (profit or loss and changes to assets and liabilities) for the period described and changes in the reported capital investors interest in the entity.

2. Allow (by classification of entities based on capital investor numbers if necessary) an entity to have an "Investor Committee" (by whatever title suitable) with powers designated by the capital investors to control entity managers, select independent auditors, require provision of information for their general purposes and determine the bases and limits on information disclosure to others. The election of members of such committee should not result of dominance by one group and by legislation or regulation there could be either an independent member appointed or reporting requirements demanded. It is most probable that such a change as I envisage will not be fully effective or practical without clear legislative or regulatory conditions but

the aim should be to place responsibility for effective entity management on effective owners' requirements to ensure control by them of the entity's capital through effective control of management arrangements and actions.

3. Consider the introduction of powers to require an independent audit in specific circumstances by extension of those in force to provide assurance to proven market and other concerns, such as pre-conditions for public investment, perceived and disclosed management failures and the like. Such powers would be preferably based on the use of other than the entity's auditors using market service providers being given **(insert 'and')** meeting clear statements of scope and requirements for each assignment and exercise of the powers would **(insert 'be')** external to owners' rights.

4. Consider a requirement for regular information to be made available publicly or to an effective regulatory body of the management and service delivery control structures of any independent audit provider including non-UK parts of it including description of how the structures ensure adequate separation of audit services from other services. The information should include clear proven information on the education and training undertaken or that will be required of existing and future staff employed and the extent to which the independent audit provider will or may rely on others in the course of providing audit services. Financial information may be required for other purposes.

The Service Providers and management

1.a) Audit is not a function restricted to service provided by individuals whose principal education and training relates to finance, economics, accounting and audit as an activity. However those whose audit activity is aimed at dealing with financial outcomes are those which the update paper describes as of most concern. Within the control structures and processes of any activity the quality of audit control and of the nature and manner of making investigations and checks will determine outcomes. This assumes that those who carry out the audit tasks are suitably qualified for this and that scope of work is unrestricted. The reliability of an outcome however is not determined by this but on the actualities of what is examined and full disclosure of documents and information. The outcome may be no more than confirmation of reliable dissatisfaction with or confirmation of the acceptability of the situation as understood by the independent auditor. But between the worst and best outcomes and the reliability placed on these should be the result of any quality audit. What is revealed may amount to damage **(insert 'to')** the client **(move 'for' here)** which or the persistence of doubts **(insert 'about which may')** require that further work must be undertaken. Opinions and facts may conflict and if opinions are the outcome to be used for presenting financial information it may be that an audit view is not possible. Internal auditors are those whose function is established almost without exception by management and to which the results of work are directed. Whilst the same sense of objectivity should prevail in doing such work the result for unconnected persons is that reliability of results is limited if not impossible.

1.b) I suggest that when any decisions are taken for improvement the most important matters to be considered must relate to the differences between internal audit and independent audit demands and to restricting the scope of work of the independent auditor with assumption by management (and consequently internal auditors including the audit committee) for the reliability and accuracy of the information financial and otherwise made available to the independent **(insert 'users')** and used in preparation of financial statements.

2. I suggest that a joint review between CMA and other governmental bodies and the Chartered and other bodies of professional accountants the National Audit Office and others should be made to determine whether changes are required to achieve the following:

i) the education and training and admittance to recognised qualification as fit for purpose of independent and internal auditors and the further qualification of such individuals for specific aspects of such services. For example using those I have experienced specific qualifications to provide services for arbitration, company failure, tax assessment, capital investor offerings. Care is need in permitting a less than definite separation between qualifications in determining service providers.

ii) restricting the responsibility of **(insert 'an')** independent auditor to providing an opinion (on whatever basis this may be and with whatever legislative and regulatory requirements are to be observed) solely to owners of an entity and if appointed by others with consent of owners then solely to such others.

iii) clarity on the exact nature of any comment or opinion provided by the independent auditor on reported financial conditions and results as noted earlier.

iv) the status of an Investor Committee if this suggestion is followed and of the Audit Committee in relation to management of an entity, its owners and the independent auditor

Public reports

1. Dependent on any change affecting auditing requirements after the 29th March 2019 I conclude there will be a need for some changes that may affect the both the demand and supply parts of the audit market, perhaps its position within the larger market for financial economic and other information requirements. Some of the suggestions I have made if followed may have **(insert 'limitation to a')** specific class of entity. But other entities are of public concern and it may be that further distinction may be in the public interest. For example the charity sector may be classed as of public concern or interest and as a consequence could be required to make available to the public a report other than now available. It may be that such report should include **(delete 'of')** information of public concern and be subject to review or audit and be accompanied by an opinion of a person qualified for this service.

3. The quality of independent audit services assuming that supply of those qualified to do this work is secure for the future - and this may require something more than the existence of present demand - can be improved by some alteration of public report requirements.

4. My earlier suggestions if accepted may allow for some reports required by legislation or regulation to be presented separately from financial statements and affirmed as "correct" by other than an independent auditor. The main purpose of an independent audit should be limited as I have suggested to a report to owners. Demand for information from others not resulting from audit should be provided either from the owners and the Investor Committee or if need **(insert 'be')** by specific legislative or regulatory requirement to meet an essential need not otherwise satisfied. Some independent work leading to opinion as to reliability may be required.

5. Means of presentation of reports and for the means of accomplishing this to meet authorised recipient demand may deserve a review. It is not satisfactory that groups of owners are provided without prior agreement of all owners with information by the management of an entity. Nor is it satisfactory that such management can independently determine what information is to be provided how and with what assurance as to its reliability. The use of internet based and other such communication facilities spurred the development of electronic report filing from the 1990s and less publicly from the 1970s. It must be presumed - dependent on the level off security in use that such systems may be able to provide - that use of this method will continue to increase. May I suggest that an examination might be usefully made now as to the most appropriate methods to be allowed in reporting information by an entity? Effective communication as you are fully aware requires targeted recipient participation and security of delivery.

This response to your update paper excludes the many other notes and observations I recorded in my attempt to make it of some use. My reading of such publications as "A Manual of Auditing" by Cooper and others of past times, the several publications of today by eminent and other authors, the information made available by many authorities have confirmed much that I have read in your update paper and **(insert 'on')** which I have refrained from any direct comment.

Yours faithfully,

Terence J. Grove