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Statutory audit market study
Competition and Markets Authority
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Victoria House
37 Southampton Row
London WC1B 4AD

By Email: statutoryauditmarket@cma.gov.uk

Dear Sir,

Submission Of Comment to Statutory Audit Services Market Study

Please find my memorandum to the above mentioned study.

I have given some views on the your analysis in section two of the concerns about audit quality and on the proposed Remedies.

I am partner in a medium sized firm Ernest & Martin Associates we are based in Nairobi Kenya. The purpose of responding to this to develop the audit profession.

Yours faithfully,

Ernest Muguku Muriu

CPA

2.46 We reviewed the FRC enforcement findings for the cases concluded since 2015 against the five largest audit firms set out in Figure 2.17. Based on our analysis, the most frequent reasons for findings of misconduct include:

- (a) failure to exercise sufficient professional scepticism or to challenge management (most cases); -
- (b) failure to obtain sufficient appropriate audit evidence (most cases); and
- (c) loss of independence (three out of a total of 11 cases).

My comment to 2.46

auditing has been reduced to a box ticking exercise, The auditing standards (with over 1,000 pages) have become to lengthy that given the amount of time required to complete an audit to meet statutory timelines or other timelines and also given fees constraints, an auditor may not have the time to take a step back to apply his mine to challenge the many assumptions made by management or to give a sceptical view to the financial status of the auditee organisation.

Its time we reviewed the auditing standards to give them a principle-based approach not a prescriptive approach. This will then allow an auditor to apply his mind more effectively when asking:

.....what could go wrong,

.....where do risk areas lay

When collecting evidence, box ticking rule-based audit standards may direct an auditor to audit activities that are of no value and do not increase the value of the audit outcomes e.g. minimise risk of discovering fraud or risk of predicting financial failure.

2.47 The FRC told us that all its recent enforcement findings have to some extent related to a lack of sufficient professional scepticism or challenge by the auditor. This suggests to us that the enforcement cases reflect underlying quality concerns.

My comment to 2.47

To increase professional scepticism or challenge by the auditor to a sufficient level, auditors should be allowed by the standard setters to have latitude in setting audit parameters specific to his understanding of the business environment and the company specific setting and based on what the audit documentation show.

Audit should not be based on checklist similar to how to make a pizza, x grams of mozzarella, y grams of tomatoes and z grams of olives.

2.49 We heard criticism from some investors and ACCs that the reports on individual audits focus primarily on the quality of the audit process rather than the underlying professional judgements. Nevertheless, the results are a key public indicator of audit quality and are used by companies in the selection of their external auditor.

My comment to 2.49

I agree with this, the AQR inspectors may focus on quality of the audit process rather than the underlying professional judgements.

As an auditor in practice, this will thus straight jacket my mind to focus audit activities to pass the AQR and give audit judgement less focus.

This may be especially true of passing AQR is made a precondition for licence renewal.

3.2 In a well-functioning market, competition and regulation would combine to ensure the right incentives through a variety of mechanisms.

(a) Selection and oversight of auditors would ensure that competition would be focused on quality (more than price), so that firms win more business if they deliver good quality and lose if their quality is poor.

(b) There would be enough opportunities to compete, and there would be sufficient choice of viable competitors over the long term, without undue barriers to entry and expansion, all to enable intense competition.

(c) Within firms, individual auditors' personal success would depend to a very large extent on whether they deliver high-quality audits.

2.53 The FRC has expressed ongoing concern and frustration with the failure of firms to address recurring problems. These include a lack of professional scepticism exercised by auditors when auditing key judgement areas and failure to adequately challenge management's assumptions. The FRC identified bank audits, group audit oversight and the audit of pension balances as particular areas of concern.

3.16 We found that bids are typically evaluated against a list of criteria. While the list varies from company to company, the criteria will, in addition to price, usually include:

(a) experience and technical capability of the audit partner, the audit team and the firm;

(b) geographic coverage of the firm's network;

3.65 The majority of companies believe they have sufficient choice. However, for a substantial minority of FTSE 350 companies, Audit Committees are faced with fewer than three credible bidders for an audit tender. Competition is, in these circumstances, fragile. If one of the bidders fails to impress, the company is left, in effect, with no choice at all. The main drivers of lack of choice in these cases appear to be:

(a) Mandatory switching rules, which mean that the incumbent bidder cannot participate (so the Big Four becomes the big three).

(b) Lack of confidence that the challenger firms would have the capability to carry out a complex audit including perceptions that the international networks of the challenger firms do not have the same reach, strength and consistency as those of the Big Four firms.

3.79 Around 30% of the FTSE 350 tenders in our sample of 247 tenders had fewer than three competing bidders

3.80 Looking across the evidence provided by companies and auditors, we identified four main reasons for lack of choice in some tenders: mandatory rotation rules; **concerns about capability of firms outside the Big Four**; conflicts rules; and choices by the audit firms not to bid.

My comment to 3.2 as read together with 2.53, 3.16 (b), 3.65(b), 3.79 and 3.80 on group tender processes and group audit oversight

I am of the view, use of network firms has the impact of diminishing competition. As is in the case now, if the parent company appoints audit company A all its subsidiary companies are compelled to use the network affiliates of audit company A (global footprint). This has little or no regard to the ability to provide good quality audits by the other members of the network.

Also, in the tendering processes, the other members of the network may not be evaluated independently and may be deemed to comply with the standards of the lead firm, which may not be necessarily correct.

To enhance competition, mandatory use of only firms in the particular network should be discouraged and component firms in a group should be allowed to independently select auditors from outside a network of the lead audit firm.

Also, where non-network firms are used, this will encourage the growth of challenger firms from the just the Top 10 or top 15 firms.

In most territories, members of Top 10 or top 15 firms have an undue advantage over other firms when competing for business, as they do not have to tender locally (since tendering is done at a group level). As such, there may be no real incentive or inclination to deliver good quality / robust audit, yet their work may impact of the overall outcome of the group audit.

3.88 The reasons given by companies as to why challenger firms were eliminated at an early stage included lack of sufficient scale, international presence and experience with large companies, and lower perceived quality. One company noted that its contribution to a challenger firm total fee income would have been significant, potentially impacting independence.

3.89 Third, the multi-disciplinary nature of the large audit firms, combined with regulations to prevent conflicts between audit and non-audit work, can lead to a significant reduction in choice in some cases.

3.93 However, the process of managing client conflicts can be complex, particularly as the rules apply to provision of non-audit services by any firm in the international network to the company or parent companies. In most cases the main constraint appears to come from the restricted services (where auditors need to demonstrate independence) rather than the broader cap of 70% on permitted non-audit work.

3.105 On the demand side, there are genuine concerns about the capability of challenger firms to carry out the most complex audits, particularly those requiring large international teams. However, we also found that the challenger firms faced a 'chicken and egg' problem – they were frequently ruled out of tenders on the basis of lack of experience, but would only be able to build that experience by gaining a more substantial foothold in the market. We also saw evidence of a reluctance on the part of some investors to support Audit Committees who recommended hiring an auditor from outside the Big Four.

3.108 It appears to be widely accepted that challenger firms do not currently have the capability to audit the largest, most complex companies at the top end of the FTSE 350. This is in part because of the size of the audit teams required to carry out these audits and, in some cases, because the challenger firms do not have the required sector or other expertise.

3.110 Even for the smaller and less complex companies in the FTSE350, several ACCs argued that the capability of the challenger firms was substantially below that of the Big Four in a number of ways. Respondents frequently cited: (a) Challenger firms' smaller international networks;

(b) lack of capacity of the challenger firms to put together a team of sufficient scale for a complex audit;

(c) concerns about quality of the challenger firms (for example as suggested through perceived lower AQR scores in some cases, and comparatively lower investment in technology and systems compared with the Big Four); and

(d) lack of experience of auditing similar firms; and/or lack of experience gained through providing non-audit services to the client.

3.111 For example, having considered the Group's needs and the experience of audit firms in leading and coordinating global audits,

3.113 Aside from the objective capabilities of the challenger firms, some have claimed that firms outside the Big Four face a perception bias. For example, we heard that Audit Committees may have an incentive to hire the Big Four because they risk criticism for hiring one of the challenger firms if things go wrong.

My comment to 3.88 as read together with 3.89, 3.93, 3.105, 3.108, 3.110, 3.111, 3.113

To deal with issue on lack of capacity of challenger firms, we should adopt a model where the lead auditor (group level auditor) need not be in the same network as the component company auditors. This model works well among non-network audit firms or where there is no network firm in a certain region.

The lead country auditor is charged with coordinating activities of component company auditors, by sending them necessary instructions and coordinating compliance. In this case, each component company tenders for the audit services independently and this opens the market to robust competition.

Challenger companies can then, tender for the lead auditor role and other auditors can independently tender for the component company auditor role.

In this model, the risk of conflict between audit and non-audit work is also minimised and, can lead to a significant increase in choice / reduction in restriction on choice.

For example, companies are open to receiving banking services from local banks irrespective of the bank used by the office. In my view, the use of network firms was a technique used by bigger firms to lock out smaller firms. [] This in my view is an anti-competitive tendency. When we tender for work, or lose clients, the often reason given is that auditors are now appointed centrally.

I have been in audits that are coordinated by a non-big 4 client. In my view its erroneous to state that smaller audit firms do not have experience in leading and coordinating global audits. This is often a reason used to lock out smaller networks or smaller firms, or to continue with the Big 4 (perception bias

or people operating in a fraternity like manner having worked with, far more companies listed or alumni are in leading positions).

Remedies

Comments under item 4.4

- 1) **CMA should try to avoid recommendations that will take us from the current situation of Big 4 to a number say Big 8 or Big 10. The reforms envisage in this report should be geared toward nurturing the small firms would are willing to take on the challenge not to give work to Grant Thornton, RSM, BDO et al work on a silver platter.**
- 2) **Other measures to break down barriers to Challengers - discourage use of only firms in the network to conduct an audit. Tenders be limited to the lead audit firm; component entities be allowed to use firms outside the lead auditor's network.**
- 3) **Full structural or operational split between audit and non-audit services - Full focus by auditors on audit – this recommendation may result in failure by audit firms to attract or retain staff. A career restricted to working in audit section may lead to boredom quickly due to its repetitive nature. Also due to the acrimonious nature of audit especially when dealing with matters of judgement – audit assignments may take long to conclude leading to dullness. As an incentive, audit staff need to have the opportunity to take a break from audit assignments and to get more attractive assignments outside audit arm. This will help in developing new skills and get away from audit monotony.**
- 4) **Auditors' individual rewards rest purely on audit quality – where an audit assignment takes long to conclude due to disagreements with the client on issues, margins may reduce due to the time take to resolve the issues, thus impacting on the rewards available.**

4.10 Most stakeholders, including investors, were opposed to an independent appointment and monitoring body. We heard that this remedy would disenfranchise shareholders and that an independent body would be incapable of replicating the functions of Audit Committees.

Comments under item 4.10

There are no guarantees that such a body would not be captured by Big 4 members or their alumni. We have seen standard setting bodies so captured. This would therefore render the body ineffective.

4.16 The type of oversight mechanisms we envisage would provide a step change in Audit Committee practice.

Comments under item 4.16

The oversight role should include approval of appointments to the audit committee and to some extent oversee adequate compensation is provided to incentivise the members to discharge their responsibilities well, Such a compensation should be benchmarked against the industry median of the partner charge out rate.

4.26 A joint audit would require two firms to sign off on the accounts of their audit client. Responsibility for the audit opinion, and audit liability, would rest with both auditors

4.28 In our invitation to comment, we also mentioned the possibility of introducing shared audit as an alternative to joint audit. A shared audit would be carried out with one firm (the statutory auditor) taking overall control, responsibility and liability for the audit. Another audit firm would support the statutory auditor on certain aspects of the audit (e.g. carrying out audit functions on subsidiaries). As we discuss below, our current view is that shared audit would not be as effective as joint audit in achieving the remedy's aims.

My comments to items 4.26 and 4.28

I am against use of joint audit where two firms to sign off on the accounts as this would result in the bigger firm overshadowing the smaller firm. Or instances where the smaller firm player second fiddle to the larger firm.

As mentioned in this commentary Tenders for the auditor's role should be limited to the lead audit firm tendering for the holding company's audit and to supervise the audit work for auditor in component entities (subsidiaries, joint ventures, associates etc). This will be in line with item 4.30 and 4.31

Component entity auditors shall be firms outside the lead auditor's network. Once this is done, there will be no need for assessing the lead auditor on the basis of their geographical reach. The only factor lead audit firms need to demonstrate is that they have experience in supervising component entity auditors. This will then lead to actualisation of item 4.31 and 4.32.

Each component entity auditor shall be required to undergo the same level of independence check needed for appointment and experience in auditing a similar entity.

Once the need to have one global auditor is eliminated, smaller audit firms need not lose their clients upon appointment of "a global auditor" and the Big 4 cannot use this advantage to knock out the competition from the race.