

Introduction

- 1 Independent Audit Limited, despite its name, does not undertake statutory audits and is therefore free from any direct interest in the outcome of the CMA's investigation. The main part of our business is undertaking reviews of board effectiveness, in the course of which we see a lot of audit committees and their work, including the oversight of the external auditors. We have on occasion helped audit committees with their assessment of the effectiveness of the external audit process, but this is not a significant part of our business.
- 2 We therefore have many opportunities to observe the company-auditor relationship in practice, although it should be noted that our client base is biased towards those who take governance seriously; nonetheless, we do have experience of unsatisfactory situations as well. Another qualification for comment is that the author of this paper was formerly a partner in PwC where he spent some years working on audit research and development.
- 3 In the interests of brevity, this paper does not attempt a full review of the market study update paper. It concentrates instead on a few points which are perhaps less likely to have been made by other commentators.

The case for change

- 4 The update paper has not adequately made the case that there is enough of a problem with audit quality to justify the extent of changes being proposed.
- 5 Any process that depends upon imperfect human beings will sometimes go wrong. There must be a certain level of failure in any such system which is inevitable and will never be driven out. The paper does not seek to determine whether the level of audit failures that it identifies is actually significantly higher than this inevitable level. Although on the face of it there looks like a large number of audit failures, they have to be set in the context of a very, very much larger number of audits which have not failed, or at least are not known to have failed. (The distinction between these two is not important to the point being made in the present argument, although it is in other contexts.)
- 6 The level of adverse findings in regulatory audit quality reviews is not conclusive evidence of a high level of audit failure since the measure of quality employed in such reviews includes a large element of process compliance, and a failure can result in an adverse AQR finding regardless of the extent to which the failure has actually resulted in or even increased the likelihood of a defective audit outcome (a shortcoming which is acknowledged in the update paper itself).
- 7 This is not to argue that audit quality is good: simply that it has not been proven to be so bad that it requires radical intervention. Further analysis to underpin the case would be helpful in justifying the scale and significance of the change that is being proposed.
- 8 What is more readily self-evident is that there is a perception of poor audit quality, which diminishes trust in audit. Past experience suggests that such perception rises significantly when audit failures are publicised, and then diminishes as investors, politicians and press return to their customary lack of interest in the topic. The extent and nature of change to address a possibly temporary issue of perception might be different from that necessary to address the substantive state of affairs, and it would be desirable for these complexities to be considered before conclusions are reached and significant action taken.

The inherent likelihood of audit failure is increasing

- 9 The job of auditing has become substantially more difficult over the years, because of the continually increasing complexity both of business and financial reporting. A particular issue with the latter is that accounting contains an increasing proportion of judgements, usually involving some sort of forecast – the outcome of negotiations, levels of interest rates, economic and market conditions, the success of a new business, and so on. Auditors do not possess crystal balls better than anyone else's and the scope for them to get things wrong is considerable and increasing – but generally unacknowledged. The significance of this is magnified by the binary audit opinions which must state whether the accounts do, or do not, give a true and fair view – there is no scope for a "probably" in this opinion. The descriptive commentary now found in audit reports goes some way towards reducing the impact of this, but is far from removing the problem altogether.
- 10 Any attempt to significantly reduce audit failure must therefore consider these conditions which increase the likelihood of audit failure and propose ways of mitigating them.

The expectations gap

- 11 The update paper's appendix on the expectations gap is a thoughtful review of a complex situation, and it helpfully identifies the scale of the issues involved. However, the paper itself does not adequately consider the implications of the issues identified in the appendix.
- 12 For example, there has been considerable comment around the presumed audit failure at Carillion. However, a "quality audit" of this company, as now defined with the benefit of hindsight, would have presented a picture that might well have led to the business being put into administration a year or two sooner, and while the directors continued to believe that there was still a good chance that it could be saved. It is not self-evident that such an outcome would have been in the public interest, nor that external auditors would have been the right party to act as the catalyst for such an outcome.
- 13 More generally, commentary by those outside the accounting profession generally betrays a conflation of financial reporting and audit. Some so-called audit failures seem to have been at least partly due to aspects of the accounting requirements. So long as the public conflate audit and accounting, public confidence will not be increased by remedies aimed only at the former of these.

The public good

- 14 Given the breadth of the CMA's ambitions for external audit revealed by the update paper, it should confront an issue on which the entire paper is premised. Does it remain the case that external audit is sufficiently a public good that it needs to be mandated by law and highly regulated?
- 15 The update paper's answer to this question is asserted, not argued. However, a case can also be made that the societal context has changed so much in the century or so since audit was first introduced that it is no longer the best answer to society's needs (whatever they are – see previous section).
- 16 For example, a higher level of deterrence through increased personal accountability of directors and senior managers, along with greater exposure to penalty, might be at least as effective, and

at lower overall cost to business and therefore to shareholders. The impact of the Senior Managers & Certification Regime in financial services provides some support for this argument.

- 17 It should also be noted that most significant stakeholders have the right to require an audit if they want (for example, regulators, tax authorities, major lenders and shareholders should they be prepared to act collectively. Pension fund trustees could also require an audit as part of their negotiations over valuations and sponsor contributions.) The only significant stakeholder group unable to require audits is small creditors, who already have very little real benefit from external audit.

Changing the audit system

- 18 On the assumption that reasons will be found for dismissing the issues raised in the preceding paragraphs, we turn to consider the impact of the proposed remedies.
- 19 Major changes are proposed, with the potential for substantial upheaval and/or unforeseen consequences. But they all represent attempts to put existing additional pressure on the existing system with the aim of making it work better. In this, it follows a pattern which has been repeated many times over the years, as described by Professor Michael Power 22 years ago in his book *The Audit Society*:

Particular audits may go wrong but not audit as such. Consequently a certain cosmetic reform is visible in the wake of crisis. Auditors are censored, conferences are organised, articles are published and, very often, new audit guidance is issued. Things settle down until the next time.

- 20 The CMA's ambitions are clearly greater than this. And there is one more change it could require, which would make the other pieces fall into place with a significantly improved chance of lasting impact. This is to break the link between statutory audits of subsidiaries and the audit of the consolidated accounts (also known as the group accounts, and which are generally the ones that are prepared for the benefit of shareholders)
- 21 There is a widespread presumption – including the underlying assumption in auditing standards – that the way to audit a set of group accounts is to undertake statutory audits of subsidiaries where these are required by local law, top them up with some degree of work at those parts of the group which are not required to have statutory audits, and then add everything up.
- 22 Conceptually, this approach dates back to the time of multinational groups sending in their year-end reporting packages by steamship. Nowadays, technology has enabled systems of management which mean that for most companies of public interest it is possible to perform high-quality audit by starting at group level, understanding the complexities of the business and how it is managed, and undertaking targeted work at a more detailed level.
- 23 A full explanation of the feasibility of this approach is contained in "Thinking Not Ticking", a paper published by the Centre for the Study of Financial Innovation in 2003. One particular point to clarify is that it does not involve the auditors of the group accounts placing reliance on statutory audit work, which would make the group auditor primarily an assembler of audit opinions prepared by others, but is a self-sufficient exercise in building up evidence to support an independent audit opinion.
- 24 An important consequence of breaking the link between the audit of the group accounts and the statutory audit of subsidiaries is that, by enabling the audit to be done in a top-down way, it

removes the need for an integrated global network of auditors. When freed from the obligation to share work within a global network of statutory auditors, group auditors are more likely to visit locations themselves, possibly employing local expertise as a supplement. Consequently, one of the principal barriers to entry in the large company audit market, impairing both the existing challenger firms and preventing new entrants, is removed.

- 25 As well as enabling greater competition, this improves market resilience. Auditors of group accounts, by virtue of being smaller, can be allowed to fail, and would be more readily replaced by new entrants.
- 26 Approaching an audit of group accounts in this way also requires a significantly different resource model from the conventional one. It requires a much lower volume of resources but places much greater emphasis on expertise. Suitably qualified staff can be drawn from a wide range of sources, including business and investment analysis as well as experienced professional advisers.
- 27 This different model addresses the very real concern (which the update paper underestimates) that audit-only firms would have difficulty attracting the best staff. The current approach to audit is increasingly procedural and compliance-based, with an ever-increasing emphasis on complex financial reporting, and consequently is an ever more specialised area of declining appeal to many of the people who otherwise have the right capability and characteristics to be effective auditors. A top-down audit of group accounts places a greater premium on in-depth understanding of the business, its management and risks, and is therefore of more intrinsic interest to a greater number of people.
- 28 Separation of the audit of group accounts for shareholders from the statutory audit of subsidiaries will also enable the Big 4 to maintain their roles as global service providers to management. This is a valuable role and the ability of the Big 4 to provide an integrated service around the world on a wide variety of matters, including compliance with statutory accounting and other regulatory requirements, is of benefit to both management and to shareholders. The proposal described here would allow that service to continue to be provided without interruption – indeed it would permit some of the existing independence constraints to be put aside.
- 29 The proposed arrangement would be likely to add some cost, but quite possibly at a lower level than that already admitted by the changes proposed in the update paper.
- 30 For this system of audit to work to its fullest effect in increasing competition and enabling different approach to quality, a number of enabling changes would be needed. These include:
 - modifying regulatory restrictions regarding dependence on a high proportion of fees from a single client – new entrants cannot be expected to remain out of the market until they can sign up a large number all at once.
 - if start-ups are to be encouraged, restrictions on outside capital should be relieved. This would also enable faster growth of challenger firms.
 - auditors are commonly seen as a backstop insurer for loss, with liability levels having been unlimited until relatively recently and remaining high. Start-ups and challengers do not have the financial capacity or availability of reinsurance to act as underwriters for loss in this way. It would likely require some sort of regulatory intervention to prevent this being a competitive disadvantage to smaller players (noting that a good audit is more in shareholders' interests than is the availability of insurance).

- group audit of the type described would give best value to shareholders if they were not required to provide the binary conclusion "true and fair or not", but could instead go beyond current practice to provide a more discursive report which included analysis of the risks and explanation of the basis on which judgements had been made.
 - ideally, although not essentially, the auditors of group accounts would be appointed for a fixed term of some years, with only limited scope for extension and with early termination requiring approval by shareholders. This would maintain the perception of independence and is enabled by the fact that under the proposed system there would be greater choice.
- 31 The benefits to choice and market resilience from this approach are fairly clear. There are also considerable benefits to audit quality, not least through making it possible to have audit-only firms whose working methods rely on expertise and critical judgement as much as on the application of process. In this short paper we have not attempted to spell these out in more detail, nor attempted to address predictable objections. We would be happy to meet you to explain the suggestion in more detail if that would be helpful.

And finally – audit committees

- 32 In our capacity as experienced reviewers of board effectiveness, we are concerned about the proposals for regulatory scrutiny of audit committees – even though we agree that many audit committees could indeed do a better job of selecting external auditors and of overseeing the audit process.
- 33 The update report acknowledges that evidence on the performance of audit committees is mixed, but then proceeds to assert without evidence that "even a few audit committees falling short in meeting their obligations is too many". Irrespective of the validity of this assertion, it is insufficient to justify what is a very heavy-handed approach to promoting more rigorous work by audit committees.
- 34 We do not support explicit regulatory intervention because experience has consistently shown this to have the effect of increasing attention on completion and documentation of process, rather than on the quality of outcome. In the same way, experience in the financial services sector has shown that having the regulator in attendance at a board or committee meeting will probably result in increased attentiveness to board process and more evidencing of challenge, but the actual quality of the work carried out during that meeting is more likely to be impaired than improved.
- 35 The update report fails to recognise that, in almost all cases, independent directors, and particularly those on audit committees, are extremely aware of their responsibilities and of the potential damage to their reputations should things go wrong. However, their work in relation to external audit (and also in some other areas) is hindered by the fact that there is no clearly established best practice and little regulatory or professional guidance on minimum standards. The Corporate Governance Code requires audit committees to oversee the effectiveness of the external audit process, but says little about how this should be done. Consequently, we see a wide range of practice, ranging from rigorous to casual, mostly somewhere in the middle.
- 36 In the same vein, there is little guidance as to how audit committees are expected to maintain independence from management during audit tenders, and consequently it has become normal practice for the finance function to undertake much of the legwork for an audit tender, with the audit committee supervising and then making the final decision. This is justified on the basis

that the audit committee does not itself have the executive capacity to run the process, and that it would be an unnecessary cost to have the work done by outsiders.

- 37 We think it extremely likely that clearer guidance on the level of rigour expected from audit committees would lead to an immediate and significant improvement, without further regulatory intervention.
- 38 If additional intervention were needed, it would be possible for independent parties to produce a report on how well an audit committee has fulfilled its obligations over the year. Unlike a board, whose obligations are so wide-ranging and varied that it is impossible to give a view on whether it has actually been effective except by second-guessing its judgements, the duties of an audit committee are well-defined and include considerable performance of process; consequently, it is possible to give a meaningful assessment of how well it has done.