Response to CMA's update paper- Practitioner view

Is there a real concern about audit quality?

The issue with audit quality is as old as the profession itself. Crises like Enron in the US and Carillion in the UK continue to remind us of the inherent challenge in assessing and improving quality. With the new EU rules for auditor rotation, there are some improvements to audit quality particularly due to a fresh pair of eyes. However, the negative unintended consequences have been underestimated. For example, audit partners are dealing with new audit tenders so their existing time (otherwise spent auditing) is being taken by this sales pressure which is detrimental to quality. Rotation rules have also put further pressure on auditor independence. Consider the period between the announcement of a new audit tender and the date of appointment. During this period the incumbent auditor's urge to please management and other decision makers puts even more pressure on their ability to challenge people who are either key decision makers or key influencers in their appointment. With these emerging pressures on audit quality, it is even more important that we fix this sector to restore trust in capital markets.

Most stakeholders would agree that there is a serious issue with audit quality. However, as I will illustrate, CMA's remedies do not identify and address the root cause of poor audit quality and therefore CMA's proposed remedies do not present a comprehensive solution *unless they are accompanied by solutions to address the root cause of poor audit quality.*

In the sections below, I will first define audit quality, then I will highlight critical limitations in CMA's methodology. Lastly, I will conclude by highlighting areas which require further deliberation.

What is audit quality?

Notwithstanding the challenge in defining "audit quality", I think we should not overcomplicate the issue. The interest of shareholders requires auditors identify **all material errors and fraud**. As such, most stakeholders will not dispute that core ingredients of audit quality must include:

1. Deep understanding of professional standards (auditing and accounting) and experience in application of standards;

2. Incentive to spend sufficient time on the job, focused on assessing the company's compliance with standards and whether management judgements are prudent; and

3. Incentive to identify instances of non-compliance and material errors and/or fraud (Note: This is not referring to instances where they come across an instance of non-compliance. Instead, it refers to the **incentive to actively search for errors**)

In my view, any attempt to improve audit quality must improve the above factors particularly no 3 as the third factor creates the conducive environment to bring the best out of an auditor's professional capabilities. The limitations outlined below will show how the current remedies do not go far enough to create such an environment.

Limitations of CMA's methodology and proposed remedies

Limitation 1: No Root cause analysis performed

CMA's paper touches on a number of relevant factors that impact audit quality, however a detailed root cause analysis was not performed. As a result, CMA's proposed remedies present a risk of treating symptoms without treating the resistant bacteria that is causing the disease.

The most noteworthy section that did go close to the main root cause was the recognition of the principal agent problem section 3.5 and 3.6 (page 43) i.e. the separation of owners and managers and the challenge for the auditors to act in the interest of company's owners rather than in the interest of the company's managers. This is the heart of the problem. It was then disappointing that the paper narrowed down this issue to the "selection and oversight of auditors" which then leads to CMA's view that some fixes around the selection by Audit Committees will solve the problem.

So what is the main root cause of poor audit quality?

The root cause lies in the behavioural assessment of audit firms and professionals and understanding whether their incentives align with shareholders. The most important question is: What can incentivise auditors to find and report the maximum errors and fraud? Some may say the answer is a tough regulator as an incentive. This begs the question: Should I do good because that's the right thing and it's in my interest OR should I do good because of the fear of being caught? The answer may be a bit of both. However, if we had left this on the latter as our general approach in society, we would need an increasingly bigger police force to prevent crime!

If you look at the Key Performance Indicators (KPIs) of auditors, they would invariably include vague scorecards covering "quality", "client relationships", "teambuilding" etc. None of the KPIs are directly linked to identification of material errors for shareholders. Moreover, there is no upside if you identify more errors or fraud. If this was a truly market solution, shouldn't reward (including promotions) be directly linked to your core purpose? *Imagine a situation where the audit fee is fixed but with a possibility of an upside if material errors are found. Would that not change behaviour and ultimately align the interest of auditors with shareholders?*[1]

The audit industry not only lacks incentives to identify and report maximum errors/fraud but there are significant disincentives do to so. CMA's paper does not even acknowledge (let alone discuss) the biggest source of this disincentive: **Remuneration of auditors**. The fact that the audit partner negotiates the fee with the CFO every year and the payment of the audit fee by management is the single biggest source of conflict and at the core of this matter. The paper's proposal to rely on the AC is equally disappointing since the non-executives, including the AC chair, is paid by management. Unless and until this remuneration link between management and the auditor is broken, I fail to see how auditor's incentives can be aligned with shareholders and how any of the proposed remedies can make a significant dent in improving audit quality.

The conflict of interest is so blatantly obvious that even the most sceptic empiricists will not ask for any further evidence of the control management enjoys in their ability to put pressure on auditor's incentives. It is also not the first time it has been documented. A number of academic studies have highlighted this issue and the aim of this paper is not to present all exhaustive evidence in this regard. [ ].

[1] This is to highlight the importance of incentives, not a strict recommendation per se.

[2] https://www.ft.com/content/91287d0a-c663-11e8-ba8f-ee390057b8c9

[ ].

Another way to analyse the issue of incentives is to look at the role of FRC as the regulator. Despite criticisms on the quality of FRC as a regulator, there is no doubt that FRC has changed the way auditors operate. For example, they have instilled a sense of seriousness with auditing and auditors are continuously fearful of inspection risk. However, the reason FRC inspections have not fundamentally improved audit quality is because there is a significant asymmetry of incentives between the audit firm, their clients, and the FRC. The asymmetry can be best illustrated by way of an example:

FRC inspects auditor files and identifies poor work over certain areas and lack of challenge to management. The auditor accepts those findings. Now the problem is that the auditor cannot go to the other side (i.e. the client) and have the same conversation in the same tone. On the one hand you have a regulator which is not paid by the audit firm and is therefore independent and powerful. On the other side you have the beloved client who pays the auditor so little (if any) challenge gets passed on to the client. The auditors therefore end up absorbing this pain and the remediation or future improvement manifests itself in the auditors' attempt to "improve documentation" or window dressing of their files instead of fundamentally changing their attitude to identify deficiencies on their clients. After all, auditor files are a reflection of their clients so in most cases poor files are nothing but a reflection of the poor control environment of the client.

Has FRC inspection results also resulted in an increase in significant control deficiencies or qualified audit opinions? It is therefore naïve to assume that more toughness on the part of the regulator will change the world. It will not. One cannot expect the auditor to significantly challenge management who are ultimately putting bread on the table for their children.

To further prove this asymmetry of incentives, consider a structure where the FRC is being paid by the audit firm. No matter how professional FRC is, how good their technology is, or how well they are trained, the tone of inspectors when they are face to face with auditors would fundamentally change. If I pay you, I control you.

I am supportive of a tough regulator. I am also not implying that auditors are always succumbing to management pressure and not complying with their obligations. However I do believe that, in the absence of an environment where auditors are fully incentivised to find material errors/fraud, and the asymmetry of incentives between the auditor, FRC and the client is fixed, we will not see a significant shift in audit quality.

In summary, there is a problem with audit quality but it's because incentives are not aligned with shareholders. CMA's paper does not identify all root causes and the main root cause of the toxic relationship between auditors and their clients has not been sufficiently addressed.

Limitation 2: Concept of Empowerment

Consider a big terrorist event in the state of New York. One could argue the law enforcement agencies failed to prevent the event and assume there's some truth in that. Now, would you consider punishing the police force or would you empower the police force (more resources, training, or more powers via legislation). Punishing your police force (unless there is criminal conduct) is never going to be the solution. In the current context, it may be fashionable to score points by threats of "break up" (which has a connotation of inflicting pain) but I think if the role of audit is important and if there is agreement that auditors do serve a purpose, then any remedy needs to be analysed from the lens of "empowerment". I would like to understand which (if any) of the CMA's remedies leads to empowerment of auditors.

Limitation 3: Where is the human side, CMA?
Market imperfections aside, the majority of auditors have consciously chosen audit as a career. The last few years have been tough on individual pride, and questions from family and friends haven't been hugely motivating. There is empirical evidence (CMA is requested to obtain) of an increase in early retirements by senior audit partners. Auditor motivation is an important lens as the basis of audit quality lies in the eagerness of audit professionals to do a good job. The simple question is: How will CMA's proposed remedies impact audit quality by impacting motivation levels of audit professionals?

Limitation 4: The myth of competition
As the CMA's update paper acknowledges, "Academic research evidence on the link between competition and audit quality is relatively limited and inconclusive". Competition works best for most companies. For example, more choice in the mobile phones market has meant lower prices and better customer service amongst various providers. However, the same concept does not apply to the audit industry because of a number of reasons. Firstly, as the paper acknowledges, the ultimate customer i.e. the shareholder does not directly observe quality of service. Introducing more players in the market (who are all still controlled by management and work with the same toxic incentives) may lead to more auditors in the market i.e. a bigger club but very little, meaningful change in quality. I am equally unconvinced if this will lead to lowering of prices either but that is still more likely than improvement in quality.

Secondly, as the paper notes, audit quality is hard to measure. Most stakeholders resort to FRC grades as a gauge in the absence of any other objective metric but we know that this metric has inherent limitations. In other markets (e.g. utilities) you could simply have customer surveys or ratings as an indicator (e.g. BT vs Vodafone) but this cannot be extended to the audit market due to its inherent nature.

Thirdly, CMA's current view is that more firms will make the environment more competitive and that clients will choose auditors based on the best quality is not grounded in empirical evidence. Granted there are only 4 firms but why is 4 too small a number? [ ]. In such circumstances, it is hard to imagine how an addition of another firm will significantly shift the current focus of firms on audit quality.

Overall, there may be benefits in adding more members to the club, the biggest of which may be the trickle down of profits from the elite 1% to the middle class through the smaller firms (e.g. profit per partner increase in BDO) but the high intensity of competition and the resultant impact on audit quality is a myth that is not supported by theoretical or empirical evidence considering the unique nature of the audit sector.

Limitation 5: The Moral Hazard Problem

The CMA correctly identifies the existence of moral hazard problem in the paper. Specifically, CMA notes that there may be a problem with the regulator not taking appropriate action against a large audit firm that was performing poorly because of the fear that this might drive the firm out of business. However, CMA fails to consider a much bigger moral hazard problem with the audit business itself: How can an audit firm, knowing the company is expected to go bankrupt, qualify its opinion on the financial statements? Doing so would only accelerate the company's demise once investors realise the company is going down, which puts the auditor's own recurring fee into jeopardy? The extent of these moral hazard challenges in practice may be debated but I have tried to show the importance of fixing and designing the right incentives for the audit firms to improve audit quality and why the current proposed remedies fall short of identifying the core issue of auditor remuneration.

So are CMA's proposed remedies not effective?

They are all "effective". However that is the wrong question to be asked. The question should instead be:

- Can any remedy work without first creating an environment where auditor incentives are fully aligned with the shareholders; AND
- Which one will increase quality the most considering some of the additional lens we introduced above?

Only answering these questions will lead us to the ultimate solution. If you layer a tough regulator, more accountability for the AC, etc. in an environment where the auditor is fully energized and incentivised to fight a bloody battle with management, majority of CMA's proposed remedies would significantly enhance audit quality by steering auditor in the right direction with constructive challenge. However, in a structure whereby auditor incentives (through their remuneration) continue to be clouded by management pressure, none of CMA's proposed remedies will make a significant improvement in audit quality.

CMA's approach- Too close, yet so far.

I have failed to determine the underlying reasons behind CMA's failure to address the issue of auditors' poor incentives in sufficient detail. While my observations on audit quality and solutions are based on more than 10 years of auditing large FTSE 100 and FTSE 350 companies, the reasons for CMA's failure are largely speculative and only based on reading CMA's paper. In this context, I made the following observations:

- While CMA seems to have researched the issue, including obtaining multiple documents/evidence from the industry, a large part of CMA's conclusions seem to rely on the feedback by the audit firms, CFOs, AC chairs i.e. "the club". I thought CMA was commissioned to independently shake the foundations of this club. I am therefore disappointed with the apparent weight provided to the feedback from the club itself. For example, the proposal by Grant Thornton[3] in section 4.19 on suggesting an independent auditor appointment body was rejected based on widespread opposition by stakeholders as noted in section 4.20. Opposition is not surprising given vested interests of the club so in the absence of any objective reasons for rejecting Grant Thornton proposals, it is hard to understand CMA's objective thinking behind this rejection.

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[3] The author has no link (current or past) with Grant Thornton

- CMA mentioned that one of their objective was to consider a solution that is "proportionate" to the problem. I was at a loss to understand whether CMA has therefore deliberately shelved any proposals to fix auditor remuneration incentives to address the root causes in the interest of not causing too much disruption to the club. If failures like Carillion were not enough to trigger extreme measures from the CMA, I wonder kind of failure is required to trigger a more thorough response?

- CMA's paper, on page 129 (section 4.156) rejects some other remedies that CMA has previously considered as possible solutions to the issue. Two of these remedies a) Introducing an insurance based system and b) creating an NAO style auditor suggests that CMA understands the root causes I mentioned in this paper. Further, CMA's comment in 4.158 that the cost imposed by these solutions would exceed any possible benefit is not supported by any detailed theoretical or empirical evidence (expect perhaps for feedback by the club itself). As such, while CMA seems to have initially come closer to the ultimate solution, the forces of status quo have prevailed and prospects of any fundamental changes in the industry now look bleak.

Conclusion

"We know - intellectually - that confronting an issue is the only way to resolve it. But any resolution will disrupt the status quo. Given the choice between conflict and change on the one hand, and inertia on the other, the ostrich position can seem very attractive."[4]

CMA has a historic opportunity to fundamentally alter the course of this profession and lead the world by reforms that go beyond any earlier attempts (e.g. US SOX legislation). However, any serious undertaking must identify and acknowledge root causes of poor quality especially the issue of auditor incentives and their alignment with shareholders. I am genuinely impressed with CMA's recognition of the principal agent problem especially the "importance of chemistry" in selection of auditor but that is only the tip of this iceberg. As I have illustrated, CMA's update paper has a number of limitations and the paper only touches upon the important issue of auditor incentives tangentially in the context of appointment by the AC. *All of CMA's proposed remedies undoubtedly have the potential to enhance audit quality but these remedies are only effective if they are accompanied by, or are preceded by, designing a system which aligns auditor incentives with the shareholder through their **remuneration structure**.*

About the author

The author is based in one of the big four firms and has spent more than a decade auditing various listed companies in the UK, USA, and Asia closely experiencing the challenges of auditing in different regulatory regimes including the FRC and the PCAOB. The views are entirely personal and the principal motive behind this paper is a deep interest in making the world a better place. While the paper is critical of CMA's current approach, it is sincerely hoped this will not prevent CMA from giving consideration to these ideas and from publishing these concerns.

[4] Margaret Heffernan, Willful Blindness: Why We Ignore the Obvious at Our Peril