"Zest for Enlightenment"

Z/Yen Group Limited
41 Lothbury
London, EC2R 7HG
United Kingdom

Brydon Review
Orchard 1, 1st floor
Department for Business, Energy & Industrial Strategy
1 Victoria Street
London
SW1H 0ET

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Dear Sir or Madam,

INDEPENDENT REVIEW INTO THE QUALITY AND EFFECTIVENESS OF AUDIT

Background

In response to your call for views on the quality and effectiveness of audit, we would like to set out some thoughts. Z/Yen Group Limited (Z/Yen) was founded in 1994 as a commercial think-tank in the City of London to promote societal advance through better finance and technology. Our clients include the majority of global investment banks and many other financial services firms, but also clients in other sectors, such as technology, government organisations, and non-governmental organisations. Three accountants were among our founders, two of whom remain as directors of the business today. Our interest in the proper functioning of markets, and our research studies, have led to many of the observations and references below, and our desire to aid your inquiry.

Audit Environment

We would preface our remarks by noting that there are several different audit markets both internationally and in the United Kingdom. A quick categorisation of these markets might be – small and medium-sized enterprise (SME) audits, audits for SME firms listed on exchanges, audits for large firms not listed on exchanges, and audits for large firms listed on exchanges. One can identify other sub-sets of interest, e.g. audits for large firms listed on exchanges with significant international activity or, as is clear from your questions, audits for large financial firms listed on exchanges with significant international activity. The SME audit markets do not exhibit the intense concentration implied in your questions, so our remarks are focused on audits for large firms listed on exchanges and, where appropriate, some comments on the sub-set of audits for large financial firms listed on exchanges.

The financial crises of 2008 certainly bring audit quality issues to the fore. The audited balance sheet and going concern statements for many major financial firms over this period were clearly wrong. Virtually all of the major financial firms were audited by the Big Four. There was no discernible dissension among the Big Four. It would be easy to claim that more variety would have increased diversity of opinion, but we could not substantiate such a claim. One could equally claim that smaller firms would have been even more eager to agree with clients (though it’s difficult to see how a smaller firm could have been more eager than the Big Four were) in order to gain clients.

Auditors were amongst the thick of the banking crisis, recommending balance sheet arrangements and advanced valuation formulae (see entries for Ernst & Young in Jenner & Block's "Lehman Brothers Holdings Inc. Chapter 11 Proceedings Examiner's Report"). It may seem controversial, but audited statements were of limited use. Rather than seeking to have auditors "contribute to better supervision of banks", would it not be better to focus on getting them to provide better quality audits first?

We would summarise our environmental remarks below as:

- the audit market for large firms listed on exchanges is overly concentrated on four firms, and this concentration seems to coincide with lower competition and lack of diversity in approach;
- lower competition appears to have resulted in higher prices and poorer service over time and low, if any, productivity improvements, as exhibited by declining productivity over two decades;
- lack of diversity appears to have resulted in little innovation and, in the case of large financial services clients, increased herd behaviour;
- given that auditors have, over time, acquired a preferential economic role (i.e. their use is mandatory for large companies) that allow them to extract economic rents it is right to consider how to ensure a vibrant, competitive market, albeit perhaps less vibrant or competitive than other sectors – as well as what social benefit is given in exchange for a preferential role;
- structural changes seeking to increase competition and transparency in the audit market are desirable. Elements of such changes we would consider might include:
  - enforcing competition policy clearly, which in other markets might lead to capping the market share of the largest firms, or breaking them up, or requiring compulsory audit retendering;
  - making it easier to take legal action against audit firms for poor opinions;
  - treating auditing standards under the same regime as ISO standards, i.e. open processes, a single accreditation body (auditor of the auditors) backing certification (company audits) within a competitive market;
- structural changes seeking to increase competition and transparency in the audit market we would particularly recommend for closer examination include:
  - providing ways to ascertain the quality of auditors' performances over time, or 'confidence accounting' as we term it;
  - requiring audit firms to provide an "indemnity" of some form for their opinions.

Lack Of Audit Competition

Concentration was clear by the 1980s, as evidenced by the term "Big Eight", followed by "Big Six" in 1989, "Big Five" in 1998 and "Big Four" in 2002. We would pick out for comment:

- globalisation – though firms in the 1980s were handling large global corporations, typically through joint audit arrangements;
- need for a single firm approach - the large firms often cite the need for single firm arrangements rather than joint audit arrangements, and moves towards single firms have

progressed, but equally note that Arthur Andersen very rapidly split into national components when under stress and the structural arrangements of the large practices are inordinately complicated – 'living will' proposals for banks might find analogues in auditing firms;

- regulation – a variety of licensing arrangements and barriers to entry restricted new audit firms;
- cost – large, single firms are presented as more efficient than smaller firms, despite the lack of evidence of more efficiency (in fact, overall costs have increased, which is attributed to increasing costs of compliance);
- quality – that larger firms provide higher quality, though there is no evidence to support or refute this.

A Big Four auditor with a client in a defined client sector (e.g. banking) will have a fairly clear idea of what the other three firms might well do in a particular situation. He or she will know the other firms and their teams well, not least because he or she may well have trained, qualified or worked for the other three, and may well see his or her future career depending on finding employment with one of the other three in the event of employment disruption with his or her existing employer. Further, the narrow field means that, with the profusion of deals and joint ventures, the Big Four are constantly finding themselves working together on similar deals and, arguably, less able to provide advice that conflicts with another firms.

Your inquiry will undoubtedly have many submissions on similar points, however we would note that the final point on quality is paramount. Without available information on audit quality, the only two externally verifiable differentiators are size of audit firm and cost. In a market where corporate finance directors have to justify moving from one audit firm to another, 'justifiable' reasons to move are limited to size and cost. Recall that any move to a new firm which seems to indicate a dispute with the existing auditor will invite adverse comment – "something must be fishy if they had to move auditors". As the industry has become concentrated, and the cost is published (a competing audit firm need only look for their competitor's price in the published accounts), there is little need to compete on price. This leads to size being the only differentiator. Imagine a FTSE100, let alone FTSE top 10, company announcing it had selected to a new, small audit firm. The FTSE100 finance director would be unable to prove to shareholders any move towards a higher quality firm (there is no objective evidence). The only facts would be that the new audit firm is indubitably smaller, and possibly (if the smaller firm so bid) cheaper.

There are anecdotal stories of conflicts of interest of course. Evidence of conflicts of interest are difficult to prove, though we would refer to the following publication where we tried to examine this some time ago, in the teeth of assertions to the contrary, and arrived at a conclusion that proved predictive:

The Auditor's Cross Subsidy (Statistical Modelling Of	Michael Mainelli, Ian Harris and Alan Helmore-	2003	Strategic Planning Society E-Newsletter, Article 1. (also published as Anti-dumping Measures & Inflation Accounting: Calculating the Non-Audit Subsidy, www.mondaq.com)

Audit Prices)	Simpson

In our opinion, audit firms hold a special position in law, therefore they have special obligations. The simplest way to avoid conflicts of interest would be to restrict audit firms to audit only.

Incentives fall into two categories, carrots and sticks. We put forward our principal 'stick', clear posting of indemnities, below.

Indemnities For Incorrect Opinions

What is the role of auditors and should it be changed (?) is an intricate question taking in market structures, law, regulation, and numerous other topics. The role of the auditor is to provide an opinion on whether or not financial statements provide a true and fair view. We would not change this. However, we would point out that auditors provide an opinion without a clear indemnity. This is, in many ways, similar to the position of rating agencies who provide an opinion without indemnity (though their defence is largely based on the premise that their opinion falls under "free speech"). Auditor opinions are subject to more direct contractual relationships, but if auditors provide a poor opinion, the suggested recourse is legal proceedings. Commercial and financial legal proceedings are inefficient and expensive, and frequently result in awards out of proportion (both ways) to the commercial effects of a poor opinion. Further, audit firms are opaque structures with ostensibly little capital, i.e. a lawsuit may be of little commercial use.

We might suggest clear indemnities and indemnity rules (or liability mechanisms), for example:
- providing strong guidelines on the range which constitutes a poor audit opinion, e.g. more than a 15% adjustment in the total balance sheet valuation of the prior year;
- a ratio for the indemnity, e.g. five times the audit fee, or up to 10% of the company's balance sheet;
- providing confidence that such indemnities and liabilities are limited, thus encouraging smaller entrants into the market;
- clear arbitration procedures that avoid, as much as possible, high legal costs.

We would argue that, with few or many firms, forcing firms to provide indemnities is the way to increase their scepticism during a boom. If the indemnities were proportionate to the boom, e.g. rise with the valuation of balance sheets, then auditors would have more reason to be careful when needed. For further information:

Put Your Money Where Your Audit Is: Financial Statement Insurance In The UK?	Michael Mainelli, Joshua Ronen	2006	Journal of Risk Finance, The Michael Mainelli Column, Volume 7, Number 4, Emerald Group Publishing Limited, pages 446-450.

Accounting: Progress May Lie In Insurance (Put Your Money Where Your Audit Is: Financial Statements Insurance In The UK?)	Michael Mainelli, Joshua Ronen	2006	Financial World, Institute of Financial Services and Centre for the Study of Financial Innovation, pages 38-39.

Confidence Accounting – Providing Measurement Of Audit Quality

In a competitive market, the principal 'carrot' is profit. Firms that provide objective advice should become more profitable over time. This can only be achieved if the marketplace has the information to see the quality of advice over time.

Confidence Accounting is a proposal by Long Finance to use distributions, rather than discrete values, where appropriate in auditing and accounting. In a world of Confidence Accounting, the end results of audits would be presentations of distributions for major entries in the profit & loss, balance sheet and cashflow statements. The proposed benefits of Confidence Accounting include a fairer representation of financial results, reduced footnotes, more measurable audit quality and a mitigation of mark-to-market perturbations. In July 2012, Long Finance, ACCA and the Chartered Institute for Securities & Investment published "Confidence Accounting: A Proposal", with a foreword by Andy Haldane, Executive Director for Financial Stability at the Bank of England (the '10 second introduction' is to look at Extract 4: Draft balance sheet on page 46 – if you understand the implications of that you needn't read anything else):

Confidence Accounting: A Proposal by Ian Harris, Michael Mainelli and Jan-Peter Onstwedder of Z/Yen Group published by Association of Chartered Certified Accountants (ACCA), Long Finance and the Chartered Institute for Securities & Investment (CISI) July 2012, 63 pages

"My hope is that this proposal moves our thinking a step closer towards a set of accounting standards for major entities that put systemic stability centre stage. In the light of the crisis, anything less than a radical re-think would be negligent."

Andy Haldane
Executive Director for Financial Stability, Bank of England

The approach is termed 'confidence accounting', where uncertainties (ranges) are presented to investors and managers, rather than discrete numbers, as scientists would do, with confidence levels. The balance sheet of Company X is worth £Y, plus or minus £Z, and we are 95% confident that it falls within this range. This would make auditing a 'measurement science', cf. with the way most laboratories report measurements. A single number for accounting terms such as profit or balance sheet value is clear and simple, but wrong. Confidence Accounting would be the presentation of audited accounts in a probabilistic manner. If an audit firm's estimates move too far outside the stated confidence ranges, their clients would be able to make their own decisions about audit quality.

Over the course of the 2012 and 2013, each of the three publishing organisations held a number of events highlighting the role that Confidence Accounting could play in reforming auditing. Confidence Accounting gained significant traction with the Institute of Chartered Accountants of Scotland (ICAS) when their President, Sir David Tweedie, former Chairman of the International Accounting Standards Board, hosted their December 2012 debate on audit reform, praising the initiative, and later followed up this support at a March 2013 CISI-ICAS joint event "Financial Reporting Unplugged". Articles have appeared in CIMA, ICAEW, and ACCA magazines. Letters of support arrived from several US academics and the work was referenced in academic research by Bank of England employees.

Also in 2013 ACCA published the consultation responses, consisting of about half email submissions and half questionnaires submitted by attendees at events – around 100 people. Virtually everyone agreed that audit and accountancy need to improve. Respondents seemed to divide into three camps – supporters (about half), change-is-too-hard (about 40%), and anti this specific approach (about 10%). There was a desire to explore a simple 'how to' primer, a desire to apply the approach particularly to tax, pensions, natural resources & insurance, and a desire to coordinate Confidence Accounting approaches with more real-time information provision.

Following from the consultation the authors believe, first, that the use of distributions would probably best start with the balance sheet alone, leaving the other financial statements to change later. Second, while regulatory, institute, legislation, and audit standards might be useful change agents, Confidence Accounting can begin immediately in the dialogues between audit committees and their auditors. Looking ahead, the challenge is to find ways to keep the discussion in the forefront of regulatory discussions while also finding simple steps, rather than a large leap, towards implementation.

We had a large conference in March 2014 at ACCA, with ICAS, CFA, Governance for Owners, etc. there, on "accounting for uncertainty". About 100 people turned up. The background was to take a hard look at the idea over the day and decide if it held up and if our suggestion of beginning with audit committees made sense. As the organiser, Paul Moxey, summarised:

> ***Accounting for Uncertainty***
> *The final session discussed whether and how Accounting for Uncertainty or Confidence Accounting could help audit committees to fulfil their obligations to consider whether financial statements are 'fair, balanced and understandable'. 94% of those answering agreed or strongly agreed that there is a need to better represent uncertainty in financial statements. 97% seemed to think that the diagrams used in the discussion paper would be useful.*

For our shortest explanation:

Banking On Confidence: Rethinking Audits Of Financial Institutions	Michael Mainelli	2011	Securities & Investment Review, Securities & Investment Institute (September 2011), pages 22-23.

Conclusion

We would emphasise that the financial crises of 2007 to 2009 require serious investigation of reform, including the role of both the professions and their disciplines:

Just Doing My Job: Intelligence Versus Integrity In Financial Professionals?	Michael Mainelli	2010	Journal of Risk Finance, Volume 11, Number 2, Emerald Group Publishing Limited, pages 235-237.

May we thank you for your time and consideration of our thoughts and wish you every success in your inquiry.

On behalf of Z/Yen Group Limited:

Professor Michael Mainelli FCCA FCSI (Hon) FBCS
Director