

# Competition and Markets Authority calls for massive aud...

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There are two reports out this morning on the future of auditing and by pure chance I will be giving a presentation at the Institute of Chartered Accountants in England and Wales later this morning on accountancy and financial scandals (on which, more later).

The first review is by Andrew Tyrie for the Competition and Markets Authority on the future of the Big 4 firms. This is what they had to say this morning:

### ***CMA proposes reforms to improve competition in audit sector***

***Improvements to the independence and the quality of audits are the focus of the CMA's market study update.***

***The Competition and Markets Authority (CMA) has published an update paper outlining serious competition concerns and proposing changes to legislation to improve the audit sector for the benefit of savers and investors alike. It is now putting these proposals out for public consultation.***

***Following the launch of its market study in October, the CMA has identified a number of reasons why it believes audit quality is falling short:***

- \* companies choose their own auditors, and as a result we have seen too much evidence of them picking those with whom they have the best 'cultural fit' or 'chemistry' rather than those who offer the toughest scrutiny***
- \* choice is too limited, with the Big Four conducting 97% of the audits of the biggest companies***
- \* auditors' focus on quality appears diluted by the fact that at least 75% of the revenue of the Big Four comes from other services like consulting***

***In order to address these concerns, the CMA is proposing legislation to: separate audit from consulting services; introduce measures to substantially increase the accountability of those chairing audit committees in firms, and***

**impose a 'joint audit' regime giving firms outside the Big Four a role in auditing the UK's biggest companies.**

**CMA Chairman Andrew Tyrie said:** "Addressing the deep-seated problems in the audit market is now long overdue. Most people will never read an auditor's opinion on a company's accounts. But tens of millions of people depend on robust and high-quality audits. If a company's books aren't properly examined, people's jobs, pensions or savings can be at risk.

**"The CMA will now consult on a number of proposals for robust reform. These intractable problems may take some years to sort out. If it turns out that the proposals are not far-reaching enough, the CMA will persist until the problems are addressed."**

**CMA Chief Executive Andrea Coscelli also commented:** "We have moved fast to come up with a comprehensive package of proposals for legislation, which we will now consult on. Successful reform of the audit market will require legislation, in combination with planned improvements to regulation as recommended by Sir John Kingman."

**The reforms proposed by the CMA are:**

- **A split between audit and advisory businesses.** To get higher quality, auditors should focus exclusively on audit — not on also selling consulting services. One way of achieving this could be a structural break-up. But the international networks these firms belong to and the extent to which audit firms draw on expertise of those advising businesses would make this protracted and complex. A more immediate solution would be for audit and non-audit businesses to be split into separate operating entities. To be effective this will also require separate management, accounts and remuneration. That way auditors will only be rewarded for scrutinising an organisation's accounts but will still be able to draw on expertise from other parts of the firm.
- **Regulatory scrutiny of auditor appointment and management.** Audits are a legal requirement, to ensure that companies act in the interests of their owners rather than their managers. Given the relative lack of engagement by investors and owners of some of Britain's largest companies, these companies should not be left to appoint their own auditors alone. The CMA proposes close scrutiny of audit appointment and management to make sure those appointing auditors are held to account and independent enough to choose the most challenging audit firm, rather than — for example — the cheapest.
- **Encouraging more choice.** At present, many of the UK's largest companies have little choice, given that one or more of the Big Four may be conflicted. Competition is weak. The CMA proposes that audits of the UK's biggest companies (FTSE350) should be carried out by at least two firms, at least one of which would be from outside the Big Four. This will give mid-tier firms access to the largest clients,

allowing them to develop their experience and credibility, while also ensuring a cross-check on quality. A possible alternative is a market share cap — ensuring that some major audit contracts are only available to non-Big Four firms.

***The CMA's proposals only address some of the concerns in this sector. Sir John Kingman's independent review addresses another: the shortcomings of the current audit regulator. We would welcome any review of the purpose and scope of audits more widely. It is already clear from the CMA's work that a robust approach will likely be required here too.***

***The CMA now welcomes comments on its update paper by 21 January 2019.***

I broadly welcome this proposal. It recognises that the Big 4 are fundamentally flawed that the audits that they have undertaken have failed. These are big steps forward.

What it does not do is break up the Big 4. I think that will happen in due course. I will welcome it when it does. I think that in the long term it is essential.

In the shorter term the changes proposed are clever. They recognise that these firms are international (whatever they might claim for legal reasons) and that splitting them in the short term will, pragmatically, be hard. So it requires that second or joint auditors be required in each large company.

What's the reasoning?

First, to create diversity in the market.

Second, to expand that market.

But much more important, to create a whole tier of whistle blowers on the Big 4. That is what these joint auditors will really be required to do. And this will be guaranteed by the new appointment process.

Am I delighted by these changes proposed? No. There is nothing to stop auditors still being linked to tax haven services, for example. And nothing to stop them seeking to capture the accounting standard setting process. Or from lobbying inappropriately. So many issues remain. But is this a step in the right direction? I think it is.