PO Box 2306 Burwood NSW 2134 Australia

The Clerk of Committee
Statutory Audit Services Market Investigation
Competition Commission
London WC1B 4AD

Dear Sir

I am a former Big 4 partner involved in financial services sector audit. I left public practice in the early 2000's and entered the field of compliance and operational risk management in the area of securities and derivatives trading. I have been following with great interest the recent debate confronting statutory auditors. I also wrote last year to the House of Lords Review on Audit, largely agreeing with their opinions on the performance of statutory auditors in the financial services industry. I believe the reasons behind the much publicised criticisms of statutory auditing are very straightforward and simpler than we might think. In the first instance I believe that we need to consider whether we are dealing with an expectation gap with statutory audits that can ever be bridged. I would go so far as to say that the statutory audit model may well be past its use by date and that an analysis of competition is peripheral to the real issues at hand. I would like to make the following comments in relation to current audit debate; particularly as it concerns the financial services industry.

Change in financial services compliance environment early 2000's

Financial services compliance went through massive reshaping in the 2000's in the western world. Some of the key compliance changes included;

- Adoption and standardization of IFRS accounting standards in most western countries
- MiFID in Europe in 2004
- Basel II in 2004.

The above were the "tips of the icebergs" and there were many resultant and detailed regulatory changes such as to licensing and market structure regimes to name but a few. Such changes were complex and voluminous. Whether it was intended as such or not, this developed into an era of rules based regulation and compliance, superseding principles based regimes. I believe that as a result of this, legalism and literalism with regards to compliance subsequently developed.

When I first trained as an auditor in the early 1980's, professional judgment and audit principles played a far greater role than they do now. Professional judgment was a prized and core value. This and the traditional audit principles are hardly ever heard of these days:

- Principle of prudence
- Principle of going concern
- Principle of consistency
- Principle of good faith.
- Principle of the permanence of methods
- Principle of non-offset
- Principle of periodicity

- Principle of materiality
- Principle of conformity

Additionally, rapid changes were taking place in transaction technology and product sophistication. Massive global flows of capital commenced from new money supplies, all leading to the financial services industry becoming extremely complicated.

Auditor responsibilities widened hugely. In financial services, auditors were not just required to simply audit the balance sheet, they were also required to sign off on the financial industry's adherence to complex operational compliance requirements through new forms of audit reporting which did not involve the traditional consideration of numbers alone. Many audit reporting requirements had insufficient guidance and scope. Auditors did not always challenge this regulatory scope perhaps exacerbating flaws in expectations on both sides.

An internal shift in audit firms

Whilst the statutory environment was changing, the internal environment of audit firms was also changing. In the late 1990's and early 2000's a cultural change occurred within the audit firms. I perceived this as a very rapid change. (Indeed it was like watching clouds roll in!) Far greater focus was made on marketing compared to previous decades. Attention to technical skills seemed to diminish with respect to value and appreciation. The "Total Client Service" approach was developed by many audit firms whereby marketing teams would analyse clients for potential tax schemes and other non audit services which could be sold.

The change in statutory environment probably contributed to this change. In my perception, the outcome of all of this was a very noticeable shift from substance to form in auditing.

What is "concentration"?

The notion of "concentration" is an interesting one. I believe we need to distinguish between competence concentration and market concentration. We rely on competence concentration to ensure compliance in the safeguarding of key public services, eg.

- Air safety and transport inspectors
- Health and Hygiene inspectors
- Customs inspectors

In the above areas, standards are centralised and managed. No conflicts of interest exist. Expertise is continually enhanced. "Concentration" works well.

Financial services compliance actually requires more competence concentration similar to other key public interest areas. The level of expertise needed to analyse a financial services business is enormous. The audit of a financial service business is vastly more complex than is auditing say a retailing company or a manufacturing company. I have already mentioned the extreme level of industry complexity in financial services which developed over past years. This simply doesn't exist to the same extent in other industries.

I would go as far as to say that unless you have been immersed in a financial services business operationally for a number of years as an employee then it is almost impossible to understand it to a level that you can make commercial opinions and judgements that go towards forming a "true and fair" opinion.

Auditors have never been employed at the intimate and operational level of a complex financial services business so is it any wonder that current audit scopes have been so severely criticised? The litany of bank and financial services collapses speak volumes .

The Big 4 structure is simply a function of the organisational resources and logistics necessary to focus expertise. The audit specialisation needed in financial services requires aggregation because there is just not enough of it to go around in such a major undertaking. And this so called "expertise" is suffering from a major credibility problem and expectation gap. If the Big 4 were to be split back into the Big 8 of the '80's, there would not be enough critical expertise to go around and I believe the competence situation would actually become worse.

A Case of Regulators over-expecting and statutory auditors over-promising?

The audit expectation gap is a massive issue full of circular arguments and unexplored questions. I believe there is a view on audit expectation which is not being considered. Are we relying on auditors for traditional responsibilities to creditors and shareholders, yet without properly appreciating it, expecting them to also play a much more important role towards financial market integrity as well? The scope of creditor and shareholder stewardship is a vastly different one to that of overall financial market integrity.

I believe that it has come to point where severe value limitations of statutory audits should be seen for what they are. Many responses given to the House of Lords Audit Review by members of the audit profession were counter-productive. The typical auditor line "but we did everything technically correctly" simply begs the response "well why then should we bother with a statutory audit?"

The more things change, the more they stay the same

Three occupations continually rank together with their repeated association with disastrous outcomes: Test pilots, Lion Tamers and financial services auditors!

One thing about getting older in your career is that you come to realise that the more things change; the more they stay the same. I can recall many distinct eras as a Chartered Accountant whereby the audit profession was going to be "fixed".

The 1980's period saw the excesses of the "corporate cowboy" speculation and takeover activity. Following the spectacular corporate and pension fund collapses of the 80's and resultant economic slow down, auditors were sued, significant common law changes occurred with respect to audit practice and standards were revised. Then there were the Eastern European Bank meltdowns, Asian Bank meltdowns. We were promised audit and reporting clarity. Then the dot.com bubbles, Arthur Andersen, Enron etc etc . We were again promised audit reform (S. Ox etc). Then came the GFC and bank collapses. Lo and behold! We are being promised audit reform! Will we ever see an economic cycle in history where reform of audit firm practice is not an outcome?

The House of Lords Review

I believe that the House of Lords Review chose very well the word "complacent" in describing the audit profession. At the most discrete one could have used the words "meant well but rather naïve" and at the most critical one could say " both ignorant and arrogant".

I would say that the notion of concentration may have been considered rather one dimensionally and perhaps we need to consider more core issues.

A different model required for auditing financial markets

Is it time for us to consider whether statutory audits are past their use by date? I would go so far as to suggest that financial services industry audits should be the domain of the Securities Commissions. This would range from the biggest bank to the smallest broker or pension fund. Total financial market integrity is too critical an issue to allow history to keep repeating itself.

Regulators responding to the GFC

The response to the GFC of regulators in nearly all jurisdictions has been rigorous. The response emerging in financial markets is one of collaboration and consultation on the part of all stakeholders. Regulators are developing specialist focuses right across the financial markets. Regulators collaborate and workshop with market participants regularly in consultations and analyses on key financial market issues. The regulators are able to compare competitors line by line on key risk management indicators.

Some of the areas in which regulators are intimately reviewing in conjunction with industry participants includes:

- Use and risk management of technology
- Credit and counterparty risk
- Algorithmic trading
- Product development and approval
- Currency exposure
- Risk frameworks and KPI's
- OTC and derivative risk
- Product valuation methodology
- Order and transaction behaviours
- Impact on customers
- Capital reserve adequacy

Positive changes in financial markets are now emerging in risk assessment. Essentially we are seeing "compliance concentration" emerge in financial market regulators similar to other industries. This could be taken a step further by removing external auditors from financial services. It would be very simple to add the review of the financial statements onto the list above of regulator reviews given that the value of statutory audit scope has proved so questionable. If the regulators were to add the review of financial statements on the above list then statutory audits would not be required.

Conclusion

There are far more fundamental issues that need to be addressed in relation to statutory audits. I do not believe that review of competition is core to this and may only just be "shuffling the deck chairs".

Yours faithfully

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