

Comments on the “Choice in the UK Audit Market” Discussion Paper
By a former partner of a large accounting firm

International issues

The Discussion Paper acknowledges that there are limitations to what the UK alone can achieve in dealing with what is fundamentally a global market issue. Nevertheless, the size of the UK capital market and the important role that the UK member firms play in their Big Four networks mean that the UK can and should take a leadership role within the EU in driving wider reforms. Measures which are taken on a consistent basis across the EU would contribute to achieving a global change, with or without the immediate participation and support of the US.

Q1: Focus of the debate

If competition for public company audits is not important, we might as well move swiftly to having a monopoly state audit agency. Real competition drives innovation and quality as suppliers adapt themselves to the needs of the market. The members of the Big Four oligopoly have made some modest improvements in audit quality since the Enron debacle, but these firms do seem extraordinarily reluctant to embrace any fundamental organizational change.

The very franchise nature of these Big Four networks makes their taking any decision, other than a decision to do nothing at all, extremely difficult indeed. They do therefore require some encouragement as they are unlikely to change of their own accord in order to improve competition. The role of their US member firms is also a significant drag on further reform since their perception is that the Sarbanes-Oxley Act has already dealt with the issue and has, in the process, provided the Big Four with a veritable fee bonanza. The Big Four firms are among the largest political donors to both major parties in the US and this has surely proved a worthwhile investment from their perspective.

The growth in audit failure problems can be traced back to a point where a consulting mentality took over the major accounting firms such that the audit (sometimes sold as a loss-leader) became a relationship which was exploited to sell an ever growing range of consulting services. It was not surprising that, in the wake of Enron and similar audit failures, attention was focused initially on the need to restore auditor independence. The impact this has had in restricting effective competition, which was clearly highlighted in the Oxera report, was entirely predictable and demonstrates that such issues cannot be addressed one-by-one in isolation. The key issues to be addressed are, it is submitted, effective competition, audit quality, auditor independence (which is code for confidence in the motivations of auditors) and auditor liability reform to protect audit firms from unjustifiably acting as de-facto insurers of corporate failure. Proposed solutions to one issue should consider the impact on the others.

The big business consulting mentality is now firmly entrenched in the major accounting firms and driving it out and restoring the primacy of auditor professionalism may be hard to achieve. Encouraging some separation of auditing and consulting activities would though surely make a contribution in this regard as well as improving effective competition of public company audits as explained below.

Although the UK is moving to introduce a type of proportionate liability for auditors in the current Company Law Reform Bill, this auditors' Holy Grail is not something which should be accorded without the major audit firms first cooperating to restore a higher level of effective competition in the market. Audit liability reform is also something which ideally should be harmonized, at least on an EU-wide basis in order to reduce the risk of another major audit network failure.

Q5: Promoting increased choice

In order to promote increased choice there should be, after a reasonable period of transition (say 2 years), a legal or regulatory prohibition on any audit firm (or network of audit firms) providing any non-audit service (with maybe some limited exceptions) to any public interest entity (including their group members) where the firm (or its network) has audited in the previous reporting period more than a

defined proportion (say somewhere between 10% and 15%) of the relevant public interest entity audit market, measured by reference to reported audit fees and/or the number of public interest entity audit mandates. Ideally this approach should be taken across the whole EU market rather than just in the UK alone and could then be overseen by the EGAOB.

This would require each Big Four firm/network either to:

- (a) Spin-off part of its public interest entity audit portfolio (together with the personnel needed to conduct such audits) either to an existing second-tier firm or to a newly created “pure” audit firm^{*}; or
- (b) Spin-off those parts of its advisory business which currently serve public interest entities. For example, tax practitioners who have traditionally served larger public companies could create or move to a specialised international tax network or join major international law firms which are already expanding their tax offerings in this sector in response to market demand for non-audit related tax advisors.

The advantages of such an approach would include:

- (a) The impact of strengthened audit independence requirements on effective competition for audits would be neutralized such that there should in future normally be at least four real competitors available to bid for most public interest entity audit mandates;
- (b) Auditor independence would be further enhanced;
- (c) It allows each Big Four firm to create its own solution, in particular in choosing whether to retain the multi-disciplinary approach in serving public interest entities or to become a pure audit firm^{*} (in which case there would be no regulatory limitation on the size of its share of the public interest entity audit market);
- (d) It allows the Big Four firms the ability to retain sufficient tax expertise to bring the necessary quality to the audit of the tax figures in financial statements since they can retain tax professionals who could also continue to provide advisory services to the important private sector of the tax market;
- (e) The Big Four firms already have significant experience of spinning off various other consulting and indeed legal services which has not proved to be unduly difficult or costly to achieve. Any dislocation in existing service arrangements for non-audit services would surely be purely temporary (as was the case on the demise of Andersen);
- (f) Second tier audit firms may be able to move into the first tier through acquisition of a sizeable audit portfolio from a Big Four firm if such a firm wished to retain the multi-disciplinary approach in serving public interest entity clients;
- (g) One or more new pure audit firms^{*} may be formed from portfolios spun off from existing Big Four firms;
- (h) Existing Big Four networks could retain their treasured global audit footprints in order to serve those clients that really need a wide geographic reach, whereas second tier firms moving into the first tier and any new audit firms created might instead focus on public interest entities with less widespread operations (e.g. pan-European), or could be accorded rights of access to the networks of existing first tier firms in more exotic jurisdictions.

Many reasons will surely be advanced by the Big Four as to why nothing needs to be done or why it is either too expensive or too disruptive to make any material changes impacting those firms. It is suggested that their arguments be scrutinised very carefully. At the end of the day, auditing in the EU is an activity required by law which needs to be regulated in order to ensure that it fulfils its statutory purpose. The regulators should therefore be prepared in the public interest to intervene in this particular market to the extent necessary to restore its effectiveness.

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^{*} A “pure” audit firm is one which opts not to provide non-audit services to public interest entities and their group members.