A POINT OF VIEW:

The audit services market – time to change the game

The OFT has said that "there are competition problems in the audit market", and added that it could ask the Competition Commission to conduct a detailed investigation, because the "statutory test" for a reference to the Commission had been passed.

Source: Robert Peston, BBC News Online, 17 May 2011

The key recommendation…

"We strongly support the development of separate risk committees in banks and major financial institutions. Other large companies should institute them where appropriate. Such committees will increasingly require specialist skills and external advice. This advice should not be provided by the firm which is the company's auditor."

Source: House of Lords, Economic Affairs Committee, Second Report, "Auditors: Market concentration and their role".

What you need to know...

- The audit market is facing further pressures with calls for a review by the Competition Commission.
- The FRC Chairman, Baroness Hogg, has called for "more radical measures" to tackle the perceived risks.
- Directors are under increasing pressure to demonstrate that they are managing risk effectively.
- Sir David Walker advocated the development of Risk Committees for Banks and Other Financial Institutions, which could seek independent advice
- The House of Lords Economic Affairs Committee has advocated that such independent advice should be available to any organisation that establishes a risk committee

What you should do now...

Boards should consider establishing a Risk Committee and should provide the members and Audit Committee members with access to independent advisors. Both Risk and Audit Committees should:

- Review risk management and assurance needs to make sure that they are all appropriately addressed.
- Reduce the impact of further market concentration amongst the Big 4 audit firms by arranging assurance so that anyone could provide the necessary sign-off.
- Put in place a far reaching risk management and assurance framework for the board under the auspices of the Risk Committee.

The possible referral of the Big-4 to the Competition Commission in the UK comes on top of a hard hitting report from the Economic Affairs Committee of the House of Lords. The committee had three principal observations:

- **"The Big Four auditors' domination of the large firm audit market limits competition and choice"**
- **"The breakdown of dialogue between bank auditors and regulators made the financial crisis worse"**
- **"Audit standards are slipping"**

That there is limited competition at the top end of the audit market should come as no surprise to anyone. It has been the case since the merger of Coopers & Lybrand with Price Waterhouse, which was the culmination of the merger boom of the 1990's, and the subsequent demise of Andersen in the wake of Enron. The only decisive action taken by the authorities was the blocking of a proposed merger between KPMG and EY just immediately after the formation of PwC. But the second two conclusions are damning indeed.

Background

The Big 4 have a stranglehold on the big audit market in the UK, auditing 99 of the 100 companies included in the FTSE100. They also audit 240 of the next 250 biggest companies. In fee terms there is a significant difference between the top of the table (PwC) and the fourth of the Big-4 (EY). There is then a step change down to the next two. It is not until you get into the Alternative Investment Market (AiM) that non Big-4 firms dominate a market segment. This phenomenon is replicated in almost every other major market.

This market concentration has been of concern to the Financial Reporting Council (the "FRC") in the UK, the main regulator for the Accountants, for many years. Their principal concerns are:

- The lack of competition is likely to result in inappropriate pricing; and
- There is a risk that one (or more) of the firms might exit the audit market, either voluntarily (because of concerns about liability) or involuntarily (because they go bust following a negligence claim).

As a consequence, the FRC in the UK has been monitoring auditor concentration for some time under the guise of the Market Participants Group (MPG) which came up with a series of recommendations. The fifth periodic review of those recommendations can be found on the FRC's website.

But the bottom line is that the risk profile (from the FRC's perspective) has changed remarkably little since the MPG's initial report. While some recommendations (such as the appointment of independent non-executive directors and a Governance Code for auditors of public interest entities) have been implemented, the committee concluded that they have not made a significant difference. The ultimate test is that to date there has been little movement in the audit market and next to no interest from FTSE100 organisations in appointing smaller firms to major audits.

Outside help advocated…

"The assessment of risk, whether by separate risk committees or as part of the audit committee, is becoming a more prominent feature of corporate governance not only in the banks and financial institutions but also in other major companies ... [T]he Walker report… suggested the use of a "high-quality source of external advice."

"In its evidence to us, the FRC wished to encourage banks and other systemic institutions to use non-Big Four firms as a source of advice to these risk committees. … Baroness Hogg argued that such risk committees – reporting to the board about the levels of risk facing different parts of the business and how these can be contained – should be advised by a firm other than the company's auditors.

"Mr John Connolly, Senior Partner Deloitte said: "I think the concept of independent advisers advising risk committees is a good one..." Mr John Griffith-Jones, Chairman, KPMG agreed that the auditor should not be the risk committee's adviser. Lord Sharman said: "I have found ... that the appointment of an independent advisor to both the audit committee and the risk committee, separate from the external auditors, separate from the internal auditor, and separate from anybody else in the organisation ... is particularly helpful."

Source: House of Lords, Economic Affairs Committee, Second Report, "Auditors: Market

Further concentration of the market

As discussed above, the FRC has two major concerns in the UK: a further major market participant (one of the Big-4) might go under as a consequence of a negligence claim. Given active litigation in the fallout from the global financial crisis, this is not beyond the bounds of possibility – a mishandled case would be devastating. Whether the regulators could then parcel the audits out to other firms would be an interesting predicament. The Lords Committee contemplates the need for audit firms to create "living wills" in a similar manner to the recommendation for banks that go under. Secondly they are concerned at the high degree of power that the Big-4 have over the market. While regulatory oversight is tough, clients cannot really differentiate between the external audit services offered by the audit firms. They have essentially become the providers of very expensive commodity service.

The fifth firm is a lot smaller…

The audit revenues of even the smallest of the Big Four are nearly three times those of the largest second-tier firm

Source: House of Lords, Economic Affairs Committee, Second Report, "Auditors: Market concentration and their role".

The European Commission has very similar concerns, as does the SEC. At the moment, the only territory that has any significant audits of listed companies carried out by non-Big-4 firms is France which has a requirement for a second firm to perform a joint audit. While the EC has included this in their consultation paper, this model is not popular with other countries and is unlikely to gain much traction.

Non-audit services

One of the big issues at the moment is the ability under ethical guidelines for Big-4 to provide non-audit services to audit clients. While the PCAOB has provided leadership on the subject in the US (and for US listed companies), ethical guidance is also in place in the UK and other territories. The Lords Committee has recommended that this too should be a matter of consideration by the competition authorities. While they do not advocate a total ban, they suggest that: "**a firm's external auditors should be banned from providing internal audit, tax advisory services and advice to the risk committee for that firm**."

The need for Radical Measures…

Baroness Hogg, Chairman of the FRC, said: "The time has come to consider more radical measures".

Source: House of Lords, Economic Affairs Committee, Second Report, "Auditors: Market concentration and their role".

Of course, it is worth noting that in any case internal audit, SOX and other services are not restricted by the same legal monopoly enjoyed by external auditors (apart from some of the opinions required from auditors for SOX). As a consequence many smaller accounting firms are providing services in these areas. Of course, these areas of risk, SOX compliance and internal audit, are also open to non-audit firms. The majority of the big-ticket Sarbanes-Oxley work is complete and is now moving to a regular on-going process. Many SEC registrants are now looking for opportunities for both cost savings and greater efficiencies in regular SOX work, by introducing better technology, reducing duplicated efforts and leveraging cost differentials – none of this should be within the realm of the existing external auditors.

Our view

Many remedies are regularly put forward to overcome the market dominance of the Big-4. But they all fall at the first couple of hurdles: clients actively choose the Big-4 because of their brand and the perceived benefits that brings and not a single one of the recommended remedies really looks like it is going to make a truly substantial difference to the market positioning of the Big-4.

Perhaps then the answer is that we should all stop trying to change the rules of a game that we no longer like, and which is always won by the existing masters of the game (the Big-4). Let us rather change the game: a wide range of stakeholders has a need for assurance from within the organisation. The board has to feel comfortable with the assurance that ***they*** are providing to external parties. This might be to regulators about specific regulations, or it might be to society at large about corporate responsibility, or it might be about their financial stewardship of the company. In many senses, it is these broad responsibilities that directors now need to consider: look at the fallout from the banking crisis, look at the consequences for BP of the Deepwater Horizon disaster. The financial audit was fine in the slow-moving world of the nineteenth century; however, it is now not fit for purpose for the fast-moving interconnected world of the virtual corporation of the twenty-first century. The limitations of a binary audit report (you pass or you fail) are now clear: as the Lords Committee clearly argues, this aspect alone contributed to the depth and severity of the financial crisis.

So what should directors be doing? Directors should consider establishing a Risk Committee and should provide the members and Audit Committee members with access to independent advisors. We believe that there are three key essentials for both Risk and Audit Committees. Directors should:

- **Review their risk management and assurance needs** to make sure that they are all appropriately addressed. While the need for an external audit remains in place, it should be put in context as a relatively small part of the overall assurance universe.
- **Reduce the impact of further market concentration** by arranging their assurance affairs so that anyone could provide the necessary sign-off. This means making sure that the risk management is fit for purpose, that internal audit is focussed on the right things and that there is an appropriate focus on fundamental controls.
- **Put in place a far reaching risk management and assurance framework under the auspices of the board** that deals with these issues. The board must take control of the risk appetite and risk tolerance, it must know the strengths and limitations of their control environment and the effectiveness of risk management strategies and it should be absolutely clear as to whether what it is being told is happening to manage risks, is indeed happening in practice.

Remedies that work…

Measures envisaged by the Minister, Mr Edward Davey MP of the Department for Business, Innovation and Skills, focus on transparency and disclosure. These echo the approach of the FRC Market Participants Group – an approach that has palpably failed. We were disappointed that the Minister is not more ambitious. We would expect exactly the same result for the measures he advocated to our Committee as the FRC's measures have had.

Source: House of Lords, Economic Affairs Committee, Second Report, "Auditors: Market concentration and their role".

Our offering

We work with boards to help them put the right risk management and assurance strategies in place. As the only globally integrated risk management consulting firm within an Accounting Network, we are well placed to provide advice to boards of global and local organisations as to the steps they need to take in order to make this work.

Richard Anderson,
Managing Director, Risk Consulting Services
Crowe Horwath Global Risk Consulting

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To discuss the contents of this ***"Point of View"*** further, contact Richard Anderson at Crowe Horwath Global Risk Consulting:

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