Audit Market Concentration: Implications and Solutions – a Personal Perspective

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After eight months of this Inquiry, the House of Lords Select Committee on Economic Affairs published their report on 30th March 2011. The Committee considers that while national measures to address the audit oligopoly will be insufficient, the UK is in a position to take a lead.

The pattern is that the government responds to the House of Lords report and a debate is also held in the House of Lords – both within two months of the report’s appearance.

The European Commission


It is likely that an EC White Paper will appear in November 2011 at which point a European parliamentary process will be commenced. So European changes are some way off.

The Economic Affairs Select Committee

In contrast to the many more select committees of the House of Commons, the UK upper house has just five major select investigative committees in addition to legislative and other committees. Typically their Economic Affairs Select Committee conducts two or three inquiries annually. The Committee’s next investigation is on the economics of development aid.

Lords’ select committees comprise members appointed as peers to the upper house without the need to persuade electors to vote to re-elect them. So Lords’ inquiries and their reports are arguably less populist, more sober and less strident. Their processes have been honed over the centuries.
In the case of Economic Affairs, the Lords Select Committee comprises members with a wealth of business acumen, including large company board and audit committee experience. Indeed two members of the committee excused themselves from this Inquiry due to being conflicted as independent non-executive members of the boards of large accounting firms. In addition, senior government ministerial experience is well represented for instance by Lord MacGregor (the committee’s chair), Lord Lawson and Lord Forsyth.

The process and the record

The Inquiry ‘opened its doors’ in July 2010 with a ‘Call for Evidence’ listing a number of questions on which the Committee intended to seek answers (http://www.parliament.uk/documents/lords-committees/economic-affairs/auditors/cfeauditors20100727.pdf). Then, between October and January, fourteen public Inquiry hearings were held in a committee room within the House of Lords, to each of which a particular group of typically three to five witnesses was invited to answer questions put by the committee. These public hearings were held with academics, ‘Big 4’ firms, ‘mid-tier firms’, professional bodies, regulators, companies, investors, internal audit and audit committee representatives, government departments and others.

It is no accident that the Committee often commences with a hearing from academics. At their best, academics can be expected to have objective insights uncoloured by vested interests. Even at their worst when they play to the gallery and delight to surprise, they may highlight issues worth delving into as the Inquiry develops.

The hearings were all webcast and a verbatim transcript of each was checked with the witnesses and placed on the Committee’s website. Volume II of the Report (30th March 2011, HL Paper 119-II, ISBN 978 0 10 947325 8, £27.50; also at http://www.publications.parliament.uk/pa/ld201011/ldselect/ldeconaf/119/11902.htm) includes all of this text, reminiscent in style to Hansard, as well the written evidence submitted in connection with these public hearings. It is 378 densely packed large format pages of evidence -- an invaluable mine of information for future researchers. Much other evidence submitted to the Inquiry by individuals and parties who did not provide oral testimony is also on the website at http://www.parliament.uk/documents/lords-committees/economic-affairs/auditors/auditorswe.pdf though not printed in hard copy format.

As an economy measure, it is intended that this is the last parliamentary Inquiry to publish evidence in hard copy form (Volume II of this Report): in future it will appear on the website only.


“In 1849 a Select Committee of the House of Lords inquired into Audit of Railway Companies. Its report is credited with helping establish the audit profession; certainly by 1872 the Great Western Railway had an external auditor (Mr Deloitte) and an audit committee.”

1 The largest audit firms now have independent non-executive board members, per the FRC’s Audit Firm Governance Code (http://www.frc.org.uk/documents/pagmanager/frc/The%20Audit%20Firm%20Governance%20Code.pdf.pdf)
Evidence-based

For a committee so steeped in history and with so much relevant personal experience amongst the committee members it is impressive that their report follows strongly the contemporary idiom of being evidence-based. Hardly any assertion is made in their report which is not cross-referenced to evidence provided to the committee. The evidence varied between being empirical, factual and the opinion of experts.

Conclusions and recommendations

The Committee’s conclusions and recommendations are at Chapter 7 of their report. Earlier chapters pick out in bold print the material which ends up in Chapter 7. Appendix 3 is a useful, virtually complete list of measures suggested to the Inquiry to deal with the issues being addressed, including the measures the Inquiry did not adopt as recommendations.

Shortly before the Committee’s report appeared the Office of Fair Trading made a pre-emptive strike by trailing a very limited OFT Inquiry into restrictive covenants that oblige companies to use a ‘Big 4’ firm as auditor. While the Committee recommends against these covenants, they also make the much more major recommendation that large firm oligopoly should be investigated in detail by the OFT with a view to an Inquiry by the Competition Commission. The OFT has in the past resisted a comprehensive investigation, citing the desirability of allowing the 2007 recommendations of the FRC’s Market Participants’ Group, intended to alleviate the situation, to work their way through. There is now general agreement, as the FRC’s fifth progress report makes plain, that these recommendations have made little difference (June 2010, http://www.frc.org.uk/publications/pub2289.html).

Taking over the competition

Of course, the committee noted that the opportunity for ‘non-Big 4’ firms to grow bigger is limited if the ‘Big 4’ take over firms just below them in ranking. It is a moot question as to whether this is competitive or anti-competitive behaviour. For instance the fifth and sixth largest audit firms in Brazil have just fallen prey to two of the ‘Big 4’, depriving BDO and Grant Thornton of their Brazilian network partners. Networks take time and effort to build. In France three of the top six firms have been absorbed by the Big 4 with the fifth largest (Mazars) holding out against takeover. The contention that the French requirement for large companies to have joint auditors has failed to significantly widen choice in the audit market must in part at least be a consequence of this strategy by the ‘Big 4’. The Committee recommends that if joint audits were to be required in the UK, it should also be a requirement that one of the auditors should be a ‘non-Big 4’ firm.

Footnotes:

1. In 2010, Terco, the Brazilian Grant Thornton firm, joined forces with Ernst & Young (International Accounting Bulletin, August 2010). In 2011 BDO’s member firm in Brazil defected to KPMG. BDO’s CEO Jeremy Newman said: ‘We are concerned that when one firm looks to dominate it reduces choice for clients and leaves the market worryingly dependent on just a few players. BDO will be lodging an objection to this deal with the Brazilian competition authorities.’ (Accountancy Age, 21Mar11).

2. BDO Marque Gendrot acquired by Deloitte in 2006; BDO was at that time the 6th largest audit firm in France with interesting listed clients in joint audits. Salustro acquired by KPMG in 2004; Salustro was at the time the 6th largest audit firm in France with a very enviable portfolio of listed audit clients, including a number listed in the CAC40 index. Calan Ramolino in 1997 acquired by Deloitte in 1997: Calan Ramolino was at the time the 6th largest audit firm in France with 60 listed audit clients.

3. With a ‘joint audit’ both audit firms are jointly and severally responsible for the complete audit report and opinion, although they share out the work between them to the extent that this is possible under a joint audit. Under a ‘shared audit’ joint responsibility is not so complete.
The key is in the profession’s hand

Appendix 3 of the Select Committee’s report lists most of the measures suggested to the Inquiry including those not adopted by the Inquiry in the form of Inquiry recommendations. One of them reads as follows:

“Appeal to the Big 4 as professional entities to put the public interest first and voluntarily break up their firms to form a Big 4 or Big 8.

“The quid pro quo for society ceding monopoly rights to practise and other privileges, is that professionals place the ideal of public service above other considerations. A clear ultimatum, time-defined, might be set for the Big 4.”

This suggestion was not developed by the Inquiry into an Inquiry recommendation. I trust it was not because the Inquiry thought they would be whistling in the wind. It is surely the most appropriate approach that should be taken. Might it not be feasible to appeal successfully to the better nature of the professionals within the ‘Big 4’ to do the decent thing in the public interest? This would avoid the need for referral to the Competition Commission, or to the Competition Directorate of the EU and thus avoid any subsequent requirements that might then be imposed on the existing large firms. It would allow the large firms a much greater degree of control over the process to be followed and the format of the large firms that would emerge. It would utilise the understanding of the ‘Big 4’ firms to engineer an optimal solution at minimal cost. It would deal most effectively with the desirability that change is implemented globally. It would modify the behaviour of clients who at present are said to most frequently demand the services of the ‘Big 4’. Total fee income per partner would remain unchanged. It may be that the annual rewards of the top partners might be ameliorated to some extent since they would be running smaller, though still very large, businesses. There would be some extra costs as economies of scale in ‘back office’ and technical functions would not be as great as at present. Weighed against that are the efficiency gains that would be encouraged through greater competition between the larger number of large firms that would emerge. The firms would regain the goodwill of society as they would be seen to be placing their duties as professionals above the pursuit of profit maximisation.

References to the hallmarks of a profession are given later in the section of this paper which suggests ideas for further research.

International networks

‘Non-Big 4’ firms disputed to the Inquiry that they were incapable of auditing multi-national companies, or that they lacked access to sufficient capital to enable them to do so. Several of them have developed international networks. It is worth noting that even the ‘Big 4’ are quite loose networks of national partnerships across the world. Some will recall that Arthur Andersen espoused a ‘one-firm’ philosophy, but following their collapse their different national partnerships went their separate ways.

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5 Appendix 3, item 31, p65.
The UK oligopoly

The ‘Big 4’ currently audit 99 of the FTSE 100 companies: only Randgold, the gold mining company whose spectacular rise has propelled them into the FTSE100, has another auditor in BDO. The Big 4 also audit 240 of the FTSE 250. The problem of market concentration is even more acute than this as there are several sectors, including UK banking, where only three of the ‘Big 4’ are active auditors. There is general concern about the systemic risk should one of the ‘Big 4’ exit the audit market, as already companies wishing to use a ‘Big 4’ firm for audit or other work can find there is insufficient choice when one or more of those firms are conflicted.

The Committee noted that large companies change their auditors about once every 48 years and tender the audit about three times as frequently. While the ‘Big 4’ argued that competition is fierce, competition occurs rarely. As a consequence, arguably auditors develop too cosy a relationship with management. Barclays Bank has not changed their auditors since incorporation over 100 years ago. Views expressed to the Inquiry varied as to whether the audit improved when the auditor changed: Paul Lee (Hermes and the FRC’s Auditing Practice Board) disagreed with the perspective that changing an auditor reduces quality but there was wide agreement that tendering and changing auditors could be costly. The Committee stops short of recommending mandatory rotation of auditors but does recommend periodic tendering of the audit and an informative audit committee report explaining the choice of auditor including any decision to retain the same firm.

A financial statements insurance approach

One witness suggested that a solution to the problems of audit market concentration would be to introduce an alternative audit market. The only alternative suggested to the Inquiry came from Professor Michael Maenelli who referred to Professor Joshua Ronen’s work on financial statements insurance (FSI) as an alternative. While the Committee stopped short of recommending FSI, their Report does discuss it in two places. Under FSI the audit committee (with the approval of its shareholders) would choose to approach an insurer to quote to cover the reliability of the financial statements which would otherwise be subject to a conventional audit. By arrangement, FSI could cover additional assertions made by management beyond those currently embraced by the conventional audit. The financial limit of FSI cover, on behalf of those who might sue, would be at least equal to any cap on auditor liability which might be introduced, but could be higher by arrangement. As with other forms of insurance, the insurer would be likely to review the company and set conditions before providing the cover: this review might be done by the insurer’s staff or by a firm of accountants chosen from a panel approved by the FRC. The insurance premium and the limit of the cover would be published. Then the insurer would appoint an auditor, also from the approved list, whose scope of work would be determined by the degree of risk that the insurer was willing to bear. Since the board and management would have no influence over the choice of auditor, better alignment with the interests of the shareholders would be achieved, it is argued. If the company failed this audit, it would have two options for the following year: first, to revert to a conventional audit; or to renegotiate the FSI cover. When a claim was made against an FSI policy it would be assessed by an arbitration process.

The Committee does not recommend capping the liability of auditors as applies, for instance, in Germany where the cap is set at €4m. I believe the Committee was not minded to pander to the profession in this way, at a time when the committee was so unimpressed by the profession’s

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6 Q418
7 Of Z/Yen and LSE and a member of ACCA’s Corporate Governance & Risk Management Committee.
current performance. Against this, a cap might encourage smaller firms to be willing to audit larger companies. It might also encourage the audit profession to extend the assurances they are willing to give beyond the audit of the financial statements. It might serve to reduce the cost of audit. While the 2006 UK Companies Act allows that auditor liability can be negotiated contractually, this rarely if ever occurs at the level of large company audits as clients don’t see the point of conceding on liability. Alternatives to contractual liability have been suggested over the years. Proportionate liability (where liability is apportioned between the various parties held to be culpable, including the directors and auditors) has the disadvantage of leaving the scale of the audit firm’s liability uncertain until the court case is concluded.

**Board risk committees**

Perhaps predictably there is a greater propensity of ‘Big 4’ firms to support measures that generate more fee income, and vice versa. While the Committee was mindful of the risk of piling costs on UK plc, it supported the Walker recommendation that banks and other ‘systemic’ entities should have board risk committees. The FRC suggested, and the Committee recommends, that outside advice to board risk committees should be obtained from a party other than the company’s external auditors so as to encourage the use on ‘non-Big 4’ firms by large companies. Mr. Griffith-Jones of KPMG told the Inquiry that ‘to mandate the auditors out of the loop because the risk advisors have to be, as it were, not the auditor would be a mistake; we need to be careful with the definitions we use...’ One was immediately put in mind of the wriggle room in the intricate wording in the Auditing Practices Board’s Ethical Standards for Auditors which has been used to justify auditors providing non-audit services such as internal auditing for their audit clients, as with KPMG’s work on behalf of Rentokil Initial. The ‘small print’ does indeed matter. During the press conference launching the report, the Committee chairman suggested that the ‘Big 4’s’ time in front of the Committee was not their finest hour.

**Bank audits and IFRS**

The Inquiry morphed to pursue a line of enquiry that had not been anticipated initially. Their concern as to whether auditors had failed in their audit of banks in the lead up to the financial crisis, led the Inquiry to examine the suitability of IFRS. The prize of financial statements being prepared on the same basis globally is attractive to international investors and others.

The Committee heard that IFRS had replaced ‘prudence’ by ‘neutrality’ and their recommendation is that ‘prudence’ should be reasserted as the guiding principle of audit. The Committee also learnt that IFRS 39 disallows provision for expected losses and thus increases reporting volatility, and that ‘mark to market’ or ‘mark to model’ allows profits to be exaggerated and to be taken even though unrealised – potentially leading to excessive distributions and excessive bonuses. The Committee

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10 Q256
11 Some have queried whether the Lords’ report should have linked ‘prudence’ to accounting standards rather than to audit. I believe the point that the Committee is making is that they consider prudence should be reasserted as the guiding principle of accounting standards but that, even if it is not, the auditor’s true and fair override should always apply the principle of prudence. Concern was expressed to the Inquiry that audit had become too much of a box-ticking exercise of compliance with financial reporting standards, with too little regard for substance over form and too little scope for the application of auditor scepticism. The Inquiry heard that the FRC had taken advice from a financial QC whose opinion was that IFRS ‘fairly present’ (IAS 1) is the same as ‘true and fair’ under UK GAAP.
12 IAS 39 says ‘losses no matter how likely are not recognised’.
learnt that these issues were particularly evident in banks and other financial institutions, and was
told that IFRS was thus a contributory factor in the development of the global financial crisis. The
‘Big 4’ and others disputed this, pointing out that the US suffered from the crisis though they have
not adopted IFRS, whereas Australia under IFRS had not suffered similarly. However, IFRS have
been developed with a view to alignment with US GAAP; and there were other reasons apart from
IFRS why Australian banks escaped the worst consequences of the global financial crisis, including
their much tighter bank regulation.

The Committee is recommending that further roll out of IFRS in the UK should be delayed until the
concerns have been resolved. In effect, the Committee desires to preserve UK GAAP as a fall back
in case IFRS falls flat on its face. It is also true that UK GAAP has already converged with IFRS, for
instance by the UK’s adoption of IFRS 39 within FRS 26, but currently it would not too late to reverse
the IFRS roll out.

IASB\textsuperscript{13} is working on a revision of IFRS 39 (to be IAS 9) which will allow accounting for expected
losses, but the Inquiry was told that this would not be applied before 2015.

Concerns were also expressed about the accountability of IASB to its stakeholders and how
appointments are made to IASB bodies. The Committee has expressed general concern about the
complex, unwieldy structure of the accounting and auditing profession and its regulation, asking for
government action if there is not rapid progress towards rationalisation. Just one aspect of this is
the presence of six separate main professional accounting/auditing bodies in UK and Ireland: one
witness drew attention to the positive competitive aspects of this plurality.

The Committee seemed to be rather shocked at the modest scope of the going concern concept. So
long as there is a reasonable expectation that the company will be in business next time the auditors
report to the shareholders, then there is no case for a going concern qualification. So, even if the
current shareholders are expected to lose everything, so long as the business will continue (for
instance under different ownership) it may be regarded as a going concern. Since the auditors
report to the shareholders, the Committee seemed to find this surprising. While ‘the company’ was
originally ‘the company of shareholders’, this situation is one consequence of companies having a
separate corporate identity to that of the shareholders and calls to question the value of the
auditor’s report to the shareholders who commission it. The assurances the auditors of banks
received from Lord Myners, then a government minister, about the government supporting the
banks were sufficient to allow the auditors to accept that their bank clients were going concerns at
the end of 2008.\textsuperscript{14}

The Committee’s report considers auditors were complacent. It also considers auditors were
derelict in duty, but not with respect to going concern – although the report is critical on that too.
The relevant paragraphs in the report read:

‘We do not accept the defence that bank auditors did all that was required of them. In the light
of what we now know, that defence appears disconcertingly complacent. It may be that the Big
Four carried out their duties properly in the strictly legal sense, but we conclude that, in the
wider sense, they did not do so.’\textsuperscript{15}

\textsuperscript{13} The International Accounting Standards Board sets International Financial Reporting Standards.
\textsuperscript{14} Q466
\textsuperscript{15} Para 198 and 142
‘We regard the recent paucity of meetings between bank auditors and regulators, particularly in a period of looming financial crisis as a dereliction of duty by both auditors and regulators.’\textsuperscript{16}

Was it a slip of the tongue for Michael Izza, chief executive of ICAEW, to respond to the House of Lords report in these terms:

“We do not accept that auditors contributed to the severity of the financial crisis. They did the job that they were expected to do: provide an audit opinion on banks’ financial statements.”\textsuperscript{17}

We have seen that their lordships conceded that auditors may have carried out their duties in a strictly legal sense, but the concept of ‘expectation’ is loaded with meaning in an auditing context and, particularly with respect to the financial crisis, it is a bold person who can aver that there was no audit expectations gap.\textsuperscript{18}

Internal audit

We end with a note on internal audit. The Chartered Institute of Internal Auditors were very effective witnesses to the Inquiry although the Committee’s report makes little mention of internal auditing. The Committee has however adopted advice of CIIA and others that internal audit services should not be provided by the company’s external auditors.\textsuperscript{19} The Committee also recommends that tax advisory services should not be provided by the external auditor. The CIIA explained that their opposition to making internal audit mandatory was to do with their desire to align themselves with the UK principles-based ‘comply or explain’ approach.\textsuperscript{20} The Committee stopped short of recommending that no non-audit services should be provided by external auditors, or that ‘pure’ audit firms should be created.

It is pertinent to ask why CIIA’s very strong written and oral testimony, led by Dr. Ian Peters (CEO of CIIA) and Dr. Sarah Blackburn (past president) who appeared as witnesses alongside Lord Sharman on 14\textsuperscript{th} December 2010, impacted only marginally on the Committee’s report. Indeed that is a question which has been put to me repeatedly.

Before addressing the question directly, it must be said that it is reminiscent of the earlier failure of internal audit to feature significantly in the 2009 report of the Walker Review. Internal audit

\textsuperscript{16} Para 201 and 161
\textsuperscript{17} Reported widely, for instance in \textit{The Times} (31\textsuperscript{st} March 2011), p53.

-- Audit expectations gap:
  \textsuperscript{19} Q380

\textsuperscript{20} Q392
received no mention at all in the draft report of the Walker Review except for an acknowledgement that the IIA had responded to the consultation. Within the 181 pages of the final Walker Report, there was only this mention of internal audit:

“Discussions in the context of this Review process suggest that failures that proved to be critical for many banks related much less to what might be characterised as conventional compliance and audit processes, including internal audit, but to defective information flow, defective analytical tools and inability to bring insightful judgement in the interpretation of information and the impact of market events on the business model.”

To paraphrase Walker, internal audit cannot be blamed for the financial crisis as internal audit was perceived as being a compliance checking process with not remit to provide assurance on information flow, analytical tools, the interpretation of information or the impact of market events on the business model. So, internal audit escaped blame for the financial crisis at the cost of being characterised as being a bit player. If no part of the problem, internal audit can hardly be regarded as part of the solution. Many internal auditors would not accept this modest role for internal audit.

Had the representatives of the internal auditing profession proposed to the Inquiry that internal audit should serve the board in a way that is truly independent of management, and that internal audit could be the provider of independent assurance to board risk committees, then I am sure the Inquiry would have sat up and taken notice, and internal audit would have featured much more prominently in the Inquiry’s report and recommendations.

Over the years internal audit has transformed itself several times to meet changing needs, but this progressive, pioneering spirit seems to have been lost and internal audit is now locked into a conservative time warp. Internal auditing is missing out on an unprecedented opportunity to enhance its status and provide a badly needed service in filling the board’s assurance vacuum. Around year 1900 internal audit was the reperformance of certain accounting processes, as a service to mid-level accounting management. By the 1940s the approach had become to provide assurance about the systems of internal control over accounting processes – on the basis that audit assurance by reperformance was no longer feasible when processes had become more complex and the volume of transactions had become so much greater. Overlapping with this transition was a morphing of internal audit to provide assurance over all operational processes, not just accounting processes. The 1980s saw the development of a risk-based approach to internal auditing – on the basis that, when as always internal audit resources are limited and business processes are being ever more complex, it was more important to provide reliable assurance about the business processes that mitigate the principal risks of the business.

In parallel with this evolution of internal auditing, it became appropriate for internal auditing to progress from reporting to mid-level accounting management to reporting to the finance director and then to the chief executive (who is the apex of all business processes). Now there is a need for internal audit to report for all purposes to the independent chairman of the board or to the board.

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itself, so that internal auditors can provide independent assurance to the board on both the internal and external risks facing the business.

Internal auditors acknowledged to the Inquiry that they share collective responsibility with other parties for the financial crisis, as indeed did most other parties who appeared before the Inquiry – almost always without accepting specific responsibility. Dr. Peters remarks to the Inquiry chime with this willingness to share collective responsibility, but also go further by tacitly rejecting the Walker Review’s diminutive characterisation of the internal audit role:

“... not surprisingly, we would take the view that internal audit does a very effective job in most instances.

“However, in the case of the financial crisis and in the case of the banks and the financial institutions, it is clear that internal audit was part of the structure that went wrong. I think there are many lessons that we need to learn from that and that we are still learning. But I think particularly important is the fact that internal audit and audit committees were very much focused on process and on internal controls within the organisation, and were not looking beyond that; were not looking at the wider picture as much as, clearly with the benefit of hindsight, they should have been doing. That would suggest that, going forward, internal audit needs to play a much broader role, in looking at the governance of the organisation, looking at the behaviour in governance, the behaviour of management and the board, the skills, the abilities, the capabilities of the board and the non-executives in particular, to ensure that they are able to play their role effectively in identifying and ensuring that the organisation is mitigating risk.”

One thing that is missing from this is a recognition that to be a reliable provider of assurance to the board, internal audit needs to report for all purposes, including ‘pay and rations’ to the board or to the independent chairman of the board. He who pays the piper calls the tune. Internal audit should be regarded as one of the costs of running the board. Internal audit in general has not yet reached this conclusion, and hence it is not being seen as a significant part of the solution to the problems we have been experiencing. Dr. Peters told the Inquiry:

“... [Internal audit] needs a relationship with internal management – it is internal – and pay and rations, if you like, in terms of where the money comes from; ...”

But it has traditionally been called ‘internal’ because it provides assurance on internal matters.

The financial crisis has been an unprecedented opportunity foregone for internal audit to make a pitch for enhancing their role to fill the board’s assurance vacuum.

Yet, there is some light at the end of the tunnel. Recently the UBS website stated:

“To maximize its independence from management, the head of Group Internal Audit ... reports directly to the Chairman of the Board. Group Internal Audit has unrestricted access to all accounts, books and records and must be provided with all information and data needed to fulfill its auditing duties. Group Internal Audit addresses any reports with major issues to the Chairman of the Board. The Chairman’s Office may order special audits to be conducted, and the Group Executive Board, with the agreement of the Chairman, may also instruct Group Internal Audit to conduct such audits.”

29 Q357, (Hof Report, Vol.2, p276); see also Dr. Peters’ answer to Q381, Vol. 2, p282.
And the head of internal audit at Novartis reports to the non-executive chairman of the board and management does not determine the audit plan. ‘Pay and rations’ for the Novartis internal audit function is a matter for the chairman of the board and for the audit committee.

By strengthening internal audit’s relationship with the board, internal audit would be able to provide stronger assurance to the board, while still being able to provide at least as strong assurance to management. Indeed, assurance is all the better if it is provided by a party that is independent of those to whom the assurance is being given. In none of the extensive evidence presented to the Inquiry was any suggestion that internal audit could satisfy a board risk committee’s need for independent assurance. Currently most internal auditors cherish their close bond with the top management team and don’t wish to move out of that comfort zone. A crucial issue is ‘how do boards get the assurance they need’. There have been so many examples of internal audit trimming their reporting to the audit committee of the board in order to accommodate pressure from top management. This issue is discussed further elsewhere.

Postscript

The Committee makes a number of other recommendations designed to improve choice and quality in the audit market, which we do not cover here.

As a postscript, perhaps it tells us something that, excluding the appendices, ACCA evidence had 14 mentions in the Committee’s main report compared to ICAEW (7), ICAS (6), CIMA (2) and CIPFA (1). Professor Fearnley of Bournemouth University had 7 mentions and Tim Bush 4. Vivien Beattie, Stella Fearnley and Tony Hines new book appeared at about the same time as the Inquiry report and discusses in depth many of the issues addressed in the House of Lords report.

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31 See Dr. Blackburn’s answer to Q383, HoL report Vol. 2, p282 which implies an advantage of a close relationship between internal audit and management.
Possible research topics arising from 
The House of Lords Inquiry into ‘Auditors: Market concentration and their role’

Competition
1. Has limited choice impacted negatively on audit quality?
2. Are mid-tier firms capable of auditing large companies?
3. Determine the extent to which covenants (with banks and others) restrict a company’s choice of auditor.
4. Model the impact of the ‘Big 4’ becoming the ‘Big 3’.
5. The costs and benefits of tendering audits and changing auditors.
6. Update of research on duration of auditor relationships with clients
7. The costs and benefits of joint (as distinct from ‘shared’) audits.
8. Predict the impact on the audit market if a financial statements insurance approach were introduced to compete with the conventional audit market.
9. The extent and nature of shareholder and other investor involvement in auditor choice and audit performance

The profession
10. Trace the consolidation of accounting firms and the emergence of new firms over the years, nationally and internationally, with a view to concluding whether this has been positive or negative in terms of competition, choice and audit quality.
11. In regard to the auditing profession, determine the extent to which, if at all, the costs of partnership capital are higher than in an external investment model.
12. Update the sociological research into the hallmarks of a profession, including the ideal of placing the concept of service above monetary reward as a quid pro quo for society giving the

35 I am grateful to Dr. Ilias Basioudis of Aston University for these references:
Recent Brazilian takeovers:
https://zephyr2.bvdep.com/version-201138/FulpeEditorialNews.sv?
product=zephyrneo&databasecontext=Deals&newsid=9176
Peter Boys (1989, 1990) “What’s in a name”, Accountancy. A series of articles in 1989 and 1990 published in the Accountancy magazine that has charted the changes in the names of accounting firms through a maze of mergers from 1780 to 1990. In that way the family trees of the largest accounting firms in British practice in 1989 were followed to their beginnings.
Basiouisis IG: PhD (2000), he quotes: “604 different accounting firms appear in my dataset between 1953-1991, and many (if not the majority) of them have now disappeared mainly due to a wave of mergers during the last 40-50 years…..the merger activities were accelerating during the 60s, 70s and 80s, and that mergers have been prevalent throughout the history of the british accounting firms.”
36 Professor Power addressed this in his witness evidence at Q36. It is widely held that the hallmarks of a profession are (a) specialised body of knowledge, (b) recognised formal education process for acquiring the requisite specialised knowledge, (c) standard professional qualifications governing admission to the profession, (d) a standard of conduct governing the
profession privileges including monopoly rights to practise; relate this to the conduct of the large public accounting practices and the appropriate action they might take and support to deal with concentration in the audit market. For instance, should they ‘do the honest thing’ and voluntarily break up?

**Choice of auditor**

13. Why do large companies favour using large firms of auditors?

**Impact of accounting standards**

14. Research into the extent to which ‘mark to market’, ‘mark to model’ and other aspects of ‘neutral’ rather than ‘prudent’ IFRS led to pro-cyclical profitability of financial institutions and to excessive distributions and bonuses.

15. Does IFRS produce true, fair and prudent financial statements, and has the auditor’s concern about ‘substance over form’ become circumscribed by the requirements of accounting standards?

**Extending the scope of external audit**

16. Could the external audit be extended to include management’s narrative on the business model, on risk and on corporate governance assertions?

**Corporate governance**

17. Ascertain the current composition, role and conduct of board risk committees, especially in financial institutions. This could become a longitudinal study.

18. The scope and transparency of published audit committee reports.

**Internal audit**

19. Whether, and how, internal audit reporting relationships impact upon the assurance that internal audit is able to provide to the board.

20. The incidence of differing reporting relationships of internal audit with respect to administrative (‘pay and rations’), functional and activity reporting.

**Regulation**

21. Research into the extent of regulatory capture by accounting firms

22. What would be the effect of removing the mandatory requirement for an audit, leaving it to the market?

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Revised 12May11

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relationship of the practitioner with clients, colleagues and the public, (e) recognition of status, (f) an acceptance of social responsibility inherent in an occupation endowed with the public interest, (g) an organisation devoted to the advancement of the social obligations of a group, and (h) a profession is represented in three forums – the professional body, the universities and the units that practise – with cross-membership between these three. Society cedes professional status to an occupational group when it is in society’s best interests to do so; in return the occupational group is expected to place the concept of service above that of personal financial gain.

Useful sources would be:


Audit Market Concentration: Implications and Solutions – a Personal Perspective

"O wad some Pow’r the giftee gie us
   To see ousels as others see us!
It wad frae mony a blunder free us,
   And foolish notion."

‘To a Louise’ (1786)
Robert Burns
“We do not accept the defence that bank auditors did all that was required of them. In the light of what we now know, that defence appears disconcertingly complacent. It may be that the Big Four carried out their duties properly in the strictly legal sense, but we conclude that, in the wider sense, they did not do so.” (§142 & 198)

and

“We regard the recent paucity of meetings between bank auditors and regulators, particularly in a period of looming financial crisis as a dereliction of duty by both auditors and regulators.” (§161 & 201, see also 164-5, 167 & 202-204)

and

“There was no single cause of the banking meltdown of 2008-09. First and foremost, the banks have themselves to blame. ... But we conclude that the complacency of bank auditors was a significant contributory factor. Either they were culpably unaware of the mounting dangers, or, if they were aware of them, they equally culpably failed to alert the supervisory authority of their concerns.” (§167).
“We do not accept that auditors contributed to the severity of the financial crisis. They did the job that they were expected to do: provide an audit opinion on banks’ financial statements.”

Michael Izza, chief executive of ICAEW, reported widely, for instance in The Times (31st March 2011), p53.

The audit expectations gap

‘A factor of the levels of expected performance as envisioned both by the independent accountants and by the use of financial statements. The difference between these levels of expected performance is the expectation gap.’

(Liggio)

‘Audit expectation-performance gap’:

– Gap between what society expects auditors to achieve and what they can reasonably be expected to accomplish (‘reasonableness gap’);
– Gap between what society can reasonably expect auditors to accomplish and what they are perceived to achieve (‘performance gap’)
  • a gap between what can reasonably be expected of auditors and auditors’ existing duties, as defined by the law and professional promulgations (‘deficient standards’); and
  • a gap between auditors’ existing duties and auditors’ performance, as perceived by society (‘deficient performance’).’

(Porter)
Is ‘Big 4’ anti-competitive?

• In 1986 Peat Marwick merged with KMG to form KPMG
  – one of the Big Four today
• Two mergers in 1989 – which created Ernst & Young and Deloitte & Touche (now ‘Deloitte’)
  – reduced the then Big Eight to the Big Six.
• In 1998 Price Waterhouse merged with Coopers & Lybrand to form PricewaterhouseCoopers
  – which created the Big Five
• Arthur Andersen collapsed in 2002
  – led to the creation of today’s Big Four.

Summary of conclusions and recommendations

• A thorough review by OFT (“in depth and in the round”) is long overdue, with a view to referral to the Competition Commission (§98 and 190), including but by no means limited to:
  – Covenants restricting auditor choice (§57, 180)
  – Investigate impact of unlimited auditor liability (§60, 181)
  – Investigate limits on outside ownership of audit firms (§64, 182)
  – Investigate impact of additional audit assurance on narrative assertions (§79, 186)
Summary of conclusions and recommendations

• More transparency and disclosure not the answer (§35, 173)

• If joint audits were promoted, one should be a non-‘Big 4’ firm (§40, 174)

• Mandatory FTSE 350 tendering every 5yrs (§44, 175)

• Audit committees to (§49, 176):
  – Hold discussions with main shareholders every 5yrs
  – Publicly detail significant issues raised in in the audit
  – Explain decisions on tendering and auditor choice

• Turn Audit Commission into a competitor to the ‘Big 4’ (§53, 178)

• More government work for non-‘Big 4’ firms (§55, 179).

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Summary of conclusions and recommendations

• Separate risk committees of boards (§69, 70, 183, 184)
  – External advice not by the audit firm

• Reduced audit burden on smaller companies (§75, 185)

• Ban the auditor providing internal audit and tax advisory services and advice to board’s risk committee (§87 and 187)

• Living wills for ‘Big 4’ (§92 and 189)

• Rationalise and reform the regulation of accounting and auditing (§110 and 191)

• ‘The Government should reassert the vital role of prudence in audit in the UK, whatever the accounting standard, and emphasise the importance of the going concern statement (§129 – 133, 192 – 196)
Other possible measures not adopted but referred to (App 3)

Measures aimed at increasing the market share of non-‘Big 4’ firms:

- Invite ‘Big 4’, in view of their professional ethics, to voluntarily break up
- Mandatory rotation of audit firms as in Italy
- End the mandatory requirement for an audit, leaving it to market forces.

Benedikt Koehler (2006) argued that government intervention has stifled competition in the audit market and is responsible for the market concentration.


Other possible measures not adopted but referred to (App 3)

Measures aimed at increasing the market share of non-‘Big 4’ firms:

- Greater use of shared audits by leading listed companies.
- Mandatory requirement for joint audits as in France
- A regulatory code of conduct promoting the use of non-‘Big 4’ firms: this might be as auditors of subsidiaries within large, public groups.
Other possible measures not adopted but referred to (App 3)

Measures aimed at reducing ‘Big 4’ dominance:

- Place limits on the market share of firms measured by the number of appointments held over a five year period.
- Audit committees to disclose when and how periodic formal evaluations of the internal and external auditors were undertaken and the key conclusions arising therefrom.
- Break up of one or more of the Big 4.

Other possible measures not adopted but referred to (App 3)

Measures aimed at strengthening non-‘Big 4’ firms:

- Relax the limit to the amount of outside capital of an audit firm (49%).
- Relax ownership rules of auditing firms (majority of the management board of an audit firm must be approved EU auditors. Oxera research shows the cost of capital in a partnership is higher than in an ownership model that allows for external investment.
- Increased investment by, or mergers of, non-‘Big 4’ firms to create one or more larger ones, to enhance their international networks, etc.
- Defection of a large number of specialist bank auditors from a ‘Big 4’ firm to a ‘mid-tier’ firm.
Other possible measures not adopted but referred to (App 3)

Measures aimed at breaking the close relationship between management and auditors

1. Alternative appointment processes for auditors, e.g. involving shareholder panels, or appointment by regulator.
2. The audit committee to appoint the auditors, as in the US under Sarbanes-Oxley, and report in some detail their decision.
3. Introduce a financial statements insurance approach as an optional alternative to the present audit
4. Debar or limit the auditor from undertaking any non-audit work for their audit clients.
5. Require fees for ‘audit related work’ and ‘extended audit work’ to be reported by audit firms separately from fees for audit work.
6. Limit the proportion of audit fees a firm can receive from a single client (EC Green Paper).

Other possible measures not adopted but referred to (App 3)

Measures aimed at regulators and standards setters – 1

• Narrow the scope of the annual audit, so that companies can get other advice from ‘mid-tier’ firms
• Consistency/alignment of the regulatory framework globally.
• Make sure that regulators of cross-border activities do not act as an to using non-‘Big 4’ audit firms.
• The regulator should be less burdensome of the profession.
• An early warning system of significant threats to the operations of a ‘Big 4’ firm.
**Other possible measures not adopted but referred to (App 3)**

**Measures aimed at regulators and standards setters – 2**

- A system for ring-fencing healthy parts of the network,[if a ‘Big 4’ fails].
- ‘The need for a clear statement that the government/competition authorities would break up a ‘Big 3’.
- Take measures to eliminate the perception and/or reality of regulatory capture of auditing regulation.

**Other possible measures not adopted but referred to (App 3)**

**Measures aimed at investors**

- Find a way of ensuring that the largest institutional investors act together to influence large companies to consider ‘Mid-Tier’ audit firms, as they usually get the changes they are looking for.
- The FRC should convene a group of large institutional investors to come up with audit market intervention initiatives.
Audit Market Concentration: Implications and Solutions – a Personal Perspective

Supplementary graphics
Widening choice in the audit market

Q504
Ed Davey

“[I] think we can persuade firms to change their auditors more frequently and look at other auditors outside the Big 4, particularly obviously in the FTSE 100 and other big listed companies”
End mandatory audit?

Q522
Ed Davey
"Government believes there is a strong case for taking away the mandatory requirement for an audit from medium-sized companies"

thus removing the requirement from, we were told, 32,385 companies (Q522, Q523, Q524).

Mid-tier:
Turnover more than £6.5m and less or equal to £25.9m; total assets of more than £3.26m and less or equal to £12.9m.

Board risk committees

Walker, Recommendation 23
“The board of a FTSE 100-listed bank or life insurance company should establish a board risk committee separately from the audit committee. The board risk committee should have responsibility for oversight and advice to the board on the current risk exposures of the entity and future risk strategy, including strategy for capital and liquidity management, and the embedding and maintenance throughout the entity of a supportive culture in relation to the management of risk alongside established prescriptive rules and procedures. In preparing advice to the board on its overall risk appetite, tolerance and strategy, the board risk committee should ensure that account has been taken of the current and prospective macroeconomic and financial environment drawing on financial stability assessments such as those published by the Bank of England, the FSA and other authoritative sources that may be relevant for the risk policies of the firm.”
Board risk committees

Walker Recommendation 24
“In support of board-level risk governance, a BOFI board should be served by a CRO who should participate in the risk management and oversight process at the highest level on an enterprise-wide basis and have a status of total independence from individual business units. Alongside an internal reporting line to the CEO or CFO, the CRO should report to the board risk committee, with direct access to the chairman of the committee in the event of need. The tenure and independence of the CRO should be underpinned by a provision that removal from office would require the prior agreement of the board. The remuneration of the CRO should be subject to approval by the chairman or chairman of the board remuneration committee.”

Board risk committees

Walker Recommendation 25
“The board risk committee should be attentive to the potential added value from seeking external input to its work as a means of taking full account of relevant experience elsewhere and in challenging its analysis and assessment.”
Board risk committees

**Walker Recommendation 26**

“In respect of a proposed strategic transaction involving acquisition or disposal, it should as a matter of good practice be for the board risk committee in advising the board to ensure that a due diligence appraisal of the proposition is undertaken, focusing in particular on risk aspects and implications for the risk appetite and tolerance of the entity, drawing on independent external advice where appropriate and available, before the board takes a decision whether to proceed.”

Board risk committees

**Walker Recommendation 27**

“The board risk committee (or board) risk report should be included as a separate report within the annual report and accounts. The report should describe thematically the strategy of the entity in a risk management context, including information on the key risk exposures inherent in the strategy, the associated risk appetite and tolerance and how the actual risk appetite is assessed over time covering both banking and trading book exposures and the effectiveness of the risk management process over such exposures. The report should also provide at least high-level information on the scope and outcome of the stress-testing programme. An indication should be given of the membership of the committee, of the frequency of its meetings, whether external advice was taken and, if so, its source.”
Board risk committees

House of Lords
The Select Committee on Economic Affairs
Inquiry on
AUDITORS: MARKET CONCENTRATION AND THEIR ROLE
Evidence Session No. 5  Heard in Public
TUESDAY 9 November 2010
Examination of Witnesses including
Witness: Baroness Hogg, Chairman, Financial Reporting Council

Q229
The Chairman:
“What one key measure would you recommend for taking this further?” [i.e. widening competition and choice in the audit market]

Baroness Hogg:
“…use the development of risk committees to develop another source of advice, which may bring into the market possibly different kinds of firms or encourage existing firms to step up on a range of work that is not quite so requiring of a global network as traditionally auditing a big international company has been supposed to do … could potentially make quite a difference.”
Board risk committees

House of Lords
The Select Committee on Economic Affairs

Inquiry on

AUDITORS: MARKET CONCENTRATION AND THEIR ROLE

Supplementary Evidence from The Financial Reporting Council
22 December 2010

“The FRC would encourage banks and other systemic institutions to use non-Big Four firms as a source of advice to their risk committees. This would give such firms an exposure to large companies that they might not otherwise have access to and may in time provide them with the opportunity to tender for the audits of some of these entities’
Board risk committees

House of Lords
The Select Committee on Economic Affairs

Inquiry on

AUDITORS: MARKET CONCENTRATION AND THEIR ROLE

Evidence Session No. 6    Heard in Public
TUESDAY 9 November 2010
Examination of Witnesses

Witnesses: Mr. Scott Halliday (Ernst & Young), Mr. Ian Powell (PwC), Mr. John Griffith-Jones (KPMG) and Mr. John Connolly (Deloitte)

Q246:
Mr. John Connolly, Deloitte:
“The concept of independent advisers advising risk committees is a good one.”

Q256:
Mr. Griffith-Jones, KPMG:
“I personally believe that the auditors have an important role to play around the risk area and to mandate the auditors out of the loop that risk advisers have to be, as it were, not the auditor; we need to be careful with the definitions that we use. I quite accept that they shouldn’t be advising but if the consequences of having a separate set of risk advisers is that the auditors do not get involved in risk, I think that would be to miss a major learning from the financial crisis and that we must be careful how we structure those rules. I also think that the chances of a risk adviser being another audit firm are by no means 100% and it’s certainly not a way of increasing competition.”
Audit Market Concentration: Implications and Solutions – a Personal Perspective
The marketing audit is a fundamental part of the marketing planning process. It is conducted not only at the beginning of the process, but also at a series of points during the implementation of the plan. The marketing audit considers both internal and external influences on marketing planning, as well as a review of the plan itself. 1. The Internal Marketing Environment. What resources do we have at hand? (i.e. The FIVE 'M's) Their number/concentration. The relative strengths and weaknesses of competition. The marketing plans and strategies of our competition. Issues 16 Auditor Liability in a Changing Environment 17 The Independent Auditor, Stock Markets and Lending Decisions 18 Corporate Fraud, Corporate Scandals and External Auditing 19 Auditing: Looking Ahead. Glossary Index. xix xxii xxv xxviii. Audit concentration Implications of rms moving into consulting services Challenges facing the audit profession Regulators' reaction to audit concentration Regulation and monitoring: can the auditing profession regulate itself?