Auditors: market concentration and their role

Domination of the global audit market by the Big Four has led to concerns about limited competition, the quality of audited accounts and conflicts of interest between auditing and consulting divisions. In addition, should auditors have done more to mitigate the financial crisis? This document sets out CIMA's response to an inquiry by the Economic Affairs Committee of the UK House of Lords into audit market concentration and the role of auditors.

CIMA consultation response
Key messages

1. Much has been said and written about the causes of the financial crisis and we believe that this is not a time for apportioning blame but rather for learning lessons that reduce the likelihood of an economic collapse of this magnitude reoccurring.

2. It is the role of the board of an organisation to deliver effective, entrepreneurial and prudent management that can deliver long-term success. External reporting should allow judgements to be made by third parties on whether this is happening. It is the role of the audit report to express an opinion on whether the financial statements present a true and fair view of the organisation’s affairs.

3. Investors and regulators should act in a manner that encourages organisations to act in their long-term best interests and in the case of public interest organisations in a manner consistent with the long-term public good.

4. We believe that there are several factors driving audit market concentration:
   - complexity of accounting standards
   - the requirement for auditors with global reach
   - the reputational risk of choosing an auditor outside of the Big Four and
   - the significant infrastructure investment required by a global audit firm.

5. Despite the degree of concentration, the audit market remains competitive. However, any further reduction in the number of market participants would significantly impair competition by presenting further conflict of interest challenges.

6. The audit process delivers what is strictly required of it legally - it tends to ensure compliance with reporting standards. There are common misconceptions about audit: it is not designed to detect fraud; or to reveal that a company is undermining its own business model and it cannot vouch that every figure in a set of annual accounts is correct.

7. The focus of audit on the financial statements is unduly narrow. The front section of the annual report, the narrative operating and financial review (OFR), provides the critical, forward looking contextual information which is essential to a proper understanding of the financial statements. It is important that consideration is given to some form of audit assurance that covers the process of generating the OFR.

8. There is a risk that management representations are being relied upon in cases in which audit verification should be possible. We believe that the management representation letter should set out the steps taken by auditors to verify the statements on which they have asked for management representation.

9. It is the purpose of good management information to equip boards effectively so as to deliver long-term success. We believe that consideration should be given to an extension to the role of audit to specifically cover whether the information provided to boards is sufficient for the board to determine the business model and adequately assess associated risks.

10. There were many factors that led to the financial crisis of 2008. Predominantly, we believe, that the lightness of regulation and the pursuit of unsustainable business models by boards were the most significant factors leading to the crisis. We conclude that there was little more that audit, as currently designed, could have done to prevent the crisis.

11. The regulation of the large audit firms is now a global issue that requires international agreement for effective change. The difficulties that this produces should not be underestimated.
About CIMA

CIMA, the Chartered Institute of Management Accountants, founded in 1919, is the world’s leading and largest professional body of management accountants, with 172,000 members and students operating at the heart of business in 168 countries. CIMA members and students work in industry, commerce and not-for-profit organisations. CIMA works closely with employers and sponsors leading-edge research, constantly updating its qualification, professional experience requirements and continuing professional development to ensure it remains the employers' choice when recruiting financially trained business leaders.

According to independent research conducted by the University of Bath School of Management, CIMA’s syllabus and examination structure are the most relevant to the needs of business of all the accountancy bodies it assessed. For more information about CIMA, please visit www.cimaglobal.com Follow us on Twitter at www.twitter.com/CIMA_News

About author

Nick Topazio is CIMA’s specialist on how corporates report to external stakeholders. The author would like to thank a number of CIMA members who are directors in FTSE 350 companies for their helpful comments and contributions to this paper.
Introduction

It is now two years since the depths of the financial crisis of 2008. There have been several reviews of events that led to the near total failure of the global banking system and now thoughts are starting to crystallise in relation to how the system of financial regulation needs to change to best avoid a repeat of the economic collapse.

The UK House of Lords Economic Affairs Select Committee decided to conduct an inquiry into the audit market and specifically the limited choice of audit firm for major corporates as well as whether those major audit firms could have done more to mitigate the effects of the banking crisis by alerting users of financial reports to the riskiness of assets being held by banks.

CIMA was invited to submit evidence to the Select Committee and was very pleased to accept this invitation. This report contains the questions from the committee’s call for evidence and the responses are those submitted to the Select Committee as written evidence on 24 September 2010.

Although the CIMA qualification does not include auditing, our members have an active interest in the effectiveness of audit as a consumer. CIMA members occupy senior positions in many of the UK’s largest public and private organisations and have direct involvement in the selection of audit firms and the work of auditors though various FTSE 350 audit committees and boards. We have consulted with a number of these senior figures in the UK and we thank them for their invaluable input. Despite this, the views expressed in this evidence remain those of CIMA only.

Letter to the House of Lords from Charles Tilley, CIMA CEO
CIMA’s response to the House of Lords Economic Affairs Committee call for evidence

Q1) Why did auditing become so concentrated on four global firms? For example, do economies of scale make it too difficult for smaller firms to compete?

There appears to us to be several reasons why auditing has become so concentrated on four global firms:

- complexity of accounting standards
- global reach
- reputation
- infrastructure investment.

International financial reporting standards (IFRS) are recognised as being complex. Proponents of IFRS cite the growing complexity in basic business transactions but nevertheless a significant amount of technical expertise is required by the audit firms to adequately advise their clients. The Big Four firms not only have more people in their technical departments but these staff are exposed to similar issues in the dealings with other multinationals. The prevalence of US GAAP and the need for advice from experts in this field also drive large companies towards a Big Four auditor.

Multinationals need access to high quality local accounting advice and audit firms outside of the Big Four may find this difficult to provide across all necessary territories. Companies often find it easier to negotiate audit fees based on global coverage rather than adopt a piecemeal approach. Companies that operate around the world need an external auditor with similar coverage. It is vital that the auditor has a deep local presence and is not totally reliant on ‘head office’ transfers for expertise. The clients who need coverage across the world are relatively small in number so cannot support a large number of international audit firms; perhaps four or five.

Reputation, whether perceived or otherwise, is also an important driver. As the 2006 Oxera report ‘Competition and choice in the UK audit market’ (available from [http://www.frc.org.uk/press/pub1083.html](http://www.frc.org.uk/press/pub1083.html)) concluded, the Big Four benefit from the so-called ‘IBM effect’ i.e. ‘nobody gets fired for buying IBM’. In addition to the ability to perform the technical audit and to provide global coverage, the Big Four are also regarded as being better able to offer value added services on top of the audit and to provide insurance against catastrophic risks and other reputational risks.

As a result of the need to offer a global solution, the infrastructure requirements of a Big Four audit firm are significantly different and more complex than those of a firm from the next tier. This gulf in the level of investment is difficult to bridge and represents a major barrier to market entry for the medium-sized audit firms.

Q2) Does a lack of competition mean clients are charged excessive fees?

The Oxera report did find some evidence that higher concentration led to higher audit fees, but it also noted that audit committees tended to focus on quality and reputation rather than price. It can also be difficult to separate the impact of concentration rather than cost increases due to other factors such as additional regulatory requirements.

On the other hand the greatest fees for auditors can come from non-audit services and there is a concern that some large company audits are done at a very low cost as opposed to being at an excessive cost as a form of ‘loss leader’. This causes concern as it is likely to lead to the audit firms seeking ways to cut costs and as such reduce the level of assurance that they provide.

On the whole we believe that the audit market remains competitive although any further reductions in the number of global firms would be harmful to competition and undesirable. While there are some limits on the alternative audit firms that an organisation could use, (due to independence, involvement with competitors), we believe that most companies would have a choice of capable firms should they decide to conduct a competitive audit tender process.
Q3) Does a narrow field of competition affect objectivity of advice provided?

From our experience, objectivity of advice is not impaired by the narrow field of competition for auditors. The larger audit firms generally have strong risk management and agreed global interpretations of accounting and reporting requirements that are not dictated by the wishes of any individual groups.

The fact that the audit firms also provide non-audit services is not, in itself, necessarily a conflict of interest in our view. The use of auditors for non-audit work should only take place in limited circumstances and under close scrutiny of senior management and the audit committee where their prior experience of our business means they are best placed to deliver the services required.

From a commercial point of view, as the revenue from an organisation being audited becomes more significant to an audit firm, the greater the potential risk of the objectivity of advice being affected. Although, we do not have any evidence that this conflict has affected any audit reports we believe that it is essential that market regulators continue to monitor and review this aspect.

Q4) Alternatively, does limited competition make it easier for auditors to provide unwelcome advice to clients who have relatively few choices as there is less scope to take their business elsewhere?

This may well be the case but in our opinion, for the reasons given in response to Q3, we would conclude that auditors provide unbiased and professional advice even if this is not welcome by clients.

Q5) What is the role of auditors and should it be changed?

The efficient allocation of capital is fundamental to the capitalist economic model. Financial audit is an important element in this allocation process. But it is only one part and there is a limit to what should be expected from an audit. The scope of the audit – what it does, what it can do and what it is not meant to do – seems to be greatly misunderstood by the general public, investors and others. An audit is not designed to detect fraud, although it often does, nor is it designed to identify poor business models or management teams. Its purpose is to allow the audit firm to express an opinion on the truth and fairness of the financial statements published by the audited organisation. This is not an exact science; it is a process, governed by auditing guidelines and standards, which provides the audit firm with the information needed to form a view on the accounts prepared by the management team and approved by the directors.

That is not to say that the audit process could not be improved. The International Federation of Accountants (IFAC) have for some time been investigating the elements of the business reporting system. As well as considering corporate governance, financial reporting and the usefulness of financial reports, IFAC also investigated the audit of financial reports. The basis of the project was a global research study, in which 74 IFAC member bodies from 59 different countries and jurisdictions, including all major economies, participated. The results from the study were published in February 2009 IFAC in an information paper entitled 'Developments in the Financial Reporting Supply Chain—Results from a Global Study among IFAC Member Bodies’ (available from http://web.ifac.org/publications/ifac-policy-position-papers-reports-and-comment-letters/reports-1)

The study built upon previous work by the IFAC team which had identified a number of recommendations with regard to the audit of financial reports, these were:

- continue to focus on independence, objectivity and integrity for auditors
- converge to one set of global, principles based auditing standards
- ensure consistent use of auditing standards and safeguarding of quality within audit firms
- improve auditors’ communication, both with the client and with external stakeholders
- consider limited/proportionate liability for auditors
- remove barriers that limit choice of auditor.
The study found that the extent to which their earlier recommendations had been addressed varied from country to country. Of all the recommendations with regard to the audit of financial reports, most progress was reported on the continued focus on independence, objectivity, and integrity for auditors, closely followed by further convergence to one set of global, principles based auditing standards and a more consistent use of auditing standards and quality control within audit firms.

Attempts to change the regulation of audit firms are difficult to implement due to the international nature of their operations which often means that cross border agreement is necessary for any change to be effective.

Returning to a UK context, the Financial Reporting Council (FRC) earlier this year published its fifth progress report on the implementation of the recommendations of the Market Participants Group (MPG) and on other UK and international developments relevant to choice in the audit market. (http://www.frc.org.uk/press/pub2288.html)

CIMA, in our response to the fifth progress report, made substantive comment on 15 of the recommendations made by the MPG, which we regard as the most important.

- The FRC should promote wider understanding of the possible effects on audit choice of changes to audit firm ownership rules, subject to there being sufficient safeguards to protect auditor independence and audit quality.
- Audit firms should disclose the financial results of their work on statutory audits and directly related services on a comparable basis.
- Regulatory organisations should encourage appropriate participation on standard setting bodies and committees by individuals from different sizes of audit firms.
- The auditing profession should establish mechanisms to improve access by the incoming auditor to information relevant to the audit held by the outgoing auditor.
- The FRC should provide independent guidance for audit committees and other market participants on considerations relevant to the use of firms from more than one audit network.
- The FRC should amend the section of the Smith guidance dealing with communications with shareholders to include a requirement for the provision of information relevant to the auditor re-selection process.
- Investor groups, corporate representatives and the FRC should promote good practices for shareholder engagement on auditor appointment and re-appointments.
- Regulators should develop protocols for a more consistent response to audit firm issues based on their seriousness.
- Every firm that audits public interest entities should comply with the provisions of the Combined Code on corporate governance with appropriate adaptations or give a considered explanation if it departs from the Code provisions.

Although the FRC should be commended for the openness of its reporting of progress on implementation of the recommendations of the MPG, it is disappointing to see that progress on only one of the recommendations listed above can be categorised as even 'moderate' whereas four rank as 'limited' and four as 'none'. Progress in this respect is determined by the degree of impact on the associated risks. Whilst it is clear that the FRC has undertaken a considerable amount of work and that the benefit of some of its changes has yet to influence the progress measurement metric, CIMA calls on all market participants to re-double efforts to act upon all 15 recommendations in as timely a manner as possible.

The audit as currently designed focuses on the financial statements and in particular on the historic financial position of an organisation at a point in time. Income or net profit for the period in question is largely determined by the difference between the opening and closing audited balance sheets. This is, undoubtedly, an important building block for an efficient allocation of capital but is only one element of the system.
CIMA believes that it is the role of the board to deliver effective, entrepreneurial and prudent management that can deliver long-term success. Internal reporting should ensure that boards are provided with the information set needed to operate in this way. We believe that there may be a role here for auditors to comment on whether the board is provided with sufficient information to be able to determine the business model and assess the associated risks.

Audited external reports should allow judgements to be made by third parties on whether this is happening; and investors and regulators should act in a manner that encourages this type of business approach.

We firmly believe that the top slice of information regularly reported to boards should form the basis for narrative reporting that supplies the necessary contextual information, including environmental and risk information, needed to help explain the financial position, performance and prospects of an organisation through its annual report and accounts.

Such narrative reporting is typically featured in the front section of annual reports. The effectiveness and completeness of this type of reporting varies considerably from company to company and, although there is a legal underpinning of minimum content through the business review legislation, we believe that there is scope to increase the mandatory requirements in this area. The Department for Business, Innovation and Skills (BIS) is currently consulting on a mandatory operating and financial review (OFR). The OFR requirements specify the type of information that should be provided in the narrative section of an annual report. At this point in time the Accounting Standards Board has published voluntary guidance on the OFR and we intend to support the BIS proposal to make this guidance compulsory and to extend its provisions in the area of social and environmental disclosures.

There is a role here for the audit profession to provide some form of assurance over the disclosures in an OFR. We accept that the level of rigour applied to the audit of financial statements is not applicable to the ‘audit’ of information in an OFR as it is more subjective and opinion based but nevertheless the audit profession should be challenged to offer an opinion on the contents of the OFR. We accept that this might raise substantial liability issues for auditors which may not be resolvable especially as liability protection would need to be global in nature. In which case we would like the audit profession to consider what assurance could be given over the process within the organisation used to generate the narrative report and its compliance with OFR requirements/guidelines.

In summary, we believe that the role of audit is largely undertaken with a high degree of professional competence by highly trained individuals. A number of recommendations have already been made that would enhance the audit function and we have highlighted those areas that we feel should be concentrated on to ensure that progress to date is turned into effective change. We believe that there is a need for consideration of a system of assurance from independent auditors on the OFR which would require an extension to the scope of the audit, recognising that this might require some form of liability protection for auditors.

We recognise that audit is only one part of the mechanism for efficient market allocation of capital and emphasise the integral part that effective narrative reporting, such as the OFR, should play in this allocation. CIMA has a history of making positive contributions in this area. Together with PricewaterhouseCoopers (PwC) and Radley Yeldar, we established the report leadership initiative in 2005, with the aim of challenge thinking on corporate reporting. Through a number of publications the group presented simple, practical, yet effective, ways to improve narrative and financial reporting. Further work is still planned for this group. In addition, we have recently joined with PwC and the think-tank Tomorrow’s Company to investigate the cultural and behavioural barriers to the effective development of corporate reporting which, we anticipate, will provide some interesting results.
Q6) Were auditors sufficiently sceptical when auditing banks in the run-up to the financial crisis of 2008? If not, was the lack of competition in auditing a contributory factor?

Much has been written and said about the role of the various market participants in the economic collapse. Overall, we believe the issue was an over lightness of regulation rather than a failure of audit. As Mervyn King, governor of the Bank of England, speaking at the Trades Union Congress in September 2010 said ‘Before the crisis, steady growth with low inflation and high employment was in our grasp. We let it slip – we, that is, in the financial sector and as policy makers.’

The overreliance in the financial sector on regulatory regimes, centred on the minimum capital requirements under Basel and the risk weightings applied to loan books, particularly in relation to property lending and especially because they were often based on short-term loan loss experience models which only captured activity during the unusually prolonged upside of the economic cycle.

Q7) What, if anything, could auditors have done to mitigate the banking crisis? How can auditors contribute to better supervision of banks?

It is not the auditor’s role to question strategy and to the extent that the banking crisis was caused by unsustainable business models then there was little more the auditor could have done. However, we do believe that there is a risk that the sheer complexity of accounting rules and liability concerns may have led to a reduction in the level of professional scepticism applied to the audit of financial statements to be replaced too often by a tick box mentality. This view is supported in the FSA and FRC joint discussion paper ‘Enhancing the auditor’s contribution to prudential regulation’ in which it questioned whether auditors ‘paid adequate attention to indicators of management bias’ and told auditors to ‘challenge management more.’

Q8) How much information should bank auditors share with the supervisory authorities and vice versa?

The primary responsibility of an auditor is to the shareholders of the company being audited and satisfying this responsibility is unlikely to require significant exchange of information with the supervisory authorities. However, the audit of certain organisations, which would include banks, might well be regarded as of general public interest. We support an open dialogue between banks, their auditors and the Bank of England which may require auditors to share information relating to financial stability with the supervisory authority. If auditors’ responsibilities were increased in this way then the issue of legal liability to shareholders for equity losses arising as a result of disclosure to supervisory authorities would need to be addressed.

Q9) If need be, how could incentives to provide objective and, in some cases unwelcome, advice to clients be strengthened?

We have no evidence that advice to clients is not objective even if that advice is likely to be unwelcome. There possibly needs to be a strengthening of the relationship between the auditors and the audit committee and chairman, for example through regular private sessions with the audit committee and/or chairman.

Q10) Do conflicts of interest arise between audit and consultancy roles? If so, how should they be avoided or mitigated?

We have no evidence that such conflicts do arise. However, to the extent that they might then the systems in place to maintain the quality of audit, including the work of the Audit Inspection Unit of the FRC, need to be maintained.
Q11) Should more competition be introduced into auditing? If so, how?

The capitalist market model depends upon healthy competition and it is difficult not to agree that more competition would be a good thing. However, it is not easy to see how this might be achieved.

If one believes that company boards act in the best interests of their company then the fact that all of the largest UK companies are audited by firms from the Big Four tells us that they are unwilling to move towards the next level of audit firms and, as such, are likely to be sceptical about moving to a new entrant to the market especially if that entrant came about artificially.

Q12) Should the role of internal auditors be enhanced and how should they interact with external auditors?

Internal and external audit are distinct but complementary to each other and CIMA believes that both are extremely important.

Good internal audit, which could be outsourced to an external audit firm, might have helped during the recent economic crisis because it would have reported on the adequacy of internal controls and risk issues – but if a bank was pursuing an unsustainable business model, it is not clear how much influence they could have had.

There are valuable synergies to be gained from a strong relationship between internal and external auditors such as reliance by external auditors on internal audit transaction testing.

Q13) Should the role of audit committees be enhanced?

The UK Corporate Governance Code is comprehensive in terms of the role of the audit committee. It is notable that the recent review of the code did not result in enhancements to the audit committee role; but the new code has a heightened focus on the whole board’s responsibility for risk.

The audit committee should adequately discharge its responsibilities in a professional and challenging manner but this should not reduce the sense of responsibility of the whole board to the entire published corporate report.

Q14) Is the auditing profession well placed to promote improvement in corporate governance?

The auditing profession is well placed to provide advice on how governance might be improved. However, it remains the responsibility of the board to ensure adequate corporate governance based upon the FRC’s UK Corporate Governance Code. The FRC and its subsidiary bodies have an important role to play in monitoring company reports and in our opinion this process appears fit for purpose.