

INQUIRY BY THE HOUSE OF LORDS ECONOMIC AFFAIRS COMMITTEE  
ON "AUDITORS: MARKET CONCENTRATION AND THEIR ROLE"

GOVERNMENT MEMORANDUM OF EVIDENCE

10 September 2010

**Introduction**

1. The Government welcomes this inquiry, which is one of a number of initiatives looking at the role of audit in the aftermath of the financial crisis. The Government has not reached firm conclusions on the need for changes to the present role of audit, since it would be wrong to do so until the conclusions of the present debates are clear. Any response to the financial crisis needs to be based on sound evidence, not knee jerk reactions or partial analysis. The Government is willing to consider alternatives, with the aim of ensuring high quality, but cost effective audit assurance for UK companies, in order to ensure the maximum economic benefits to companies and the UK economy.
2. Apart from the work of the Select Committee, there are several other important streams of work presently ongoing, amongst which are:
  - a. the Financial Services Authority (FSA) and the Financial Reporting Council (FRC) have issued a Discussion Paper on "Enhancing the auditor's contribution to prudential regulation";
  - b. the European Commission is scheduled to publish a wide ranging Green Paper on audit in the Autumn;
  - c. the FRC has announced that it expects to publish, also in the Autumn, a discussion document to examine the lessons learned from the credit crisis and other market developments as they impact corporate reporting, accounting and auditing of non-financial services companies.
3. The Government asked its officials to review the evidence base on the role and value of audit in order to assist in determining the direction of future policy. The discussion of the academic and other papers referred to in this memorandum is a result of this exercise. The results of the review of the evidence base have also been sent to the European Commission and the FRC.

## **The regulation of audit and the Government's role**

4. The present structure for statutory audit in the UK is based on the Companies Act 2006. Shareholders of companies (unless exempt – such as most small companies) are required to appoint external auditors for each financial year. The auditor is required to report to shareholders on whether the accounts have been properly prepared and constitute a true and fair view of the state of the company's affairs.
5. The auditor is required to follow the technical and ethical standards as set by the Auditing Practices Board, and an audit firm wishing to be appointed as a statutory auditor in the UK must be registered with, and supervised by, their Recognised Supervisory Body<sup>1</sup>. Auditors are subject to inspection by the Recognised Supervisory Body (RSB) to which they belong, and these RSBs are in turn overseen by the Professional Oversight Board (POB), part of the FRC. Through its own Audit Inspection Unit, the POB reviews the quality of the audits of listed and other major public interest entities. Smaller audits are subject to review by the monitoring units of the RSBs. A further part of the FRC, the Accounting and Actuarial Discipline Board provides for independent investigation of important cases of poor auditing.
6. The Department for Business, Innovation and Skills has the following roles in relation to audit:
  - a. It is responsible for the Companies Act 2006 and associated regulations.
  - b. It takes the UK seat on the Audit Regulatory Committee, which assists the European Commission in its adoption of measures under the Statutory Audit Directive using the comitology procedure.
  - c. It is responsible for the regulatory framework of UK law on audit, and for ensuring that it remains consistent with EU law, by implementing into UK law the 2006 EU Statutory Audit Directive and associated Commission Decisions.
  - d. It keeps abreast of audit issues as an observer on the UK's Auditing Practices Board and through contacts with stakeholders.
  - e. It sponsors the Financial Reporting Council.
7. We have attempted to estimate the costs of audit in the UK: information provided to the Professional Oversight Board by 31 of the larger UK audit firms, shows that together they earned in excess of £2billion in 2009 in audit fees<sup>2</sup>.

## **The present challenge**

8. The aftermath of the financial crisis has raised questions about the role of audit, in particular why banks failed shortly after having clean audit reports, and what the role of audit is, if it is unable to warn of such incidents. These questions were articulated very clearly by the 2009 report of the House of Commons Treasury Select Committee. Alongside the questions raised by the economic crisis, there are other

current pressures for change: the investor community has been expressing concern about audit reports, including that they should contain much more useful qualitative information about the company, rather than just the “pass or fail” opinion on the numbers in the accounts that is currently provided. Alongside that, there is the longstanding concern, discussed later in this evidence, about the concentration of supply of major audits in the hands of a very small number of audit firms.

9. The present crisis is not, of course, the first to result in challenges to the audit structure. It is notable that the reaction to this and previous crises or scandals has been to tighten the regulation of accounting and audit. The present system came into being largely as a result of the Enron and other corporate scandals in the last decade: amongst other measures, the ethical standards of the Auditing Practices Board have been revised; the Audit Inspection Unit was formed for monitoring the audits of all listed and other major public companies; and law now contained in the Companies Act 2006 increased the rights and powers of auditors in relation to information from employees, officers, directors and subsidiaries. Nevertheless, these steps have not prevented some parties from criticising audit and the auditors for failing to stop the most recent crisis from occurring. Others feel that the crisis cannot be attributed to a failure in audit and auditors.
10. As a result, the Government is inclined to be cautious about adding to the role of audit or its regulation in relation to published accounts enhancements, which have the potential to increase costs to the economy, unless it is clear there are significant benefits, and these have been demonstrated by a robust assessment of the economic impacts, in line with the Government’s commitment to better regulation. The outcome of this , and other current debates will inform Government thinking.

### **The role of audit**

11. Ideally, the current debate on the role of audit would be based on a clear understanding of exactly what value audit adds to the economy. Unfortunately, the academic and other evidence on this is not conclusive.
12. The theoretical rationale<sup>3</sup> for audit is that it is demanded under two conditions:
  - a. accountability, whereby an agent gives an account of his actions to a principal;
  - b. complexity, where principals are distant from the actions of an agent and unable to verify them.This leads to two consequences:
  - a. moral hazard, when agents may act against the principals’ interests;
  - b. information asymmetries, when agents know more than principals.

Thus audit is a risk reduction practice which benefits the principal because it inhibits the value reducing actions by agents. The categories of principal and agent can be filled out in a variety of ways. Principals can comprise, for example shareholders, creditors and tax authorities.

13. In voluntary audit environments<sup>4</sup>:
  - where a company has an audit voluntarily, it does benefit from a reduction in its cost of capital because of the signalling effect of the audit<sup>5</sup>,
  - the bigger the company the more likely it is to have a voluntary audit<sup>6</sup>.
14. The theoretical justification for mandating audit is that it increases confidence in, and the strength of, the financial system, but it is not clear, for instance, what value is added by a mandatory (rather than voluntary) audit regime: for example, whether mandating audit works to decrease the cost of capital across the economy<sup>7</sup>.
15. In mandatory audit environments, the signalling effect of voluntary audit is lost, because all comparable firms have to have an audit, but voluntarily opting for higher quality audit<sup>8</sup> enables companies to regain some of the effect. This research also demonstrates that bigger companies gain disproportionately more from higher quality audits than smaller companies do. Bigger audit firms are perceived to offer higher quality audits<sup>9</sup> partly because of their increased expenditure on training, systems and branding, partly because they have more to lose in reputation<sup>10</sup> and partly because they have more to lose via litigation<sup>11</sup> (auditor liability). It is difficult to split these effects<sup>12</sup>. There is some evidence that audit firms that specialise in industry sectors deliver audits that are acknowledged to be higher quality, but the effect is reduced in regulated industries (e.g. banking) because regulation acts as another substitute<sup>13</sup>. Financial directors and investors do however find audit valuable in checking company compliance with accounting standards and other regulatory requirements<sup>14</sup>, while they do not find value in the very limited (and often boiler-plate) qualitative assessment currently provided<sup>15</sup>.
16. There are other modes of assurance available for regulators, companies and investors as an additional support or substitute for audit and vice versa. These include accounting standards, dispersed ownership, risk management committees, audit committees<sup>16</sup>, internal auditors, credit ratings, insurance markets, investment analysts, or additional disclosures above those mandated by accounting standards and the law, and regulatory and supervisory bodies. Hence, rather than having a unique role to play in corporate reporting, the importance of audit is as one element in a multi-faceted regime of corporate governance and regulation<sup>17</sup>.
17. Mautz and Sharaf, in their seminal work on auditing (1961)<sup>18</sup>, suggest that audit works best in normal environments – that is, in non-collapsing systems and non-fraudulent firms – where auditors can

expect that normal audit procedures will uncover normal errors and normal managerial misstatements. This suggests that audit cannot provide a defence against systemic risk in an economy<sup>19</sup>. Audit also provides only a limited defence against material fraud in a company, especially where there is significant collusion by senior management. These issues give rise to the much quoted expectation gap, which arises where people expect to get more assurance out of an audit than is in reality provided, or can be provided. - there is an expectation gap in as much as the audit is often assumed to provide a greater degree of assurance than it can actually provide..

### **Way forward – debate on mandating audit?**

18. Given this evidence, it seems to the Government that there is value in a debate about the extent to which audit should be mandatory, and what the nature of any mandated audit should be. The Government's view is that audit has an important but not unique role to play in ensuring vibrant capital markets. It is less clear that a modern audit, designed largely for listed companies with diverse shareholders, should necessarily be imposed on, for instance, a medium sized owner-managed company. This is a debate which will need to take place at EU level; the current accounting directives do not allow the audit requirement to be lifted, other than from small companies or subsidiaries. At the same time, given the importance of key financial institutions to the economy, the Government recognises the need for auditors to contribute to prudential supervision as described in the FSA/FRC Discussion Paper.

### **Auditor Independence**

19. Professor Ray Ball suggested that both the fact that auditors are remunerated by companies and the total level of that remuneration inevitably affect auditor independence and judgement<sup>20</sup>. This has the potential to make it hard for auditors, who are in reality selected by management<sup>21</sup>, and who are commercial organisations, to stand up to management, particularly when financial results are poor<sup>22</sup>. Lennox (2000) shows that companies are able to engage in opinion shopping<sup>23</sup> in their choice of auditor. However, opinion shopping in the UK is likely to be infrequent, given the very low switching rates for auditors described later in this paper. Geiger and Raghundan (2002) find some supporting evidence that auditors are more likely to issue a clean audit report prior to a bankruptcy filing in the early years of the auditor-client relationship<sup>24</sup>. However, there are a number of reasons that there may be problems in the first year of an audit relationship, as the auditor builds familiarity with the client's business, and audit and its regulation have changed significantly since Enron<sup>25</sup>.

20. The Government's view is that while there is no evidence of systematic problems of auditor independence, the body best placed to bolster auditor independence is a strong audit committee.

## Way forward – what should be in the report?

21. The challenge to auditors that they should have seen the bank collapse coming is linked to the question about what should be said in the audit report, which has been raised by investors and other users. Elements of the developing investor view are that the standard audit report is not very useful at present in that it is of standardised form, and could be reformed to include useful company-specific information and the auditor's view as to the degree of aggression in the company's accounting choices. There could also be more disclosure about the risk position of the company, and the key judgements taken during the course of the audit. Such an approach, it could be argued, might have provided some forewarning of the collapse of the banks, but it is hard to see that audit alone could provide a defence against systemic risk of that kind. However, the Government is committed to the objective of improving bank corporate governance and will continue to work closely with the EU and internationally to increase transparency and accountability in a consistent and proportionate manner. The joint Discussion Paper by the FSA and FRC already referred to explores wider ideas about the contribution of audit to prudential regulation.
22. The audit profession concedes that there may be some room for improvement in making audit reports more informative, but it has concerns that by providing more information or assurance, it will be exposed to greater liability. This could tend to push up fees, or increase pressure for more liability protection for auditors, or both. Ian Powell, the Chairman of PWC in the UK is quoted as saying "On a bilateral basis, you will not see an auditor start making a more informative audit report while the rules are as they are and there's unlimited liability"<sup>26</sup>. There would need to be clear evidence that the information benefit exceeded the cost either in fees or liability capping before Government would act.
23. It is not clear that the company specific information sought by users is best provided by an auditor. There is an argument that such issues and information about the company are more properly disclosed by the audit committee and management, with the auditors then possibly providing some assurance over the accuracy of the information. Whether information were to be disclosed by the company or by the auditor, it would be a challenge to ensure that genuinely useful company specific information is provided, and not just boiler plate. It is by no means clear that a mandatory requirement is the best route to securing disclosure of the information. Some form of voluntary route could be considered, perhaps by an amendment to the UK Corporate Governance Code.
24. Research on a sample of listed companies published in 2009 by the Financial Reporting Council shows that for many listed companies there is much room for improvement in their narrative reporting as required by the Companies Act. In the reporting of the principal risks facing their business, 66% of companies were technically compliant

with the law, but fell short of the spirit of the requirements. In providing a description of their business, 58% of companies were either not compliant with the law, or were technically compliant but fell short of the spirit.<sup>27</sup>

25. It is therefore not obvious exactly how to achieve more informative disclosure of the affairs of companies, either by management or by the auditors. There are clearly costs associated with the various routes, and it may be hard to achieve the benefits desired. It is for these reasons that the Government has not come to a firm view on the way forward, and wishes to see the outcome of this inquiry by the House of Lords and other debates.

### **Audit market**

26. The market for the supply of audit for public interest companies in the UK is very concentrated. Just four firms undertake the audits of 99% of FTSE100 companies and 95% of FTSE 350 companies. Complex sectors such as finance are already reduced to two or three audit firms that have the necessary expertise to undertake these audits while auditor independence rules can further reduce this choice.
27. In the late 1980s there were eight major accounting firms that provided audit services. Since 2003, there have only been four. This is a result of a series of mergers including Price Waterhouse and Coopers & Lybrand, which was approved by the EU in 1998 and the collapse of Arthur Andersen in 2002, which resulted in the UK firm merging with Deloitte. The Deloitte merger was approved by the EU who raised competition concerns but concluded there was no better alternative as the international Andersen network had effectively collapsed.
28. The share of the audit market held by the Big 4 differs across G8 countries. In 2007, Canada, Italy, UK and US had the greatest concentration of the Big 4, accounting for a market share of 95% or higher, followed by Russia at 90%, Japan at 84% and France at 61%.
29. The high concentration levels in the UK audit market are limited to the audit of FTSE 350 companies. Smaller companies have access to a much wider selection of firms, for example there are 119 medium sized audit firms with between 11 and 50 Principals<sup>28</sup>.
30. The Government has been concerned about competition for FTSE 350 audits for some time. BIS and the FRC jointly commissioned an independent analysis<sup>29</sup> of competition in the audit market. This paper was published in April 2006 and the main findings were:
- a. The FTSE350 market for audit services is highly concentrated.
  - b. Switching rates are low at around 4% on average for all listed companies, and 2% on average for FTSE100 companies.
  - c. A limited number of UK listed companies, primarily in the financial services sector of the FTSE100, have no effective choice of auditor in the short run. This elimination of choice is

- driven by high market concentration, auditor independence rules, supply-side constraints, and the need for sector expertise.
- d. Higher concentration has led to higher audit fees (although this finding of the report has been disputed). While there is a degree of price sensitivity among companies, and some bargaining on fees takes place during the annual audit firm reappointment process, in general the focus of audit committee chairs is more on quality (and reputation) than on price. Separately from the impact of concentration, audit fees seem to have risen in recent years as a result of cost increases, caused by factors such as change in regulation.
  - e. A range of barriers to entry to new competitors helps to sustain this concentration, in particular
    - i. Acquiring a credible reputation/perception of reputation;
    - ii. Establishing an extensive, integrated network; and
    - iii. Resource and technical expertise in audit.

31. In response to the competition issue, the FRC established the Market Participants Group (MPG), which comprised representatives from companies, investors and audit firms. They were tasked with advising the FRC on possible action to mitigate the risks arising from the concentration. Their advice was limited to market-led solutions with responsibility for implementation of their recommendations falling to the FRC. Most of the recommendations<sup>30</sup> have now been implemented and the FRC recently published their fifth progress report<sup>31</sup>. They have found that the market-led approach has not had a significant impact on market concentration and the FRC are currently undertaking a review with the aim of developing further proposals. This review, alongside the Commission Green Paper, will feed into HMG's future policy on competition in the audit market.

32. The Government will be working closely with the FRC on its review. Without in any way wishing to prejudice the outcome of that review, the Government's initial view is that, with the current (four-player) state of the audit market, it may be difficult to identify measures that will be effective in increasing choice for the largest audits without also imposing major costs. Those costs might be hard to justify.

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<sup>1</sup> Association of Chartered Certified Accountants (ACCA); Institute of Chartered Accountants in England and Wales (ICAEW); Chartered Accountants Ireland (CAI); Institute of Chartered Accountants of Scotland (ICAS); Association of Authorised Public Accountants (AAPA).

<sup>2</sup> UK Professional Oversight Board *Key Facts and Trends in the Accountancy Profession* calculated from p.46 <http://www.frc.org.uk/pob/publications/pub2301.html>

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