European Audit Committee Leadership Network

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EACLN

VIEWPOINTS

Perspectives on audit reform

Recent accounting controversies in the United Kingdom (UK) have brought the audit profession into the limelight, prompting calls for greater scrutiny and actions that could change the way the profession works. If past debates on audit and financial reporting in the UK are any indicator, this effort could inspire the European Union (EU) to consider further measures in these areas. What kind of changes are being debated in the UK, and how realistic would it be to adopt them?

Executive summary

With the broader significance of the UK debate in mind, members of the European Audit Committee Leadership Network (EACLN) explored elements of this debate at their meeting in Brussels on November 16, 2018. Using some of the ideas that are emerging in the UK debate as a springboard, members discussed the advantages and disadvantages of these concepts for improving audit quality.[1]

- **Background on the UK debate** *(page 2)*

  Recent accounting-related controversies in the UK have raised questions about oversight of the audit industry. Investigations are examining both the industry and its regulator, the Financial Reporting Council (FRC), while a broader debate has generated varied proposals for reform. EACLN members see a clear possibility that the ultimate outcome in the UK could influence evolving practices in the EU.

- **Promoting competition** *(page 3)*

  EACLN members discussed several ideas aimed at increasing competition in the audit market and raised concerns about whether the reforms were capable of achieving their intended effect. They said that breaking up the Big Four accounting firms is impractical because of the size and resources required to audit a large, global company, and they feared that market share caps would limit access to the best auditors. Entry by a technology company, on its own or in partnership with a smaller audit firm, is unlikely, members suggested, as is the merger of two smaller firms.

- **Promoting independence** *(page 4)*

  EACLN members also raised questions about the viability of any proposal to prevent audit firms from also having consulting businesses. Members noted that audit and nonaudit services complement each other, and the latter helps firms attract talent. However, some members generally supported a ban on nonaudit services to audit clients, so long as the scope of the audit is broadened to include more activities that enhance an auditor's understanding of its client's business.

- **Other ways of improving audit quality** *(page 6)*

  Members also contemplated other ways in which regulators could enhance audit quality, including ramped up enforcement of current regulations. A few saw potential benefits in regulations along the lines of the US Sarbanes-Oxley Act (SOX), though others were skeptical about the ability of regulators to intervene effectively. Several members mentioned an enhanced role for the audit committee, noting that requirements in the EU's Audit Regulation and Directive (ARD) of 2014 are already nudging audit committees in that direction.

For a list of members attending, see Appendix 1, on page 8. For a list of discussion questions for audit committees, see Appendix 2, on page 9.

Background on the UK debate

When the UK government contractor Carillion filed for liquidation in January 2018, the tremendous costs imposed on a wide range of stakeholders sparked a parliamentary investigation and a heated public debate on the root causes. Blame fell on the company itself, including its board and management, but also on government regulators and the company's auditors, who had given the company a clean bill of health. For many observers, this failure of the auditors to flag problems ran parallel with other controversies, raising the question of whether there were deep, systemic problems with the audit industry and how government oversees it.

An investigation by two UK parliamentary committees—Work and Pensions, and Business, Energy, and Industrial Strategy—found fault with Carillion's auditor, KPMG, and in the nonaudit work done by other auditing firms.[2] It also found that the Pensions Regulator and the FRC had been "feeble" and "timid" in their enforcement efforts.

Even before the release of Parliament's final report in May, these findings led to the launch in April of an investigation of the FRC led by Sir John Kingman and the launch in October of a formal competition probe of the audit market by the UK Competition and Markets Authority (CMA). The Kingman review is looking at whether the FRC's oversight of the Big Four accounting firms is rigorous enough.[3] The CMA is investigating whether the Big Four constitute an oligopoly that is harming audit quality and whether these four firms are "too big to fail."[4] Provisional findings will be published by the end of 2018. In the meantime, the ongoing investigations have fueled much discussion of alleged problems in the audit industry and potential remedies.

The debate in the UK is likely to have broader impact, EACLN members suggested. Several commented that the UK is perceived as having the most rigorous corporate governance standards in Europe. *"The UK is viewed as best practice. It will come to the EU sooner or later,"* a member said. Another member agreed, highlighting one element: *"I think that if there is a change in the UK, the EU will follow suit shortly after. When the EU sees an opportunity to shift the burden to boards, they will take it."*

Promoting competition

One aspect of the audit market that has come under fire is the concentration of assurance services among the Big Four. In the debate that ultimately prompted the CMA investigation, participants proposed a number of measures intended chiefly, or at least partly, to increase competition: breaking up the Big Four into smaller firms; imposing market-share caps on the Big Four or requiring shared audits in order to allow smaller firms to grow; and requiring the Big Four to share technology with smaller firms in order to enhance the quality of their audits. Members discussed the merits and feasibility of these proposals, along with potential ways to bring new competition into the audit market.

Breaking up the Big Four?

EACLN members spent considerable time dissecting and ultimately dismissing one of the more radical proposals under debate: breaking up the Big Four to create more firms. They identified two key problems with such an intervention in the audit market, both of them involving the size and resources required to effectively audit a large company:

- **Audit firms need to be global.** A member said, *"We need external auditors who have a truly global reach because we are global. The Big Four have that reach. It is critical."*
- **Audit firms need technological capabilities.** Technological capability is linked to the size of the audit firm, as a member explained: *"They need to invest in technology, and they need volume to have enough money to invest."* Another pointed out a key question that a large, sophisticated company will ask about its auditor: *"Does the audit firm have the technology in house to support our own transformation in the finance and auditing functions? Four firms have those capabilities."*

Members were not in favor of imposing market-share caps either, as capping the number of large companies that a single firm is permitted to audit also limits access for companies. *"When you work with a market cap limit, there is a possibility that you don't have access to the kind of auditor you want. The international footprint is so important. Smaller firms can't support that, which doesn't guarantee a quality audit,"* a member explained.

Creating new competitors?

Given the problems with splitting up the big firms to create more competitors, EACLN members looked at other potential ways to boost market competition. One helpful measure, several members noted, would be to reduce the regulatory barriers to entry. Others suggested that shared audits can help smaller firms build up their market share. Members contemplated ways in which smaller firms (existing and potential) might be able to develop the technological capabilities to compete effectively. They endorsed the idea of smaller firms having access to larger firms' technology. They also considered several other possibilities for increasing the number of viable market players, though each came with additional problems:

- **Entry by a technology firm.** Could a large technology company leverage its capabilities to create a viable alternative to the Big Four? Members were skeptical of this possibility. One explained, *"As a technology provider, a company like IBM would be really good. But we* *need professional standards. How would the technology be applied and connected to the profession? The profession is supposed to bring trust in the marketplace. I'm not sure how others would be connected to the professional standards."*

Other members agreed. One said, *"Technology is a key piece, but not the core piece of the audit. I don't see why a tech company would have interest in entering the audit world. It is a different world, with different risks."* Members also had difficulty contemplating how a technology company might create a viable platform that would enhance competition in the audit marketplace: *"A platform has often been the basis of disruption, but I don't see a platform play by a tech firm into statutory audit."*

Another member noted, however, that even if this were a viable concept, it would be difficult to see a technology company meeting its independence and compliance obligations. *"A big tech firm couldn't meet the independence requirements. Also, developing standards is a slow process for auditing-standards bodies, yet technology itself doesn't mean anything unless it fits with the auditing standards. Technology needs to be relevant to audit,"* the member said.

- **Partnership between a tech firm and a smaller audit firm.** A technology company could potentially combine its processing power with an audit firm's professional standing to create a disruptive entrant. A member explained, *"The most likely scenario is partnering with a smaller audit firm. As a business, audit has a risk profile that most technology firms wouldn't really like. We see competitors in tax, but not in audit. The scenario would be a tier-two auditing firm partnering with a technology firm."*
- **Merger of smaller audit firms.** A member raised—but also questioned—the possibility of smaller firms joining forces to become a stronger player: *"Another option might be a merger to create a fifth player. An obvious source of the next big firm would be China. American regulators hate this idea. The other possibility is India. With the benefit of hindsight, we shouldn't have allowed some mergers. But BDO and Grant Thornton don't want to merge; they are making a lot of money in their current model."*

Promoting independence

Another aspect of audit that has persistently worried observers is auditor independence, which is manifested in the auditor's willingness to challenge management, an essential element of a quality audit. Observers note that such independence is threatened by the fact that the audited company pays for the audit; and because audit firms also sell various consulting and advisory services to many companies, they may be even more reluctant to challenge management. Also, some critics say that independence could be compromised if an auditor handles the audit of a company for a very long time, allowing overly cozy relationships to form.

These threats to independence have prompted regulations such as restrictions on the provision of nonaudit services to audit clients and mandatory rotation of both audit partners and firms. A key question in the UK debate is whether the current regulations go far enough. Some observers would prefer more aggressive measures, such as banning the auditor from providing nonaudit services to audit clients; creating audit-only firms that provide no nonaudit services at all; and even having the auditor be appointed by a public body. While few audit chairs were in favor of audit-only firms or the appointment of auditors by a public body, several supported a ban on providing nonaudit services to audit clients.

Creating audit-only firms?

EACLN members acknowledged the rationale behind the establishment of audit-only firms. One member noted that such firms would remove the perception of conflicts of interest, thereby boosting confidence in the role of the auditor. The lure of providing nonaudit services at some point in the future would not be a factor in relations with a client. Audit-only firms may also improve competition, a member said: *"Restrictions on nonaudit services would serve the competition among firms by allowing other firms to grow in auditing services without providing other services."*

The problem with this approach, however, is that members believe the two types of services strongly complement one another. One said, *"If we create strictly audit firms and nonaudit firms, we will deteriorate audit quality because the pure audit firms won't have the capabilities that audit firms have today."* Conducting an effective audit requires understanding the business, so *"input from other service lines helps."* Also, attracting talent to audit-only firms could be a challenge: *"The risk with specialized firms is that not all the skilled people will go to the firms where their skills are most needed, especially if audit is a lower-margin business."* They underscored the importance of having lead partners who can understand the company's strategy.

One member noted that an alternative to audit-only firms that could achieve a similar outcome without some of the identified drawbacks is to ring-fence the audit practice from the rest of the firm. *"You get all the benefits of being part of the firm, but you've ring-fenced the legal entity that does the audits,"* the member noted.

Restricting nonaudit services to audit clients?

Restricting the provision of nonaudit services to audit clients is already an established policy in many jurisdictions, but EACLN members endorsed a stronger focus in this area. A member suggested that prohibiting all nonaudit services to audit clients might be necessary: *"The auditing profession is really under attack now. The perception of lack of independence from management is pervasive. It would be useful for audit committees to restore trust in the auditing profession, which is why I favor auditors only providing audit-related work for an audit client."*

At the same time, banning nonaudit services to audit clients might mean curtailing some of the benefits of an audit firm's capabilities. If the firm is further restricted in the work it can do within a company it is auditing, it may not acquire the company-specific understanding of the business that would make it even more effective as an auditor. Members pointed out that if further restrictions were placed on nonaudit services, it would be useful to think about what is considered part of an audit. Defining the scope more broadly might permit more activities that enhance the audit firm's understanding of the company's specific situation.

Other ways of improving audit quality

In addition to nurturing an environment that supports audit quality—by ensuring there is competition among audit firms and encouraging independence from management—concepts emerging in the UK debate also target audit quality more directly by calling for better accounting standards and regulation, including stronger enforcement of current requirements and the addition of new requirements along the lines of those imposed in the United States by SOX.

Several EACLN members were in favor of ramping up enforcement, and some supported more SOX-like regulations in Europe. Some also supported revisiting how auditors report their opinion on whether a company is a "going concern." At the same time, members underscored the importance of the audit committee in improving audit quality, a role that was enhanced by the ARD of 2014.

Better regulation?

The FRC has "significantly increased the number of investigations and fines of auditors" in recent months.[5] One member endorsed tougher sanctions for audit failures: *"When you look at the responsibility of the auditor and all the legal issues, their responsibility is quite narrow. We should clearly increase the responsibility and penalties of the auditor."* The auditor's work could be supplemented by SOX-like requirements imposed on management, such as certification of the financial statements and attestation on internal controls, backed up by penalties for misconduct.

At the same time, some members were skeptical that more regulation is the answer. One member said, *"After every failure, there is an overreaction by regulators. SOX came in after Enron. It was lots of work, but it hasn't broken the back of fraudulent conduct."* The member noted that regulators are not always well-equipped to intervene: *"They have never sat on a board, never had the responsibilities of running a company."* Members also cautioned that policy makers should think carefully about reforms because technology-driven changes could have a major impact on the audit.

A stronger role for audit committees?

Members turned to the role of the audit committee and its potential to improve audit quality. One member explained, *"We should increase the level of prevention, rather than punishment or sanctions. We want benchmarks; we want best practices. This group is a great way to hear what others are doing. It is okay to sanction the bad actors, but we would benefit from more sharing of best practices. There are ways to improve the way we run our audit committees."*

Several members noted that implementation of the ARD is already nudging audit committees in this direction. One said, *"The ARD enhanced audit committee responsibilities. They have already put us more on the hook. It's just a question of implementation right now."* Article 39 of the directive builds on the audit committee duties laid out in the Statutory Audit Directive of 2006 by adding text on monitoring the performance of the audit, as well as taking responsibility for the procedure to select the auditor.[6]

Members underscored that audit quality is a key concern for audit committees when assessing the auditor. One member said that audit committees should do more to publicize their emphasis on audit quality: *"We may speak up as individual chairs, but we need to find a voice to speak up as a group. I don't know the format, but we need to express our view that audit quality is important for us. It is the primary thing we look for when choosing an auditor. Fees are far from being primary."*

Conclusion

Despite the clamorous calls for substantial reform of the audit market, EACLN members did not see the more dramatic interventions proposed in the ongoing UK debate as advisable. They pointed to significant problems with trying to break up the Big Four or create audit-only firms, including the loss of synergies between audit and nonaudit services. Entry into the market by technology firms, on their own or as partners of smaller audit firms, was also seen as infeasible and unlikely.

Members' preferred approach would be a total ban on audit firms providing nonaudit services to audit clients, though the definition of what constitutes an audit-related service might usefully be broadened. Some members did see benefits to stronger enforcement of regulations on audit, but they also underscored the importance of improving—and publicizing—the audit committee's role in audit quality.

About this document

The European Audit Committee Leadership Network is a group of audit committee chairs drawn from leading European companies committed to improving the performance of audit committees and enhancing trust in financial markets. The network is organized and led by Tapestry Networks with the support of EY as part of its continuing commitment to board effectiveness and good governance.

ViewPoints is produced by Tapestry Networks to stimulate timely, substantive board discussions about the choices confronting audit committee members, management, and their advisors as they endeavor to fulfill their respective responsibilities to the investing public. The ultimate value of *ViewPoints* lies in its power to help all constituencies develop their own informed points of view on these important issues. Those who receive *ViewPoints* are encouraged to share it with others in their own networks. The more board members, management, and advisors who become systematically engaged in this dialogue, the more value will be created for all.

Appendix 1: List of participants

EACLN members and alumni participating in all or part of the meeting included the following:

- Carolyn Dittmeier, Generali
- Byron Grote, Tesco, Akzo Nobel, and Anglo American
- Lou Hughes, Alumnus
- Dagmar Kollmann, Deutsche Telekom
- Helman le Pas de Sécheval, Bouygues Telecom
- Nasser Munjee, Tata Motors
- Marie-José Nadeau, ENGIE
- Pierre Rodocanachi, Alumnus
- Guylaine Saucier, Wendel
- François Thomazeau, Bolloré
- Isabel Torremocha, Repsol
- Martine Verluyten, STMicroelectronics and Thomas Cook

EY was represented in all or part of the meeting by the following:

- Andy Baldwin, EMEIA Area Managing Partner
- Jean-Yves Jégourel, EMEIA Assurance Leader
- Patrick Rottiers, Country Managing Partner, Belgium

Appendix 2: Discussion questions for audit committees

- Would measures to increase competition among audit firms drive innovation and quality?
- What are the advantages and disadvantages of the proposals such as breaking up the Big Four or promoting the entry of new competitors?
- Have you ever observed an auditor with a lack of independence from management? What was the cause?
- What are advantages and disadvantages of audit-only firms or banning the provision of nonaudit services to audit clients?
- Should audit regulators adjust auditing standards to improve audit quality?
- Should audit regulators intensify their enforcement efforts?
- How should audit regulators themselves be reformed?
- Is the debate in the United Kingdom taking into account all the important aspects of audits and the market for audit services? What other factors and considerations should be on the table?
- What other proposals for improving audit quality and efficiency would you suggest? How could enhancing or strengthening the role of the audit committee contribute to the solution?

Endnotes

[1] The European Audit Committee Leadership Networks comprise audit committee chairs of leading global public companies with over $10 billion in revenue. This document reflects the network's use of a modified version of the Chatham House Rule whereby names of members and their company affiliations are a matter of public record, but comments are not attributed to individuals or corporations. Italicized quotations reflect comments made in connection with the meeting by network members and other meeting participants.

[2] House of Commons, *Carillion: Second Joint report from the Business, Energy and Industrial Strategy and Work and Pensions Committees of Session 2017–19* (London: House of Commons, May 16, 2018).

[3] George Parker and Jonathan Ford, "UK to Press for Shake-up of Big Four Auditors," *Financial Times*, September 28, 2018.

[4] Madison Marriage and Barney Thompson, "UK Watchdog Launches Investigation into Audit Market," *Financial Times,* October 9, 2018.

[5] Paul Hodgson, "No Easy Answers for Breaking up Big Four in U.K.," *Compliance Week,* September 21, 2018.

[6] Directive 2014/56/EU of the European Parliament and of the Council of 16 April 2014 amending Directive 2006/43/EC on Statutory Audits of Annual Accounts and Consolidated Accounts (2014) OJ L158/196, Art. 39.