Urgent need for audit market reform

There is an urgent need around the world for reform of the audit market for listed companies and other Public Interest Entities (PIEs) to enable it to serve properly the needs of shareholders, other stakeholders and wider society. Key concerns relate to the interlinked areas of audit quality, unduly high concentration, inherent conflicts of interest and relevance.

Rebuilding trust in audit

Trust in audit is crucial if it is to be of value to stakeholders and wider society. There are, however, currently significant differences between the assurance audits are providing and what is sought from them. Concerns exist, for example, about the extent to which audits successfully identify frauds and material misstatements, and on conflicts of interest - whether perceived or actual. Relevance is another area of focus with the requirements generally limited to the financial statements even though most of the value of modern businesses lies in their intangibles which are generally not properly dealt with in the accounts. More broadly, fuller consideration needs to be given to issues surrounding sustainability. As seen in other industries, a fully competitive market with capable newcomers is much more likely to deliver the necessary innovation.

Deep-rooted resistance to a more open audit market

The largest firms enjoy a number of advantages over challenger firms when tendering for audits relating to their size and their brand recognition and familiarity including that arising from having powerful alumni networks. There is also a marked level of subliminal bias against challenger firms. In addition, there is a clear reluctance to appoint firms as auditors to major PIEs that do not already have a significant share in this market thereby perpetuating the problem.

Risks from excessive levels of concentration

Substantial risks flow from just four firms having a dominant market share of the PIE audit market. Avoiding perceived commercial conflicts of interest is becoming increasingly difficult even where current Ethical Standards are formally satisfied as consulting and other non-audit services account for an ever larger proportion of the largest firms’ businesses. The ‘too few to fail’ threat to effective regulation is also very present due to the problems that would arise were one of the largest firms to exit the market, for whatever reason. Moreover, for some PIEs, the number of these firms that are potential auditors is already less than four due to conflicts arising from consulting and other relationships.
Guiding principles

To achieve the necessary audit market reform, we propose a number of principles should be applied:

**1.** The overriding aim of reform should be to enhance audit quality and to ensure auditing adapts to the changes occurring in business, technology and societal expectations.

**2.** The changes introduced should have a very high probability of success.

**3.** Change should be introduced as soon as possible to maintain momentum for reform.

**4.** The aim should be for a temporary intervention leading to the creation of a genuinely competitive market with capable newcomers in order to promote innovation.

Audit reform – the way ahead

**Independent review needed on the future of reporting and auditing**

We support a major independent review being undertaken of the current and future needs of investors and other stakeholders regarding information in corporate reports and which elements should be audited. The business world has changed considerably in recent years and it is not clear that reporting and auditing have kept up with developments in the wider marketplace, in particular when it comes to information in the annual report beyond the financial statements. Moreover, the future of reporting and auditing must be considered together.

**Joint audit should be at the centre of market reform**

The introduction of joint audits, especially at the upper end of PIE markets, with a Big 4 firm working together with a challenger firm, should be at the centre of audit market reform around the world: There is often a very substantial concentration of audit fees in the upper part of national markets and it is where the systemic risk is greatest. Through joint audit challenger firms can play a part in the auditing of leading PIE companies in the near future. It may be appropriate to combine the use of joint audits with market caps on the maximum share of audit fees in a given market that can be held by the currently dominant firms.

**The Big 4 PIE market share should be reduced to no more than 80% of audit fees within five years**

The aim should be to initially reduce the combined market share of the Big 4 to 80% of audit fees in national PIE markets, divided into appropriate segments, such as large and smaller listed, on a steady basis over five years. At that stage, consideration should be given to tightening the cap over the following two to three years to a 70% market share for the Big 4.

**More open audit tendering and better information for shareholders**

There should be a more open process for audit tendering with a regulatory or investor-led body in each country operating a website containing details of all listed and other PIE tenders and which enables all eligible firms wishing to do so to submit a proposal. This is often not happening currently in many jurisdiction. In addition, shareholders should be provided with information by their audit committees on which firms responded to the tender, which were shortlisted and the selection criteria adopted in arriving at the committee’s preferred choice. Investors should also be encouraged to take a more active interest in auditor appointments than has generally been the case until now.
Stricter limits on the non-audit services PIE auditors can provide to their audit clients

To avoid actual and perceived conflicts of interest, PIE auditors should in future only be able to provide a much more limited range of non-audit services to their audit clients from an agreed list made up of audit-related services and a modest list of others which would raise no conflicts of interest. Auditors should also set out actual and perceived conflicts of interest in their audit reports and how they have been managed or mitigated.

Barriers to Big 4 partners moving to challenger firms should be removed

A number of partners will very likely need to move from Big 4 to challenger firms if the necessary audit reforms are to be successfully implemented. At present, moving can be very difficult due to the length of notice periods and lower remuneration during this time. This barrier to fair movement needs to be removed.

Support for relevant expertise in larger firms to be made available to smaller firms

Where larger firms, including our own, have special expertise, e.g. with regards to audit software or experts with particular skills, that would assist smaller firms to undertake PIE audits, we support it being made available to them.

Need for proportionate regulation and liability and regulatory focus on competition issues

If challenger firms are to enter the market for listed and other PIEs, including at the upper end, they will need assurance that the regulatory system will be proportionate and based on a model which involves firms and regulators working together to promote a learning environment and a culture of continual improvement. In addition, audit regulator should be expected to have due regard to competition issues in their work. It would also be fair for there to be a system of proportionate liability for the auditors on listed and other PIE clients.
Striking the appropriate balance between the respective roles of directors and auditors

There should be an appropriate balance in corporate governance systems between the respective responsibilities of directors and auditors and similarly in the exercise of oversight and enforcement.

Recognising the stewardship role of investors in relation to audit matters

Investors should recognise the importance of their stewardship role on audit matters especially in relation to the appointment of auditors and in considering their audit opinion.

Emphasising sustainability in developing requirements in reporting, audit and assurance

Sustainability should be at the heart of the development of standards and legal requirements on reporting and audit / assurance in view of its importance in modern society. Given their interdependence, a fully integrated approach should be adopted in setting reporting and audit/assurance standards.

The importance of audit regulators having proper regard to competition issues

Audit regulators around the world should have regard to competition issues in their work given its impact on audit quality. This should include ensuring proportionality in matters of audit oversight and enforcement and promoting fair, open and regular tendering of audits and their periodic rotation.

Promoting a learning culture in audit oversight

Audit firm oversight should recognise the need for regulators, auditors, audit committees and investors to work together to enhance audit quality continuously through a shared learning culture.

Ensuring effective audit firm and network governance at national and global levels

Audit firms and networks should be required to have effective systems of governance at national and global levels including applying an audit firm governance code and appointing independent non-executives. This is particularly important given audit practices in the largest firms are part of much wider professional service firms.

Addressing expectation gap on auditing issues

Plans need to be developed to address the extent to which audits are currently not meeting the reasonable needs of shareholders, other stakeholders and wider society. These would be expected to cover the extent to which audits should identify fraud and misstatements in accounts, the need for tighter restriction on the non-audit services auditors are allowed to provide to audit clients so as to avoid conflicts of interest and, as already discussed in this section, how reporting needs to develop in areas such as sustainability and intangibles, and the related impact on auditing. It is not enough to just keep explaining what can reasonably be expected of the current model.
Substantial reform of statutory audit market urgently needed

Substantial reform of the audit market around the world is urgently needed. Its current composition with excessive levels of concentration, which have persisted for decades, poses a direct threat to audit quality. The challenges of maintaining an orderly market while protecting against conflicts of interest, ensuring the market remains innovative in the context of changing stakeholder expectations, and mitigating against the risk of one of the four largest firms leaving the audit market, for whatever reason, are substantial and have to be faced and addressed.

Major regulatory reform and enhanced stewardship focus by investors also required

Successful audit market reform will also require significant regulatory change in many jurisdictions and an enhanced stewardship focus by investors in line with the seven key principles set out in this paper.

All stakeholders in the PIE audit market have a role to play in implementing making reform

Robust reform of the statutory audit market for listed companies and other PIEs is essential if it is to meets the needs of investors, other stakeholders and wider society. This will require significant changes by Big 4 and challenger firms, investors, audit committees, regulators and professional bodies.
The benefits of joint audit

Addressing market concentration
The one major market in which joint audit is present for listed companies, France, is also the one where concentration is materially lower and the pool of audit firms operating in it significantly broader than in other jurisdictions.

Enhancing audit quality
A strong case can also be made for joint audit on grounds of quality. Leading businesses have become larger and more complex due to globalisation and financial reporting has become inherently more subjective as the use of fair value has, for example, increased. In this modern business environment there is significant merit in two firms designing and undertaking the audit of our largest listed companies, reviewing each other’s work and agreeing their views on the key issues arising on the audit before giving their overall opinion on the whole financial statements for which each joint auditor is then jointly and severally liable.

Building capacity and reducing unconscious bias
Joint audits offer the opportunity to build capacity in the market for listed and other PIEs as it enables challenger firms, working with the Big 4 to build their experience of working on the largest audits in a given market which in the early stages of a programme of audit reform, they would not be able to complete on their own. the challenger firms can also build their capacity in the early years of reform by progressively increasing the proportion of the audit they undertake. Moreover, as the challenger firms become better known by audit committees and management of leading companies the level of unconscious bias should be reduced.

Facilitating auditor rotation
Where joint audit appointments are made on a staggered basis, this makes the transition smoother when auditors change with the balance being struck between the deep knowledge of the ongoing auditor and the fresh pair of eyes brought by the newly appointed one.

These issues are discussed more fully in ‘A guide to joint audit for a more effective audit market’
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