4 November 2011

Inquiry Manager, Audit Market investigation

Dear Sir

As invited by the Commission’s announcement of this investigation, I write with a view to assisting in the drawing up of the terms of reference for this investigation.

The key to the investigation must, in my view, lie in an examination of the highly defined remit with which major audits must comply. Competition considerations will differ fundamentally between a market where competitors have an entirely free hand in the way they are to deliver results, and one in which the parameters in which the work is to be performed are so narrowly defined as to leave competitors only the smallest scope for competition.

The audit activity must be the most highly regulated of all activities in the UK. The task is to ensure that the audit meets immensely voluminous accounting standards, and the way in which the task is to be performed is laid down in similarly voluminous auditing standards. The work is then subjected to an extensive external scrutiny after the event.

I do hope that the Commission’s remit does not merely require the acceptance of these regulatory constraints – but that the Commission is able to, and does, examine whether the combined effect of these constraints and the conduct of the firms concerned operates in the public interest. It seems clear to me that the audit process failed in relation to many of our major financial institutions in the run-up to the recent, and ongoing, financial crisis – a state of affairs surely brought about not merely by the actions of the accounting firms concerned but also by the regulatory straightjacket within which they were required to operate.

I attach a copy of the letter that I sent to the OFT, making the point more fully.

Yours sincerely

Charles Allen-Jones
Dear Mr Hill

Competition in the audit market

I write someone who has been involved with the accounting profession throughout my career as a City lawyer, and since retirement.

There clearly is a problem with the audit market – how could this not be, given the apparent irrelevance of audits in the 2007/09 financial crisis. However, the cause of this is to be found in the heavily regulated nature of audit work – which limits judgement (by design), and hence greatly reduces the scope for competition. The auditing profession is unified in its desire to limit the scope for judgement; this has its origins in a concern to reduce the scope for litigation, a concern greatly heightened, I believe, by the inability of auditors to limit their liability.

I write because I do not see this train of thought in the recent House of Lords Select Committee report (I am sending a copy of this letter to the Clerk of the Select Committee on Economic Affairs). I will below separately address:

- How competition is limited by the regulatory framework
- My thoughts on limitation of liability by auditors
- The resulting competitive environment between the Big 4.

Can I make clear at the outset that I do not believe that the present (highly undesirable) situation results from bad faith or collusion amongst or between the auditing firms.
However, it may also choke off the blue sky thinking that may be the only way of identifying a problem outside anyone's normal contemplation. One result will be that the relative abilities of different firms when it comes to blue sky thinking will be irrelevant in any audit competition process.

Limitation of liability

Although this is now permitted to some extent in theory, it is unachievable in practice. Boards are not going to be prepared to make proposals to this effect to shareholders. I used to be against auditors enjoying limited liability - feeling that a statutory regime would just not be appropriate. However, I have come to believe that without change it is probably unrealistic to think that auditors are going to be prepared to accept judgement on significant matters - and without this I do not see that we are going to be able to get the sort of blue sky thinking out of auditors that might have stopped the financial crisis. As it was, they stayed on piste - and on piste was presumably not where the problems were.

I also fear that the grind of audit work is going to be so great that we are going to find that the best people are reluctant to go into this work - or at least to stay there throughout their careers. It always used to be said that the rules-based system in the US meant that the auditors there were of lower quality - in effect confronting a job involving too much box-ticking. I don't know whether this remains the case in the US - nor whether a trend has emerged over here since accounting went over to a rules-based system. But the possibility is certainly concerning.

The current competitive environment

The problem is the very limited scope for competition. The cost of audits is very high - but I do not think this to be due to the limited number of firms involved - certainly not to any cartel between them. They are all required to do the same job, and the accounting and auditing standards make this a very extensive performance.

Nor do I think that there is a defective competitive environment when it comes to commitment. The work is pressurised, delivered over very tight deadlines. The problem is the very limited scope for one firm to differentiate itself against the others. An outsider looking into the market might imagine that Bank A might say that its good fortune in dodging some of the 2007/09 bullets was due to the quality of penetrating analysis and advice that came from Mr (or Ms) X at its auditor firm with their privileged access to its affairs. That of course should lead to the firm concerned increasing its market-share. I do believe that this was much more likely to happen when "true and fair" really ruled the day - although financial disasters were far from absent in those days.

Conclusion
I write this in the hope that it may encourage you to look not just at the competitive environment as things stand today – but more at how judgement and relevance can be brought into the competitive process.

I do not know what to think about the pros and cons of a break-up – of the Big 4. However, the highly regulated landscape and the global nature of the tasks make me despair of the prospect of evolution being successful in increasing the Big number to 5 or more.

I hope this is helpful.

Yours sincerely

Charles Allen-Jones