

Independent Audit Limited submission – via email

The Review team is to be complimented on achieving a survey of the issues around auditing which manages to be both brief and thoughtful.

Rather than responding to individual points, we invite you to consider a monograph on audit reform published by the Centre for Studies in Financial Innovation in 2003, a copy of which is attached. Despite the passage of time, most of its observations remain valid today, and touch on many of the questions raised in your paper.

The proposal for reform in the attached monograph is based upon breaking the link between statutory audits of subsidiaries and the audit of the consolidated accounts (also known as the group accounts, and which are generally the ones that are prepared for the benefit of shareholders). An important consequence of breaking the link between the audit of the group accounts and the statutory audit of subsidiaries is that, by enabling the audit to be done in a top-down way, it removes the need for an integrated global network of auditors. One particular point to clarify is that it does not involve the auditors of the group accounts placing reliance on statutory audit work, which would make the group auditor primarily an assembler of audit opinions prepared by others, but is a self-sufficient exercise in building up evidence to support an independent audit opinion. The viability of this approach to group audit was successfully tested 20-odd years ago on large, complex multinationals as part of an R&D programme for a global audit firm.

When freed from the obligation to share work within a global network of statutory auditors, group auditors are more likely to visit locations themselves, possibly employing local expertise as a supplement. Consequently, one of the principal barriers to entry in the large company audit market, impairing both the existing challenger firms and preventing new entrants, is removed. If this were to be combined with a different approach to audit reporting, one which made the audit's quality more transparent to users of accounts, then it would create increased competition in quality as well as in price and service.

Various other changes that would be helpful in making this system work as well as possible are outlined in the attached. All are foreseen by the questions asked in your paper.

One additional point relevant to the scope of your review is that commentary by those outside the accounting profession generally betrays a conflation of financial reporting and audit. Some so-called audit failures seem to have been at least partly due to aspects of the accounting requirements. So long as the public conflate audit and accounting, it will be difficult to achieve a sustained increase in public confidence by dealing only with the former.

Finally, a note of our credentials in this area. The author of the attached monograph was formerly a partner in a large audit firm where he spent some years working on audit research and development. He co-founded Independent Audit Limited in 2002. Our firm does not undertake statutory audits and main part of our business is undertaking reviews of board effectiveness. In the course of these we see a lot of audit committees and their work, including the oversight of the external auditors. We have on occasion helped audit committees with their assessment of the effectiveness of the external audit process, but this is not a significant part of our business.

Jonathan Hayward
Director

Thinking not ticking:

Bringing competition
to the public interest
audit

Jonathan Hayward



CSFI
Centre for the Study of
Financial Innovation

The Centre for the Study of Financial Innovation is a non-profit think-tank, established in 1993 to look at future developments in the international financial field - particularly from the point of view of practitioners. Its US affiliate, the New York CSFI, was set up in 2002. The goals of both institutions include identifying new areas of business, flagging areas of danger and provoking a debate about key financial issues. The Centre has no ideological brief, beyond a belief in open and efficient markets.

Trustees

Minos Zombanakis (Chairman)
David Bell
David Lascelles
Sir Brian Pearse

Staff

Director - Andrew Hilton
Co-Director - David Lascelles
Manager – Fleur Hansen

Governing Council

Sir Brian Pearse (Chairman)
David Bell
Rudi Bogni
Robert Bench (US)
Manny Bussetil
Peter Cooke
Bill Dalton
Professor Charles Goodhart
John Heimann (US)
Henry Kaufman (US)
Angela Knight
Richard Lambert
John Langton
Dame Judith Mayhew
John Plender
David Potter
Sir Brian Williamson
Minos Zombanakis

Published simultaneously in the US and UK by
the New York CSFI and the Centre for the Study of Financial Innovation (CSFI).

Centre for the Study of Financial Innovation
5 Derby Street
London W1J 7AB
Tel: 020 7493 0173
Fax: 020 7493 0190

E-mail: info@csfi.org
Web: www.csfi.org

Unless otherwise stated, CSFI publications can be purchased through Central Books.
Email: www.centralbooks.co.uk
Tel: 0845 458 9910

© CSFI 2003

This publication is in copyright. Subject to statutory exception and to the provisions of relevant collective licensing agreements, no reproduction of any part may take place without the written permission of the Centre.

Printed in the United Kingdom by Heron, Dawson & Sawyer.

ISBN 0-9543145-6-5

Cover image: Getty Images

Contents

Preface	1
Summary	3
Introduction: Dead fish to black sheep	5
Problem? What problem?	7
Rules or principles?	11
Riding two horses	17
Competition, or the lack of it	26
A brief mythology of auditing	32
Audit reports	42
Revitalising audit	46
Conclusion	51
 <u>Appendix I</u> : Non-audit services and technological trends	 53
<u>Appendix II</u> : What about... ..	56

Thinking not ticking: Bringing competition to the public interest audit

Jonathan Hayward

Preface

This paper is about how our system of auditing large company financial statements could be made better. The topicality of such a subject is obvious and needs no explanation. However, it may be helpful to say a few words on what this paper is *not* about.

Most importantly, it is not about company reporting or accounting standards. There are papers to be written about this, in addition to the several million already written; but this paper is quite long enough even without straying into this territory. Instead, I make the simplifying assumption that the purpose of corporate reporting is to enable informed decisions to be made on the basis of a proper understanding of a company's past performance, present condition and future prospects. (Most people seem to agree that this is a reasonable, albeit oversimplified, objective, even though many would also say that corporate reporting could and should be improved to bring it closer to fulfilling that objective.) This paper deals with the auditor's role in giving assurance that a company's reporting is good for this purpose – or at least as good as is possible within the existing limitations of corporate reporting. There may be some implications for corporate reporting, but these are not the focus.

Nor does it deal with the role and responsibilities of non-executive directors, other than where directly relevant to the appointment and control of auditors. Again, this is a separate topic.

Finally, it does not presume that audit exists for the sole purpose of protecting investors. The fact that statutory audit reports are addressed to the members of a company does rather suggest that it is for the benefit of shareholders, and this is a point that auditors are very keen to emphasise whenever the question of liability to anyone else comes up. Nonetheless, there are grounds for supposing that, irrespective of the legal liability, the actual *purpose* of audit goes beyond the protection of shareholders.

If audit were only for shareholders, there would be no need for it to be a statutory or regulatory requirement. The shareholders have the power to decide for themselves whether or not they want an audit. The fact that the state has decreed that audit is mandatory is a clear indication that some sort of wider good is thought to arise from it.

The possible additional beneficiaries of audit include employees, local communities, creditors, customers, taxation authorities, regulators, a wide variety of interest groups (such as environmental lobbies), and of course those who are not yet shareholders but who are thinking of investing. In addition to this diverse group of stakeholders, there is another more general public interest in the efficient functioning of the capital markets, and trustworthy information is essential for this.

It seems to be generally agreed that the public interest is in corporate reporting being as close to "the truth" as is possible. It is important to remember that this interest is not necessarily shared by individual stakeholders – a fact that becomes significant when considering who should control the appointment and activities of auditors. In particular, shareholders benefit from the overvaluation that might result from overoptimistic reporting, so long as it continues until after they sell their shares. The shorter-term their horizons, the more likely they are to benefit from any overvaluation. The prevalence

of share option schemes has also turned many senior managers of corporations into investors with short-term horizons, while the performance of institutional investors is increasingly being measured over periods of months rather than years.

The discussion in this paper is framed around large company audits, as that is where public interest issues become most visible. It is also the area where the lack of competition has become an acute problem. However, the arguments and proposals should be read as applying to all companies in which there is a high degree of public interest, irrespective of size; I therefore use the terms “large company” and “public interest company” interchangeably.

Auditing is a very wide-ranging topic with lots of interconnections between its different aspects. I have dealt with this by allowing occasional repetition, which makes for a longer but easier read than if the document was filled with internal cross-references. Also, I have referred to auditors as “he”. This should of course be read as meaning “he or she”. In my experience, women frequently make the best auditors, but the unfortunate fact is that there are relatively few women in the senior ranks of the audit firms.

Finally, I must acknowledge the invaluable help given to me by a number of most perceptive critics, who between them represented investment institutions, regulators, lawyers and two of the Big Four audit firms; by Professor Michael Power of the London School of Economics, who, in addition to his astute advice on the content, was also able to reassure me that I wasn’t inadvertently revealing secrets of my former firm; by my colleagues Richard Sheath and Laura Ball, whose patience was severely tested but remained unbroken; and by the late Gabi Beau, who until her untimely death served as a constant source of inspiration in the unlikely field of audit reform.

Jonathan Hayward

jonathan.hayward@independentaudit.com

1. Summary

The audit problem

There are two fundamental problems with independent audit. The first is that it isn't independent at all. It is in reality – and, as things stand, inevitably – closely aligned with company management. The second problem is that it is an uncompetitive market, dominated by four large firms. This paper shows how these two problems are interdependent and how they can be tackled together.

Our system of audit is built on compromise. In effect, we require an auditor to take on the role of “honest broker” between the public interest and the interests of management. But the scales are not evenly balanced. Not only is the auditor financially dependent on management, but there is almost always some degree of emotional alignment. At its simplest, this is shown by the way that auditors speak of “the client”, meaning not shareholders but management. This situation leads to unconscious bias, even in the most honest and rigorous auditors; at worst, it sets the stage for an Enron-type audit disaster.

Current reform proposals miss the point...

Trying to tackle “the audit problem” by banning certain non-audit services misses the point and would make no significant difference. Non-audit fees are a *symptom* of the supportive and mutually-beneficial relationship between auditor and client, not a *cause* of the problem. Other varieties of fine-tuning will also make little difference. What is needed is to break the commercial relationship which is the basis for the alignment between auditor and management and so enable an inherently more independent and objective view.

Proposals for putting greater responsibilities on audit committees will on their own do little or nothing to alter the fundamental dynamics of the practical, day-to-day circumstances which for decades have been encouraging auditors to become aligned with company management. Furthermore, it will not be easy for audit committees to meet these new obligations. The audit committee is expected to exercise greater supervision of financial reporting and internal control, as well as of the external auditors. Its main sources of information are the management and the auditors themselves. This is not an easy situation for the audit committee. The proposals contained in this paper will not only alter those dynamics, but will also provide audit committees with independent, expert support to help them fulfil their new responsibilities.

Global service providers to management

Over the last couple of decades, audit firms have evolved into global professional service firms, with the audit as the basis for wide-ranging business relationships with clients. Good auditors develop strong and supportive relationships with management, who come to rely on them for help in getting things right. This includes help in producing financial statements that comply with professional and legal requirements, and which both management and the auditor are prepared to sign. This is not a wholly independent and objective view; but it is a valuable and necessary function, and one whose importance will increase as business reporting moves closer to real time.

So don't try to force the Big Four to reverse their evolution and become pure audit providers rather than global service firms. Apart from anything else, any such effort to put the genie back in the bottle would certainly be slow to achieve results, and would probably fail, since the Big Four's business models are entrenched in dependence on non-audit work. Instead, let them

The public interest audit

continue to pursue the strategies proclaimed by their websites. Let them be global service providers to management, performing audits as part of a service to help management produce accounts which comply with law and professional standards. It's a valuable role, and it's what they are organised and resourced to do.

Evaluators – the new public interest auditors

Meanwhile, the public interest in large company audit can be met by the emergence of a new class of public interest auditors who are genuinely – totally – independent of management and external to a company's processes. These small, specialist firms (here called "evaluators" to distinguish them from existing auditors) would exist solely for the purpose of providing assurance on public interest accounts. This means that they would audit only a relatively small number of large and other public interest companies. Importantly, they would be prohibited from doing *any* work that was in the gift of management, and they would not normally perform the statutory audits of subsidiaries. They would not replace the existing system of audit, but would be complementary to it.

There are a number of commonly held presumptions about audit which on examination turn out to be incorrect. These include the presumption that only audit firms with extensive global networks and large numbers of staff can audit multinational companies. In fact, the techniques already exist for performing high-quality independent audits, at a group level only, with a small number of expert staff and little or no network of offices.

Because the resource demands are small, these evaluator firms could be formed from scratch or as newly created divisions of medium-sized accounting firms. They could even be formed by insurance companies, rating agencies or specialist consultancies. They would be organised around small teams of experienced, expert people, and not around trainee accountants. They would compete on their independence, expertise and quality of assurance. They would be profitable enough – and their work interesting enough – to attract high quality people.

Appointment

In principle, all auditors – and evaluators – should be appointed by a body which is totally independent. In practice, it is likely that appointment will continue to be in the hands of audit committees, whose own independence is variable – and, even after the recent report on non-executive directors by Derek Higgs, this is unlikely to change overnight. But this weakness can be overcome if evaluators are appointed for fixed, non-renewable terms of between three and five years. After appointment, their only interest will be in the maintenance of their public reputation, to help them win replacement work from other sources. Because the conventional auditor will continue in place and serve as a source of information, this regular change of evaluator will not cause a loss of client knowledge which might impair the quality of the evaluator's work.

A proposal which should be investigated further is for independent evaluators to be appointed by insurance companies as part of a "financial statements insurance" scheme. If it could be made to work, this scheme would transfer much of the responsibility for audit quality to the private sector.

Reporting

Today's formulaic audit reports contain almost no useful information – and consequently brand has come to be used as a (very unsatisfactory) shorthand for quality. To encourage real

competition on grounds of quality and independence, and to enable quality to be judged on the basis of their outputs, evaluators' reports should contain real content. Realistically, this will only occur if the reporter's liability is limited, which is one reason for keeping evaluators quite distinct from statutory auditors, who are not allowed to limit their liability.

There are likely to be concerns about putting the evaluator's analytical reports into the public domain. To address these concerns, evaluators' reports should be kept confidential to audit committees. They would play a valuable role in helping audit committees to fulfil their governance obligations. In due course, as the usefulness of these reports became established, it is likely that demand would emerge for independent evaluators' reports, or restricted versions for them, to be published as "second opinions" alongside the existing auditors' reports.

Cost

Evaluator fees are estimated to be in the range of 15-35% of current audit costs. These are additional costs, but are not significant in relation to the benefit of making a dramatic improvement in the independence and objectivity of public interest audit. And there need be no "invisible" costs or disruption. Because evaluators are additional to the existing system, it does not require any major change to existing structures. Nor does it create complications at an international level. Everything which is currently in progress can continue.

Competition

The (new) evaluator market would be competitive from the outset, and would bring competent small audit practices back into the picture.

Furthermore, the existence of evaluator reports – particularly when published – would over time lessen the capital markets' present unhealthy dependence on Big Four brands in the (existing) market for combined global professional services and audit. Competition in this market would be primarily on the basis of quality of service to management. Although the Big Four's networks would continue to provide advantage in many circumstances, there would still be new opportunities for medium-sized firms to compete.

2. Introduction: Dead fish to black sheep

It's getting on for 25 years since I entered the UK audit profession as a trainee Chartered Accountant. Almost immediately I found that parties had become more stressful experiences, because there was bound to be someone there who would ask "and what do you do?". The truthful answer was invariably met with a somewhat distant expression, shortly followed by the discovery of a need to go and fetch a drink for someone else. The temptation to invent something more exciting was strong; but, being bound by the Chartered Accountant's code of ethics and integrity, I was of course unable to enter into any deception that was likely to be found out.

Be careful what you wish for, they say, and it's true enough. For much of the last year, owning up to being an auditor wouldn't leave you standing alone in a corner of the room. It would leave you surrounded by non-accountants eager to share their effortless sense of moral superiority.

Many of these people seemed to have a particular interest in shredding, of either documents or reputations.

The epidemic of Enronitis that has been responsible for the auditor's sudden change of social status from dead fish to black sheep is now receding, but the condition has left its scars. Even its most loyal supporters have had to admit that the audit profession has been badly damaged by Andersen's role in the Enron affair, coming as it did after a trail of other scandals. The larger audit firms were even driven to the extremity of putting up the grand total of £40,000 to fund the Institute of Chartered Accountants in England and Wales "as it defends the reputation of the profession in the wake of the Enron scandal".¹

Audit reform may no longer be entertaining the public in the pages of the tabloids, but it still features with unaccustomed frequency in the *Financial Times*. Select Committees have enquired; the DTI has reviewed; think-tanks are thinking; academics are analysing (or at least pronouncing); articles on audit, corporate governance and the threat to global capitalism are to be found in almost all magazines.

And, of course, the fuss, like most things, is bigger in America. In a perverse way this has played into the hands of those in Britain who think the *status quo* here is pretty much okay. Their reassuring voices are not protecting the self-interest of the accounting establishment; they are protecting British sovereignty. The country that gave us Enron is now presuming to tell us how to manage our affairs? Harrumph.

In amongst all the noise, however, a few themes have survived to find their way into the British Government's official position on improving the independence and objectivity of audit. These include:

- stricter audit regulation;
- more active audit committees; and
- restrictions on the provision of non-audit services.

The reforms are all very well as far as they go; but that isn't very far. They are in fact dealing with *symptoms*, and not with underlying *causes*.

There is also considerable disquiet at the fact that the large company audit market is now controlled by only four firms. However, nobody seems to have any idea what, if anything, could be done about it, and the generally preferred approach is to put this particular problem off to another day.

If we want to tackle the causes, rather than continue trying to fine-tune an imperfect system, then we need to concentrate on two main areas: independence and competition. By tackling these together, fundamental improvement becomes possible. *This paper explains how it can be done.*

¹ "Big firms bankroll fightback", *Accountancy Age*, 16 May 2002.

3. Problem? What problem?

Public servants or profiteers

Before reading – or, for that matter, writing – about reform of our system of auditing, it would be as well to ask one important preliminary question. *Is there actually anything wrong with auditing in the UK?*

Opinions on the degree of brokenness vary widely. At one extreme, there is a small but vociferous group which holds that accountancy firms are at the centre of a web of conspiracies to:

...operate cartels, launder money, facilitate tax avoidance/evasion, bribery and obstruct enquiries into frauds and deliver shoddy audits.²

Coming at the end of this list, shoddy audits might seem to be one of the lesser evils, but they are in fact central to the accusation of “anti-social practices” by which audit firms “pick up fees whilst the public picks up the cost of lost jobs, savings and investments”.³

The accusations go further still: partners and employees of audit firms are not merely anti-social, but complicit in an anti-democratic conspiracy:

...through their intimate knowledge and ability to work the international financial system, the [large firms] are aiding in aggressive tax minimisation that ultimately undermines democratic government; implicitly supporting dubious financial regimes and other forms of sleaze.⁴

Not altogether surprisingly, this point of view is not widely held amongst auditors, regulators or government.

At the other extreme are the voices of the establishment, reassuring us that audit in the UK is fundamentally sound, and that although some adjustments might be appropriate, the big audit failures such as Enron and WorldCom are very much an American phenomenon, caused by factors specific to the United States and in no way likely to happen in this country. For example, the then Deputy President of the ICAEW, speaking to the Treasury Select Committee:

Chairman, might I pick up your point. You said if there is a lot to worry about, we need fundamental change, and I think my position is that we have had the fundamental change in the UK, and that is the distinction with the US; the US has not learned the lessons from the late 1980s, the early 1990s, and I think we have had the fundamental change in the UK in both financial reporting, corporate governance, and in auditing. What

² Austin Mitchell and Prem Sikka, *Dirty Business: The Unchecked Power of Major Accountancy Firms*, Association for Accountancy and Business Affairs, Basildon 2002, page 50.

³ *ibid*, page 28.

⁴ New Economics Foundation, *Five Brothers: The Rise and Nemesis of the Big Bean Counters*, London 2002.

**What's wrong
with the
way we
do it now?**

we need now is to build on that, and it is quite a lot of, but it is incremental change rather than fundamental change.⁵

In the first half of 2002, however, as much of the world gazed in rapt fascination at the spectacle of Andersen hurtling over the edge of the precipice, commentators were increasingly clear that more than this was needed. *The Economist* headlined an article “the entire auditing regime needs radical change”, and concluded:

It is time for another effort to realign the system to function more in shareholders’ interests.⁶

Implicit in this sentence is the suggestion that efforts had been made in the past, but without success. However, as time passed, a certain weariness crept in, with the recognition that this opportunity to realign the system in shareholder’s interests would also pass, unless a higher authority stepped in to shake things up:

American auditors now face strict new laws on audit independence. But British accountants reckon that their greater abilities mean that there is no need for radical reform... The government is not so complacent... since the profession, on both sides of the Atlantic, has come up with little to stop its members cuddling up to clients, it may have to start listening with a more open mind to ideas from outside.⁷

These hopes that the British Government would take on the role of Scourge Of The Accounting Establishment proved to be misplaced. The omens were clear at quite an early stage:

For now at least accountants have persuaded government and regulators on this side of the Atlantic that not all the industry’s current problems are of its own making... Thanks in no small part to Peter Wyman [president of the ICAEW and a partner in PricewaterhouseCoopers] ...ministers currently appear convinced that an eye-catching sweeping reform of accountancy is not necessary.⁸

The joint Treasury/DTI Co-ordinating Group on Audit and Accounting published its report in January 2003. Described by the Secretary of State as “a balanced but robust approach”⁹, it was welcomed by the auditing profession but dismissed by the *Financial Times* as “terribly, terribly cosy”:

⁹ *Accountancy Age*, 6 February 2003.

⁵ Peter Wyman, then Deputy President of the Institute of Chartered Accountants in England and Wales, giving evidence to the Treasury Select Committee on 10 April 2002. Recorded in Minutes of Evidence HC 578-i of Session 2001-02, The Stationery Office Limited, London.

⁶ *The Economist*, 7 February 2002.

⁷ *The Economist*, 13 July 2002.

⁸ *Accountancy Age*, 5 September 2002.

Were they breaking open the champagne bottles in the offices of Britain's Big Four accountancy firms last night? They certainly should have been as the government's post-Enron reviews of auditing and accounting issues turned out to be remarkably benign for the industry's leaders.

...the government has fallen in line with the industry's pre-emptive move merely to change the lead audit partner every five years; it has pushed on to a new, independent accountancy regulator the task of examining whether certain non-audit services, such as tax planning, pose conflicts; and it has abandoned thoughts of an anti-trust inquiry...¹⁰

The other main feature of the CGAA report is its enthusiastic support for the recommendations of the Smith Report¹¹, placing much of the practical responsibility for controlling auditors on audit committees.

Altogether, it rather looks as if events are once again conforming to the pattern described by an astute observer in 1997:

Particular audits may go wrong but not audit as such. Consequently, a certain cosmetic reform is visible in the wake of crisis. Auditors are censured, conferences are organised, articles are published and, very often, new audit guidance is issued. Things settle down until the next time.¹²

Riding two horses

It's a great pity that one of the main alternatives to the establishment line on audit comes wrapped up in anti-global, anti-capitalist polemic, causing most people to dismiss it out of hand. Similar assaults have been made for at least 20 years without noticeable results.¹³ But there are some important issues that need to be addressed by those who want to make our financial system work better. The system isn't corrupt, but nor is it the best of all possible worlds. *It could undoubtedly be improved.*

I was a partner in a large audit firm for just under 10 years. At the time, it certainly did not feel as if I was engaged in a vast criminal conspiracy or busy undermining democracy. We were indeed trying very hard to make a generous profit, but we were also always conscious that the enormous value of our brand came largely from its association with integrity and trustworthiness. Putting the firm's name on an audit report is not lightly done.

Auditors view themselves as the guardians of the public interest, keeping an eye not only on management's external reporting but also on the general conduct of their business. After all,

¹⁰ 30 January 2003.

¹¹ *Audit Committees – Combined Code Guidance*, Report and proposed guidance by an FRC-appointed group chaired by Sir Robert Smith, Financial Reporting Council, London, January 2003.

¹² Michael Power, *The Audit Society*, London 1997, page 33.

¹³ See for example M Stevens, *The Big 8*, New York 1981.

even though they employ practically every caveat known to the legal profession and can feel fairly sure that there isn't much an aggrieved claimant could get to stick, it still doesn't reflect well on them if a client goes spectacularly bust, or has its dodgy business dealings plastered across the pages of *The Sunday Times* (or *The New York Times*).

At the same time as they stand on this high moral ground, auditors are also convinced that they are some of the world's best business advisors, whose invaluable insights will give those who are fortunate enough to be their clients a real competitive edge. The more expert they can become, and the more their audits come to be seen as valuable diagnostics of business performance, the more they can grow a valuable relationship as trusted business advisors to management.¹⁴ And quite apart from any question of earning non-audit fees, it's this which provides much of the intrinsic interest and job satisfaction for auditors.

When they stop to think about it, auditors acknowledge that this is riding two horses. On the one hand, they are keeping something of a controlling eye on management on behalf of investors and the public interest. On the other hand, as can be seen from a cursory glance at any Big Four firm's website, they are assiduously cultivating the status of management's right-hand men, able to provide almost any professional service to help them achieve their business objectives. Keeping these two things going without falling between them is undoubtedly an extremely challenging responsibility. Fortunately for the public, there can be no-one better equipped to fulfil that responsibility.

The vast majority of auditors are indeed responsible professionals who are very conscious of their public responsibilities. They *know* that the public can trust them, and so the system is self-evidently as good as it could be. And of course, self-regulation is self-evidently the best form of regulation.

The large firms' responses to the present crisis of confidence in auditing are thus entirely predictable. There is no reason for any lack of confidence; everything is quite all right really. Just calm down, don't do anything in a hurry – and most certainly don't make any ill-considered, knee-jerk changes (a category that seems to include any reforms that might actually have much effect, or anything from America regardless of its merits).

From within, this attitude is a noble self-confidence. Auditors genuinely believe that they are protecting the public interest, and that what they are doing is the best way to do it. But their dismissal of public concerns can appear patronising to those on the outside, and exposes them to the charge of placing their profits over their public responsibilities.

Our present system of auditing is not providing investors and the public with the degree of confidence that it should. The profession's response to this has been to label the phenomenon "the expectation gap" and imply that it is the public's fault for wanting too much, particularly in relation to the discovery of fraud. As a solution to the problem, this cuts more ice with auditors than it does with the public. But the situation has persisted, because there is a shortage of practicable and convincing suggestions for how to make real improvements. Suggestions from

¹⁴ All of the big firms were pursuing similar strategies. Competitive differentiation lay in the speed and consistency of implementation of the strategy, and in the personal relationships between the firms' partners and the senior management of actual and potential clients.

How to regain public confidence

outside the profession tend to be made without much understanding of what is possible, and can easily be dismissed as “Kama Sutra” suggestions – interesting but impracticable.¹⁵

But many of the supposed barriers to change in auditing are actually matters of custom and practice, rather than unalterable facts. If we take a fresh look at the problem, and think about how to approach it from a different angle, we will find that some relatively simple measures could cause far-reaching improvements.

Our analysis must begin with a look at some fundamental issues:

- the question of rule-based versus principle-based systems;
- the way in which the structure of our audit system is inherently compromised; and
- the lack of competition in the large company audit market.

4. Rules or principles?

True and fair

**Don't be
taken in
by British
smugness...**

It has become something of a cliché in recent months to say that the self-evident (on this side of the Atlantic, at least) superiority of the UK system over the system in the US lies in the fact that here we are governed by principles, whereas over there the rule book is dominant. Under our system, we are repeatedly assured, Enron could not have happened.

This statement is in fact only partly true. It is instructive to examine it more closely. It may be true insofar as it relates to financial reporting. However, in relation to auditing – as distinct from financial reporting itself – our system is, in practice if not in theory, rule-based.

The essential differences between the UK and US approaches is shown by the different wording in audit reports on each side of the Atlantic. In both countries, most of the verbiage consists of various caveats and descriptions intended to make it clear what the auditor cannot be blamed for. The critical part is to be found in the audit opinion punchlines.

The UK version centres on “true and fair”:

In our opinion the financial statement *give a true and fair view* of the state of the group's affairs as at ... and of the group's profit for the year then ended and have been properly prepared in accordance with the Companies Act 1985.¹⁶

The concept of “true and fair view” is fairly widely understood in the UK and might loosely be taken as meaning that the story being told by the accounts does indeed give a reasonable version of what actually happened.¹⁷ Accounting standards and Companies Act requirements

¹⁵ Stella Fearnley, *Financial Times* 11 July 2002.

¹⁶ Auditing Practices Board Bulletin 2001/2, emphasis added.

¹⁷ This interpretation of “true and fair” is not to deny the existence of the well-established “expectation gap”. It is clearly the case that public expectations of audit are greater than the profession's, particularly but not only in relation to uncovering fraud.

are there for the purpose of helping companies and auditors achieve this objective on a consistent basis, and are not an end in themselves. The Companies Act makes this explicit when it requires that, should the strict application of accounting standards and Companies Act requirements lead to the financial statements not giving a true and fair view, they should be overridden. The obligation to give a true and fair view takes priority over any particular rule.

Perhaps in consequence, accounting standard-setters in the UK are clearly focussed on the objective of giving a true and fair view. Allowing for the fact that they will never please everybody in every respect, they have on the whole done a pretty good job of keeping standards sensibly aligned with that objective.

The American version of the audit report, on the other hand, uses a form of words which is different, although the uninitiated could be forgiven for not immediately spotting the significance of the difference:

In our opinion, the financial statements referred to above *present fairly*, in all material respects, the financial position of X Company as of [at] December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended *in conformity with accounting principles* generally accepted in the United States of America.¹⁸

Auditors in the US take those words to mean something along the lines of “these accounts have had a reasonable crack at complying with the rules”. In effect, companies and their auditors are only required to follow the rules, and the responsibility for achieving a sensible outcome (namely, accounts that actually mean something) therefore lies with the accounting standards, and not with the preparers and auditors of accounts.

US accounting standards are more voluminous, more prescriptive and less grounded in common sense than British ones. Their standard setting regime appears to have been more open to the influence of vested interests. For whatever reason, US accounting standards permitted Enron to exclude large losses and liabilities from its accounts. British accounting standards would not have permitted this treatment. Even if they had, a UK auditor would have been required to invoke the “true and fair override” in order to produce a set of accounts that showed a meaningful picture. No such obligation exists in the US.

To this extent, then, our system is different from – and superior to – the US one, and would have reduced the likelihood of Enron happening here. *However, this is only half of the story.*

A principle-based system of financial reporting provides a framework in which management can employ the most suitable methods to convey the economic reality of a company (at least to the extent that financial reporting can achieve this at all). Of course, freedom can be abused, and the flexibility of the system also offers management the opportunity to choose methods which achieve less than ideal results.

For the principle-based system to work properly, therefore, it is essential to have auditors who operate in a way that is consistent with its objectives: who think in terms of principles, not

¹⁸ Statement on Auditing Standard 93, American Institute of Certified Public Accountants 2001, emphasis added.

rules, and whose mission in life is to ensure that management's choice of accounting methods has in fact achieved the most desirable outcome.

But when you turn to look at how auditing is actually regulated, managed, taught and even thought about in the UK, you find that we aren't very principle-based at all. In these respects, our system is really not very different from the American one. We are trying to make our principle-based accounting system work by employing auditing which is more than a little rule-based.

Free from misstatement

Start with the question of what an audit is. It's actually quite difficult to find a comprehensive definition: it turns out that, in practice, audit is described in terms of either its purpose or its process – and predominantly the latter.¹⁹

The UK auditing standard SAS 100 gives the objective of an audit as:

...to provide reasonable assurance that the financial statements give a true and fair view (where relevant) and have been prepared in accordance with relevant accounting or other requirements.²⁰

Curiously enough, this inoffensive statement is not actually part of the “basic principles and essential procedures” which technically constitute Auditing Standards, but is merely “guidance”. That part of the text which forms the official Auditing Standard is set out in full below:

In undertaking an audit of financial statements auditors should:

- a) carry out procedures designed to obtain sufficient appropriate audit evidence, in accordance with Auditing Standards contained in SASs, to determine with reasonable confidence whether the financial statements are free of material misstatement;
- b) evaluate the overall presentation of the financial statements, in order to ascertain whether they have been prepared in accordance with relevant legislation and accounting standards; and
- c) issue a report containing a clear expression of their opinion on the financial statements. (SAS 100.1)

In the conduct of any audit of financial statements auditors should comply with the ethical guidance issued by their relevant professional bodies. (SAS 100.2)

¹⁹ The best general definition of audit that I have been able to find combines the two elements of purpose and process, with process being given precedence: “An audit is a systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between these assertions and established criteria and communicating the results to interested users.” American Accounting Association, *A Statement Of Basic Auditing Concepts*, Sarasota, FL., 1971.

²⁰ Statement of Auditing Standards 100, *Objective and general principles governing an audit of financial statements*, Auditing Practices Board 1995.

According to the Auditing Standard, the purpose of evaluating the financial statements is not to determine whether they give a true and fair view – whether the story they tell is a realistic one. That objective is merely guidance. The official purpose is to ascertain whether the accounts have been prepared in accordance with relevant legislation and accounting standards.²¹ Accordingly, audit activity is summarised as procedures aimed at determining not whether the accounts give a true and fair view, but whether they are free of material misstatement.

You might argue that this is splitting hairs, that “free from material misstatement” means the same as “true and fair view”. But there is a subtle – and important – difference between something being right, and something not being wrong. The latter enables considerably more emphasis on compliance with the rules. And I am not aware of any evidence to suggest that in practice UK auditors approach their work with a mindset which is different in kind from that of their American colleagues. There may be a difference of degree, but the same broad outlook on life can be observed. A quality audit is one which has followed its proper process, as set out in the applicable rule-book. Its purpose is to detect errors – and errors are most readily defined by reference to whatever rules might apply.

The process of audit

The idea that an audit is a process to look for errors pervades auditing literature. Textbooks, methodology manuals and academic papers almost all concentrate on procedures, rather than on outcomes:

“Official and semi-official techniques define good auditing in terms of a series of procedural inputs which can be more or less programmed into the audit process and which leave room for practitioner judgement. But they do not touch, other than by mere assertion and in the most general terms, the relation between these procedures and the production of levels of assurance.”²²

This philosophy underpins Auditing Standards. These originated in the 1980s. They reflect the then current practices of the large audit firms who were the main providers of resources, both human and financial, to the Auditing Practices Committee, and were drafted in a style which enabled them to apply to a wide variety of audit approaches. This was not just to suit the big firms, but was an inevitable consequence of trying to describe an audit in terms of process. Every company is different, and its audit must necessarily be adapted to the characteristics of its business, accounting systems, types of transaction, organisation, and other things. The audit process will therefore vary from case to case; so it can only be described in very high level terms.

Although the APC was replaced by the Auditing Practices Board in 1991 and auditing standards were comprehensively rewritten to bring them into alignment with International Standards on Auditing,

²¹ The purist might point out that legislation requires accounts to give a true and fair view, and so this concept does indirectly feature in the auditing standard’s purpose. This is logically correct, but does not affect the face value emphasis of the standard.

²² Power, *op cit*, page 30.

they retain both their essential vagueness and their process-based approach.²³ For example, SAS 200 on “audit planning” consists of the following mandatory requirements, quoted in full:

Auditors should plan the audit so as to perform the audit in an effective manner.

Auditors should develop and document an overall audit plan describing the expected scope and conduct of the audit.

Auditors should develop and document the nature, timing and extent of planned audit procedures required to implement the overall audit plan.

The audit work planned should be reviewed and, if necessary, revised during the course of the audit.

This is expressed in such high-level terms that it provides no practical guidance. So audit firms take the outline processes described in auditing standards and turn them into methodologies. These set out the steps to be followed from beginning to end of an audit, in a sequential process whose main phases are often known as “planning, execution, completion”. Some firms have decision trees or expert systems to help deal with all the variations in circumstances that might occur, while others seek flexibility through careful wording. Either way, the audit is clearly seen as a process to look for errors.

Audit quality is primarily defined in terms of compliance with the required process. Computerised audit systems check that mandatory steps have been recorded as completed, but cannot check how much thought went into them. The firms’ internal quality reviews are designed to see if files show that the steps in the firm’s audit process have been completed. Audit teams undergoing internal quality reviews will scurry around to ensure that all necessary checklists have been completed and are on file. They do not usually expect to receive much challenge on the extent or quality of the work that was done.

This approach to quality is replicated by the Joint Monitoring Unit, the UK profession’s quality review body, whose approach concentrates on ensuring that an audit firm’s own compliance procedures have been operated.²⁴

Preparers of accounts

Auditors are trained mainly from the perspective of preparers of accounts, rather than as users.

Almost all auditors in the UK’s large firms trained with one of the three Institutes of Chartered Accountants, the English and Welsh Institute (ICAEW) being the largest. Their training covers a range of subjects: assurance and audit, taxation, business finance, and commercial accounting. The accounting syllabus includes both preparing and understanding accounts.

²³ Recent work by the APB on developing standards on “input” and “output” rather than just “process” is a start, but much more needs to be done. As UK auditing standards are likely to be replaced by international standards in 2005, this work should be continued by IAASB.

²⁴ “The visit always focuses on the firm’s own compliance review... The detailed work concentrates on the selection and review of client files and may include reperforming a sample of your cold file reviews undertaken as part of your compliance review... [in order to] confirm the firm’s results.” *Your Monitoring Visit*, ICAEW, undated but available from ICAEW website in September 2002. See also Power, *Op Cit*, page 113.

**...the UK
is not much
different
from the
US**

The amount of time that ACA trainees spend learning about understanding accounts is much greater than it used to be. There have been substantial changes to the syllabus to make accountants more business-aware. In my day, the accounting syllabus was almost entirely about preparing accounts. Understanding of accounts consisted of not much more than knowing what a gross profit percentage was and how to calculate a liquidity ratio. It didn't begin to improve until relatively recently. The training regime that existed until only a few years ago was described in disparaging terms by no less than the President of the ICAEW:

To become a chartered accountant became largely a test of the ability to retain huge amounts of information in one's head... Keeping up to date with ever more new rules began to drive out the ability to use professional judgement in real life.²⁵

The new syllabus is certainly a great improvement, although opinions vary over the extent of the improvement. But in any event, it hasn't yet affected a significant proportion of the auditor population.²⁶

Of course auditors need to know about financial reporting standards, and need to know how debits and credits get turned into a balance sheet. But because they have been trained from the perspective of *preparers* of accounts, rather than *users* of accounts, they can be better at recognising technical errors in accounts than at understanding what the accounts are actually saying. This qualification sits well with meeting the auditing standard's goal of determining whether accounts are "free from material misstatement".

Post-qualification experience fills out the accountant's education. However, most accountants leave their audit firms soon after qualifying, and only a relatively small proportion of the big firms' total resources actually possess this experience.

A rules-based mindset

We like to think we have a principles-based system in the UK, but in practice it isn't that straightforward. The philosophy of audit in the UK is rule-based, and presumes that its purpose is to detect errors. This is reinforced by professional literature, training and quality procedures. Not surprisingly, therefore, the mindset of the UK auditor has been drifting towards that of his US counterpart – particularly as the larger firms have all been introducing "global" methodologies, which have to be capable of application across the firm's entire network. The US is the largest player in any firm's network, and consequently its approach to audit will always be the most influential in methodology development.

²⁵ Peter Wyman, *Financial Times*, 27 June 2002.

²⁶ There are some grounds for wondering whether the accountant, as we know and love it today, is a species faced with extinction. With a world view formed around structure, order, process and classification of data, the accountant is outstandingly well adapted to the conditions prevailing in Modernist times. The species is much less well adapted to the Post-Modernist era, with its emphasis on networks, relationships and adaptability. The collapse of the dot.coms and the continuing stories of corporate excess have caused a resurgence in the old-fashioned accountants' values; it remains to be seen whether this will be sufficient to stop Post-Modernism in its tracks, or whether it is merely a 'dead cat bounce'.

We might not have gone to the extremes of the US, thanks mainly to our “true and fair view” approach. But we have come close enough to make it possible for a UK auditor of average imagination to see how easily an Enron-type situation could happen over here.

How this is so will become apparent in the following chapter.

5. Riding two horses

An inherently compromised system

It often sounds as if the problem of auditor independence is all about non-audit fees. But this misses the real point. Non-audit fees are a *symptom* of the underlying problem, not a *cause* of it.

The fundamental problem is pervasive and inherent in the system of audit that exists today. It is succinctly described by one of Britain’s leading accountants, the former secretary-general of the International Accounting Standards Committee:

Principal/ agent problem

The essential conflict of interest is in the audit process itself... If policemen were selected and paid by burglars, we would not expect the job to be well done; and even the brightest student will hesitate before seeking out the toughest examiner.²⁷

The so-called “principal/agent problem” is at the root of the matter. Auditors are supposed to protect the interests of shareholders by ensuring the truthfulness of the reports given to them by management. Unfortunately, the shareholders are not a single or stable body, and have neither the funds nor the formal processes to enable them to appoint auditors for themselves. Consequently, the appointment is made by the company itself. In practice, this has meant delegating the appointment of auditors to the management – the very people that the auditors are supposed to be providing a check on.

In theory, audit committees may have recommended appointments, and investors approved them at Annual General Meetings, but it was rare for these ever to be more than formalities. Proposals to make audit committees more independent, and to have greater responsibility for the appointment and control of auditors, might prove to be helpful, but they will not fundamentally alter the dynamics of the relationship that is elaborated on in this section.

Who is the client?

My point here is not a new one. It has long been the case that, when an auditor speaks of “the client”, he is almost invariably referring to the executive management in general, or to the specific executive with whom he is dealing. Similarly, “client satisfaction surveys” are normally sent to executive management, not to the audit committee. “Client service improvement programmes” are about winning the hearts of the management, and “client entertaining” only rarely involves taking the chairman of the audit committee to Wimbledon (unless he’s also the CEO of another big company, of course).

²⁷ John Kay and Sir Bryan Carsberg, *Financial Times*, 2 April 2002.

In recent months, the audit firms have been trying to teach their staff that the audit committee is a client, while the Smith Report has been following Sarbanes-Oxley and the SEC in requiring audit committees to take responsibility for managing the audit relationship. But new *processes*, however well thought out, do not automatically result in different *behaviours*. Even in the best of likely scenarios, it can be expected to take quite a while for auditors to stop thinking that the audit committee is something that has to be managed on set-piece occasions, and to start thinking of it as the body that calls the shots.

The proposals for audit committees are a step in the right direction, and not unhelpful. But they are facing an uphill struggle. The problem is not just that many years have gone into forming the large firms' management-centred client service cultures. Day-to-day practicalities have always served to keep the auditor's focus on the management, regardless of the formal processes around audit committees, and this is not going to change. The working relationship is between auditor and management, and it normally – and quite understandably – leads to some degree of emotional alignment, grounded on commercial dependence.

The large firms have now all sold their big-ticket consulting businesses, which has caused substantial reductions in the headline figures for non-audit fee income. But that actually has a rather small effect on the daily life of an ordinary audit partner. The relationship between auditor and management exists irrespective of the amount of non-audit fees that the auditor earns in any given year.

In practice, if not in theory, management will negotiate the audit fee with the auditor. Only management has the information necessary for these negotiations, and audit committees will not be able to do it without them. The audit committee is supposed to review audit reappointments, but once again members will depend on the management for information, which means that in practice management can cause the audit to be put out to competitive tender.

Perhaps even more importantly, management has discretion whether to engage the auditor in any of a wide variety of special projects, many of which would be regarded as perfectly acceptable by even the most vocal critic of non-audit services; and even has considerable discretion over the choice of auditor at subsidiaries.²⁸ This means that a substantial proportion of fee income is in the gift of management, even at a company which might take the strictest possible view of non-audit services.

In addition, emotional alignment between auditor and client is entirely natural, and tends to grow over time.²⁹ Like most people, management and auditors want to have a trusting and supportive relationship, rather than an adversarial one, as this makes life both more productive and more enjoyable for all concerned. And auditors are not trained to view the development of

²⁸ Discretion over audits of subsidiaries is not total – professional practices limit the number of subsidiary audits that can be done by firms other than the main group auditors – but it is substantial. For example, until recently Citigroup was audited by KPMG but its subsidiary group Salomon Smith Barney was audited by PricewaterhouseCoopers. Some companies appear to view this sort of arrangement as a good way of keeping the auditors on their toes.

²⁹ “...psychological dependence is only one of many problems that arise from a long-term relationship. Other problems include the development of scripted behaviour with respect to an oft-audited client, and the development of inter-organizational norms that inhibit the willingness of the parties to engage in open conflict – with the result that inappropriate compromises are reached.” Kleinman and Palmon, *Understanding Auditor-Client Relationships: A Multi-Faceted Analysis*, Princeton 2001, page 122.

an adversarial relationship and the issuance of qualified audit opinions as successes, but rather as failures. A success usually comes in the form of a compromise acceptable to both parties.

Audit teams work with client management on intensive projects, both audit and non-audit, where they are working together under great pressure towards a common goal. This sometimes leads to a breakdown in relationship, as people fall out under pressure; more commonly, however, it leads to formation of the bonds which are entirely normal in such circumstances.

In addition, there is a steady movement of people of all levels from the audit firms into management positions at clients. Although leavers might be more likely to retain feelings of loyalty to specific former colleagues, rather than to their old firm in general, their personal relationships can reduce the adversarial component of the auditor-client relationship yet further and increase the emotional alignment between management and auditors.³⁰

Bias

This alignment of auditor and management matters because of the existence of unconscious bias. Unconscious bias affects every human being, a category that – contrary to widespread opinion – does actually include accountants and auditors. The effect on audit is the subject of recent research, which well describes what most people have at some time or other experienced:

Because of the often subjective nature of accounting and the tight relationships between accounting firms and their clients, even the most honest and meticulous of auditors can unintentionally distort the numbers in ways that mask a company's true financial status...

Psychological research shows that our desires powerfully influence the way we interpret information, even when we're trying to be objective and impartial. When we are motivated to reach a particular conclusion, we usually do... without knowing it, we tend to critically scrutinize and then discount facts that contradict the conclusions we want to reach, and we uncritically embrace evidence that supports our positions. Unaware of our skewed information processing, we erroneously conclude that our judgments are free of bias...

...even the suggestion of a hypothetical relationship with a client distorts an auditor's judgments. Imagine the degree of distortion that must exist in a long-standing relationship involving millions of dollars in ongoing revenues.³¹

This bias is particularly dangerous because it “works by distorting how people interpret information”. So a judgement that seems to all involved to be highly objective can in fact be

³⁰ Despite Enron's example, we should not rush to conclude that this always works to lower standards. There are many times when ex-auditors bring with them high ethical standards, as well as technical expertise, and are positive influences on their new employers. Unfortunately, these don't get reported. There are also some notable exceptions to the generalisation that auditors changing sides will increase the emotional alignment between management and auditor, usually when somebody has left an audit firm in acrimonious circumstances.

³¹ Bazerman, Loewenstein and Moore, “Why Good Accountants Do Bad Audits”, *Harvard Business Review*, November 2002 pp 97-102.

biased, because it is based on selective information. And this problem arises not because auditors are bad or even merely weak, but because they are normal people, and unconscious bias in favour of ourselves and our friends, or those on whom we are dependent, is normal behaviour.

Keeping things in balance

The influence of the commercial relationship and emotional alignment with management, and the bias that inevitably results from it, is supposed to be checked by a number of counterbalancing pressures, which should serve to remind the auditors of their obligations to shareholders and the public interest.

The fear of litigation...

Increasingly high on this list of counterbalancing forces is the fear of litigation. As it has become more common to sue auditors over company failures, firms have become much more alert to the risks that they run should it become apparent that their objectivity was impaired or the work of poor quality.³²

Another counterbalance is the threat of a catastrophic loss of reputation if an auditor slips up. This can and does happen – Andersen’s fate was sealed when, after the criminal indictment, institutional disquiet reached such a level that client company managements began to calculate that their share price would benefit from dumping Andersen and appointing a new firm – but it is extremely rare. Until last year, the big firms had demonstrated a most impressive capacity to shrug off embarrassing incidents and continue with business as usual.

A more common, and fortunately less all-or-nothing, way of keeping auditors honest is through regulation. Regulators set rules governing the relationship between audit firms and clients, and minimum standards for the qualification and behaviour of auditors, as well as for the processes to be used in an audit, and then police compliance with those minimum standards. (At the time of writing, the SEC is vigorously pursuing KPMG over its audit of Xerox, and reports from the US suggest that the large audit firms there are bracing themselves for a very rough time over the next year or two, as newly-invigorated audit regulators assert themselves.)

The system in the UK and the US requires pressures of this sort to balance the pressures that arise from the auditor’s commercial relationship with management, so as to keep the auditor poised between the public interest and the management’s interest. It is not a very finely-tuned system, even for dealing with conscious bias, let alone unconscious. We should not be surprised if every now and then an auditor comes unstuck.

Self-regulation

One of the principal regulators on whom we have depended to keep auditors honest is the Institute of Chartered Accountants in England and Wales, and its Scottish and Irish equivalents. The Institutes have wide-ranging responsibilities: they regulate corporate finance, investment advice, insolvency

³² Some commentators (eg Cousins, Mitchell, Sikka and Wilmott, *Auditors: Holding the Public to Ransom*, available from <http://visar.csustan.edu/aaba/aaba.htm>) have argued that auditors have little economic incentive to maintain quality. Irrespective of their theoretical case, that isn’t how it feels in practice. Firms have made strenuous efforts to improve quality because of their alarm over the rising cost of claims against them. It is arguable that these efforts may be less efficacious than the public would wish, perhaps partly because of the way that quality is defined as compliance with process, or for other structural reasons, but it is not for want of incentive.

and general tax and accountancy services provided by Chartered Accountants, as well as audit. More damagingly, they are also responsible for the promotion of the profession's business interests, which means that unsympathetic critics can dismiss them as mere trade associations. The current President of the ICAEW is a partner of PricewaterhouseCoopers, the largest audit firm. Most of his predecessors have also come from the large firms.

In fact, the accounting institutes operate with great integrity, and play a very useful and valuable role in regulation and technical support. This should not be decried. But there is an intriguing circularity at work here.

By the very nature of auditing, it is almost impossible for outsiders to have any real understanding of what audit firms do or how they do it. Bad auditing is presumed when an audit firm is found to be associated with a bad company or with a bad set of accounts. But good auditing has to be taken on trust, and must be presumed to be the case if a company's accounts appear to be satisfactory. This leads to the situation where:

...the more we are concerned with... the financial health of our institutions, the more we must rely on appearances created by organizations whose very success is judged by the appearances they create.³³

Seen from this perspective, the economic basis of self-regulation is clear. Business success depends on the appearance of "technical" success. The profession will optimise its profitability if it enforces standards on all its members so that major disasters are avoided and auditing's technical success is not questioned. But there is no commercial advantage in self-regulating any more than is necessary to maintain the public confidence.

Even the Accountancy Foundation, the recently-created and apparently short-lived body established to provide independent oversight of the profession, was, according to the ICAEW, set up as part of the profession's self-interest:

The current independent regulatory framework under the Accountancy Foundation was established by the CCAB Bodies [the various accountancy institutes] in order to provide the public with assurance that the conduct of the profession, and the standards of all types of work carried out by it, meet the public interest.³⁴

This is not to say that the Foundation did not serve the public interest. But a self-regulatory system which sees advantage in inviting independent scrutiny does not thereby stop being self-interested.

So what appeared to be two opposing forces maintaining an equilibrium is actually a little more complex than first appears. You might have hoped that regulation would be a direct counterbalance to the pressures created by the commercial relationship with management. But self-regulation

³³ J Van Maanen and BT Pentland, "Cops and Auditors: The Rhetoric of Auditors". In Sitkin, Sim B and Robert J Bies (Eds.), *The Legalistic Organization*, Beverly Hills: Sage, 1994, pp 53-90.

³⁴ ICAEW "Response to the Consultation Document on the Review of the Regulatory Regime of the Accountancy Profession", 2002, available from www.icaew.co.uk.

must inherently be directed at achieving just enough regulation to secure the profession's position, through maintaining the "appearances" of success. This is not the same thing as disinterestedly representing the public interest.

At the time of writing, it has just been reported that the Accountancy Foundation's responsibilities are to be transferred to the Financial Reporting Council, a more independent body, and extended to include setting standards for auditors' independence, objectivity and integrity.³⁵ It is to be hoped that the FRC will seize the opportunity to make the regulation of public interest audit substantially – and visibly – more independent. No system is perfect – occasional audit failures are inevitable. But a system which is both visibly independent and centred on the public interest, rather than the profession's interests, would be better placed to withstand failures and maintain the public confidence.

Global service providers to management

A system which requires auditors to ride two horses and be kept in balance between the pull of opposing forces is inherently unstable. It has been made even more unstable by the audit firms' diligent efforts to reinvent themselves as business advisory firms which also do audits.

The large audit firms have recently rediscovered the importance of audit. But like most deathbed conversions, this one is less than wholly convincing. For years now, all of the big firms have been evolving into what could best be characterised as "Global Service Providers to Management". One of the many services that they provide is to help the management get out a set of accounts which meet professional and legal requirements, and to which the firm will put its name. Their strategies, structures, resources and brandings have all been designed to this end. This will not be reversed in a hurry. It's easier to let a genie out of a bottle than to put it back.

One large firm's Annual Review published in December 2001 devotes its entire first page to defining the firm, in very large print, as:

...the global provider of advisory services whose aim is to turn knowledge into value for the benefit of its clients, its people and its communities.

Later in the same document, it spells out how audit fits into the grand scheme of things:

Evolution of our risk-based approach to audit attracts more and more adherents. By helping organisations and individuals to achieve their objectives and succeed in the new economy through measuring performance, managing risks and leveraging knowledge we increased Assurance revenue last year by 21%...

The [Assurance] practice is... aimed at improving a client's efficiency and performance through intimately understanding their business and the market in which they operate. Attestation services are an essential part of the way in which we help clients to protect their businesses by providing a highly valued audit opinion.

³⁵ *Review of the Regulatory Regime of the Accountancy Profession*, Report to the Secretary of State for Trade and Industry, London, January 2003.

Good reasons for auditors to provide non-audit advice...

It is possible to figure out from this how the audit firm serves shareholders and the public interest, as well as management, but you really do have to work at it. Quite clearly, *the primary purpose of the audit service is directed at management.*

It would be a little unfair to pick on one particular firm just because it has been more open than its peers. The fact is that this description of the nature of the firm could have come from any one of the then Big Five. All were pursuing very similar strategies, although some were rather more effective in their implementation than others. Andersen was widely regarded as the most effective in the implementation of this strategy, which might have some bearing on why it ran off the rails.

For some time now, the large audit firms have no longer seen the audit as the reason for their existence.³⁶ Important, yes; fundamental, no. Performing audits is an important part of the branding for the firms, all of whom wish to portray themselves as associated with integrity and competence. But the economic importance of the audit lies in the fact that it forms the bedrock of a close, long-term relationship with management.

Being the auditor provides the opportunity to develop a relationship of trust, to get to know the client's business around the world, to develop personal relationships across all levels within the company, and to identify areas where the client would benefit from further assistance.

From the point of view of management, there is tremendous convenience and value in having a large international audit firm available to undertake other services. There are many things that need to be done in a hurry and/or in remote locations, and the auditors, with their global networks of professionals who already understand the company's business and culture, are by far the best placed to step in and help out with the minimum of bother.

The type of issue which the auditors might be called on to help out with can be straightforward emergency firefighting, such as investigating trading problems in a subsidiary or providing teams of junior accountants to help unravel the mess after the discovery of an accounting breakdown somewhere. It might be more strategic, such as standing alongside the finance director in meetings with bankers or potential purchasers, or performing due diligence on a proposed acquisition target. Or it might be helping to identify or remedy weaknesses in the company's systems.

The genuine merit of this is captured well by Robert Bruce in the *Financial Times*³⁷, recounting a conversation with the CEO of a FTSE 100 company:

He saw no reason why he should be forced to buy tax advice, or corporate finance advice, from a firm that knew less about the intricacies and culture of his business than the auditors, whose job it was to know the place inside out.

He has a point. Everyone knows that you get better results if you go to a supplier who knows you and your business.

³⁶ A friend who was with one of the big firms (not Andersen) a few years ago remembers the celebrations that were organised by the management when it was announced that audit revenues had for the first time fallen below 50% of the firm's total fee income.

³⁷ 8 August 2002.

The big firms built some of the world's largest businesses by responding to this need and making the most of the opportunity they have. The fact that they have recently sold off their big-ticket consulting businesses hasn't really changed things. The headline figure of non-audit fee income is down, and there are some specific services that they are no longer able to provide. But there's still a very extensive range of services available, as can be seen from a cursory look at their websites, and auditors have not stopped aspiring to become trusted business advisors to their clients.

There is a real benefit to management – and ultimately to investors – in having access to a global pool of resources with a broad and deep understanding of their business. Clearly, it is also of significant benefit to the audit firms, both financially and by providing a greater variety of work, enabling firms to attract and retain higher quality staff.

The large audit firms have spent many years evolving to the point where their *raison d'être* is to provide a range of professional services, which happens to include audit and compliance services. To adapt the well-known judicial expression, audit firms became neither bloodhounds nor watchdogs, but Global Rent-A-Mutt, canine suppliers for a wide range of purposes.

Riding two horses leads to accidents

Our current system of audit, based as it is on auditors developing a commercial relationship with management, counterbalanced by regulation, will inevitably cause auditors in their own economic self-interest to push the boundaries of that commercial relationship as wide as the market and the regulators will let them. It would be unrealistic to expect anything else. It would be equally unrealistic not to expect these circumstances to produce the occasional disaster.

I have no more knowledge of Andersen's work at Enron than anyone else who reads the *Financial Times* (or *The Wall Street Journal*). But I don't find it difficult to imagine how such a disastrous situation could occur, even if the auditor started off with the best of intentions. You don't need to suppose either criminal conspiracy or gross incompetence. A perfectly plausible story could go like this.

David Duncan would not have woken up one morning and thought "I know, let's collude with Enron management to defraud stockholders". He was successful in Andersen, and that success would have been built over many years by helping clients to achieve their business objectives, while at the same time keeping them and the audit firm out of trouble. (With only very occasional exceptions, audit firms have never been very forgiving towards partners and staff who get them into trouble.)

So when Enron management came along with the first idea for using SPEs (special purpose entities) to keep certain transactions off the balance sheet – no doubt for what at the time might have seemed to be entirely valid business reasons – the successful auditor's first instinct would be to find a way to help management achieve its objective. If it could be made to comply with the rules – and it has been reported that most of Enron's SPEs did comply – then the auditor would have fulfilled his public duty of preventing errors, while at the same time establishing himself once more as a trusted business advisor and so earning credit from his firm. The firm's profits would grow as it followed its strategy of becoming an all-round business advisor, and the successful auditor would be rewarded with status and an even larger share of those growing profits.

If I'd been in that auditor's shoes, I don't think my judgement would have been influenced very much by the size and nature of the non-audit fees that Enron was paying. I'd have been delighted by these highly visible signs of the fact that I was indeed a trusted business advisor to a valuable client, concrete evidence that the firm was right to entrust this precious relationship to me. Losing non-audit fees would have made my success less visible, and probably less well-rewarded by my firm. But *real* failure – the only thing other than the threat of a lawsuit that would have the capacity to keep me awake at night – would be to lose the audit client. If the regulators had banned certain non-audit services, it would have made not the slightest bit of difference to my relationship with the management. I would have continued to be economically dependent on them, and to have measured my success by how well I served them.

This practical view of the fundamental irrelevance of non-audit fees to the issue of an auditor's (non-) independence is supported by recent research:

We have no evidence that the extent of non-audit services influenced the behaviour of the partners faced with the possibility of losing a client. The issue arising for the AEP [audit engagement partner] is the loss of the client rather than the mix of the fees arising from the engagement.³⁸

It probably wasn't even material, that first SPE of Enron's. But then there would be another, and then another, and then another. Seeing the wood for the trees can be difficult, even at the best of times. I can imagine it being a while before an auditor woke up to the fact that he'd helped to construct a house of cards. And then what to do about it? Confess, and bring the whole edifice down on your own head? That wouldn't be an easy decision for anyone to make. You can imagine any auditor going through torments as he realised the size of the hole that he'd dug himself into. No wonder David Duncan seems to have panicked and decided at just the wrong time to comply with his firm's official policy on document destruction.

The UK's "true and fair approach", combined with our more sensible accounting standards, should reduce the likelihood of an Enron occurring here. But they won't necessarily prevent anything like it ever happening.

Auditors' training as accountants encourages them to think that an avoidance of errors gives a right answer. Their approach to quality encourages them to think that an outcome must be defensible if it was arrived at by means of proper process. UK auditors have the same commercial relationships with management as American ones. The same pressures are on auditors to help their clients within the rules. Similar criteria are used on both sides of the Atlantic for judging audit partner and manager performance.³⁹

And it is unreasonable to expect that newly-invigorated Audit Committees will prevent audit failures. An Audit Committee's increased involvement in appointment and supervision of auditors is a good thing, but there will inevitably be some ambiguity around the independence of Audit Committee members themselves, and their increased involvement merely adds a further complex dynamic to an already complex situation. Furthermore, technical expertise alone is not the answer – Enron's Audit Committee included a professor of accounting.

³⁸ Beattie, Fearnley and Brand, *Behind Closed Doors*, Palgrave 2001.

³⁹ No doubt the emphasis on audit quality has been increased in recent months, but it is not likely that whole systems will have changed.

“Two horses need two riders”

Horses (and riders) for courses

Having audit firms riding two horses, of management’s adviser and of protector of the public interest, is inherently unsatisfactory – all the more so given the way the audit firms’ businesses have evolved into global service providers to management. *But the solution to this is not to shoot one of the horses.*

The large audit firms are actually doing something useful when they provide non-audit services. They wouldn’t get paid otherwise. And as business gets more and more complex, and the pace of events gets ever faster, the need for such services will become greater.

Instead of shooting one horse, we must recognise that *two horses need two riders*. Let public interest audits be done by wholly independent firms who exist for that purpose alone, and not in order to use the audit relationship as the basis for building global service businesses. Let the big global firms continue to build their global service businesses by helping management get things right.

6. Competition, or the lack of it

Going down...

The pace of this amble through the byways of the world of auditing should be able to speed up here. It cannot take a lot of argument to prove that there is not much competition in the large company audit market.

Twenty years ago we had the Big Eight. Ten years ago it was the Big Six. Four years ago it became the Big Five, at which point the EU competition authorities said “thus far and no further”. Unfortunately, Andersen failed to heed the directive and now we have Four.⁴⁰

Of the world’s largest companies, all but a tiny handful were audited by the Big Five. Second tier audit firms have not benefited from the redistribution of Andersen’s clients, virtually all of whom have gone to the Big Four.

Does it matter?

Lack of real choice seems self-evidently a bad thing:

Consider now the position of a big company that wants to change auditors. It essentially has a choice of three firms, but it may find that one works for its principal competitor, or another has a conflict from non-audit work. In

⁴⁰ This consolidation seems to have arisen largely because business has become more complex and more global, causing the firms to seek competitive advantage through depth and extent of resources, and more price-sensitive, leading to a search for economies of scale. Over the same period, presumably as a result of these competitive pressures combined with the growth of the Big Four brands, we in the UK have seen the smaller firms which once occupied niche positions in certain sectors of the audit market (such as Spicer & Pegler in financial services, Neville Russell in insurance and Moore Stephens in shipping) lose their larger public company audit clients.

that case, it's Hobson's choice – and the one firm in the race will be able to charge accordingly.⁴¹

The tightening of the big firm oligopoly will undoubtedly create competitive difficulties. Even with five large firms, it was sometimes difficult to find properly independent advisors in complex transactions. And the Chairman of the UK Financial Services Authority has spelled out how the situation is even worse than it might at first sight appear:

We are very concerned about the impact of further consolidation in the accounting industry. I find it difficult to think that the current position is in fact stable... because in some sectors, for example the insurance sector, there are not really four competitors. It is now a position where it is impossible for any one of these four to fail because anybody would agree you could not go down to three or two.⁴²

Lack of competition has consequences...

A virtual elimination of choice is inherently unsatisfactory. But it is worth taking a brief look at some of the specific practical consequences that might be expected to arise from the tightened oligopoly in large company auditing. These might include:

- increases in audit fees;
- reductions in audit quality; and
- an increase in the oligopoly's ability to stonewall any efforts at reform.

The actual likelihood of these possible consequences varies.

Increases in audit fees

It certainly didn't take long for the auditors to start talking this one up, although of course they attributed it to the need to do more work, rather than to opportunism.

Quite why more audit work is needed is not clear. Presumably the firms are not inferring that previous audits were inadequate. In any event, it doesn't seem to have been a shortage of audit procedures which caused the problems at Enron, but a failure of judgement concerning facts which were known to the auditor. It is not obvious how the auditor's judgement would have been improved if fees had been higher.

It remains to be seen whether or not the firms will succeed in making their hoped-for fee increase stick. Reports suggest that so far they are being more than a little successful, with audit committees not daring to resist demands for fee increases based on audit quality.⁴³

⁴¹ *Daily Telegraph*, 18 June 2002.

⁴² Sir Howard Davies giving evidence to the Treasury Select Committee on 2 July 2002. Recorded in Minutes of Evidence HC 758-iv of Session 2001-02.

⁴³ The competitive dynamics in relation to new appointments have been different on the two sides of the Atlantic. It appears that in the US, where Andersen simply disintegrated, there has been something of a feeding frenzy as the other big firms fought over its clients, with fees being forced down. In the UK, by contrast, most of Andersen's clients were taken over by Deloitte & Touche, with relatively few of those clients going out to competitive tender. (Those who harbour anti-American sentiments can take pride in the fact that we seem to have a better-organised and more effective oligopoly than the US does.)

Reduction in audit quality

This should in theory be a likely outcome of a tightening of oligopoly, but it is unlikely to happen. For one thing, of course, the breathtaking spectacle of a respected firm vanishing in a puff of smoke has concentrated the minds of the survivors to a most wonderful extent. This will only last for a couple of years – human beings have short memories, and things soon begin to look different – but it's certainly making an impact now.⁴⁴

But there is another, more fundamental, and rather unfortunate reason why a reduction in competition will have no effect on audit quality, even in the longer term. This is because audit quality simply does not feature to any meaningful extent in the competition between the big firms. *What they actually compete over is the quality of the service to management.*

This can be seen quite clearly from the firm's occasional advertising campaigns, when they are at pains to market themselves as partners with the management. In fact, it isn't very many years since one of the large firms had advertising hoardings across Britain describing itself in those terms. Today they're a little more circumspect, but the general message remains the same. The following text is taken from a Big Four website:

...we help CFOs manage the velocity intrinsic to today's business climate, increase the visibility of their organisation's most important - yet often intangible - assets, and lead the value creation process for shareholders.

It's not entirely clear what, if anything, this means; but it certainly doesn't sound as if it has much to do with audit quality. Another big firm's website, meanwhile, offers:

...a service designed to help our clients reduce risks and inefficiencies in their business processes. It applies the same skills and knowledge that the audit relationship delivers to the wider operating needs of the business... As auditors, we know our clients' finance processes in great depth and are therefore in an excellent position to help them review the contribution that their finance processes make to their overall business objectives, and to look at the options for improving the effectiveness of the processes...

Since audit firms don't compete on the basis of audit quality, there's no reason to suppose that a reduction in the number of firms will make any difference to quality.

Even more stonewalling

We have an audit system which is inherently flawed because audit firms are primarily global service providers to management. But an oligopoly of four firms is unlikely to choose to reform itself, and in the absence of alternative suppliers it can put up stiff resistance to the imposition of reform.

⁴⁴ History seems to show a regular cycle. In the immediate aftermath of a major audit failure, the pendulum swings sharply towards audit quality, with the audit firms making the avoidance of audit failures their top priority. Over the years that follow, it gradually swings back, with quality becoming a more routine affair and the business focus being increasingly on sales growth until the next disaster.

Even if they were willing to reform, they probably couldn't. Because of their size and unwieldy organisation structures, and because their businesses have evolved to be deeply dependent on providing a wide range of services to their clients, the large firms would as a practical matter find it extraordinarily difficult to convert themselves into truly independent audit specialists.

Might the recent Sarbanes-Oxley Act, which prohibits US audit firms from providing a range of non-audit services to audit clients, force transformation on the big firms? It's possible, but unlikely. And any change which does result is likely to be more form than substance.

Admittedly, many UK companies are showing signs of infection by the Sarbox virus, as are the UK subsidiaries of US companies. Audit committees and managements everywhere are hastily withdrawing consulting contracts from their auditors, while white-faced partners are rushing from working party to working party trying to figure out how to get large numbers of accountants excited by the prospect of having to sell to companies that are not audit clients.

But we've seen something rather similar before. The present circumstances bear a resemblance to the situation that arose in the UK some ten years ago, when all but smaller companies were required to disclose the non-audit fees paid to their auditors. For a year or two, there was a marked downturn in non-audit business, as companies fought shy of having to disclose significant amounts. (This time, the unpleasantness is compounded by the high levels of uncertainty over how Sarbanes-Oxley will actually be applied and enforced, leading many companies to be ultra-careful.) But it didn't take long for the fees to make their way back up again, to levels which are now far higher than they were before – for the simple reason that companies found it very useful to be able to ask their auditors, who know them and are always available, to help out.

This basic practicality has not changed since then, and companies are already experiencing the inconvenience and (often) extra cost that arises from excluding their auditors from special projects. It should not take much time before companies' knee-jerk reactions wear off and are replaced by a growing realisation that Sarbox doesn't actually prohibit much that wasn't prohibited already. At that point, *business as usual will be resumed*.

Pressures today are greater than they were ten years ago. But on the other hand, the firms' business models are more deeply entrenched in a dependence on non-audit work than they were then, and consequently will be even more resistant to change.

It does not help that most of the audit firms have already disposed of their large-scale consulting businesses. Had these been retained, it might have been easier, although still very difficult, for them to hive off their audit divisions to leave large, well-integrated consulting businesses. As it is, many of their remaining non-audit businesses – such as tax, risk management and small-scale consulting – are highly dependent on audit clients for work. Relatively few people in audit firms actually have much experience of, or aptitude for, selling from scratch, because they have spent most of their careers in a business which was dominated by audit client relationships. The most likely outcome is that the firms will struggle along, doing the best they can and making the most of what they have, until the business recovers. It will be painful, particularly as partner profitability will be protected as far as possible by cost-cutting, *but really radical restructuring is unlikely*.

Even if they did decide to restructure, the audit firms probably wouldn't be able to get very far with it before business recovers and the motivation diminishes. Despite their efforts to portray themselves as global organisations, the big firms are actually confederations of self-governing

**“Competition
is essential
to effective
reform”**

national firms. Andersen was widely perceived as the best-integrated of the Big Five, but it took no time at all for its non-American firms to put up large notices saying “Nothing to do with us”. Confederal structures of this sort are very useful for risk management, as they help to keep lawsuits contained within separate jurisdictions. But they could have been designed for the express purpose of frustrating effective management and slowing down anything in the way of significant change.

For example, the audit firms have been struggling for years with the problem of trying to maintain audit quality in some of their more remote locations, such as across most of Asia. “Will it work in Bangkok?” is a cry that can be heard echoing along head office corridors whenever anyone has a new idea. But, despite often heroic efforts, their networks still tend to go their own ways:

The East Asian financial crisis highlighted a number of cases where the level of assurance conveyed by well-known international firm names differed significantly from one network member firm to another, and where the absence of mechanisms normally associated with ownership and control prevented the uniform enforcement of standards which the network had agreed upon.⁴⁵

Given these difficulties, the firms stand little chance of being able to accomplish anything in the way of major reform unless it is forced on them. And there is no global regulator with the jurisdiction to do this – not even the SEC, although no doubt it would like to think otherwise.

There is, however, one global force that might do the trick. That is competition. If genuinely independent, niche specialists were to enter the public interest audit market, and if the capital markets were to show that they placed value on independence, then the Big Four would be forced to choose. They could hive off part or all of their audit arms into separately owned businesses, to compete as totally independent specialist providers, or they could continue to be Global Service Providers whose audit businesses were clearly part of their client companies’ processes for getting things right.

If real reform of the system of audit is equated with reform of the individual large firms that constitute the oligopoly and dominate the profession’s self-regulatory structure, then it is fairly safe to predict that not much will happen. *Competition is essential to effective reform.*

Unfortunately, it is generally assumed that doing anything about the oligopoly is out of the question because the barriers to entry in the large company audit market are too high. The chairman of the UK-based Accountancy Foundation is well placed to express an authoritative view:

As a former head of the Office of Fair Trading, he said he thought grounds existed for the Big Four accounting firms to be investigated by the competition authorities.

But Lord Borrie, who stressed he was giving a personal view, questioned whether a solution could be found to the way the Big Four firms dominated the auditing of large companies. The competition authorities have

⁴⁵ Claude Trollet and John Hegarty, *Regulatory Reform and Trade Liberalisation in Services*, OECD-World Bank, March 2002.

traditionally been reluctant to force the break-up of companies or partnerships.⁴⁶

Given the complex and nearly unmanageable structures of the Big Four firms described above, the competition authorities' reluctance to take them on is quite understandable. But does this really mean that we are stuck with the status quo? *Are the barriers to new entrants really insurmountable?*

Barriers to entry in the large company audit market

A review of competition in the UK professions commissioned by the Office of Fair Trading found no evidence of cartel activity to account for the concentration of the large company audit market in the hands of the then Big Five.⁴⁷ It summarised the lack of competition as arising from the following characteristics:

Multi-national clients often want their audit or other accountancy work to be done consistently round the world by a firm with global reach. Although the second tier firms have tried to set up their own international networks, their coverage is only partial. Thus, only the Big Five effectively compete for this work.

Even large national companies often prefer to use a Big Five firm because they believe their investors feel more comfortable if their accounts are signed by a firm with a strong reputation...

Barriers to entry in this segment are also high: a new entrant would lack reputation and would find it difficult to build an international network (as established second-tier firms have found). A new entrant would also face a vicious circle in becoming established: it would be difficult to win business without adequate numbers of staff, and it would be difficult to attract staff until the firm had a substantial client base.⁴⁸

In short, the real impediments to competition fall under two headings:

- the insurmountable difficulty of forming the international networks and armies of people needed to audit multinational companies; and
- the unwillingness of the capital markets to accept unfamiliar brands.

These reasons are widely accepted and frequently repeated. In fact, neither of them should be regarded as the state of nature.

⁴⁶ *Financial Times*, 8 July 2002.

⁴⁷ The report notes a small number of professional restrictions which reduce competition in the accountancy profession in general, but these are not particularly significant in relation to large company audits, and they pale into complete insignificance when set against the other characteristics of the market.

⁴⁸ Report by LECG Ltd published as part of *Competition in Professions*, Office of Fair Trading, 2001, paragraphs 303-5.

**It ain't
like you
think...**

Things are that way because we have allowed them to be that way. They do not have to be like that.

This sweeping assertion will require some explaining. The best way to do this will be to digress for a few moments in order to take a look at a few commonly-held presumptions about auditing. We will find that the *status quo* rests on a raft of myths.

7. A brief mythology of auditing

Myth one: There's only one way to do an audit, and it's boring

The case that audits really are boring is made at regular intervals by the big firms to support their case that they need to be allowed to continue doing other things as well as audits. The argument runs something like this: "Audits are boring. Therefore quality people would not want to do them. Lower quality people would do lower quality audits. *Ergo*, if you want high quality audits, we must be able to hire and retain high quality people, and we can only do that if we are able to offer them some interesting work to counterbalance the appalling tedium of doing audits."

It is undoubtedly the case that audit staff do find much of their work very boring. Large numbers of auditors leave the profession soon after qualifying, and the lack of interest in the work is one of the most common reasons.

On its own terms, the firms' apparently self-serving argument is both logical and borne out in practice. The only trouble is that it is founded on a false premise. *What if audits didn't have to be boring?* What if the boredom arises not from the fact that it is an audit, but from the way in which it is done?

In fact, this is the case. Despite what some might think, being bored witless is not actually an essential element of a good quality audit. It is perfectly possible to do an audit in a way which is inherently interesting.

Fundamentally, the boredom arises from the way in which audit firms are organised and resourced. The big firms employ many thousands of recent graduates who are training to be chartered accountants. These may be quality people – intelligent, committed and eager to learn – but they have little or no experience of business or of management. These people, who outnumber the experienced members of staff, have to be put to work on audits.

To achieve a consistent quality of work from inexperienced people, it is necessary to define as closely as possible the steps of the process that should be performed. The result: auditing standards which define an audit in terms of the process to be followed; firms' audit approaches which set out structured procedures, often systematised through checklists, decision trees or flow diagrams, and supported by specially designed computer software to control and record the work; and a general presumption that auditing consists largely of junior people carrying out the steps prescribed for them. This doesn't sound very exciting, and often it isn't.

But if the resource model were different – particularly if audit firms were to use experienced people instead of trainees - then there would not be a need for the tedium of a process-based

approach. Instead, *there could be more thinking and less ticking*. And thinking – about how a business works, and how that is reflected in the financial statements – is an inherently interesting activity. That’s why audit staff fight to get on to due diligence assignments.

More than that: it is also how to get a better quality audit. Although there may be the odd exception, it is fair to say that, on the whole, the major audit failures in recent years have not arisen because of a lack of ticking, but because of an insufficiency of critical thought.

The Barings case provides a clear example of how a failure to see the wood for the trees can lead to embarrassment or worse. The profession’s disciplinary body reported that:

The overriding criticism of C&L London and of [the audit partner] is that they missed a crucial part of the broader picture.

As the Appeal Tribunal said of them, the belief that Mr Leeson’s trading activities ‘posed little (or no) risk to the Barings Group, but yielded very good returns, is implausible and in our view, demonstrates a degree of ignorance of market reality that totally lacks credibility’.⁴⁹

The Tribunal also found that the auditors had not been generally slapdash or indifferent to the quality of their work. On the contrary:

C&L carried out much skilled and detailed work in the course of their audits... generally their work was of a high standard.⁵⁰

Audit firms take their responsibilities seriously and do a lot of work for their fees, usually very diligently and professionally. Unfortunately, a recurring theme of audit failures is that the professional ability to count trees with a high degree of precision, in which accountants are so carefully trained, does not necessarily bring with it the ability to see the wood.

So a way of auditing which focuses on seeing the wood for the trees sounds like a good idea. Apart from anything else, it stands a very much better chance of detecting the management frauds which are often behind large-scale corporate disasters. And this is precisely what all the big firms have been working on. The idea of auditing through understanding the business and the management, which is the basis for the approach taken by this paper, is not a revolutionary one. It has been tried and tested.

Over the last few years, all of the big firms have been developing audit approaches around this principle:

The findings of this research are that the business risk approaches are the predominant trend in the direction of methodological development in practice.⁵¹

⁴⁹ Joint Disciplinary Scheme, findings of Joint Disciplinary Appeal Tribunal summarised in Press Notice of 29 April 2002.

⁵⁰ Report of the Joint Disciplinary Tribunal, 13 June 2000, paragraph 49.

⁵¹ Lemon, Tatum and Turley, *Developments in the Audit Methodologies of Large Accounting Firms*, ABG Professional Information, May 2000, page 23.

These “business risk approaches” have been inspired partly by the genuine (and justified) belief that a better quality audit would result, but were also partly motivated by strategic considerations:

Many firms are no longer content to use the audit as loss leader for high-margin consulting work. They now sell the high-margin consulting work in the name of the audit. Since they could not abandon the audit, they have reengineered it...

The factors that underlie the success of the clients’ enterprise are now that [*sic*] which the auditor needs to be concerned with...

This approach prioritises the development of deep knowledge about industries and a full-scale mandate of industry specialization for audit personnel.⁵²

This is quite a good summary of the firms’ strategic aspirations. Until Enron, it seemed to make perfect sense. In the post-Enron environment, it doesn’t look quite so well-conceived.

This unfortunately gives rise to the real danger that, because of the association of the audit methodology with the strategic goal of selling other services, it will be criticised for audit failures, and that there will be a resurgence of demand for the good old-fashioned method of auditing lots of detail (that is, counting trees with renewed enthusiasm). This would be to throw the baby out with the bathwater. All of the large, and some of the medium, firms have invested heavily in the development of business risk approaches, and all have found that they are capable of delivering a high quality audit – *so long it is done with the right resources and in the right context of independence and objectivity*. It is these questions – of resources and independence, and the extent to which they are matched to the audit approach – that require attention, not the business risk approach itself.

In practice, audit firms have not found it straightforward to implement this new approach. As the extract quoted above shows, it demands expertise; without high levels of expertise, it would be unacceptably risky. With the right sort of expertise, on the other hand, it can produce very high quality work. The implications for the audit firms’ resources are immense:

Conducting financial statement audits through a business risk approach redefines what should be regarded as the necessary expertise of the auditor... This has implications for the nature of the formal qualifications recognised as appropriate for auditors, for the structure of educational courses accredited in the process of qualification and for the recruitment and training of audit staff by the public accounting firms.⁵³

What these dry words are saying is that *audit firms need to be resourced in a way that is different from the current model in every significant respect*. But this is an enormous change,

⁵² Timothy J Fogarty, “Everything you know about auditing is probably wrong: Practice realities in the 00’s”, *Ohio CPA Journal*, Columbus July-September 2000.

⁵³ Lemon, Tatum and Turley, *op cit*, page 22.

which would be difficult enough in any business, let alone one as inherently conservative as the auditing business. And in fact the firms' resource models are not very different from ten years ago. Their hierarchical "staff pyramids" might be slightly steeper-sided than they used to be, but they're still pyramid-shaped. Even though some of the firms have spent large amounts on knowledge management systems geared towards making everybody smarter, there's a limit to what junior people can realistically be expected to do.

If the team doesn't change very much, the work can't change as much as might be hoped.⁵⁴ The consequence is that the new approach to auditing, while well established as potentially superior, has to be watered down if the firms are to make any use of it on a large scale. And this watering down is then compounded by the need for methodologies to be acceptable across a firm's entire global network.

Part of the firms' difficulty is the supposed chicken-and-egg problem. It is presumed that firms need to train junior people in order to have experienced people in the future, and so they continue to recruit graduates in large numbers.

In fact, this is only a problem if you make the presumption that the experienced people needed for audits must be Chartered Accountants (or, in the US, CPAs) whose experience consists of qualifying with an audit firm and climbing the post-qualification hierarchy. But of course, those are not the only available experienced people.

For a start, in the UK at least, there are the other accounting bodies, most of whose members train in industry rather than in the profession. And then, as the population ages, there will be an increasing number of financially literate people with experience in areas such as management, banking, investment, consulting and corporate finance, all of which could provide an excellent basis for becoming a "thinking auditor".

Audit firms, which must be among the most hierarchical organisations to be found in the commercial world, often find it difficult to hire and retain such people today because their cultures and their processes are totally committed to the "up or out" career plan. But that doesn't mean it can't be done. There is a valuable resource pool out there, waiting to be used by any audit firm that chooses to organise itself around expertise and roles, rather than around process and hierarchy.

To sum up: it's simply not the case that auditing has to be done by accountants following what most people think of as the boring old process of audit. Much more interesting and useful approaches have been developed in recent years. These "business risk approaches" give their best results when they are carried out by experienced auditors who are expert in a range of relevant disciplines – including, but not predominantly, accounting experts.

Audit firms are also known as accounting firms, and the methodologies that they can perform in practice have to reflect the fact that the firms are primarily equipped to field audit teams containing lots of trainee accountants. But if you were starting with a clean sheet, you could assemble a resource pool of experienced people that would be tailor-made for doing interesting and effective audits, using the existing, proven methodologies which demand *more thinking and less ticking*.

⁵⁴ See, for example, Eilifsen, Knechel and Wallage, "Application of the business risk audit model: a field study", *Accounting Horizons*, September 2001, page 203.

Myth two: Audit firms need armies of people and huge international networks

The Big Four audit firms certainly *have* vast armies of people and huge international networks. They do not actually *need* them in order to fulfil their public interest role of reporting on whether the consolidated financial statements of large companies give a true and fair view. They use them for this purpose, certainly, but that's because they've got them. Not because there's no other way.

To set the scene for this discussion, let's look at a situation in which the overseas network can sometimes be not merely unnecessary to a quality audit, but a positive hindrance.

There has been a trend in the last few years, particularly in the European single market, for companies to organise themselves across national boundaries, for example with the management of functions such as supply chain being on a pan-European basis, rather than a national basis. Statutory companies continue to exist in the various countries in which the company operates, but those companies exist for tax and legal compliance purposes, rather than as separately managed entities with an economic life of their own.

You don't need to be a professional auditor to see that, if you were setting out to audit such a pan-European business, the best way to do it would be to understand the business in the way that it is actually organised: its risks, how it is managed, the information that is used and the controls in place. In other words, apply the "thinking not ticking" business risk approach described in the previous section to the actual business organisation, which is likely to be defined primarily by the management organisation structure. But despite this being fairly readily apparent to non-auditors, it remains common to find the group audit revolving around the statutory entities, even when they have little or no economic meaning.

Quite frequently, there is nobody in a management position who has any interest in or understanding of the profit or loss shown in the statutory accounts. The local auditors, on the other hand, take a great interest. The Belgium firm wants its share of audit work; so do the French firm, the Italian firm, the Spanish firm and the German firm, to name but a few. After all, "the international networks consist of multiple member firms linked by contract"⁵⁵ – and contracts must provide benefits as well as costs. The local auditors are in a strong position because all of these European countries, and most others, have statutory audit requirements for locally-incorporated companies, and statutory audits can only be done by locally-licensed auditors.

Consequently, a high proportion of audit time and cost can go into this work, when common sense suggests that a much better approach would be to audit the business in the form in which the business actually operates, and to deal with local compliance as a separate matter.⁵⁶

These statutory audits of subsidiaries are not being done because they are the best way to audit the consolidated accounts of the cross-border entity. They are done because local custom and practice require local audits - and, unfortunately, the consolidated audit is made to fit around that local work.

⁵⁵ Trollet and Hegarty, *op cit*, paragraph 39.

⁵⁶ One further implication of all this is to raise a question mark over the effectiveness of the statutory audits of these subsidiaries from the point of view of local compliance. However, this is more of a problem for Continental Europe than it is for the UK, and is not explored further here.

This is the crux of the matter. *The public interest relates to the consolidated accounts of the group, not to the individual elements of it.* As far as the public interest is concerned, auditing the various subsidiaries has to be a means to an end, not an end in itself. And that end can be achieved in other ways.

We've grown so used to the idea that a group audit involves auditing all the subsidiaries that it's not easy to take in the idea that subsidiary audit is something distinct from the public interest audit. But it's worth making the effort, because where this distinction leads to is the realisation that extensive networks are not necessary for the public interest audit alone. They are necessary for other things. And what that means is that one of the principal barriers to entry in the public interest audit market is actually illusory.

Multinational companies publish consolidated accounts, and these are the accounts that the capital markets react to. The public interest is in these consolidated accounts. It really doesn't matter if a small subsidiary in Botswana gets its statutory accounts wrong. In fact, it probably doesn't matter to the UK (or US) public interest if a large subsidiary in Germany gets its statutory accounts wrong, except to the extent that it has an effect on the consolidated accounts. The important issue for us is the accuracy of the consolidated accounts, not the local compliance.

The whole point about consolidated accounts is that they present the financial result and position of the group as if it were a single business. So if you want to use the "thinking not ticking" approach to the audit of the consolidated accounts, and if you want to be sure that you see the wood for the trees, you must start by understanding the business of the group as a whole – what it is, how it is organised and managed, and how it is measured. And of course you will start this process of understanding at the top of the organisation, the head office, because that is where the business as a whole is managed.

Accountants are trained to prepare consolidated accounts by taking the separate accounts of subsidiaries and adding them up; so it is not surprising that they think of auditing them the same way. It's only fair to note that until relatively recently there was little alternative. In the days before network computing, when the audited consolidated accounts might well have been one of the main sources of information for the head office, and when there was usually not much difference between the statutory, management and geographic organisation structures, there would be little opportunity to view the group as a single business. Approaching it as a collection of separate entities was usually the most efficient, and perhaps the only, way.

Nowadays, though, the picture is different. Most multinational companies invest large amounts of money and effort in managing their worldwide activities. They have strategic planning systems to set directions; budgetary systems to set goals; management information systems to monitor progress; internal audit to keep everyone on their toes.

They also have complex management matrices covering every imaginable (and some unimaginable) dimensions of the business, and performance management systems that seek to keep everyone motivated. They have automated consolidation systems that collect data from around the world at frequent intervals.

And they have financial control systems scrutinising the financial information reported all the way up the chain, because exercising discretion over reporting is a prerogative that top management wants to keep for itself. If you're a group finance director, the last thing you want is to have no idea what the real profit is, because every subsidiary has been squirreling away reserves for a rainy day.

Now, none of this is to say that every multinational company is perfectly organised and controlled and doesn't actually need an audit at all. Of course, there are usually many imperfections and problems across diverse and complex groups. Often the most corrosive is a badly managed target-setting system. If you threaten subsidiary managers with the loss of bonuses, or even of their jobs, if they don't meet targets, you shouldn't be too surprised if a few of them succumb to the temptation to report success when they ought not. And there can still be errors caused by plain old processing failure, although modern technology means it's getting much less frequent.

Nonetheless, the point is that the consolidated group is not a special fiction prepared by accountants a few times a year for shareholders, but is actually a management entity. With or without weaknesses, it exists. And an auditor who wants to see the wood for the trees should start at this level, and then work his way down the organisation structure, digging deeper and seeking corroboration where necessary.

An auditor who properly understands the management performance measurement and remuneration systems, for example, from the head office downwards, will do a much better job than one who dives straight into a subsidiary's general ledger. Our thinking auditor will very probably do less work at that detailed level than a ticking auditor would do; but his work will be better informed and more perceptive, and will contribute more to the total audit picture.

This is nothing more complicated than the application of the new audit methodologies. These presume that the auditor will start at the top of the organisation and work down, identifying the risks and controls, and performing more detailed investigations where required. All that I am doing here is to point out that there is no practical or theoretical reason why that approach should not be applied to the business organisation of a multinational company. All it takes is for the auditor to have the consolidated accounts as his sole focus, so he can switch off the autopilot leading him to the separate audits of subsidiaries.

So how does this mean that you don't need a big network? The easiest way to explain is to use the example of due diligence. Business risk audits have a lot in common with due diligence: both rely on experienced people to gain a detailed understanding of the business.

When an audit firm is commissioned to do a due diligence investigation of a company with significant overseas operations, it does not usually begin – as it would in a traditional audit – by preparing written instructions detailing what it would like its offices in each of the relevant overseas locations to do. Instead, it is much more likely that the partners and managers who are working on the due diligence at head office will actually jump on planes and go to visit the principal locations. If there is detailed work to be done, they might utilise the local resource, but they are just as likely to fly out staff from home base and hope that the local office never finds out.

There is a good practical reason for this (quite apart from minimising the amount of fees diverted from the home office to the local office). When experienced people are working to build up an understanding of the strengths and weaknesses of a business, they can achieve far more by getting out and about themselves than they could by sending in teams of people who know nothing about the big picture or how the local work fits into the overall context.

Exactly the same principles apply to doing the audit of a group's consolidated accounts. The audit team would be relatively small, but experienced. Some would be expert accountants, but

others would be expert in the relevant industries or in technical disciplines. As already explained, much of the work would take place at global and divisional head offices, since this is where the high-level management and control activities take place. In the course of this work, it would become apparent that the auditors needed to visit many outlying locations, either because of identified issues or to confirm that there are no issues. The audit team would pick itself up and make those visits, just as it would on a due diligence investigation.

A big global network has plenty of uses, but those uses relate to the audit firm's role as Global Service Provider to management. The audit of subsidiaries is often (although not always) something that is valued by management, and audit firms are often selected by management because of their global capability. Nonetheless, *the network is not a prerequisite for doing the public interest audit of a large company's consolidated financial statements*. When we understand this to be something distinct from the audit of subsidiaries, it is easy to see how it could be done with little or no international network and very small – but specialised – resources. One of the supposedly insurmountable barriers to entry in the large company audit market need not be a barrier at all.

In addition to the implications for competition, there are implications for independence too. In fact, if you want to make auditors properly independent, then you're better off arranging matters so that they don't audit subsidiaries, and therefore don't need networks. There are two reasons for this.

The first is that, under the existing scheme of things, auditors do not automatically get the audits of all subsidiaries. They have to be separately appointed to each separate subsidiary. There are some restrictions, but in general there is nothing to stop management giving a third or even more of the total business to other firms. In a big group, this is a lot of fees which are for all practical purposes in management's gift. Even if an audit committee were to decide to impose a complete ban on non-audit services, this commercial dependence would remain.

The second reason takes us back to the principal/agent problem. It's complicated enough that the parent company auditor sees the parent company management as his client. It gets much more complicated when you remember that, in most cases, a subsidiary auditor will see the subsidiary management as his client.

The dynamics of auditor-management relationships described earlier in this paper apply regardless of a company's place in the corporate hierarchy. Local audit firms want to become business advisors to their local clients, because that's how they will get the most job satisfaction and the opportunity for selling other services. They want a mutually supportive relationship with their local clients because they're the ones they have to work with. So inevitably, and entirely naturally, you end up with auditors who have a mixture of loyalties: to the local management, to the local regulator, to their local firm, to the parent company auditor. This can make for a certain lack of predictability. It doesn't contribute a great deal to the public interest in the parent company.

Finally, a word on medium-sized audit firms. The fact that these firms have practically given up trying to compete in the large company audit market because of their lack of global networks does not prove that such networks are essential. The medium-sized firms are not independent providers of specialist audit services any more than the Big Four are. The second tier firms would not object to being in the first tier, and when it comes to large company audits they try to compete with the big firms on the big firms' terms. They also want to be management's business

partners, and they have similar ways of working. They would expect to audit a multinational company in exactly the same way as would a big firm, by auditing all the subsidiaries. They have to be appointed by managements which are looking for global service capability. Of course, their weaker networks place them at a disadvantage.

If the medium-sized firms want to compete in the large company audit market, *they will have to do so on different terms*. The distinction between public interest audit and the audit of subsidiaries gives them the opportunity to do just that. They may not have the networks to compete with the Big Four, but *they do have brands, know-how and resources that equip them to be wholly independent auditors of public company consolidated accounts*.

Myth three: Auditing is unprofitable and must be cross-subsidised by consultancy services

This myth plays an important part in defending the audit firms' evolution into Global Service Providers to management. After all, if a plain old audit is impossible to do at a profit, then you won't get many specialist providers competing for the business. Perhaps we should be grateful that the big firms, in a spirit of true public service, earn fees from doing other things and then pour their money into providing audits for the benefit of society?

The economics of audit firms

For many years, the basic economics of accounting firms were expressed as the "three-thirds" rule. One third of fee income went on salaries; one third on overheads; and one third was the partners' profit. But over the last couple of decades, this has changed.

Salaries have increased substantially. When I entered the profession, my starting salary was one-third that of my wife, who was then a head of department in a smallish private school. The ratio today would be closer to two-thirds. Even though the big firms have responded by reducing the number of graduates they recruit, total staff costs are still heading up.

Overheads have also risen, fuelled by a number of things including the growing complexity of the firms' international networks and the ever-rising cost of insurance and defending claims. The proportion of fees which makes it through to the bottom line has therefore dwindled steadily.

The firms' attempts to make up for this by increasing audit fees have been partially successful, but not wholly. There are two reasons for this. One is that – surprisingly, for an oligopoly – competition does hold down audit fees, at least to some extent. The other is that the audit profession has systematically devalued the audit and, not surprisingly, clients are less and less inclined to pay high prices for it.

Competitive pressure on fees

An oligopoly whose members all operate the same business model would not normally be expected to show much differentiation on costs, but in fact there is a surprising amount of downward pressure on audit fees. It has not been uncommon for an important competitive bid to be won at fee levels which are well below a firm's normal target levels. Every time a firm loses an important bid there is much shaking of heads and mutterings about the winner's ruthless price-cutting. It does appear that the potentially restraining effect of oligopoly has been offset by the fact that the rewards of success in a competitive tender go far beyond the audit fee.

There is not much prospect of growth in the large company audit market. Companies normally grow slowly and new large companies appear relatively rarely. In recent years, mergers have been much more common than demergers, reducing the number of large company audits available. Since audit appointments come up for tender at only infrequent intervals, the firms' growth strategies have, out of necessity, been focussed on non-audit services.

The audit appointment, with its relative security of tenure and its opportunities for learning about a client's problems, makes a wonderful platform for the sale of other services – and for the development of a relationship as Global Business Advisor. The mere fact of being able to win even small projects without the cost of having to tender is worth enough to make other consultants' mouths water.

In an audit tender, price competition between firms usually occurs only over the audit itself. Although the proposals will place much emphasis on each firm's ability to provide other services, it is relatively uncommon for there to be much indication of pricing for these services. On the other hand, fixed prices will usually be quoted for the audit. Consequently, *all of the competitive pressure on pricing is focussed on the audit fee.*

Given that audit firms are competing not just for the right to do an audit but for a long term business relationship, we should not be surprised if audits fees in competitive tenders are set at levels which take into account the overall value of the relationship. It would be very odd if they were not.⁵⁷

Profitability

Audit's profitability has been declining, and it undoubtedly commands lower hourly rates than most non-audit services. But this is not the same thing as actually being unprofitable, as any accountant should be able to tell you.

As none of the Big Four firms publishes full accounts (except KPMG UK, and even it provides no information on the profitability of its different business segments), it is difficult to make any definitive statement about audit profitability. It is in fact very difficult to measure with any accuracy.⁵⁸ Even the best of information systems would not conclusively settle the matter, particularly in where work is carried out in more than one country and consequently has the potential to become a highly political issue.

In any event, even though partners in audit firms like to make themselves feel impoverished by comparing themselves to investment bankers,⁵⁹ the fact is that their average earnings place them

⁵⁷ There is some concern over whether the so-called practice of "low-balling" in order to win audit tenders impairs audit quality. For a number of reasons, I do not think this is a significant issue in practice, but in any event it is not relevant to the main argument of this paper.

⁵⁸ This is partly because of the problem of allocating largely fixed costs between businesses with very different characteristics. Audits are a stable and recurring source of fees but are highly seasonal, with a big peak in demand for staff in the winter and downtime in the summer. Non-audit services, on the other hand, are not particularly seasonal but they are very unpredictable, and are highly sensitive to the economic cycle. In addition, there are difficulties of definition over what constitutes non-audit services, and the costing is further complicated by the fact that the same staff are likely to work on a variety of types of assignment.

⁵⁹ A diagnosis also made by Paul Volcker, *Financial Times*, 25 September 2002. From standpoints other than those of investment bankers and audit partners, it is easier to argue that the former are overpaid than that the latter are underpaid.

well towards the top of any league table. Even in years of economic slowdown, when non-audit fees can reduce sharply, there are few occasions when partners have to take their children out of private school.

Any assessment of the profitability of auditing has to take into account two things. One is the fact that wholly independent auditors would have no possibility of cross-subsidy, and therefore competition would be unlikely to drive fees down to unprofitable levels for any length of time. The other is the fact that auditing is currently practised in an inherently inefficient way.

Having work done by relatively unskilled people increases the amount of supervision and rework that is needed. Junior staff who are learning the trade (and, in the UK, studying for their professional examinations) spend lots of time on training courses and study leave, so their productivity is low. The seasonality of work means that excess staff must be carried in the summer in order to have enough in the winter. The process-based approach to quality means that time is spent on activities whose only purpose is to show that an audit has been done, rather than to generate real information.⁶⁰ The “up or out” approach to career management is wasteful of people in whom the firms have invested substantial amounts. And complex international organisations and unwieldy matrix management structures are not cheap to run.

Financial modelling of firms designed and resourced to be specialist independent auditors suggests that they would in fact be highly profitable, even at existing levels of audit fee. Auditing is quite capable of being a profitable business in its own right without cross-subsidy. If it were to be done efficiently by specialist firms, without the high costs of training large numbers of staff and of trying to manage a complex network, it would be even more attractive. It is safe to predict that the public interest audit market will be attractive to specialist independent providers as soon as the barriers to entry come down.

8. Audit reports

The power of the brand

The Big Four have fabulously powerful brands. No upstart competitor could ever hope to replace one of these brands on a large company audit report. To understand how this arose, and what might be done about it, we must look at how audit reporting works.

Why qualified audit opinions are rare

The profession’s more vocal critics can sometimes be heard to say that audits can’t be tough enough, or there would be more qualified audit opinions. You sometimes also find this belief in the most junior members of an audit team, who are still doing their professional examinations and are therefore likely to see everything in black and white. Those who remain in the profession for more than a few years, however, find that their understanding matures. As they start to have more direct contact with senior client management, and indeed with the senior members of the

⁶⁰ This is a frequently-heard complaint. For a micro-sociological analysis of the phenomenon, see Brian T. Pentland, “Getting comfortable with the numbers”, *Accounting, Organizations and Society*, Vol 18, No. 7/8. This argues that much audit work is best seen as ritual, whose purpose is to give the emotional sense of meaning necessary for an audit to be brought to a conclusion and an opinion committed.

**So what do
you buy from
the Big 4?**

audit team, they come to realise that confrontation is not helpful to anybody, and that a qualified opinion is more likely to be a sign of failure than a sign of success.

When it comes to giving opinions on financial statements, auditors have a strictly limited range of options available to them under Auditing Standards. They can say that the accounts are satisfactory; they can say that they are wrong, and explain why; or they can say that they were unable to form an opinion because, either by accident or design, the necessary information was not given to them.⁶¹

If the management of a client is proposing to publish accounts which the auditor thinks are wrong, he can threaten to give an audit report which says that the accounts are wrong. Not surprisingly, management rarely views this as an acceptable outcome. It wants to publish accounts with an unqualified opinion.

In fact, this is so much taken for granted that an audit partner who is unhappy with the accounts is extremely unlikely to say that he will give an adverse opinion. What he will actually say is “I can’t sign that”, meaning that the accounts must be changed to his satisfaction before he can give an unqualified opinion. Management and auditor then embark on a series of negotiations to find an outcome which is acceptable to them both.

The most desirable outcome for the auditor will be to end up with a set of accounts that he is entirely happy with, but without having soured the client relationship so much that it is difficult for them to work together in future. The most successful auditor is one whose client produces perfect accounts and then thanks the auditor for his help in getting them to that state.

Brand value or valuable content?

What this means is that when a reader receives a set of accounts with an unqualified audit opinion, he has no way of knowing whether it is the result of a perfect audit as just described, or whether it is the result of an inadequate or acquiescent audit. Perhaps the auditor was so aligned with management that he had failed to ask the right questions? Or perhaps he was so afraid of damaging the relationship that he failed to stand up to management when he should have? The more doubts there are over the auditor’s independence, the more opportunity there is for such suspicions to take root.

Audit reports have grown substantially in length over the last decade or two. But all of these extra words are about trying to reduce the “expectations gap” by defining the auditor’s responsibilities more precisely. None of them are there to provide additional information about the accounts to which the reports are attached, or about the nature and quality of the audit work that was actually done.

Because of this, the information value of a standard, clean audit opinion is very low. It might mean that the accounts are good, or it might mean that the auditor is not. Consequently, it is not wholly surprising that there should be calls for more qualified audit opinions. At least they do communicate something.

⁶¹ There is one further option, known as the “emphasis of matter”, which the auditor can use to draw attention to significant facts affecting the accounts. In practice, this is rarely used except where there are “going concern” problems.

What would be really valuable in an audit?

This absence of information in audit reports is a principal contributor to the commoditisation of audits, and therefore to the maintenance of the oligopoly in large company audits. With no other information to enable quality to be assessed, *users have to make do with brand names*.⁶²

Communicating useful information

If audit reports are to have real value to the readers of accounts, not only do they need to be given by properly independent auditors, but they should also contain some real information about what went on in the audit and the nature of the assurance that was produced. This would do two things.

In the first place, the audit would be substantially more useful if the audit report were to help readers interpret the accounts. Financial accounting is a highly inexact science, with enormous scope for judgement. There is no “right” answer in estimating profit, but a range of alternative outcomes depending on the assumptions and methods used. A useful audit report would help the reader understand these issues, and the probability of different outcomes.⁶³

Secondly, an informative audit report would provide a basis for a more informed judgement about the quality of the audit which had been done. Not only could this be judged from the report’s usefulness, and the extent of insight shown, but the report should contain information about the auditor’s activity which would further help an assessment of quality.

Some examples of the sort of thing that might usefully be included in a *public interest audit report* are set out below:

- the material uncertainties affecting the accounts, and the effect of making different assumptions about the future;
- the principal risks affecting the sustainability of the business, and information concerning how those risks are managed;
- reasons for the selection of the accounting policies used, and the effect of using alternatives;
- details of any matters which the auditor believes to be incorrect or inadequately described;
- any areas where the auditor could not obtain all the information that he required;
- a review of how what was said in the previous year’s audit report turned out in practice;
- an explanation of the difference between cash flow and profits;
- an explanation of the relationship between the management reward system and the reported profits;
- details of the time spent by audit staff of different skills and experience levels;
- a summary of how this time was spent;
- the actual audit fee for the year, an explanation of any difference from the fee estimated at the start of the year, and an estimate of the fee for the forthcoming year; and
- the name of the individual audit partner taking responsibility for the report.

⁶² The consensus that large firm brand equals quality appears to be surviving the fact that one of those brands suddenly started giving grounds for suspicion rather than confidence. We *need* to believe that Andersen was an exception and that the generalisation of quality is still there for the remaining firms. The consequences of believing otherwise would be too uncomfortable.

⁶³ An interesting approach to this topic is described in “Balancing the Odds: Stochastic Accounting”, Mainelli and Harris, *Balance Sheet*, Volume 10, No 2, pages 22-27, MCB University Press 2002.

Sticking their necks out without having their heads chopped off

Auditors have an entirely natural desire to avoid being sued into oblivion, and this is one of the main reasons why they say as little as possible in audit reports. Bitter experience has taught them that the less said, the less there is to get wrong, and the fewer people likely to try and claim damages.

Auditors will generally accept that they should take responsibility for the quality of their work. But, not surprisingly, few of them feel much enthusiasm for the idea of being left to pick up the entire bill for every corporate disaster. If you expect auditors to act as an insurance policy for aggrieved investors, then you can expect them, like some insurers, to do their best to lose their liability in a mass of small print. Turkeys won't vote for Christmas or Thanksgiving, and the survival instinct of auditors is no less strong. It's no good fulminating about their lack of moral fibre, or pointing out that they've been well fed for years, and so should march cheerfully up to the chopper. Life isn't like that.

If we want to get some useful content into audit reports, not only do we need auditors who are independent of management. We also need to have auditors who are willing to stick their necks out, rather than sheltering behind a barricade of caveats. This means allowing them to limit their liability. And in turn this means that management, investors and bankers must accept that what they have to look for in an audit report is assurance, not insurance.

Some practicalities

But limiting auditors' liability is evidently a very sensitive issue. The UK Company Law Review⁶⁴ accepted the need for it in principle, but the subsequent White Paper has merely described the question as "difficult" and said that:

"The Government will announce its response in due course."⁶⁵

This doesn't sound as though immediate action is likely in the UK, and it's even less likely in the US; but without it, you can't expect audit reports to become any more useful.

This is one of the reasons why this paper recommends that properly independent audit should be introduced *in addition to* existing statutory audit, rather than *instead of* it. The status quo can continue, with its unlimited liability matched by low-value audit reports. Meanwhile, a new class of specialist firm (here called "evaluators" to distinguish them from existing auditors) can provide wholly independent reports on public interest accounts. Because they would be able to limit their liability by contract (something which statutory auditors may not do) they would be able to put some real meat into their reports. And because they would have no basis for competition except the quality of these reports, they would have a real incentive to make them worthwhile.

A further practicality arises in relation to the question of publication of the evaluator's report. Although it's nice in theory to argue for having all of this information put into the hands of

⁶⁴ *Modern Company Law: Final Report*, The Company Law Review Steering Group, London 2001.

⁶⁵ *Modernising Company Law*, HMSO July 2002, CM5553-I page 41.

investors (as recommended in a recent *Investors Chronicle* article that approaches the audit problem from a similar perspective to mine⁶⁶), you can imagine it leading to all sorts of difficulties. Auditors know that if they ever have to write anything about a client which isn't bog-standard boilerplate, they are headed for endless debate with the management. Hours, if not days, can be spent agreeing not just the wording but the precise position of every comma. Management is very, very sensitive about anything that's headed for the public domain.

The fact that evaluators have no commercial relationship with management (and that they should be appointed for fixed, non-renewable terms, as explained in the next section) means that they would approach the drafting of a report rather differently from existing auditors. Their future business success will not depend on having a supportive relationship with management; it will depend on their public reputation, particularly amongst audit committee members, institutional investors and the press.

On the other hand, there will be many occasions where the facts are not absolutely black and white, and the evaluator's judgement is then just that – a judgement, which others can disagree with. In such circumstances, it would be a brave evaluator who would stick to his guns if faced with the threat of a libel action from a client company's management.

So as a practical solution, to avoid the danger of being trapped in blandness and technical circumlocutions, *evaluator reports should be kept confidential to audit committees*. The audit committee, in its own report, should describe how it has dealt with the evaluator report.

This arrangement won't remove all of the practical difficulties in reporting, especially at those companies with highly politicised cultures where auditor's observations are used as weapons to beat people with. But it would enable a substantial improvement.

It would also give time for the content of reports to settle down, and for management, audit committees and – through their representation on boards – investing institutions to get used to the new type of report, and to learn how to interpret it. And over a period of years, it is likely that market demand will pull evaluator reports, or versions of them, into the public domain, possibly on a non-statutory basis.

9. Revitalising audit

The ideal solution

Our present system of public interest audit is inherently flawed. Moreover, the market for large company audits is uncompetitive to the point of being oligopolistic. It can be changed for the better. The supposed obstacles to significant change are based on myth, not fact, and it is possible to make a difference. *A system in which wholly independent, specialist, auditors compete with one another on the basis of the quality of audit, and the usefulness of their reports to users, is entirely conceivable.*

In a perfect world, a public interest company would be required to have its public interest accounts audited by a firm which did nothing else for that company – no subsidiary audits, no

⁶⁶ Alistair Blair, "Poachers make good gamekeepers", *Investors Chronicle*, 22 November 2002.

A way out...

consulting, no advice. This would cause the emergence of small, specialist firms. Their liability would be limited, and their reports would contain real information that would help a reader of the accounts to understand the risks and uncertainties involved. They would be appointed either by an independent third party, or by audit committees whose independence should be very much greater than it is today.

This would be the ideal solution. However, direct introduction of such a system would create considerable disruption, require significant legislative change and complicate moves towards international harmonisation. The barriers to rapid, radical change are high, and a more pragmatic approach is called for.

The practical solution

These proposals preserve the good elements of the present system, do not threaten the legitimate interests of the Big Four firms, and can be implemented by means of relatively few measures. By virtue of being complementary to the existing system rather than a replacement for it, this proposal is low risk and minimises upheaval.

Policy point 1: Concentrate on where the public interest in audit lies – that is, the consolidated financial statements of public interest entities.

Make a clear differentiation between this and the audit of subsidiaries, or anything else which is in the gift of management.

Policy point 2: Let the existing audit system continue, more or less.

There are some currently proposed reforms of the existing system which should be taken forward. These include increasing the role of independent Audit Committees in appointing auditors, and making the system of audit regulation more independent. On the other hand, restrictions on non-audit services should be relaxed, so that existing audit firms can continue to provide a useful and necessary service as management's auditors and advisors, without arbitrary and possibly unhelpful limitations.

For example, auditors are supposed to keep a distinction between preparing accounts and auditing them. This distinction does not make a lot of sense for an auditor who is there to help management get things right, and will make even less sense as automated financial reporting becomes increasingly common. The distinction could quite reasonably be dropped. Similarly, there would be no reason to prohibit auditors from involvement in systems implementation, tax planning or internal audit.

Policy point 3: Require the audit committees of public interest companies to obtain “independent evaluator” reports on their public interest accounts

These reports would not replace the existing statutory audit reports. They would be additional to it, and – at least to begin with – confidential to audit committees. The audit committees' own reports should make reference to the appointment of evaluators and explain how the evaluators' report had been dealt with.

In due course, as the market gets more accustomed to these reports, and as corporate reporting starts to broaden (as for example through development of the Operating and

Financial Review proposed in the UK's Company Law White Paper), it is likely that evaluators' reports, or versions of them, will begin to seem less threatening, and companies will begin to publish. First of all, those companies who have the best story will publish; market pressure will then work to pull others into it.

Evaluators would be prohibited from auditing subsidiaries, except where a subsidiary is a public interest company in its own right, and from providing any other service to the management of companies for which they are the independent evaluators.

They should be appointed for fixed, non-renewable terms of between three and five years. The normal arguments against rotation of auditors do not apply to evaluators who are in addition to, rather than instead of, existing auditors.⁶⁷ Because of the independence that this arrangement would promote, it would be good enough if the appointment were to be made by audit committees rather than by an independent body.

To be useful, and to enable judgements of quality, evaluator reports should contain real information. Some suggestions for the sort of content that might feature were given above.

The evaluators' liability should be limited, in order to enable them to provide real content in their reports. The visible quality of reporting should in time become the main basis for competition between evaluators.

What would it cost?

Evaluators' reports would be an additional cost, but not as much as you might expect. The global audit fee of a large public company today includes the cost of auditing the subsidiaries. Work back by removing this cost. Then allow for the efficiencies that will result from employing a small number of experienced people, rather than a large number of people of whom a high proportion are inexperienced. This leads to an estimated cost for an evaluator's report of perhaps 15-35% of what a large company's global audit currently costs. (The exact amount will depend on its complexity, the quality of its management information and control systems and the nature of the issues arising from the work.)

These costs are small in relation to the potential positive impact on market capitalisations. For instance, the stock market capitalisation of the FTSE 100 is around £1,000 billion. An average additional cost of (say) £500,000 each would be covered if increased transparency and credibility were to result in an increase in share price of just 0.005%.

A recent survey indicated that UK asset managers were prepared to pay an average premium of over 11% for shares in companies that demonstrated good corporate governance.⁶⁸ The quality

⁶⁷ One of the main arguments against rotation of sole auditors is that there is some evidence of audit quality being reduced in the early years of an auditor's appointment, due to the auditor needing time to get to understand the business and its issues. This proposal substantially mitigates that problem, because the existing auditor has knowledge and experience which can be shared. Unlike today's joint auditors, the auditor and the evaluator will not be competitors, and are therefore more likely to have an constructive collaboration. Obviously, companies should be discouraged from changing both their auditor and their evaluator at the same time.

⁶⁸ "Corporate Governance: The Opinions of UK Asset Managers", KPMG, London 2002. The report quotes a McKinsey Global Investor Opinion Survey (2002) as suggesting an average premium of an approximately similar amount.

and integrity of financial reporting must be a significant element of this – more than 0.005%, at least.⁶⁹

If we are to suppose that a significant increase in the credibility of corporate reporting would make a difference of less than one-twentythousandth to stock market prices, then we might as well not bother with any audit reforms of any sort. But the mere fact that there has been so much controversy over audit, and so many calls for reform, suggests that it does matter to the capital markets. *In that case, 0.005% is a modest amount to spend for getting it right.*

Smaller companies

Moves to tighten up auditing always provoke cries of pain from the auditors of smaller companies. With considerable justification, they complain that audit regulation is directed primarily at the larger firms, and that it tends to be inappropriate, expensive or both, when applied to smaller firms.

The requirement for an evaluator's report as proposed in this paper would apply only to public interest companies, and so would exclude most smaller companies. The existing system would continue to apply, and smaller companies and their auditors would benefit from the relaxation of the independence restrictions that would be possible after evaluators are introduced for higher public interest companies.

The dividing line between higher and lower public interest companies is necessarily arbitrary and there is some room for manoeuvre in setting it. A simple basis for classification as higher public interest on grounds of size, and therefore requiring an evaluator's report on their public interest accounts, might be public companies in the FTSE 350 (or the NYSE or Nasdaq equivalent), together with private companies of similar size. In addition, certain categories such as financial services companies or providers of important public services might be deemed to be of higher public interest, irrespective of size.

It would be better to set the bar too high, rather than too low, and to err on the side of requiring too few companies to have evaluators' reports. From the point of view of enabling a newly competitive market for specialist, niche firms, a few hundred relevant companies would create enough demand. As the market becomes accustomed to evaluators' reports, demand for them should increase.

Regulation and auditing standards

The proposals set out in this paper are not dependent on regulatory change to be effective. It is possible to do a "thinking not ticking" audit within the existing auditing standards, and a specialist independent audit firm could comply with all regulatory requirements.

⁶⁹ There does not seem to be much in the way of empirical research on the value of audit. On the whole, it is taken as self-evident that information which has been independently attested will be more trusted by the markets, and therefore more valuable, than information which is the unsupported assertion of management.

But although existing audit regulation and auditing standards need not be *impediments* to the implementation of the proposals set out in this paper, it would be desirable to modify them in order to increase their relevance to the new approach.⁷⁰

As evaluators will be competing on the basis of audit quality, the regulator should periodically verify the quality-related information that evaluators report. It might need to set minimum standards for disclosure of quality-related information, at least initially, and it should also monitor the auditor's total independence from management.

Over the longer term, for all auditors as well as for evaluators, there should be a gradual move away from the rules-based approach to regulation. Principle-based financial reporting requires properly principle-based auditors. Regulation – and auditor training – must place a greater emphasis on outcomes rather than on process, and give a new level of attention to the cultures within firms and the mechanisms that maintain awareness of the auditor's public responsibility.

How can it be made to happen?

There are a number of ways in which this change could be made to happen. At one extreme, it could be left to the self-interest of audit committees, for whom evaluators would be an invaluable support. At the other extreme, government could make this system mandatory, after a couple of years' transition to allow evaluator firms to emerge. In between these extremes, it is open to exchanges and/or listing authorities to require it, or to investment institutions to demand it.

The most practicable approach is probably some combination of these things. Self-interest of audit committees and institutional demands for better governance can be powerful forces, which government should support in every way short of legislation. The legislative option would remain open if necessary.

Financial statement insurance

There is one further idea that should be considered. It might particularly commend itself to government, as it transfers responsibility for maintenance of audit quality to the private sector.

The essence of the idea is that insurance companies should underwrite losses made by investors through reliance on incorrect financial statements.⁷¹ Not all losses – this would rather overstretch the industry's underwriting capacity. But at least an amount equivalent to the levels of cover that are presently available but dispersed over Directors' and Officers' insurance, auditors' liability insurance, and other policies. All this cover would be brought together and directed towards financial statement accuracy. Claims, should any arise, would be made by investors as class action suits.

⁷⁰ "...care has been taken to ensure that their methodologies are consistent with international standards and the standards in [the UK, Canada and the USA]. Nevertheless, the extension of the conventional audit approach embodied in the business risk approaches raises the question of whether audit methodologies have evolved such that they are no longer well described by current auditing standards." Lemon, Tatum and Turley, *op cit*, page 22.

⁷¹ The idea is fully described by Professor Joshua Ronan of New York University's Stern Business School in "Post-Enron Reform: Financial-Statement Insurance and GAAP Revisited", *Stanford Journal of Law, Business & Finance*, Volume 8, Autumn 2002, Number 1.

As part of their own risk management, insurance companies would need to perform detailed investigations of company accounts, and would appoint auditors to report on all insured information. The auditors would not be permitted to do any consulting work, and would be answerable only to the insurers.

This proposal has high novelty value and is easy to dismiss out of hand. It may also be rather countercultural for Europe: we are less inclined than the Americans to presume that more litigation, actual or threatened, will improve matters. However, although there are some theoretical and practical issues to be dealt with,⁷² the idea does have considerable attractions:

- it breaks the commercial relationship between auditor and management;
- companies could be required to publish their financial statement insurance premium rates, which would be an extremely valuable piece of information about the amount of risk inherent in the financial statements;
- the private sector would be responsible for independent appointment and control of auditors; and
- by being built around a repackaging of existing levels of cover, it minimises the incremental cost.

If insurers were allowed to appoint only the Big Four, this proposal would also solidify the present oligarchy. However, it would be possible for financial statement insurance to be introduced in parallel with the requirement for evaluators' reports, and for the newly-formed firms of evaluators to provide the service that the insurers would require.

Government should consider asking the insurance industry to investigate further.

10. Conclusion

The proposals in this paper are not complex, risky or expensive. They involve using market forces to create a small but specialist profession of wholly independent public interest auditors, here called evaluators, who would operate in tandem with the existing auditors. Those existing auditors, although retaining a public interest responsibility, have the entirely legitimate role of global service providers whose function is to help management get things right.

The evaluator market would be competitive from the outset. Over time, independent evaluators' reports would reduce the capital markets' dependence on Big Four brand names and increase the opportunities for medium-sized and specialist firms to compete as service providers to management.

⁷² The insurer's interest is not in avoiding any financial statement misrepresentation, but in avoiding misrepresentation that may give rise to a claim. In theory, the insurer should be concerned about undervaluation just as much as about overvaluation. In practice, however, over-valuations often emerge suddenly and in dramatic circumstances which make them highly visible, and are therefore more likely to give rise to claims than are undervaluations, which often emerge as higher profits over a period of time and are happily ascribed to smart management. When this is combined with the fact that auditors have a deeply ingrained belief that overvaluation is a much greater risk than undervaluation, there must some risk of audits which are consistently over-conservative. However, the cynic might say that this merely compensates for management's tendency to lean the other way, while the economic theoretician might argue that consistent undervaluation reduces volatility and is therefore a good thing in its own right.

Other proposals for reform of auditing are all variations on the theme of helping a single auditor keep his balance while riding two horses. The proposals set out in this paper deal with this fundamental issue and offer a major improvement in the quality of assurance given by audit, both real and perceived, while at the same time enabling much greater competition. They are made possible by the simple recognition of the fact that the public interest in financial statement auditing relates only to the truth and fairness of the consolidated accounts of public interest companies, and not to any of the other things that auditors customarily do. Require these accounts to be audited by wholly-independent evaluators, and *change will follow*.

Appendix one: Non-audit services and technological trends

Banning selected non-audit services

If we want to keep the present system going, then banning selected non-audit services seems to make good sense. Riding two horses is exciting enough; it's positively foolhardy to have one foot on a Shire horse and the other on a Shetland pony.

But trying to regulate the riding-two-horses system by banning certain non-audit services reveals the contradictions and tensions inherent in this system. There is endless opportunity for further debate over what should be in and what should be out. Is the objective simply to prevent auditors from reporting on their own work? If so, we should surely ban auditors from giving advice on accounting.

But despite the unhappy example of Andersen advising Enron on the accounting policies relevant to keeping SPEs off the balance sheet, most people would think it quite unreasonable to prohibit auditors from telling their clients how to account for things if they want to get a clean audit opinion. In the context of accounting, we take it for granted that auditors should have a get-it-right-first-time role, and don't stop to think that there is therefore no independent, objective view on the suitability of the accounting treatments actually adopted in the final published financial statements.

Tax is another area where it seems to be accepted that auditors can give advice, and as a practical matter they are usually very well placed to do so. But the tax charges in the accounts – which can be very significant items – are usually estimated figures, because liabilities are not agreed with the tax authorities until after the accounts have been published. These estimates are based on assumptions. Those who gave the tax planning advice in the first place, or who provide tax compliance services, are not the obvious choice of people to ask for an independent view on the figures.

But after swallowing these camels, we then strain at gnats. For example, there seems to be widespread agreement that auditors should not be involved in systems implementation, and the regulatory pressure on this type of work was one of the main drivers for the big firms spinning off their consulting arms. However, I am not aware of any significant instances of audit failure that have arisen from the consultancy arms of audit firms being involved in systems implementation. If it has happened at all, it must be very rare.

The regulators' concern, which predated more general concerns about the impact of non-audit fees, originally appeared to relate to the possibility that a newly-installed system would operate incorrectly, and that the auditors would not detect this because they simply presumed that the new system must be sound and did not test it adequately. Either that, or they might detect it, but would sign off on incorrect accounts rather than admit to the failure of the new system. Neither of these possibilities looks very likely in the face of business reality. In today's world of networked systems used for operational purposes right across companies, the chances of an auditor discovering that a new system isn't working, while all the users of the system are fooled into thinking it's fine, must be very remote indeed. And as for the likelihood of an audit partner choosing to sign off on incorrect accounts, knowingly running the risk of professional disgrace

and unlimited liability, just in order to help the consulting division get away with having given a bad service to his client... I've never met an auditor with such a capacity for self-sacrifice, and don't suppose that I ever will.

The problem with consulting arises not from the type of work but from the fact that it – along with any other work beyond the essential audit – extends the commercial relationship with management. PricewaterhouseCoopers was recently fined \$5m by the SEC for matters relating to systems implementation at two audit clients. But it wasn't because its work on the systems had somehow interfered with its ability to do an audit. The problem arose because PwC had permitted the companies to capitalise its own non-audit fees, rather than charging them against profits.⁷³

The underlying issue in this case – and practically all other cases – is the lack of independence and objectivity that comes from auditors having a commercial relationship with management. Selective restrictions leave auditors commercially dependent on management. The thin end of the wedge is still in place and ready to be knocked further in. If we want auditors to be independent, then they should have no commercial relationship with management at all.

Conversely, if we recognise that management's auditors are providing a useful quasi-insider function, then we should allow them a relatively free rein. Let them act wherever their depth and breadth of expertise and resources can help companies get things right, and let evaluators provide the wholly independent view.

Technology trends

There are trends in technology and reporting that will make this issue starker. These arise from the use of XBRL for company reporting, together with reporting coming quicker and more often.

XBRL (eXtensible Business Reporting Language) is a way of labelling the separate elements of data used in financial reporting so that they can be understood by other computer systems. This means that if a company's financial information is posted on the web, individual users can access it, pull out the pieces they require, and assemble their own tailor-made financial report.

Clearly, the present system whereby auditors give their opinion on a single "official" financial report isn't going to work when every user has the ability to create unique reports. Instead, it will be necessary for auditors to assure the integrity of the various pieces of data that are the building-blocks of possible reports, as well as the integrity of the distribution system that gets them to the users' computers.

Now put this together with another trend: that towards faster and more frequent reporting. This trend has been evident for many years and there is no reason to suppose it will end now that web-based technology is enabling significant improvements in timeliness and frequency. The likelihood is that reporting will move closer and closer to real time.

For real-time reporting, or anything approaching it, to work, companies must have right-first-time processes. There simply won't be time for the type of after-the-fact checking that takes place before publication today. No company would dare publish its information in real time unless it had complete confidence in the reliability of its systems.

⁷³ *Accountancy*, August 2002, page 11.

No auditor, on the other hand, could individually check more than a tiny proportion of the millions of pieces of data that might make up a large company's XBRL reports. The auditor could only give an opinion that the data was valid if he had complete confidence in the reliability of the systems. And if his report was required in real-time, or within a few hours of the company's report, his confidence in the systems would also have to be continuous and real-time.

In other words, in this technologically-driven scenario, the interests of the auditor and those of the management will converge on making sure the systems and the controls work properly, all the time. This is going to create major problems with the traditional idea of independence:

...the growth in on-line auditing systems raises the level of interaction between the auditor and the client's operations since it provides the auditor with an almost constant involvement in the activities of the client... they extend the ability of the client to interact with the auditor, thereby raising the salience of client behaviour and opinion to the audit firm. Further... it may become more difficult for auditor personnel to remain as cognizant of the clear distinction between the audit firm boundaries and those of the client firm as it had been before.⁷⁴

If you take an auditor whose mission in life is to help management get things right, and give him a common interest with management in the proper functioning of right-first-time systems, there doesn't seem to be a lot of sense in letting him do some things to help those systems work, while preventing him from doing others. If the auditor is going to be in the thick of things at all, then he should be allowed to be properly constructive and to do whatever it takes to help ensure that the systems are indeed designed and operated to right-first-time standards.

The alternative is for the auditor to stay right out of it, completely detached from the process, and to report on whether or not the company *did* get it right first time. This would mean that his report would have to come some time after the company's publication. This would be more valuable to users of the information, as it would be totally objective, but it would be of no use at all to management.

Technology will make it impossible for the auditor to ride two horses and still claim to be independent. The logical response is to have auditors and evaluators performing the two different roles.

⁷⁴ Kleinman and Palmon, *op cit*, page 141.

Appendix two: What about...

Joint audits

Joint audit seems at first sight to have some merits. It provides an opportunity for medium-sized firms to compete in the large company audit market. As explained by the senior partner of a second-tier UK firm with strong connections to France, where joint audit is the norm, it should also increase quality:

Joint audit does more than foster competition in the marketplace; it also provides other significant benefits. Joint audit provides a check and balance on each firm and support on contentious audit issues increasing the credibility attaching to the financial statements, something the capital markets in the US and UK need now more than ever. The coordination cost involved is minimal compared to the overall cost of an audit and miniscule compared to the loss to shareholders and others of corporate failure or of a loss of confidence.⁷⁵

These benefits undoubtedly exist, at least to some extent. However, it is by no means universally agreed that the coordination cost is insignificant. And there are other reasons for doubting whether the overall outcome is as beneficial as its proponents argue.

A joint audit involves two (or occasionally more) firms agreeing between themselves to divide up a company so that each audits a part. They review each others' audit plans and audit findings, and put their work together so that when combined it forms a complete audit. This means that each firm has first hand knowledge of only part of the picture, which is not helpful to audit quality.

A good working partnership between the firms might overcome the limitations that this imposes, but in practice this is rare. The firms are competitors, not just in general, but in relation to this particular client, and, unsurprisingly, tend to be protective of their greatest insights.

Competition between the firms is bound to arise when each firm has the same sort of commercial relationship with management, similar opportunities to extend the relationship into other services, and the same interest in impressing management with their perceptiveness and helpfulness. This is not helpful to their independence.

The combined benefits of increased quality and increased competition that the proponents of joint audit describe are indeed available. But it does require the second auditor to be wholly independent from management, along the lines described in this paper, rather than merely carving up the *status quo* between two firms who compete on similar terms.

Internal audit

If audit in its present form is accepted as a valuable but quasi-insider role, it begs the question of what, if any, difference there is from internal audit.

⁷⁵ UK: *Joint audits could solve crisis*, Mazars Neville Russell, August 2002; available from www.mazars-nr.co.uk.

This is not actually a new problem. A considerable degree of overlap – indeed, competition – between internal and external audit exists today. External auditors usually believe that they could do a better job than the incumbent internal auditors, and if not restrained by regulation are happy to take on the role if they can. The internal auditors, on the other hand, often define success in terms of the reduction in the external fee that they have won by doing the external auditors’ work for them. The proposals set out in this paper do not create this issue, but they do make it more obvious.

Internal and external auditors do in fact bring different resources to bear and they should not fall into the trap of competing with one another as if they were straightforward alternatives. The internal auditor will have much greater inside knowledge of his own organisation and industry, and is very often (although not always, if properly costed) less expensive than external audit. The internal auditor has no explicit public interest role, although individuals may have public interest responsibilities arising from membership of professional bodies.

On the other hand, the external audit firm will have much greater resources, in more locations and with a wider range of expertise, than any individual company can afford. It will have the ability to benchmark across its client base. The external audit firm is regulated in its role as auditor and has a specific public interest function.

Large, complex businesses have a lot of things that need to be done if they are to be well-governed and get most things right most of the time. In theory, either the internal or the external auditors might make a bid to do all of these necessary things. In practice, it is much better for such a large task to be divided between the two according to their different strengths.

Rotation

Rotation of audit firms

At first sight, it seems sensible for companies to change their auditors at regular intervals. The chances of the auditors being “captured” by the management must reduce substantially if auditors know that their tenure is limited and that a fresh pair of eyes will take over at some point in the foreseeable future. However, enthusiasm for the idea has been waning, as it has become clear that countries which have tried it have found little or no benefit to outweigh the disadvantages of regular changes of auditors. The principal disadvantages are the increased cost of regular tendering and the fact that auditors are most likely to miss things when they don’t know their clients very well.⁷⁶

Irrespective of the arguments for and against it, compulsory rotation of auditors is unlikely to deliver benefits if there is no increase in competition. With only four firms to choose from – or frequently even fewer, as some will very often be ineligible owing to conflicts of interest – rotation would become a “Buggin’s turn next” merry-go-round.

However, if companies were to have evaluators as described in this paper, then something like rotation could in fact have a useful part to play. The evaluator would be appointed for fixed, non-renewable terms of three to five years. This would greatly reduce the risk of “capture” by

⁷⁶ The only major country to have maintained mandatory rotation of auditors is Italy. Research findings from that country are described in “Rotation of auditors ‘has no impact’”, *Financial Times*, 17 September 2002.

management. The auditor, on the other hand, could continue as long as the management wanted, and would provide a continuity of knowledge that would help a newly-appointed evaluator to get up the learning curve quickly.

Rotation of audit partner

Audit partners in England and Wales were previously limited to seven consecutive years on a client. This has now been reduced to five years by the ICAEW.

It would be unduly cynical to deduce that, because the profession has done it voluntarily, it must be low impact. Different auditors do have different standards and different strengths, and rotation will mean that a fresh look is taken a bit more frequently.

But audit partners do not work alone, and changing one person, even the most senior one, out of a large audit team is not a significant step. Nor does it do anything to alter the fundamental dynamics of the commercial relationship between auditor and management.

Rotation of all the partners in an audit team would make more of an impact, but could also cause so much upheaval that it would be akin to a change of firm, with all the same objections applying.



Jonathan Hayward

Jonathan Hayward has more than twenty years experience as an auditor. He was a partner at PricewaterhouseCoopers for over ten years. For several years prior to leaving the firm in 2002, Jonathan played a leading role in audit development and research for the global organisation. Before this he was one of a small team that opened the Price Waterhouse office in Moscow, for three years helping build the largest international auditing practice in Russia. In September 2002, he founded Independent Audit Limited, a niche advisory firm specialising in the provision of financial and governance support to boards and audit committees.

CSFI PUBLICATIONS

1. **"Financing the Russian safety net"**: A proposal for Western funding of social security in Russia, coupled with guarantee fund for Western investors. By Peter Ackerman/Edward Balls. September 1993 £40/\$65
2. **"Derivatives for the retail client"**: A proposal to permit retail investors access to the risk management aspects of financial derivatives, currently available only at the wholesale level. By Andrew Dobson. Nov 1993 (Only photostat available) £10/\$15
3. **"Rating environmental risk"**: A proposal for a new rating scheme that would assess a company's environmental exposure against its financial ability to manage that exposure. By David Lascelles. December 1993 £25/\$40
4. **"Electronic share dealing for the private investor"**: An examination of new ways to broaden retail share ownership, inter alia, by utilising ATM networks, PCs, etc. By Paul Laird. January 1994 £25/\$40
5. **"The IBM dollar"**: A proposal for the wider use of "target" currencies, i.e. forms of public or private money that can be used only for specific purposes. By Edward de Bono. March 1994 £15/\$25
6. **"UK financial supervision"**: A radical proposal for reform of UK financial regulation, (prepared pseudonymously by a senior commercial banker). May 1994 £25/\$40
7. **"Banking banana skins"**: The first in a periodic series of papers looking at where the next financial crisis is likely to spring from. June 1994 £25/\$40
8. **"A new approach to capital adequacy for banks"**: A proposal for a market-based alternative, using the concept of 'value-at-risk', to the present mechanistic Basle approach to setting bank capital requirements. By Charles Taylor. July 1994 £25/\$40
9. **"New forms of Euro-Arab cooperation"**: A proposal for a new public/private development finance corporation to promote employment-generating projects in the Arab world. By Jacques Roger-Machart. October 1994 £25/\$40
10. **"Banking banana skins II"**: Four leading UK bankers and a senior corporate treasurer discuss lessons for the future from the last banking crisis. November 1994 £25/\$40
11. **"IBM/CSFI essay prize"**: The two winning essays for the 1994 IBM/CSFI Prize. November 1994 £10/\$15
12. **"Liquidity ratings for bonds"**: A proposed methodology for measuring the liquidity of issues by scoring the most widely accepted components, and aggregating them into a liquidity rating. By Ian Mackintosh. January 1995 £25/\$40
13. **"Banks as providers of information security services"**: Banks have a privileged position as transmitters of secure data: they should make a business of it. By Nick Collin. February 1995 £25/\$40
14. **"An environmental risk rating for Scottish Nuclear"**: An experimental rating of a nuclear utility. By David Lascelles. March 1995 £25/\$40
15. **"EMU Stage III: The issues for banks"**: Banks may be underestimating the impact of Maastricht's small print. By Malcolm Levitt. May 1995 £25/\$40
16. **"Bringing market-driven regulation to European banking"**: A proposal for eliminating systemic banking risk by using cross-guarantees. By Bert Ely (Only photostat available). July 1995 £10/\$15
17. **"The City under threat"**: A leading French journalist worries about complacency in the City of London. By Patrick de Jacquelot. July 1995 £20/\$35
18. **"The UK building societies: Do they have a future?"**: A collection of essays on the future of UK building societies and mutuality. (Only photostat available). September 1995 £10/\$15
19. **"Options and currency intervention"**: A radical proposal on the use of currency option strategies for central banks. By Charles Taylor. October 1995 £20/\$35
20. **"Twin peaks"**: A regulatory structure for the new century" A proposal to reform UK financial regulation by splitting systemic concerns from those involving consumer protection. By Michael Taylor. December 1995 £25/\$40
21. **"Banking banana skins III"**: The findings of a survey of senior UK figures into where the perceived risks in the financial system lie. March 1996 £25/\$40
22. **"Welfare: A radical rethink - The Personal Welfare Plan"**: A proposal (by a banker) for the private funding of health, education, unemployment etc. through a lifetime fund. By Andrew Dobson. May 1996 £25/\$40

23. **"Peak Practice"**: How to reform the UK's regulatory structure. Implementing "Twin Peaks". By Michael Taylor. October 1996 £25/\$40
24. **"Central bank intervention: a new approach"**: A radical approach to central bank intervention – without foreign exchange reserves. By Neil Record. November 1996 £25/\$40
25. **"The Crash of 2003: An EMU fairy tale."**: An all too plausible scenario of what might happen if EMU precedes economic convergence. By David Lascelles. December 1996 £25/\$40
26. **"Banking Banana Skins: 1997"**: A further survey showing how bankers might slip up over the next two or three years. April 1997 £25/\$40
27. **"Foreign currency exotic option"**: A trading simulator for innovation dealers in foreign currency (with disc). Winner of the 1997 ISMA/CSFI Prize for financial innovation. By Stavros Pavlou September 1997 £25/\$40
28. **"Call in the red braces brigade... The case for electricity derivatives"**: Why the UK needs an electricity derivatives market, and how it can be achieved. By Ronan Palmer and Anthony White. November 1997 £25/\$40
29. **"The fall of Mulhouse Brand"**: The City of London's oldest merchant bank collapses, triggering a global crisis. Can the regulators stave off the disaster? A financial thriller based on a simulation conducted by the CSFI, with Euromoney and PA Consulting Group, to test the international system of banking regulation. By David Shirreff. December 1997 £25/\$40
30. **"Credit where credit is due: Bringing microfinance into the mainstream"**: Can lending small amounts of money to poor peasants ever be a mainstream business for institutional investors? By Peter Montagnon. February 1998 £25/\$40
31. **"Emerald City Bank... Banking in 2010"**: The future of banking by eminent bankers, economists and technologists. March 1998. (Only photostat available). £25/\$40
32. **"Banking Banana Skins: 1998"**: The fifth survey of possible shocks to the system. July 1998 £25/\$40
33. **"Mutuality for the 21st Century"**: The former Building Societies Commissioner argues the case for mutuality, and proposes a new legislative framework to enable it to flourish. By Rosalind Gilmore. July 1998 £25/\$40
34. **"The role of macroeconomic policy in stock return predictability"**: The 1998 ISMA/CSFI prizewinning dissertation analyses how government policies affect stock values in markets in Japan and the Far East. By Nandita Manrakhan. August 1998 £25/\$40
35. **"Cybercrime: tracing the evidence"**: A working group paper on how to combat Internet-related crime. By Rosamund McDougall. September 1998 £6/\$10
36. **"The Internet in ten years time: a CSFI survey"**: A survey of opinions about where the Internet is going, what the main obstacles are and who the winners/losers are likely to be. November 1998 £25/\$40
37. **"Le Prix de l'Euro... Competition between London, Paris and Frankfurt"**: This report sizes up Europe's leading financial centres at the launch of monetary union. February 1999 £25/\$40
38. **"Psychology and the City: Applications to trading, dealing and investment analysis"**: A social psychologist looks at irrationality in the financial services sector. By Denis Hilton. April 1999 £25/\$40
39. **"Quant & Mammon: Meeting the City's requirements for post-graduate research and skills in financial engineering"**: A study for the EPSRC on the supply of and demand for quantitative finance specialists in the UK, and on potential areas of City/academic collaboration. By David Lascelles. April 1999 £25/\$40
40. **"A market comparable approach to the pricing of credit default swaps"**. Winner of the 1999 ISMA/CSFI prize for financial innovation. By Tim Townend. November 1999 £25/\$40
41. **"Europe's new banks: The non-bank phenomenon"**. A report for euro-FIET on the threat posed by new technology to European banks' traditional franchise. By David Lascelles. November 1999 £25/\$40
42. **"In and Out: Maximising the benefits/minimising the costs of (temporary or permanent) non-membership of EMU"**. A look at how the UK can make the best of its ambivalent euro-status. November 1999 £25/\$40

43. **"Reinventing the Commonwealth Development Corporation under Public-Private Partnership".** £25/\$40
By Sir Michael McWilliam, KCMG. March 2000
44. **"Internet Banking: A fragile flower"** Pricking the consensus by asking whether retail banking really is the Internet's "killer app". By Andrew Hilton. April 2000 £25/\$40
45. **"Banking Banana Skins 2000"** The CSFI's latest survey of what UK bankers feel are the biggest challenges facing them. June 2000 £25/\$40
46. **"iX: Better or just Bigger?"** A sceptical look at the proposed merger between the Deutsche Boerse and the London Stock Exchange By Andrew Hilton and David Lascelles. August 2000 £25/\$40
47. **"Bridging the equity gap: a new proposal for virtual local equity markets"** A proposal for local stock exchanges, combining Internet technology and community investment. By Tim Mocroft and Keith Haarhoff. £25/\$40
48. **"Waking up to the FSA"** How the City views its new regulator. By David Lascelles. May 2001 £25/\$40
49. **"The Short-Term Price Effects of Popular Share Recommendations"** Winner of the 2001 ISMA/CSFI Essay Prize. By Bill McCabe. September 2001 £25/\$40
50. **"Bumps on the road to Basel: An anthology of views on Basel 2"** This collection of sixteen (very brief) essays offers a range of views on Basel 2. Edited by Andrew Hilton. January 2002 £25/\$40
51. **"Banana Skins 2002: A CSFI survey of risks facing banks"** What bankers are worrying about at the beginning of 2002. Sponsored by PricewaterhouseCoopers. By David Lascelles. February 2002 £25/\$40
52. **"Single stock futures: the ultimate derivative"** A look at a new product being introduced almost simultaneously on each side of the Atlantic. By David Lascelles. February 2002. £25/\$40
53. **"Harvesting Technology: Financing technology-based SMEs in the UK"** DTI Foresight sponsored report, which examines what has been done (and what will be done) on the financing tech-based SMEs. By Craig Pickering. April 2002 £25/\$40
54. **"Waiting for Ariadne: A suggestion for reforming financial services regulation"** £25/\$40/€40
A new proposal for fund management. By Kevin James. July 2002
55. **"Clearing and settlement: Monopoly or market?"** An argument for breaking the monopoly mindset for ACHs. By Tim Jones. October 2002. ISBN 0-9543145-1-4. £25/\$40/€40
56. **"The future of financial advice in a post-polarisation marketplace"** A discussion of the structure of financial advice post-CP121 and post-Sandler, with support from Accenture. £25/\$40/€40
By Stuart Fowler. November 2002. ISBN 0-9543145-2-2 £25/\$40/€40
57. **"Capitalism without owners will fail: A policymaker's guide to reform"** A comprehensive look at the debate over transatlantic corporate governance, with detailed recommendations. £25/\$40/€40
By Robert Monks and Allen Sykes. November 2002. ISBN 0-953145-3-0.
58. **"Who speaks for the city? Trade associations galore"** A survey of trade association effectiveness. By David Lascelles and Mark Boleat. November 2002. ISBN 0-9583145-4-9. £25/\$40/€40
59. **"A new general approach to capital adequacy: A simple and comprehensive alternative to Basel 2"** £25/\$40/€40
By Charles Taylor. December 2002. ISBN 0-9583145-4-9.

REGULATORY PAPERS

1. **"Accepting failure":** A brief paper from the CSFI's regulatory working group on the need for the new FSA explicitly to accept the likelihood that banks will fail. £6/\$10
By David Lascelles. February 1998
2. **"Financial education and the role of the regulator: the limits of caveat emptor":** A brief note of warning to the FSA on what can and cannot realistically be expected of financial education. By Victoria Nye. May 1998 £6/\$10
3. **"Independence and accountability: tweaking the Financial Services Authority":** A proposal for fine-tuning FSA governance. By Robert Laslett and Michael Taylor. June 1998 £6/\$10
4. **"Embracing smoke: The Internet and financial services regulation"** £6/\$10
A new regulatory framework is necessary for the Internet, most important 'lose the paper'. By Joanna Benjamin and Deborah Sabalot. June 1999

OTHER REPORTS

Internet and Financial Services: a CSFI report. In-depth analysis of the industry's key sectors. Please order through City & Financial Publishing. Tel: 01483-720707 Fax: 01483 740603. £45/\$75

"The new world of European e-finance" A book by a panel of experts which looks at the current state of play and future challenges for European e-finance. ISBN 0-9543145-9-X. £40/\$65/€65

Over the last year the Centre has received general purpose support from the following institutions:

Abbey National
 Accenture
 Barclays Group
 Citigroup
 EFG Private Bank Limited
 International Securities Market Association
 JP Morgan Chase
 Merrill Lynch
 Newsdesk Communications
 PricewaterhouseCoopers
 UBS Warburg

Alliance & Leicester
 Aon
 AVIVA
 Bank of England
 BT Global
 City & Financial
 Corporation of London
 CRESTCo
 Deloitte Consulting
 Deutsche Bank
 DTI/OST
 Ernst & Young
 Euronext.liffe
 Financial Services Authority
 Fitch Ratings
 GISE AG
 Halifax plc
 HM Treasury
 HSBC Holdings plc
 INVESTEC

ISMA Centre, University of Reading
 Law Debenture Corporation plc
 Link Network Interchange
 Lloyd's of London
 Logica Consulting
 London Stock Exchange
 Merlin Financial Communications
 MilleniumAssociates AG
 Misys International Banking Systems
 mi2g
 Moody's Risk Management
 Morgan Stanley International
 PA Consulting
 Premchand Roychand & Sons
 Prudential plc
 Reuters
 Royal Bank of Scotland
 Securities Institute
 Standard & Poor's Ratings Group
 Swiss Re New Markets
 virt-X

Bankgesellschaft Berlin
 Banking Code Standards Board
 Brigade Electronics
 Canadian High Commission
 Chown Dewhurst LLP
 City Consultants
 Finance & Leasing Association
 Futures & Options Association
 GCI Financial
 Housing Finance Corporation
 IFSL
 Lombard Street Research
 Record Currency Management
 Schroders
 TRW Investment Management
 Z/Yen

In addition, the Centre has received special purpose support from, among others, Linklaters, the Building Societies Association, World Bank and *The Banker*.

UK £25
 US \$40
 €45
 CSFI ©
 2 0 0 2

CSFI Registered Charity Number 1017353
 Registered Office: Sussex House, 8-10 Homesdale Road, Bromley, Kent, BR2 9LZ
 Registered in England and Wales limited by guarantee. Number 2788116