BOARD MAGAZINE – JULY 2019

WORKING TOGETHER TO BOOST COMPETITION

JOINT AUDITS AS AN IMPORTANT ELEMENT FOR GREATER COMPETITION AND QUALITY IN AUDITING

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A NEW REPORT BY THE BRITISH COMPETITION AND MARKET SUPERVISORY AUTHORITY ONCE AGAIN SHINES A LIGHT ON THE LACK OF COMPETITION AND THE CONTINUING DISCUSSION ON QUALITY IN AUDITING. THESE TOPICS ARE NOT JUST RELEVANT IN THE UNITED KINGDOM, HOWEVER – THEY ARE ALSO THE SUBJECT OF DISCUSSIONS IN GERMANY. ONE SOLUTION IS JOINT AUDIT, WHICH HAS BEEN A PROVEN SOLUTION IN FRANCE FOR MORE THAN 50 YEARS.

SUMMARY

On 18 April 2019, the British Competition and Markets Authority (CMA) published a comprehensive report that spoke in favour of a far-reaching reform of auditing. To strengthen competition, the CMA recommends steps including making a joint audit obligatory for the 350 largest listed companies (FTSE 350). During these joint audits, at least one of the auditors has to be a company outside the "Big Four" auditing firms that dominate the market. Like in most countries worldwide, in the United Kingdom the largest companies have long been audited almost exclusively by the Big Four: 100% of companies listed in the FTSE 100 and 97% in the FTSE 350 are catered for by these firms. The CMA believes that joint audits are an indispensable measure for increasing diversity in the British audit market, creating sustainable competition and thereby permanently enhancing audit quality.

UK: consensus that reform is necessary

In the United Kingdom there is a political consensus that the audit market needs to be reformed. Following a series of scandals including the collapse of the Carillion construction company in 2018, legislators are under great pressure to act. To prepare for a reform of the audit market, numerous reports over the last six months have examined its market structure, regulation and audit scope:

- In April 2019, the Business, Energy and Industrial Strategy Committee of the UK's lower house of parliament (House of Commons) published a cross-party report which called for measures including splitting the auditing business of the Big Four from their other business areas, limiting their market share and proposing the introduction of joint audits on a pilot basis.
- The "Kingman review" examined how the market is to be regulated in the future. It recommends replacing the Financial Reporting Council (FRC), which has been the subject of criticism, with a new governmental Audit, Reporting and Governance Authority (ARGA) with an expanded range of responsibilities and powers.
- The "Brydon review", which has just been launched, will investigate the future of auditing in greater detail. Results are expected by the end of 2019. The latest final report of the CMA ("Statutory Audit Services Market Study") focuses on the lack of diversity in the market. Specifically, the CMA attests "serious competition problems in the UK audit industry" due to the market concentration of the Big Four auditing companies.

The CMA recommends three key measures in its report:

- Introduction of mandatory joint audits: the introduction of mandatory joint audits for the FTSE 350 companies, in which one of the auditors must be a company from outside the Big Four. The CMA stresses that joint audits are the only proven method of creating genuine market diversity. Therefore, there should only be very few exceptions to this rule: a) for companies which commission a firm from outside the Big Four with the entire audit, and b) for the largest, most complex companies for the duration of a transition period until the market has built up enough capacity for auditing them. For this group of companies, the CMA suggests a possible external quality control by an auditing firm from outside the Big Four to build up capacity more quickly.

- Stricter separation of auditing and consulting services: Stricter separation of auditing and consulting services among the Big Four is intended to prevent conflicts of interest. This includes separate governance and management structures, a separate CEO and board and separate financial statements for auditing and consulting arms.

- Stronger regulation of audit committees: Stronger regulation of audit committees by the proposed Audit, Reporting and Governance Authority (ARGA). In the future, the ARGA should have the authority to request information from audit committees and to issue public warnings in the event of infringements. They should also be able to send an observer to the committee. As an alternative approach to joint audit, the CMA has also intensively examined limiting the market share for the auditing of companies listed in the FTSE 350. Although this could be a quicker solution, it brings problematic side effects: companies' freedom of choice would be restricted, there would be a risk of reducing the competition and the Big Four could "cherry-pick" the most attractive audit mandates. As a result, the CMA currently rejects market share limitations, but does not rule them out as a future step if the joint audit approach does not bear fruit quickly enough.

I. Why four competitors are not enough

The lack of competition in the audit market is the key driving force behind the CMA's recommendations. At first glance one could assume that four large competitors are sufficient for guaranteeing sustainable diversity in the market. However, the framework conditions in the audit market are different.
Most auditing firms – not only in the Big Four – are now also involved in consultancy. To prevent conflicts of interest, there are regulations in many countries restricting a company procuring auditing and specific consulting services from one and the same firm. While these regulations are sensible in themselves, they have a negative impact on competition. Because the Big Four are often involved at large companies as consultants, they are no longer available as candidates when re-tendering audit mandates. When changing auditors, it is therefore possible that, for reasons of independence, only one auditing firm actually comes into consideration. For this reason, the CMA believes it is necessary for five to seven auditing firms to be active in the FTSE 350 segment in the long term.

II. Goals of the EU audit reform still far from achieved

Greater diversity in the market segment of large companies was a key objective of the EU audit reform back in 2014. One important aspect of this was the obligatory rotation of auditors for "public interest entities" (PIE) at the latest after twenty years. The audit mandate must be re-tendered every ten years.
Although the reform was and is a step in the right direction, it has had, until now, an insufficient effect on market diversification. This is also the conclusion of a recent report for the European Parliament: while the level of market concentration is declining somewhat in the financial sector, it has remained virtually constant for the auditing of large companies in the EU as a whole[1]. With respect to the reduction of market concentration in particular, the EU's reform has fallen well short of its goals. Therefore, the lack of competition is expected to play an important role in the upcoming review of the EU reform.
In many respects, the objectives of the European Union correspond to the recommendations of the CMA report. It is once again evident that a change to the status quo is necessary throughout Europe and that further-reaching reform that overcomes the existing barriers to entering the market for auditing large companies is important. The introduction of mandatory joint audits is the only measure proven in practice to remedy this in the long term.

A glance at the French audit market reveals that the joint audit concept works and increases diversification of the market (see also the information box on "The situation in France").

The situation in France

France introduced mandatory joint audits more than 50 years ago. They are compulsory for companies listed on the stock exchange. As a result, the French audit market is more diverse than any other national economy in the EU. In France, an auditing company from outside the Big Four participates in the audit of more than 50% of the 100 largest listed companies. Furthermore, thanks to the "four-eyes principle" and the joint responsibility of the auditors, a joint audit increases the quality of an audit. Because it also creates an additional incentive to uncover irregularities more quickly, a joint audit effectively constitutes a permanent quality control.

1. Policy Department for Economic, Scientific and Quality of Life Policies, Directorate-General for Internal Policies, EU Statutory Audit Reform, Impact on costs, concentration and competition, April 2019

III. Audit quality can also be further enhanced

Alongside increasing market diversity, mandatory joint audits also have positive effects on the audit itself:

Increased auditing quality

The three-way relationship between the two auditors and the company can improve the quality of the audit. The "four-eyes principle" represents an additional control mechanism as well as ensuring that the auditors are more independent and objective.

Moreover, the risk of an auditing firm and the company to be audited becoming excessively familiar is greatly reduced. The company to be audited also has the advantage of being able to utilise the expertise and strengths of two auditing firms. This raises the diversity of governance in general, which is increasingly becoming a focus in many countries.

Increased safety when changing auditors

Thanks to the mandatory rotation, joint audits are also gaining in importance in Germany. This is because a change of auditor is always accompanied by a certain risk of a loss of knowledge; after all, established processes need to be set up again with the new auditor. One way of counteracting this risk is through the asynchronous appointment of a joint auditor. As such, knowledge and experience can be passed on to the new auditor in a structured manner, while an auditor who is already familiar with the company remains on board. Moreover, joint audit actually means that in some cases you can increase the duration of your mandate before mandatory rotation. For Instance, in Germany, public interest entities also have the option of extending the rotation duration to a total of 24 years if they commission a joint audit.

IV. Advantages more than make up for minimal additional costs

The most common argument against joint audits is that the joint audit process leads to redundant work and thereby drives up costs. In reality, however, a joint audit is not the same audit performed twice; rather, two auditing firms divide up the auditing activities among themselves and issue a joint audit opinion for the consolidated financial statements. Comprehensive experience in France shows that this division of activities does not necessarily result in additional costs. Audit fees in France are not generally higher than in other countries despite the obligatory joint audits[2].

At first glance, the involvement of two auditing firms appears potentially complex. In reality, and in particular when experienced auditors are involved, there are clear and established processes with joint audits that guarantee an efficient audit process. The auditing activities are divided between the two auditing firms in accordance with criteria agreed in advance – for example, taking into account geographical aspects (e.g. by region), segments (e.g. by business line) or technical aspects. The auditing firms only work in parallel on certain general tasks at the corporate level in order to cross-check both the results and the audit opinion. Following a cross review of the respective results, a joint audit report is then drawn up.

V. Conclusion

It is clear that achieving real market diversification will take time. And joint audits alone will not be sufficient to equip the audit market for the challenges of the future. However, they are a key element of a sustainable reform with the objective of stimulating competition.

Supervisory boards in Germany and in other countries should familiarise themselves with the legal consequences of the CMA's proposals outside the United Kingdom. It is currently difficult to predict the precise effect of a reform after Brexit, for example on the auditing of subsidiaries. Audit committees should keep a particularly close eye on the situation over the next few weeks within the scope of their duty to prepare for upcoming developments. In light of the great importance of the British financial market, the decisions made in the United Kingdom will also have an effect beyond its borders and very probably beyond Europe.

2. In 2018, Mazars compared the top 100 listed companies in France and the United Kingdom. The result: audit costs in the United Kingdom (without joint audits) were 57% higher than in France (with joint audits) per billion euros of market capitalisation.