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Note

AUDITING OVERSEAS: HOW THE UNITED STATES CAN LEARN FROM RECENT FINANCIAL AUDIT REFORM IN THE UNITED KINGDOM

Daniel Damitio

ABSTRACT—Financial auditing is one of the cornerstones of an effective capital market structure. When performed correctly, an independent financial audit provides investors with the security they need to effectively transact based on company disclosures. When this system fails, however, the results for investors and the economy as a whole can be devastating. In recognition of this danger, the market for financial auditing in the United States is regulated by a number of governmental and nongovernmental bodies charged with maintaining its health and effectiveness. But stakeholders within the U.S. market and government have criticized these regulators for failing to adequately respond to concerns lurking in the country's financial auditing system. While audit reform can be an expensive and convoluted process, this Note argues that U.S. regulators can streamline the field's development by monitoring and building upon the actions taken by U.K. regulators.

This Note describes the current audit regulatory structure employed by the United States and examines the most pressing concerns expressed by interested parties. It then analyzes the findings and proposals offered in the U.K. Competition and Markets Authority's comprehensive report on competition and audit quality in the U.K. financial auditing market. This Note proposes that the conclusions of the Competition and Markets Authority's report should serve as both a warning and a guide for domestic audit regulators. The United States is past due for a comprehensive examination of their financial auditing system. Using the U.K. findings as a guide will provide more immediate and relevant data for policymakers and regulators alike.

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INTRODUCTION

History's first recorded business scandal occurred in 360 B.C.E. The Greek shipowner, Hegestratos, attempted to swindle a client out of a delivery of corn.[1] Since that ill-fated attempt, financial fraudsters have continued besieging economies. To combat this ever-evolving threat, governments have devised systems of financial regulation and market protection. This Note identifies and evaluates the present state of one of the most important tools of modern fraud prevention: financial auditing. Mandatory financial auditing requires businesses to obtain independent verification and evaluation of the financial data which the government requires them to disclose to the public. When functioning as intended, this system reduces investors' risk and transaction costs, thus promoting a healthy and active capital market. If the system fails, however, the economic results can be disastrous for investors who relied on its effectiveness.

The United States' financial auditing system is no stranger to such failures. Twenty years after the collapse of Enron and its auditing firm Arthur Andersen, investor concerns about the audit services market have again

[1] *See Crime and Fraud*, ENCYCLOPEDIA.COM, https://www.encyclopedia.com/finance/finance-and-accounting-magazines/crime-and-fraud [https://perma.cc/NE9J-P2JV]. When others discovered Hegestratos's plot, he jumped into the sea and drowned. *Id.*

surfaced in the regulatory landscape. Part I of this Note examines the history and characteristics of the U.S. audit market and assesses the two primary causes for contemporary investor concern: concentration among the top audit firms and the proliferation of nonaudit services provided by audit firms. Part II identifies the relative strengths and weaknesses of the current U.S. audit regulatory structure and argues that regulators are exposing investors to risk by operating on outdated information about the financial auditing market. Part III introduces the significant financial auditing reforms currently underway in the United Kingdom in response to recent audit failures. Next, Part III argues that U.S regulators can learn several lessons from examining a report generated by the U.K. Competition and Markets Authority through its extensive review of the United Kingdom's audit system. Finally, this Note concludes by affirming that the implementation procedures and findings generated during U.K. regulators' review provide U.S. regulators with an effective roadmap for undergoing its own thorough review of the health of its financial auditing system.

This topic has remained largely unexplored by legal scholars, and much of the U.S. data originates from government reports over a decade old. Historically, this subject attracts serious attention only after a disastrous systemic failure. This reactionary approach is misplaced; serious audit failures can contribute to catastrophic economic damage. Reactionary policies cannot fully redress the harm that such failures cause to investors. Considering the significant danger of inaction—and informed by the findings of the comprehensive U.K. review—this Note argues that the United States should adopt a more prospective and active approach to identifying and mitigating potential threats to its financial audit system. This process should begin with a comprehensive assessment of the effects of concentration and the proliferation of nonaudit services among financial auditors in the U.S. market. In adopting this approach, the United States should look to the findings of significant audit reforms currently underway in the United Kingdom and monitor further developments.

I. History of the U.S. Audit Market

A. *Purpose and Structure of the U.S. Audit Market*

Sophisticated financial fraud recurs in the U.S. capital markets. Driven in part by a long string of individual state scandals[2] and further catalyzed by

[2] *See, e.g.*, Glenn A. Vent & Cynthia Birk, *Insider Trading and Accounting Reform: The Comstock Case*, 20 ACCT. HISTORIANS J. 67, 67, 80 (1993) (detailing a string of insider trading scandals related to the mining industry in California in the 1880s); Richard A. Epstein, *Regulatory Enforcement Under New*

the stock market crash of 1929 and the ensuing Great Depression, Congress instituted the first iteration of our modern system of financial regulation in the early 1930s.[3] The Securities Exchange Act of 1934 (Exchange Act) established the Securities and Exchange Commission (SEC) and introduced a system of periodic financial reporting for large and publicly traded companies.[4] This landmark legislative act also required for the first time that all publicly traded corporations hire licensed, independent accountants to audit their financial statements.[5]

The Exchange Act—in tandem with more recent legislation such as Sarbanes–Oxley and Dodd–Frank—is thus responsible for outlining the current system of financial auditing. Financial auditing—one of the economy's most important prophylactic tools for fraud prevention—is "the process of checking a company's or organization's financial statements to make certain they are correct and complete, and then providing this information in an official report."[6] In the United States, auditors review financial statements to ensure that they comply with official standards and are free from material misstatements.[7] Auditors must also assess and certify the issuer's own internal controls to ensure that they are effectively preventing material mistakes and fraud in the first place.[8]

The process of mandatory independent auditing, when functioning as intended, encourages public investment in U.S. companies by alleviating investors' fears of losing money because of inaccurate information.[9] The effectiveness of a company's financial audit, therefore, has significant implications for practically any stakeholder with an interest in the performance of the company.[10] If these stakeholders cannot rely on the information examined by an independent auditor, they must incorporate the

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York's Martin Act: From Financial Fraud to Global Warming, 14 N.Y.U. J.L. & BUS. 805, 819–20 (2018) (describing the conditions leading to the 1920 enactment of the Martin Act in New York State, a "blue-sky" law intended to combat fraud).

3 *See* Howard B. Levy, *History of the Auditing World, Part 1*, 90 CPA J. 50, 51 (2020).

4 48 Stat. 881, 885, 897 (codified as amended at 15 U.S.C. §§ 78d(a), 78q(a)(1)).

5 *Id.* at 893 (codified as amended at 15 U.S.C. § 78l(b)(1)(j)–(k)).

6 *Financial Auditing*, CAMBRIDGE DICTIONARY, https://dictionary.cambridge.org/us/dictionary/english/financial-auditing [https://perma.cc/2MDY-3AYK].

7 *All About Auditors: What Investors Need to Know*, SEC (June 24, 2002), https://www.sec.gov/reportspubs/investor-publications/investorpubsaboutauditorshtm.html [https://perma.cc/V56Y-LQ6U]. For an explanation of GAAP, see *infra* Section I.A.

8 *See* 15 U.S.C. § 7262(b). One example of an internal control that helps prevent fraud includes segregation of duties, which refers to a system where no single employee possesses the authority to take unilateral action without oversight from another person. Auditors can assess segregation of duties by examining a company's process for authorizing expenses or confirming customer orders.

9 United States v. Arthur Young & Co., 465 U.S. 805, 819 n.15 (1984).

10 *See* SEC, *supra* note 7.

risk of using insufficient or unreliable information into their own cost calculations, which results in higher transaction costs and a less efficient overall allocation of resources.[11] Without some basis for trust in the marketplace, the gap that separates entrepreneurs in need of capital and investors who can provide capital remains difficult, if not impossible, to cross.[12] Independent auditors are capable of bridging the entrepreneur–investor gap.[13]

B. The Big 4 and Concentration in the Audit Market

Since the early 2000s, when the massive auditing firm Arthur Andersen collapsed,[14] four public accounting firms—Deloitte, Ernst & Young (EY), KPMG, and PricewaterhouseCoopers (PwC)—have dominated the financial audit industry. These four firms—collectively known as the "Big 4"—audited 491 of the 497 publicly listed firms appearing on the S&P 500 in 2020.[15] In 2016, the Big 4 audited around 97% of the total U.S. market capitalization.[16]

Particular client sectors are even more concentrated than the overall market for large company audit services. In the U.S. telecommunications services sector, for example, a single firm audits 92% of the S&P 500 market capitalization.[17] The energy, materials, and information technology sectors—where two firms audit approximately 75% of the S&P 500 market capitalization—provide other examples.[18] Concentrated sectors' preference for a particular auditor reinforces this cycle of concentration. As one firm dominates a specific sector, it continues to "develop a depth of industry-

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11 *See* James R. Doty, Chairman, Pub. Co. Acct. Oversight Bd., The Role of Audit in Economic Growth (Dec. 3, 2014), (transcript available at https://pcaobus.org/news-events/speeches/speech-detail/the-role-of-audit-in-economic-growth_545 [https://perma.cc/C2LU-LU2P]).

12 *See id.*

13 *See id.*

14 Andersen's demise was a direct result of its involvement in the historic Enron scandal and the prosecution that followed. *See* Flynn McRoberts, *The Fall of Andersen*, CHI. TRIB. (Sept. 1, 2002, 2:00 AM), https://www.chicagotribune.com/news/chi-0209010315sep01-story.html [https://perma.cc/F5XD-SBNT]. *See generally* Kathleen F. Brickey, *Enron's Legacy*, 8 BUFF. CRIM. L. REV. 221 (2004) (providing a summary of the Enron scandal and the resulting legislative and regulatory responses).

15 *S&P 500 Auditor Analysis*, BIG4 BY THE NUMBERS (July 31, 2020), https://big4stats.com/sp-500-auditor-analysis/ [https://perma.cc/CUR3-PB4S].

16 Steven B. Harris, Bd. Member, Pub. Co. Acct. Oversight Bd., Audit Industry Concentration and Potential Implications (Dec. 7, 2017) [hereinafter Harris on Audit Concentration] (transcript available at https://pcaobus.org/news-events/speeches/speech-detail/audit-industry-concentration-and-potential-implications_674#_edn6 [https://perma.cc/6AES-U6H9]).

17 *Id.*

18 *Id.*

specific expertise unmatched by rivals," which further strengthens that industry's predilection in its favor.[19]

Because the Exchange Act mandates audit services for public corporations,[20] there is no danger of a substitute supplanting the current market absent legislative changes. Therefore, the regulatory structure effectively "grants a franchise to the nation's public accountants."[21] But while this statutory scheme may guarantee stable general demand for audit services, it does not adequately explain why small and midsize audit firms remain unable to capture market share from the Big 4.

The Big 4 dominate the audit industry for several reasons. The first is self-selection: most small and midsize firms simply do not desire to take on the risk of large public company audits.[22] The minority of firms that do indicate interest in expanding into large public company audits face seemingly insurmountable barriers to entry. The current structure keeps small firms out and entrenches the status quo of heavy concentration in the market for large company audits. The most significant of these barriers include "having adequate capacity (e.g., staff and geographic coverage) to audit large public companies, acquiring the needed technical capability and industry specialization, and developing name recognition and a reputation for this kind of work."[23]

Another reason the Big 4 dominate—risk diffusion—represents both the greatest threat facing the viability of large audit firms and one of the greatest barriers to smaller firms growing in prominence.[24] Since auditors are responsible for exposing flaws and inaccuracies in financial statements, they owe a duty to foreseeable users of those statements to take reasonable care in performing their audit and in identifying material misstatements in their client's financial statements.[25] If a firm breaches this duty in the context of a large corporation's audit, its exposure to widespread or class action litigation

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[19] ORG. FOR ECON. COOP. & DEV., COMPETITION AND REGULATION IN AUDITING AND RELATED PROFESSIONS 202 (2009), https://www.oecd.org/daf/competition/44762253.pdf [https://perma.cc/E67C-D5QK].

[20] *See* 15 U.S.C. § 78m(a)(2).

[21] U.S. GOV'T ACCOUNTABILITY OFF., GAO-08-163, AUDITS OF PUBLIC COMPANIES: CONTINUED CONCENTRATION IN AUDIT MARKET FOR LARGE PUBLIC COMPANIES DOES NOT CALL FOR IMMEDIATE ACTION 7 (2008), https://www.gao.gov/assets/gao-08-163.pdf [https://perma.cc/4NSB-DQEG].

[22] *Id.* at 37.

[23] *Id.*

[24] Christopher C. McKinnon, Note, *Auditing the Auditors: Antitrust Concerns in the Large Company Audit Market*, 11 N.Y.U. J.L. & BUS. 533, 550 (2015).

[25] Jeff Schmidt, *Legal Liability of Auditors: Civil and Criminal Liability Faced by an Auditor*, CORP. FIN. INST., (Jan. 5, 2023), https://corporatefinanceinstitute.com/resources/knowledge/accounting/legal-liability-of-auditors/ [https://perma.cc/UMS9-ZHSC].

could be severe enough to cripple or destroy the firm entirely.[26] Firms are likewise subject to significant regulatory oversight and face the risk of fines and even indictment that can threaten their staying power.[27] Although even the Big 4 cannot entirely evade this risk, their size allows them to diffuse the risk to a degree that smaller firms simply cannot emulate.[28] Without greater protection from legal liability, small and midsize audit firms generally choose to forego the liability risk attached to large clients.[29]

From the demand-side perspective of audit clients, audit firm reputation can significantly impact auditor choice. Large companies indicated that they would prefer to entrust their audit to established firms rather than spend the time and resources necessary to conduct sufficient due diligence on lesser-known auditing options.[30] Companies also expressed concern that engaging a non-Big 4 auditor may send negative signals to investors that they have sacrificed on the quality of their audit, particularly in the context of initial public offerings.[31]

These barriers to entry have created a status quo favoring continued dominance of the Big 4 in the market for audit services. Yet empirical studies have not conclusively established the extent to which the concentrated nature of the market tangibly harms consumers. Specifically, some reports attempt to measure consumer harm via reduced audit quality or artificially inflated audit service fees.[32] Despite a lack of expert consensus, general concerns about concentration in the U.S. audit market largely mirror those common to the financial industry: namely, that the Big 4 firms have become "too big or too few to fail."[33] While the U.S. government remains inactive toward the current entrenchment of the Big 4 in the audit market,[34] regulators and

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[26] *See* McKinnon, *supra* note 24, at 549 ("Exacerbating this problem, Big 4 firms are unable to obtain liability insurance."). As smaller audit firms take on larger clients, insurance companies will charge them increasingly higher premiums for relatively thin coverage to reflect the substantial risk posed by such engagements.

[27] *See id.* at 552–53.

[28] *See id.* at 549–50.

[29] *See id.*

[30] *See* U.S. GOV'T ACCOUNTABILITY OFF., *supra* note 21, at 43 (specifying that conducting due diligence on unfamiliar firms is particularly time consuming because PCAOB reports supply insufficient information by which to judge the unfamiliar firm's quality).

[31] McKinnon, *supra* note 24, at 547.

[32] *See, e.g.*, U.S. GOV'T ACCOUNTABILITY OFF., *supra* note 21, at 86–93 (analyzing factors influencing audit fees and quality).

[33] Harris on Audit Concentration, *supra* note 16.

[34] *See* U.S. GOV'T ACCOUNTABILITY OFF., *supra* note 21, at 6 ("In light of limited evidence that the currently concentrated market for large public company audits has created significant adverse impact and the general lack of any proposals that were clearly seen as effective in addressing the risks of concentration or challenges facing smaller firms without serious drawbacks, we found no compelling need to take action.").

scholars alike have expressed concerns over the adverse effects that could result from the collapse or market exit of one of these massive firms.[35]

Arthur Andersen's dissolution in 2002 caused widespread compliance disruptions. The SEC immediately intervened in a situation where "approximately 1,300 companies had to find new auditors."[36] And the collapse of one of the Big 4 could have even more severe effects on today's financial markets.[37] The Big 4 becoming the Big 3 would have devastating effects on the audit market's ability to carry out its purpose. Yet the United States has not comprehensively evaluated the effects of audit concentration since the Government Accountability Office (GAO) investigated amidst the financial crisis of 2008.[38] This delicate status quo poses the question: can regulators effectively police unscrupulous behavior by auditors if their action might lead to the collapse of one of the Big 4?

C. The Rise of Advisory Services Among the Big 4

While the Big 4 are perhaps best known for their audit services, they each also provide taxation, strategic consulting, marketing, human capital, and legal services, among others.[39] In 2022, these firms collectively

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35 *See id.* at 5 ("[P]ublic company officials and others we interviewed indicated that a merger or the failure of one of the largest firms would further reduce companies' auditor choices and could potentially result in higher audit fees and fewer choices."); Harris on Audit Concentration, *supra* note 16 ("A collapse by one of the Big Four today could cause paralysis in the financial markets as the resulting 'Big Three' would almost certainly be too few to ensure an adequate degree of competition in large-company audits."); Lawrence A. Cunningham, *Too Big to Fail: Moral Hazard in Auditing and the Need to Restructure the Industry Before It Unravels*, 106 COLUM. L. REV. 1698, 1702 (2006) ("If only three firms are available to serve thousands of global enterprises, many enterprises will lack sufficient choice to obtain required auditing services."); Francine McKenna, *Big Four Audit Firms Enjoy a "Too Few to Fail" Regulatory Hall Pass*, PROMARKET (July 14, 2017), https://promarket.org/2017/07/14/big-four-audit-firms-enjoy-fail-regulatory-hall-pass/ [https://perma.cc/SA3R-GUH5] ("[I]f one of those global audit firms falters financially or fails, the remaining three will unlikely be able to absorb the clients, the work, and the employees the way four of them did back in 2002 following the failure of Arthur Andersen.").

36 Harris on Audit Concentration, *supra* note 16.

37 *Id.* (explaining that the remaining audit firms would lack the geographic coverage and industry specialization necessary to effectively absorb new market share); *see* Joseph J. Gerakos & Chad Syverson, *Competition in the Audit Market: Policy Implications* 23 (Nat'l Bureau of Econ. Rsch., Working Paper No. 19251, 2013) (estimating that the exit of one of the Big 4 from the market could decrease consumer surplus from somewhere between \$1.3 to \$1.8 billion in the first year alone).

38 *See* U.S. GOV'T ACCOUNTABILITY OFF., *supra* note 21, at 2–4 (recounting the timing and findings of the GAO's review).

39 *See Who Are the Big Four Accounting Firms?*, ESG: THE REP., https://www.esgthereport.com/who-are-the-big-four-accounting-firms/ [https://perma.cc/9EC5-A862]; *see, e.g.*, *Services*, EY, https://www.ey.com/en_us/services [https://perma.cc/MNG3-QLC3].

employed nearly 1.46 million people globally[40] and made over $189 billion in total revenue.[41] Despite maintaining their dominance in the audit market, the Big 4 have become increasingly dependent on advisory revenue in recent years.[42]

The Big 4's focus on nonaudit services is nothing new. Rapid growth among advisory services was a distinctive feature of the audit market leading up to the Enron scandal in 2001.[43] The Big 4's growth of nonaudit services only abated when Congress, in the wake of Arthur Andersen's collapse, enacted the Sarbanes–Oxley Act of 2002 (SOX), which strictly limited firms' ability to offer nonaudit services to their current audit clients.[44]

As SOX took effect, "three of the Big 4 divested a significant portion of that [management consulting] business to independent spin-offs or to non-auditing companies," and audit fees again became the dominant source of income among the Big 4.[45] It appeared that audit firms had rededicated their resources back to independent and diligent financial auditing.

SOX, however, only *restricted* nonaudit services. It did not prohibit them entirely. Once the Big 4 better understood how to navigate the restrictions of SOX, they began reconstructing their advisory arms.[46] The Big 4's rapid rebuild of these services has caused a resurgence in concerns about audit quality and independence.[47]

Under President Biden, the SEC identified the potential dangers of this trend. According to Paul Munter, the Acting Chief Accountant at the SEC, "[e]ntering into significant . . . non-audit service contracts . . . with non-audit clients can impact the auditor's ability to remain independent of its existing

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40 *See Number of Employees of the Big Four Accounting/Audit Firms Worldwide in 2022*, STATISTA (Jan. 26, 2023), https://www.statista.com/statistics/250503/big-four-accounting-firms-number-of-employees/#statisticContainer [https://perma.cc/G6W3-3QR7].

41 *See Revenue of the Big Four Accounting/Audit Firms Worldwide in 2022*, STATISTA (Feb. 7, 2023), https://www.statista.com/statistics/250479/big-four-accounting-firms-global-revenue/ [https://perma.cc/EY2Z-7377].

42 *Big 4 Leaving Audit Behind as Advisory Revenues Grow*, INSIDE PUB. ACCT. (Mar. 3, 2020), https://insidepublicaccounting.com/2020/03/big-4-leaving-audit-behind-as-advisory-revenues-grow/ [https://perma.cc/K4TM-YKKC].

43 ORG. FOR ECON. COOP. & DEV., *supra* note 19, at 199.

44 *See id.*; Steven B. Harris, Bd. Member, Pub. Co. Acct. Oversight Bd., The Rise of Advisory Services in Audit Firms (Nov. 24, 2014) [hereinafter Harris on Advisory Services] (transcript available at https://pcaobus.org/news-events/speeches/speech-detail/the-rise-of-advisory-services-in-audit-firms_544 [https://perma.cc/P7ZC-GAR8]).

45 ORG. FOR ECON. COOP. & DEV., *supra* note 19, at 199.

46 *See* Harris on Advisory Services, *supra* note 44.

47 *See, e.g.*, *id.* (raising concerns about firms devoting too much energy to their consulting practices to the detriment of their auditing activities).

audit clients in certain future circumstances."[48] Since the effectiveness of the audit system depends on investors' faith in the process, both actual and apparent auditor independence are "foundational to the credibility of the financial statements."[49] Mergers and acquisitions among Big 4 clients, however, threaten both apparent and actual auditor independence by blurring or even erasing the lines between audit and nonaudit clients.[50]

The Big 4 maintain that audit services and auditor independence remain "core to their business."[51] PwC ensured the public that it has "bolstered its internal compliance systems . . . and will continue to tighten its quality controls as the firm expands" its advisory services.[52] So PwC, along with the rest of the Big 4, will continue to expand its advisory services in the absence of additional regulation. On top of the revenue generated directly from advisory services, the firms may also experience benefits from the interaction between these services. As audit transactions and technology grow more complex, the Big 4 claim that "their audit teams rely on expertise in areas like valuations and cybersecurity that their consulting colleagues bring to the table."[53] According to this logic, robust advisory services provide synergies that may bolster the effectiveness of audits.[54]

Much like the issue of concentration in the audit market, neither the government nor experts have reached a consensus on the actual effects of the Big 4's growth in advisory services on audit quality.[55] And these two issues are not the only unknown factors at play. Other concerns such as auditors' increasing reliance on technology and outsourcing along with the rise of anonymous cryptocurrency transactions may also pose significant threats to the integrity of the system.[56]

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48 Paul Munter, Acting Chief Acct., SEC, The Importance of High Quality Independent Audits and Effective Audit Committee Oversight to High Quality Financial Reporting to Investors (Oct. 26, 2021) (transcript available at https://www.sec.gov/news/statement/munter-audit-2021-10-26 [https://perma.cc/B42G-RCF7]).

49 *Id.*

50 *See id.* If a Big 4 firm's audit client merges with a nonaudit client, it creates a new conflict of interest where one did not previously exist.

51 Amanda Iacone, *SEC Questions Auditor Independence as Firms' Advisory Work Booms*, BLOOMBERG TAX (Nov. 3, 2021, 3:45 AM), https://news.bloombergtax.com/financial-accounting/sec-questions-auditor-independence-as-firms-advisory-work-booms [https://perma.cc/N834-R7LQ].

52 *Id.*

53 *Id.*

54 *See id.*

55 *See* Nicholas J. Hallman, Antonis Kartapanis & Jaime J. Schmidt, *How Do Auditors Respond to Competition? Evidence from the Bidding Process*, 73 J. ACCT. & ECON. 1, 3 (2022).

56 *See* Greg Farrell, *Twenty Years After Enron, Investors Still Vulnerable to Fraud*, BLOOMBERG L. (Dec. 2, 2021, 6:00 AM), https://news.bloomberglaw.com/financial-accounting/twenty-years-after-enron-investors-still-vulnerable-to-fraud [https://perma.cc/B6QL-R42R].

Capital markets in the United States and abroad are evolving rapidly. This evolution has cascaded through the financial audit system which supports and monitors these markets. As audit concentration continues to rise and the field becomes increasingly reliant on technology, the multitiered system of U.S. audit regulators must make informed decisions based on current industry data and examinations. Despite longstanding regulator concerns about the effect and threats of concentration in the audit industry, scholars remain sharply divided regarding its actual effects on audit fees, quality, and competition.[57] The dearth of publicly available information drives this uncertainty.[58] To stay ahead of the next auditing crisis, U.S. regulators must first understand the magnitude of the threat posed by concentration. An effective regulatory structure in this space requires flexibility and policy reforms that respond to current data.

To be clear, an informational deficit among audit regulators does not necessarily imply that the current system is dysfunctional. But without a reassessment of potential threats that have arisen in the past two decades, regulators cannot adequately validate *or* dispel investors' fears about the integrity of the financial auditing system. The government originally mandated financial audits to bridge the trust gap between investors and businesses.[59] If that bridge fails—or even if investors simply believe the bridge is unreliable—the U.S. economy will fail to capture the economic benefits of financial auditing.

II. THE UNITED STATES' AUDIT REGULATORY SYSTEM

Audit regulation in the United States is a complex system characterized by overlapping jurisdictions and oversight by both public and private bodies. A combination of federal, state, and professional organizations devise and regulate official accounting and auditing standards.[60] While the federal government retains—and sometimes exercises—an oversight-responsibility role over this entire system, Congress has "allowed financial accounting and auditing practitioners to remain largely self-regulated."[61] This Part provides a basic introduction to United States' audit regulation and identifies existing areas of concern with self-regulation and regulatory gaps.

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57 For a helpful summary of economic scholarship on this question, see Hallman et al., *supra* note 55, at 1, 3.

58 *See id.* at 2. This lack of information stems from the Big 4's status as private companies as well as the opacity of the so-called "competitive bidding" process.

59 *See supra* text accompanying notes 7–9.

60 *See* RAJ GNANARAJAH, CONG. RSCH. SERV., R44894, ACCOUNTING AND AUDITING REGULATORY STRUCTURE: U.S. AND INTERNATIONAL 1 (2017), https://crsreports.congress.gov/product/pdf/R/R44894 [https://perma.cc/DV48-HB89].

61 *Id.*

A. GAAP: A Common Set of Standards

Congress, through the Exchange Act, delegated ultimate oversight authority for public company financial auditing to the SEC.[62] Through this grant, Congress authorized the SEC to create and enforce common standards with which all publicly issued financial statements must comply.[63]

The SEC has designated the Financial Accounting Standards Board (FASB) to establish accounting standards—referred to as "Generally Accepted Accounting Principles" (GAAP)—for the private sector.[64] FASB is an independent not-for-profit organization that the government largely funds through fees collected from issuers of publicly traded securities.[65] Another private-sector not-for-profit, the Financial Accounting Foundation (FAF), oversees the FASB and carries responsibility for appointing the seven members of the FASB board.[66]

The FASB, through GAAP, ensures that each company prepares their financial statements according to a common set of procedures.[67] GAAP tells companies which items they must recognize in their statements, the amounts they must report for those items, whether those items must be displayed as aggregated amounts or displayed individually, and the additional information the company must provide to supplement and explain the financial figures they report.[68] When auditors assess the accuracy of financial statements, they do so by comparing the actual amount reported with the amount that should have been reported according to GAAP. Although the SEC has the final say on all GAAP procedures, private sector organizations developed and continue to adapt GAAP.[69]

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62 *Id.* at 3.

63 *Id.* at 3–4.

64 *Id.*

65 *See id.* (citing 15 U.S.C. § 7219).

66 *See About the FASB*, FIN. ACCT. STANDARDS BD., https://www.fasb.org/facts/ [https://perma.cc/CB8M-Z9L2].

67 GNANARAJAH, *supra* note 60, at 3.

68 *See About GAAP*, FIN ACCT. FOUND., https://www.accountingfoundation.org/page/PageContent?pageId=/overview-accounting-and-standards/gaap/aboutgaap.html [https://perma.cc/VVU5-NLDJ] (referring to these four principles as recognition, measurement, presentation, and disclosure).

69 *See* GNANARAJAH, *supra* note 60, at 4.

B. The PCAOB: Watchdog or Lapdog?

Until the early 2000s, public accounting firms were largely self-regulated by their peers, with loose oversight from the SEC.[70] After the collapse of Arthur Andersen, however, it became clear that this self-regulatory system was not effective. Additionally, the SEC was already stretched thin carrying out its own statutory mandate. Public company audit oversight had become a large enough task to merit its own dedicated regulatory body. Thus, SOX established the Public Company Accounting Oversight Board (PCAOB or the Board) to provide independent oversight of the public company auditing process.[71] The SEC has complete oversight authority over the PCAOB and is responsible for appointing the five board members of the PCAOB.[72]

The PCAOB registers firms, adopts standards, investigates allegations of rule violations, and disciplines those found to have engaged in such violations.[73] When the PCAOB identifies an audit violation, it is authorized to "impose sanctions, including censures, monetary penalties, and limitations on a firm's or an individual's ability to audit public companies."[74] SOX requires that the PCAOB keep all investigations and disciplinary proceedings confidential and nonpublic until the matter is resolved to avoid premature adverse market reactions.[75]

1. PCAOB Inspection Procedures

Perhaps the most important function of the PCAOB is to "audit" the auditors. According to the statutory language of SOX, the PCAOB must annually inspect any registered audit firm that "regularly provides audit reports for more than 100 issuers," and must inspect every other registered firm at least once every three years.[76] These inspections assess each firm's

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70 *See* Steven B. Harris, Bd. Member, Pub. Co. Acct. Oversight Bd., The Public Responsibility of a CPA (May 19, 2017) (transcript available at https://pcaobus.org/news-events/speeches/speech-detail/the-public-responsibility-of-a-cpa_656 [https://perma.cc/GBR9-3FCK]).

71 *See* GNANARAJAH, *supra* note 60, at 7–8. The PCAOB is a nonprofit corporation funded by levies on certain institutional investors.

72 *Id.* at 8 (specifying that the SEC appoints PCAOB board members with input from the Secretary of the Treasury and the Chair of the Board of Governors of the Federal Reserve System).

73 *About*, PUB. CO. ACCT. OVERSIGHT BD., https://pcaobus.org/about [https://perma.cc/J7XH-C8PT].

74 *Enforcement*, PUB. CO. ACCT. OVERSIGHT BD., https://pcaobus.org/oversight/enforcement [https://perma.cc/WM5J-8Q4Y].

75 *See id.*

76 15 U.S.C. § 7214(b)(1).

compliance with all applicable standards and regulations.[77] The PCAOB proceeds by reviewing a sample of the total audits conducted by a firm and collecting general information about the firm's procedures and processes.[78] It selects individual audits for review with a particular focus on engagements with significant complexity, a high risk of material misstatement, and recurring deficiencies.[79]

Following each inspection, the PCAOB generates a two-part report detailing their findings and identifying any areas of significant concern they encountered.[80] Part I of the report describes the deficiencies identified in specific audits by the PCAOB—Part I.A of the report identifies areas where the auditor drew conclusions without sufficient evidence to support its position.[81] After anonymizing the subject of the inspection, the PCAOB releases this section to the public.[82]

Part II of the inspection report details potential defects in the firm's overall quality control systems, such as concerns over a lack of auditor independence or a culture that puts profit above diligence.[83] The PCAOB does not initially disclose Part II of the report to the public, but it does privately share its findings with the subject audit firm.[84] The firm then has a year to address any quality control deficiencies to the PCAOB's satisfaction, or the PCAOB will publicly issue Part II of the report.[85]

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77 *PCAOB Inspection Procedures: What Does the PCAOB Inspect and How Are Inspections Conducted?*, PUB. CO. ACCT. OVERSIGHT BD., https://pcaobus.org/oversight/inspections/inspection-procedures [https://perma.cc/J6TY-88K9].

78 *Id.*

79 *Id.* For reference, the PCAOB inspected "portions of 690 audits" in 2021. PUB. CO. ACCT. OVERSIGHT BD., SPOTLIGHT: STAFF UPDATE AND PREVIEW OF 2021 INSPECTION OBSERVATIONS 3 (2022), https://pcaob-assets.azureedge.net/pcaob-dev/docs/default-source/documents/staff-preview-2021-inspection-observations-spotlight.pdf [https://perma.cc/TGY7-MLBQ].

80 *See PCAOB Inspection Procedures*, *supra* note 77.

81 *See id.*; Daniel L. Goelzer, *Audit Oversight and Effectiveness: Understanding the Past and Looking Toward the Future*, 90 CPA J. 50, 52 (2021).

82 *See* Goelzer, *supra* note 81, at 51–52 ("[D]eficiencies in individual audits are described . . . in enough detail to give the reader an understanding of the problem, but without violating the SOX confidentiality provisions.").

83 *See id.* at 52.

84 *See id.* at 50–52; *see also* PUB. CO. ACCT. OVERSIGHT BD., GUIDE TO READING THE PCAOB'S NEW INSPECTION REPORT 2, 5 (2018), https://pcaobus.org/Inspections/Documents/Inspections-Report-Guide.pdf [https://perma.cc/PN6D-5M2N].

85 PUB. CO. ACCT. OVERSIGHT BD., *supra* note 84, at 5; Goelzer, *supra* note 81, at 51.

2. *PCAOB Enforcement Procedures*

Under SOX, the PCAOB has the authority to investigate any registered auditing firm or associated person for violations of SOX, other securities laws, or rules adopted by the PCAOB.[86]

If the PCAOB finds a violation, it must notify the target firm and allow them to defend against the charges in a nonpublic hearing.[87] If the hearing concludes that a firm did in fact violate an enforceable rule, it may censure the firm or issue up to a $2 million civil money penalty for each violation.[88] If the PCAOB determines that the firm intentionally, knowingly, or recklessly violated an enforceable standard—or even that the firm repeatedly violated standards through negligent conduct—then the Board may impose even more severe sanctions.[89] These include the suspension or revocation of an audit firm's registration, the limitation of their activities or operations, and an increased civil penalty of up to $15 million.[90]

The SEC retains the authority to review—either through a sanctioned party's application for review or by its own discretion—any disciplinary action taken by the PCAOB.[91] Although the disciplinary proceedings must remain nonpublic until they are resolved, the PCAOB is obligated under SOX to publicly report any resolved disciplinary actions and the reasons why such actions were taken.[92]

Despite its broad enforcement authority, the PCAOB has made sparse use of its sanction powers against the Big 4. From its founding in 2003 to the year 2019, the PCAOB found the Big 4 issued 808 audits containing at least one significant deficiency.[93] Of those 808 significantly deficient audits, only 18 resulted in the PCAOB bringing an enforcement case against a Big 4 firm or employee.[94] Those 18 enforcement cases resulted in total fines assessed against the Big 4 of only $6.5 million.[95] Assuming that each of these 808 violations were eligible only for the lower penalty of $2 million, the PCAOB

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86 15 U.S.C. § 7215(b)(1).

87 *Id.* § 7215(c)(1)–(2).

88 *Id.* § 7215(c)(4).

89 *Id.* § 7215(c)(5).

90 *Id.* § 7215(c)(4)(A)–(D).

91 *See id.* § 7215(e).

92 *Id.* § 7215(d).

93 David S. Hilzenrath & Nicholas Trevino, *How an Agency You've Never Heard of Is Leaving the Economy at Risk*, PROJECT ON GOV'T OVERSIGHT (Sept. 5, 2019), https://www.pogo.org/investigation/2019/09/how-an-agency-youve-never-heard-of-is-leaving-the-economy-at-risk/ [https://perma.cc/M8VA-Z2HP].

94 *Id.*

95 *Id.*

could have issued up to $1.6 billion in fines against the Big 4 for these 808 violations.[96]

Critics of the PCAOB often key in on its seemingly lenient approach to enforcement and its overall lack of transparency.[97] The opaque process by which the PCAOB enforces audit regulations adds to uncertainty among stakeholders of the financial auditing system. The PCAOB also notably has no express authority or specific mandate to monitor audit market concentration levels. The presence of gaps—both real and apparent—in the audit regulatory process at best harms investor confidence, and at worst disguises serious deficiencies in the health of the system.

III. AUDIT REFORM IN THE UNITED KINGDOM AND WHAT IT CAN TEACH THE UNITED STATES

The United States is not the only government battling to determine the future of its statutory audit system. Accounting scandals—particularly those perpetrated by various Big 4 international offices—are a global problem.[98] The United Kingdom, which has an audit market with very similar characteristics to that of the United States, is currently considering several policy proposals designed to address issues of concentration, independence, and audit quality. While audit reform is a global problem, this Note focuses only on the findings and proposals of U.K. regulators.[99] By examining U.K. findings and policy decisions closely, the United States will not have to start from scratch in reexamining its own audit market and devising effective regulatory responses to the issues facing both countries.

Prior to making official policy proposals, the United Kingdom conducted an extensive and multifaceted assessment of its financial auditing system.[100] This assessment generated several government-commissioned

96 *Id.*

97 *See, e.g.*, *id.*

98 *See, e.g.*, *Big 4 Accounting Scandals*, BIG 4 ACCT. FIRMS (2018), https://big4accountingfirms.com/the-blog/big-4-accounting-scandals/ [https://perma.cc/B4JE-PFVE] (listing scandals committed by the Big 4 around the globe in 2018).

99 This scope is based both on market similarities between the United States and United Kingdom and the lack of language barriers for government reports. But audit reform is not unique to those two nations. *See, e.g.*, Max Oehm & Lennart Schrick, *The Impact of the FISG for Auditors in Germany*, GLOB. LITIG. NEWS (Sept. 6, 2021), https://globallitigationnews.bakermckenzie.com/2021/09/06/the-impact-of-the-fisg-for-auditors-in-germany/ [https://perma.cc/K2FH-7TBT] (describing recent audit reform measures in Germany); *Audit Reform*, SAICA, https://www.saica.org.za/initiatives/trust-restoration/audit-reform [https://perma.cc/AM97-JEN2] (describing recent audit reform measures in South Africa).

100 The assessments and proposals also encompass issues of corporate governance, but this Note focuses specifically on the external financial auditing aspect of the assessment.

reports in 2018,[101] each of which provided in-depth research, statistics, and policy suggestions about different aspects of the U.K.'s audit market.

This Part begins with an introduction to the U.K. audit regulatory system. It then keys in on the issues specifically addressed in the Competition and Market Authority's (CMA's) Statutory Audit Services Market Study (CMA report). Many of the issues identified by the CMA report mirror concerns that investors and regulators in the United States have expressed for years. Rather than waiting until after another economic catastrophe to motivate the identification of failures in the nation's auditing system, the United States should follow the United Kingdom's lead and conduct a similar analysis to ensure the health of the current regulatory regime and identify threat areas that would benefit from more active monitoring.

A. A Brief Overview of the U.K. Audit Market and Existing Regulations

The U.K. Companies Act serves as the primary source for the country's statutory auditing requirements.[102] Under this Act, companies in the United Kingdom are required to abide by audit procedures that resemble U.S. corporate law requirements. Many of these regulations apply specifically to Public Interest Entities (PIEs), which include any company with tradeable securities listed on a U.K.-regulated exchange, credit institutions, and insurance undertakings.[103] Each company's financial statements must

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[101] These included Sir John Kingman's Independent Review of the Financial Reporting Council, Sir Donald Brydon's Report of the Independent Review into the Quality and Effectiveness of Audit, and the CMA's Statutory Audit Services Market Study. DEP'T FOR BUS., ENERGY & INDUS. STRATEGY, CP 382, RESTORING TRUST IN AUDIT AND CORPORATE GOVERNANCE: CONSULTATION ON THE GOVERNMENT'S PROPOSALS 14 (2021), https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/970673/restoring-trust-in-audit-and-corporate-governance-command-paper.pdf [https://perma.cc/6UUG-TGNV].

[102] *See* COMPETITION & MKTS. AUTH., STATUTORY AUDIT SERVICES MARKET STUDY 21 (2019), https://assets.publishing.service.gov.uk/media/5d03667d40f0b609ad3158c3/audit_final_report_02.pdf [https://perma.cc/QVQ6-EHZB]. Many of the U.K.'s rules on audit were established while it still belonged to the European Union. Since the Kingman and CMA reports were generated in 2018, they rely on pre-Brexit EU rules. These reports remain relevant, however, because the U.K. adopted the EU Audit Regulation—subject to certain amendments—as domestic, retained law. James E. Barbour, *Information for Auditors and Audit Firms Regarding Arrangements from 1 January 2021*, INST. OF CHARTERED ACCTS. OF SCOT. (Dec. 1, 2020), https://www.icas.com/professional-resources/brexit/news/information-for-auditors-and-audit-firms-regarding-arrangements-from-1-january-2021 [https://perma.cc/PTX4-DPWA].

[103] JOHN KINGMAN, INDEPENDENT REVIEW OF THE FINANCIAL REPORTING COUNCIL 30 (2018), https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/767387/frc-independent-review-final-report.pdf [https://perma.cc/G56V-W4k2]; *see also* Barbour, *supra* note 102 (explaining that after Brexit, the definition of PIE no longer includes any company traded on an EU-

undergo an annual external audit unless the company is exempt, either by meeting specific financial thresholds or through its status as a nonprofit company.[104]

The United Kingdom also restricts statutory auditors from providing nonaudit services to their PIE audit clients.[105] These restrictions mirror SOX's restraints in the United States, which promote auditor independence and avoid undue pressure to provide nonaudit services to audit clients.

The U.S. and U.K. regulatory environments share several other key features. All companies traded publicly in the United Kingdom must prepare their financial statements according to the International Financial Reporting Standards (IFRS).[106] IFRS is a set of principles-based financial reporting standards.[107] It serves as most international governments' preferred alternative to the rule-based standards of U.S. GAAP.[108] Despite some notable differences between the two systems, IFRS and GAAP serve the same purpose and are similar enough that the United States permits foreign SEC registrants to file their financial statements using IFRS standards.[109]

The Financial Reporting Council (FRC) serves as the U.K.'s primary audit regulator.[110] From its establishment in 1990, the FRC took on a number of additional duties, including becoming responsible for audit regulation in

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member's exchange and will instead only include those firms traded on British-regulated securities markets).

[104] *U.K. Audit Requirements*, OURY CLARK, https://www.ouryclark.com/resource-library/quick-guides/general/uk-audit-requirements.html [https://perma.cc/7H6Z-R428].

[105] COMPETITION & MKTS. AUTH., *supra* note 102, at 22 (explaining that some nonaudit services to a firm's audit client are "blacklisted" while others are subject to a general nonaudit fee cap equal to 70% of the average audit fees paid by the company over the last three years).

[106] *Who Uses IFRS Standards?: United Kingdom*, INT'L FIN. REPORTING STANDARDS FOUND., https://www.ifrs.org/use-around-the-world/use-of-ifrs-standards-by-jurisdiction/view-jurisdiction/united-kingdom/ [https://perma.cc/WZU4-N22B].

[107] *See IFRS vs. U.S. GAAP: Know the Differences Between the Two Accounting Standards*, CORP. FIN. INST. (Dec. 6, 2022), https://corporatefinanceinstitute.com/resources/knowledge/accounting/ifrs-vs-us-gaap/ [https://perma.cc/P3XN-YMUS].

[108] *Id.*

[109] *See Who Uses IFRS Standards?: United States*, INT'L FIN. REPORTING STANDARDS FOUND., https://www.ifrs.org/use-around-the-world/use-of-ifrs-standards-by-jurisdiction/view-jurisdiction/united-states/ [https://perma.cc/YC7X-NQ5X].

[110] *See generally* KINGMAN, *supra* note 103, at 18 ("Before then, the oversight of standards for accounting and financial reporting had been carried out—and funded—by the UK's (then) six professional accountancy bodies . . . ."). This Note was written as the United Kingdom transitioned to a new audit regulator, the Audit, Reporting and Governance Authority (ARGA), which will supplant the FRC at the earliest in 2024. Jim Pickard & Michael O'Dwyer, *UK's New Audit Regulator to be Based in Birmingham*, FIN. TIMES (Sept. 4, 2022), https://www.ft.com/content/4c08a6d8-00dc-4062-bce4-6cc33183676b [https://perma.cc/83CD-APNW]. ARGA will largely serve the same functions as the FRC, albeit with some slight structural adaptations and increased enforcement powers. ARGA was one of the most significant proposals offered by the Kingman Independent Review.

2005 and serving since 2016 as the "UK Competent Authority for Audit, following implementation of the 2014 Audit Directive in the UK."[111] Much like the PCAOB in the United States, the FRC is charged with registering auditing firms, issuing accounting and audit standards, inspecting audit engagements, and investigating and sanctioning wrongdoing by individual auditors and partners.[112]

All accounting firms conducting audits of PIEs are subject to FRC's Audit Quality Review (AQR), which resembles the PCAOB's inspections process.[113] The FRC publicly releases a summary of each firm's AQR, and provides confidential reports to the firms on individual audit engagements that the FRC reviews during the inspection process.[114] The FRC's investigation and enforcement process is likewise similar to the PCAOB's, although not all ongoing FRC enforcement proceedings must remain nonpublic.[115]

The level of Big 4 concentration within the U.K. audit market for large companies is comparable to that of the U.S. market. According to the CMA, the Big 4 audited 97% of the FTSE 350 in 2017.[116] Even among the companies on the FTSE SmallCap Index—which consists of London Stock Exchange-listed companies not large enough to be constituents of the FTSE 350—the Big 4 conducted 89% of all audits and collected 92% of the total audit fees paid by listed companies.[117] The two markets are similar in terms of concentration level, independence concerns, and general regulatory processes.

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111 KINGMAN, *supra* note 103, at 18–19. *Contra id.* at 28 (explaining that the FRC lacks enforcement authority against audit firms outside of actions brought for violations on individual audits).

112 *See* FIN. REPORTING COUNCIL, FRC ROLES AND RESPONSIBILITIES: SCHEDULE OF FUNCTIONS AND POWERS 2–8 (2022), https://www.frc.org.uk/getattachment/9c78e7fd-b9ff-4aa2-a563-2141fabfaa20/FRC-Roles-and-Responsibilities-Schedule-of-Powers-December-2022.pdf [https://perma.cc/Q3UX-ZNW3].

113 *See Audit Quality Review*, FIN. REPORTING COUNCIL, https://www.frc.org.uk/auditors/audit-quality-review [https://perma.cc/AM3X-6LGM].

114 *See id.* (noting that the FRC reviews large auditors annually and all other auditors every three years with some exceptions).

115 *See* FIN. REPORTING COUNCIL, THE AUDIT ENFORCEMENT PROCEDURE 19 (2022), https://www.frc.org.uk/getattachment/26e687a9-05a1-47bd-861d-497b22678c24/FRC-Audit-Enforcement-Procedure_January-2022.pdf [https://perma.cc/Q2VB-7GVN] (specifying that Liability and Sanction Hearings shall be held in public). For a list of the FRC's available sanctions, see *id.* at 30, which includes financial penalties as a permissible sanction.

116 COMPETITION & MKTS. AUTH., *supra* note 102, at 25–26. The FTSE 350 is a stock index consisting of the 350 largest companies listed on the London Stock Exchange by market capitalization. *See generally* FIN. TIMES STOCK EXCH. RUSSELL, FACTSHEET: FTSE 350 INDEX 1 (2023).

117 COMPETITION & MKTS. AUTH., *supra* note 102, at 26, 216–17. *See generally* FIN. TIMES STOCK EXCH. RUSSELL, GROUND RULES: FTSE UK INDEX SERIES 17 (2023), https://research.ftserussell.com/products/downloads/FTSE_UK_Index_Series.pdf [https://perma.cc/N9CQ-JGJU].

The United Kingdom's drive for audit reform began with recent collapses of two major British companies: British Home Stores (BHS)[118] and Carillion.[119] In both cases, the FRC identified concerning aspects of the relationships between the companies and their Big 4 auditors. These collapses put the financial auditing system under intense public scrutiny.

This process is a familiar one in the United States: major companies fail, the public looks for somewhere to place the blame, and politicians enact new auditing regulations as a solution to the problem. Of course, it is unrealistic to expect financial audits to identify and prevent every major corporate failure.[120] But the U.K. government did recognize that effective financial auditing provides advance warning of impending failures, thereby stabilizing markets and mitigating abnormal negative economic impacts on investors.[121]

B. Lessons From the Competition and Market Authority's Statutory Audit Services Market Study

The report issued by the CMA addresses the effects of heavy concentration in the market for audit services. The CMA is an independent department of the British government charged with promoting competition in the market for the benefit of consumers.[122] The report begins by providing a summary of the British auditing system and the concerns which prompted the report, which include the failures of BHS and Carillion as well as market-wide AQR results that consistently fell below the FRC's established expectations.[123] The CMA then analyzes the structural issues present in the British audit market and recommends remedies.

According to the report, companies' lack of sufficient auditor choice and the potential market dangers of a Big 4 collapse posed problems to the United Kingdom severe enough to merit drastic remedial measures.[124] These

[118] This collapse resulted in the loss of 11,000 jobs and put 19,000 pensions in jeopardy. *See Sir Philip Sold BHS to Dodge Pension Cost, Says Regulator*, BRIT. BROAD. CORP. (June 28, 2017), https://www.bbc.com/news/business-40421414 [https://perma.cc/5XP5-5AKU].

[119] Carillion's collapse in 2018 represented the largest insolvency in British history up to that point. *See* Russ Banham, *Lessons on Auditing from Carillion's Collapse*, CFO (Oct. 23, 2018), https://www.cfo.com/auditing/2018/10/lessons-on-auditing-carillions-collapse/ [https://perma.cc/7GLL-STLH].

[120] KINGMAN, *supra* note 103, at 12, 47 ("The Review believes, first, that a degree of realism is necessary. Companies will sometimes fail. To some degree, despite the very painful dislocation this can cause, this is inevitable in a vibrant and competitive economy.").

[121] *See id.* at 47.

[122] *About Us*, COMPETITION & MKTS. AUTH., https://www.gov.uk/government/organisations/competition-and-markets-authority/about [https://perma.cc/Q97K-XQBX].

[123] *See* COMPETITION & MKTS. AUTH., *supra* note 102, at 7–10.

[124] *Id.* at 76, 95–96.

proposals notably included mandating that the Big 4 conduct joint audits with small firms,[125] operationally splitting the audit and nonaudit practices of the Big 4,[126] and empowering a regulator to directly intervene and prevent further concentration if a Big 4 firm is in distress or fails.[127] The feasibility of similar proposals in the United States remains an open question, but the magnitude of the CMA's response indicates that there is a perception in United Kingdom of a grave threat to their audit market.

Because the U.S. and U.K. markets share such similar features, the findings of the CMA may indicate that an updated market analysis would benefit U.S. audit regulators. The United States has not conducted any comparable in-depth analysis of its audit market since 2008, when the GAO evaluated the effects of concentration in the audit market at the request of Congress.[128] The GAO concluded in that report that the audit market did not require any immediate intervention despite its significant level of concentration.[129] The report considered potential regulatory remedies to address the concentration, including breaking up the Big 4, limiting audit firms' liability, allowing outside ownership to fund firms, and a national accreditation system to boost market confidence in challenger firms, but it found significant flaws with each available proposal that outweighed any potential benefit they would provide.[130]

Although the GAO report provided useful information at the time, it is now over a decade old. The PCAOB does not currently directly monitor or promote competition in the financial audit market.[131] Although audit quality inspections and enforcement actions may have indirect market effects—particularly among small and midsize audit firms—the PCAOB has historically not exercised its power to control concentration in the audit market.[132]

Perhaps the need for updated information is greater than ever. The audit market has grown more globalized, technology-dependent, and complex since the GAO's last audit concentration report. An effective assessment of the U.S. audit system will require an updated profile of the market and

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[125] *Id.* at 144–45.

[126] *Id.* at 187–88.

[127] *Id.* at 177.

[128] *See* U.S. GOV'T ACCOUNTABILITY OFF., *supra* note 21, at 2.

[129] *See id.* at 51.

[130] *See id.* at 51–62.

[131] *See* Daniel L. Goelzer, Bd. Member, Pub. Co. Acct. Oversight Bd., The PCAOB and Small Business Auditors (Feb. 27, 2006) (transcript available at https://pcaobus.org/news-events/speeches/speech-detail/the-pcaob-and-small-business-auditors_50 [https://perma.cc/2R3Y-TMU8]) ("We do not have any direct authority over matters of industry concentration and competition.").

[132] *See id.*

analysis of the threats facing that market. Without this information, the U.S. audit system remains potentially exposed to significant threats.

While the United States should consider implementing permanent procedures for monitoring and gathering audit market information, the CMA report provides a useful starting place for assessing the most immediate threats posed by the financial audit market's unique characteristics. In particular, a parallel inquiry in the United States should focus on three major areas of concern identified in the CMA report: (1) insufficient choice of auditors, (2) dangers to Big 4 resilience, and (3) the effect of advisory services on audit firm incentives.

1. Insufficient Choice of Auditors

The CMA determined that audit quality should be the "key focus" in measuring the effectiveness and health of its audit market.[133] With the right regulatory oversight, the CMA believes that competition and choice in the audit market can be important tools for achieving high audit quality.[134] Responses from audit firms, audit committees, and investors apparently confirm this theory. Each group expressed its belief that reputation, trust, and credibility are important competitive features in the U.K. market for audit services.[135]

If a firm's ability to compete for audit clients does depend on its reputation for audit quality, one would "expect any damage to their reputation to have serious consequences for their audit business."[136] Yet according to the CMA's analysis, this theory does not track with the evidence from the U.K. audit market. Rather, when U.K. regulators publicly expressed concerns about a firm's audit quality, the CMA found no evidence of any corresponding drop in that firm's market share. From 2015 to 2018, KPMG consistently received AQR results for FTSE 350 audits from the FRC that were lower than its peers in the Big 4.[137] In 2018, the FRC reported a "deterioration in the quality of the audits that [it] inspected to an unacceptable level" at KPMG.[138] Amidst these statements and a host of other FRC investigations into KPMG audits, the firm announced its strongest growth in a decade and actually saw its market share of FTSE 350 audits increase in 2018.[139]

133 COMPETITION & MKTS. AUTH., *supra* note 102, at 35.

134 *See id.* at 76. Without regulatory oversight, increased competition could cause a race to the bottom where firms focus too much on cutting costs at the expense of audit quality. *See id.* at 78–79.

135 *See id.* at 79–80.

136 *Id.* at 80.

137 *Id.*

138 *Id.*

139 *See id.*

This evidence suggests that even when a firm's reputation suffers, there are too few alternative choices available in the market to punish the firm for its poor quality.[140] The Big 4 thus face little prospect of losing their competitive advantage due to poor quality audits, which removes competitive pressures that would otherwise force the firm to make the necessary quality improvements at the risk of losing their market share.

In pursuing the insufficient choice theory, the CMA examined the audit tender process in the United Kingdom to determine how many choices were actually available to audit committees when selecting an audit firm.[141] An analysis of 250 FTSE 350 audit tenders showed that 25% of the tenders had only one or two competing bidders.[142] The majority of other tenders conducted in the United Kingdom had a choice of three bidders.[143] While the CMA recognizes a tender process involving three bidders can be sufficiently competitive, a substantial percentage of tenders involve only two firms, indicating a concerning lack of choice for many large company audit committees.[144]

There are several reasons why audit tenders present limited choices for audit committees. Mandatory auditor rotation requirements mean that the incumbent auditor is sometimes unauthorized to participate in the tender process.[145] Since most incumbent auditors belong to the Big 4, this restriction usually serves to exclude a Big 4 firm from the available choices. Another potential limiting factor is the restrictions that prevent firms from providing certain nonaudit services to their audit clients.[146] With the massive growth of the Big 4's advisory services, most large companies are already receiving consulting services from at least one of the Big 4. For that firm to be eligible to provide audit services, it would first have to remove all potential conflicts of interest. Instead, the Big 4 sometimes will not participate in a tender offer to avoid sacrificing their lucrative nonaudit revenue for a new audit engagement.[147] This disincentive further decreases the number of competitive audit tenders.

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[140] *See id.*

[141] Audit tendering is a process in which audit firms submit competitive bids to potential clients. The client will consider each bid and select an audit firm based on whichever factors they deem most important in an auditor. In the United Kingdom, PIEs must rotate their auditor every ten years, but they may extend that limit by another ten years if they go through a competitive tender process and still select their current auditor. *See id.* at 22.

[142] *Id.* at 81, 83.

[143] *Id.* at 83.

[144] *Id.*

[145] *Id.* at 84.

[146] *Id.* at 85–86.

[147] *See id.* at 103.

While the previous two explanations may account for tenders with limited Big 4 participation, they do not clarify why challenger firms struggle to compete for audit clients.[148] The CMA found that from 2013 to 2018, only 30% of FTSE 350 tenders included an invitation to bid sent to a non-Big 4 audit firm.[149] Non-Big 4 firms ultimately submitted bid proposals in less than 20% of all FTSE 350 tenders examined by the CMA.[150] Companies often do not perceive challenger firms as real alternatives to the Big 4. And even in those limited cases where a company would consider a challenger firm's bid, the companies seem reluctant to take on big clients anyway.

Like in the United States, several demand- and supply-side constraints limit the potential of challenger firms to expand, a situation that maintains the status quo in the U.K. audit market. From the demand side, challenger audit firms in the United Kingdom face the same barriers identified in the GAO's 2008 report on concentration in the audit market. Many companies perceive challenger firms as lacking the necessary capacity or capability to effectively complete the work of large company audits.[151] As a result, hiring a non-Big 4 audit firm is seen by many audit committees as a risk.[152] While these concerns may ring true for the largest FTSE 350 companies, the CMA finds that they do not sufficiently explain why the Big 4 still dominate among the smallest members of the FTSE 350. According to the CMA, "[t]here is evidence that when challenger firms are given serious consideration and the opportunity to demonstrate their capability, they can win audit contracts."[153] Whether challenger firms do in fact produce lower quality audits, or companies and their investors simply *believe* that this is the case, the ultimate effect on the market is the same. Audit committees will continue to hire the Big 4 until they are convinced that challenger firms are both capable and perceived as such by investors.

The supply-side barriers in the U.K. audit market also resemble the GAO's 2008 U.S. audit market findings. The CMA found that from the challenger firms' own perspectives, auditing large companies can present a significant regulatory, reputational, and financial risk.[154] Furthermore, the

[148] "Challenger firm" refers to those audit firms outside the Big 4 who possess the greatest potential to compete with Big 4 firms in the market for audit services. *See id.* at 8, 25–26. Examples include Grant Thornton, BDO, and RSM.

[149] *Id.* at 85.

[150] *Id.*

[151] *See id.* at 89–90.

[152] *See id.* at 90–91 ("[W]e heard that Audit Committees may have an incentive to hire the Big Four because they risk criticism for hiring one of the challenger firms if things go wrong.").

[153] *Id.* at 90. *But see id.* at 91 n.297 (listing studies conducted on the U.S. audit market which conclude that smaller auditors do provide, on average, lower quality audits).

[154] *See id.* at 93.

tender process itself is expensive, and challenger firms may be unwilling to expend the necessary resources to compete for FTSE 350 clients when such a large bias for the Big 4 already exists.[155] When challenger firms bid on a FTSE tender, they are only successful 10% of the time.[156] With such a low success rate, investing in the "expensive and time-consuming" tender process seems like a waste of resources to challenger audit firms.[157]

The CMA concludes that the problem of insufficient choice primarily stems from demand-side constraints, although the supply-side barriers do significantly influence the audit market.[158] By reducing the demand-side barriers to challenger firms, the CMA hopes to increase the number of choices available to companies when they select their auditors.[159] If more auditor options were available on the market, the CMA believes that the Big 4 would face increased pressure to provide consistently high-quality audits or risk losing their market share to challenger firms.[160]

To achieve this goal, the CMA has recommended that FTSE 350 companies be jointly audited by at least two firms.[161] The recommendation would further require that one of the two joint auditors be a non-Big 4 firm, subject to a few exceptions.[162] These joint audits would require both firms to assume joint and several liability for the audit.[163] While much of the work would be divided among the two firms, the CMA recommends that both firms audit the most sensitive areas and those areas which require a high level of judgment on the part of the auditor.[164]

Mandated joint audits reduce barriers for challenger firms by allowing them to essentially complete a portion of large company audits. They would not initially require the full capacity needed to complete the entire audit, but they would still be able to gain experience from working alongside the Big 4 and demonstrate their competence to FTSE 350 companies over time.[165] The availability of new work would also allow the challenger firms to invest in expanding their capacities to cover the needs of larger clients. In the long run, the CMA hopes that this arrangement will break down the

155 *See id.* at 93–94.

156 *See id.* at 94.

157 *See id.* at 94–95.

158 *Id.* at 95 ("If the challenger firms had a higher chance of winning FTSE 350 audit contracts then they would be able to invest to overcome the supply-side barriers.").

159 *Id.* at 144, 146.

160 *Id.* at 79.

161 *Id.* at 144.

162 *Id.*

163 *See id.* at 145.

164 *Id.*

165 *See id.* at 146.

barriers separating challenger firms from the Big 4 and reduce concentration in the market.[166]

According to the Big 4 and their largest clients, a joint audit regime could significantly increase audit costs and lead to gaps in responsibility between the two auditors.[167] BDO, one of the challenger firms, also opposes the joint audit proposal because it could serve to "lock in" challenger firms as the minority party.[168] It fears the initial imbalance in power between the Big 4 auditor and the smaller joint auditor would further reinforce the dominance of the Big 4 in the audit market. Despite these and other concerns, the CMA believes that mandated joint audits present a proportionate and effective remedy for increasing competition and company choice in the U.K. audit market over time.[169]

Notwithstanding the feasibility of this regulatory suggestion in the U.S. system, the U.K.'s analysis nonetheless provides a useful benchmark by which to reevaluate the U.S. audit market. While the GAO's 2008 report identified many of the same features and issues raised by the CMA in 2018, the CMA found these issues far more concerning and proposed significant regulatory measures to respond to the dangers they posed. By conducting an updated analysis of the U.S. audit market with a particular focus on the adverse effects of concentration as identified by the CMA, U.S. regulators will have far better information at their disposal when assessing risks to their own audit systems. It is possible that a U.S. report, using the same methods as the CMA, will reach an entirely different threat assessment than did the CMA. But that assessment would, at the very least, be informed by relevant and contemporary data and therefore do more to put investors' minds at ease.

2. Resilience

Another major concern of the CMA is the potential for one of the Big 4 to fail, leading to further market share concentration among the remaining "Big 3" firms. The CMA's report found that a "Big 3" market would be unsustainable, and would likely lead to further audit quality decline.[170] According to Deloitte's response to the CMA's request for comment, "[T]he withdrawal or failure of a Big Four firm could be catastrophic for the market."[171] The CMA considered two adverse effects that may stem from a

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166 *See id.*

167 *Id.* at 149.

168 *Id.* at 148.

169 *Id.* at 167. This conclusion is bolstered by the success of a joint auditing regime for large companies in France. *See id.* at 150.

170 *Id.* at 95–96.

171 *Id.* at 97 (noting that PwC also commented that a potential collapse would increase audit risk and could negatively impact audit quality).

potential Big 4 failure: a further restriction of auditor choice and a constraint on regulatory enforcement for fear of causing a collapse.

The first effect addressed by the CMA is the potential aggravation of the existing lack of auditor choice. Because most FTSE 350 companies already face three or fewer choices for auditors, the loss of one of the Big 4 "would clearly exacerbate these problems."[172] Although the GAO's report expressed little concern about concentration among four large firms, it did recognize that the failure of one of the Big 4 could artificially inflate audit fees and cause a host of other negative market effects.[173] Despite these risks, the GAO made no additional recommendations for mitigating these risks aside from reiterating that the SEC and other regulatory agencies could take reactionary measures after such a collapse.[174]

The CMA's analysis concluded that although "[r]ecent experience suggests that the Big Four firms are resilient," even a small risk of such a catastrophic failure merits concern on the part of regulators.[175] The Big 4 generally agree that reputational damage resulting from large lawsuits or enforcement actions creates the biggest risk to an audit firm's sustainability.[176] In their response to the CMA, the Big 4 specifically pointed to the SEC's enforcement action against KPMG for its 2005 tax shelter fraud as an example.[177] Although the CMA agrees with the GAO that reactive measures by regulators could help mitigate concentration in the event of a Big 4 failure, it ultimately concluded that such measures are not sufficient to cover all forms of concentration that may occur.[178]

The CMA also considered whether concerns about a possible Big 4 collapse prevented regulators from adequately punishing poor quality and bad behavior by audit firms. The report concedes that a well-functioning audit market requires both sufficient choice and effective regulators that can "take action to tackle poor quality."[179] If regulators are unwilling to allow firms to fail, they risk creating a moral hazard that will weaken the incentives of poorly performing firms to improve the quality of their audits.[180] Stakeholders in the U.S. audit system share these concerns.[181]

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172 *Id.* at 96.

173 *See* U.S. GOV'T ACCOUNTABILITY OFF., *supra* note 21, at 34–36.

174 *See id.* at 36–37.

175 *See* COMPETITION & MKTS. AUTH., *supra* note 102, at 97–98 (pointing to the collapse of Arthur Andersen to support this conclusion).

176 *See id.* at 98.

177 *Id.*

178 *See id.* at 127–28.

179 *Id.* at 99.

180 *Id.* at 99–100.

181 *See supra* Section I.B (discussing "too big or too few to fail" concerns in the United States).

As for the United Kingdom, some commentators to the CMA's report called the Big 4 "too big to fail."[182] Another response stated that due to resiliency concerns, "the profession is likely to escape censure from either the government or regulators."[183] Two members of the Big 4 and the FRC disagreed with this characterization. The FRC noted that "firm failure was more likely to be triggered by litigation or a more general loss of reputation or confidence, rather than directly as a result of regulatory action."[184] Ultimately, the CMA found insufficient evidence to prove or disprove the "too big to fail" theory.[185] It did, however, note that Big 4 resiliency concerns could become more significant to regulators in the future "[i]f the FRC or the new regulator is under greater pressure to exercise its inspection or enforcement powers."[186]

The CMA's preferred remedy for resiliency concerns would require the audit regulator to "monitor the health of the audit practices and have powers to intervene when necessary."[187] As part of these new responsibilities, the regulator would oversee each Big 4 firm in the creation of detailed contingency plans to be used in the event of their distress or collapse.[188] If such a collapse were to occur, the regulator would be empowered to intervene directly. The regulator could alleviate concentration concerns by transferring the failed firm's clients to a newly established firm, a non-Big 4 firm, or by keeping them with the same firm while a turnaround is implemented.[189]

Interestingly, similar proposals have been offered in the United States. After the 2008 financial crisis exposed weaknesses in the U.S. banking system, the Dodd–Frank Act required certain key financial institutions to craft "living wills."[190] These documents create concrete plans that can be used to guide other banks and regulators in the event of their collapse.[191]

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182 COMPETITION & MKTS. AUTH., *supra* note 102, at 100.

183 *See id.* (quoting ATUL SHAH, BRIAN LITTLE, PAUL MOORE & RICHARD MURPHY, "EXPERT" PUBLIC-INTEREST RESPONSE TO CMA INVESTIGATION OF AUDIT COMPETITION 3 (2018), https://assets.publishing.service.gov.uk/media/5c094b0fe5274a0b55a14924/professor-atul-shah-mr-brian-little-mr-paul-moore-and-professor-richard-murphy-statutory-audit-invitation-to-comment-re.pdf [https://perma.cc/E8XQ-6NFU]).

184 *See id.* at 101.

185 *See id.* at 97–98.

186 *Id.* at 101.

187 *Id.* at 177.

188 *Id.* at 178, 181–82.

189 *See id.* at 178 (explaining that any of these methods could be used to achieve the outcome of preserving competitive levels depending on the particular circumstances surrounding the distress or failure of the Big 4 firm).

190 *See* Harris on Audit Concentration, *supra* note 16.

191 *Id.*

Steven B. Harris, a former board member of the PCAOB, suggested in 2017 that the PCAOB should require these "living wills" from the Big 4 as well.[192]

By gathering more information and creating detailed contingency plans, regulators will not only be more prepared to facilitate a smoother transition in the case of a Big 4 collapse, but they will also face less pressure when taking action against a firm for poor audit quality or rules violations. With better information, regulators will have a better sense of how far they may go without risking collapse, and they will be better able to weigh the benefits of serious enforcement actions against the expected risk and effects of a Big 4 collapse.

3. Advisory Services and Firm Incentives

The final audit market issue considered in the CMA report arises from audit firms' increasing focus on advisory and nonaudit work. In 2018, the CMA found that nonaudit services accounted for 79% of total Big 4 revenues.[193] Nonaudit activities also had a higher margin and generated a greater proportion of total profits than auditing services.[194] From 2011 to 2018, audit partners as a percentage of total partners at the Big 4 fell from 22% to 19%.[195] While challenger firms also generate a majority of their revenue from nonaudit services, such firms on average rely comparatively more on audit services and partners than the Big 4.[196] Unlike audit services—which require independence, diligence, and objectivity on the part of the firm on behalf of shareholders—nonaudit services are intended primarily to provide a service directly to the client.[197] Any cross-pollination between these two diametrically opposed objectives threatens to corrupt effective auditing relationships.

Like in the United States, concerns in the United Kingdom about the Big 4's nonaudit services used to be focused on their cross-selling to companies that the firms also audited.[198] Both countries have since implemented restrictions against such arrangements to avoid these direct conflicts of interest.[199] Concerns about nonaudit services are now generally

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[192] *Id.* (clarifying that the "living wills" requirement for the Big 4 was first suggested in a report generated during the Bush administration by the Treasury Department's Advisory Committee on the Auditing Profession). Harris also favored the Committee's recommendation that the Big 4 annually publish their own audited financial statements.

[193] COMPETITION & MKTS. AUTH., *supra* note 102, at 33.

[194] *See id.* at 102, 105.

[195] *Id.* at 105.

[196] *See id.* at 107.

[197] *Id.* at 102.

[198] *See id.*

[199] *See id.* at 22, 102; *supra* Section I.C.

focused on more indirect effects that may lead to dangers within the incentives or culture of the Big 4.

The CMA identified four reasons why the dominance of nonaudit services in audit firms is still likely to adversely impact audit incentives: (1) audit partners "share in the profits earned by non-audit services,"[200] (2) firms "use . . . the expertise of audit partners to help sell non-audit work to other clients,"[201] (3) firms encourage a single shared culture among all employees that blurs the lines between the public interest purpose of audit and the profit-based purpose of nonaudit services,[202] and (4) the rules against providing audit and nonaudit services risk further limiting choice and competition in the audit market.[203]

While the CMA report focuses primarily on the dangers of nonaudit services, it does acknowledge that the firms' nonaudit work may also generate some positive externalities for their audit wings. The money brought in by nonaudit services may be used across operations to attract high-quality staff, provide valuable training, and invest in technology within the audit department.[204] Auditors are also able to call on the expertise of their nonaudit colleagues more cheaply than if they had to contract with a third-party organization, which may reduce the overall cost of audits.[205] The profits generated by nonaudit services may also increase the Big 4's self-insurance capabilities, thus reducing concerns about the Big 4's resiliency.[206] But the CMA does recognize that these benefits must be balanced against the significant long-term dangers that nonaudit services present.[207]

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200 COMPETITION & MKTS. AUTH., *supra* note 102, at 102 ("This gives them a stake in the profits of the whole business, not just the part which is focused on audit.").

201 *Id.* at 103. This process risks audit quality by drawing audit partners away from their work. Evidence also suggests that audit firms generate significant nonaudit fees from their former audit clients after their auditing contract expires. *Id.* Thus, audit partners have an extra incentive to avoid challenging management as they near the end of an audit relationship for fear of harming the opportunity to pick up new nonaudit work.

202 *Id.* ("Despite statements by the firms that audit remains core to their business and on the importance of reputation of the firm in delivering high quality audit to the brand, audit appears to have a relatively weak voice within these firms in driving culture and values.").

203 Firms may choose not to bid for audit work if they can get current or future nonaudit work instead, which reduces the number of auditors available to companies. The availability of nonaudit work when a firm loses an audit contract will also serve to generally soften competition between firms for audit clients. *Id.* at 103–04.

204 *Id.* at 104, 118 (weighing these benefits against the cost of drawing auditors' focus away from audit quality and raising barriers for potential audit-only firms "because they would not be able to replicate the cost transfers within the multi-disciplinary model").

205 *Id.* at 118.

206 *See id.* at 121, 124.

207 *Id.* at 104.

After considering the firms' profit breakdowns, governance policies, and overall cultures, the CMA found that the effect of nonaudit services was "to dilute the focus on delivering high quality audit[s]."[208] Despite pushback from the Big 4 to the conclusions of the CMA report, "the firms have themselves acknowledged that their current internal controls and governance structures are in need of change."[209] The FRC's own review of audit culture reached the same conclusions about potential adverse impacts to audit caused by the growth of nonaudit services.[210]

To address these dangers, the CMA recommended that the Big 4 institute "a strong strategic and operational split between their audit and non-audit" practices.[211] In particular, the CMA recommends a split between audit and nonaudit services that requires firms to (1) prohibit profit sharing, (2) produce separate audit practice financial statements, (3) institute transparent transfer-pricing procedures for nonaudit specialists used for audits, (4) appoint a separate CEO and independent board for the audit practice, and (5) establish separate pay and promotion policies for the audit practice tied to audit quality metrics.[212] As challenger firms grow in size, they would become subject to the same procedures.[213]

The FRC adopted this suggestion and told the Big 4 in 2020 that it expects them to have separated their audit divisions from their other operations by June 2024.[214] The CMA and FRC seem to recognize that this split will place significant costs and strain on the Big 4, but the corresponding improvements to audit quality and competition justify a drastic regulatory step. The CMA chose not to require legal separation to avoid tax implications and operations reorganization, but the separation will still require significant regulatory monitoring to ensure success.[215]

Much like the requirement of joint audits, this remedy would likely be seen as extreme in the United States. Nonetheless, the United States should monitor the implementation of this policy very closely. The lessons learned during the separation process will be invaluable if the United States chooses to craft its own policy for limiting the dangers of mixing nonaudit and audit practices at the Big 4. This could entail providing for stronger internal

[208] *Id.* at 117.

[209] *Id.* at 123.

[210] *See id.*

[211] *Id.* at 187.

[212] *See id.* at 187–88.

[213] *Id.* at 187.

[214] *See* Rob Davies, *UK's Big Accountancy Firms Told to Split Off Audit Arms by 2024*, GUARDIAN (July 6, 2020, 5:57 AM), https://www.theguardian.com/business/2020/jul/06/uk-big-four-accountancy-audit-frc-kpmg-pwc-deloitte-ey [https://perma.cc/4UYY-Q3JU].

[215] *See* COMPETITION & MKTS. AUTH., *supra* note 102, at 197.

controls between the two divisions or a partial separation that incorporates pieces of the U.K. policy.

Regardless of how the United States proceeds, collecting further data on the dynamics of its own audit market through stakeholder surveys and culture assessments will allow it to weigh the costs and benefits of implementing any sort of U.K.-style separation measures more effectively.

CONCLUSION

A strong and independent financial auditing system reduces informational risks to investment and promotes an active capital economy. The effectiveness of audits, however, only extends as far as stakeholders' trust in the health of the audit system. The existence or appearance of flaws in an auditing system will gradually erode the investing public's trust to the point where the informational benefits generated by financial audits are no longer justified by their significant costs.

Current trends in the U.S. audit market, including concentration among the Big 4 firms and the growth of nonaudit services, have led to investor and regulator concerns about the long-term health of the financial audit system. The extent to which new substantive policies are necessary to address these concerns remains an open question, but the more pressing matter is that no one seems to have the data necessary to effectively answer that question.

The United Kingdom's recent comprehensive review of its statutory auditing system should serve as both a warning and a roadmap for U.S. regulators. The CMA report discusses dangerous and flawed features present in the U.K. audit system that could well be threatening the U.S. system too. U.S. regulators should take the United Kingdom's findings seriously and use them to guide a similar investigation into the health and effectiveness of their own audit system. U.S. regulators should further monitor the effectiveness of resulting U.K. regulations to determine the potential effects of similar measures in the United States, should they become necessary.

Whether these actions reveal serious deficiencies in the U.S. audit system, or they find no cause for concern whatsoever, the data produced will nonetheless allow for relatively more-informed regulatory decisions. When regulators can point to concrete data for their conclusions, stakeholders will grow more confident in the system, which will in turn increase the overall utility of the audit system in promoting valuable economic activity.