To split or not to split – should auditors sell non-audit services?

The question of whether audit firms should be able to sell non-audit services has been a topic of some debate recently. The Competition and Markets Authority (CMA) raised the issue in its recent consultation document, 'Statutory Audit Market – Invitation to Comment'.

Arguments against splitting

The CMA identified a number of problems, some real, some perceived, in obliging audit practices to divest themselves of their consultancy businesses, including:

• The international nature of many large audit firms, which would make it impossible to force audit firms to split their audit and consultancy practices in overseas territories.
• The possibility that it might reduce audit quality if specialist in-house non-audit staff were not as easily available or as skilled in advising the audit teams on complex issues. UKSA and ShareSoc believe that this is a weak argument.
• The claim that it could reduce audit quality if it made it harder to recruit high-quality staff into audit-only firms. It is a damning reflection on the state of audit that it has come to be seen as such a dreary backwater that good recruits can only be enticed into it with the offer of a future escape route into consultancy.
• The concern that it could affect the mid-tier audit firms more than the Big Four, as the former are less likely to have the scale and resource to employ in-house specialists in an audit-only firm.
• The fact that audit-only firms might become more financially dependent on their large audit clients, which could impair their independence.

Muddied waters

Interestingly, KPMG recently announced that it was going to stop doing non-audit work for audit clients. Deloitte added its support for the idea of banning all non-audit services to FTSE 350 audit clients. However, such a move can only serve to reduce choice and competition in the audit market. No audit firm is going to dump its consultancy work with a non-audit client just so that it can bid for the audit contract. This proposal, if implemented, could mean that many FTSE 100 companies would be left with just three potential audit providers at most – one of whom would be the incumbent. The CMA notes this problem as well. The sudden promulgation of the idea by some of the audit firms suggests a pre-emptive strike to head off calls for a more fundamental division of their businesses.

We have heard assurances from some quarters that there is really no need to worry about this particular issue because current rules governing the provision of non-audit work to audit clients are so draconian and so well prescribed that auditors are prohibited from providing any consultancy (or non-audit work) to audit clients. You can read the full text of what is supposed to be allowed and not allowed in the FRC's 'Revised Ethical Standard 2016'. This link will take you to it:

While this document is long on things that can't be done by auditors, it is notably silent on things that, presumably, can be done – such as strategic planning, marketing planning, new product development, business reorganisation and a number of other popular areas of consultancy which can be very lucrative. The constraints on advising on implementation of major IT projects seem to contain many 'grey' areas. Most areas of M&A work seem to fall within the scope of things an audit firm can provide to an audit client.

Arguments for splitting

Those who have worked in consultancy (which includes Cliff Weight and me) will be familiar with the culture and know that as a consultant you are always selling. Consultancy is project-based; having sold one project you have to sell another (and another) to ensure a flow of new work to feed the business. This might be an extension to an existing project or a completely new project. It is also good if you can get a referral to a new client. To be effective at doing this you need to build close working relationships with the executive management team within the client company. It pays not to upset them. As they say, 'he who pays the piper calls the tune'. As a consultant you tend to go along with whatever the client wants. It is a case of just helping them to do it a bit better.

Contrast this with the culture that you need in an audit practice. Detachment, objectivity and professional scepticism are all things that one might consider to be important. Added to this is the need to understand that, while the client company may be paying you, you are actually supposed to be looking after the interests of the shareholders. With a ten-year audit contract there is no need and no justification for constantly trying to sell more to the client. Any pressure to pass leads to the consultancy side of the business represents a clear conflict of interests.

From an ethical point of view, consultancy and audit do not sit well alongside each other. The culture required for success in each case is fundamentally different. The measures of success should also to be different. Growing revenue by keeping the client happy is not an appropriate measure of success for an auditor. Unfortunately, the likelihood that the consultancy culture will assert itself within any firm providing both consultancy and audit is very real and is potentially damaging and dangerous.

Here is one last point to ponder on. It is not always clear whether the large global firms are auditors with a consultancy sideline or whether they are really consultants with an audit sideline. Looking at the 2017 results for two of the largest firms is revealing. Ernst and Young, for example, had UK revenues in 2017 of £2.35 billion, of which £689 million was accounted for by assurance (audit) services. PWC had UK revenues of £3.8 billion, of which assurance accounted for £1.3 billion. For these two firms true audit work accounts for 25-30% of total UK revenue. Given this level of dependence on consultancy work, what sort of culture do you think is likely to prevail?