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Reported SEC probe of Big Four taking page from U.K. breakup plans?

By Neil Hodge | Wed, Mar 30, 2022 7:00 PM

The U.S. Securities and Exchange Commission (SEC) is investigating whether it should prevent audit firms—namely, the Big Four—from cross-selling consultancy services to audit clients to preserve audit independence, according to a report published by the *Wall Street Journal* earlier this month.

The SEC has not publicly commented on the reported probe. However, Gurbir Grewal, director of the agency's Division of Enforcement, warned in December that audit firms could face increased scrutiny and see steeper penalties for repeated auditor independence violations "when historical penalty amounts are not having the desired effect."

"You will see us really ratcheting up—where appropriate—penalties so they do have that desired deterrent effect, particularly in these auditor independence cases because there is almost a static penalty amount and it is sometimes viewed as the cost of doing business," Grewal said, according to ***Bloomberg Tax***.

The SEC has had concerns over auditor independence and objectivity for some time, especially as the Big Four—Deloitte, EY, KPMG, and PwC—have continued to increase fee income from nonaudit services. If the regulator is considering taking a stronger approach to ensure auditor independence, it is likely examining recent developments in the United Kingdom closely.

In July 2020, the U.K. Financial Reporting Council (FRC) **unveiled its principles for operational separation** of the audit practices of the Big Four firms. Under the plan, the largest auditors have until 2024 to split their operations.

The objectives of the **FRC's plan** are to put stakeholder concerns and audit quality ahead of profits, as well as "ensuring that no material, structural cross subsidy persists between the audit practice and the rest of the firm."

The FRC wants firms to have an “arms-length” relationship between the audit practice and the rest of the firm so the audit practice does not receive fees for opening the door to consultancy work for other parts of the business. Audit partner pay should also be aligned to audit fee revenue and audit quality.

The regulator also wants firms to publish separate profit and loss account statements to show revenues from audit work account for at least 75 percent of the total.

While the FRC described its reforms as “world-leading,” it is still hard to tell what kind of impact they are having as the U.K. audit sector transforms itself.

Julie Matheson, regulatory partner for accounting services at law firm Kingsley Napley, said it is too early to judge the regime’s effectiveness.

“Given the changes were brought in relatively recently, and that operational separation will not be fully in place until 2024, any positive effects will not be obvious for some time,” she said.

Views are mixed as to whether the decision to split audit and consultancy work will necessarily improve audit quality and corporate governance or open the market up to audit firms outside the top tier.

In the United Kingdom, mid-tier audit firms have expressed reluctance to pitch for FTSE250 clients given increased regulatory and public scrutiny following high-profile accounting scandals and audit failures at the likes of infrastructure company **Carillion** and supply chain finance firm **Greensill Capital**, both of which collapsed.

Andrew Collier, director of quality and professional standards at international accountancy and advisory network Kreston Global, says such firms “are now focusing to a greater extent on managing the risk of corporate failure arising from clients,” with the result that some firms “have chosen to not continue to act for some of them.”

Matheson said the Big Four “may think carefully about whether there will be a greater revenue stream from carrying out the audit of a company or from declining to tender for the audit work and focusing instead on consultancy opportunities which may arise.”

Operational separation might also present a golden opportunity for consulting firms that do not have an audit function “as they can focus on harvesting the consultancy opportunities, which the Big Four may have to pass up.”

Matheson believes the SEC "may keep a watching brief" on the U.K.'s reforms before deciding upon whether it wishes to follow the same model. "If the scheme works as intended, it will certainly minimize lack of independence issues," she said.