

Sharpening the Thinking about Competition and Choice in the UK Audit Industry

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Executive Summary

This policy paper contributes to the public discussion facilitated by the Financial Reporting Council (FRC) concerning levels of competition and choice within the UK audit market. It specifically responds to the Oxera report that launched the debate, and applies economic theory to the complexities of the audit market to make two key points: that the notion of a “Big Four” is a mirage; and that the audit market *is* competitive (regardless of concentration or switching rates). Despite this the paper suggests broad institutional reforms that could make the market function more smoothly: permit cross-ownership; reduce the geographical basis of regulation; relocate the burden of large-scale risk; and pursue measures to get company information into the public realm.

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Introduction

Following the publication of “Competition and choice in the UK audit market”¹, the Financial Reporting Council (FRC) has hosted a public discussion for industry stakeholders intending to understand and address potential problems highlighted in the report. This policy paper intends to add to this debate by providing an overview of the UK audit market as it currently stands, and assess whether the FRC and the Department of Trade and Industry (DTI) should be concerned. In particular, it is important to look beyond the caricature of “a four firm industry” and tussle with the difficulties of defining and analysing the nature of large and complex firms operating in a global market.

The central theme of this paper is to question the causality between regulatory involvement and levels of choice and competition. Rather than treating consolidation as being the result of free markets and intervention as being a possible solution, several points will be made to support the view that increasing market concentration is inherently linked to recent increases in financial reporting standards, and therefore a relaxation of regulatory control is the best bet to deliver competition and choice.

Analysis

The paper does not intend to offer a single solution, because the inherent complexity of the audit market means that there is no “bottom line” or quick fix. On the contrary there are many factors at play, and their combined effects are hard to trace. Therefore several distinct issues will be discussed and the arguments can be judged on their own merits. Although together they represent a consistent view that markets work best when they’re free from regulatory intervention, one needn’t accept the entire collection to consider the worth and implications of each separate point.

1. The Mirage of a Big Four

¹ “Competition and choice in the UK audit market” *Oxera*, April 2006

The chief difficulty for any traditional measure of competitiveness is defining the market and the product. For the UK audit industry this is somewhat eased by the clear and straightforward end product: an audit. Indeed as a result of existing legislation audits are uniform and therefore firms appear to offer a standardised product. However the definition of the market is less obvious, and therefore open to manipulation. The “Big Four” (Deloitte & Touche, Ernst & Young, PriceWaterhouseCoopers (PwC) and KPMG) audit 99 of the FTSE100, and collect 99% of audit fees of the FTSE350. But this isn’t “the market”, since *all* publicly listed firms are required to be audited, and the FTSE100 and FTSE350 represent just a small share of the total number. Consequently concerns about high levels of market concentration *must* redefine the market from “UK firms requiring audits” to “Large UK firms requiring audits”, where “large” is somewhat subjective².

This suggests that the whole debate regarding “the UK audit industry” is fundamentally ill defined: we are only analysing a particular section of the UK audit *market*, applying to a relatively small number of firms with relatively high turnover. Although this doesn’t detract from the implications of a lack of choice, it does demonstrate a bias in the framing of the debate – it is only the *top end* of the UK audit industry under analysis.

This clarification is important because if the market *is* segmented (i.e. if the issue of competition and choice applies only to the top end of the auditing industry), then this implies that the product (an audit) might not be the same after all. When a Big Four firm performs an audit for a FTSE100 company, and a mid-tier firm performs an audit for an AIM company, on the surface it seems that both are supplying the same service. However if we acknowledge that a market imperfection might occur in the former but not the latter we have two separate markets and therefore two separate products – it’s simply incorrect to assume that “an audit” is the same product regardless of the size of the company being audited.

² This point was made in “Discussion Paper: Choice in the UK Audit Market” *Financial Reporting Council* May 2006

Indeed evidence produced by Oxera takes this point even further by looking at the concentration rates *by sector*.³ The results further demonstrate the mirage of the Big Four by showing how certain sectors of the FTSE350 have different concentration rates. For example Ernst & Young are barely involved in “Construction” and Deloitte have an almost unnoticeable presence in the “Insurance Companies” sector (indeed a “Big Four” doesn’t even exist since Mazars has a larger market share than Deloitte).

Therefore it is erroneous to compare audits in the traditional manner – there is simply no reason to assume that the product being analysed is “an audit”. Such a definition is simplistic and inaccurate. According to the Oxera report audit committees from FTSE100 companies acknowledged that mid-tier firms might be technically capable of performing an audit, but issues of reputation and risk-aversion meant they’d “play it safe” and stick to one of the a Big Four. And since audit committees have better knowledge of Big Four firms than mid-tier, Oxera infer that there’s scope for correction:

“Overall, audit committee chairs seem to have a relatively poor knowledge of the mid-tier firms, which contrasts with the perceived good knowledge of the Big Four. This suggests that the differences noted by the audit committee chairs between the Big four and the mid-tier firms are to some extent based on perception rather than fact⁴

This implies a market inefficiency similar to a Keynesian Beauty Contest, and justifies intervention to make all sides gain by returning to fundamentals – i.e. force them to choose technical competency ahead of signalling and grandstanding. But as we’ve seen, comparing a Big Four audit with a mid-tier audit is *not* comparing like to like. The two are *not* close substitutes and therefore auditing committees are simply responding rationally to their quality requirements. The fact that committee chairs know more about Big Four firms than mid-tier has two explanations: one that rests on the bizarre assumption that chairs make decisions based on perception rather than facts, or, alternatively, that different types of audits aren’t close substitutes and therefore expecting committee chairs to have as good knowledge about mid-tier firms as they do Big Four is akin to expecting the England football manager to spend as

³ See Oxera, Fig. 4.5 p. 64

⁴ Oxera p.39

much time scouting rugby players as he does footballers. In brief, a Deloitte audit might be very similar to a PwC audit, and a Grant Thornton audit might be very similar to a Baker Tilly audit, but because Deloitte and PwC, and Grant Thornton and Baker Tilly operate in different markets, they're respective services aren't close substitutes. Therefore we're not talking about an *industry* with high concentration, but a *market* with high concentration, and they are two very different things. This "mirage of the Big Four" explanation is corroborated by a recent report by the Audit Inspection Unit (AIU) that is critical of the audit quality provided by mid-tier firms (also known as "Other Significant firms"):

"The level of resources available to other Significant firms, though generally appropriate to their size and market focus, is significantly less than those available to the Big Four firms"⁵

As always, the claim that individuals are behaving irrationally is as empirically invalid as it is intuitively unsound, and once we accept that people are responding rationally and efficiently the case for intervention changes dramatically. The role of regulator is not to alter legislation in a hands-on manner to "correct" market outcomes, but to make more foundational changes to the rules of the game, and ensure that perversions that currently exist are not down to existing (and unnecessary) regulations. It is to avoid interaction with the players, and instead focus on building a stage upon which those (sensible) players can compete fairly.

2. *The Audit Market is Competitive*

In claiming that the Big Four is a mirage two points are being made. Firstly, that the Big Four is only applicable to a subsection of the UK audit industry. And secondly, that within that subsection of FTSE350 companies concentration rates differ wildly by sector. Therefore the convenient depiction of an audit market dominated by four firms is a caricature. In order to appreciate why such a caricature is intuitively plausible, it's important to comment on the economic theory behind competition since this is the root cause of the crude and inaccurate misunderstanding of what constitutes competition.

⁵ "2005/6 Audit Quality Inspections" *Audit Inspection Unit* July 2006

2.1 Concentration is irrelevant

A pervading assumption throughout much economic analysis is that competition can be measured by the degree of market concentration: that the market share of leading firms indicates the competitiveness of the market. It's therefore appropriate to question whether this assumption is valid, because if it isn't then much of the concerns about the UK audit market will be misplaced. In his history of the economic meaning of the term "competition", McNulty makes a distinction between "*Competition as a market structure and competition as a behavioural activity*"⁶. He points out that competition used to mean in economics what it means in common English – the attempt to outdo one's rival. It is only relatively recently that competition has come to mean something else entirely – a certain hypothetical market state characterised by many buyers and sellers, homogenous products and free entry/exit. Accordingly the Oxera report makes great efforts to demonstrate the concentration rates of the audit market under the assumption that high concentration means low competition. But surely investors and the general public want a competitive market, rather than the textbook definition of a competitive market *structure*, and therefore the term "competition" should be measured by behavioural activity. Wagner underlined this point by explaining the difference between competition as an *adjective* (a static state of affairs), and competition as a *verb* (a rivalrous process)⁷. The Oxera report does an excellent job at showing how uncompetitive the UK audit market is (for FTSE350 firms) if we consider "competition" to be an adjective. But if we see "competition" as a verb (i.e. how it's used in ordinary language so that it captures the reasons *why* a market process is considered to be good for consumers), then levels of concentration are irrelevant. Rather, we must investigate the degree to which Big Four firms attempt to outdo their rivals – how they engage in competitive behaviour.

2.2 Switching

⁶ P.J McNulty "Economic Theory and the Meaning of Competition" *The Quarterly Journal of Economics* (1968) Vol. 82 No.4 pp.639-656

The Quarterly Journal of

⁷ Richard E. Wagner (2001) "Competition as a Rivalrous Process: Attilio da Empoli and the Years of High Theory that Might Have Been." *Journal of Economic Studies* Vol. 28 No. 4/5 pp.337-45

The competitiveness of the UK audit industry using this alternative (and more straightforward) definition can be judged by looking at how auditing firms react to potential new business. The more they fight each other to secure new clients, the more competitive they're behaving. According to the Oxera report new business (tenders) *are* indeed competitive: “*tendering does indeed allow competition, and can lead to switching*”⁸. Although tenders – when they occur – are competitive, it *is* also important to look at the frequency with which they happen. But even if switching rates are low, this doesn't automatically make the market uncompetitive. Oxera explain the low rate of switching due to:

“the fact that the relationship between companies and their auditor is, by nature, long-term... and that switching is a costly process”⁹

But neither of these factors justifies the conclusion that low switching rates reflect a lack of choice, since neither contradicts the common-sense view that low switching rates imply customer satisfaction! If we're defining competition as a verb rather than an adjective, it's wholly consistent for a competitive industry to have few firms and stability – it implies that those firms are producing efficiently (potential rivals are unable to out-compete them) and satisfactorily (since customers decide not to switch). But despite this somewhat obvious explanation being ignored, Oxera fail to satisfactorily argue that long-term relationships or high costs to switching are inherent signs of an uncompetitive market. As long as contracts are voluntarily made, potential costs of switching can be factored into initial agreements: the costs are common knowledge. In fact the presence of high switching costs suggests that companies expect to be *highly* satisfied with the relationship they'll develop with their auditor, because it would be irrational to commit to such an association if you suspected that it won't work out.

To apply these claims to the real world requires evidence about the thought process behind company decisions to switch between auditors, and also their decisions to stick. Oxera produce a small survey (fifty respondents) to assess what factors might trigger switching¹⁰, but – critically – this only provides counterfactual evidence. This

⁸ Oxera, p. 42

⁹ Oxera, p. 45

¹⁰ Oxera, Fig. 3.11, p. 45

creates a major limitation because we'd *expect* audit committees to want greater choice (who doesn't?), and since the responses are hypothetical they cannot be assumed to accurately depict the real state, and how respondents would *actually* behave if those conditions arose. They are an indication, but only an indication.

To truly understand whether low switching stems from choice or necessity multiple interviews are inappropriate. Instead we require detailed case studies of the unique events where switching has (or hasn't) occurred - where a firm desires to switch and succeeds, or attempts to switch but fails. To test this claim I performed a focused interview with the CEO of a listed UK company, which switched from a Big Four auditor to a mid-tier in 2000.¹¹ The firm in question subsequently transferred from the main-market to the AIM, with both decisions down to the changing needs of the business. Rather than viewing their Big Four auditor as an indispensable reflection of their reputation, it voluntarily recognised that a mid-tier auditor was capable of a better service (a higher degree of specialised knowledge, more attention to the client, and at a lower price) – a decision made as a simple calculation of whether an image was worth the cost. Therefore the decision to switch from Big Four to mid-tier was seen as a *positive* thing because the company in question (at <£50m market capitalisation) was domestic and loss making, and therefore didn't require the foreign expertise or tax knowledge that a Big Four firm would possess. For this case at least, switching was in keeping with fundamentals, was possible, and was well received by investors.

Also of interest are the conditions that might make this company switch *back* from the mid-tier auditor to one of the Big Four. According to the CEO their mid-tier auditor struggled to help with a US acquisition, requiring a reciprocal relationship with a US firm. So any decision to switch back would be dependent on the future acquisitions (i.e. the complexity of their operation). Again, this is in keeping with the view that companies aren't forced to select an auditor through lack of choice, but simply select the most appropriate firm for the task. For this particular firm (being outside the FTSE350) the Big Four is a myth, further demonstrating that the so-called "audit industry" under investigation is far narrower than is often assumed.

¹¹ Private interview conducted Tuesday 25th April 2006

This analysis fails to hold, however, if companies *are* hiring an auditor unwillingly. But for this to be the case we've strayed from the operations of competing firms within a market economy, and instead there must be an intervening power that is restricting competition. Since (by definition) this has to come from outside of a free market it can only be the result of state intervention, and therefore further intervention as a solution would be akin to curing third-degree burns with fire. Having said that the auditing industry clearly requires some form of regulatory system, and this will be discussed in more depth later.

3. *The Real Reason for Rising Fees*

Whilst economists might fret about abstract terms such as competition and choice, for the consumers of auditing reports (i.e. shareholders) the only concern is the real effects on price and quality. The Oxera report explicitly confesses to ignoring any issues of auditing quality (although the AIU's recent report partially fills that gap¹²), but it does wade into the issue of prices. Indeed one of the key findings of the report is that:

“Oxera has found evidence that higher concentration has led to higher audit fees”¹³

Unfortunately this is deeply misleading, since Oxera's own evidence suggests the opposite. Their justification lies in an econometric study that demonstrates correlation and not causation – i.e. they show that increasing concentration has coincided with higher audit fees, but not that one has caused the other.¹⁴ Alternatively a third factor may have caused both, for example the introduction of new standards. It is well known that regulation raises the cost of doing business, and therefore favours larger firms who can spread that cost over more customers. As Oxera acknowledge, therefore, increases in fees might be the result of market power by Big Four firms, or due to increases in costs associated with new auditing rules. So we have two competing explanations: either the Big Four are becoming increasingly concentrated

¹² see footnote 5

¹³ Oxera, p.i

¹⁴ In fact this claim can be questioned because increases in fees have been far from uniform across the industry.

and using their market power to charge higher fees, or new auditing rules are causing an increase in concentration *and* an increase in fees.

There are two reasons why the second explanation (higher fees due to new standards) should be favoured. Firstly it is consistent with the fact that there *have* been new accounting rules introduced over this time period. The first explanation (higher fees due to market power) fails to explain this – effectively it assumes that the new standards are effortlessly absorbed and don't raise the costs of performing an audit. The second reason this explanation should be favoured is because it's supported by the evidence contained within the Oxera report. The audit fee is split into two components – hourly rates and time taken – and this offers a handy measure of whether market power or new standards are causing the increase in fees. If a firm had a degree of monopoly power it would increase its hourly rate, rather than the time taken to perform an audit. Put simply it's more favourable to earn £100 per hour than £50 for two hours. By contrast new auditing standards would make an audit take longer to perform than previously¹⁵. Therefore we can predict that market power would push up the hourly rate of an audit, and new standards would increase the time taken. As Oxera admit:

“The negotiation is usually on the number of hours required than on the hourly rates”¹⁶

This implies that the hourly rate isn't the bone of contention – it's an increase in the number of hours quoted for an audit that audit committees object to.

It may well be true that Big Four firms are simply using the new standards as an excuse, but this raises two questions: If there hasn't been an increase in the cost of providing an audit why doesn't one of the Big Four simply undercut the rest? But more importantly, where is the evidence for this being the case? Oxera may have an instinct that market power is to blame but that's not what the report supports. They've drawn the wrong conclusion from their own evidence.

¹⁵ ISA plus 240, ISA plus 260, ISA plus 300 and particularly ISA plus 315 are examples of recent requirements that increase the time taken to perform an audit.

¹⁶ Oxera, p.67

4. Sarbanes-Oxley

By claiming that market power has caused an increase in audit fees Oxera have wilfully ignored an explanation that is richer (it takes into account accounting standards) and more consistent with the facts (hours required are more contentious than hourly rates). Unfortunately this error is inevitable given that their analysis explicitly *ignores* the impact of regulation, and can only ever offer a partial explanation (and perhaps misleading one) of the UK audit industry. Simple theory predicts that the greater the changes in accounting standards, the greater the advantage of larger auditors due to disproportionate compliance costs faced by smaller companies. The new regulation will have (at least) three effects, each of which are empirically testable.

Firstly the Big Four firms receive a competitive advantage since they can absorb the extra training costs, they possess more capabilities, and their international networks are more suited to standardised regulations.

Secondly Big Four firms will be forced to spend more time dealing with larger clients, and therefore restructure their client base to concentrate on larger companies. These effects have received some degree of validation:

“the Big Four...say that they are dropping small firms because they are overworked. Their major burden reportedly is the need to help their largest clients gear up for...the Sarbanes-Oxley Act”¹⁷

And thirdly some firms will attempt to avoid the regulations, and again there is some evidence for this occurring:

“A handful of non-U.S.-based companies have chosen to de-list from the U.S. exchanges according to the *Wall Street Journal*. Their decisions have come before governance provisions like Sarbox section 404 go into effect next year for foreign-based companies that are listed in the United States”¹⁸

¹⁷ Stephen Taub “Big Four Seen Shedding Small Clients”
<http://www.cfo.com/printable/article.cfm/3217664?f=options>

¹⁸ Stephen Taub “Sarbox: Spur to Foreign-Company Flight?”
<http://www.cfo.com/printable/article.cfm/3217608?f=options>

These three effects combine to suggest that the top end of the auditing market will become *increasingly* concentrated: Big Four firms are given a competitive advantage; they shed smaller firms and therefore extenuate the top end audit market; and firms more likely to hire mid-tier auditors drop out of the market.

Perhaps the indictment of the effects of the new regulation on the industry is the declaration by the Chairman of the New York Stock Exchange (NYSE) that the planned Euronext merger *wouldn't* mean that European based companies would be subject to Sarbanes-Oxley rules.¹⁹ Regardless of whether Sarbanes-Oxley would be legally required under existing law, the lack of active sentiment that it *should* be is telling.

5. *The Boundaries of the Firm*

The difficulty with regulatory involvement is that potential solutions are limited by the extent to which they fit into the current regulatory framework. For example regulation often requires a single price for a particular good, and therefore cannot function with “two-sided” prices. Traditional means of regulations simply can't apply to industries such as credit cards²⁰. Also intervention requires a tight definition of the boundary of a firm, and therefore a whole plethora of possible market scenarios are incompatible with the remit of a hands-on regulator. The solution to the concentration rates in the UK audit market may be unobtainable because current regulatory practices - for whatever reason – forbid them.

An interesting development in the automobile industry is that Nissan and Renault-Peugeot have bought stakes in each other²¹ a phenomenon known as “cross-ownership”.

“There are many cases in which firms acquire their rivals' stock as passive investments that give them a share in the rivals' profits but not in the rivals' decision making...passive investments in rivals were granted a de facto

¹⁹ “NYSE head says Sarbanes-Oxley won't come to Europe” *Reuters* 15th June 2006

²⁰ See “Matchmakers and trustbusters” *The Economist* 8th December 2005

²¹ See “Three carmaker pile up” *The Economist* 10th July 2006

exemption from antitrust liability in leading cases, and have gone unchallenged by antitrust agencies in recent cases”²²

This poses the question of where one firm begins and another ends – we can conclude that it amounts merely to tacit collusion, or perhaps it’s a competitive means to improve quality and provide greater choice to customers. The present methodology employed by regulatory bodies would treat moves toward cross ownership with suspicion, because it superficially appears to be consolidation. However it can also be viewed as a strategic attempt for a firm to use the position of another firm to gain a foothold in a new market.

6. *The geographical basis of regulation*

The main trouble with regulatory intervention is that it’s somewhat self-fulfilling: if accounting standards are implemented to reduce bad practice but such standards actually *create* bad practice we can find ourselves in a vicious circle of deepening intervention and worsening standards. Another problem is that regulation is inherently national (since governance reflects state borders), and this might deviate the patterns of governance that stem from voluntary standards. Voluntary standards have numerous advantages over compulsory instructions, and according to Professor D.R. Myddelton:

“Compulsory Instructions concerning measurement may seem tempting in the short term, since they make it look as if someone is ‘doing something’. But laissez-faire too has advantages. Instructions have insidious effects in the longer term, which may not become fully apparent until it is almost too late to reverse the trend. Standards telling companies which accounting methods they must use can legitimise bad accounting and prohibit good accounting.”²³

If governance is removed from the anchor of a national regulator, then a major shift in the nature of accounting standards can be achieved: a global regulatory framework to reflect global markets. At present if firms are legally obliged to use domestic auditors

²² David Gilo and Yossi Spiegel (2003) “Partial cross ownership and tacit collusion” *Working Paper* <http://www.tau.ac.il/law/members/gilo/collusion19-aug-20-04-as-submitted.pdf>

²³ D.R. Myddleton (2004) “Unshackling Accountants” *Institute of Economic Affairs Hobart Paper No. 149*

then clearly choice is more constrained than if they are free to use whoever is most suitable for their business. The requirement of a domestic auditor makes no economic sense - it's purely a means to monitor firms from a legal position. If accounting standards are permitted to change organically rather than through each national government, then we might expect fewer regulations, but greater synchronisation, which expands the market to become genuinely international. This would give greater scope to the International Financial Reporting Standards to overview global practice, and could stimulate competition between different national offices of the same auditing firm.

If a company based in Ireland does most of its business in the UK it may well deem a UK auditor most suitable, however by law it's required to file it's accounts with an auditor based in Ireland. Not only does this serve no economic purpose, it can be circumvented if their auditor has an office in both countries and simply uses it's UK office to do the work, and gets the Irish office to officially sign off. Once more this practice is easier for Big Four firms to engage in, providing them with a competitive advantage. The big concern about narrow choice in the present audit industry is the conflicts of interest that arise if competing firms use the same auditor. If those firms were free to choose between foreign as *well* as domestic auditors – and different offices of the *same* auditor - that conflict would somewhat diminish and the market might become more competitive.

7. *The risk burden*

The main reason for concern over the state of the UK audit industry is down to *potential* events, and therefore we're dealing with risk. Although little evidence has been shown to indicate that the current situation is a problem, the worry is that problems *may* occur *if* something were to happen that turned the Big Four into a Big Three. Whilst this event would indeed pose serious problems regarding available choices for companies, rather than automatically conclude that “something must be done now” it's worthwhile to step back and consider how likely the scenario truly is, and whether intervention might actually *increase* the chance of it happening.

Although it's understandable for shareholders, investors and regulators to fret about "another Andersen" the biggest incentive to prevent one of the Big Four from collapsing lies with the firms themselves. If the FRC takes on the responsibility for discovering means to prevent it from happening, it implies that the firms are passively burying their heads in the sand. But in reality the Big Four recognise the potential dangers of "another Andersen" and are changing as a consequence. Before Andersen collapsed the large auditors stressed the extent of their network: they had an office in every major city and when you dealt with one branch you dealt with them all. This had the benefit of eliciting trust, assurance, and expertise in every country but also came with the risk that the entire network was vulnerable to a domino effect should problems arise. Since Andersen suffered from this, the remaining Big Four have altered their organisational structure to decentralise and therefore spread risk. This was demonstrated nicely when Chuo Aoyama - a Japanese subcontractor of PwC - was investigated for fraud charges, and rather than starting a sequence that brought down the whole company the central office quickly severed ties with the firm in question and replaced them with an alternative.²⁴ Although this case and Enron differed dramatically, the general point is valid: Big Four firms have altered their strategy to reduce the risk of "another Andersen".

It'd be impossible to expect that the lesson has now been learnt so that there's no chancing of making the same mistakes, but there's every reason to assume that the firms themselves will be more effective at reducing their exposure to such risks than if a third-party sought to do it on their behalf. This is obvious by simply looking at who loses out should an auditing firm collapse.

The main damage is done to the firm itself since their staff lose their jobs and their shareholders lose their money. The clients of that firm will come next, since they must incur the cost and inconvenience of switching auditor and building up the necessary trust, and whilst this will be a serious burden it won't be long lived. It didn't seem to take long after Andersen collapsed for it's clients to find alternatives, and new relationships have been built. Finally come the shareholders and investors who suffer from a general decline in share prices that results from a loss of confidence in the

²⁴ "PricewaterhouseCoopers to Set Up New Japan Firm After Penalty" *Bloomberg* 11th May 2006

market. Again the costs are real, but they're "fair" in the sense that investing is a risky venture. But there is another stakeholder who suffers from the collapse of the firm – the regulator who's charged with ensuring a healthy industry.

To some extent therefore there's a myth about the potential problems that arise when a large firm collapses, because the organisation responsible for preventing such a risk will (understandably) overestimate the chances of it occurring. In other words, we'd expect the regulator to be more risk averse than the general public, since if anything bad *does* happen, they'd come under fire. Aside from the effects listed previously that show how regulation can lead to increased concentration, the main problem with hosting such a debate is that the FRC sends out a signal that "another Andersen" would be seen as a disaster. This creates moral hazard because if Big Four firms expect the FRC to help manage the underlying risks, it could unintentionally make their behaviour more risky²⁵. The surest way to encourage sensible and high standard auditing is a message that malpractice will be punished in the heaviest way – collapse. While it might be valiant for regulators to assume the burden for large-scale risk, it is wrong. If firms are becoming so large that the potential harm caused by collapse is massive, the stock market would be healthier if it was in the public realm (and factored into share prices) rather than masked by the regulator. The Big Four are already actively trying to avoid the problems suffered by Andersen, and it is their responsibility to succeed.

8. *Overcoming barriers to entry: the potential for entry*

The potential costs that arise from the collapse of a large firm in a concentrated market are obviously offset if there's the likelihood of new entry.²⁶ Indeed the likelihood of new entry is critical to the issue of whether or not the industry is competitive because using the definition discussed previously the competitiveness depends on *contestability* rather than concentration. It's important to note that

²⁵ The FRC have made clear that "it is neither possible nor desirable to eliminate the risk of a firm leaving the market" ("Discussion Paper: Choice in the UK Audit Market" *Financial Reporting Council*, May 2006 p.8), however they do "consider ways to reduce the risk of a firm leaving the market" (p.7) and "consider ways to reduce the costs of uncertainty and disruption in the event of a firm leaving the market" (p.8)

²⁶ For a discussion on how, despite this, entry can be a poor substitute for rivalry see A. Geroski (1995) *International Journal of Industrial Organization* No. 13 pp.421-440

“barriers to entry” do *not* mean, “costs that rival firms must incur to enter the industry”. Clearly such costs are present for any industry, and their level doesn’t change whether a genuine barrier exists – costs are *not* barriers to entry. Rather, “barriers to entry” means non-market constrictions on competition. This difference is crucial because it dictates whether or the market is efficiently allocating resources: if a potential new entrant is unable to make enough profit to offset the costs of entry, then it wouldn’t be efficient if it entered the market. Regardless of the number of firms in the market, consumers only want ones that are profitable. Therefore some of the reasons that Oxera list as being barriers to entry (e.g. building a reputation, establishing long term relationships) are *not* genuine barriers. Although lower costs of entry do make entry more likely, they don’t imply that consumers are better off than if they were higher.

Since they confuse a cost of entry with a barrier to entry, it’s no surprise that Oxera also make a mistake with their entry model. Although they accept that the main danger facing the audit industry is if the Big Four becomes the Big Three, the model that they use to show that that market entry by a mid-tier firm is unfeasible uses the present market conditions. The laissez-faire opinion would be that the present market structure (of four dominant firms) is efficient, so if one firm collapsed there’d be demand for a new entrant to take its place. The Oxera entry model fails to respond to this position, since it merely confirms the common sense view that at present the market suits four firms. It fails to answer the simple point: *if* a firm collapses, would it *then* be feasible for a mid-tier firm to enter? They provide no evidence to say why this wouldn’t be the case, and although restructuring costs would be real, as we’ve already discussed they don’t necessitate intervention on the grounds of improving efficiency (they’d merely be a redistribution).

So the question is how feasible is market entry? The simple answer is that *we cannot know*. There’s no objective way to judge whether market entry is feasible because it depends on the expectations and abilities of the mid-tier firm/s who’d potentially enter. Oxera seem to focus on one mid-tier firm endogenously growing but a sequence of mergers seems more obvious and likely. But the viability of such a scheme depends on the current state of the market – whether or not the existing Big Four firms are satisfying their customers. Put simply either they are, and market entry is unfeasible

(and therefore the market is functioning efficiently), or they're not, suggesting potential profits are available, and market entry is feasible (and if those firms are permitted to merge and enter then once more the market is responding efficiently). This isn't the tautology that "what is, is efficient" (the mantra of the Chicago School), but "every inefficiency is a profit opportunity" (a more Austrian approach).

But mergers are just one very crude means to enter a market characterised by high "barriers", and a vast plethora of strategies exist for firms who sense that the current market structure isn't satisfying the demands of consumers. Perhaps the most common means to enter an industry is through technical innovation, which is seemingly denied to auditors on the grounds that their product is (by law) standardised. There's little scope to reinvent the way in which audits are done. Having said that if a mid-tier firm could avoid inefficiencies that the Big Four are subjected to, this would constitute a technical innovation. For example Big Four firms invest heavily in new staff but have difficulty retaining them – so if a mid-tier firm discovered a means to retain staff it would be at a competitive advantage. On investigation of this point however it becomes clear that staff retention is not much of a problem for larger firms – they deliberately recruit widely to ensure a large pool of potential staff and are happy to grant qualifications in exchange for the chance to separate the wheat from the chaff. This demonstrates the problem with studying market entry: if a genuine inefficiency existed it would have probably been corrected, and if apparent inefficiencies are actually effective operations it simply reaffirms the view that the market is currently operating efficiently! It's somewhat unlikely that consultants, academics or regulators can pinpoint where the inefficiency lies because the firms involved have far greater incentives, and far more relevant knowledge to discover this for themselves.

The sensible reaction is not to reinvent economic theory by imagining inefficiencies, but to humbly point to other instances where new entrants have succeeded in reducing market concentration when it seemed unlikely. This provides evidence to support the claim that *the market is probably efficient, but if it isn't there's no reason why new firms won't enter*. This is a concession to pessimists: *even* if the optimistic view that the current structure is efficient is wrong, there's a solution that doesn't require

intervention. And therefore if we don't see that solution occurring, we can conclude that it is, after all, efficient.

In a response to the FRC consultancy period a group of students from ESCP-EAP (European School of Management) produced four case studies where market entry has occurred in industries that share similar characteristics to the UK audit market.²⁷ Since they are case studies the objective is to highlight key insights rather than provide a complete explanation, but all four cases are examples that should reassure stakeholders that high concentration is not inevitable, and competitive behaviour is capable of finding a solution.

9. To reduce the power of gatekeepers, open the gates!

It is worth concluding this assessment by questioning how fixed the current regulatory structure is, and imagine how alternative arrangements might not only solve the current perceived problems, but also ensure a better functioning market that would make future issues less likely. Regardless of the feasibility of enacting radical reforms to the way the auditing industry operates, it's worthwhile putting such reforms on the table: to sharpen debate if nothing else. Auditing firms possess power mainly due to the legal requirement that firms must be audited, and therefore the obvious way to reduce the market power of the Big Four is to find alternative ways to govern financial records without creating such high profits for individual firms. It's important to note two points: auditors are strong because information is private; and regulations typically suit institutional investors rather than small shareholders.

Prominent legal scholar Henry Manne wrote an article in the Wall Street Journal recently calling for insider trading to be legalised²⁸ and his reasoning could be brought into the present debate on the audit market. In brief auditing exists to solve the agency problem (i.e. to reduce the information asymmetry between shareholders and managers) and if alternative means are used to make information public than the

²⁷ See "How to increase competition in the audit market" ESCP-EAP <http://www.escp-eap.net>

²⁸ Henry Manne "Efficient Markets: The Welfare of American Investors" *Wall Street Journal* 13th June 2006

power of auditors falls. If a problem arises when the gatekeepers of information possess too much control, then why not throw open the gates?

Despite the radical nature of such a policy, it is important to discuss it on its own merits rather than dismiss it because “it can’t be done”. They all said that a flat tax couldn’t be adopted in Estonia, but it was.²⁹ The chief thing to realise is that insider-trading laws do *not* ensure a level playing field: information exists and it can always be profited from. The only question is how such information comes to the market at large, and if all information holders are freely able to trade on that information, the *marginal* trader becomes the *informed* trader. Therefore the share price will always move in the “right” direction – it will always become a more accurate value of the underlying stock. Consequently the beneficiaries of insider trading are the general shareholders, and the losers are the brokers that currently profit from the release of public information. When it comes down to it insider-trading laws are interest group legislation designed to protect concentrated interests at the expense of the market as a whole. Any criticism of insider trading must answer three questions: Why were there *no* complaints about the effects of insider trading prior to it being made illegal? Why has no stock market independently chosen to adopt it other than the NYSE? And, if the reason for banning insider trading is to ensure investor confidence, why is there no loss in market confidence following instances of insider trading?

Conclusion

This report has intended to sharpen the thinking behind the current debate about the UK audit market, by criticising several aspects of the initial Oxera report that launched the consultation period, and suggesting several potential solutions that are worth having at the table. Underpinning this discussion is a slight paradox in that the great fear of there being “another Andersen” is blamed on a lack of competition and choice. These two aspects conflict with each other because choice and competition are parts of a market process that *does* produce instability and *should* punish firms that make mistakes. Although the collapse of Enron and subsequently of Andersen hit investors hard, the damage has not been long lasting and the market is *healthier* as a

²⁹ For a paper discussing the means by which radical policy can be adopted see Anthony J. Evans (2006) “The Constitutional Moment and Subjectivist Public Choice” *Mercatus Center Working Paper*

result – imperfections and mismanagement should be forced out of the system rather than covered up for the sake of preserving the standing market structure. Maybe the best thing for the audit industry would be the collapse of a Big Four firm and investors learn a second lesson that risky investing should never be artificially subsidised, and perhaps the resulting reallocation of capital could ultimately throw up a less concentrated market – large companies lose some faith in the remaining Big Three and mid-tier firms benefit from the recruitment of the displaced accountants. As Robert Cole points out:

“Although one of the established Big Four firms would disappear, the accountants would not. As they resettle, competition could well be enhanced”³⁰

And this is the underlying difficulty in defending the ability of free markets to respond to concentrated industries – the solution is waiting to be discovered. The FRC should therefore ensure that regulation isn’t actually creating the very problem that they’re attempting to solve, but we simply cannot know what specific solution might work. If the market is genuinely inefficient then there are immense financial rewards waiting on the table for whichever firm can best solve them – and it is those firms who are our best bet for doing so. That’s not to say that the FRC can’t take a proactive role in promoting choice and competition, but this can only be done via broad institutional reforms to chart the direction of the auditing governance structure, to permit cross-ownership; reduce the geographical basis of regulation; relocate the burden of large-scale risk; and pursue measures to get company information into the public realm. But all these activities must be pursued with the saying “first, do no harm”, and a realisation that “if it aint broke don’t fix it”.

³⁰ Robert Cole “Big Four rivals can count only on merger” *The Times* 13th July 2006