

Improving Choice in the UK Audit Market

by

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Abstract

There is strong evidence that concentration ratios in the UK audit market have increased over time. Scholars have long voiced concerns that high concentration levels may have a detrimental effect on price competition. Recent studies contend that market concentration has reached statistically significant levels and that consumer choice is limited in some sectors of the market. Other reports argue that the threat of departure of another international accounting firm is real. This study discusses the advantages and disadvantages of measures that could be introduced to improve competition and choice in the UK audit market. I provide a series of recommendations that would improve market competitiveness and ensure that every company can hire a high quality auditor without any conflict of interest. I urge the regulatory bodies to seriously consider our proposals to improve competition, increase choice and reduce the risk of another failure.

Introduction

The number of international accounting firms has fallen to four due to mergers and the collapse of Arthur Andersen. The Big Four (Ernst & Young, KPMG, PricewaterhouseCoopers or Deloitte, hereafter Big Firms) have a comparative advantage in the market for accounting services. This advantage exists because the reputation and depth of resources of the Big Firms puts them in a strong position to mitigate the agency and costly contracting costs that are increasingly significant for large companies (McMeeking *et al.*, 2006a). The decrease in the number of suppliers and the desire for a reputable auditor has led to very high levels of concentration in the large (FTSE100) and medium sized (FTSE250) client sectors (Pong, 1999; Wolk *et al.*, 2001). Scholars have long used the structure-conduct-performance paradigm to criticise the effect of concentration on prices and consumer choice (Stigler, 1968; Scherer and Ross, 1990; Romeo, 1999; Beattie *et al.*, 2003). Studies argue that concentration levels have reached statistically significant levels that are consistent with a tight oligopoly market structure characterised by few rivals, stable market shares and medium to high entry barriers (Beattie and Fearnley, 1994; Willekens and Achmadi, 2003; McMeeking *et al.*, 2006b). Motivated by these concerns, reports and discussion papers have been published by the Office of Fair Trading (2002), the Department of Trade and Industry (hereafter Oxera, 2006) and the Financial Reporting Council (hereafter FRC, 2006). FRC (2006) warns that there is a real threat that another accounting firm might voluntarily or involuntarily leave the market. The motivation for this study is to discuss the measures that could be introduced to avoid another failure and improve competition and choice in the UK audit market.

The remainder of this paper is organised as follows. I discuss the issue of choice in section two and how to mitigate the associated risks in section three. Section

four assesses what can be done to help non Big Firms increase their market share. I discuss possible regulatory changes in section five and measures to prevent or respond to the withdrawal of another accounting firm in section six.

Choice in the UK Audit Market

The first question asked by FRC (2006) is whether the focus of the debate should be on the degree of choice in the market for audit services to large public companies, rather than other features of this market. I agree that choice in the large company market is an important question. However, consumer choice is not the only important issue in the market for audit services. Moreover, large companies represent only a small proportion of the total number of business entities in the UK. I believe that the regulatory bodies should consider the following questions across *all* sectors of the market:

- ◆ How can competition be improved?
- ◆ Do the existing auditor liability regulations restrict the degree of competition in the audit market?
- ◆ Should the limit to the liability of accounting firms be amended?
- ◆ What are the advantages and disadvantages of mandatory auditor rotation?
- ◆ Are there any consultancy services that UK auditors should *not* be allowed to provide to their audit clients?
- ◆ What measures can be introduced to further improve auditor independence?
- ◆ Are companies actively engaging in ‘opinion shopping’?
- ◆ Does the ‘standard’ audit report convey sufficient information?

The first four of these issues are touched upon in the remainder of this paper and the latter four are left for further work.

Mitigating risks arising from the level of choice in the audit market

The second question asked by FRC (2006) is what are the most important criteria for evaluating any opportunities for mitigating risks arising from the level of choice in the audit market. The main risk in this area is that a company is unable to hire a reputable accounting firm. Problems arise when a client wishes to hire a Big Firm but is unhappy with their current choice of auditor. The client's choice may be severely limited by conflict of interest if the other Big Firms do not specialize in your industry, audit a competitor and/or are involved in a takeover battle of a rival company. In such circumstances, the large gap between the Big Firms and the fifth largest accounting firm (Accountancy Age, 2005) could enable the extant auditor to abuse their market power. I believe that the most important criteria in this regard are to compare the costs of creating a new high quality auditor against the benefits of reassuring the market that a credible alternative exists for all companies. The next section examines the opportunities for the non Big Firms to provide such an alternative.

Helping the non Big Firms to expand their share of the audit market

FRC (2006) invites views on how different groups, acting individually or collectively, could increase the propensity of non Big Firms or new firms to seek to be major players in the market for audits of large companies. Most of the largest multinational companies perceive that only the Big Firms have the resources, global reach and industry expertise to satisfy their assurance and consultancy needs. Gerald Russell, chairman of the Audit Quality Forum states, *“the Big 4 accountancy firms audit virtually the whole of the FTSE100, for reasons which include geographical location, methodology, industry and global experience. But they also audit a significant proportion of the FTSE250, where there is a lot of choice. There must be reasons why*

these companies choose Big 4 auditors, but it is not clear what they are”
(Accountingweb.co.uk, 2005).

The Big Firms’ dominance of the FTSE100 and FTSE250 markets creates a large divide between the audit and consultancy fee revenues of the Big Firms and their smaller counterparts (Pong, 1999; McMeeking, 2006). This gap would be reduced if a large number of the medium sized firms agreed to merge. Competition could also be improved if the government introduced tax or other incentives to encourage the mid-tier auditors to grow. Mergers and tax breaks might allow the Non Big Firms to gain more of a foothold in the market by targeting the audit committees of the FTSE250. However, medium sized accounting firms do not have the motivation or resources to undertake this form of growth overnight (Accountingweb.co.uk, 2005). Moreover, the gap between the Big Firms and the fifth largest firm is so large that these measures will not significantly increase market competition in the short term. The creation of a new reputable auditor is not simply a case of encouraging the medium sized firms to grow. I further discuss the problem of creating a high quality alternative in section six.

Information on auditor effectiveness and selection

FRC (2006) calls for views on how competition can be improved by the provision of information on auditor effectiveness and selection. It is difficult for financial statement users to assess the quality of an auditor because they do not have access to audit working papers and internal control systems. The quality of the services offered by auditors cannot easily be verified and user groups are forced to rely on the reputation of the firm as a proxy (McMeeking *et al.*, 2006a). Due to this information asymmetry, many companies that wish to signal their quality are willing to pay a

premium to hire one of the Big Firms because of their brand name and industry specialist reputations (Palmrose, 1986; Craswell *et al.*, 1995). Accounting firms invest heavily in the creation and maintenance of industry specialist reputations but the effect of this investment on fees is mixed (Craswell *et al.*, 1995; DeFond *et al.*, 2000; McMeeking *et al.*, 2006a). One explanation for these mixed findings is that companies are unaware of the industry specialist investments made by the accounting firms. In this scenario, market competition might be improved if the preferences of investors, lawyers, investment bankers and other advisers were made clearer and regulations were introduced that required firms to justify industry specialist claims at the four-digit SIC level. Competition would increase if the Non Big Firms took the opportunity to specialize in a particular industry and use their lower staffing costs to gain market share by undercutting the Big Firms (DeFond *et al.*, 2000). If information about the preferences of user groups and four-digit SIC industry specialist reputations were freely available, FTSE250 companies would be more willing to hire Non Big Firm industry specialists because this would result in lower costs.

The issue I now turn to is auditor selection. Beattie and Fearnley (1998) find by questionnaire survey that the five most common reasons for consideration of a change in auditor are the level of audit fee, dissatisfaction with audit quality, changes in the company's top management, need for group auditor rationalization and the need for a Big Firm. They also note that the five most frequently cited reasons for selecting a new auditor are competitive audit fee, 'chemistry' of relationship with senior audit firm personnel, business understanding, international spread and capabilities of the audit firm. Although the motivation for auditor selection represents potentially valuable information, companies are not required to disclose the reasons why they have chosen their auditor. Market competition would be improved if incentives were

introduced that encouraged companies to develop or strengthen their links with a wide range of auditors and improve relations with their investors, lawyers, investment bankers and other advisers. This investment should be supplemented with mandatory disclosure of detailed information about the company's motivation for hiring and firing their auditor and the company's view of the quality and effectiveness of their auditor. This disclosure could increase competition because audit committees would have more information to compare accounting firms. Companies might be more willing to accept Non Big Firm tender offers because any criticisms of Big Firms would impair their brand name reputations. Another advantage of this disclosure is that more detailed information should make any change to a Non Big Firm less costly or risky for both the company and its new auditor.

Regulatory changes

FRC (2006) asks how the existing laws and regulations could be modified to increase the opportunity for participation by more firms. The lack of high quality alternatives could be circumvented by a legislation change that would open the market to other suppliers such as the Comptroller and Auditor General, Inland Revenue, Customs and Excise, National Audit Office or financial services groups. It would initially be very costly for one of the aforementioned groups to develop a reputation as a firm with auditing expertise. The main expense would be the recruitment and training of a team of auditors with an industry specialist reputation. However, reassuring the market that every company has an "auditor of last resort" would have a beneficial effect on the stock market. These benefits would increase substantially if one or more of the remaining Big Firms were to leave the market. Moreover, unlike the Big Firms, the new auditor would not incur the costs associated with developing industry specialist

reputations in *many* industries but could focus their attention on the area(s) of need. Such a strategy would pave the way for the new firm to gain market share by undercutting the Big Firms.

The Big Firms might object to such proposals on the grounds that the service provided by the new supplier is of lower quality because their training and experience is limited. The regulatory bodies could mitigate these concerns by funding an intensive high quality education and training programme for a select group of elite individuals. Alternatively regulators could appease the international accounting firms by revising the legal liability regulations to reduce the threat of another failure. Competition would be improved by a relaxation of the auditor liability regulations because the removal of this 'deep pockets' barrier would allow new suppliers to enter the market (Wallace, 1987; Beattie and Fearnley, 1995; Smith, 2005). I believe that the lack of competition in the large client market provides sufficient motivation to warrant a further investigation of the existing legal liability regulations. However, any study of the limit of liability of auditors must aim to prevent directors from colluding with auditors, engaging in aggressive earnings management, excessive risk taking and consider the needs of shareholders, investors, banks, employees and creditors.

If new and mid-tier auditors are unable to offer a viable alternative to the Big Firms then one must look at fresh ideas. A more radical form of market intervention would be the introduction of compulsory auditor rotation or mandatory joint audit engagements. Compulsory auditor rotation represents an extension of the principles of the Sarbanes Oxley Act 2002 (hereafter SOX) and has been typically adopted on a seven-year basis. Mandatory rotation and/or joint audits might encourage companies to think beyond the Big Firms and thereby increase independence and market competition (Gietzmann and Sen, 2002; Ashworth, 2002). If mandatory rotation or

joint audits were recommended, modern technology could be used to make auditor switches inexpensive and low risk. However, the downsides with this proposal are that audit fees would increase and it might be unpopular in free market economies such as the UK.

Another option for increasing competition is the mandatory division of the Big Firms. Japan's Financial Services Agency has given serious thought to this concept in relation to the break-up of Chuo Aoyama PwC (Accountancy Age, 2006). However, the main problem with the division of accounting firm(s) on a global scale is that this action would require the consensus of the world's governments and/or regulators because of the international reach of the Big Firms. I believe that competition and consumer choice are serious issues because further consolidation or collapse of a Big Firm would have very serious implications for competition and choice. Although regulatory changes are an extreme solution, it is difficult to see how consumer choice can be improved in the short term without market intervention.

Withdrawal from the market

FRC (2006) invites views on the steps that could be taken to mitigate the risks and effects of withdrawal of a firm from the audit market. Comments by the regulatory bodies in the aftermath of the collapse of Andersen suggest that they would not allow another merger amongst the Big Firms. The main risk therefore is that an accounting firm is forced out of business by another accounting scandal. In this regard, it is important that lessons are learnt from recent debacles such as WORLDCOM and ENRON. There is a considerable literature on this issue leading up to the release of SOX. SOX aims to prevent another scandal by alleviating the pressures on directors, empowering audit committees, giving whistle-blowing powers to employees and

eliminating creative accounting schemes that were exploited by Arthur Andersen. Although these rules apply to corporations that are listed on the US Stock Market, any non-US company that is not listed in the US is not bound by the SOX requirements. Moreover, SOX has only recently been enacted into US law and it remains to be seen whether its recommendations will be effective.

I now turn to the issue of how UK accounting firms can prevent another failure. UK accounting firms should ensure that all of their staff undertake a thorough ethical accounting training and education scheme to ensure that they are able to resist management pressures and act in a professional manner. I believe that the partners of all accounting firms should go back to basics and work together to assess and mitigate the risks that they face within their own markets and internationally. Moreover, the audit committee should be required to meet regularly with investors, lawyers and bankers to discuss how best to deal with any problems that might arise with their company and/or accounting firm. Finally, the regulatory bodies should mandate accounting firms to set aside a reserve to try to insure against failure and tax all companies to provide sufficient resources to deal with another insolvency. If these measures were introduced they would help to reduce the level of uncertainty and disruption in the audit market.

Finally, FRC (2006) invites views on steps that could be taken to mitigate the effects of a voluntary or involuntary withdrawal of a firm from the audit market. Since the threat of withdrawal is real, it is important that strategies are put into place now to deal with another departure. A priori, one would expect that the remaining Big Three firms would capture the majority of the large company audits of the exiting firm. This would increase concentration ratios, reduce consumer choice and possibly price competition even further. I expect that the loss of another firm would

significantly increase the auditor selection problems of large companies. Therefore, if another accounting firm were to fail, an 'auditor of last resort' must be urgently introduced to ensure that companies that were previously audited by the failed firm can quickly find a new auditor that they feel happy to hire. Investors should also support their companies and their audit committees in this scenario by offering advice about the best accounting firm to meet their needs. Finally, the Non Big Firms should be given considerable financial encouragement to bid for the tenders of the companies that were previously audited by the failed firm. These measures should help UK companies come to terms with the loss of another major accounting firm.

Summary

Audit market concentration ratios have increased to statistically significant levels that restrict consumer choice and could impair price competition. The threat that another firm might voluntarily or involuntarily leave the market is tangible and would result in a further increase in concentration ratios. The motivation for this paper is to discuss the measures that could be introduced to improve market competitiveness and consumer choice in the UK audit market. I discuss the advantages and disadvantages of a number of recommendations that should enhance market competitiveness. I recommend that the regulatory bodies must make amendments to the extant legislations to prevent a further reduction in the number of audit suppliers. I also conclude that the regulatory bodies should take steps to create an 'auditor of last resort' to ensure that all companies can hire a reputable accounting firm without any conflict of interest. The medium sized accounting firms should be encouraged to grow but will continue to struggle to compete against the Big Firms for the foreseeable future.

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