



**FINANCIAL REPORTING COUNCIL**

**DISCUSSION PAPER: CHOICE IN THE UK AUDIT MARKET**

**MAY 2006**



## **Introduction**

1. This Discussion Paper follows the publication of a study jointly commissioned by the Financial Reporting Council (FRC) and the Department of Trade and Industry (DTI), “Competition and choice in the UK audit market” (“the study”), and an open meeting held on 26 April at which the study was discussed. The study, conducted by economic consultancy Oxera, considered the factors that contribute to the competitive environment for audit services to large listed companies in the UK. The objective of this Discussion Paper is to facilitate a public debate on how to identify the appropriate response to the findings of the study.

2. In this Discussion Paper we describe the importance of audit to the UK economy. We summarise key findings from the study, including the components of large company audit services and how these influence the competitive environment in the audit market. We discuss risks to the public interest that may arise from the existing competitive environment and types of opportunities for mitigating these risks in the UK market and internationally. Finally we describe our consultation process.

## **Importance of audit to the UK economy**

3. The FRC’s aim is to promote confidence in corporate reporting and governance. Confidence in the reliability of financial information is essential to the healthy functioning of markets to the benefit of business, investors, creditors, employees and other stakeholders. Independent audit provides a cost-effective way of increasing confidence in the financial information of corporate and other public interest entities. A well-functioning market for audit services is, therefore, essential to ensuring confidence in corporate reporting and governance, ultimately helping to protect and enhance the UK’s economic strength in competitive international markets. Given the importance of audit, we consider that any risks to the effectiveness of the market for audit services should be the subject of public debate.

4. We believe that the public debate should consider the:

- Nature of any risks arising from the characteristics of the audit market
- Potential implications if any risks are realised
- Types of opportunities for mitigating such risks
- Potential effectiveness and proportionality of any opportunities for mitigating such risks.

## Key findings of the study

5. This section summarises the key findings of the study that we currently consider to be most relevant to promoting an effective market for audit services.

### *Components of audit*

6. The study notes that the principal output of the audit process is the independent auditor's report on the annual financial statements which is directed to shareholders. Undertaking a quality audit involves obtaining sufficient and appropriate audit evidence to support the conclusions on which the audit report is based and making objective and appropriate audit judgements (termed the 'technical' component of audit in the Oxera report).

7. The study identifies two other components of the audit product that are directed to company management and the audit committee:

- The provision of advice to audit committees and company directors as part of the audit (termed the 'value-added' component in the Oxera report).
- The provision of comfort that the auditor is capable of detecting accounting irregularities and instances of fraud, thus preventing accounting catastrophes; or at least, the provision of comfort to the audit committee that in the event of an accounting catastrophe it could demonstrate that it had put an appropriate safeguard in place by appointing an auditor with a well-established reputation (termed the 'insurance' component in the Oxera report<sup>1</sup>).

### *Concentration in the market*

8. The study confirms that the Big Four audit firms – Deloitte & Touche, Ernst & Young, KPMG and PricewaterhouseCoopers - supply audit services to most large companies. This high level of supply concentration follows mergers between audit firms and the dissolution of Arthur Andersen. The Big Four firms currently audit 99 of the FTSE 100 companies, 97 per cent of the FTSE 250 and 93 per cent of all listed companies other than those on AIM. In contrast, the Big Four audit only around 39 per cent of companies on AIM.

### *Barriers to entry*

9. Significant barriers to entry to the market for audits of large companies are identified in the study. Key barriers to entry include the need to demonstrate:

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<sup>1</sup> It is important to distinguish Oxera's use of the term 'insurance' in this context with that used more commonly to describe a promise of reimbursement in the case of loss.

- A credible reputation with large companies, their investors and other stakeholders.
- Appropriate resources and expertise in place to carry out large company audits, including relevant sector-specific skills.
- An effective capability to secure timely and reliable audit opinions on overseas subsidiaries for audits of companies with significant international operations.

#### *Market entry*

10. The study concludes that substantial entry or expansion by the non-Big Four firms into the audit of large companies may not be economical unless current market conditions and perceptions change. Even if one of the Big Four firms was to leave the market, the study suggests that no non-Big Four firm is likely to become a major challenger to the remaining large audit firms.

### **Risks arising from the competitive environment**

11. This section describes the risks that may arise from the current levels of concentration in the market, barriers to entry and associated market dynamics.

12. As a result of the current competitive environment most large companies are perceived to have a choice of a maximum of four audit firms. In many cases the effective choice is perceived to be less than four firms if, for example, one or more firms are ineligible for appointment as auditor due to auditor independence rules or due to a company's own policies and procedures. In a small minority of cases, particularly in the financial services sector, companies may have no effective choice of auditor in the short term. Around one-third of audit committee chairs surveyed for the study considered that the current choice of auditors in the market was not enough for their company to choose from.

13. This concern would be considerably exacerbated if one of the Big Four firms was to leave the market. In this situation it is possible that a few large companies would be unable to find an auditor with appropriate capabilities causing uncertainty for companies and investors and a risk of disruption to the markets, at least in the short term.

14. A restricted degree of choice might also be expected to represent a risk to high quality and competitive prices in a market. Audit quality is fundamental to the work of the FRC and is already the subject of considerable attention. For example, our Auditing Practices Board establishes high standards for auditing and our Audit Inspection Unit monitors the quality of audits of large companies and other public interest entities.

15. With regard to prices, whilst the Oxera study found that audit fees have increased well above the rate of inflation for various reasons, it also found that price remains a relatively unimportant factor in auditor selection. The audit market, meanwhile, needs to be sufficiently profitable to at least attract and

retain adequate numbers of qualified and experienced individuals. Therefore, we consider that current levels of audit fees do not represent a material risk to confidence in corporate reporting and governance.

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Q1 Do you agree that 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?

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## Opportunities for mitigating risks

16. It is likely that one outcome of this debate will be agreement that if one of the Big Four firms was to leave the market this could present significant risks to confidence in corporate reporting and governance. It is appropriate, therefore, to begin to consider opportunities for mitigating the risks.

17. One aspect of considering any opportunities for mitigating risks will be the criteria by which any opportunities should be evaluated. The appropriate criteria could include, for example:

- Whether steps could be taken within the market rather than by regulators, because market-led steps are generally more effective and less expensive than regulatory intervention.
  - Whether steps would maintain or improve audit quality whilst seeking to protect or enhance choice.
  - If any modification to existing regulation was needed, whether this would help to achieve a better informed and more effective audit market whilst avoiding the significant disadvantages of measures that could distort the market by favouring one supplier over another.
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Q2 What do you regard as the most important criteria for evaluating any opportunities for mitigating risks arising from the level of choice in the audit market?

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18. It may also be useful to consider broad types of opportunities for mitigating the risk prior to debating specific options. At the stakeholder meeting held on 26 April, three broad types of opportunities were discussed:

- To promote increased choice, such that there would be more audit firms participating in the market for audit of large public companies.
- To reduce the risk of an existing firm leaving the market.
- To reduce the costs of uncertainty and disruption in the event of a firm leaving the market.

## Promoting increased choice

19. Several options for promoting increased choice have been proposed by various commentators. Some of these options involve very significant and costly regulatory intervention in the functioning of the market, including mandatory auditor rotation, the forced break-up of Big Four firms, mandatory transfer of clients to a non-Big Four firm or setting up a state-backed audit firm.

20. Other options for promoting increased choice involve improving the way the market functions to increase the opportunity for participation by more firms. Such an approach needs to consider the two interacting dimensions of the market:

- The 'supply-side' of the market, i.e. the propensity of non-Big Four or new firms to seek to be major players in the market for audits of large companies.
- The 'demand-side' of the market, i.e. the propensity of companies, their audit committees and investors, to purchase audit services from firms other than the Big Four.

### *Supply of audit services*

21. It is likely that non-Big Four or new firms would need to make substantial investment in people, in brand development through marketing and advertising, and in forming or strengthening international networks, to become significant suppliers of audit services to large companies. The study concludes that market characteristics currently make the incentive for such investment unattractive.

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Q3 We invite views on how different groups, acting individually or collectively, could increase the propensity of non-Big Four or new firms to seek to be major players in the market for audits of large companies, for example:

- a. Non-Big Four firms: how firms could successfully identify and enter particular segments of this market.
- b. Big Four firms: how the actions of one or more existing firms could improve the prospects for a non-Big Four firm or a new entrant.
- c. Companies and their audit committees: whether the criteria used for selecting auditors, and for considering the effectiveness of their current auditors, could be more explicit.
- d. Investors: how investors' preferences for auditors could be clearer.
- e. Lawyers, investment bankers and other advisers: how advisers' preferences for auditors could be clearer.

- f. Legislators and regulators: how existing laws and regulations could be modified to increase the opportunity for participation by more firms.
  - g. Other stakeholder groups.
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#### *Purchase of audit services*

22. The study finds that an increased propensity to purchase audit services from non-Big Four firms would require a change of perceptions amongst audit committees, company directors, investors and others, accompanied by more frequent tendering for audit services.

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Q4 We invite views on how the propensity of companies and their audit committees to purchase audit services from non-Big Four firms could be increased by:

- a. All firms: for example, how firms could provide further information to audit committees to facilitate comparisons across different types of firms.
  - b. Non-Big Four or new firms: for example, how the firms seeking to supply audit services to this market could better demonstrate their capabilities.
  - c. Big-Four firms: for example, how these firms could make any change of auditor less costly or risky to the company and its new auditor.
  - d. Companies and their audit committees: for example, how companies could develop working relationships with a wider range of audit firms to help them to evaluate tenders.
  - e. Investors: for example, how investors could support audit committees in evaluating auditors and in selecting from a wider range of audit firms.
  - f. Lawyers, investment bankers and other advisers: for example, how advisers' could support audit committees in evaluating auditors.
  - g. Legislators and regulators: for example, how existing laws and regulations could be modified in order to make auditor changes less costly or risky.
  - h. Other stakeholder groups.
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#### *Summary – promoting increased choice*

23. Increased choice is only likely to be achieved if the propensity of non-Big Four or new firms to enter the market is increased together with the propensity of large company audit committees to purchase services from these firms.

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Q5 We invite views on:

- a. The combination of steps that would be most likely to lead to increased choice.
- b. Whether these steps could be taken forward by market participants, or whether existing laws and regulations may constrain or prevent this.
- c. The costs of the steps relative to the risks arising from the existing or potential degree of concentration in the market.

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### **Reducing the risk of a firm leaving the market**

24. Any measures designed to promote choice would take time to have any significant effect and, therefore, risks arising from the competitive environment are likely to persist for some time. In the meantime, there are risks that one of the Big Four firms (or indeed, any non-Big Four firm providing audits to large companies) might leave the market, voluntarily or non-voluntarily.

25. In these circumstances it is appropriate to consider ways to reduce the risk of a firm leaving the market. This might be particularly relevant when the threat to a firm is caused by damage to its reputation prior to the full circumstances of a problem being known.

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Q6 We invite views on steps that could be taken to mitigate the risk of unnecessary withdrawal of a firm from the market, including steps by:

- a. Big Four firms: for example, how the arrangements by which the firms assess and mitigate the risks that they face within their own markets and across their international networks could be more effective.
- b. Companies and their audit committees: for example, how they ensure that their response to new information about potential problems faced by a large audit firm is well-informed and well-timed.
- c. Investors: for example, how investors can support companies and their audit committees in responding to new information about potential problems faced by audit firms.
- d. Lawyers, investment bankers and other advisers: for example, how advisers could support companies and their audit committees in responding to new information about potential problems faced by audit firms.

- e. Legislators and regulators: for example, how regulators could facilitate the effectiveness of the arrangements by which information about potential problems faced by audit firms is handled in the markets.
  - f. Other stakeholder groups.
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## **Reducing uncertainty and disruption costs**

26. If a firm did leave the market, the current competitive environment is such that there could be considerable uncertainty and disruption, resulting in significant costs for some market participants. However, it is neither possible nor desirable to eliminate the risk of a firm leaving the market. Therefore, it may be necessary to consider ways to reduce the costs of uncertainty and disruption in the event of a firm leaving the market.

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Q7 We invite views on steps that could be taken to mitigate the effects of a voluntary or involuntary withdrawal of a firm from the audit market, including steps by:

- a. Audit firms: for example, how the arrangements by which the remaining firms would respond to the loss of an audit firm could be more effective.
  - b. Companies and their audit committees: for example, how to increase the effectiveness of the arrangements by which companies that were previously audited by the failed firm would find a new auditor.
  - c. Investors: for example, how investors could support companies and their audit committees in responding to the loss of an audit firm.
  - d. Lawyers, investment bankers and other advisers: for example, how advisers' could support companies and their audit committees in responding to the loss of an audit firm.
  - e. Legislators and regulators: for example, how regulatory requirements in the scenario of the loss of an audit firm could be modified so as to reduce uncertainty and disruption to the markets.
  - f. Other stakeholder groups.
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## **International issues**

27. The characteristics of the UK audit market are shared with other markets worldwide, reflecting the global nature of many large companies, the capital markets and the audit firm networks. Regulators in other markets and international regulatory organisations have similar concerns over the competitive environment for audit services in their jurisdictions.

28. Some options to mitigate risks arising from the competitive environment may be capable of being implemented in the UK alone, although we recognise that the effectiveness of some options would be enhanced if similar action was taken in other markets. We expect that a consensus over the types of measures needed in the UK may provide a basis for coordination with other jurisdictions.

## **Consultation process**

29. Written responses to this Discussion Paper are invited by Friday 4 August 2006. We would also welcome comments on other issues relevant to choice in the UK audit market not mentioned in this Paper. Those responding are invited to suggest examples of how any risks could be mitigated. Responses should be sent to: Julian Rose, Financial Reporting Council, 5<sup>th</sup> Floor, 71-91 Aldwych, London, WC2B 4HN, Email: [j.rose@frc-pob.org.uk](mailto:j.rose@frc-pob.org.uk). Telephone 020 7492 2342. We intend to publish responses on our website. If you do not want all or part of your response, or your name, made public please state this clearly in your response and, if possible, please also provide a non-confidential version for publication.

30. Following the consultation period, a stakeholder meeting will be held at which general approaches to mitigating any agreed risks will be presented and discussed. This meeting will take place on Monday 18 September 2006 at 4pm in London. After that meeting we will publish a paper seeking views on options for mitigating those risks that are considered to be most significant.