

## **Auditors: market concentration and their role**

### **Submission to the House of Lords Select Committee on Economic Affairs**

**24 September 2010**

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#### **SUMMARY**

1. This submission is made by the Office of Fair Trading (OFT), the UK's consumer and competition authority, whose mission is to make markets work well for consumers.
2. The OFT has been keeping the market for external audit services<sup>1</sup> in the UK under review since November 2002.<sup>2</sup>
3. The OFT considers that competition in the market for audit services in the UK may be limited. Some aspects of the audit market giving rise to this concern include companies' lack of clear incentive to switch auditors; the focus on established reputation in companies' choice of auditor; high switching costs; the established competitive advantage of the 'Big Four'<sup>3</sup> over mid-tier auditors<sup>4</sup>; the limited choice of auditors to appoint; and the difficulties mid-tier firms face in raising funds to finance expansion.
4. The OFT considers that these aspects of the audit market may explain low levels of switching of audit contracts; very high market concentration, with high and stable market shares for the Big Four being maintained at least as far back as 2002; and potentially high fees. The OFT also notes that there are significant concerns about the systemic risk arising from the potential impact of an audit firm failing.

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<sup>1</sup> Please note that throughout this document 'audit' refers to external audit only.

<sup>2</sup> See [http://www.offt.gov.uk/shared\\_offt/press\\_release\\_attachments/accountancy.pdf](http://www.offt.gov.uk/shared_offt/press_release_attachments/accountancy.pdf)

<sup>3</sup> The 'Big Four' auditors are PricewaterhouseCoopers, KPMG, Deloitte and Ernst & Young.

<sup>4</sup> Mid-tier auditors include companies such as BDO and Grant Thornton.

5. Audits enable stakeholders such as investors, lenders and trading partners to assess the reliability of a company's financial statements. If this is not done effectively, they may be deterred from doing business with that company, in which case companies would be likely to face less favourable terms of trade, including higher costs of obtaining finance.
6. Higher audit fees or higher financing costs are likely to feed through to higher prices for consumers. Weak competition may also contribute to a risk of wider, systemic failure in the audit market. Moreover, barriers to expansion might make it difficult for mid-tier firms to step up to replace one of the Big Four firms if it were to exit the market unexpectedly.
7. Given that competition may be limited, there are a number of changes that may have the potential to increase competition in the market. OFT's preference would be for changes to be delivered through the market. Market-led solutions ultimately result in the right incentives being harnessed so as to deliver the best outcomes for consumers. However, certain improvements may also be sought through regulatory or legislative change, at least in the short term. The nature of the audit market is such that changes may have to be international to be successful.

## **INTRODUCTION**

### **The Office of Fair Trading**

8. The OFT is the UK's consumer and competition authority. The OFT's aim is to make markets work well for consumers. It performs this role by deploying a variety of tools at its disposal including the enforcement of consumer and competition laws and advice to policy makers where wider government policies affect competition and markets.

### **OFT's previous and current work on the audit market**

9. In 2002, the OFT considered whether a market investigation or Competition Commission referral would be appropriate for addressing competition concerns following the Enron affair and subsequent collapse of the audit firm Arthur Andersen. In November 2002, the OFT stated:

*'There is public concern about the increased concentration in the supply of audit and accountancy services, and its implications for competition and choice. The OFT recognises that concern. But [...] we do not, at this stage, propose to launch a full-scale investigation into the sector, or to refer it for investigation by the Competition Commission. [...]*

*Rather, our approach is to keep the market under review and to examine any competition implications of regulatory proposals that may arise from current reviews of audit and accountancy services.'*<sup>5</sup>

10. Since then, the OFT has provided advice to Government on the implications for competition in the audit market of proposals to permit auditors to limit their liability by way of negotiated caps<sup>6</sup> and contributed to the UK's submission to the OECD roundtable on competition and regulation in auditing and related professions in June 2009.<sup>7</sup> In addition, the OFT has, since 2002, liaised, and will continue to liaise, with the Department for Business, Innovation and Skills (BIS) and the Financial Reporting Council (FRC) in relation to concerns regarding this market.
11. A recent report by the FRC indicated that a number of recommendations intended to result in the audit market working more efficiently and to increase audit choice in the UK had been implemented but had been largely unsuccessful. The FRC found that 'there is limited evidence that the recommendations have had a significant impact on market concentration and the risks arising from that concentration'.<sup>8</sup>
12. In addition, in preparing this submission, we have met with four of the largest providers of audit services (BDO, PwC, Deloitte, and Grant Thornton), providing them with an opportunity to tell us their views and experiences of the market for auditors.<sup>9</sup> However we have not shared this document with them.

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<sup>5</sup> See [http://www.offt.gov.uk/shared\\_offt/press\\_release\\_attachments/accountancy.pdf](http://www.offt.gov.uk/shared_offt/press_release_attachments/accountancy.pdf)

<sup>6</sup> See [http://www.offt.gov.uk/shared\\_offt/reports/financial\\_products/offt741.pdf](http://www.offt.gov.uk/shared_offt/reports/financial_products/offt741.pdf)

<sup>7</sup> See <http://www.ftc.gov/bc/international/docs/competitionaccount.pdf>

<sup>8</sup> *Choice in the UK Audit Market: Fifth Progress Report* (June 2010). See: <http://www.frc.org.uk/publications/pub2289.html>.

<sup>9</sup> The invitation to meet was extended also to KPMG and Ernst and Young.

13. Further details of the OFT's ongoing work can be found on our website.<sup>10</sup>

## **THE MARKET**

14. This submission addresses the concern that competition in the audit market may be limited and may deteriorate in the future. Therefore, it relates primarily to three questions posed in the call for evidence from the Select Committee on Economic Affairs:

**Q1:** Why did auditing become so concentrated on four global firms? For example, do economies of scale make it too difficult for smaller firms to compete?

**Q2:** Does a lack of competition mean clients are charged excessive fees?

**Q11:** Should more competition be introduced into auditing? If so, how?

15. In addressing these questions in particular, the remainder of this submission is presented in the following three sections:

- aspects of the audit market that may adversely affect competition;
- effects observable in the market; and
- key questions about possible changes to the market.

### **Relevant market**

16. For the purpose of this submission, the relevant market is the provision of external audit services to large companies. This may be taken to mean FTSE350 companies. However, there may be separate markets defined more narrowly than this, for example by reference to FTSE100 companies and/or according to particular sectors that have more complex audit requirements, such as banking and insurance.

## **ASPECTS OF THE AUDIT MARKET THAT MAY ADVERSELY AFFECT COMPETITION**

17. The OFT considers that competition may be limited as a result of the following six aspects of the audit market:

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<sup>10</sup> See: <http://www.offt.gov.uk/OFTwork/markets-work>

- **There is little incentive for companies to switch auditor.** Audit fees may not drive auditor selection and switching because they are small in comparison with the level of companies' finances. In addition, the difficulty of discerning audit quality and the tight regulation of how audits are conducted may mean that little difference between the audits of different suppliers is apparent, so that it is difficult for Finance Directors and audit committees to distinguish between the audit offerings of different suppliers.<sup>11</sup> Where the scope for differentiation in service quality is perceived to be limited, companies may view audit simply as a regulatory hurdle, rather than as a service that is capable of adding value.
- **In choosing an auditor, companies focus on established reputation, which imposes a barrier to entry to non-Big Four auditors.** Given the difficulty of differentiating quality, companies may select auditors on the basis of existing reputation, calculating that this will avoid risk and the need to consult investors, rather than on the basis of maximising the value added by the audit. There seems to be little difference in reputation between the Big Four, but a larger difference between the Big Four and mid-tier firms. As a result, mid-tier auditors may struggle to compete even on the basis of a better value or quality proposition.<sup>12</sup>
- **It is very costly for companies to switch auditor.** Substantial management and audit committee time is required to put an audit out to tender and select a new auditor; it takes time for a new auditor to gain an understanding of the business in order to audit it, during which time the company management will have to invest time in bringing the auditor up to speed; and there is a higher risk of a new auditor making mistakes initially.<sup>13</sup>

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<sup>11</sup> Source: survey of audit committee chairmen in Oxera's report *Competition and choice in the UK audit market* (April 2006), commissioned by the Department of Trade and Industry and the FRC. Also stakeholder comments and FRC (Market Participants Group) and academic papers.

<sup>12</sup> Source: comments of institutional investors and survey of audit committee chairmen in Oxera's report *Competition and choice in the UK audit market* (April 2006), commissioned by the Department of Trade and Industry and the FRC. Also, FRC (Market Participants Group) and academic papers.

<sup>13</sup> Source: Interviews and survey of audit committee chairmen in Oxera's report *Competition and choice in the UK audit market* (April 2006), commissioned by the Department of Trade and Industry and the FRC. Also, stakeholder comments and FRC (Market Participants Group) consultation responses.

- **Larger auditors possess certain attributes necessary for auditing large companies.** These attributes are difficult to acquire so may constitute a barrier to entry. These include an extensive, integrated international network; relevant industry specialisation; greater experience in auditing complex businesses; a greater ability to offer additional services (audit may be used as a gateway to providing these services and larger audit firms may have an ability to provide a more attractive and complete range of services than smaller audit firms); existing links with Finance Directors and audit committee chairmen; and possibly an ability to recruit higher calibre staff attracted by the audit firm's reputation. It seems that it is difficult for smaller auditors to develop the necessary attributes, such as reputation, expertise and resources, to undertake large audits because of the difficulty of securing large audit contracts in the first place – potentially a vicious circle.<sup>14</sup>
- **Companies may have a limited choice of auditors that they can appoint.** Companies may require an auditor with a particular technical capacity, such as a particularly large international network or a specific industry specialism, which may favour the Big Four. Choice may also be restricted by regulation, such as the USA's Sarbanes-Oxley Act of 2002, which limits the ability of public reporting companies to appoint as their auditors firms who supply them with certain types of non-audit services. Further, choice may be limited by commercial considerations, for example companies not wanting to employ auditors that work closely with competitors. This leaves some companies with a very limited choice of their current auditor and only one or two others.<sup>15</sup>
- **There are barriers to smaller auditors raising sufficient capital to grow.** The OFT understands that substantial investment would be required for mid-tier auditors to gain a significant foothold in the market for audit services provided to FTSE250 companies and that this may very well exceed the potential returns, with significant risks and a long payback period. Further, avenues for raising capital are limited by the requirement for a firm to be majority-

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<sup>14</sup> Source: Interviews with large-scale companies and survey of audit committee chairmen in Oxera's report *Competition and choice in the UK audit market* (April 2006), commissioned by the Department of Trade and Industry and the FRC. Also stakeholder comments and FRC (Market Participants Group) paper.

<sup>15</sup> Source: Survey of audit committee chairmen in Oxera's report *Competition and choice in the UK audit market* (April 2006), commissioned by the Department of Trade and Industry and the FRC. Also, stakeholder comments and FRC (Market Participants Group) paper.

controlled<sup>16</sup> by qualified auditors<sup>17</sup> and by their partnership structure, as investment may not be attractive to older partners due to the limit that retirement imposes on the period in which they can receive a return on investment.<sup>18</sup>

## EFFECTS OBSERVABLE IN THE MARKET

18. The OFT considers that the aspects described above could result in the following three potential market effects:

- **Low levels of tendering and switching:** Tendering does not appear to occur very often. One of the Big Four cited in Oxera's 2006 report was aware of only 28 FTSE100 companies that had held competitive tenders in the previous 15 years.<sup>19</sup> Other evidence demonstrates that between 2001 and 2009 average switching rates were less than four per cent annually.<sup>20</sup>
- **High concentration:** In 2009 the Big Four earned all audit fees (that is 100 per cent) levied for FTSE100 companies and 98 per cent for FTSE250 companies, with PwC alone earning 47 per cent of FTSE100 companies' audit fees.<sup>21</sup> Concentration is higher in some specific industry sectors including mining and quarrying; hotels and restaurants; and electricity, gas and water supply.<sup>22</sup> The

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<sup>16</sup> This relates to the exercise of control according to voting rights and by the firm's management board.

<sup>17</sup> The legal rules relating to the control of audit firms are contained in the Audit regulations, pursuant to the requirements of Part 2 of Schedule 10 of the Companies Act 2006. These requirements flow from Article 3 of Directive 2006/43/EC on statutory audits.

<sup>18</sup> Source: modelling of prospects for entry by mid-tier firms and observations in Oxera's report *Competition and choice in the UK audit market* (April 2006), commissioned by the Department of Trade and Industry and the FRC. Also, FRC (Market Participants Group) paper and comments by stakeholders.

<sup>19</sup> Oxera's report *Competition and choice in the UK audit market* (April 2006), commissioned by the Department of Trade and Industry and the FRC, p.43.

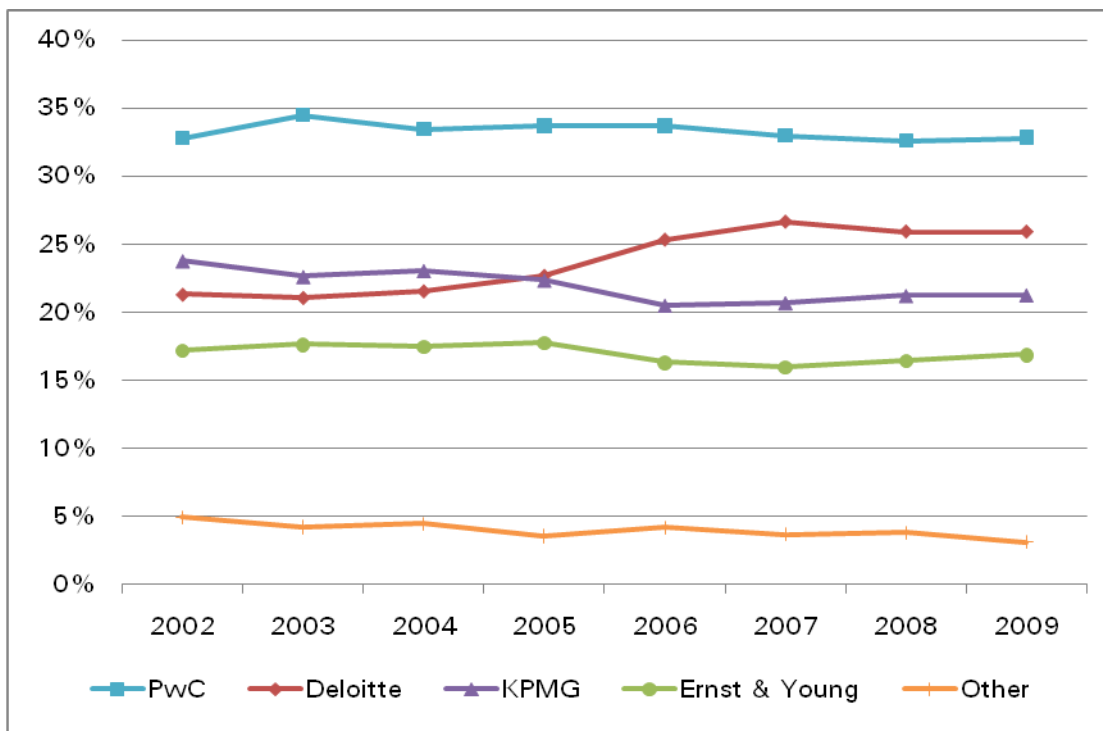
<sup>20</sup> OFT analysis shows that rates were 1.7 per cent annually for FTSE100 firms and 3.3 per cent annually for FTSE250 firms (this analysis covers firms that are still in the FTSE350 currently).

<sup>21</sup> These figures are calculated according to audit fees levied for current FTSE100 / FTSE250 companies only. When concentration is measured using the Herfindahl-Hirschman Index (HHI), the figure for the FTSE 100 is 3,175, while the figure for the FTSE 250 is 2,772. A HHI figure in excess of 1800 for a market is typically considered to represent a highly concentrated market.

<sup>22</sup> Two of the Big Four supplied more than 80 per cent of audit services in wholesale and retail trade; mining and quarrying; hotels and restaurants; and electricity, gas and water supply.

combination of high market concentration and low rates of tendering and switching gives rise to a stable market with limited opportunities for rivalry and few changes in market shares over time. This can be seen in the following graph of shares of supply of audits for FTSE 350 companies between 2002 and 2009.

**Table 1: Shares of supply for audits of the FTSE 350 companies (by number of clients)**



- **High fees:** Some evidence has been found of a link between concentration and fees and also that audit fees for clients of the Big Four appear higher than for companies using mid-tier auditors, all other things being equal.<sup>23</sup>

19. The OFT considers, therefore, that weak competition in this market may mean that audits cost companies more than is necessary, with the possibility that the market does not operate as efficiently as possible and that the value added by audits is not maximised.
20. Audits enable stakeholders such as investors, lenders and trading partners to assess the reliability of a company's financial statements. If this is not done effectively, they may be deterred from doing business with that company, in

<sup>23</sup> Oxera's report *Competition and choice in the UK audit market* (April 2006), commissioned by the Department of Trade and Industry and the FRC.

which case companies would be likely to face less favourable terms of trade, including higher costs of obtaining finance. Higher audit fees and higher financing costs are likely to feed through to higher prices for consumers.

## **SYSTEMIC EFFECTS**

21. The limited choice of auditors and high barriers to expansion for mid-tier audit firms mean that if one of the Big Four were to exit the market, existing competition problems in the market could be exacerbated. There might also be a short-term risk of some companies being unable to purchase audit services, leading to a loss of confidence in the financial status of high-risk companies and possibly among investors more generally. Thus the existing high barriers to entry, leading to high market concentration, can be seen as contributing to the identified risk of wider, systemic failure in this market. Moreover, barriers to expansion might make it difficult for mid-tier firms to step up to replace one of the Big Four firms if it were to exit the market unexpectedly.

## **KEY QUESTIONS ABOUT POSSIBLE CHANGES TO THE MARKET**

22. If indeed competition in the audit market is limited, there are a number of issues to consider before determining what changes to the market could lead to the most effective outcome. These considerations cover regulatory change, changes in ownership arrangements and planning for the possible failure of one of the Big Four.
23. We make two key observations in relation to these issues. Firstly, the OFT's preference would be for changes to be delivered through the market. The OFT considers that market-led<sup>24</sup> solutions ultimately result in the right incentives being harnessed so as to deliver the best outcomes for consumers. However, the OFT recognises that certain improvements may also be sought through regulatory or legislative change, at least in the short term. Secondly, we recognise that many of the potential solutions will require action on an international level if they are to be wholly effective.

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<sup>24</sup> Market-led solutions are those which can be delivered by the firms within or the customers of a market, perhaps through voluntary initiatives to increase transparency. market-based solutions are solutions which are based on making the market itself function more effectively, as opposed to regulatory solutions.

24. The issues to consider in relation to different types of possible changes to the market are discussed below.
25. Under the broad heading of regulation of the audit market, the OFT has considered a number of specific changes that could be contemplated, such as:
- **Changes to the minimum requirements of the statutory audit<sup>25</sup>.** We consider that it is worth exploring whether the level of detail, scope<sup>26</sup> or materiality<sup>27</sup> required of statutory audits should be reduced. Companies could then choose whatever methods (in addition to the statutory audit) were necessary to enable them, investors and any other bodies using the accounts (for example companies wishing to trade with them) to assess the company's financial position with the level of confidence that is appropriate for their particular purposes. Thus they might, for example, commission audit firms or consultancies to provide a more thorough audit or whatever assessments of particular aspects of their operations, for example the performance of particular assets, divisions or products were thought necessary.

As well as potentially reducing the burden on companies, reducing the requirements of statutory audit might stimulate switching to smaller auditors that are able to undertake a more limited audit. Doing this might also reduce auditor liability for errors and hence auditors' risk of failure. Despite evident risks around such a change, the OFT considers that these must be balanced against the compelling possible gains that would result from shifting the requirements and incentives of companies when selecting auditors. Such a regulatory change could result in companies being more motivated to ensure that the potential value added by audits is maximised.

- **Reducing differences in the approach and standard of audits in different countries.** Ensuring that auditors who approve accounts in one country are able to do so in other countries could increase the ability of mid-tier firms to win contracts to audit international companies (if not on their own then possibly in

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<sup>25</sup> 'Statutory audit' refers to the functions and duties of a company's auditor in reviewing and reporting on a company's annual accounts, directors' report and directors' remuneration report as required by UK company law. See Part 16 of the Companies Act 2006.

<sup>26</sup> i.e. coverage.

<sup>27</sup> This relates to the size of error that would be required to change the view of someone reading the accounts as to whether they are 'true and fair'.

combination with other firms). This might also facilitate companies employing different auditors in different countries since the likelihood of time-consuming disagreements on how to consolidate accounting results might be reduced. Increasing standardisation and harmonisation might assist in reducing concerns, whether based on fact or simply perception, regarding the ability of mid-tier firms to handle audits of international companies.

- **Changes to the rules covering the use of audit firms.** There are a number of possibilities for changes in this area, including a requirement for a company to have two auditors (either through a split or joint audit process) and the mandatory regular tendering of audit contracts. In addition, a requirement for outgoing auditors to provide information to incoming auditors in a standard format would address concerns around the time and investment by company management that is required for a new auditor to understand the business and the greater risk of mistakes being made in this initial period. The aim of such measures would be to strengthen rivalry in the market by increasing the incentives and ability of companies to switch between auditors and reducing the costs of doing so.

26. Another issue to consider is whether some form of change in the rules governing the ownership arrangements of audit firms might be beneficial. Audit firms currently have to be majority controlled by auditors which limits the scope for new investment and hence expansion of mid-tier firms.
27. In the event that less interventionist changes are not successful in bringing about an increase in competition and a reduction in systemic risk in the market, attention might turn to whether direct intervention is called for in order to shift the market to a new equilibrium. However, it is necessary in all such cases to ensure that any such response is at most targeted 'micro-surgery' rather than potentially more drastic intervention in order to avoid the risk of undermining competition in the long run.
28. In addition to the issues to address before determining what interventions should be used to achieve the most effective market outcome, it may also be appropriate to focus attention on what could be done to mitigate harm if any of the Big Four firms were to leave the market. In this regard, the OFT is considering undertaking further research and analysis vis-à-vis potential competition issues in concentrated markets where there may be a risk of systemic failure, where any such failure could cause significant harm to the UK economy. Our interest in such markets is distinct from other regulators who do not have a competition focus. Our interest is not on assessing the level of

systemic risk as such but in assessing whether such markets currently deliver what consumers want on competitive terms that present good value to consumers and, more broadly, to the wider economy. Any such work, if undertaken, would likely consider what, if any, appropriate solutions may be available.

## **CONCLUSION**

29. This submission has explained that the OFT considers that competition in the market for audit services in the UK may be limited. It has presented a number of issues to be considered in determining appropriate changes to the market that could increase competition in the market and thereby possibly reduce the systemic risk of failure of one of any of the Big Four, with the resulting significant impact of this on companies and consumers.

**John Fingleton**

**Chief Executive**