

Agenda

Advancing economics in business

Auditors and the financial crisis: beyond the status quo

The financial crisis has brought renewed attention to the audit market, which is dominated globally by the ‘Big Four’ accountancy firms. According to European Commissioner, Michel Barnier, ‘the status quo is not an option for the world of auditing.’ In the UK, a House of Lords Committee has called for a wide-ranging competition inquiry. What is the economic evidence for a competition problem in the audit market, and what are the proposed solutions?

Sometimes competition issues simmer away for a decade or more before a combination of events turns up the heat and leads to calls for regulatory intervention. Such may be the case for the audit market, which has been highly concentrated since the merger of Price Waterhouse with Coopers & Lybrand (1998) and the dissolution of Arthur Andersen (2002), which led to the current situation of the ‘Big Four’ audit firms.

It is now five years since the publication of an Oxera study on competition and choice in the audit market.¹ Following that study, the UK Financial Reporting Council (FRC) instituted a working group to increase audit choice—yet the latest working group report of June 2010 shows virtually no change in market concentration in the last five years.² Last month, the House of Lords Select Committee on Economic Affairs published an inquiry recommending ‘a detailed investigation of the large-firm audit market by the Office of Fair Trading’ (OFT) and highlighting concerns around bank audit.³

The financial crisis has also brought audit market competition into focus for the European Commission—a Green Paper was published in October 2010, and policy proposals are expected in November 2011.⁴ Michel Barnier, EU Commissioner for Internal Market and Services, has recently described the audit market as ‘hyper-concentrated’ and said that, following the consultation on the Green Paper, ‘the status quo is not an option’.⁵ The Commission’s Green Paper explores concerns beyond the pure competition issues, including that auditors gave ‘clean audit reports’⁶ to banks which subsequently revealed huge losses and were bailed out by the taxpayer, and that the Big Four audit firms may now be ‘too big to fail’.⁷

It is therefore timely to recap what these inquiries found to be the fundamental problems in audit market competition, and, in light of that evidence, to ask what remedies are now proposed for increasing competition and choice.

The evidence on competition

Oxera

Oxera has published two studies on the audit market: the FRC-commissioned study in 2006 assessing the drivers of competition and choice in UK auditing; and a study for the European Commission in 2007 evaluating the impact of audit firm ownership rules.⁸ The main findings of the 2006 study were as follows.

- The Big Four audit firms—Deloitte, Ernst & Young, KPMG and PricewaterhouseCoopers (PwC)—audit all but one of the FTSE 100 companies, and represent 99% of audit fees in the FTSE 350. Switching rates are low (around 4% on average for all listed companies, and 2% on average for FTSE 100 companies), and competitive tendering does not occur frequently. Market concentration ratios as measured by the FRC in 2010 show no significant change since Oxera’s study in 2006.⁹ In 2010 the Big Four audited 99 of the FTSE 100 firms and around 240 of the FTSE 250.¹⁰
- Reputation is an important driver of choice, and therefore favours the Big Four. This may be based on real or perceived differences with the mid-tier firms, which seek to compete with the Big Four on the audit of large listed companies.
- There is evidence that higher concentration is associated with higher audit fees (in line with

economic theory and with several other empirical studies).

- A limited number of UK-listed companies, primarily in the financial services sector of the FTSE 100, have no effective choice of auditor in the short run. This lack of choice is driven by high market concentration, auditor independence rules, supply-side constraints, and the need for sector expertise.
- The current market structure is likely to persist. Substantial entry and expansion are unlikely to be attractive due to significant barriers, which include the perception bias against mid-tier firms; high costs of entry; a long payback period for any potential investment; and significant business risks when competing against the incumbents in the market.
- The loss of another Big Four firm would exacerbate problems around auditor choice, requiring regulators to make exceptions to auditor independence rules.

The main findings of the 2007 Oxera study for the European Commission were as follows.

- Rules on ownership of audit firms impose restrictions on access to capital that serve as a barrier to entry and expansion in auditing.
- Relaxing ownership rules (by allowing external capital) could create new investment and entry opportunities.
- The potential negative effects on auditor independence of departing from the partnership model of ownership are limited, and could be mitigated, for example, by strengthening public oversight and restricting concentration of ownership.

House of Lords Economic Affairs Committee

The March 2011 report of the House of Lords Select Committee on Economic Affairs calls on the OFT to carry out a market study in the UK audit market, criticising the bank auditing situation in the UK, which is seen as a 'Big Three' rather than a 'Big Four' market (since Ernst & Young does not operate in this area). The Select Committee raised concerns about the prospects for competition and financial stability if one of the Big Four were to withdraw or collapse, as occurred in 2002 with Arthur Andersen, the auditor of Enron. The report states that the 'disconcertingly complacent'¹¹ attitude of bank auditors was a 'significant contributory factor' in the banking crisis.¹²

In its evidence to the Select Committee, the OFT identified aspects of the audit market that it considered tended to restrict competition, including a lack of incentive to switch auditors, due to the difficulty in discerning audit quality. This is reinforced by the cost

of switching auditor, by a focus on reputation rather than value added, and by very limited choice of auditor for some large listed companies.¹³ Philip Collins, chairman of the OFT, concluded: 'we think that the market, as currently structured, may not operate in a way that works well for users.'¹⁴

European Commission

The Commission's 2010 Green Paper finds that the total market share of the Big Four audit firms for listed companies exceeds 90% in a vast majority of EU Member States. It notes that 'the market appears to be too concentrated in certain segments and deny clients sufficient choice when deciding on their auditors'.¹⁵ Michel Barnier highlights that 27 out of 30 companies listed on the DAX30 are audited by just two firms: KPMG and PwC.¹⁶ The Commission has concerns not only about choice and competition, but also about financial stability, stating that the collapse of one of the Big Four could affect the stability of the financial system as a whole. It argues that the size of each of the largest audit firms 'has attained systemic proportions', to the extent that they might ultimately require similar treatment to other 'too big to fail' firms in the banking sector.¹⁷

The options for change

If a competition authority or regulator spends a substantial amount of time and resources on an investigation and concludes that there is a competition problem, this is of little value to consumers if a suitable remedy cannot be found. It is therefore always useful to think about the practicability of remedies, even before an investigation has reached its conclusions.

If there is indeed a problem, the audit market is probably one in which competition is functioning ineffectively for structural reasons, not necessarily because of anti-competitive behaviour. The remedies proposed should therefore be aimed at changing some of the structural features of the market. A recent example in the UK is the forced divestment of airports by BAA with the aim of increasing competition.¹⁸ Other market investigations under the Enterprise Act 2002 have led to behavioural remedies aimed at increasing consumer switching (including the Competition Commission investigations into personal current accounts and payment protection insurance).

The European Commission considers the following remedies in its Green Paper, under the heading 'Concentration and market structure' (other remedies are noted for matters such as the governance and independence of audit firms).

- Joint audits/audit consortia: listed companies could be required to appoint more than one audit firm, with the inclusion of at least one non-systemic (ie, non-Big Four) audit firm in the case of large companies.

- Mandatory rotation of auditors and re-tendering: a mandatory time limit could be imposed on the period that one audit firm can serve as a company's auditor, with mandatory tendering of the audit at the end of that period and transparent criteria for appointing the new auditor.
- Addressing the 'Big Four is Best' bias: in order to recognise the ability of other audit firms to perform audits of large listed companies, restrictive covenants that require a Big Four auditor in order to access capital could be removed, and quality inspections and certification could be imposed.
- Contingency plan: a plan could be imposed to deal with the demise of a systemically important audit firm, in a similar way to the 'living wills' that are formulated to deal with the eventuality of the future failure of large banks.

Alternative options

In his February 2011 speech, Michel Barnier referred to several additional options for change currently being explored by the European Commission.

First, a prohibition on audit firms performing non-audit functions. This would be a form of vertical separation (a structural remedy), since the non-audit services of tax advice or consultancy are usually complements to the audit business. Presumably this remedy would be aimed at fixing conflicts of interest and safeguarding auditor independence, as well as at improving competition, since it would not immediately affect the current market shares in the audit market.

Second, giving a greater role to the audit committee in the selection of auditors. This might be considered a behavioural remedy in the same sense as interventions in other markets that seek to improve consumer information and switching.

Third, the establishment of market share caps for the audit of larger companies. Depending on the limits set for such caps, this could involve horizontal separation (a structural remedy of divestment) by some or all of the Big Four—in the UK it would affect PwC more than the others, since PwC has around 40% market share.

Finally, Michel Barnier suggests that another way to open the markets would be to create a 'European passport'. This principle already applies to many companies in the financial services sector. Firms offer services in other European Member States (known as 'host states') under a European passport, which is granted by the home state authority and becomes effective if the supervisory authority of the host state has no objections to the firm carrying out activities in its jurisdiction. This remedy might depend on the degree of cooperation and common standards between different EU audit regulators.

The European Commission is also considering changes to the ownership restrictions for audit firms, following the Oxera study for the European Commission described above. According to the Commission, allowing alternatives to the partnership model could 'help non-systemic firms to gain access to more capital and allow them to ramp up capacities and grow more rapidly'.¹⁹

Clearly, a wide range of remedies is under consideration but, like the banking sector, the audit market is subject to a range of regulatory concerns beyond those of pure competition. Auditor independence, systemic risk and the quality and utility of audit reports are all issues that are subject to review in light of the global financial crisis and the lessons drawn from it. Designing a solution to the perceived problems in the market is therefore a complex and sensitive task, but perhaps not one that is unfamiliar to competition authorities and regulators who have been dealing with the financial services sector since the global financial crisis.

¹ Oxera (2006), 'Competition and Choice in the UK Audit Market', prepared for Department of Trade and Industry and Financial Reporting Council, April.

² Financial Reporting Council (2010), 'Choice in the UK Audit Market. Fifth Progress Report', June.

³ House of Lords Select Committee on Economic Affairs (2010), 'Auditors: Market Concentration and their Role', 2nd Report of Session 2010–11, Volume 1: Report, p. 6.

⁴ European Commission (2010), 'Green Paper. Audit Policy: Lessons from the Crisis', COM(2010) 561 final, October 13th. Barnier, M. (2011), 'Audit 2011 – L'Année de l'Audace', Speech/11/89, Brussels, February 10th.

⁵ Barnier (2011), op. cit.

⁶ European Commission (2010), op. cit., p. 3.

⁷ European Commission (2010), op. cit., p. 4.

⁸ Oxera (2006), op. cit. Oxera (2007), 'Ownership Rules of Audit Firms and their Consequences for Audit Market Concentration', prepared for DG Internal Market and Services, October.

⁹ Financial Reporting Council (2010), op. cit.

¹⁰ House of Lords Select Committee on Economic Affairs (2010), op. cit., p. 9.

¹¹ House of Lords Select Committee on Economic Affairs (2010), 'Auditors: Market Concentration and their Role', 2nd Report of Session 2010–11, Volume 1: Report, p. 40.

¹² Ibid., p. 46.

¹³ House of Lords Select Committee on Economic Affairs (2010), 'Auditors: Market Concentration and their Role', 2nd Report of Session 2010–11, Volume 2: Evidence, pp. 168–9.

¹⁴ Ibid., p. 28.

¹⁵ European Commission (2010), 'Green Paper – Audit Policy: Lessons from the Crisis', COM(2010) 561 final, October 13th, p. 15.

¹⁶ Barnier (2010), op. cit.

¹⁷ European Commission (2010), op. cit., p. 4.

¹⁸ Competition Commission (2009), 'BAA Airports Market Investigation', March.

¹⁹ European Commission (2010), op. cit., p. 13.

If you have any questions regarding the issues raised in this article, please contact the editor, Dr Gunnar Niels: tel +44 (0) 1865 253 000 or email g_niels@oxera.com

Other articles in the April issue of *Agenda* include:

- price versus volume: decarbonising the electricity industry
Tim Tutton, Exeter University Energy Policy Group
- private damages claims: questions relating to the passing-on defence
Mario Siragusa, Cleary Gottlieb Steen & Hamilton LLP, Rome
- the economist on trial: can judges rely on the evidence?

For details of how to subscribe to *Agenda*, please email agenda@oxera.com, or visit our website

www.oxera.com