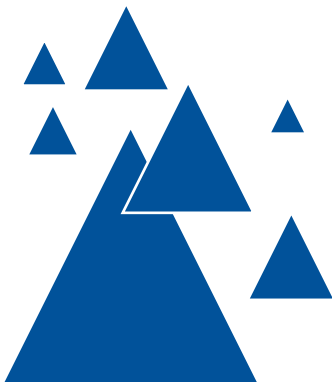




# Competition, Choice and Governance in the UK Audit Market: Interview Evidence

## Executive Summary



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# EXECUTIVE SUMMARY

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A *Market Participants Group* was appointed by the Financial Reporting Council (FRC) following concerns about competition and choice in the UK audit market. The *Market Participants Group* issued a report in 2007 containing 15 recommendations that aim to improve choice and reduce risks in the UK audit market. This research explores:

- (i) Whether there is sufficient market competition and whether there is a desire by stakeholders to improve choice;
- (ii) The governance structure of firms that undertake audit work and how possible changes and proposed new ownership rules could be manifested; and
- (iii) The challenges to, and likely impact of, each of the 15 recommendations.

Audits are traditionally part of the work undertaken by accounting firms and therefore throughout this report reference is made to ‘accounting firms’.

The study is based on a series of 34 interviews with a number of stakeholder groups, including: partners from a range of accounting firms; directors and/or audit committee chairman of listed companies; shareholders; analysts; regulators; and government representatives. These interviews were conducted in the spring of 2008.

The main findings of this report are as follows:

- The audit of the large company market is heavily concentrated and choice is very limited, particularly in specialist industries such as the banking sector. Some companies searching for a specialist Big Four auditor are faced with a choice of only one or two firms.
- There are some concerns about the level of market competition and there is a strong stated desire for improved choice in the UK audit market by all interviewees in this study, including, perhaps surprisingly, the Big Four firms.
- When pressed further, Big Four partners believe that generic growth amongst firms five and six is desirable but they are not willing to resign from clients to improve choice.
- Several non-Big Four firms are striving to reduce the gap between themselves and the Big Four but are focussing on FTSE 350 client audits and FTSE 100 consultancy contracts.
- Barriers to non-Big Four firm growth are perceptions of quality, resources, reputation, depth of pockets and contractual obligations to hire specified audit firms.
- All interviewees believe that bridging the gap between the Big Four and non-Big Four firms will take time and effort and will be far from straightforward.
- There are mixed views on the Companies Act 2006, which allows auditors to limit their legal liability by contract to an amount which is proportionate to the degree of error or negligence of the auditors. Recent developments also include the European Commission's recommendation that Member States should take measures to limit liability. Further work on the advantages and disadvantages of limits to liability, proportionate liability and the likelihood of a catastrophic claim is essential.

- Non-Big Four partners believe that the 15 recommendations will not make a significant difference to the market and will have little impact on choice in the audit market.

Most of the larger accounting firms have changed to committee-based governance structures, have taken advantage of limited liability partnership (LLP) regulations, and do not appear to have experienced any major difficulties in making these adjustments. Combined with the new measure in the Companies Act 2006 that permits a liability limitation agreement to be put in place between the auditor and the company, with the shareholders agreement, these measures should help auditors to limit a claim for damages and may help to improve choice in the UK audit market.

The Big Four partners interviewed welcomed the 15 recommendations (subject to safeguards about quality and independence) but non-Big Four partners and many company directors feel that they will not make a significant difference to the market and will have little impact on choice. Big Four partners raised concerns about the finer details of a handful of recommendations but on the whole were satisfied. By contrast some non-Big Four partners felt that much more could have been done by the *FRC*. Allegations were made that the *FRC* had turned its back on the issue of broadening the audit market in favour of recommendations that aim to prevent another withdrawal of a firm from the market place.

Most partners were sceptical about the effectiveness of the new ownership recommendation but are in favour of the introduction of proportionate liability. Most other interviewees were opposed to proportionate liability for auditors. Partners strongly promoted proportionate liability on the grounds that they would then be liable for the percentage of damages attributable to them, but not for the full amount of the corporate loss. Interviewees believed that a big firm 'four-to-three' scenario would be destructive for the profession and the economy but the associated risks have yet to be fully considered. There were even claims that a 'four-to-zero' scenario could arise because the remaining three firms might leave the market on their own terms rather than under the cloud of a further claim. The researcher is sceptical about the likelihood of this

scenario and believes that sustainability was being raised as a political lever to force through proportionate liability. Further work on the pros and cons of the current model of liability reform and the likelihood of a catastrophic claim is therefore essential. However, these issues extend beyond the UK and will therefore probably need a common European or global approach to provide an adequate solution.

As a result of these findings there are six policy recommendations:

- On the back of the choice debate, the larger non-Big Four firms should implement new marketing strategies to inform audit committees of their abilities and work harder to win the tenders for FTSE 350 companies' audit and consultancy contracts.
- The *FRC*, as it has already indicated, and other stakeholders should assess the level of take up and the impact of the new auditor liability limitation agreements enabled by the Companies Act 2006.
- The government should seek to remove any barriers to non-Big Four growth, such as contractual obligations to appoint only a Big Four firm as auditor.
- Directors and audit committees should be encouraged to shortlist from a wider range of accounting firms than the Big Four firms.
- The *FRC* should evaluate the issue of choice in the UK audit market on an annual basis. If the various supply and demand side measures suggested by the *Market Participants Group* do not improve the level of choice then the *FRC* should consider the implementation of non-market based measures if improved choice is seen as desirable to the majority of stakeholders.
- The *FRC*, with the support of audit firms and audit committees, should commission a thorough review of the likelihood and economic consequences of a further withdrawal of a Big Four accounting firm from the market.



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