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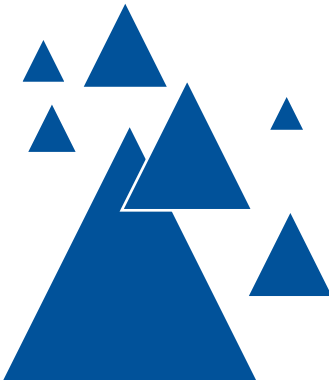


# Competition, Choice and Governance in the UK Audit Market: Interview Evidence

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Researcher: Kevin McMeeking

OCCASIONAL PAPER



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



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

by

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Published by

The Institute of Chartered Accountants of Scotland  
CA House, 21 Haymarket Yards  
Edinburgh EH12 5BH

First Published 2009  
The Institute of Chartered Accountants of Scotland

© 2009  
ISBN 978-1-904574-22-4  
EAN 9781904574224

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The Institute of Chartered Accountants of Scotland.  
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Printed and bound in Great Britain  
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## OREWORD

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The large listed audit market is dominated by the Big 4 accounting firms; this has led to concerns about the lack of competition and choice in the audit market and the establishment by the Financial Reporting Council (FRC) of the Market Participants Group. Most stakeholders agree that additional choice in the audit market would be beneficial but should this be left to market forces or should regulatory measures be adopted? This interview based study investigates: the extent of such concerns; to what extent there is a desire to improve audit choice; and the challenges and likely impact of the Market Participants Group's 15 recommendations made in 2007.

The study identifies concern about the level of market competition and a strongly stated desire by interviewees for improved choice in the audit market, although it is recognised that bridging the gap between the Big Four and non-Big Four firms will take time and effort. The author makes a number of recommendations for stakeholders with an interest in the audit market to consider.

This project was funded by the Scottish Accountancy Trust for Education and Research (SATER). The Research Committee of The Institute of Chartered Accountants of Scotland (ICAS) has also been happy to support this project. The Committee recognises that the views expressed do not necessarily represent those of ICAS itself, but hopes that the project will add to the debate on audit choice.

David Spence  
Convener, Research Committee

December 2008

# A

## CKNOWLEDGEMENTS

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This study benefited from the generous financial support of The Scottish Accountancy Trust for Education and Research and the support of The Institute of Chartered Accountants of Scotland, the time and valuable insights of the interviewees, the helpful encouragement and comments of Christine Helliar, Vivien Beattie, Ruth Bender and the research assistance of Elizabeth McMeeking and Christine Down.

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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.

# 1 INTRODUCTION

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The effect of market structure on the conduct and performance of firms has been debated for many years (Scherer and Ross, 1990; Martin, 1994; McMeeking 2007; Stigler, 1968). A series of mergers amongst the leading accounting firms, the collapse of Andersen and significant barriers to entry (e.g. the need to generate a strong brand name reputation and 'deep pockets') have led to four firms dominating the large client audit market. Concerns have been raised that the high concentration levels and significant barriers to entry may impair consumer choice and/or price competition (*FRC, 2007; Oxera, 2006*). These concerns led the Financial Reporting Council (*FRC*) to host a series of stakeholder meetings at which the *Market Participants Group* was formed to investigate these issues and how the profession might best respond. After a lengthy period of investigation and debate, the *Market Participants Group* issued a report containing 15 recommendations that aim to improve choice and mitigate the risks arising from the characteristics of the UK market for audit services (*FRC, 2007*).

The main aims of this research are framed as three objectives that fall across a number of research agendas. These objectives are to explore:

- Whether there is a desire by auditors, accounting firms and/or companies to reduce the gap between the Big Four and the remaining firms, and if so how this can best be achieved;
- Perceptions of the differences between various alternative legal forms of governance in accounting firms, how the effects of any proposed changes could be manifested into different organisational structures and systems within accounting firms and the likely effects on other entities; and

- Perceptions of the challenges to, and likely impact of, each of the 15 recommendations put forward by the *Market Participants Group*.

This research will consider the challenges and impact on companies, directors, the UK audit market and the auditing profession.

The research approach adopted in this report is a series of 34 semi-structured interviews, conducted in spring 2008, with interested parties to assess stakeholders' views of these three objectives. The interviewees were senior partners, shareholders, audit committee members, directors, analysts and the Government. The remainder of this report is organised as follows. A summary of the literature is presented in chapter two and chapter three describes the methodology used in this report. The results are then described in chapter four and a summary is presented in chapter five.

# 2 LITERATURE REVIEW

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## Introduction

This chapter reviews the prior literature that is relevant to the study. First a summary of the evolution of the legal framework underpinning the UK audit market is provided. The next section summarises the structure of the UK audit market and the firms that operate within it. The relationship between market structure, conduct and firm performance is discussed in the third section and finally the work of the *FRC* appointed *Market Participants Group* is summarised.

## Legal framework

Accounting firms were originally established as general partnerships and auditors were not permitted by Company law to set up in an incorporated form. A partnership is defined by the Partnership Act of 1890 as:

*... not incorporated and has unlimited liability, but can be a legally acknowledged organisation where two or more and often not more than fifteen join together to carry out a business.*

Partnerships are common amongst tradesmen and, traditionally, professionals such as accountants, GPs, architects, surveyors and lawyers.

There are two key aspects to a partnership: liability is unlimited and partners have joint and several liability status. The main implication

of joint and several liability is that the mistakes of one partner can impact on the personal assets of other partners, possibly leading to bankruptcy. In the UK the auditor can, and generally will, be liable to its client companies for breach of contract and in tort if auditors have been negligent in carrying out their audits. These partnership regulations provide a client company with a form of creditor protection but in general there is no contractual relationship between an auditor and any third party (although this can be reversed in certain restrictive conditions). The 1989 Companies Act permitted an individual or a 'firm' to be appointed as a company auditor, with a 'firm' defined as a body corporate or a partnership. Nevertheless, this did not address the liability issue for auditors because, under the general law, professional people owe a duty of care to their clients which cannot be avoided.

Accounting firms lobbied for a relaxation of the liability rules. As the modern world became increasingly litigious, accounting firms faced lawsuits of increasing size and were often seen as good litigation targets because of their 'deep pockets' (Lennox, 1999) and reputations whereby they might be more likely to settle out of court than other entities because of a reluctance to undertake a lengthy court battle due to the associated adverse publicity. Accounting firms reported that they faced a considerable number of high-value actual or potential claims arising from statutory audits. For example, the largest six accounting firms indicated that as of 31 October 2005, their risk managers were dealing with 28 outstanding matters that could lead to claims arising from audit in excess of €75M. The costs of final settlement and of dealing with claims are considerable and professional indemnity insurance cover for these risks is limited. The risk that a Big Four firm would have to pay out a large settlement themselves increased substantially in recent years (London Economics and Ewart, 2006) and led to increasingly loud calls for an adjustment to the liability regime.

The case that general partnership law was no longer an appropriate vehicle for the Big Four firms, and some national ones, had reached a

watershed and it became clear that a regulatory change was required. One obvious solution was incorporation but accounting firms were prohibited from reducing their liability. A new vehicle, the Limited Liability Partnerships Act 2000 and Regulations 2001, was introduced enabling partners to limit their exposure and to protect their personal assets, although those of the LLP remained at risk and did not address liability limitation on individual audits. This has since been addressed in the Companies Act 2006, which allows liability limitation agreements, with effect from April 2008. These agreements are subject to shareholder approval and therefore represent a modest victory for accounting firms. The ability to agree a limited liability contract is due to come into effect at companies' 2008 annual general meetings and onwards. Guidance on this has been issued by the *FRC* (*FRC 2008*), however, some firms have criticised the *FRC* for the delay in issuing this guidance (Sukhraj, 2008).

Many of the larger accounting firms converted into LLPs, some into limited liability companies and most of the remaining accounting firms have considered, or are considering, the issue. At the end of 2007, 21 UK firms were registered as LLPs and ten accounting firms have restructured as limited companies (Table 2.1).



*Table 2.1 List of accounting firms that have taken limited liability partnership or corporate status by the end of 2007*

LLP	Company
Adler Shine	BDO Alto
BDO Stoy Hayward	BDO Novus
Deloitte & Touche	Blueprint Audit
Ernst & Young	Hill Wooldridge & Co
Fish Partnership	HWCA
Grant Thornton	KPMG Audit
Hazlewoods	Nexia Audit
Horwath Clark Whitehill	RBS
Kingston Smith	Royce Peeling Green
KPMG	Tenon Audit
MacIntyre Hudson	
Mazars	
Moore Stephens	
MRI Moores Rowland	
PKF	
PricewaterhouseCoopers	
RSM Robson Rhodes	
Shipleys	
Smith Williamson Solomon Hare	
UHY Hacker Young	
Wingrave Yeats Partnership	

Source: Stock Exchange Yearbook

The *Market Participants Group* recommends that the *FRC* should promote a wider understanding of the possible effects on audit choice of changes to audit firm ownership rules because, at present, under the eighth directive auditors must control their firms. Regulators and legislators should seek to promote choice, subject to the overriding need to protect audit quality when developing and implementing policy on

auditor liability arrangements. Studies of the effects of different forms of legal governance on the UK audit market are scant. One exception is Oxera (2007). Oxera is an independent economics consultancy group that works regularly for governments, regulators and major companies. Oxera (2007) notes that aspects of the employee-owned corporate form of ownership are likely to increase the required rate of return of accounting firms and may also limit their ability to access capital. The report notes that there are other barriers to entry including reputation, the need for international coverage and liability risk that should be considered in addition to rules on access to capital. Using a stylised model, they find that audit firms with partnership structures are unlikely to undertake the investment needed for expansion from a medium-sized firm to a large firm in one transaction. Moreover, there were doubts about whether expansion into auditing large companies would be profitable for employee-owned firms because the rates of return might not exceed the cost of capital. Oxera (2007) notes, however, that the negative effects from changes in ownership rules on auditor independence could be mitigated. It is clear that there are many complex issues surrounding ownership structure and changes to ownership rules may not be the sole solution to the issue of competition and choice in the audit market.

## **The structure of the UK audit market**

The market for audit services is unique because it is a statutory requirement for companies to have an audit but it is provided by the private sector. Audit firms generally consist of a group of partners, managers and juniors, the majority of which are qualified practitioners. Qualification is dependent on passing professional examinations, observing an ethical code and having practical experience of auditing over a period of years. These requirements create an entry barrier into the profession. There are also a number of other entry barriers into the

market, including the need for firms to have a strong reputation to attract clients, deep pockets to fight any litigation suit and a pool of qualified staff to meet resource demands. These barriers restrict: (i) the supply of individuals that are qualified as auditors; and (ii) the number of audit firms that can compete in the market. Although these restrictions aim to prevent unscrupulous service providers from exploiting the information advantage they hold over other stakeholders, there are no guarantees that this strikes the correct balance between protection and the consumer benefits from competition. Nevertheless, restrictions on supply are likely to limit access and consumer choice, increase prices and result in poorer value for money than would occur in a competitive market.

Accounting firms offer a range of audit and non-audit advisory services. Unlike other business entities, there is a limit to the amount of audit and non-audit services that any one accounting firm can undertake for a particular company because: accounting firms are required to be independent of their clients; and the auditor is required to be independent of the provider of other services. Accounting firms should not engage in excessive price competition for audits because any economic bond created with a company might also impair auditor independence (see Pong and Whittington, 1994 for an example of the 'lowball pricing' literature). Firms were accused of lowballing in the 1980's but this has been banned by the European Union Eighth Directive. Accounting firms have evolved since the 1980s in response to these issues in different ways. Today's market is characterised by: a large number of small local accounting practices, many of which are not audit registered, with just a handful of partners; a large range of medium sized firms with local to national coverage; large firms with national and international coverage; and four very large firms that have many partners and an international reach.

The demand for audit services and non-audit services varies across the UK market. There is no legal requirement in the UK for sole traders, partnerships and small companies to have their accounts

prepared by a qualified practitioner or an accounting firm or have such accounts audited. Sole traders, partnerships and small companies are only willing to hire an auditor if they believe that the benefits of an audit outweigh the associated costs or if it is required by, say, banks or grant providers. By contrast, the demand for an audit is relatively inelastic in the large corporate sector because all UK companies above the minimum size threshold are legally required to have their accounts audited by a registered audit firm. Some business entities are happy to appoint an auditor that provides the (low cost) minimum level of service. However, many entities demand a level of service that is above this threshold and some medium-sized and large companies demand a very high-level (or quality-differentiated) of audit service that can only be supplied by a few firms.

The three sources of demand for quality-differentiated audits are agency-demand, information-demand and insurance-demand (Beattie and Fearnley, 1995). Jensen and Meckling (1976) explain that audits can reduce agency costs, such as limiting the excessive consumption of perks that result from the self-interested actions of agents. The information demand for an audit refers to situations where management wish to hire a particularly credible firm of auditors to signal their own honesty and integrity (Dopuch and Simunic, 1980). The insurance demand for an audit refers to the opportunity that an audit opens up for investors and creditors to seek recompense from the auditor, through the law courts, for any losses they might suffer as a result of corporate failures through audit negligence, with higher quality auditors having more insurance capacity. Differences in client circumstances lead to a demand for quality-differentiated audits.

There is a general belief that the Big Four firms can offer a quality-differentiated product due to their strong brand reputation, specialist expertise and significant resources. Evidence to support these claims comes from studies that have shown that the big firms can charge an audit fee premium (Ireland and Lennox, 2002; McMeeking *et al.*, 2006), are

more likely to issue a going-concern opinion for distressed companies (Ireland, 2003) and reduce earnings management by corporate executives in company accounts (Becker *et al.*, 2002; Francis *et al.*, 1999). Further, there are fewer sanctions against the Big Four (Feroz *et al.*, 1991) and fewer law suits against them (Palmrose, 1988). Oxera (2007) notes that the repercussions for corporate managers are less severe during times of financial distress if they have hired a Big Four firm rather than a small or medium sized firm (the 'IBM effect'). Thus, the pressure to hire one of the Big Four firms is extremely high in certain segments of the audit market. This is demonstrated by Table 2.2 which shows that the Big Four have almost complete control of audits for both the FTSE 100 and FTSE 250 markets but a relatively small share of the FTSE Small Cap market. The market for quality-differentiated audits within the FTSE 350 is of interest because the competition and choice issues are greatest in this segment as many FTSE 350 companies act as though there are only four auditors to choose from. The FTSE 350 will thus be the main focus of attention in this study.

*Table 2.2 Market shares based on the number of UK audits as at December 2007*

Firm	FTSE 100		FTSE 250		FTSE Small Cap		Total market	
	No.	%	No.	%	No.	%	No.	%
PwC	37	37.0	79	31.6	260	12.1	376	15.1
KPMG	27	27.0	55	22.0	297	13.9	379	15.2
DT	18	18.0	67	26.8	228	10.6	313	12.5
EY	17	17.0	38	15.2	265	12.4	320	12.8
BDO			6	2.4	174	8.1	180	7.2
GT	1	1.0	3	1.2	196	9.2	200	8.0
BT			1	0.4	112	5.2	113	4.5
RSM					72	3.4	72	2.9
PKF					79	3.7	79	3.2
NEXIA					39	1.8	39	1.6
HCW					18	0.8	18	0.7
CLB					25	1.2	25	1.0
MRI					18	0.8	18	0.7
MS			1	0.4	22	1.0	23	0.9
UHY					24	1.1	24	1.0
KS					20	0.9	20	0.8
Others					296	13.8	296	11.9
Total	100	100.0	250	100.0	2,145	100.0	2,495	100.0
CR4	99	99.0	239	95.6	1,050	49.0	1,388	55.6

PwC denotes PricewaterhouseCoopers; KPMG denotes KPMG; DT denotes Deloitte and Touche; EY denotes Ernst and Young; BDO denotes BDO Stoy Hayward; GT denotes Grant Thornton; BT denotes Baker Tilly; RSM denotes RSM Robson Rhodes; PKF denotes PKF; NEXIA denotes Nexia Audit; HCW denotes Horwath Clark Whitehill; CLB denotes CLB; MRI denotes MRI Moores Rowland; MS denotes Moore Stephens; UHY denotes UHY Hacker Young; KS denotes Kingston Smith; Others denotes all of the other accounting firms that have less than 20 audit clients and CR4 is the four-firm concentration ratio.

Source: Stock Exchange Yearbook

## The effect of market structure on price competition

The relationship between market structure, firm conduct and performance has long interested industrial economists (e.g. Stigler, 1968). The traditional structure-conduct-performance framework states that the number of firms in an industry determines the degree of price competition, which in turn determines whether or not these firms earn excess profits. Industrial economists contend that prices also depend on the extent of any barriers to entry and the strategies of the leading firms (e.g. Farrell and Shapiro, 1990). Scholars use the structure-conduct-performance paradigm to warn that increases in industry concentration levels may adversely affect price competition (Stigler, 1968; Gist and Michaels, 1995).

The relationship between structure and the level of price competition in the audit market is interesting for a number of reasons. There is considerable evidence that audit market concentration has increased in the UK (Briston and Kedslie, 1984; Moizer and Turley, 1989; Beattie and Fearnley, 1994; Pong, 1999; Oxera, 2006; McMeeking *et al.*, 2007) and in other countries (Zeff and Fossum, 1967; Rhode *et al.*, 1974; Hermanson *et al.*, 1987; Wolk *et al.*, 2001). Concentration ratios increase after an audit firm merger; or if management of a company switch to a quality-differentiated supplier because they believe that the big firm will offer a better audit, consultancy services and greater insurance against catastrophes than their smaller counterparts (Jensen and Meckling, 1976; Dopuch and Simunic, 1980; Menon and Williams, 1994). However, the rate of auditor switching is low, around four percent based on the number of clients, and the largest increases in concentration followed the formation of Ernst and Young and PricewaterhouseCoopers, and the demise of Arthur Andersen. Concerns have been raised that concentration ratios in some segments of the market are extremely high and this may have adverse effects on price competition and consumer choice. The Sarbanes-Oxley Act (2002), the recommendations of the

Treasury Committee (2002), the Coordinating Group on Audit and Accounting Issues (2003) and Oxera (2006) indicate the extent of this concern about the audit services market in both the US and UK. Kittsteiner and Selvaggi (2008) conclude that concentration and fees are positively correlated from 2002 to 2006 (post the demise of Andersen) but not correlated from 1998 to 2001 (pre Andersen) and observe that the big firm premium increased after the Andersen collapse. This raises questions about: whether the market is competitive; and whether companies have sufficient alternatives to enable them to appoint a high quality, independent auditor at a competitive price (Oxera, 2006).

## **Market Participants Group**

The *FRC* organised a series of stakeholder meetings in 2006 during which interested parties were encouraged to voice their opinions on these issues. Following these meetings, a *Market Participants Group (MPG)* was established by the *FRC* to provide advice on the action that could be taken to mitigate the risks arising from the current status of the market for audit services to public interest entities in the UK. The *MPG* comprises of individuals from the entities being audited; the firms providing the audit services; and the users of audit services (e.g. investors), thus representing the market for the supply of, and demand for, audit services. This is summarised in Table 2.3.



*Table 2.3 Constituents of the Market Participants Group*

Name	Position in MPG	Affiliation
Paul Boyle	Group convenor	Chief Executive <i>FRC</i>
Philip Broadley	Member	Group Finance Director, Prudential plc and Chairman of the Hundred Group of Finance Directors
Michael Cleary	Member	National Managing Partner, Grant Thornton UK LLP
John Connolly	Member	Senior Partner and Chief Executive, Deloitte UK, Deloitte & Touche LLP
David Herbinet	Member	Partner & Head of Public Interest Markets, Mazars LLP
Huw Jones	Member	M&G Investment Management Limited
Ian Percy CBE	Member	Deputy Chairman of the Weir Group plc and Ricardo plc
Michael Power	Member	JP Morgan Cazenove
David Robertson	Member	Finance Director, Mears Group plc
Derek Scott	Member	Chairman, Stagecoach Group Pension Scheme trustees
Robert Talbut	Member	Chief Investment Officer, Royal London Asset Management
Brian Walsh	Member	Formerly Deputy Chairman and Chairman of Audit Committee, National Building Society
Peter Wyman	Member	Partner, PricewaterhouseCoopers LLP

It is worth noting that in spite of the Oxera (2006) findings, the *MPG's* final report (*FRC* 2007) focuses on the issue of choice rather than competition. The *FRC* (2007) notes that due to the level of auditor concentration there is a high degree of concern amongst market participants over the uncertainty and costs that could arise in the event

of one or more of the Big Four firms leaving the market. The *MPG (FRC 2007)* made 15 recommendations (see Table 2.4) that it believes should, when combined with other changes, contribute to increased choice whilst at least maintaining audit quality, at a cost which is proportionate to the likely benefits, and at a cost which is lower than any alternatives offering equivalent benefits. The main aims of the recommendations are to: make investment in the supply of audit services more feasible; reduce the perceived risks to directors of selecting a non-Big Four firm; improve the accountability of boards for their auditor selection decisions; improve choice from within the Big Four; reduce the risk of firms leaving the market without good reason; and reduce uncertainty and disruption costs in the event of a firm leaving the market.

Table 2.4 Recommendations of the Market Participants Group

No.	Recommendation
1	The <i>FRC</i> should promote wider understanding of the possible effects on audit choice of changes to audit firm ownership rules, subject to there being sufficient safeguards to protect auditor independence and audit quality.
2	Audit firms should disclose the financial results of their work on statutory audits and directly related services on a comparable basis.
3	In developing and implementing policy on auditor liability arrangements, regulators and legislators should seek to promote audit choice, subject to the overriding need to protect audit quality.
4	Regulatory organisations should encourage participation on standard setting bodies and committees by appropriate individuals from different sizes of audit firms.
5	The <i>FRC</i> should continue its efforts to promote understanding of audit quality and the firms and the <i>FRC</i> should promote greater transparency of the capabilities of individual firms.
6	The accounting profession should establish mechanisms to improve access by the incoming auditor to information relevant to the audit held by the outgoing auditor.
7	The <i>FRC</i> should provide independent guidance for audit committees and other market participants on considerations relevant to the use of firms from more than one audit network.
8	The <i>FRC</i> should amend the section of the Smith Guidance dealing with communications with shareholders to include a requirement for the provision of information relevant to the auditor selection decision.
9	When explaining auditor selection decisions, boards should disclose any contractual obligations to appoint certain types of audit firms.
10	Investor groups, corporate representatives, auditors and the <i>FRC</i> should promote good practices for shareholder engagement on auditor appointments and re-appointments.
11	Authorities with responsibility for ethical standards for auditors should consider whether any rules could have a disproportionately adverse impact on auditor choice when compared to the benefits to auditor objectivity and independence.
12	The <i>FRC</i> should review the independence section of the Smith Guidance to ensure that it is consistent with the relevant ethical standards for auditors.
13	Regulators should develop protocols for a more consistent response to audit firm issues based on their seriousness.
14	Every firm that audits public interest entities should comply with the provisions of a Combined Code-style best practice corporate governance guide or give a considered explanation.
15	Major public interest entities should consider the need to include the risk of the withdrawal of their auditor from the market in their risk evaluation and planning.

A number of these recommendations are currently being taken forward by the *FRC*, which issues regular progress reports on the implementation of the recommendations. These are available to download at [www.frc.org.uk](http://www.frc.org.uk).

It is not clear whether the MPG's aims will be achieved in the short, medium or even the long-term. Assuming that there are no further mergers or withdrawals from the audit market, concentration ratios in the large and medium-sized company markets may drift upwards unless there is a change of mindset because the Big Four seem to be the preferred choice of corporate management. The MPG's recommendations have been welcomed by many parties (BBA, 2007; Chartered Institute of Management Accountants, 2007) but criticised for being too weak by others (Anonymous, 2007; Fraser, 2007). The *FRC* has said that it will review the situation if things do not improve. However, the *FRC* has not indicated what measures it would take if choice does not improve and it is not clear whether there is a demand for non-market based solutions. The question of whether these recommendations will be effective is therefore moot. Given this difference of opinion, this report addresses governance, choice and competition in the light of the MPG's recommendations.

## Summary

The UK audit market is an interesting research area for a number of reasons. UK companies above a certain size threshold are required by company law to have their financial statements audited. The demand for audit assurance services is therefore relatively inelastic but the supply of audit firms is restricted due to significant entry barriers. Accounting firms traditionally met this demand as unlimited liability partnerships that were bound by joint and several regulations. However, most of the larger accounting firms have now taken advantage of a recent legislation change to restructure as LLPs. The MPG argues for a greater understanding of

the possible effects of further changes of ownership and of promoting liability arrangements on choice and quality, but work on these issues has been limited to date.

The number of accounting firms has fallen over time as a result of the barriers to entry and mergers. This could impact on firm conduct and performance. The very high concentration ratio in the audit of large companies has prompted concerns about the degree of price competition, the level of choice in the market and the possible implications for audit quality. Studies have examined some of these issues but no research has assessed the implications for the market of a withdrawal of one of the Big Four from the market. This report examines the perceptions of stakeholders on governance structures, competition and choice in the UK audit market.

# 3 RESEARCH METHOD

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## Introduction

Interviews were carried out with a number of stakeholder groups in Spring 2008. The interviews were semi-structured around a number of key issues but interviewees were allowed to deviate if this was seen to be important. The main topics covered were the state of the UK audit market, the governance of audit firms and each of the 15 MPG recommendations.

The objectives of the interviews were threefold. The first objective was to elicit views on whether there is sufficient competition and choice in the audit market, whether there is a desire by auditors, accounting firms and/or companies to reduce the gap between the Big Four and the remaining firms and, if so, how this can best be achieved. The second objective was to obtain detailed insights into the various alternative forms of governance of accounting firms, how any changes in governance could be manifested into different organisational structures and systems and the likely effect on other entities. The final objective was to obtain perceptions of the challenges to, and likely impact of, each of the 15 recommendations put forward by the MPG to improve choice in the UK audit market. In depth data on these issues could not, however, be elicited using questionnaire surveys, which have been a frequently used method to investigate auditing issues in the past. As very little is known about the three aforementioned objectives, a semi-structured interview approach allowed the researcher to focus on an understanding of these issues within individual settings.

## The interviews

The interviewees were: the partners and/or managers of the international, national and regional accounting firms; directors and/or audit committee chairmen of listed companies; regulators; shareholders; analysts; banks; and government representatives. These subjects were chosen as being the most influential parties in the regulation and operation of the audit market. Details of the 34 interviewees are included in Table 3.1.

*Table 3.1 Details of the interviewees*

No. of interviewees	Position	Category
5	Partner	Big Four firm
1	Manager	Big Four firm
7	Partner	Non-Big Four firm
2	Manager	Non-Big Four firm
2	Directors	Listed companies
5	Audit committee chairmen	Listed companies
2	N/A	Regulators
4	N/A	Shareholders
2	N/A	Analysts
2	N/A	Banks
2	N/A	Government representatives

Twelve partners and three managers were selected from firms of different sizes including all of the Big Four firms and a number of national and regional firms. The partners were all very senior with considerable experience and were responsible for overseeing auditing within their firm. In addition, five audit committee chairmen and two directors of listed companies were interviewed. Selection criteria were adopted to ensure

that the sample contained representatives from a range of company sizes, industry sectors, geographical locations and listing status. Two regulators were chosen from two different regulatory bodies. Four shareholders were identified from company accounts and two analysts from newspapers. Two banks were randomly chosen and two interviewees from a further regulatory body represented the UK Government.

Interviews were one-to-one and carried out by the researcher, an experienced academic accountant, who had not worked for any of the accounting firms, companies or regulatory bodies and was independent of all the interviewees. A relationship of trust was created with the interviewee by the researcher through his independent status, the assurance of confidentiality and the common professional background. The interviews were semi-structured but involved a number of general open-ended questions designed to elicit the interviewee's thoughts about the issues. The main topics identified in the literature were formulated into a series of interrelated questions. However, interviewees were allowed to deviate from this structure if this aided the flow of the questions and other related issues were explored in such circumstances. The interviewer used neutral, conversational prompts and a laddering methodology that involved asking 'why and with what effects' as required. Interviews lasted an average of 60 minutes and were digital voice recorded and subsequently transcribed for further analysis.

## Summary

The objectives of this study are to elicit the views of stakeholders on whether there is sufficient competition and choice in the market and, if not, what could be done to improve choice, what are the current corporate governance structures within firms and likely future developments, and what is the expected impact of the 15 recommendations put forward by the *MPG*. The subjects of this research are partners, managers, audit committee chairmen, regulators, shareholders, analysts, banks



and government representatives. Semi-structured interviews were used to collect views on key issues relating to governance, competition and choice.

# 4 RESULTS

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## Introduction

This chapter reports the findings from the interviews with the seven stakeholder groups identified in chapter three. The remainder of this chapter is organised as follows. The first section describes interviewees' perceptions of competition and choice in the audit market. The second section outlines the governance of accounting firms and issues relating to auditor liability. The remaining sections focus on interviewees' responses to the MPG recommendations before providing a final summary.

## Competition and choice

There were mixed feelings about competition and choice in the UK audit market. Some interviewees believed that the market was competitive, arguing that the level of competition at the tender stage was fierce. For example, most representatives of the banks, audit committees and regulators were happy with the overall level of competition in the audit market. By contrast, shareholders complained that some companies had used the same auditor for many years; but accounting firms countered that these companies were happy with their choice of firm. A non-Big Four partner stated that the higher fees earned by Deloitte, Ernst and Young, KPMG and PricewaterhouseCoopers reflected better quality in a competitive market:

*You've only got to partake in any tender to see that pricing is pretty keen. Certainly the firms at the top end of the market are used*

*to giving a quality service and expecting their customers to pay a premium for quality and to a large extent they are willing to buy quality as well.*

Some shareholders expressed fears about competition and its effects on pricing and audit quality. They noted that audit fees had increased in recent years but could not distinguish between inflationary effects, increases due to additional regulation and anticompetitive fee increases. The evolution of audit and consultancy fees over a period in which the number of large suppliers has fallen and regulation has increased interested many interviewees but this question requires further work.

No interviewee perceived choice of accountant to be an issue for sole traders, partnerships and small companies because of the wide range of suitable firms. However, almost all interviewees were concerned about the limited choice of auditor for large companies. Regulators and the government representatives noted that all of the FTSE 100 companies and the vast majority of the FTSE 350 companies hired one of the Big Four firms. Some large companies in specialist industries, such as the financial services sector, were restricted to a choice of one or two audit firms because of independence rules and the desire to hire an industry specialist that was not involved with one of their competitors. The issues of choice and auditor withdrawal were particularly acute for these companies.

The Big Four were attractive to large companies for many reasons including their huge resources, international reach, specialist expertise, deep pockets and reputation. Non-Big Four firms agreed that they could not always compete with the Big Four for the audits of large multinationals because of their lack of geographical spread and high quality people. Big Four partners argued that they also possessed other advantages that were related to audit quality. For example, one Big Four partner stated that:

*Some of the obstacles are that there is a reputation effect with some of the Big Four. There's industry expertise, the size of litigation that could be filed against other pockets and all sorts of different things that interweave to make it difficult for non-big firms to go for the very large client.*

Non-Big Four partners also mentioned that the Big Four firms benefited from additional resources as a result of economies of scale. Some of these benefits could be passed on to directors and audit committee members and may be important in the auditor engagement decision but have not previously been identified in the literature. One non-Big Four partner explained that:

*Audit committees are dominated by the Big Four and the Big Four also offer fantastic networking. KPMG and Deloitte have office suites available that if you're a non executive of a FTSE 100 company and you want a meeting room and some separate telephone facilities you can go to anyone of the Big Four firms and they will make it available to you.*

Non-Big Four partners contended that the aforementioned audit quality issues are often overplayed and that the Big Four have incorrectly promulgated the view that Big Four means high quality and non-Big Four means low quality. They argued that they could also offer a quality product but they had to convince audit committees and boards that they were substantially better than other Big Four firms to win audit tenders. A non-Big Four partner summarised this as follows:

*We don't lose many tenders on price. In the tendering process from our point of view, we tend to win where we are prepared to demonstrate service quality, not just about technical knowledge but*

*the way that we look after these companies, in a way that perhaps some of these other firms are not able to or inclined to. We are in a position where we are engaging with the board, it's essentially the audit committee and the board who we have to convince we're better than any other firm and we have to be substantially better to warrant there being an upheaval having to change. It is addressing misconceptions about what we can and can't do.*

Many audit committees, with an imperfect knowledge of shareholders wishes, adopted the 'buy IBM' doctrine and hired a Big Four firm. A non-Big Four audit partner mentioned a conversation he had had with a CEO about the importance of reputation preservation. Ironically, the same CEO had previously lamented the lack of choice in the audit market implying that while CEOs are aware of the issue they may be unwilling to act on it:

*What upside is there in it for me to say yes we'll go outside the Big Four? Zero, no one is going to come along and give me a pat on the back and say 'well done great move'. We'll save a bit of money on the audit fees maybe but I know if I go out to tender the Big Four will cut to match your fee anyway so I'm not going to save money anyway and if something goes wrong that's nothing to do with audit failure everyone will turn round and say it's because you put in a small firm of auditors. If something goes wrong and I stick with my Big Four firm everyone will say 'well you are ok' so for my reputation I'm going nowhere.*

Some of the partners of larger non-Big Four firms stated that another obstacle was breaking down misconceptions about their abilities and, in particular, about their credibility, specialist knowledge, expertise, international experience and resources. They argued that there were no

statistically significant differences between the quality of the products offered by Big Four and non-Big Four firms. One non-Big Four partner described perceptions as follows:

*There's the horrible misconception that Big Four is a shortcut phrase for quality, not knocking those four firms, they are good, but they are not the only good firms. There are misconceptions about our quality, there are misconceptions about our depth of knowledge, there are misconceptions about the sectors that we can service and there are misconceptions about our international reach. All of those things you might say are down to us to sort – market ourselves better and promote our business better, and it is incumbent on us to do a good job. But it is the misconception that people who are just not interested and go to the Big Four and say I don't care what you're going to say to me, I'm just not interested.*

These discussions indicate that the work to improve choice in the large company audit market will not be straightforward, which leads to the question of whether there is a desire by stakeholders to work to improve audit choice. Shareholders, audit committee members, regulators, banks and government representatives interviewees all strongly supported the notion that improved choice in the UK audit market was desirable. The need for additional choice was also supported by the Big Four firms, and this was perhaps more surprising since it implies that they would lose some of their existing business. However, the Big Four firms' partners qualified this by stating that they would like the fifth and sixth largest firms to provide a more credible opposition, but unsurprisingly they were not willing to off-load audits to improve choice. They recommended a process of generic growth by firms five and six; although it was not clear whether these claims were politically motivated. Non-Big Four partners stated that they were actively seeking to increase their portfolio

of FTSE 350 audit clients but were not presently aiming to expand into the FTSE 100 audit market. There were a number of reasons for this decision, not least the cost of competing for the business of FTSE 100 audit clients. A Big Four partner stated that:

*Firms outside the Big Four, certainly BDO & Grant Thornton as the fifth and sixth biggest firms have a desire to attract clients in the FTSE 350 but they are not really aiming at the FTSE 100... The challenge is with BDO and Grant Thornton to consolidate and grow their networks and if they're up for it and prepared to throw that resource at it, (the audit fees are around £30m) and you extract it from the hours – I think if they thought they were going to win they would go for it. The worry is they feel they could get involved in the process... if you were pitching for BP, the team would have to literally fly the world to go to the main units to get a very strong feel for what the issues are and pull together a lot of expertise technically. You would spend millions just getting into pitch mode.*

Although the FTSE 100 audit market is not in their immediate line of sights, some of the partners of larger non-Big Four firms spoke about the gains that they had recently made in the FTSE 250 audit market (and FTSE 100 consultancy market). A non-Big Four partner contended that only with further successes in the FTSE 250 audit market could the issue of choice be successfully addressed:

*The problem is we need to have some credibility and the credibility comes from having some FTSE 250 audits. In order to be credible I need to have staff with the capability and confidence to deal with that dispute on the completion of accounts or to provide some advice to somebody and I can only get those people from the FTSE*

*250. I don't want the FTSE 250 audits because all of a sudden they're the most super duper thing, because they are not. I need them because, if I'm to provide choice in that part of the market place where it really does matter, I have to have a footprint and if I don't, and the market place turns around in five years time, its campaign has gone nowhere, and we've still only got three or four FTSE 350 audits, then we will start to lose credibility in the non-audit business and then the choice issue will be really sharp.*

The issue of choice was seen by some as most acute in the FTSE 100 audit market but since non-Big Four firms are not actively targeting this sector, a Big Four partner argued that the choice debate is more relevant in the FTSE 350 audit market:

*The debate about choice is more relevant in the next tier down from the very large client market. At the moment the perception you have in the market place, [is that] number five and six are not over eager in slogging it out over the FTSE 100, because where they had opportunities in the past in the FTSE 100 area and they haven't won pitches, the cost is so high that the view is that they build up the market share around 350 and use that as a launching platform to then represent the FTSE 100.*

Other interviewees looked beyond the FTSE 350 to concentration ratios in the Alternative Investment Market (AIM). A regulator stated that the Big Four were increasing their dominance in these markets:

*If you look at the FTSE 350, the number using non-Big Four has increased in the last few quarters but it's still very low. ... But, AIM is becoming even more concentrated ... if you look at the AIM100 or AIM50 it's totally dominated by the Big Four and that is an increasing trend.*



Non-Big Four partners argued that the issues of geographical spread and depth of resources were less relevant in the FTSE 350 and AIM than the FTSE 100 market. Furthermore, they contended that they did have the experience, expertise and quality to undertake such audits. However, although non-Big Four firms' partners have had some success in winning contracts to provide consultancy services to FTSE 100 companies, non-Big Four firms have had little success in winning FTSE 100 audit contracts. Non-Big Four firms argue that large companies are willing to hire them for consultancy but not for audit because of the need to disclose the audit firm's identity. This is illustrated by the following quotes by two non-Big Four partners:

*We do tax, forensic, some modest insurance work, but not main service work, but other bits and pieces, corporate finance work and so on for 50 something of the FTSE 350 and for about 20 odd of the FTSE 100.... When it comes to, for example corporate finance work, they will give us work that doesn't have to appear in a public circular, so that nobody knows we are doing it. They will give work that nobody knows they have given to us, which suggests that we have capability but there's a place where they'll put it and a place where they won't.*

*Last year we worked with about 20 - 25% of the FTSE 100 companies on various consulting work – doing tax, maybe some internal control work, maybe doing some deals advice ...for us it's not just about winning more big company audit work, it's about promoting our presence in the public company market place... The big part of our strategy is if you want to win more work from these public companies, we don't really care where it comes from but if we get a foot in the door with these companies with the tax team they're promoting the firm and these people work on lots of different boards and they talk and if we can't do a very good job with the tax work in one company then that hits us in five or ten*

*other companies. It's all about promoting credibility of the firm. If we have creditable tax teams and quality tax teams that reflects well on the brand.*

The challenge of improving choice ultimately rests with whether non-Big Four firms can persuade sufficient CEOs, directors and audit committees that they have the capabilities to undertake audit and consulting work for large companies for an agreeable fee. Increasing their portfolio of consulting contracts may provide a springboard to growth in the FTSE 350 audit market. However, this is not the only change that is needed to entice more large companies to switch their auditors. The Big Four argued that non-Big Four firms can grow larger by taking more risks and having the desire and will to succeed. This is illustrated by the following quote by a Big Four partner:

*...but its all about if you've got the will – when I joined this firm in 1984 our market share of FTSE 100 was about 3% or 4%, we started getting the benefits of a fairly enlightened management team ...who decided to invest a huge amount of resource in such things as technical expertise and quality checking. A lot of people were brought in to augment what was there and also work hard to getting things global and pushing in lots of tiers of quality control so we didn't make mistakes, and it took a long time, so it grew from 3 or 4% to whatever the market share is today. If we hadn't done that we would have a Big Three now!*

## Governance and liability

There are four *MPG* recommendations relating to governance and liability:

No.	Relevant <i>Market Participants Group</i> recommendations
1	The <i>FRC</i> should promote wider understanding of the possible effects on audit choice of changes to audit firm ownership rules, subject to there being sufficient safeguards to protect auditor independence and audit quality.
3	In developing and implementing policy on auditor liability arrangements, regulators and legislators should seek to promote audit choice, subject to the overriding need to protect audit quality.
12	The <i>FRC</i> should review the independence section of the Smith Guidance to ensure that it is consistent with the relevant ethical standards for auditors.
14	Every firm that audits public interest entities should comply with the provisions of a Combined Code-style best practice corporate governance guide or give a considered explanation.

Accounting firms structure their organisations in different ways and interviewees had a range of views about *MPG* Recommendation one. Almost all of the accounting firms are partnerships, with a few exceptions of mainly equity based companies that only audit small business entities. Small accounting firms have retained the traditional partnership structure under which partners have a say on key issues. Many large and medium-sized accounting firms have a group of committees that oversee the major executive, operational, investment, financing and remuneration decisions. All of the partners interviewed were very happy with their existing structural arrangements. Some accounting firms were concerned about the implications of *MPG* Recommendation 12 on the implementation of the Smith Guidance and particularly Recommendation 14 that proposes to introduce the Combined Code requirements on the corporate governance of accounting firms. The main worry of Big Four partners was the introduction of non-executive directors to the aforementioned committees. Big Four partners were

apprehensive about whether it was appropriate to include non-executive directors on the boards of partnerships at all, and whether there were sufficiently high quality non-executives available that had a good grounding of the issues faced by accounting firms and what added-value these non-executives could offer. The corporate interviewees, however, believed that they had considerable management knowledge and experience to offer to the accounting firms, subject to time and resource constraints. Shareholders argued that non-executives were a good idea but several audit partners believed that the requirements would need to be modified prior to implementation. This is an area for further research because little is known about how governance structures could evolve, the availability of non-executive directors and the effects that *MPG* Recommendation 14 might have on accounting firms and other business entities. The *FRC* appointed a working group in 2008 to develop a code of best practice governance for accounting firms.

With reference to the legal structure of accounting firms (*MPG* Recommendation three) all of the small practices interviewed had retained the traditional unlimited liability status. The partners of these firms had discussed the issue of liability reform amongst themselves but chose the traditional governance structure mainly because the statutory requirements of an unlimited liability partnership, in particular the disclosure requirements, were less onerous than those of a limited liability partnership (LLP). The Big Four and many medium-sized accounting firms have taken advantage of the recent legislation change to adopt LLP or corporate status. For example the German, Swiss and UK KPMG firms have merged into a single practice with a single profit share and single liability code called KPMG Europe. The other big firms have made similar changes. These developments show that firms are moving away from separately owned and managed entities that share the same name to genuine international corporations. Audit partners explained that they did not have any significant difficulties with making this switch. The changes required some additional work to comply with LLP and SORP regulations but this work was not onerous (particularly as accounting firms prepare accounts for other partnerships). Shareholders and audit

committees did not have major objections to being audited by a LLP although a few raised slight concerns about recouping potential losses if a company went bankrupt. Accounting firms' partners did not think that liability status made any difference to client demand because they felt that the 'hire or fire' decision was largely due to staff quality. They argued that audit quality was not affected because of the importance of maintaining the reputation of the firm. Unsurprisingly, partners were in favour of changing to a LLP because it offered greater protection of the people within the firm and protection of the firm itself. One Big Four interviewee stated that the main advantage of LLP status was:

*It means that there will be less chance that the initial partner would be immediately bankrupted. If LLP fails then the partner would go down with it because we are all sitting on first guarantees and various key properties. I remember when Andersen were teetering in the UK after the Enron stuff, the partners were facing bankruptcy – they were days away from bankruptcy.*

Non-Big Four partners also saw the merits of LLP as being firm preservation and raised the issue that the greatest risks to continuity came from outside the UK, as explained by one partner:

*It's all about sustainability of the firm, protecting the sustainability of the firm, it's not about making it more efficient or making more money for the partners, that's about protecting the sustainability of the firm. The way the environment is in the UK and because we work internationally that was something which was a no brainer.*

The discussion of how the governance of accounting firms could change in the future was particularly interesting. The *FRC* (2007) stated

that the aim of MPG Recommendation one was to facilitate additional choice by making it easier for new players to enter into the audit market and for existing firms to grow. A regulator argued that facilitating choice could be achieved by opening up the markets to equity capital:

*First of all there are two ways you could have more choice, one is that investing firms grow; the other way is new funds come in. The aim is to facilitate to make it more feasible... it's up to individual market participants what they want to do. If we can make it more feasible then that makes it more likely... Obviously if the ownership rules were changed, the point of changing them would be to facilitate companies being able to raise equity capital from outside the partnership.*

Another regulator was convinced that MPG Recommendation one would be successful and that firms were only opposed for fear of additional competition:

*As far as numbers 4, 5, 6 and 7 are concerned the last thing they want is a well capitalised new entrant coming into the market. If you want to enter the audit market, you personally have to put up all the funds, not surprisingly people don't do this very often because it's an unattractive thing to do. But there are plenty of examples of industries where new entrants have been able to find a way of penetrating otherwise markets that were previously dominated by existing players. The one thing they all have in common, you create a set of conditions in which it's possible to take somebody with a good business idea, join them up with some investors who are looking for a return on capital, you put the two together and you give it a go. Some new business ventures succeed and some fail – that's capitalism. The rules of capitalism are – this applies to the audit market because we're preventing people who have got*

*capital looking for return to apply that capital to help people with a good business idea.*

Most interviewees agreed that it was important to broaden the understanding of these matters. *MPG* Recommendation one may well increase choice in the long-term but it is far from clear whether the changes will be significant in the short-term or medium-term. The vast majority of interviewees stated that a rapid improvement in choice in the large company market was only theoretically possible if there was an enormous injection of capital in the larger of the medium sized firms along the lines of the investment by Roman Abramovich in Chelsea Football Club. Non-Big Four partners argued that a similar injection might enable them to poach large numbers of staff from Big Four firms and restructure their existing business model to keep their existing staff happy. However, it is extremely unlikely that such a benefactor could be found and there were also concerns about the possible effects on audit quality. Non-Big Four partners stated that they were planning to grow their market share gradually through conventional methods whilst maintaining audit quality levels. One non-Big Four partner did not believe that opening up the markets would improve choice because lack of funds was not seen as a major barrier to entry:

*Our firm thinks, if you're looking for external investors in a professional services firm, they're going to want a return and they're probably not going to settle for an equity return, so they are going to want some fixed return which puts pressure on the partnership which wasn't there before. We are all really, really conscientious about quality, particularly about audit quality and that seems to me to be an external pressure on quality that we don't need... If we wanted to go out and spend some money we wouldn't have a great deal of trouble raising finance. Availability of the cash isn't the problem. There's no point in us going to raise £50 million to increase our capacity to do audit work. No professional services*

*firm is going to spend £50 million on a wing and a prayer. To a large degree, if you aren't going to go out and buy another firm, you've got to grow organically. We will invest time and new partners and stuff, but we are not going to do that in a step unless there is something we need to react to.... I have to say that that particular issue is not going to be the most helpful, certainly not in the next five or ten years. In the long-term if restrictions relax then maybe once we've got over these misconceptions, then there might be the opportunity to go and, we might want to buy a team, a specialist team in this particular centre; but if we want to do that, we can do that now, we're a pretty healthy firm, funding is not the issue for us.*

By contrast, some interviewees believed that the accounting firms were opposed to MPG Recommendation one for fear of new competition entering the market. Partners countered that there were already a number of all-equity accounting firms but these did not have a substantial market share. Some partners cited Tenon as an example of a well-run firm involved with smaller entities. The majority of interviewees, therefore, felt that Recommendation one would not have any impact on choice in the short-term because firms would not use this finance. Moreover, problems servicing such investors were envisaged because the rate of return demanded by equity investors may be higher than extant rates. For example, a non-Big Four partner explained:

*Changing ownership rules doesn't mean someone will invest on uncommercial terms. You need to get people who are prepared to invest on uncommercial terms because I can borrow money from the bank at the moment, cheaper than I can get equity finance. I had a meeting with my bank two weeks ago, they would happily lend me more money at a very cheap rate. So it's not a shortage of available cash, it's what you do with it. If you want to talk about recruitment, what you would have to do is recruit teams*



*in their entirety from the Big Four. Why would a Big Four team move here?*

The partners of large and medium-sized audit firms argued that they could easily raise finance from their banks and that this finance would be less costly than equity finance. There was also considerable scepticism as to whether sufficient capital could be raised by an equity start up company to provide an adequate reserve for one catastrophic loss because the litigation risks would probably outweigh the return on the investment. Moreover, insurance is very difficult to acquire and/or costly for auditing at the large company level. Most interviewees, therefore, did not believe that an all equity firm could become a key player in the FTSE 350 market. For example:

*There has been a debate in recent years about whether it's possible for accounting firms to raise money from the stock market or other investment vehicles. I would be surprised if the people who are auditing in these large company environments will be able to get a listing... You have a liability problem, if people knew how much risk they run it would really scare most investors... Some of the insurance we get hold of is so expensive (you're effectively talking self-insurance). The transport industry is a costly business to run in terms of management risk, but we leave them behind by an order of five or six times more costs upon litigation and related list costs.*

(Big Four partner)

*Some smaller firms might go for equity but they're in a different market place. The largest firm in the US outside the Big Four are basically corner shops that deal with tax returns. The equity model they use has its problems, if they're ever pitching for somebody against us, we always lose because we're always going to charge more money. They've got a great business but it's at a level and they will*

*get bigger and bigger and have no impact on us at all. They don't want public interest accounts, they don't want the regulation that goes with it, and there are all those other issues that go with it. If there was an equity funded model available where you could get equity dirt cheap, I would go there. But equity returns are higher than bank returns because of the risk.*

(non-Big Four partner)

All of these partners stressed that inaccessibility to resources was not a major obstacle to growth. Instead non-Big Four firms must consider what to do with modest amounts of additional capital rather than worry about making any large injections, as illustrated by the following comments from a Big Four partner:

*If you look at Grant Thornton and BDO, what do they need most? The actual industry gurus of the firms aren't that huge in number and this firm has decided that it needs five accounting tech partners to cope with all the resources that the clients' demands put on us. Looking at Grant Thornton and BDO, how many accounting tech partners do they have? It's really a competitive battle as to how many people do you have who can deliver in those areas. It's about attracting people to come and work for the firm and we occasionally lose people, who are mostly in their 30s and who feel that they are not going to make it in our kind of environment and those people can be quite talented. We are always on the look out for talent, so you could be talking of banks, insurance companies, investment schemes, charities or pension schemes – all sorts of different areas where you're constantly striving to get the right people in those positions. There's this myth that it's the brand that makes the company, but actually it's the people.*

Most interviewees believed that opening up the stock markets would not have a major impact on auditor choice.

All of the partners of Big Four firms and several partners of medium sized audit firms felt that a more pressing corporate governance issue was the structure of legal liability in the UK. Partners highlighted the large number of lawsuits that are currently being fought by firms that could cause a firm to go bankrupt. They argued that a bankruptcy would exacerbate the issue of choice in the market. Many partners of large audit firms used these arguments to call for the introduction of proportionate liability in addition to the cap on liability. One Big Four partner argued:

*There seems to be a sentiment, particularly with investors, that they will bind to proportionality and the logic for that is that you are responsible for the losses you cause.*

Partners were not overly concerned about the finer details of proportionality (i.e. whether this is done in relation to assets, fees, capitalisation etc.) but felt that this was an area for future debate. They stressed that proportionality was an essential change to protect existing firms and to allow firms to take up insurance policies again, as one Big Four partner explained:

*The thing about liability limitations, about protecting the sustainability of the profession in the long run, even with the thought of liability you're still at risk of losing one of the major firms as a result of a catastrophic claim which was maybe one bad egg. ....Joint and several liability is not sustainable in the medium-term and may be to the detriment of the public interest and capital markets. If so confidence would collapse, firms would withdraw, maybe either through claims or because they just didn't want to get involved because the risk and reward isn't good enough.*

By contrast, many shareholders, directors and audit committee members were not convinced of the merits of proportionality. Many institutional investors were against proportionality for fear that audit quality might decline. Some directors and banks were against proportionality for fear of claims being made against them, instead of auditors, and the perceived risks to audit quality. Following the introduction of limited liability agreements in the 2006 Companies Act, the *FRC* have issued guidance on this issue (*FRC* 2008). It is likely that the audit partners will have much to do to persuade other stakeholders of the advantages of proportionality and this topic will rumble on for some considerable time. Whilst the collapse of another major accounting firm would be hugely problematic, arguably, accounting firms may be using the sustainability issue as a political lever to try to force through proportionate liability legislation. Whilst proportionality might help prevent a further reduction in the number of accounting firms, it is difficult to see how proportionate liability can materially improve choice in the audit market. This issue will be considered again later.

## Disclosure

There are two *MPG* recommendations related to disclosure:

No.	Relevant <i>Market Participants Group</i> recommendations
2	Audit firms should disclose the financial results of their work on statutory audits and directly related services on a comparable basis.
8	The <i>FRC</i> should amend the section of the Smith Guidance dealing with communications with shareholders to include a requirement for the provision of information relevant to the auditor selection decision.

The response to *MPG* Recommendations two and eight was mixed. Regulators were keen to ensure that all accounting firms disclosed financial information in their annual reports consistently and used the same structure. Regulators wanted to improve disclosure to facilitate better comparability and an assessment of returns and stated that this might have an impact on the choice debate. The *FRC* passed on this recommendation to the Consultative Committee of Accountancy Bodies (*CCAB*) for further work:

*This one is being taken forward by a working group of the CCAB so it is up to them how they implement the recommendation. I think it's clear from the MPG report that we're not just talking about revenue here, which is already published as you say, this is about a measure of results which implies profitability.*

(Regulator)

Many shareholders argued that accounting firms currently disclosed little or no financial information. They contended that increased disclosure would allow them to make judgements about audit firms' profitability levels and could influence the hire and fire decision. Audit committees were aware of the information provided by audit firms and seemed happy with the current arrangements. One Big Four audit partner mentioned an information gap between the level of disclosure provided and those read by shareholders:

*I keep going to meetings where very senior people make wild statements such as 'you people don't disclose anything', but it is ill informed. If they look on the website or track what is said in the media then they will find the stuff. I don't think it has a great impact out there.*

Most partners stated that their firms had no problem with adhering to the Smith Guidance and considered it to be good practice. Accounting firms, therefore, did not have any objections to Recommendations two or eight. Many firms argued that since they already provided substantial financial information to the market Recommendation two would not have any significant impact. However, there was a difference of opinion about the content of information that should be provided. The Big Four partners stated that they disclosed enough information already as illustrated by the following quote:

*We have tried in recent years to give as much information as given by plcs, if you look at our last report you will find very detailed information as to how our business breaks down and we also give interim information as well. Every six months we issue this information to the market place, quite voluntarily, all we get is about half an inch which simply refers to the pay of the senior partners, that's it. We are prepared to disclose the fees paid, what our average partners are paid, to show the results of the audit part of the business – any part of the business and the whole thing. Normally the reaction from the newspapers is just about zilch.*

(Big Four partner)

Non-Big Four partners also argued that they provided substantial financial information and were prepared to disclose more if required, for example:

*We provide certain figures in the break down of our staff. If there were more guidelines would I provide more? I don't think I care, I'll provide whatever the market place wants provided.*

(non-Big Four partner)

By contrast, other interviewees felt that there was scope for more uniformity in the disclosure. They highlighted a number of differences in the disclosures of firms that made comparison of results difficult. One such example, illustrated by a regulator interviewee, was the variable use of allocated overheads:

*You need to look at what they publish and have a close look at the unallocated amounts because that's where things get a bit tricky, some firms allocate all costs but don't really explain how they've done it. Other firms leave huge amounts unallocated, possibly for good reasons but the inconsistency makes it very difficult to compare the figures.*

Most stakeholders were sceptical about the effectiveness of this recommendation on improving choice in the market. Non-Big Four firms' partners summarised the feelings of stakeholders by stating that the increased disclosure proposed would have little impact on the market because the facts were already well known by most parties. This is illustrated by the following quote from a non-Big Four partner:

*The basic facts are very simple. The average earnings of a partner in a Big Four firm are more than twice the average earnings of a partner outside a Big Four firm. The average earnings of a partner in a Big Four firm are £600,000-£700,000. They are in their published accounts. Our average earnings for the partners is about £320,000, Grant Thornton's is £340,000, go to the next stage down and you go to £200,000 and then it starts falling away. The Big Four firms are clearly significantly more profitable. We disclosed that the highest earning partner earned £900,000 last year... the highest paid partner in Deloitte earned £4.6 million. I don't need a breakdown to tell you they make more money out of the business than we do.*

## Participation

There is one *MPG* recommendation related to participation:

No.	Relevant <i>Market Participants Group</i> Recommendation
4	Regulatory organisations should encourage appropriate participation on standard setting bodies and committees by appropriate individuals from different sizes of audit firms.

The discussion relating to *MPG* Recommendation four was reasonably uncontroversial. Wider participation on regulatory bodies, was welcomed by all, subject to the individuals appointed being of a high quality. For example, one Big Four partner stated that:

*I'm all for this and there's no doubt that there are some excellent people in those firms... We have to put aside a huge amount of time and that's not what all firms can do.*

Some of the larger non-Big Four firms' partners argued that it was imperative that there was wider participation on regulatory boards to have a thoughtful and wide ranging debate on key issues. A non-Big Four partner stated that:

*There is no point just having representatives from the Big Four firms because you just get four views which are just the same. Two from the Big Four and one or both of Grant Thornton and BDO would be much better.*

Non-Big Four firms contended that they had enough spare capacity to free up such resources:



*We've got to provide the resource for it and I have agreed with the FRC to provide a list of people who would be available and willing to do so.*

(non-Big Four partner)

If successful, *MPG* Recommendation four should provide regulators and standard setters with a more balanced viewpoint on some of the key issues. Interviewees believed that a more rounded perspective would not hinder moves to improve choice in the audit market but equally they were not sure whether it would guarantee any major improvements in choice. The overall view was that the constitution of the regulatory bodies was not directly related to the hire and fire decisions of the audit committees of major public interest entities.

## Audit quality

There is one *MPG* recommendation related to audit quality:

No.	Relevant <i>Market Participants Group</i> recommendation
5	The <i>FRC</i> should continue its efforts to promote understanding of audit quality and the firms and the <i>FRC</i> should promote greater transparency of the capabilities of individual firms.

With regards to *MPG* Recommendation five, there was general agreement that the *FRC* should continue its efforts to promote understanding of audit quality and promote greater transparency of the capabilities of individual audit firms. The Big Four firms were happy that the market understood their quality, stressing that they were constantly working to maintain high standards:

*It means that you're only as good as your last audit, and you can become very obsessive about what you've got to do to manage your risks. Different firms have different methodologies, different quality ethos, different culture, so your track record isn't just luck or bad luck. You can create your own luck. If you're smart and do the right things you can manage your teams better but it takes a lot of effort.*

(Big Four partner)

It was generally agreed that audit quality was not a well understood concept and some firms had difficulty in signalling their quality. Non-Big Four firms thought that the Big Four had been successful in the promotion of their own work and, while some interviewees felt this was the level to reach, others argued that the Big Four's efforts sometimes undermined their own work. They argued that the Big Four had fuelled a conception that the Big Four represented high quality and the non-Big Four low quality audits. Some non-Big Four partners called for the general release of all of the reports of the FRC's Audit Inspection Unit as a measure of quality. One non-Big Four partner mentioned that this might have signalling effects:

*What I'm hoping will make a difference is the publication of an annual inspection report, which you may be aware I've been pitching for ever since the Audit Inspection Unit view came into being, and this year they are going to be published.... It could make a difference; it would have made more of an impact three years ago. Three years ago the reports on the Big Four firms were not good, but our reports were very good. Now it's evening out. I hope it will make some difference.*

Non-Big Four partners mentioned that Big Four firms had been criticised about the quality of their work in the past and this might give stakeholders a more balanced perspective of audit quality. However, fears were raised that Big Four firms could shrug off a critical Audit Inspection Unit report in a way that non-Big Four firms could not. All parties were in agreement that the Audit Inspection Unit reports would only have added value if there were thorough inspections of each firm and the reports balanced both praise for good practice with criticism of bad work.

## Auditor selection and re-selection

There are two *MPG* recommendations related to auditor selection and re-selection:

No.	Relevant <i>Market Participants Group</i> recommendations
6	The accounting profession should establish mechanisms to improve access by the incoming auditor to information relevant to the audit held by the outgoing auditor.
10	Investor groups, corporate representatives, auditors and the <i>FRC</i> should promote good practices for shareholder engagement on auditor appointments and re-appointments.

Improving access to information held by an outgoing auditor (*MPG* Recommendation six) was welcomed by most participants interviewed:

*The new audit regulations which take effect in April 2008 have this in them.... it's a legal requirement ... that is implemented through audit regulations which will be monitored by the professional bodies and by the Audit Inspection Unit.*

(Regulator)

One Big Four interviewee argued vociferously against the *FRC*'s recommendation of improved access to the outgoing auditor's files. He stressed that while the intention might be to cut switching costs, there were significant 'fishing costs' associated with this recommendation that the *FRC* had underestimated:

*The notion that arose in the Eighth Directive is that there needs to be access to information about the audited entity and somehow that has been converted by the MPG into access to information about the audit. I had debates about this with the FRC and his argument about this is 'it's to reduce switching costs'. My response to him was that this is going to dramatically increase switching costs. We're going through a regime that is called the Statutory Offence, whereby if you don't do things you could be at risk of being reckless, and that becomes criminal behaviour. What MPG are trying to add to it (I think) is you could come on a fishing expedition through my files. When we do fishing expeditions I can assure you that we send in people who do nothing else except fishing expeditions. They'll spend weeks with you and they will dredge up all the files and it will be a 'full forensic examination ... It increases litigation risks, which is also against the notion of trying to prevent people exiting the market place... All I know is that the lawyers are salivating over this.*

(Big Four partner)

Most parties agreed that a change of auditor introduces extra costs for both the auditor and client although the majority of interviewees believed that improving access was a good idea because it allowed the auditor a better starting point to work from. There was little support for the argument that rotation should be enforced or requirements introduced to enforce switching on a regular basis. Interviewees

expressed a strong preference for allowing audit committees the freedom to choose the auditor that they would like to hire.

Interviewees welcomed the requirement for the provision of information relevant to the auditor selection and re-selection decision (*MPG Recommendation ten*). Non-Big Four interviewees highlighted the extremely long tenure of some companies' auditors, and thought that this requirement might encourage audit committees to consider putting their audit out to tender. They again reiterated the importance of allowing audit committees the freedom to choose the firm that they wanted to hire but stated the importance of doing so with information about all possible candidate firms.

## Joint audits

There is one *MPG* recommendation related to joint audits:

No.	Relevant <i>Market Participants Group</i> recommendation
7	The <i>FRC</i> should provide independent guidance for audit committees and other market participants on considerations relevant to the use of firms from more than one audit network.

Interviewees were not in favour of joint audits (*MPG Recommendation Seven*) because hiring one auditor was considered by most people to be more efficient and more effective than hiring two or more. There was also the fear of key issues being overlooked because neither firm would claim ownership. One Big Four interviewee explained this succinctly:

*You do get circumstances where there have been several auditors, such as when there has been an amalgamation but that is normally resolved within a few years. When you have a number of audit firms involved in the same audit – BCCI, there were two auditors,*

*one firm did most of the world and the other firm did the rest of the world and that's where 'things fall through the middle'. You have to be very careful and there doesn't seem to be a huge enthusiasm in the UK from directors to have to deal with a joint audit.*

The use of firms from more than one network was seen to be appropriate if one firm audited the parent and most of the subsidiaries but another was contracted to audit some of the subsidiary company accounts. Reasons for this might be historical, a temporary arrangement immediately following a takeover or merger, or because of a lack of expertise or an office in a particular industry or country. Interviewees did not believe that guidance on the use of firms from more than one network would have any material effect on the market. Joint audits were seen by all interviewees as being exceptional circumstances rather than the norm. Stakeholders therefore did not believe that Recommendation seven would have any major effect on choice.

## **Contractual obligations**

There is one *MPG* recommendation related to contractual obligations:

No.	Relevant <i>Market Participants Group</i> recommendation
9	When explaining auditor selection decisions, boards should disclose any contractual obligations to appoint certain types of audit firms.

The conversations related to contractual obligations (*MPG* Recommendation nine) were particularly controversial. The main choice issue was that stakeholders such as financial institutions or institutional investors were pressurising companies to sign documents that bind them to appointing one from a limited number of auditors. There was a very mixed response to the pros and cons of contractual obligations from the

Big Four firms. Whilst some Big Four partners argued that they had no knowledge of them, others accepted that these contracts existed. Some Big Four partners considered that companies should be free to write whatever contracts they wanted as long as they were within the law. Other Big Four partners made the point that contractual obligations were probably not helpful to the choice debate. One Big Four partner argued for a simple ‘beauty parade’ of accounting firms:

*There are incredibly leveraged companies out there. Our view would be that you don't need all that stuff you're just judged on your merit, but ultimately if that's what investors want that gives you quite a deep philosophical issue which is 'do you want to deny an owner the rights that they have as ownership'. One of the rights is that if they believe in their heart that they need to have these conditions. So you've got that issue. This firm's issue is that we don't really need these artificial devices but when you speak to investors and the likes, they'll push you back. They will simply say if it's the hirers business and our money is on the line we are not going to deny ourselves the mechanisms that we think is relevant to managing our risks. I don't know how to answer that. It's not only their money, it's other people's money and that's a tricky one, but our position on that is that we don't need to have these artificial devices.*

Most shareholders had not heard of contractual obligations. This is particularly interesting given, as company owners, they have delegated authority to other parties to write such contracts. The British Bankers Association argued that banks do not introduce contractual obligations, except in extreme circumstances, and pointed the finger of blame solely at the institutional investors. By contrast, a non-Big Four partner provided a range of evidence of contractual obligations set by different parties including banks, financial intermediaries and institutional investors, for example:

*A pro forma issued by the Loan Market Association defines “Auditors” as referring to: “Deloitte and Touche LLP, KPMG LLP, PricewaterhouseCoopers LLP or Ernst & Young LLP, or any other firm of chartered accountants of internationally recognized standing that has been approved by the Majority Lenders (such approval by the Agent and appointed as auditors of such Group Entity)”.*

*No Group Company shall appoint as its auditors any firm other than Grant Thornton, KPMG, Ernst & Young, PricewaterhouseCoopers, Deloitte & Touche or any firm to which the Bank has given its prior written approval” (This agreement was amended to include Grant Thornton when they were appointed as auditors).*

*Banking documentation on PFI transactions generally use wording such as “a firm of international auditors acceptable to the Agent” which is invariably interpreted as one of the Big Four. The non-Big Four argue that these documents seem to be formed to protect the lenders from weak firms, and banks are alleged to support when challenged. However, it does place firms with a strong standing outside the Big Four on the back foot and companies are sometimes unwilling to challenge for fear of upsetting their lenders.*

A non-Big Four interviewee argued that these conditions represented a severe restriction on choice in the market:

*One thing I do agree with is that there are certain people (big investors) who are trying to formalise conditions as investors that they don't want non-Big Four firms.*



Moreover, they argued that such obligations have contributed to increased levels of concentration. One non-Big Four partner provided an example of a large company with a £100m turnover that switched to a Big Four auditor in response to a condition in its banking contract. The contract stipulated that:

*The Parent shall procure that, within 60 days of the closing date, Senior Management will review the current auditors and thereafter the Parent shall procure the appointment (if so requested by the agent) of an Auditor from any of PricewaterhouseCoopers, Ernst & Young, KPMG or Deloitte and Touche.*

Non-Big Four partners argued that obligations that are written into contracts or debt covenants are not in the public domain so shareholders that vote on audit engagement decisions are not aware of their existence and therefore cannot make fully informed decisions. Some non-Big Four partners considered that disclosure was not enough because many shareholders did not understand the full implications of the contracts and there was a risk that they might simply be withdrawn at the last minute. These partners urged the FRC to outlaw contractual arrangements by legislation, for example one non-Big Four partner said:

*The FRC's view is that these [contracts] have to be disclosed and over one time they'll disappear because people will be embarrassed. My view is that over time there'll be a formal understanding, there will be a first draft taken out at the last possible minute. But, if the FRC said as a matter of best practice these are not permitted, then it would send out a massive message to the market place and they will start to drift away elsewhere. The FRC says that they don't have that right, we can't ban them. But I do think that in the same way the FRC had the right to change a Combined Code and switch guidance and all the rest of it, they have the right to put*

*in guidance that these things should not be in banking agreements and companies should not enter into banking agreements that add them. A statement like that would send a message to the market place.*

Audit committees are free to hire whichever audit firm they wish in a free market. However, audit committees do not know the wishes of the shareholders that they represent. Although examples of such terms were provided by the interviewees, it was not clear how common these arrangements really are and whether non-Big Four firms are using these for political gain. Nonetheless, it appears vital that regulators ensure that all companies, at least publicly, disclose these obligations, whether they are explicit or implicit, to enable stakeholders to make the best possible decisions. Given that most Big Four partners appear to be in favour of freedom of choice, the regulatory bodies need to seriously consider making these contractual obligations illegal for listed companies. However, such regulation would be difficult to enforce because unscrupulous companies that wish to use such arrangements could simply remove the wording just prior to drafting or use verbal contracts that are known to all parties but are not formally disclosed.

## **Auditor withdrawal**

There is one *MPG* recommendation related to auditor withdrawal:

No.	Relevant <i>Market Participants Group</i> recommendation
15	Major public interest entities should consider the need to include the risk of the withdrawal of their auditor from the market in their risk evaluation and planning.

The issue of auditor withdrawal (*MPG* Recommendation 15) raised a huge amount of interest. Audit committees that had expressed reservations about the lack of available choice were very concerned about the possibility that their auditor might withdraw from the market. The regulators and Government interviewees stressed that a merger amongst two firms from the Big Four would not be allowed in normal circumstances but would be sanctioned if one audit firm were to fail. For example, one regulator stated that a merger would be allowed if the only alternative was a reduction to three firms:

*A merger would be allowed in the event of a firm failing because if you look at the competition rules, they focus on something called the counterfactual, and if the counterfactual is three firms anyway then there is no reason why a merger wouldn't be allowed.*

The *FRC* are working on an audit continuity plan to try to reduce the associated risks of withdrawal. Moreover, accounting firms argued that lessons had been learned from the Andersen debacle. However, accounting firms insisted that the risk of another withdrawal from the market cannot be eliminated, no firm is too big to fail, and again, highlighted the difficulties that litigation placed on them, as one Big Four interviewee said:

*Lessons have been learnt but we can't eliminate the possibility of a collapse. At the moment we are in credit crunch, we had liquidity crunch, we had evaluation models where events which shouldn't have happened in 125 years, we've had 8 of them in the same week. We've had so many standard deviations away from normality that have actually occurred, so there could be a possible situation that could pull down entities and yet people are expecting us to be what is effectively the guarantee of last resort.*

One regulator went further stating that the risks faced by accounting firms were enormous and that it was only a matter of time before the market experienced a withdrawal under the current regulations:

*[Firms state] 'If you don't grant us liability reform, it's just a matter of time before one of us winds up.' If one of these firms falls over, which is not a remote possibility, there's a battle of presumption that high quality auditing will be widely available and then where will we be? One of the lessons of the financial crisis in the last six months... is that the unlikely events are still unlikely but they are not as unlikely as we thought they were... The same thing is true about the collapse of another firm... the question is given that one of these events which has a low probability but a massive impact if it were to occur, what could we, or should we, do to try to reduce the likelihood of the event occurring and reduce the impact of it if it were to occur? That is really what we are talking about.*

Despite the well documented problems of recent years and the work of the *MPG*, the general consensus was that shareholders, audit committees, banks and directors did not fully appreciate the implications of another withdrawal nor had they factored the risks into their plans. Although several parties believed that the Government would intervene, one regulator argued that this was unlikely and that the Government might not be able to solve the problem:

*People say they want the Government to come in and sort it all out. Well the only difference is that the Bank of England has got a lot of gold bars they can turn into cash and it can act as a last resort. It could pump liquidity into the financial markets, but there is no regulator who could pump liquidity into the audit market. None of them have a basement full of auditors waiting to*

*be released into the market. The assumption ought to be that the market participants ought to take steps to protect their position in the event of disruption.... In other words, companies are expected to manage the risks to which they are exposed and one of the risks you should think about managing is, what would you do if your auditor was no longer available to you?*

One Big Four partner neatly described some of the problems that another accounting firm withdrawal could create for companies and the audit market:

*There is obviously some debate in some boardrooms about what would happen, but I think that the main hope they could have is that if one firm failed they would quickly switch to another firm. It doesn't work like that; the independence rules are absolutely crazy. The reality is that the other firms are probably providing non-audit services to their audit clients. You've got an issue there immediately – auditors holding investments and any personal relationships which prevent auditor relations. So, you've got a whole mass of independence rules.*

Interestingly, accounting firms have not made any specific plans for such an event. Many partners considered that their firm would respond to the problem in due course. They stated that it was important to consider how such a scenario might arise because the effect on the market varied across jurisdictions and across firms. Non-Big Four partners argued that the collapse of Andersen affected concentration in the US differently from the UK market, as one interviewee stated:

*In the US post Enron, the Big Four firms found themselves resource constrained. Andersen didn't go in a neat tidy lump to one firm,*

*as effectively as they did in the UK. In the US it was much more split. Grant Thornton for example took a chunk of partners; BDO took one or two... The copper bottom guarantee that you get when you have a Big Four audit report was damaged in the States in a way that it wasn't in the UK. In the UK what seems to have happened is that people have thought, if that could happen to an Andersen client just think how much it could happen to us... that's partly because Andersen was the smallest of the Big Five, in terms of its footprint in the listed market place. In the US, because Andersen was so much bigger, it damaged the standing of the major firms in their entirety and there has been a significant drift in numbers of audits away from the Big Four. So that BDO, Grant Thornton, but also a whole host of independent businesses in the States, have all been picking up a significant number of sizeable SEC companies.*

(non-Big Four partner)

In the event of a four-to-three scenario arising from litigation, strong concerns were raised by Big Four partners about the potential lack of competition and risks of lower audit quality, complacency and conflicts of interest. One Big Four partner succinctly argued:

*Some companies would have no choice if one firm were to disappear. And could we absorb all these audits? ...If there was a financial meltdown, let's say that an auditor of banks suddenly stopped, then you start to get the sort of event that happened in the 1920s. It took us a long time to dig ourselves out of that, decades actually for the stock market to really recover.*

There was a general feeling that the profession would lose many gifted accountants and many graduates would choose a different career

path if such a scenario arose. Two partners summarised the widespread concern as follows:

*If another firm went down, I would think, 'Is this really the right route for me?' I can imagine that at that stage there could be quite a pile out of people. I'm 57 and I've got to ask myself 'When do I want to retire?' There are a lot of partners in their 50s and you could imagine the circumstances whereby if you got out you could survive.*

(Big Four partner)

*I don't think anybody really has thought about what would happen if another firm disappeared. I think most people assume that which ever firm collapsed that capacity wouldn't go out of the market place it would just be reallocated and they would go to wherever... but it depends who collapses. If it's PWC, I think it's a nightmare scenario. In the UK if it was Ernst & Young, I suspect things can be absorbed, but there are global issues as to whether it could or could not be. I think it does depend unfortunately, if PWC collapsed I don't think it could be absorbed by everybody else.*

(non-Big Four partner)

Interviewees believed that, in the UK, if the firm to succumb to litigation was PricewaterhouseCoopers or KPMG then many companies that searched only for a Big Four industry specialist might be left with one or no audit firm to choose from but if Deloitte or Ernst & Young were to succumb then the remaining Big Three firms might be able to cope because their share of the large company market is lower. Much would depend on what happened to the partners, managers and juniors of the firm that failed – the good ones that wanted to stay in the profession would presumably find employment elsewhere. If they moved en masse

to one of the remaining Big Three firms concentration would rise even further but if they moved to one or more of the non-Big Three firms this could possibly lower concentration.

Some interviewees mentioned second order effects, such as the Big Four might decide to shed some of their smaller or riskier clients because they would rather audit the largest and/or least risky companies. A regulator contended:

*The market share of all the Big Four firms is so large that they've ultimately crossed the threshold. It would be catastrophic for the market and one of the factors that people really haven't thought about is there would be second order effects. If you look at the portfolio of clients that any one of the firms have, there will be some real gems of clients that other firms would be desperate to get. You could well find that if PwC, Deloitte and KPMG cherry pick the best of E&Y clients, they then say to some of their existing clients, 'well actually I'd rather audit BP because they are a big client'.*

A regulator argued that firms had tabled the possibility of a four-to-zero doomsday scenario that could arise from a litigation induced withdrawal. On this issue a regulator stated:

*If another big firm falls over, there would most likely be one of two causes, either it will be some legal action by some regulator or it will be a result of some catastrophic litigation. The other three that are left standing may well conclude at this point that frankly it's just a matter of time before this happens to us. The risk to audit business is no longer acceptable and they would rather exit the audit market at a time and a manner of our own choosing than waiting for some regulator or some judge to destroy us.... From the public policy point of view, we need to be concerned about the*



*punitive risk of any one of the firms collapsing. So although the odds of PwC collapsing might be rather remote, if you look at the punitive odds of any one of PwC, Deloitte, E&Y and KPMG falling over, well at that point they all start to mount up... it's the risk that anyone of the Big Four would collapse at any point in the next three, five or ten years. At that point the punitive risks which we are all exposed to start to become very high indeed, particularly when you say because of the close inter-relation of the international networks, that we in the UK are exposed not only to risks emanating from the UK, which we may be able to have some influence over, but we are also exposed to risks in other parts of the world..... the risk we need to think about is the punitive risk of anyone of the Big Four firms arising from any one of their lines, anywhere in the world, at any point in the next ten years, being so big as to cause a problem in the UK audit market.*

The doomsday scenario, whilst unlikely, would have enormous implications for UK business and the economy. An alternative outcome suggested by a different regulator was the possibility that a new firm might evolve from the constituents of the current Big Four:

*There is one other possibility and I would emphasise that I'm speaking quite hypothetically here, but you're talking about a new firm coming from the non-Big Four, the other option is a new firm comes from the Big Four.*

(Regulator)

However, all parties agreed that the credibility of financial reporting and auditing would be severely damaged by another failure, the economy would be harmed, and the profession might take many years to recover. In addition, the existing reputation of the remaining Big Three firms

would be substantially eroded, possibly yielding the concept of a Big Three redundant. Some partners drew parallels with the Wall Street Crash and asked in this scenario whether audits were needed at all if it was only a money game anyway?

If a four-to-three scenario arose because a firm elected to leave the market or merged with another firm, assuming that regulatory bodies permitted this combination, then interviewees believed that the effects on the market would be less severe. Many of the partners, managers and students of the firm would probably continue to seek employment in the profession. This might provide an opportunity for non-Big Four firms to grow larger and to compete on a more equal footing. Choice would still be affected but the effect on the economy and the profession would not be as destructive.

### **Summary views of competition, choice, governance and the Market Participants Group recommendations**

Stakeholders had mixed views on the level of competition – most considered that the market was competitive but expressed concerns about increased fees and the length of auditor tenure in relation to certain companies. There was agreement that partnerships and small companies could hire any accountant from a large number of accounting firms but choice in the FTSE 350 market, and the AIM to a lesser extent, was restricted. The main reason for the lack of choice was clients' desires to hire what they considered to be reputable firms that could provide a high quality audit. The Big Four firms were often perceived as providers of higher quality audits and audit committees followed the 'IBM effect' if in doubt. There was a strong desire by non-Big Four firms to win FTSE 350 and AIM audit contracts but they presently have no desire to compete for FTSE 100 audit work. The best way to win more contracts is by promoting the firm's abilities, taking calculated risks and growing gradually by winning contracts or further mergers.

Small partnerships have maintained the traditional structure with joint and several (unlimited) liability. Most large and medium sized firms have a number of committees that oversee their operations and are organised on a limited liability partnership status. Some of these large firms were opposed to adopting the Combined Code (*MPG* Recommendation 14) because of fears about the availability, quality and effectiveness of non-executive directors. The recommendation to consider the effects of opening up the equity markets was welcomed by all but, if implemented, was thought unlikely to have any major effects because lack of resources is not a barrier to growth for most firms. There was considerable support for proportionate liability by audit partners on sustainability grounds but the other stakeholders were less convinced. It was not clear whether the warnings about firm sustainability were issued to place political influence on regulators to force through proportionality.

The *MPG*'s recommendation on disclosure was uncontroversial. There was an information provision gap between shareholders and partners with the former believing that firms provided less than they actually did provide. Firms believed that they already provided enough information although the regulatory wish for firms to provide consistent data has yet to be achieved. Similarly, parties welcomed the *MPG*'s recommendations on ethical standards (11) and protocols for consistent response to firm issues (13). The interviewees did not think that recommendations 11 and 13 were controversial and therefore discussion of these issues was very brief.

All parties welcomed the recommendation for increased participation by non-Big Four firms on regulatory committees, subject to quality assurances and resource constraints. Unsurprisingly, the *FRC*'s work to improve knowledge of audit quality was also well received. Some non-Big Four partners were in favour of general publication of all of the Audit Inspection Unit reports, citing that the Big Four had been criticised in earlier reports. However, other non-Big Four partners felt that the Big

Four firms might be better able to deal with a bad report than a non-Big Four firm and were less cautious. All partners agreed that the Audit Inspection Unit reports must provide a balanced perspective and avoid generic statements to add value.

Increasing the availability of information available to newly appointed auditors was welcomed by most interviewees. One partner argued that although the *FRC*'s aim was to cut switching costs, a thorough forensic investigation might result in increased costs. There was very little support for joint audits and stakeholders did not believe that this recommendation would have any impact on the market.

The contractual obligation recommendation was greeted well by non-Big Four partners, although some felt that these contracts should be outlawed rather than simply disclosed. Big Four partners had mixed views – some considered that companies should be free to choose their auditor without constraints while others argued that shareholders, banks and other parties should not be prohibited from exercising their right to place restrictions on their investee companies.

The issue of a further withdrawal of an accounting firm was particularly interesting. A few shareholders drew from the Northern Rock example to contend that a firm that has made a significant error should be allowed to fail. However, although most interviewees were extremely concerned about the threat of another withdrawal, the risks of withdrawal have not been fully assessed by stakeholders. The effects would vary depending on which firm withdrew and the reason for the withdrawal. Parties agreed that the effects of a financial scandal driven withdrawal would be much more severe than one due to a merger amongst two going concerns (assuming the latter was permitted by the regulators). If the withdrawal resulted from litigation, fears were raised about the effects on students, managers and partners leaving the profession and the likely impact on the stock markets. Choice would undoubtedly fall in such an eventuality in many markets. It seems likely that many of the good partners of the firm would move to one of the

remaining Big Three firms. In this scenario, concentration ratios would rise even further and choice would fall. If the good partners moved to a non-Big Four firm or created a new firm from scratch then concentration ratios may fall. One interviewee raised the possibility of a 'four-to-zero' scenario in which the remaining three firms chose to exit the market on their own terms rather than under the threat of another black cloud.

Non-Big Four partners were sceptical about the likely impact of the 15 recommendations. One interviewee was very critical of the role of the *FRC* suggesting that it had turned its back on the issue of competition in favour of avoiding another withdrawal and stated:

*I think that on a good day, my view of the FRC recommendations is that perhaps collectively the 15 of them might do something. On a bad day my view is that, individually none of them will do anything. Where the FRC come from as is it has been explained to me is that the concern that these four become three. The FRC project used to be on competition and choice. The comment regulators always made to me is 'you know the regulators job is to ensure continuity of supply, it's my job to always make sure that there's always a client auditor. If one of the Big Four firms collapses in the UK, I don't know if I could do that. I don't have a bottom drawer full of auditors.' So it is almost about protecting the Big Four as much as it is about expanding it to others. Expanding it to others is helpful as a fall back position.*

(non-Big Four partner)

The *FRC* has threatened to investigate this issue again if market-based measures fail. One interviewee argued that the *FRC* had turned its back on competition and stated that if it really wanted to improve choice it needed to implement non-market measures. There are a number of possible non-market measures including the mandatory break up of

accounting firms (as occurred in Japan), mandatory rotation, caps on the number of companies a firm can audit in an industry and the forced resignation of auditors from some of their clients. These possibilities would undoubtedly prove controversial in a free market economy and may be impractical due to the international nature of accounting firms and their clients. Another option would be to encourage companies to hire the National Audit Office or another organisation to provide more competition to the Big Four. However, the Big Four partners were extremely sceptical about non-market measures and argued that government bodies were not equipped to complete large company audits. This is illustrated by the following quote:

*If suddenly the national auditors were to audit BP, how would they cope? How would they cope if suddenly the National Audit Office was exposed to US litigation? What would then happen if there was a problem at a major company audited by the national audit office and suddenly a £300 billion claim arrived on their doorstep. Can you imagine that person going to Gordon Brown and saying 'Gordon, you lost £100 billion on Northern Rock by the way I don't know how to say this but we've got an exposure of £300 billion because we messed up the audit of X. Can you imagine what would happen? It would bankrupt the country. You are running big risks, then you get the circumstances where you break up the firms, what's going to happen? Again you will be in turmoil.*

(Big Four partner)

# 5 SUMMARY AND CONCLUSIONS

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## Introduction

The effect of market structure on the conduct and performance of firms is interesting in the light of high concentration ratios attributable to mergers amongst the largest accounting firms, the collapse of Andersen, the desire to hire a reputable firm and substantial barriers to entry. Concerns that concentration may impair consumer choice and/or price competition led to the *Market Participants Group* report which contains recommendations to improve choice and mitigate the risks arising from the characteristics of the UK market for audit services (FRC, 2007).

The motivation for this research was to explore:

- Whether there is a desire by auditors, accounting firms and/or companies to reduce the gap between the Big Four accounting firms and the remaining firms, and if so how this can best be achieved;
- Perceptions of the differences between various alternative legal forms of governance in accounting firms and how they could be manifested; and
- Perceptions of the challenges to and likely impact of the 15 recommendations put forward by the *Market Participants Group*.

## Findings

Rich data on these issues was collected by one-to-one interviews with company directors, audit committee chairmen, partners, representatives of the Government, banks and regulators of the UK audit market. There

were mixed views on the issues of market competition and consumer choice. Shareholders were concerned that audit fees have risen rapidly in recent years and pointed to concentration ratios and the slow rate of auditor rotation as signs of an uncompetitive market. Partners countered that their workload increased significantly in the aftermath of the Sarbanes-Oxley Act and the introduction of International Financial Reporting Standards. Most other parties were of the opinion that competition for initial tenders was fierce but some interviewees expressed reservations about the pricing of repeat audits. The evolution of audit and consultancy fees after the demise of Andersen is an area of potential future research.

The Big Four firms had 99% of the FTSE 100 audit market in 2006 and it has increased to 100% in 2007), a very large share of the FTSE 350 market and they are currently expanding into the Alternative Investment Market. Non-Big Four partners were keen to increase their share of the FTSE 350 but were not presently targeting the FTSE 100 audit market. Non-Big Four partners claimed that they have had success in the consultancy market but only moderate success in the audit market due to entry barriers and perceptions of their firm. Audit committees of large companies strongly favoured the Big Four and asked the question ‘what is in it for me to switch?’ It was clear that reducing the gap between the Big Four and other firms would not be easy to achieve.

Most audit partners were sceptical about the new ownership recommendation but strongly favoured proportionate liability. Partners stressed the threats that their firms were under were so large that withdrawal was a serious risk. However, it was not clear whether sustainability was being overplayed and used as a political tool to encourage the regulators to adjust the liability rules. There are several scenarios in which it may not be in the public’s interest to protect a firm in financial difficulties, even in a market with such limited choice. Some interviewees were concerned that audit quality might fall if a



firm perceived itself to be 'too big to fail'. It was very clear that there is opposition to proportionate liability from some parties.

There was general agreement that choice was limited in some sectors of the market and improvements were desirable. The Big Four firms' partners were broadly in favour of the 15 recommendations put forward by the *MPG* in 2007 but the non-Big Four firms' partners argued that the recommendations will not make a big difference to choice in the short-term. Non-Big Four partners revealed evidence of several contractual obligations and called for their abolition. Contractual obligations to hire certain firms are by definition inconsistent with the original aim of improving choice in the audit market.

Some Big Four partners were concerned about the guidance on audit committees and Combined Code recommendations; they argued that there may not be sufficient high quality non-executives available and questioned whether non-executives could add value to their existing corporate governance structures and systems. The availability and pros and cons of the use of non-executives on the boards of accounting firms is worthy of further investigation. However, this report does not make any recommendations on these topics because of the recent *FRC* guidance on these issues (Financial Reporting Council, March 2008; Financial Reporting Council, May 2008).

Interviewees argued that any litigation that induced a 'four-to-three' scenario would be very destructive for the profession and the economy but companies, audit committees and auditors have not yet fully considered the associated risks in their risk management strategies. The credibility of the UK profession was currently high and interviewees stressed that these high standards would leave the UK profession well placed to deal with any further disruption. One interviewee raised the issue of a doomsday 'four-to-zero' scenario in which all of the remaining three firms chose to exit the market on their own terms rather than face the humiliation of doing so on the behest of a judge or regulator. This scenario is extremely unlikely and is possibly being used as a political ploy

to pressurise regulators to accept proportionate liability. Nonetheless, the economic impact of a further withdrawal of one or more firms is likely to be significant, at least in the short-term.

## Policy recommendations

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 impact of the new auditor liability limitation agreements enabled by the Companies Act 2006.
- The government should legislate to remove any barriers to non-Big Four growth, such as the prohibition of contractual obligations, and work hard to ensure that these rules are enforced.
- 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.

- The *FRC* should commission a thorough review of the likelihood and economic consequences of a further withdrawal of a Big Four accounting firm from the market.

## Summary

This report documents the views of a large number of interviewees on auditor choice, but some limitations exist, such as, the interviewees may not be fully representative of the related organisations. Some groups were also more widely represented than others, although the researcher has tried to offer a balanced perspective in this report, and interviewees may have made politically motivated statements. Nevertheless, the findings of this report provide evidence of some concerns of auditor concentration by various stakeholders and has led to the six recommendations that hopefully the *FRC* and non-Big Four firms will consider in their future plans.

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

The large listed audit market is dominated by the Big 4 accounting firms; this has led to concerns about the lack of competition and choice in the audit market and the establishment by the Financial Reporting Council of the Market Participants Group. Most stakeholders agree that additional choice in the audit market would be beneficial but should this be left to market forces or should regulatory measures be adopted? This interview based study investigates: the extent of such concerns; to what extent there is a desire to improve audit choice; and the challenges and likely impact of the Market Participants Group's 15 recommendations made in 2007. The author makes a number of recommendations for stakeholders with an interest in the audit market to consider.

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ISBN 978-1-904574-22-4

EAN 9781904574224



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