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Are the Big Four still holding on to their dominance?

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Competition analysis: Is it all change for competition in auditing services? Frances Murphy, partner and head of the antitrust, competition and trade regulation group at Bingham McCutchen in London, explains why change is afoot.

Original news

Auditing market continues to lack competition, LNB News 20/02/2014 13

Financial Times, 20 February 2014: Despite attempts to diversify the auditing market for Britain's largest companies, the Big Four continue to dominate. Insiders have warned that mid-size auditors will struggle to get a foot into the door of larger companies due to the complexity of major audits.

What is the risk of a lack of diversity in the auditing market?

In its October 2013 report on the provision of statutory audit services to large companies in the UK, the Competition Commission (CC) determined that the market for the supply of statutory audit services to large companies in the UK is dominated by four firms, PwC, Deloitte, KPMG and EY (the Big Four).

The CC determined that this level of market concentration makes it difficult for mid-tier audit firms to enter the statutory audit market, to expand in that market and to get selected to act by any of the firms in the FTSE 350. Mid-tier firms face experience and reputational hurdles which, together with the infrequency and unpredictability of opportunities to tender, affects their incentives to make the necessary investments to overcome such hurdles.

The lack of diversity and the difficulties it presents to mid-sized firms has the effect of reinforcing current market positions, and hindering the emergence of new or strengthened rivals and that potential competition is thereby damaged. It reduces the potential competitive constraints firms can exercise on rivals. It weakens instructing companies' bargaining power since instructing companies may have a lesser range of outside options available to them.

What are the key regulatory concerns?

The key regulatory concerns identified by the CCin its report on the provision of statutory audit services to large companies in the UK included:

- barriers to switching--giving rise to an appreciable effect on competition because they weaken a company's bargaining power outside the tender process
- barriers to entry--giving rise to an appreciable effect on competition because they have the effect of reinforcing current market positions thereby chilling potential competition

- influence of executive management--executive management have a material ability to influence external auditors in how they conduct and report their audit
- information asymmetry--there exists an information asymmetry between shareholders and audit firms that creates a situation in which shareholders have little information regarding the investigation carried out by the auditor

The CCwas concerned that influence of executive management and Information asymmetry (above) would give rise to an appreciable effect on competition because (together or individually) they have the effect of giving firms incentives and the ability to respond to the interests of executive management and firms may therefore compete to satisfy a demand that is not fully aligned with shareholders' interests. Firms therefore may not compete on the right parameters.

As a result of all of the above, the CC thinks that instructing companies are offered higher prices, lower quality (including less sceptical audits) and less innovation and differentiation of offering than would be the case in a well-functioning market.

In the light of the regulatory concerns established by the CC, it decided to implement a remedy package the main aspects of which are:

- FTSE 350 companies must put their statutory audit engagement out to tender at least every ten years--during the course of the Competition Commission's investigation, the Financial Reporting Council (FRC) amended its UK Corporate Governance Code to the effect that FTSE 350 companies should put their audit engagements out to tender at least every ten years
- the Audit Quality Review team (AQR team) of the FRC should review every audit engagement in the FTSE 350 on average every five years, although it should have discretion to review audits that it perceives to be particularly low risk less frequently--the AC should report to shareholders on the findings of any AQR team report concluded on its company during the reporting period, stating the grade awarded and how both the AC and auditor are responding to the findings
- the AQR team should review and report on the firms in its scope on an annual basis, where such firms conduct sufficient public interest entity (PIE) audits for this to be practicable
- provisions in loan agreements which restrict a company's choice of auditor to lists or categories should be prohibited, although parties may require that any auditor should meet objectively justified criteria
- an advisory vote should be introduced on the AC Report, and amendments to the UK Corporate Governance Code and Stewardship Code should be made to further encourage shareholder engagement
- measures should be introduced to strengthen the accountability of the external auditor to the AC
- the FRC should amend its articles

What impact have European legislation and audit tender requirements had?

In its market investigation the CCfound that 31% of FTSE 100 companies and 20% of FTSE 250 companies have had the same auditor for more than 20 years, and 67% of FTSE 100 companies and 52% of FTSE 250 companies for more than ten years.

Given the structure of the market it was not expected that the CC's audit tender requirements would have an immediate impact. In the medium to long term, however, it is hoped the mandatory tender requirements will bring greater competition to the market and lower barriers to entrance as they encourage more frequent rotation of auditing firms. The recent changes might also strengthen accountability and independence of auditing firms as they transfer more powers to shareholders and auditing committees which are now more able to accurately evaluate the auditors work when selecting a new service provider. By creating conditions for more frequent reviews and extended reporting, the new legislation aims to increase transparency and information in the market which in turn will facilitate (if not encourage) companies' decisions to frequently switch auditors.

The CC thinks its package of remedies is likely to increase choice, as both Big Four and mid-tier firms will have increased incentives to develop and expand their capabilities in order to win engagements. The CC thinks that measures to prohibit restrictions on auditor appointment in loan agreements, in combination with more frequent tender opportunities, will encourage firms other than the Big Four firms to invest in the capabilities necessary to win FTSE 350 engagements, particularly those engagements lower down the scale of complexity and international breadth.

The proposals agreed by the European Commission in December 2013, have yet to be ratified. If they are adopted it is expected that the effects of them will also be felt in the medium to long term.

Are there plans to encourage further diversification?

In December 2013 the European Commission agreed a set of proposals that include mandatory firm rotation, substantial bans on non-audit services and, in specific instances, the formation of 'audit only' firms. Though ostensibly aimed at improving audit quality rather than competition, the new rules (if ratified) will prohibit restrictive third party clauses that require one of the Big Four to conduct the audit. The European Commission believes the size of the Big Four and the breadth of services they can provide are a barrier to the ability of small and mid-tier firms to develop the necessary skills and expertise to undertake the statutory audit of large, global companies. The European Commission intends its proposals to address these issues.

If adopted, the proposals ought to encourage growth among the mid-tier firms and lead to greater competition in the FTSE 350 statutory audit market.

How can small to mid-size audit firms cope in the current market?

Mid-tier audit firms face experience and reputational barriers to expansion and selection by firms in the FTSE 350. Due to the lack of scale they struggle to win jobs from international companies that are usually looking to place their work with one firm that can meet its needs on a global basis. This is not going to change unless and until the mid-tier firms respond to regulatory changes by investing in the capabilities necessary to win FTSE 350 engagements, particularly those engagements lower down the scale of complexity and international breadth.

Interviewed by Nicola Laver.