Concentration of Audit Market

The Audit Market in the UK has continued to be dominated by only four audit firms. The market is extremely, and persistently, concentrated. There exist a wide gap in sizes between the top four and mid-tier audit firms. The top four audit firms include Ernst & Young, Deloitte & Touche, PricewaterhouseCoopers (PwC) and KPMG). The Big Four firms according to Tysiac (2012), audit all except one of the FTSE 100 companies. The same Big Four audit firms audit 242 of the FTSE 250 companies. Both the mid-tier and the top four firms supply the other section of the audit market comprising of the small listed firms. Even in auditing the small listed firms, the Big Four audit firms have a greater market shares as compared to the mid-tier audit firms. Because of the domination of the big, four firms in the audit market; various individuals and institutions have raised concerns on the impact on audit fees, competition, quality, and choice. These report discuses on whether the audit market concentration is a cause for concern. It also focuses on steps taken, and proposals made to widen participation and to increase competition in the large company audit market.

Arguably, the concentration of large company audit market in the big four big firms is a cause for concern. Midsize and small firms have continued to undergo various challenges in entering the large companies audit market. Thus, there is a need to give attention to their challenges in order to enhance competition and participation for large company audit market. Among the challenges are limited technical capabilities and specialized industry knowledge, entry barriers, reputation, and unlimited liability among others.

Most listed companies in London Stock Exchange are large and have complex accounting procedures and policies. There is an entry barrier in entering the large company audit market for small firms because of the sheer size of large companies, as well as the size gap existing between

top four and small audit firms. Midsize and small firms does not have enough resources to audit the large companies. To achieve the standard that have been reached by the top four firms will require other firms to invest heavily in terms of resources, energy, and time. More so, investing in financial and other resources can be extremely risky for other firms. This is because of the costly nature of scaling up to achieve the resources needed in auditing large companies. There is need to reduce barriers to entry in order to enhance competition from midsize and small audit firms.

Midsize and small audit firms face the problem of limited technical capabilities and specialized industry knowledge. Large companies have complex organizational structures and complex accounting policies. Thus, in looking for an auditor, public companies seeks audit firms with excellent industry knowledge and technical capability. Since small audit firms does not have sufficient expertise, large companies are left with limited to the big audit fiems. Technical and specialized industry knowledge limits small firms' ability to enter the large company audit market and lowers their concentration. Smaller audit firms face difficulty in sustaining their technical knowledge. According to Velte and Stiglbauer (2012), smaller firms consider maintaining technical expertise as time-consuming and extremely costly. In addition, smaller audit firms face difficulty in updating its staff with new standards and procedures. Auditing standards and procedures keep changing due to the changing nature of business environment.

Reputation is another problem that has hindered midsize and small firms from competing with the largest audit firms. Midsize and small audit firms does not enjoy the reputations that the largest firms are enjoying. Large companies seeks the services of firms with excellent reputation.

Accordingly, large organizations are confident that big firms will meet their organization's audit needs. This is because big audit firms have excellent brand name and reputations for high quality services. The challenge with smaller firms is that large companies are not familiar with their service quality and thus, are not certain on their ability and sufficiency to serve large organizations.

Various interested parties in order to widen participation as well as to raise competition in the large audit company market have put various proposals forward. Among the plans, does competition commission propose the mandatory five-year tendering? The proposal of compulsory tendering seeks to enhance greater competition between audit firms. The current audit market tenders every ten years and is does not promote competition because the period is long. Arguably, reducing the tendering period to five years could be essential in providing opportunity for other firms to compete in the tendering process. The Financial Reporting Council (FRC) has openly criticized the proposal. FRC claims that biding for every five years will be costly. More so, it claims that the proposal may not be taken seriously by firms and may lead to sham process.

The Competition Commission also put forward a regulation preventing financial institutions from requiring an auditor from the top four firms for loan agreements. This will assist in enhancing competition as well as widening participation because it does not limit auditors to the top four. This is so because firms seeking loans can seek services from an audit firm beyond the top four, thus, enhancing wide participation.

Another proposal that has been sounded by some parties is mandatory rotation of audit firms. The proposal seeks to encourage large companies to look beyond the existing Big Four. Arguably, the approach has the potential of enhancing competition because other firms will have

the opportunity to compete. The proposal according to Velte and Stiglbauer (2012) has the advantage of promoting auditor independence as well as increasing competition in the audit market. The use of mandatory rotation can prove to be efficient because it will limit the number of years an audit firm can provide audit services to a company. Now, most large companies retain their auditors. According to Tysiac (2012), an estimate of 40 percent of large organizations have used one audit firm for at least five years. 25 percent have used a single audit firm for more than ten years. Auditor rotation has the potential of reducing concentration as well as providing an opportunity for smaller firms to compete to offer audit services to large companies. However, some critics argue that rotation may not essentially lower concentration, especially where large companies rotate auditors within the big four.

Improving the technical abilities as well as specialized industry knowledge are the important steps that have been taken to improve competition. One of the challenges that have been hindering small and midsize firms competing for large companies audit market is limited specialized industry knowledge and technical capabilities. According to Tysiac (2012), technical and specialized industry knowledge limits small firms' ability to enter the large company audit market and lowers their concentration. The large companies audit market requires audit firms with excellent technical capabilities to handle the vast nature of their audit needs. Arguably, increasing the specialized industry knowledge and technical abilities of small firms to the level of Big Four audit firms will increase competition and widen participation. The step can be every essential in bringing the much needed competition and breaking of the concentration. The step can be very effective in that small firms will gain sufficient skills necessary in auditing large companies with complex nature of accounting policies.

Some interested parties have proposed placing caps on a firm's potential liability. The reason that smaller firms have not been offering services to large companies is because they fear the risk of being liquidated in case of a liability. By placing caps, the audit firm's risk of litigation will be reduced. Tysiac (2012) has that the introduction of liability caps has the impact of limiting a liability that a firm could incur through lawsuit. The proposal can be productive in ensuring increase competition and participation by smaller firms. Smaller firms will be willing to offer services to big companies because they will not fear liquidation. More so, liability caps can result in increased efficiencies because firms will not be focusing much on protecting themselves from lawsuits. Capping liability has the disadvantage of lowering service quality. Firms will not be focusing much on providing high quality because they are protected in case of errors.

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