

Workshop on Innovation and Competition in the Audit Market

Friday 10 February 2023

Financial Reporting Council, 125 London Wall, London, EC2Y 5AS

- 10:00 - 10:20** **Welcome from Mark Babington** (FRC Executive Director of Regulatory Standards)
Followed by brief self-introductions from workshop participants.
- 10:20 - 10:30** **Workshop Introduction, Franco Mariuzzo** (Centre for Competition Policy, University of East Anglia)
- 10:30 - 12:00** **Theme 1 session. Innovation in the Audit Market**
Chair: Alexa Scherf (LSE) / **Panellists: Steve Davidson** (FIG Norwich), **Martin Martinoff**, **Vinita Mithani** (Southampton), and **Georg von Graevenitz** (QMUL).
*** There will be a coffee break halfway through the session ***
- 12:00 - 12:45** *Lunch*
- 12:45 - 14:15** **Theme 2 session. The Relationship Between Innovation, Competition and Quality in the Audit Market.**
Chair: Sean Ennis (CCP) / **Panellists: Stefano Comino** (Udine), **Amelia Fletcher** (CCP), **Bernhard Ganglmair** (Mannheim), **Carmine Ornaghi** (Southampton).
- 14:15 - 14:30** *Coffee break*
- 14:30 - 16:00** **Theme 3 session. Future Research and Implications for ARGAs.**
Chair: Ilias Basioudis (Aston) / **Panellists: Chris Humphrey** (Manchester), **Niels Philipson** (Maastricht), **Atul Shah** (City), and **Javed Siddiqui** (Manchester).
- 16:00 - 16:15** **Closing remarks by Laura Warren** (FRC, Director of Competition Policy)

Scope and outline of the workshop

- i) The Centre for Competition Policy (CCP), at the University of East Anglia (UEA), has been commissioned by the Financial Reporting Council (FRC), to further understanding of how innovation and competition interact in the United Kingdom (UK) market for audit services. As part of this project, we are gathering expert opinion through a structured workshop with leading innovation and competition academics and practitioners on the 10th of February 2023. This paper provides background information and suggests questions to guide discussion at this workshop.

The FRC regulates auditors, accountants, and actuaries and sets the UK's Corporate Governance and Stewardship codes. They are also the competent authority for statutory audit in the UK and so they also set auditing/ethical standards and monitor and enforce audit quality. The FRC considers a high-quality audit one which provides investors and shareholders with high level assurance that financial statements give a true and fair view whilst complying with the spirit and letter of audit regulations and standards (FRC 2021). The FRC's strategic objectives for 2022-2025 include promoting improvements and innovation in its areas of responsibility and creating a more

resilient audit market through competition and choice. The outputs of this project will therefore inform the FRC's work to drive up audit quality and improve the functioning of the UK audit market.

The FRC is set to become in the Audit, Reporting and Governance Authority (ARGA) as part of plans to reform the UK's corporate reporting and audit regimes. Following some large corporate failures, including Carillion, and three independent reviews by Sir John Kingman (2018), the Competition & Markets Authority (CMA) (2019), and Sir Donald Brydon (2019), in 2021 the UK Government published, for consultation, proposals to restore trust in audit and corporate governance. In May 2022, the UK Government set out its planned reforms to create ARGA with new objectives and powers including to improve resilience, competition and choice in the audit market.¹

Ahead of the legislation that will create ARGA, the FRC is taking action to deliver on the planned reforms, including to improve competition in the audit market. The FRC is focused on the market for statutory audit which includes, but is not limited to, audits of the UK's largest listed companies (i.e. the FTSE 350 audit market). In December 2022, the FRC published a policy paper setting out its approach to competition in the audit market and its current work on this area.²

- ii) When we refer to the client/consumer of audits in this paper, we refer to the shareholders of the audited company. Audits are crucial to shareholders as they pose a solution to the principal/agent problem of management/owners, i.e., they serve as a means of ensuring management acts in the interest of the owners rather than their own interests. The literature highlights this is not a perfect solution, as management who buys the audit report is often price focused and the shareholders who are primary consumers of audit information are often quality focused (this is known as the two-customers problem). An 'expectations gap' is also regarded to exist, since stakeholders and commentators' expectations of auditors is different from the role that auditors actually perform, as the role of an auditor is limited to providing a true and fair view of financial statements, certain other elements of the annual report, and checking the consistency of the financial statements with the rest of the annual report. That said, audits also hold wider social importance beyond shareholders. They provide assurance to other stakeholders such as investors, and to an extent, act as a safeguard to avoid the financial failure of companies which is in the greater interest of society.

- iii) We consider the UK audit market exhibits several key market characteristics which are relevant to note. First, a 2013 Competition Commission (CC) report found that the market for audits for the largest UK companies (FTSE 350 companies) has significant unmet demand (in the form of some shareholders requiring further granularity and information from the audit report). Second, the CMA report (2019) found that the FTSE 100 audit market in particular faces constrained demand, as there are only a limited number of auditors that have the resources to conduct the very large-scale audits needed by FTSE 100 companies. Third, audit is a compulsory product (all listed companies have a legal requirement to be audited). Fourth, a client's choice of audit firm might be further limited by audit rotation (auditors must be rotated every 10 years), and because of conflict of interest rules if audit firms are providing non-audit services to the client. Therefore, whilst the market for most FTSE 250 audits is oligopolistic, the market for a particular audit might be duopolistic or even monopolistic in nature.

- iv) Regulators (CC 2013, CMA 2019, FRC 2022) have raised concerns that this high concentration of suppliers in the UK audit market may be associated with insufficient competition. The Big Four (Deloitte, EY, KPMG and PwC) earned 98% of FTSE 350 audit fees in 2021.³

- v) To explore the topic of innovation and competition in the audit market, the remainder of this discussion paper is divided into three thematic areas:
 - a. Understanding innovation in the audit market;
 - b. Discussing the relationship between competition, innovation and quality in the audit market;
 - c. Drawing implications for the FRC and ARGA's future work about innovation and competition and areas for future research.

- vi) Within each area we provide background on several subtopics and outline questions for discussion. Although for convenience we also provide the list of all questions below.

Questions for discussion at the workshop

Theme One

1. What forms does innovation take in the UK audit market? How can innovation be measured in the UK audit market?
2. What do you think drives and hinders innovation in the UK audit market?
3. What are the opportunities for future innovation in the UK audit market?

Theme Two

4. How accurately does the literature characterise the relationships between innovation and competition in the UK audit market?
5. How would you conceptualise the relationship between competition and innovation in the UK audit market? How does this relationship compare to that found in other markets with similar characteristics? How do the incentives for innovation differ between Big Four and non-Big Four firms?
6. What are the primary mechanisms through which audit innovations affect audit quality in the UK?

Theme Three

7. What role could competition policy and regulation play in increasing innovation in the UK audit market? What might be relevant regulatory tools?
8. What should be the priorities for future research on competition and innovation in the audit market?
9. To what extent do we need a new theoretical paradigm to understand the relationship between competition and innovation in the UK audit market?