Competition, regulation and innovation in the UK audit market: some reflections

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CCP/UEA workshop, 10-2-2023

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Question 7

What role should competition policy and regulation play in increasing innovation in the UK audit market? What might be relevant regulatory tools?

Competition and quality (1)

- Lack of competition in audit market
  - lack of choice in FSTE 100 / FSTE 350 markets
  - how to increase choice, keeping in mind the minimum audit quality standards (to be) defined in regulation?
  - and does this lack of choice affect audit quality and innovation?

- Competition remains important because the alternatives (monopolies and full government control) are worse:
  - markets with only 2-4 players (likely) result in higher prices and lower incentives to offer high quality (and innovation?)
  - a 'communist' regime requires perfect information

Competition and quality (2)

- How does competition relate to quality?
  - product innovation: little impact
    - regulated, which is ok (gatekeeper)
    - audit clients do not easily recognize (and award!) higher quality beyond the minimum level => experience goods
    - perhaps some competition for product innovation may come from (1) accountancy markets or (2) abroad
  - process innovation: *relative* positive impact likely
    - cost-efficiency (including offshoring?)
    - (other) technological innovations: AI, Big Data
  - but note again: given a minimum quality defined in law

How to increase such ‘regulated’ competition? (1)

- Problems highlighted in OECD study (2009)

  - big accounting firms outside of Big 4 are unwilling to enter the market for audits of quoted and large companies, because of high litigation risks and insurance costs
  - unlimited exposure to liability in combination with insurance problems (level, amount, conditions)
  - other entry barriers: reputation, capacity, specialization (e.g. in financial sector)
  - however, many mid-tier firms (GTI, BDO, etc) already had international networks

How to increase such ‘regulated’ competition? (2)

- OECD proposals (2009) to reduce entry barriers:
    - quality regulation and regulatory oversight
        - auditor rotation and independence
    - de-regulation of LFS requirements
        - may alleviate the problem of raising sufficient capital
  - ‘regulating’ liability: limited liability, caps
    - positive effect on insurability
  - lenient merger control for mid-tier (challenger) firms?

- Currently: audit sandbox
  - note the link with the discussion on ‘green cartels’ and competition law

Question 8

What should be the priorities for future research on competition and innovation in the audit market?

Priorities for research

- How does competition really work in audit markets (FTSE 100 / FTSE 350)?
- Focus less on product innovation (but regulate this well)
- Keep global context in mind

- Because an increase in the number of market players increases incentives for process innovation, it may also be important to:
  - critically examine liability (caps) and insurance
  - critically examine regulations on shareholding or legal form, if any (?)
  - consider a more lenient application of cartel prohibition and merger control

Limitations of liability (1) – Recommendation 2008/473/EC

- "There are many variations between civil liability systems of Member States. Member States hence must be able to choose method of limitation themselves."

- Article 5 of the Recommendation suggests:
  - cap
  - proportionate liability
  - limitation via agreement (subject to judicial review and published)

Limitations of liability (2) – L&E theory

- compensation of victims vs prevention of risks
  - care taken by auditors / intensity of audit efforts
- Interaction liability rules and regulation *(Shavell, JLS, 1984)*
  - disadvantages liability rules in case of insolvency problem or lacking threat of lawsuit
  - however, regulation is difficult to design (less dynamic, public choice concerns) and enforce
- Interaction liability rules and insurance
  - insurance is necessary for compensation, but *moral hazard* needs to be controlled

4.3. Limitations of liability (3) –applied to auditors

- Potentially negative effects of limited liability (e.g. caps) may be smaller in auditing sector:
  - reputation effects
  - liability only in cases of negligence (which provides incentives to auditors to meet the due care standard)
  - overcompensation as a result of liability for pure economic loss and wrong assessment of damages

  - conclusion: due to the special characteristics of auditors' liability, a limitation of liability is likely to have only limited adverse effects on deterrence, while having positive effects also for insurability

Question 9

To what extent do we need a new theoretical paradigm to understand the relationship between competition and innovation in the UK audit market?

Answer:

- We don’t need a new paradigm.

- Focus should be on increasing choice, i.e. number of audit firms
  - e.g. the audit sandbox, a more lenient application of competition rules, decreasing other barriers
  - but we need to know how competition really works: what are the entry barriers to the FTSE 100/350 markets?

- Liability caps and insurance may help to create a climate in which competition and innovation (particularly process innovation) can prosper (more).