

UKSA position paper on audit competition and quality failures

1. Introduction

This paper has been prepared by the Policy Team of the UK Shareholders' Association. It sets out our view on two key issues concerning the audit profession, both of which impact upon our members who are the ultimate owners of listed companies.

2. Two key issues in auditing

Two key issues, namely competition and quality, are often conflated. However, they are distinct and need to be considered separately.

A. Shortage of competition in the provision of audit services

There are relatively few auditing firms which operate in the market for auditing listed companies.

In any market, a limitation in the number of suppliers always reduces competition and increases prices. As companies belong to their shareholders, ultimately our members bear any increased fees that auditors are able to charge due to limited competition.

B. Quality failures in audits

There have been too many cases, both in the UK and overseas, of listed companies publishing accounts which have "a clean audit opinion" but whose accounts proved to be materially misstated.

On many occasions, such companies collapse into insolvency. Even when they do not, for extended periods of time a false market will have existed for the listed shares concerned.

Again, as the owners of listed shares, our members suffer the damage caused by auditing quality failures. Just to be clear, where there are audit quality failures, these are secondary to the primary failures of companies' directors and management in their corporate reporting, since it is directors and management who are responsible for preparing company accounts that give a true and fair view.

3. Competition in audit services

A. Multinational companies

By definition, multinational companies operate in multiple jurisdictions. Accordingly, their auditors need to be able to carry out auditing functions in those foreign jurisdictions, regardless of whether the multinational is operating through branches or subsidiaries.

UKSA position paper on audit competition and quality failures

It is not feasible to audit overseas operations relying entirely upon audit staff sent from the home jurisdiction. Quite apart from cost and language issues, when foreign subsidiaries are involved, the countries concerned will have their own rules regarding who is legally permitted to audit subsidiaries incorporated in that country.

Historically, as businesses grew and became multinational, their audit firms followed them, by setting up overseas audit firms that operated as part of an integrated network with common training standards, and usually a common firm name.

By the 1970's there were eight major international networks of audit firms, known as the "Big 8." Since the early 1980's, there has been a shrinkage of the major international networks of audit firms from eight down to four.

This has significantly reduced competition in the marketplace for audit services provided to large multinational companies. Although there are smaller international networks outside the "Big 4" such as the BDO network, in practice most multinational companies, especially the large ones, are audited by the Big 4.

B. Companies that are UK domestic only

In principle, there is more scope for competition in auditing listed companies that are purely UK domestic, since the audit firm does not need an international network. Accordingly, UK audit firms outside the Big 4 have a reasonable presence in the audit marketplace for domestic UK listed companies. However, they struggle to compete for larger domestic UK listed companies, and also have problems developing sufficient expertise in areas such as financial services.

Accordingly, larger UK domestic listed companies also tend to choose their auditors from just the Big 4.

C. Increasing the number of competitors in the audit marketplace

There are three broad ways of increasing the number of competitors.

(i) Audit market share caps

The Big 4 firms could be limited to only auditing X% each of a defined audit marketplace, (with $4 \times X < 100\%$) thereby forcing a certain number of companies in that audit marketplace to appoint auditors outside the Big 4.

For some parts of the audit marketplace, such as the FTSE-100, this appears completely unrealistic. There simply may not be firms capable of auditing those companies left over which the Big 4 would be prohibited from auditing.

For smaller listed companies, e.g. the FTSE-250, it may be possible for smaller audit firms to take on such audits. However, it appears wrong to force companies to exclude the most capable audit firms from being their auditors.

UKSA position paper on audit competition and quality failures

(ii) Breaking up existing audit firms

To increase the number of audit firms available to large multinational companies, it would be necessary to break up the Big 4 networks. In theory, one could for example convert the Big 4 into the Big 8 by dividing each of these networks into two.

No individual country could achieve this since these are networks of independent firms governed by the laws of many countries. International cooperation would be required. With such cooperation, the international networks could be divided into smaller ones, but without such cooperation no individual country (and especially not the UK alone) can achieve anything.

However, the UK could unilaterally divide the UK audit arms of the Big 4.

Nevertheless, the UK alone could not require that the international network concerned to refer work to both of the successor UK firms. As an example, if the UK audit firm of KPMG were split, one firm would in practice continue as the UK arm of the international KPMG network while the other would be an audit firm which had domestic clients only. Such a firm would not be seen as an attractive employer by ambitious professional auditors and would rapidly be seen as “second-class.”

(iii) Encouraging new entrants into the audit marketplace

Historically, medium-size UK audit firms have found the listed company audit market unattractive. Accordingly, they have gradually dropped out of the market.

The March 2021 consultation paper “Restoring trust in audit and corporate governance”¹ from the Department for Business, Energy and Industrial Strategy (“BEIS”)² proposed government action to help smaller audit firms to develop their audit practices.

Paragraph 8.1.12 proposed:

The core of the Government’s proposal is a managed shared audit requirement for UK-registered FTSE 350 companies. This form of shared audit would see an audit firm appointed to lead the group audit, for which it bears the overall liability. When tendering the statutory audits of entities within the group, companies would be required to appoint a Challenger audit firm to conduct a meaningful proportion of the statutory audits. The requirement would apply across the FTSE 350, giving the audit firms the opportunity to gain exposure to the statutory audit engagements and audit committees of the largest and most complex companies, and giving those companies greater choice of auditor.

¹ <https://assets.publishing.service.gov.uk/media/60523dc18fa8f55d39eef03a/restoring-trust-in-audit-and-corporate-governance-command-paper.pdf>

² BEIS no longer exists. It has been replaced by DBT, the Department of Business and Trade

UKSA position paper on audit competition and quality failures

UKSA and ShareSoc in their joint response of 1 July 2021³ were sceptical about this proposal. While paragraphs 208 – 216 of our response did not explicitly reject the proposal, they identified many practical difficulties and pointed out that a significant increase in audit fees would be an unavoidable consequence. The government never proceeded with the proposal and the government's announcement on 20 January 2026 that it will not be proceeding with an audit reform bill means that there are no plans to take this proposal forward.

4. Quality failures in audits

Company management have many reasons for presenting the financial results of their company in the best possible manner. Managers' bonuses are often linked to the level of company profits reported in the accounts. Managers often own shares, or options over shares, and therefore want to see the share price as high as possible, which requires the financial accounts to be well received by current and potential investors.

Ever since the establishment of stock markets, there have been many cases where companies have collapsed into insolvency, with subsequent revelations that their accounts had mis-reported the true state of their financial affairs.

The auditor exists to protect investors from the company publishing accounts that do not give a true and fair view of its results. Accordingly, there is a permanent and inevitable tension between the duties of the auditor and management's desire to present the best possible results.

A. Independence is fundamental

The auditor's responsibility to examine the company's accounts, including examining its operations, requires the auditor to be independent of management. Otherwise, shareholders and creditors could have no faith that the audit was being conducted properly.

The professional requirements for independence have increased over the decades, as the regulators have learned from the hard lessons of audit failures.

That is why auditors are prohibited from owning shares in their clients, prohibited from being close family members of company management, etc.

³ [Joint response from United Kingdom Shareholders Association and UK Individual Shareholders Society](#)

UKSA position paper on audit competition and quality failures

B. Non-audit services

Historically, it was commonplace for audit firms to provide many additional services to their audit clients⁴, completely separate from the audit of their financial statements.

Examples included preparation of company tax returns, tax planning advice, advice on executive compensation schemes, installation of computerised accounting systems etc. The list was almost endless. The rationale was that the auditor's staff already knew the company's business and management well, and could therefore provide these other services more efficiently and effectively than other professional services firms.

A series of major audit failures demonstrated how the provision of other services impaired auditor independence. If the audit firm is earning fees for other services which are four or five times the size of the audit fee, the audit partner has enormous incentives to avoid "rocking the boat" by challenging the accounts even if he is not satisfied that they give a true and fair view.

A particularly egregious example was the US firm Enron Corporation which filed for bankruptcy in late 2001. The audit firm Arthur Andersen earned very significant fees for non-audit services which appear to have led the audit partner to be insufficiently critical of Enron's accounting practices. The collapse of Enron (and Worldcom at the same time) led to Arthur Andersen disappearing as an audit firm.

Consequently, both formal prohibitions set out by government bodies and other regulators, combined with changes in market practice, have led to a very significant decline in the provision of other services by audit firms to their audit clients.

While commentators occasionally still complain about non-audit services, they are simply out of date.

Current market practice is that auditors provide very few non-audit services to their audit clients apart from certain permitted (and narrowly specified) services where it would be irrational for the firm to hire anyone other than the auditor to provide the service. However, this leads to limitations in the choice of audit firms for audit clients (and we are then back to the first issue of competition).

C. Who appoints and terminates the auditor?

However, there remains a fundamental problem which in our view impairs the independence of auditors. That is the way that auditors are appointed and terminated.

⁴ "Audit clients" is a common term describing the companies that auditors audit. The real clients of auditors are the members (shareholders) of the companies they audit and to whom they report.

UKSA position paper on audit competition and quality failures

The law and formal practice in the UK are now very clear. The company's audit committee, which should consist of independent non-executive directors, evaluates proposals from potential auditors and makes a recommendation to the full board of directors. The board of directors, if it approves the audit committee's recommendation, proposes the new auditor to the members of the company at the annual general meeting. The new auditor is only appointed if the members approve the appointment.

The practical reality is somewhat different. Although the Chief Financial Officer and the Chief Executive Officer normally have no formal role in the deliberations of the audit committee, in practice it is unheard of for the audit committee to select a new auditor if the CFO and CEO are hostile to the appointment.

Similarly, it is unheard of for shareholders to reject the audit firm which is proposed on the AGM agenda paper.

Accordingly, all of the audit firms seeking appointment to the company go out of their way to emphasise to the CFO and the CEO how "smoothly" the audit process will proceed if they are appointed.

Even more serious is the process for terminating auditors.

In practice, if the CFO and the CEO indicate to the non-executive directors that the auditor is "difficult to work with" the auditor's appointment is likely to be terminated by the audit committee. Accordingly, the audit partner has every incentive not to give the CFO (or the CEO) a "hard time" and risk being seen by the management of his or her audit firm as having "lost" a major audit client.

Each time a potentially doubtful feature of the financial statements is identified, the auditor typically does not ask the question "Is this the best possible accounting?" Instead, the question in the auditor's mind is usually "Can I live with this accounting?" Unless the company's accounting is clearly unacceptable, the auditor will not object.

This is how accounting disasters often develop. It is extremely rare for an auditor to deliberately approve accounting that they know is materially incorrect. However, it is all too easy for borderline acceptable accounting to escalate over time until it becomes seriously problematical.

This is why Appendix 2 "How auditors should be appointed" of our consultation response to BEIS mentioned above recommended that the regulator take a much more active role in the appointment of auditors to "Public Interest Entities."

Appendix 2 used the measured language that is commonplace in consultation responses. Our current view is that the best approach to ensuring audit independence would be to take the power to appoint and terminate auditors of listed

UKSA position paper on audit competition and quality failures

companies away from them entirely. Instead it should be vested in an audit appointments authority set up by the government.

5. Conclusions

The limited competition for audits of multinational companies and large domestic listed companies almost certainly increases audit fees. However, there is almost nothing that the UK alone can do about this. The importance of the problem should not be exaggerated since audit fees in absolute terms are a relatively small cost compared with the many other inefficiencies in the UK economy.

The independence of auditors is a much more serious problem because it goes to the heart of the reliability of published financial statements. This is something that the UK can take unilateral action on with regard to the audit of companies which are incorporated in the UK or traded on a UK stock exchange. We consider that the power to appoint the auditor should be taken away from the company and vested in an audit appointments regulator. This would mean that auditors no longer needed to pay any heed to the views of the CFO or the CEO when reviewing the financial statements since only the regulator could terminate their appointment.