

LEGAL UPDATE

Once upon a time there were eight big global players... a competition law perplexity

6 June 2018 5 min read

Currently, a number of audit firms in South Africa are under scrutiny. The Auditor General Kimi Makwetu announced on 17 April 2018 that his office made a decision to terminate, with immediate effect, the government’s auditing contracts with KPMG and Nkonki Inc.^[1] On 24 April 2018 it was announced that Nkonki Inc. have entered a process of voluntary liquidation because of the announcement. It has been well reported that there are a number of high-profile cases of companies, with accounts validated by a major auditor, experiencing severe financial constraints which were apparently invisible to external stakeholders. The latest such entity being VBS Mutual Bank.

The audit profession has been the subject of regulatory scrutiny over a prolonged period. During the 1980s, the eight major audit firms that existed,^[2] consolidated through a series of mergers to form five firms.^[3] Then, in 2002, the collapse of Enron led to the demise of Arthur Andersen, its auditor, being sold to other large auditors. In South Africa this was to KPMG, while in other countries this was to Deloitte, Ernst & Young or PwC. Furthermore, the banking and financial crisis of 2008 led to renewed interest with regard to both competition in the audit sector as well as the part that auditing plays in preventing economic downturn.

The objective of an audit is to express an independent opinion as to whether the company’s financial statements give a true and fair view and are properly prepared in accordance with the legislative requirements. Potential investors will inevitably take into consideration the credibility that auditing gives to a company’s financial status as per the financial statements published when considering investments to be made. Confidence in the operation of capital markets depend, at least in part, on the credibility of the opinions and reports issued by auditors.

The question could be asked as to what extent competition law intervention could assist in strengthening the South African economy and in fact contribute, in order to prevent audit failures in future, if at all.

Potential concerns, from a [competition law](#) perspective, that might be identified, when considering the audit profession could relate to, amongst others^[4]:

- high barriers to entry and expansion. Specific knowledge is required to operate an audit firm, there is significant cost involved in attracting and training staff and it is accepted that the existing size and reputation of an auditing firm plays a crucial role in a company’s choice of auditor;
- high concentration. There are only 4 000 qualified audit professionals in South Africa and 4 big firms dominate this sector; and
- the audit profession is subjected to extensive regulation which sets out how an audit should be conducted.

These above characteristics suggest that the competitive landscape of the audit profession might prevent, restrict or distort competition. Where there is a restriction or distortion of competition, adverse effects on competition, in the supply of audit services to businesses and the economy in general, can occur. Inevitably a negative impact on the competitive landscape will lead to detrimental effects on customers.

The above said, there always remains a fear that should one of the four largest firms, with international presence, fail or exit the market, it could represent a systemic risk to the wider economy. In addition, this might induce the regulator with auditor oversight, to protect the four largest firms, for example through tailored interventions in their favour. Such outcome is the converse of what a competition regulator would wish to achieve, in that interventions of this nature could increase barriers to entry. Furthermore, a risk presents itself that the failure of an audit firm could result in higher concentration, result in low investor confidence, market instability and risks to the financial system.

Adverse effects that could potentially result from a distorted competitive landscape could relate to lower levels of audit quality and innovation and higher prices and costs. At the same time it should be recognised that excessive and burdensome audit quality procedures could lead to higher prices and costs, which will also impact negatively on the consumer and the competitive landscape as well as the expansion of smaller firms. However, there could also be a suboptimal level of regulation in the market. Under regulation may facilitate entry, but could result in a low-quality service.

The above is a clear indication that when considering the impact of competition law on the audit profession, the present difficult concepts which affect far more than just the professional body and how an audit is conducted should be considered. There has been a recent call by the Financial Reporting Council, the UK accountancy watchdog, for the Competition and Markets Authority to once again scrutinise the close relationships between company executives and their auditing firms. While the IRBA is scrutinising and conducting a number of investigations into the audit profession, this might be an opportune time for the IRBA to co-operate with the competition authorities and in so doing, formulate a clear view as to the necessity for a competitive dynamic audit profession and market in South Africa.

[1] <https://www.agsa.co.za/MediaRoom/Mediareleases/tabid/232/ArticleID/310/Auditor-General-of-South-Africa-terminates-its-auditing-contracts-with-audit-firms-KPMG-and-Nkonki-Inc.aspx>

[2] Arthur Andersen, Arthur Young & Co, Coopers & Lybrand, Ernst & Whinney, Deloitte, Haskins and Sells, Peat Marwick Mitchell, Price Waterhouse and Touche Ross.

[3] Ernst & Whinney merged with Arthur Young to become Ernst & Young, while later in the year, Deloitte, Haskins & Sell merged with Touche Ross to become Deloitte & Touche and Price Waterhouse merged with Coopers & Lybrand to form Pricewaterhouse Coopers (“**PWC**”)

[4] Competition Commission, Audit Market Investigation, Issues of Statement, 2013

