

STATUTORY AUDIT SERVICES MARKET INVESTIGATION

Notice of a Further Possible Remedy under Rule 11 of the Competition Commission's Rules of Procedure

Introduction

1. Our summary of provisional findings, published on 22 February 2013, set out how we have provisionally found an adverse effect on competition (AEC) within the meaning of section 134(2) of the Act. Paragraphs 3 to 5 of the summary (paragraphs 31 to 33 of the provisional findings report) identified those features which give rise to the AEC and the resulting detrimental effects on customers.
2. Our Notice of Possible Remedies (Notice) also published on 22 February 2013 set out and invited comments on possible actions, which the CC might take in order to remedy, mitigate or prevent the AEC or any resulting detrimental effects on customers.
3. This Notice of a Further Possible Remedy (Further Notice) sets out a further remedy proposal. We are seeking evidence and views on this further remedy.
4. Prior to deciding what, if any, action should be taken and by whom, the CC will take into account all comments received in response to this Further Notice, which it will consider alongside the evidence and views it has gathered in response to the Notice. We are undertaking this additional consultation in order to consider fully all possible remedies and no decisions on remedies have yet been taken.
5. Parties to this investigation and any other interested persons are requested to provide any views in writing by **19 June 2013**.

The further proposed remedy

6. The further proposed remedy we are considering is to give the Financial Reporting Council (FRC) a secondary duty to promote competition between firms providing audits to FTSE 350 companies.
7. The scope of this duty would be limited, so that FRC would not have powers concurrent with the Office of Fair Trading (OFT) to enforce the competition rules (as many regulators have). The duty would be a secondary duty - that is to say the FRC would be required to carry out its primary duties in a way which, so far as possible, promoted competition between firms providing audit services to FTSE 250 companies
8. A formulation of this duty would be on the lines of having a duty carry out its functions, where appropriate, in a manner which it considers will promote competition between audit firms in the provision of statutory audit services to large companies (ie companies listed on the London FTSE 100 and FTSE 250 indices).
9. We consider that such a duty could be conferred on the FRC by means of a special resolution to amend its corporate objects to add this new duty.

10. This remedy would be aimed at ensuring that the FRC in future perform its functions, where appropriate, in a way which promotes competition between audit firms, in addition to carrying on its activities concerned with audit quality.

Background

11. The FRC told us that it monitored the quality of audits through its Audit Quality Review (AQR) team. In our provisional findings report, we provisionally found that the reports produced by the AQR team identified a range of issues (of varying degrees of gravity) regarding quality and a possible lack of auditor scepticism in the relevant market, but that it was difficult to identify an objective external metric to allow reliable comparisons between audits and audit firms.
12. The AQR reports are the only independent external source of information that we identified on audit quality for large companies. They are based on access to detailed information about the audit, including the relevant audit files. In preparing its reports, the AQR team takes into account the applicable auditing standards, ethical standards and quality control standards for auditors issued by the FRC's Auditing Practices Board and the requirements of audit regulations and guidance issued by the relevant professional accounting bodies.
13. The FRC publishes on its website an annual review of its AQR inspections. It also reports each year on individual firms, specifying the number of audits by that firm that it has inspected, stating the percentage of these audits which fell into one of three quality bands ((a) good with limited improvements required; (b) acceptable but with improvements required; and (c) significant improvements required) and providing a summary of principal findings.
14. Not all of the major audit firms are included in the annual reports for any one year (for example, neither BDO nor Grant Thornton was included in the 2012 reports, though they have been reported on in 2013). This in part reflects the purpose of these reports, which is to ensure that all audit firms are aware of matters that caused the AQR team concern, so that any lessons to be learned can be considered by all firms and reflected in their procedures and staff training where appropriate.
15. In our provisional findings report, we found that in the period 2007 to 2011, the quality of ten of the 149 FTSE 350 audits reviewed by the AQR team was either unacceptable or in need of significant improvement, and 78 per cent of the 149 FTSE 350 audits reviewed required some level of improvement.
16. However, although the information provided by such reports is useful for the purposes of identifying areas of auditing quality that may require attention, the reports are not designed to enable companies or their shareholders to compare the performance of rival audit firms in carrying out audit services.
17. We consider that one effect of giving the FRC a secondary duty to carry out its functions, where appropriate, in a manner which it considers will promote competition between audit firms in the provision of statutory audit services to large companies, would be to require the FRC to consider how it might review and report on audits of large companies in a way which promoted competition.
18. In our view this may contribute to remedying the AEC by:
 - (a) increasing the transparency of AQR reports, thereby enabling companies and shareholders to assess better the quality of their existing auditor, compared with other options;

(b) increasing, in combination with other remedies, a company's bargaining power outside the tender process; and

(c) making a company more likely to switch auditors, thereby increasing rivalry.

19. We note that a regulator may have a competition objective without also having concurrent powers to apply and enforce the Competition Act 1998 and Articles 101 and 102 of the Treaty on the Functioning of the European Union. For example, section 1B(3)(c) and 1E of the Financial Services and Markets Act 2000¹ gives the Financial Conduct Authority a general duty to act, so far as is reasonably possible, in a way which advances its competition objective of promoting effective competition in the interests of consumers in the markets for regulated financial services, or certain other services provided by a recognized investment exchange.

Issues for comment

20. **Views are invited on the specification, effectiveness and proportionality of this remedy and, in particular, on the following:**

(a) whether giving the FRC a secondary duty to promote competition between audit firms will assist companies in comparing auditors; and

(b) whether giving the FRC a secondary duty to promote competition between audit firms will assist shareholders to influence the auditor appointment decisions of companies in which they hold shares.

Next steps

21. The parties to this investigation and any other interested persons are requested to provide any views in writing by **19 June 2013** either by email to auditors@cc.gsi.gov.uk or by writing to:

Inquiry Manager
Statutory Audit Investigation
Competition Commission
Victoria House
Southampton Row
LONDON
WC1B 4AD

(signed) LAURA CARSTENSEN
Group Chairman
5 June 2013

Note: This Notice is given having regard to the CC's provisional findings, which were published on 22 February 2013. In the light of responses by the parties or by other interested persons to these provisional findings, the CC's findings may change and the CC may consider other possible remedies, if appropriate.

¹ As substituted by section 6(1) of the Financial Services Act 2012.