COMPETITION COMMISSION

STATUTORY AUDIT SERVICES FOR LARGE COMPANIES MARKET INVESTIGATION

Summary of report

Notified: 15 October 2013

The reference

1. On 21 October 2011, the Office of Fair Trading (OFT) made a reference to the Competition Commission (CC) for an investigation into the supply of statutory audit services to large companies in the UK. Under the terms of reference, 'statutory audit services' means an audit conducted by a person appointed as auditor under Part 16 of the Companies Act 2006 (Companies Act), and 'large companies' means companies that may be listed from time to time on the London FTSE 100 and FTSE 250 indices. The reference was made under sections 131 and 133 of the Enterprise Act 2002 (the Act).

2. We were required to determine whether any 'feature' or combination of 'features' of any relevant market prevents, restricts or distorts competition in connection with the supply or acquisition of any goods or services in the UK or a part of the UK,[1] ie results in an 'adverse effect on competition' (AEC).[2]

Background

3. Under the Companies Act, FTSE 350 companies must keep adequate accounting records and the directors of a large company must not approve the accounts unless they are satisfied that they give a true and fair view of the company's financial position. The accounts must be audited and external auditors must give either an 'unqualified' report (ie that the accounts are presented fairly in all material respects and in the auditors' opinion give a true and fair view of the financial state of the company) or a 'modified' report. A modified report may contain either 'an emphasis of matter' (which does not affect the auditors' opinion) or matters which do adversely affect the auditors' opinion. The duties of auditors are owed to the company in the interests of the shareholders.

4. Statutory audits are extensively regulated. Auditors' reports are prepared in accordance with an International Standard on Auditing[3] and use standard and formulaic wording. Statutory audit services must be supplied by auditors which are registered with a supervisory body. In addition, the Financial Reporting Council (FRC)—the UK's independent regulator responsible for promoting high-quality corporate governance and reporting—monitors the quality of audits through its Audit Quality Review team (AQR team) and is the independent disciplinary body for accountants and accountancy firms.

5. We considered the purpose of audits. The issue facing shareholders is that, although they collectively own the company, it is the directors and officers (management) who run the company (a relationship termed by economists as 'principal–agent'). Further,

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[1] See section 134(1) of the Act.
[2] As defined in section 134(2) of the Act.
[3] ISA (UK and Ireland) 700, The independent auditor's report on financial statements.

shareholders have significantly less information than management of the company regarding its performance and financial standing. Such an information asymmetry may deter investment, as it creates uncertainty for shareholders and provides scope for management to act in ways that might not always be in the best interests of shareholders. This may result in a conflict of interest between the shareholders (the principals) and the management (the agents).

6. We found that audits are intended to provide assurance to shareholders that the financial reports prepared by the directors give a 'true and fair' view of the financial state of the company. Accordingly, although in practice the directors are most responsible for selection of the audit firm, we found that the shareholders are the primary customers of the audit, and it is their interests that we bore principally in mind during our investigation.

7. Due to the possible conflict of interest between management and shareholders, FTSE 350 companies have Audit Committees (ACs) to help with corporate governance issues relating to audit. ACs monitor and review internal audits and the effectiveness of external audits, thereby protecting to some extent the interest of shareholders. Although ACs may also recommend to management the appointment or replacement of external auditors, management is highly influential in the conduct of a company's audit relationship.

Market characteristics

8. We found that the relevant market was a single market for the supply of audit services to FTSE 350 companies, and not separate markets for audit services to segments of this group. The overwhelming majority of such audits are prepared by one of four firms[4] of auditors: Deloitte LLP, EY LLP, KPMG LLP and Pricewaterhouse Coopers LLP (collectively, the Big 4 firms), although some FTSE 350 companies are audited by other firms such as BDO LLP and Grant Thornton UK LLP. Under the Companies Act, a company may only engage an auditor for one year. However, in practice firms are frequently and repeatedly reappointed, and some FTSE 350 companies have not switched auditor for many years. We found that 31 per cent of FTSE 100 companies and 20 per cent of FTSE 250 companies have had the same auditor for more than 20 years, and 67 per cent of FTSE 100 companies and 52 per cent of FTSE 250 companies for more than ten years. During the course of our investigation, the FRC amended its UK Corporate Governance Code to the effect that FTSE 350 companies should put their audit engagements out to tender at least every ten years, although the guidance allows any such tender to be delayed if the company can explain why it is not doing so.

9. The switching rates we observed were not determinative of whether or not there was an AEC. We investigated the FTSE 350 statutory audit market to inform our assessment of competitive conditions within the relevant market. With regard to prices, we found that companies which had gone out to tender or switched their auditors had, on average, obtained a relative price reduction, albeit one that eroded over approximately three years.

10. We were not able to reach a conclusion on whether audit firms were making profits above competitive levels or otherwise in this market. This was on account of difficulties in valuing capital employed; the intangible nature of the asset base in this market; difficulties in cost allocation (as firms offered both audit and non-audit services (NAS)); and difficulties in identifying costs due to the partnership ownership

[4] References to 'firm' are to the audit firm and references to 'company' are to the entity which is audited.

structure. We identified a number of companies from which audit firms appeared consistently to earn above-average profit.

11. With regard to quality of statutory audits, it was difficult to identify an objective external metric to allow reliable comparisons between audits. However, the reports produced by the AQR team identified a range of issues (of varying degrees of gravity) regarding quality and auditor scepticism.

12. Finally, it appeared that there was some unmet demand, in that shareholders and potential future shareholders sought more information regarding the audit and audit process than was currently provided by the audit report and the annual report and accounts.

Features of the market

13. A 'theory of harm' is a hypothetical explanation of how characteristics and uncompetitive outcomes may arise in a market. We framed our investigation of whether there are features of the relevant market which can be expected to harm competition by identifying a number of such theories of harm. We decided whether or not a theory of harm was borne out by gathering, analysing and assessing the available evidence.

14. We considered whether audit firms had some market power over their client companies. To do this we assessed companies' willingness (or not) to switch auditor and the extent to which companies can exert bargaining power in their negotiations with audit firms. We also considered how well auditors represent shareholders' interests and the extent to which competition was directed at satisfying executive management whose interests may differ from those of shareholders. We did not look at each of these theories of harm in isolation, but considered whether there were links between them. We also considered theories of harm related to coordinated effects, bundling and regulatory distortions.

15. In identifying the competitive effect of possible features of the market, we sought to apply a theoretical benchmark of a 'well-functioning market' to determine how the market may be judged to be performing. We took into account all the evidence we found during our investigation when deciding whether any features or combination of features resulted in an AEC.

Firms' market power and companies' willingness to switch auditor

16. Under our first theory of harm, we investigated why companies (acting on the advice of their executive management and ACs) did not switch auditor more frequently and whether there were barriers to entry, expansion and selection of audit firms in the market.

17. In particular, we considered whether information asymmetries and switching costs affected companies' bargaining power with respect to their auditors, so that companies' bargaining power was insufficient to ensure that prices, quality, rates of innovation and differentiated offerings were offered at competitive levels. We assessed the situation both outside and within a tender process, and found that conditions of competition were significantly different in the two situations.

18. Each audit engagement is negotiated individually, so there is no prevailing market price that could protect those companies that might be in a weaker bargaining position. We considered other factors that might weaken a company's bargaining

position and, conversely, factors that might weaken the bargaining position of the audit firm in any negotiation.

19. We identified three factors that could make a company reluctant to contemplate switching auditor and so weaken its bargaining position. First, company management face significant opportunity costs in the management time involved in the selection and education of a new auditor. In particular, we received evidence that running a tender process is onerous in terms of management time, and companies must invest considerable time in educating a new auditor regarding its specific circumstances. Second, companies and firms invest in a relationship of mutual trust and confidence from which neither will lightly walk away as this means the loss of the expected benefits of continuity stemming from the relationship. In particular, the loss of the expertise and knowledge of the incumbent arising from a loss of continuity may lead to reduced efficiency in the conduct of the audit and increased risk in the technical quality of the audit in the early years of the incoming firm. Third, companies face difficulties in judging audit quality in advance due to the nature of audit, which means that companies cannot calculate accurately the benefits that going out to tender and switching would bring. This means that any incumbent has an advantage against the uncertainty of what an alternative auditor might provide. This means that companies do not put their audits out to tender as frequently as they would if they did not face such costs.

20. We found that an incumbent audit firm enjoys advantages in that it has opportunities to respond to dissatisfaction expressed by the company (although issues of particular gravity will usually lead to an immediate switch). This gives the audit firm some leeway within which to position its offer before it faces a genuine threat of the company switching.

21. Audit firms told us that, when newly appointed, they made considerable investments in companies during the early years of an engagement (in terms of additional hours). We were told that it took perhaps two to three years before an audit firm fully understood the complexities of a company, but that this investment led to increased quality and efficiencies from which companies benefited. We were told that audit firms had much to lose should a company switch, in terms of income, reputation, and the ability to win further engagements. This meant, they said, that companies were able to ensure that their audit services were offered competitively, even outside a tender process. We considered these submissions carefully, but were not persuaded that the scale of such losses was sufficient to remove the power held by that incumbent firm, given the opportunities the incumbent has to mitigate the risk of these losses occurring.

Barriers to entry, expansion and selection

22. We investigated why audit firms other than the Big 4 firms were not more successful in winning audit engagements of FTSE 350 companies. We found potential customers looked for a substantial track record of experience of auditing FTSE 350 companies when selecting auditors, and only the Big 4 audit firms could demonstrate such experience (and therefore might appear to be the ‘safe’ option). We considered that the use of ‘Big 4 clauses’ in some loan agreements (which specified or favoured the use of a Big 4 audit firm) added to the reputational barriers that Mid Tier audit firms face. We did not consider such barriers to be insurmountable, given appropriate investments. We considered that low levels of tendering and the difficulty of predicting the timing of any tender opportunity had hindered the ability of firms to make such investments.

Auditors' serving shareholders' interests

23. Under our second theory of harm, we investigated how well auditors represented shareholders' interests and the extent to which competition was focused on satisfying executive management whose interests may differ from those of shareholders, leading to lack of appropriate scepticism on the part of the external auditors and/or unmet demand for better information as regards the audit process from shareholders.

24. We were satisfied that both management and auditors generally aim to perform their respective functions diligently and effectively. Nevertheless, we took into account the importance of audit as a safeguard that company accounts give shareholders a 'true and fair' view of a company's financial position. We investigated whether auditors sufficiently represented shareholders.

25. It appeared that shareholders, despite their legal rights, played very little role in any decision to appoint or reappoint an auditor, while in contrast executive management was influential. We considered how well the interests of executive management and shareholders were aligned with respect to audit. While, broadly, we found that each has an interest in the auditors detecting issues likely to lead to a material misstatement of accounts, we considered that each might, on occasion, have different incentives in how issues requiring judgement were treated. In particular, we found that at times executive management had incentives to manage reported financial performance to accord with expectations and present accounts in an unduly favourable light. We found that, in general, shareholders would have no such interest.

26. We found that the incentives on auditors to accommodate executive management included the wish to be reappointed, with the direct benefit of the income of the engagement, and the indirect benefit to reputation and experience from retaining an engagement that might allow an audit firm to win further engagements.

27. We also found that auditors had incentives to challenge executive management. In particular, we were told that loss of reputation (in terms of being seen as susceptible to executive management influence) would be very damaging to an audit firm. Audit firms make significant internal efforts to maintain quality and are subject to external regulation by the FRC and professional bodies. Under the UK Corporate Governance Code, ACs monitor and review the effectiveness of the audit. However, we were not satisfied that these countervailing factors or ACs were sufficient to align the incentives of audit firms and shareholders.

28. We balanced these factors and considered the evidence that we had observed regarding the scepticism and independence of auditors. We concluded that any loss of auditor objectivity or scepticism in conducting a given audit would not easily be detectible, and so it was possible that such loss of independence occurred without being known by shareholders. We found that a loss of scepticism could arise because competition between audit firms was focused towards satisfying demand from executive management including instances where this demand is not fully aligned with the interests of shareholders. We also considered that this was the explanation for the unmet shareholder demand that we identified.

Other theories of harm

29. We considered whether the market conditions were conducive to coordination or that Big 4 audit firms engage in tacit collusion; that they bundle audit and NAS together in order to raise barriers to entry or expansion to other audit firms; that they target the customers of Mid Tier audit firms with particularly low prices; or that they are able to

exercise undue influence over the formation of regulation or on regulatory bodies through their extensive alumni networks. We did not identify sufficient evidence to support these other theories of harm.

Findings regarding features and an AEC

30. Taking all these considerations into account, we identified the following as relevant features of the market:

(a) barriers to switching:

(i) company management face significant opportunity costs in the management time involved in the selection and education of a new auditor;

(ii) companies and firms invest in a relationship of mutual trust and confidence from which neither will lightly walk away as this means the loss of the benefits of continuity stemming from the relationship. In particular, the loss of the expertise and knowledge of the incumbent arising from a loss of continuity may lead to reduced efficiency in the conduct of the audit and increased risk in the technical quality of the audit in the early years of the incoming firm; and

(iii) companies face difficulties in judging audit quality in advance due to the nature of audit which means that companies cannot calculate accurately the benefits that tender processes and switching would bring;

(b) Mid Tier audit firms face barriers to entry, expansion and selection in the FTSE 350 statutory audit market. Mid Tier firms face experience and reputational hurdles which, together with the infrequency and unpredictability of opportunities to tender, affects their incentives to make the necessary investments to overcome such hurdles;

(c) the ability of executive management to influence external auditors in how they conduct and report their audit; and

(d) the information asymmetry between shareholders and audit firms, so that shareholders have little information regarding the investigation carried out by the auditor.

31. We found that the features listed in paragraph 30*(a)* gives rise to an AEC either individually or in combination by weakening a company's bargaining power outside the tender process. We think that these features are pervasive throughout the FTSE 350 statutory audit market but their effect will be uneven across companies. How a feature or combination of features impacts on an individual company's strength of bargaining power will vary over time and depend on its particular circumstances.

32. We found that the feature listed in paragraph 30*(b)*, either individually or in combination with the other features, gives rise to an AEC as it has the effect of reinforcing current market positions, and hindering the emergence of new or strengthened rivals and so damages potential competition. It reduces the potential competitive constraints firms can exercise on rivals. It weakens companies' bargaining power since companies may have a lesser range of outside options available to them.

33. We found that the features listed in paragraphs 30*(c)* and *(d)* give rise to an AEC as they have the effect of giving firms incentives and the ability to respond to the

interests of executive management and firms may therefore compete to satisfy a demand that is not fully aligned with shareholders' interests. Firms therefore may not compete on the right parameters.

34. As a result of the AEC that we found, we think that companies are offered higher prices, lower quality (including less sceptical audits) and less innovation and differentiation of offering than would be the case in a well-functioning market.

Remedies

Summary

35. The main aspects of the remedy package that we decided to implement are:

(a) FTSE 350 companies must put their statutory audit engagement out to tender at least every ten years. While we considered the FRC's 'comply or explain' provisions carefully, we do not think that a company should be able to delay tendering beyond ten years. Those unwilling to risk some unforeseen event occurring in the final permitted year may choose to go out to tender before then. We think that many companies would benefit from going out to tender every five years but if they choose not to, then the AC should set out in the AC Report section of the Annual Report in which financial year it next plans to go to tender and why going out to tender in that year is in the best interests of shareholders.

(b) The AQR team should review every audit engagement in the FTSE 350 on average every five years, although it should have discretion to review audits that it perceives to be particularly low risk less frequently. The AC should report to shareholders on the findings of any AQR team report concluded on its company during the reporting period, stating the grade awarded and how both the AC and auditor are responding to the findings.

(c) The AQR team should review and report on the firms in its scope on an annual basis, where such firms conduct sufficient public interest entity (PIE) audits for this to be practicable.

(d) Provisions in loan agreements which restrict a company's choice of auditor to lists or categories should be prohibited, although parties may require that any auditor should meet objectively justified criteria.

(e) An advisory vote should be introduced on the AC Report, and amendments to the UK Corporate Governance Code and Stewardship Code should be made to further encourage shareholder engagement.

(f) Measures should be introduced to strengthen the accountability of the external auditor to the AC, including a stipulation that only the AC is permitted to negotiate and agree audit fees and the scope of audit work, initiate tender processes and make recommendations for appointment of auditors and authorize the external audit firm to carry out NAS. The AC may receive submissions from executive management regarding these matters. It may establish a materiality threshold below which executive management may instruct the audit firm to conduct NAS.

(g) The FRC should amend its articles of association to include an object to have due regard to competition.

Rationale for remedies

36. The remedy package includes measures to improve the bargaining position of companies and encourage rivalry among audit firms; measures to enhance the influence of the AC in a company's relationship with its external auditors; and measures to promote shareholder engagement in the audit process. These remedies work in combination to promote competition and to ensure that competition is directed towards satisfying the demands of shareholders.

37. We found that tender processes were thorough, fair, and transparent processes in which the AC had an influential role, ensuring that shareholder interests are given appropriate weight and which strengthen the incentives of audit firms to offer a competitive product. We consider it to be a matter of judgement as to the appropriate interval between tender processes. We note the FRC's judgement that five years was the appropriate interval for rotation of an Audit Engagement Partner (AEP) to ensure their objectivity and independence and we saw no grounds to alter it. We were persuaded of the benefits of aligning the interval between tender processes with AEP rotation, as this provides a break in the audit relationship at which the AC can make an informed choice of audit partner, and if it wants, switch audit firm without incurring more disruption than is necessary, and would limit the advantage that the incumbent firm derives from being able to offer an AEP with pre-existing experience of the company.

38. Our view is that five years is an appropriate interval at which to subject the audit relationship to scrutiny and challenge for many (perhaps even most) companies, and that going out to tender at this interval would increase company bargaining power and ensure a competitive service between tender processes. As the period since the last tender process increases, we think that an increasing proportion of companies would realize benefits from going to tender. However, we noted the views of significant numbers of companies, audit firms and, in particular, investors and the FRC that such an interval may be too frequent, largely on the basis of the costs this would impose on firms and companies, the risk that such frequency may undermine the intensity of competition that a tender process provokes and the quality of audit that a firm could deliver. Given these submissions, we decided that companies must go out to tender at least every ten years. Given our considered view that five years is the appropriate interval for many companies, we think that any company that does not decide to go out to tender after five years should set out in its AC Report, in which financial year it next plans to hold a tender process, and why going out to tender in that year would be in the best interests of shareholders. The AC Report should be subject to an advisory vote.

39. We decided to take further steps to increase the influence of the AC in the relationship with the external auditors. These steps include: enhancing the accountability of the auditor to the AC and enhancing the accountability of the AC to shareholders. The increased influence of the AC in combination with more frequent tender processes should help ensure that competitive outcomes are achieved and that shareholders can be more confident that their interests have been at the forefront of any tender process and subsequent appointment decision, as well as throughout the ensuing audit relationship.

40. Information is important to the ability of shareholders to hold ACs to account in representing their interests, and our remedies in this area reinforce the FRC's recent changes to the AC Report and to ISA 700 to encourage greater disclosure by ACs and auditors. We decided to require the AC to report on the results of any AQR during the period and to require companies to hold an advisory vote on sufficiency of the disclosures in the AC Report. We consider that these measures will encourage

meaningful disclosure, promote high-quality audit, and enable shareholders to better appraise the effectiveness of the AC.

41. In designing an effective package of remedies, we sought to ensure that the measures work in combination to produce the necessary incentives to ensure that competition works well. Our remedies designed to increase AC influence will work in combination with more frequent tender processes to ensure that competition is better focused on shareholder demand and, in particular that audit quality and scepticism is given appropriate weight. Our remedy package will also promote information flow between companies and investors in relation to external audit and thus allow ACs to understand shareholder concerns better, and so better act on them.

42. We consider that our package of remedies is likely to increase choice, as both Big 4 and Mid Tier firms will have increased incentives to develop and expand their capabilities in order to win engagements. We consider that measures to prohibit restrictions on auditor appointment in loan agreements, in combination with more frequent tender opportunities, will encourage firms other than the Big 4 firms to invest in the capabilities necessary to win FTSE 350 engagements, particularly those engagements lower down the scale of complexity and international breadth.

43. We considered the role of the FRC carefully in formulating our remedy proposals, and we note that it has evolved over time into a regulator that is increasingly well equipped to provide high-quality independent regulation to the audit market. We found that the work of the AQR team was well regarded, considered carefully by audit firms and companies, and so we found that it had an important role in promoting competition between audit firms. We welcomed the recent changes to the UK Corporate Governance Code to increase tendering and expand AC reporting, and changes to ISA 700 to expand auditor reporting, as we see them as beneficial steps towards promoting competition.

44. However, we considered that further steps were required to increase the resources of the AQR team, and to encourage transparency of AQR grades. We considered that a change to the FRC's objects so that the FRC should have due regard to competition would ensure that it places appropriate weight on the role of competition in facilitating high-quality audit. We would necessarily be reliant on the FRC to take our recommendations forward, and to ensure that it secures the appropriate funding to facilitate this. In doing so we consider that the FRC will further strengthen its role as an accountable, transparent, and independent regulator of the audit industry.

45. We expect that the above measures taken together as a package will be effective and proportionate in remedying the AEC. We expect this remedy package to result in a substantially improved environment for competition in the FTSE 350 statutory audit market.

46. We decided not to pursue the following remedies:

(a) mandatory switching;

(b) further constraining NAS provision by the auditor;

(c) joint or major component audit;

(d) shareholder group or FRC responsibility for auditor reappointment; and

(e) independently resourced Risk and AC.

47. We gave careful consideration to whether mandatory switching should be introduced. Our view is that while mandatory switching would address concerns expressed by some investors about very long tenures, our remedy package addresses the AEC more effectively whilst delivering similar benefits and avoiding some of the costs associated with mandatory switching, and in particular the weakening of competition that would result from the incumbent firm being excluded from the tender process. As a result, we decided not to impose mandatory switching as a remedy to the AEC that we found.

48. We also decided against introducing measures to further constrain NAS, to further encourage or mandate joint/shared audit provision, to provide for shareholder or FRC appointment of auditors, and to establish an independently resourced Risk and Audit Committee. We decided that including any of these measures in our remedy package would not add significantly to its effectiveness in addressing the AEC that we found, and may add to the costs incurred. However, as noted above (paragraph 35(f)), ACs may establish a materiality threshold below which executive management may instruct the audit firm to conduct NAS.

49. The measures we are prescribing impose some additional costs principally arising from the increased activities of the FRC with respect of the AQR team, which we estimate to be in the order of £1 million to £2 million a year plus any opportunity costs incurred by the firms in engaging with the AQR team. We believe that under the existing requirements many companies would choose to tender every ten years. However, some companies might have chosen to extend this period in certain circumstances and there may be some additional cost for these companies. As the changes have only recently been introduced the level of compliance with the current regulations under the Code is not known but, we believe that the costs incurred by companies and firms are unlikely to exceed £3 million a year.

50. Our remedy for ACs to take on responsibility for more aspects of the audit relationship will incur either cash or opportunity costs for those ACs which do not undertake those duties at present. However, some of this increased AC activity will reduce the burden on FDs. We estimate that a 10 per cent increase in AC workload would cost approximately £3 million if there were no benefits to FDs. We have estimated the upper bound of costs for these three remedies at £8 million and, including those remedies for which we are not able to estimate the cost, we do not believe the total cost of our remedies package to exceed £10 million a year.

51. On the other hand we consider that the benefits of our remedy package are considerable. In our judgement, we think that an increase in competition and a refocusing of competition towards shareholder demand should increase audit quality and have important beneficial effects on shareholder value. We place considerable weight on the resultant public benefits for the UK economy. An audit market in which shareholders can have increased confidence will assist in promoting the UK's corporate governance regime as a centre of excellence and will encourage investment in UK companies. It is not feasible to quantify the size of such benefits with precision, however, in our considered judgement, they are likely to exceed the costs of our remedy package by a substantial margin.

52. In view of the above considerations, we decided that our package of measures represents as comprehensive a solution as is reasonable and practicable to the AEC and the resulting detrimental effect on customers that we found.