STATUTORY AUDIT SERVICES MARKET INVESTIGATION

Barriers to entry: reputation and experience

Introduction

1. Reputation and experience may create an incumbency advantage for current suppliers and hinder entry to the market for the supply of statutory audit services to FTSE 350 companies. In our Framework working paper (restrictions on entry and expansion)[1] we considered that the inability of Mid Tier firms to match the reputation of the incumbent firms appeared to be a key reason why their chances of winning tenders for FTSE 350 audits may be lower than necessary to make entry profitable.

2. We considered factors affecting reputation that may create a virtuous circle for the Big 4 firms. These factors included existing large company engagements and experience and expertise in the large company audit market; as well as the effect such clients and experience may have on the firm's ability to recruit and retain staff. Potential entrants may find it hard to enter the market as the absence of these factors may create a vicious circle: the lack of client base leads to a lack of experience and perceived expertise (and increase the would-be entrant's difficulties in recruiting staff). This may restrict the ability of potential entrants to act as a competitive constraint on those already operating within the market.

3. We also considered that reputation may serve as a proxy for current information on capability and quality in this market as the quality of an audit is difficult to observe directly. We considered that reputation may be established over a long period of time and be reinforced through strategic actions such as marketing and branding. We said to the extent that reputation is objectively justified in terms of capacity, quality,

[1] www.competition-commission.org.uk/our-work/statutory-audit-services/analysis/working-papers.

expertise, and efficiency, it allows companies to distinguish accurately between potential suppliers of audit services and select the most appropriate for their needs. Conversely if reputation is not objectively justified, it has the potential to distort companies' selection decisions, and may add a further element additional to objective factors that may act as an obstacle to expansion.

4. This paper presents:

(a) the evidence we have gathered in relation to reputation and experience acting as a barrier to entry in paragraphs 11 to 48; and

(b) the evidence that we have of use of reputation as a proxy for quality and the evidence regarding the influence of more subjective elements of reputation on companies in their selection of auditor in paragraphs 49 to 73.

5. We set out our current views on reputation and experience as a barrier to entry in paragraphs 74 to 82. We consider to what extent the evidence indicates *(a)* barriers to entry as a result of the difficulty of replicating experience/expertise of the Big 4 firms and *(b)* barriers to entry as a result of the difficulty of demonstrating capability to potential clients leading to auditor selection based on less objective factors.

Reputation and experience

6. In our Framework paper we set out eight factors affecting reputation that we considered may create a virtuous circle effect for Big 4 firms.[2] For the purposes of this paper, we have grouped them into three categories which we consider in turn.

[2] Framework for the CC's assessment and revised theories of harm, Figure 1, p13.

7. First, ‘Experience and capability’ covers: demand for experience and expertise in large client audit market; the importance of the international network; and demand for technical resource (paragraphs 11 to 24).

8. Second, ‘Attracting talent and influence of alumni network’ covers the importance of attracting and retaining the best graduates and partners; and the influence of alumni networks (paragraphs 27 to 37).

9. Third, ‘Awareness of audit firms’ discusses knowledge of and familiarity with audit firms (paragraphs 40 to 48).

10. In some cases, particularly for the capability requirements, we have cross-referred to evidence presented elsewhere in other working papers.[3]

Experience and capability

11. We considered evidence as to whether the following created a barrier to entry:

  (a) a lack of experience and expertise in the large company audit market;

  (b) a lack of existing relationships with large companies (with regard to the supply of non-audit services);

  (c) the reputational role of the firms’ international network; and

  (d) the firms’ technical resources.

Demand for experience and expertise in large company audit market

Case studies

12. Companies wanted their auditors to be experienced both within the industry within which they operated and within the FTSE more broadly. For example:

[3] For example, International networks, Suppliers, Nature and strength of competition.

(a) At Company F, the Finance Director (FD) said that when considering potential auditors sector experience was a given, with the level of investment the larger firms put in this was not an issue and they all had the capability to perform the audit. The questions asked therefore focused on the audit team's experience, tax experience, cultural fit and the individuals that would work on the audit.[4]

(b) At Company G, the Group Financial Controller (GFC) said that the skills required to audit other financial institutions would be similar to those required at Company G. He would also be interested in the other large and global FTSE 100 work that the audit firm undertook.[5]

Survey

13. The results of the CC's survey showed the great majority (90 per cent) of the companies that responded considered the experience and knowledge of the engagement partner important in deciding whether to appoint or reappoint a statutory auditor, as well as sector-specific expertise (which was important for 71 per cent of FTSE 350 companies).

Tender documents

14. Our review of the tender documents found that all firms frequently mentioned other clients, experience and professional awards received. They focused on listing their best known clients, and the best known clients from the relevant industry, often adding their experience working in that sector. They also mentioned awards received in categories such as best firm and graduate employment credentials. The difference between the Big 4 firms and their competitors here was one of scale; they both mentioned similar achievements in their proposals, but non-Big-4 firms relied on

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[4] Company F, paragraph 24.
[5] Company G, paragraph 26.

lower key awards (best firm outside the Big 4, for example), less prestigious clients and less industry experience.[6]

15. The review of tender information also showed that the most frequently mentioned reason for losing a tender was lack of experience or competition from a firm with more experience.[7]

Existing relationships with large companies

16. We considered whether having a pre-existing relationship (via the supply of non audit services) with a company was an advantage in being asked to tender for, or being selected as, auditor.

Case studies

17. Both firms and companies viewed provision of non-audit services as a way of developing a working relationship with one another. For audit firms, this was a way of gaining knowledge of a client that might lead to further non-audit work or help the firm if preparing to tender for the company's statutory audit. For companies, non-audit service provision was perceived to be an opportunity to assess service quality of a prospective auditor. For example:

(a) At Company C the evaluation of tender proposals included a review of the assignments conducted for the company by the firms over the past two years.[8]

(b) The FD at Company F had used potential audit firms for non-audit work prior to a tender to get experience of working with them.[9]

(c) The FD at Company H said that there was a benefit in firms other than the auditor providing non-audit services. If the company wanted to change auditor it was

[6] Working paper on Evidence relating to the Selection process, paragraph 73.
[7] Working paper on Evidence relating to the Selection process, paragraph 132.
[8] Company C, paragraph 24.
[9] Company F, paragraph 16.

beneficial to have people who had an understanding of the business and had established credibility with the company's employees.[10]

Tender documents

18. Our review of tender documents showed there were advantages to having pre-existing relationships with large companies:

(a) References to previous work for the tendering companies were common, and the Big 4 firms were more likely to have a previous relationship to draw on, as well as being more likely to be the incumbent auditor. This was often emphasized, and there was often a breakdown of the achievements of the firm whilst working with the company.[11]

(b) Knowledge of the company, together with being the incumbent auditor were cited as important factors when winning a tender. A rival firm having a stronger relationship was the second most mentioned reason for losing a tender. (See Evidence relating to the selection process: Tendering, Annual renegotiations and Switching, paragraph 133.)

Reputational effect of international network

19. We considered the role of international networks as a barrier to entry specifically in a separate paper (International networks). In terms of the reputation of the international network, our case study interviews highlighted that for some companies, concerns about the quality and scope of Mid Tier firms' international networks was an issue (International paper, paragraph 126).

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[10] Company H, paragraph 48.
[11] See working paper on Evidence relating to the selection process, paragraph 65.

Survey

20. While international scope or quality of the audit was an important factor in the decision to switch auditor for only 14 per cent of the respondents to the survey, the strength of a firm's international network was an important characteristic for 53 per cent of respondents (and this increased to 64 per cent of FTSE 350 companies that responded and 83 per cent of FTSE 100 companies that responded).

21. The strength of international network was an important factor in the decision to appoint or reappoint the statutory auditor for (i) companies that are willing to appoint only a Big 4 auditor (64 per cent of the respondents); and (ii) for companies that had more than 40 per cent of their audit fee accounted for by activities outside of the UK.

Tender documents

22. Our review of the tender documents showed that both the Big 4 and non-Big 4 firms pointed to their international or local coverage where appropriate. We found that non-Big 4 firms provided evidence of their international coverage: they appeared to anticipate that in some areas they might be perceived to be weaker, such as sector coverage or global presence, and therefore emphasized their strengths particularly in those areas.[12]

Demand for technical resource

Case studies

23. The case study interviews showed that certain technical sector-based skills were required for a firm to be selected as auditor. For example:

(a) at Company C one of the selection criteria used in the tender process was insurance expertise;[13] and

[12] See working paper on Evidence relating to the selection process, paragraph 71.
[13] Company C, paragraph 23(a).

(b) at Company H one of the Audit Committee's prime concerns when selecting auditors was that the auditor understood the technicalities of the industry. The FD did not feel limited within the Big 4 firms as IFRS for extractive industries was now more established than when the company previously selected an auditor, she also thought a Mid Tier firm could do the work.[14]

24. The Audit Committee Chair (ACC) at Company G said that in addition to traditional auditing skills, non-audit skills were required to undertake a bank audit and so a strong multidisciplinary firm was essential.[15]

[✂] plc[16]

25. In its tender process [✂] plc had invited the Big 4 firms to tender, since it thought they had the necessary geographic spread and accounting and actuarial skills. It had assessed the capability of Mid Tier firms (based on desktop research) and decided not to invite them to tender: it did not think that they had adequate worldwide capabilities, in particular with regard to actuarial skills.[17]

Summary of evidence on experience and capability

26. Accordingly, it appears that:

(a) Companies look for experience, in particular sector-specific experience, when choosing auditors. Firms respond to this by citing work on other clients in the same sector. Tenders are often lost due to competition from a firm with more experience.

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[14] Company H, paragraphs 26, 31 & 32.
[15] Company G, paragraph 70.
[16] www.competition-commission.org.uk/our-work/statutory-audit-services/evidence/summaries-of-hearings-held-with-parties.
[17] Published summary: paragraph 13.

(b) Pre-existing relationships are important when choosing auditors. The track record of the firm in providing non-audit services may be considered in the selection decision.

(c) A strong international network is cited as important for many firms and this appears to reflect the large proportion of FTSE 350 companies operating in overseas territories. Companies may consider the size of the international network as well as sector-specific capability of network firms.

Attracting talent and influence of alumni network

27. We considered whether there was evidence that the Big 4 firms were better able to attract higher calibre staff and partners, and whether their alumni networks convey an advantage in building their client bases.

Attracting talent

Case studies

28. With regard to staff, the majority opinion expressed in the case studies was that the quality of staff in the Big 4 firms was higher:

(a) the Company B FD assumed that the best people were in the Big 4 firms;[18]

(b) the Company E FD thought that when interviewing he had found a marked difference in overall capability between candidates from Big 4 and Mid Tier firms: he was more likely to find a better candidate from the bigger firms;[19] and

(c) the Company F Chief Financial Officer (CFO) thought there were 'real issues' with Mid Tier firms and this boiled down to the quality of the individuals.[20]

29. However, this view was not universal. The Company D ACC thought that the quality of the accountants in the Mid Tier firms was the same as in the Big 4 firms. This was

[18] Company B, paragraph 21.
[19] Company E, paragraph 25.
[20] Company F, paragraph 26.

based on experiences of recruiting finance teams, taking former employees of both the Big 4 and Mid Tier firms.[21]

30. With regard to partners, the case studies indicated that the quality of the AEP was key.

Other

31. ✂ said that it paid its staff only marginally less than Big 4 firms; however, Big 4 partners earned considerably more.[22] ✂ indicated that it could not afford to hire partners with experience of auditing the largest UK corporates.[23] ✂ stated that it focused ‘most’ of its graduate recruitment budget on four ‘tier one’ universities.[24]

32. Investor representatives noted that there were differences between the quality of partners within firms, although it was difficult for investors to have any visibility of this.[25]

Review of tender documents

33. As noted in paragraph 14 above, firms mentioned their graduate employment credentials in tender documents. Firms’ reputation may allow them to attract better graduates.

Alumni network

Case studies

34. We interviewed ten CFO/FD equivalents, of whom seven had trained at a Big 4 firm, and a further two who having trained elsewhere then went on to work for a Big 4 firm.

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[21] Company D, paragraph 65.
[22] ✂.
[23] ✂.
[24] The Universities of; ✂.
[25] See Summary of a hearing with institutional investors, 16 April 2012, paragraph 35.

Most had practised as an auditor at a Big 4 firm, although one was a tax practitioner and another (who had joined after qualifying) worked on management consultancy. One CFO/FD equivalent had previously been an audit partner at a Big 4 firm.

35. We interviewed ten ACCs, of whom seven had trained at a Big 4 firm, and three had gone on to be audit partners at a Big 4 firm. Of the three ACCs who had not trained at a Big 4 firm two subsequently went on to work in audit at a Big 4 firm for a time after qualifying.

36. The two interviewees (one ACC and one FD) who had never worked for a Big 4 firm (either as trainees or after qualification), had both trained as management accountants (CIMA) in industry (rather than in public practice).

Survey

37. Our survey showed that 64 per cent of all respondents (both FDs and ACCs) had previously worked for a Big 4 firm (this reflected 67 per cent of the FTSE 350 respondents, 58 per cent of Top track respondents and 55 per cent of AIM respondents). Overall, 6 per cent of respondents had previously worked for a non-Big-4 firm, this figure dropped to 4 per cent for FTSE 350 respondents whilst 14 per cent of AIM respondents had previously worked for a non-Big-4 firm.

Summary of evidence on attracting talent

38. The quality of the audit partner and the audit team is seen as important. There appears to be a common belief among FTSE 350 FDs that the quality of staff in the Big 4 firms is higher, although this view is not unanimous.

39. Many FDs and ACCs in FTSE 350 companies are alumni of Big 4 firms.

Awareness of audit firms

40. We considered the evidence of companies' awareness of audit firms and their capabilities, including:

(a) general awareness and marketing; and

(b) knowledge of Mid Tier firms' international presence.

General awareness and marketing

Case studies

41. The interviewees (all FDs or ACCs of FTSE 350 companies[26]) generally had much better awareness of the capabilities of the Big 4 firms than they had of the Mid Tier firms. This was driven in part by their previous experiences working for the Big 4 firms (see section on Alumni above) and by their almost universal use of Big 4 auditors.

42. CFOs and ACCs often did not know much about the Mid Tier firms and some views appeared founded on distant experience. For example:

(a) The Company A ACC's view of the Mid Tier firms was based on the original FRC reports, which in the first year found that the Mid Tier firms were not as strong as the Big 4 firms. He was not aware if they had improved since then.[27]

(b) The Company C CFO did not think he had ever been approached by anyone from the Mid Tier. He was not entirely sure which firms made up the Mid Tier.[28]

43. Mid Tier firms were sometimes recalled as an afterthought: for example, the Company A CFO said that he had worked with 'all of them, well all the big ones', by which he meant all of the Big 4 firms.[29]

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[26] Selected as set out here: http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/conclusions_case_study_consultation_final.pdf.
[27] Company A, paragraph 65.
[28] Company C, paragraph 32.

44. In general, the case study interviewees (CFOs and ACCs) received marketing material from, and were invited to seminars/briefings by, the Big 4 firms more than the Mid Tier firms.

Survey

45. Our survey evidence captured a much wider pool of companies than our case studies. The results showed that 77 per cent of the FTSE 350 companies had been approached in relation to the audit of their company by only Big 4 audit firms. The Top Track 350 companies appeared to be more contested by non-Big-4 firms: of the Top Track 350 companies responding to our survey, 10 per cent had been approached by non-Big-4 firms only and 33 per cent had been approached by a combination of Big 4 and non-Big-4 firms. AIM companies were also likely to have been approached by non-Big-4 firms, in 21 per cent of cases they had been approached only by non-Big-4 firms and in 49 per cent of the cases they had been approached by a combination of Big 4 and Mid Tier firms.

Knowledge of firms' international networks

Case studies

46. The main concern that the case studies raised about Mid Tier firms was that they did not have the geographic spread and quality in required locations to be able to undertake some international audits. The inaccurate perception that Mid Tier firms predominantly used affiliates prevailed.[30]

Survey

47. A large number of FTSE 350 companies gave 'size of audit firm/geographical coverage' as a reason for not considering a non-Big-4 auditor. As the factor cited

[29] Company A, paragraph 12.
[30] See also International networks working paper, paragraph 126.

covers both size and geographic coverage, the importance of geographic coverage in itself is unknown. Comments suggest that companies are concerned about quality and technical expertise as well as coverage.[31]

Summary of evidence on awareness of audit firms

48. We found that CFOs and ACCs in FTSE 350 companies often did not have up-to-date knowledge of the capability of Mid Tier firms and about the nature of their international networks.

Use of reputation as a proxy for quality; external pressures and subjective factors

49. This section considers reputation and the views of investors that may influence company choice of auditor.

Reputation

50. Reputation was cited in the case studies and survey as being a reason for selecting or trusting an audit firm.

51. The Company G ACC used reputation (as one of a number of factors) to assess quality.[32] However, he did not say how he defined reputation.

52. Our survey indicated that 'reputation' was an important or very important factor in auditor selection for 84 per cent of FDs/CFOs and 82 per cent of ACCs. However, of the companies that stated they would not formally consider any firms outside of the Big 4, only 18 per cent indicated 'reputation' as the reason.

[31] Survey working paper, Annex 2.
[32] Company G, paragraph 76.

Academic literature

53. Professor Vivian Beattie's literature review reports[33] that Azizkhani et al (2010) found that the ex ante cost of capital was lower for Big 4 audits up to 2001, but not after the financial scandals of 2001/02, indicating that the these events eroded perceptions of audit quality differences between Big 4 and non-Big-4 firms. She noted that a working paper that used a similar approach, Cassell et al (2011) concluded that the financial reporting credibility of clients of Mid Tier firms was lower than clients of Big 4 firms in the six years pre-SOX, but similar in the six years post-SOX (US study). However, Boone et al (2010) found that, for the period 2003 to 2006, the ex ante equity risk premium (a proxy for perceived audit quality) was lower for Big 4 clients than for non-Big-4 clients, indicating that perceived quality differences persisted after the scandals.

Companies' views of external pressures

54. We considered whether there was evidence that companies used the reputation of an audit firm to satisfy external pressures, including use of Big 4 firms as an accepted norm; and use of Big 4 firms to meet investors' expectations.

Use of Big 4 firm is the accepted norm

55. Participants in some case studies said that they did not want be regarded as unusual, and therefore wanted to use a Big 4 firm as this was the norm and so was perceived as lower risk:

(a) The Company A ACC thought that if a company used a Mid Tier firm and there was something wrong in the accounts, shareholders would ask why a Big 4 firm was not used.[34]

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[33] Initial review of relevant academic literature on the audit market, section 2.11.1, p26.
[34] Company A, paragraph 64.

(b) The former ACC of Company B thought that it would be a 'brave ACC or CFO of a FTSE 100' to appoint an auditor other than one of the Big 4 firms. He considered the Big 4 firms were perceived as more capable by the market and that this perception was driven not just by Boards but also by investors. FTSE 250 businesses had less pressure to appoint a Big 4 auditor, but most aspired to be a FTSE 100 company and so would adopt similar approaches to FTSE 100 companies when appointing advisors, including auditors.[35]

(c) The Company B FD thought that it would look odd to have a Mid Tier firm as auditor as the majority of FTSE listed companies used a Big 4 firm.[36]

(d) The Company D FD thought that if a Big 4 firm could provide the scale, strength and depth required by the company then there was no need to look outside the Big 4 firms. General practice was to use a Big 4 firm. Using the Big 4 was the safe option. There was less to worry about or justify, and using a Big 4 firm was in line with all the company's peers and the companies that it came into contact with. Choosing a Mid Tier firm would make it the odd one out.[37]

(e) The Company D ACC said that it was a commonly held perception in the market that the Big 4 were more credible and therefore that it was safer to use a Big 4 firm.[38]

(f) The ACC at Company D would look at Mid Tier auditors in the future, if they could prove that they had the coverage and that this was credible and not an issue to shareholders then she would have no issue with using them in principle. She noted that this view was a personal opinion and might not be shared by the FD or other Audit Committee members.[39]

(g) Based on his experience, the ACC at Company E thought a Mid Tier firm would be able to perform the company audit, although he only had experience of the

[35] Company B, paragraph 64.
[36] Company B, paragraph 21.
[37] Company D, paragraph 29.
[38] Company D, paragraph 66.
[39] Company D, paragraph 67.

Mid Tier firms in the UK. However, the ACC thought that there was pressure for a PLC to use a Big 4 firm and that the larger the company the greater the pressure was. It was very hard to move away from the Big 4 and that 'no one lost their job for appointing a top four'.[40]

56. The former AEP of Company F was from a Mid Tier firm, he considered that Company F's FD was surprised (on his appointment) that the company did not have a Big 4 auditor and the former AEP felt his firm had struggled against this preconception.[41]

57. In response to our survey, the reputation of the audit firm with investors, corporate brokers, analysts or external advisers was cited as being important in deciding to appoint or reappoint a statutory auditor for 82 per cent of the companies in the survey (overall).

Companies views of investors' expectations

58. The FD at Company D said that he was concerned at how a Mid Tier audit firm would be perceived by investors. He thought that they might be uncomfortable with a Mid Tier firm. However, this was just a gut feel and not something he had tested.[42] The ACC at Company D thought that shareholders and banks also preferred a Big 4 firm to sign the accounts.[43]

[40] Company E, paragraph 54.
[41] Company F, paragraph 100.
[42] Company D, paragraph 29.
[43] Company D, paragraph 66.

59. At Company F, the ACC said he thought that as companies got bigger shareholders, lenders and investors expected to see a Big 4 auditor, but he had not experienced such pressure of expectation whilst at the company.[44]

60. At Company H, the ACC had not faced pressure from outside the Company to continue using a Big 4 firm. Regarding bank covenants, the ACC thought the perception that there was pressure to use a Big 4 firm had been unfairly criticized. Given the uniform consistency across the Big 4 firms it was easier for the bank to remove the hassle and risk by mandating one of those firms: 'If something goes wrong, they have big enough insurance, you can sue them anyway.' The ACC thought other audit firms could do the job but it was just easier to comply with the terms of a covenant by not considering other options.[45]

61. The ACC at Company I thought that the reputation of the auditor was important for the City and other stakeholders, such as debt providers.[46]

62. At Company J (a company with a Mid Tier auditor):

(a) The FAM had experienced no external pressure to switch to a Big 4 auditor.[47]

(b) The ACC said that there had been no issues regarding the company using a Mid Tier firm rather than a Big 4 firm. The ACC thought that the current auditor was a large and well-recognized firm, particularly in the UK outside of London.[48]

(c) The ACC did not consider that there was any issue in agreeing financing arrangements when a company had a non-Big-4 auditor. The company would not have accepted the current auditor if there was a financial implication to this.[49]

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[44] Company F, paragraph 54.
[45] Company H, paragraph 75.
[46] Company I, paragraph 52.
[47] Company J, paragraph 30.
[48] Company J, paragraph 57.

63. Our survey responses showed that overall 58 per cent of companies said that they were likely to seriously consider switching their auditors if pressured by shareholders, bankers, lawyers or analysts. However, only 25 per cent of Top Track 350 companies cited this as a trigger to consider switching auditor.

64. Only 8 per cent of respondents who had tendered and limited the invited firms to the Big 4 firms said that this limitation was as a result of investor perceptions or financial institution requirements.

Investors' views

65. Investors wanted to see an audit firm name on the accounts that they recognized—both that we spoke to said that they would include the top six audit firms in this list.[50,51] BlackRock said that the identity of the auditor was unlikely to affect its decision to invest due to the concentrated pool of auditors that were appointed to audit FTSE 350 companies.[52]

66. BlackRock said that investors did expect to see a bigger auditor appointed as companies got larger, although they felt the lack of use of non-Big-4 auditors stemmed from reluctance at board level and not from investors such as themselves.[53]

Investor questionnaire

67. We sought the views of investors. For some it was important that companies had a Big 4 firm as auditor, for example:

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[49] Company J, paragraph 58.
[50] BlackRock, paragraph 15.
[51] Legal and General, paragraph 15
[52] BlackRock, paragraph 11.
[53] BlackRock, paragraph 17.

(a) Schroder: ‘Top 4 firms are the best’, ‘Large firms have the resources while small firms don’t’, ‘It is a big concern if it’s a change from the Big 4 but not if it’s from a small to a big firm.’

(b) ✄: ‘The so called ‘Big 4’ would carry the highest rating. Audit firms in the ‘third tier’ would be a cause for concern in the case of listed equities.’

(c) ✄: ‘No barriers, but any switch would have to be explained to investors. A switch from the Big Four to a smaller auditor would require careful explanation.’ ‘A change within the Big Four would not be of concern. A change to a smaller/obscure auditor would raise questions.’

(d) Artemis favoured the Big 4 firms. A shift to a division 2 player would cause concern.

(e) Fidelity Worldwide: ‘As investment manager: Yes, we generally want a Top 4 firm, particularly in Emerging markets. The choice of a local, unknown auditor with limited experience in our markets, particularly for companies domiciled in emerging or developing markets would negatively affect our willingness to invest.’

Oxera’s investor survey on behalf of BDO/Grant Thornton

68. Oxera found that:[54]

(a) The investors surveyed generally took note of the identity of a company’s auditor, but, with the exception of either the very largest companies or those with very widespread multinational interests, would have no concerns with the larger Mid Tier firms auditing companies in the FTSE 350. Indeed, none of the investors surveyed thinks that there is a genuine gap in capability between the Big Four and mid-tier firms for the purpose of many FTSE 350 audits.

(b) Nonetheless, around half of those interviewed believed there to be a ‘perception gap’, which some suggested is the factor that leads virtually all of the FTSE 350

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[54] Oxera investor survey, p(ii).

companies to choose a Big 4 firm. All investors consider that there may be a genuine capability gap between the Big 4 and Mid Tier firms for certain very large (the top 15–30 FTSE 100 companies), specialist, or multinational companies.

Cardiff Business School report

69. The Cardiff Business School reported that there were some suggestions in the academic literature that debt providers were concerned by the identity and/or quality of borrowers' auditors:

> Pittman and Fortin (2004) found, based on a sample of 371 newly public US firms, that the cost of debt capital is lower if the firm appoints a (then) Big 6 auditor. This effect was, however, found to subside over time and to be most pronounced for younger firms, for which less financial information is available. Furthermore, this study relied on a 'noisy' measure of the cost of debt estimated from interest payments in the financial statements, rather than directly on lending agreements. Mansi et al. (2004) also find that bond yields are lower for US firms employing a Big 6 auditor, and this effect is larger for non-Investment Grade firms.[55]

Summary of evidence on reputation

70. Reputation is an important factor for FTSE 350 FDs and ACCs in choice of auditor.

71. FTSE 350 companies see risks in switching to Mid Tier firms as they think the market would view it unfavourably.

[55] Cardiff Business School report, p2.

72. Whilst investors have no specific concerns with the use of larger Mid Tier firms, there appears to be a tendency on the part of some investors to favour the Big 4 firms.

Initial views of reputation as a barrier to entry

73. Trust in the quality of auditors is of key importance given the role of audit is to provide assurance to shareholders. Several characteristics of the audit product combine to make it hard for new entrants to demonstrate that they can supply the requisite quality. First, it is difficult to judge the quality of an audit, especially for third parties including potential clients. Second, audit is an experience good so that quality cannot be observed until after the audit has occurred (and even then, certain parties may have limited visibility). As a result, perceived as much as actual, quality may be important to reassure shareholders and stakeholders.

74. These difficulties reinforce the importance of reputation and experience in the selection decision. Companies respond to a lack of information about audit quality by selecting auditors based on proxy measures such as relationships, familiarity and market norms. We note in this regard that many FTSE 350 FDs and ACCs are Big 4 alumni.

75. The need for reputation has the effect of favouring the large, incumbent audit firms in selection decisions.

76. Further we consider that there is risk that auditor selection decisions may not be based on objective information. Because reputation is only a proxy for accurate information on quality and capability it may over time depart from reality, unless an exceptional event occurs to call it into question (such as happened with Arthur Anderson).

77. Conversely it may be hard for a new entrant to establish a reputation, and likely to take a long time, notwithstanding that its quality and capability may match or exceed that of incumbents. Hence, reputation may present a particular difficulty for a firm looking to expand into the FTSE 350 audit market because investments in capability and capacity may not result in winning more FTSE 350 clients.

78. Given the investment made by a firm in building its reputation, for example in marketing or relationship-building targeted towards FTSE 350 companies is likely to be sunk, this increases the risk of any entry strategy.

79. The problem for the Mid Tier firms is that when they match the capability of the Big 4 firms, it may be hard for them to demonstrate this to potential clients, given the lack of FTSE 350 client base. Companies generally make selection decisions based on proxy measures for quality including experience and reputation. Mid Tier firms score relatively lower on these measures and are likely to be at a disadvantage in being invited to participate in, and competing in, tender situations as a result. They face difficulties given the reluctance we encountered in companies to share their audits. Audit engagements are typically awarded on an exclusive basis, which makes it difficult for entrants initially to demonstrate their capability by auditing say, a single subsidiary or territory.

80. Our initial view is that the combination of *(a)* the difficulty of demonstrating the requisite experience and *(b)* the difficulty of overcoming the additional reputational hurdles discussed in this paper hinders the expansion of the larger Mid Tier firms into the FTSE 350 audit market. We are continuing to consider the other factors that may act to restrict entry or expansion and how these may work in combination.