AUDIT MARKET INVESTIGATION

The ABI's comments on the Competition Commission's Issues Statement

Introduction

1. The Association of British Insurers (ABI) welcomes the opportunity to comment on the Competition Commission’s Issues statement as it commences its investigation of the audit market.

2. The ABI represents the UK’s insurance, investment and long-term savings industry, the largest in Europe and the third largest in the world. It has over 300 members, accounting for some 90% of premiums in the UK domestic market. As institutional investors with some £1.6 trillion of assets under management we have a strong interest in seeing a competitive market in audit services that delivers a high quality product that will underpin confidence in the truth and fairness of financial statements.

3. We would be happy to engage further as the Competition Commission progresses its investigation but at this stage we hope that the following brief comments on the perspectives of institutional investors will be helpful.

Specific comments

4. The public policy agenda around audit ranges beyond aspects of competition and choice and the European Commission's current proposals for changes to audit regulation in its proposed directive and regulation range widely. We think that it is important, however, that the competition and choice elements should be separately identified and addressed as such and we therefore welcome the UK’s treatment of the subject. Clearly, though, the structure of the market in the UK cannot be seen in isolation from European and, indeed, the global organisation of the audit market which is dominated by the Big 4 networks.

5. The high level of concentration that pertains in the market for audit of major listed companies extends to the FTSE Mid-250 as well as the FTSE 100 where the size and complexity of companies makes the engagement of a top tier auditor more appropriate. The four largest firms do, in our opinion, enjoy a material degree of market power. We are opposed to ‘Big 4 only clauses’ which we consider to constitute an unnecessary barrier to entry for other firms and an undesirable entrenchment of this market power of the Big 4.

6. A market dominated by four firms, largely the product of mergers of its major players, is not healthy or in the best interests of investors or wider interests. Accordingly, we support the undertaking of a Competition Commission review in the
UK and, in view of the international nature of the market structure, would support a wider EU review. The current EU regulatory proposals will potentially have an impact on market structure but a wider review, to help achieve a market with wider choice and thus greater assurance for companies and their audit committees as to access to quality audit provision, would be supported by investors.

7. It is important to recognise that the scope for competition and choice is to a significant extent constrained by business conflicts that may prevent some accountancy firms from being appointed as auditors to major companies. Therefore choice may be even more limited than might be expected to be the case in a market with four dominant players. In some sectors, including banking and finance where need for technical expertise makes the barriers to entry higher than they would otherwise be, there is even greater concentration. We have no evidence, however, to support the suggestion made in paragraph 49, however, that the Big 4 have tacit understandings not to compete in certain sectors or geographical areas.

8. We recognise that audit appointments (not just by FTSE 350 companies but more widely) may be longstanding, and there is a risk that this may not be for good reasons. Thus we agree with the Issues Statement’s concern that customer conduct in this regard may be limiting competition. However, we consider this to be more a governance rather than a competition issue. The introduction of a comply-or-explain regime to ensure that audit appointments of more than, say, 10 years without tendering are given adequate scrutiny, as was proposed last year by the FRC, might strike the right balance and help achieve the required improvement in competition. Similarly, information asymmetry concerns that ultimately impact on assessment of audit quality and the appointability of audit firms might be addressed through improved reporting as envisaged under the FRC’s Effective Company Stewardship initiative.

9. The provision of non-audit services to audit clients is a long-standing area of potential concern to shareholders, and to regulators who, as with the APB and its FRC parent in the UK, have been responsible for imposing appropriate restrictions and prescribing safeguards and transparency. Sometimes the auditor is best placed to provide a service and, indeed, familiarity can help provide a better value service. We are also not aware that the effect has been to reduce choice across the range of non-audit services, whether accountancy-based or in wider business services. However, it is important that non Big 4 firms are not impeded in their ability to compete for accountancy-based non-audit work with major companies, including those where it would be challenging for such firms to compete strongly for audit appointments. Further research might be undertaken in this area if its significance appears to be high enough.

10. We have no evidence to support the suggestion made in paragraphs 33 to 38 that audit firms could be bundling audit and non-audit services and creating a barrier to entry for other firms. It is expected, rather, that audit committees will have oversight of any decisions by companies to employ the audit firm to supply non-audit services. In many cases there should be a presupposition that the company’s auditor will not be used for provision of services that can as readily be provided by another firm.
The scope of the audit will normally be laid out in the Audit Engagement Letter and it would be surprising if this were to extend to inclusion of any services that are not obviously directly associated with or supportive of the undertaking of the statutory audit or analogous activities of providing assurance in respect of financial reporting to investors.

11. We share the concerns expressed by the OFT and the House of Lords in its recent report Auditors: Market concentration and their role, noted in paragraph 58, that the failure of an existing big 4 firm would further increase concentration and risk of audit firm failure. Avoiding this scenario should be a particular goal for the competition authorities. It would not be acceptable for major firms to be treated as ’too big to fail’. This would involve such firms being further shielded from competitive and market forces. The recognition of this risk is clearly informing developments in current thinking, which we support, about ‘living wills’ for the largest firms.

12. The possibility that excess audit quality could be promoted and that higher prices and costs could prevail, are not concerns for our Members as owners and investors. We therefore disagree with the suggestion to this effect in paragraphs 17 to 20 although there is a possibility that enforcement of standards designed to underpin quality could add as a disincentive towards innovation. We also question whether the monitoring work of the Financial Reporting Council shows there is a need to increase audit quality at the major firms which cannot at this stage be met through the use of existing regulatory measures. That might not be the case in the eventuality that there is a further reduction in the number of major audit firms. We think that impact on audit quality could usefully be added to the possible outcomes of a major firm leaving the audit market under the proposed study referred to in paragraph 61. We believe the financial evidence relating to profitability of audit and assurance as compared to non-audit services does not support concerns as to excess profits in the former. Rather, we think that the provision of audit is used to gain access to lucrative non-audit work generally, not just with existing audit clients.

ABI

12/1/12

[s:\inv\consultations\compComm ja12]