Oxera

Investor views on market outcomes and potential remedies in the audit market

Prepared for the Competition Commission on behalf of BDO and Grant Thornton

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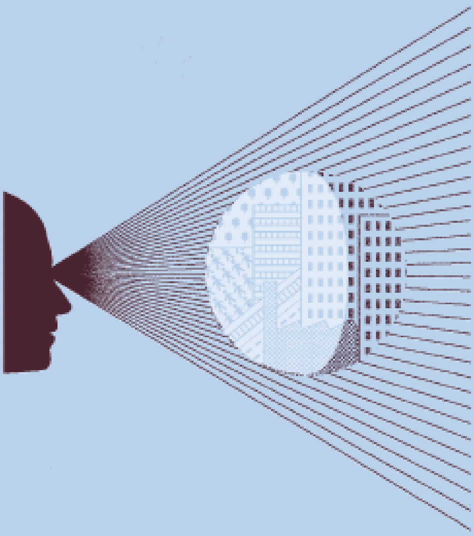

Executive summary

The market for statutory audit services to large companies is currently being investigated by the UK Competition Commission (CC). In June 2012 audit firms BDO and Grant Thornton jointly commissioned Oxera to conduct research on investor views, in order to provide supplementary evidence to the CC.

The views of investors are important to the CC's inquiry because they are the ultimate customers of audit services. Capital markets are dependent on auditors for assurance that annual accounts provide a true and fair view of a company's financial situation.

Oxera interviewed 11 of the UK's major investment firms and pension funds, plus the three main investor associations (the Association of British Insurers, the Investment Management Association and the National Association of Pension Funds).[1] Interviewees included five of the top ten investment firms as measured by funds under management, and three of the top ten pension funds by the same measure. This provided coverage of a quarter of all funds managed by the UK's top 100 investment firms, and around one-sixth of all funds invested by the top 100 pension funds. The interviews covered both a diagnosis of potential problems in the audit market, and remedies that might address them.

This series of interviews therefore has a wider coverage of the investor community than the CC interactions to date with investors, and has relevance to the next stage of the CC process, since it covers investors' views on the merits of different potential remedies.

The key findings on market outcomes are as follows.

– All investors surveyed confirmed the importance of independent audits of accounts for their investment decisions, and for their confidence in capital markets more generally. They are, however, divided on whether the audit market is meeting their expectations, with three stating that it is meeting expectations, and the other 11 giving a mixed answer or stating that it is not meeting expectations. Almost all interviewees identified areas of concern with the current operation of the large-company audit market, which include limited choice, the impact of non-audit services, conflicts of interest, and lack of disclosure. The one interviewee who did not identify any such concerns nonetheless stated that: 'There is a perception problem. Audit committees seem to think they need to have a Big Four name, although investors do not generally require this.'

– No investor surveyed feels fully able to judge the quality of an audit. Typically, investors rely on the audit committee to ensure the integrity of an audit, but several of those surveyed keep an eye on audit quality and independence by considering proxy measures, such as the ratio of non-audit fee to audit fee, or by reading the reports of the UK Audit Inspection Unit or the US Public Company Accounting Oversight Board.

– The investors surveyed, especially the larger ones, would typically prefer more engagement and dialogue with the auditors of companies in which they invest, which would help them to derive more value from the audit process and to judge the relative strengths of different audit firms. However, in general, the interviewees do not want any radical change to investors' degree of involvement in auditor selection (see section on remedies below).

[1] For confidentiality reasons, the names of the individual investor entities participating in the interviews have been disclosed only to the CC.

– All except one consider that there is a problem with choice in the large-company audit market. The problem can be restrictions on choice within the Big Four (due to conflicts), or a desire for a choice of more than four firms. The benefits of greater choice are said to be linked to confidence and resilience in capital markets, as well as to better quality, innovation and pricing in the audit market. Only one investor surveyed considers that having four firms is enough.

– A large majority of investors surveyed would support companies paying more for audit services if they could be confident that this would enhance the quality and independence of the audit. One investor surveyed considers that audit fees should not increase any further.

– The investors surveyed generally take 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. Nonetheless, around half of those interviewed believe there to be a 'perception gap', which some suggested is the factor that leads virtually all of the FTSE 350 companies to choose a Big Four firm. All investors consider that there may be a genuine capability gap between the Big Four and mid-tier firms for certain very large (the top 15–30 FTSE 100 companies), specialist, or multinational companies.

Turning to potential remedies, the interviewees were asked to assess the advantages and disadvantages of a series of remedy options, and then to consider whether they would recommend any other remedies. As a final point, they were asked to judge whether their preferred set of remedies would improve market outcomes for investors.

The key findings on potential remedies are as follows.

– There is broad support for intervention by competition authorities in the audit market, in addition to ongoing regulatory initiatives, with all but three interviewees noting that remedies are needed, although these must be selected with care.

– Almost all investors surveyed do not want to see structural separation of the Big Four firms into audit and non-audit activities.

– There is broad support for further restrictions on non-audit activities performed by the auditor, with mixed views as to whether this restriction should be a ban on certain services, or a financial restriction with a cap on the ratio of non-audit to audit income. The more popular option would be to prohibit certain non-audit services from being provided by the auditor (such as valuation work).

– All interviewees support more re-tendering of audits, which is widely expected to improve the quality of audits by providing a regular opportunity for audit committees to step back and reflect on the quality and independence of the incumbent auditor. Investors surveyed recognise that a re-tendering exercise entails costs for corporates and auditors, and, as such, suggested an interval of five to ten years as the deadline for re-tendering.

– A minority think that mandatory re-tendering should be supplemented with the mandatory rotation of audit firms, sometimes as a 'backstop' where companies have not changed their auditor for a very long period (10 to 20 years). Investors surveyed have sophisticated views on the costs and benefits of introducing mandatory rotation; most have concerns about the temporary impact on quality, and the costs of disruption. However, some also argue that the disruption in itself may be healthy, that audit firms in their pitches claim that they can get up to speed rapidly in new audit assignments, and that changing auditor provides an incentive on the outgoing auditor not to leave itself open to liability or criticism for mistakes that may be picked up by the new auditor.

– There is little support among investors surveyed for joint or shared audit, although if one of these two options were imposed, shared audit is regarded as the more attractive.

– There is almost unanimous support for the removal of 'Big Four only' clauses in financing arrangements. Yet some interviewees suggest that lenders should be free to specify a minimum quality threshold for auditors.

– Most investors support minor changes in the process of auditor selection. None wishes to see a radical change in the role of the audit committee as the agent of shareholders in selecting and monitoring an auditor, but most of the larger investors would like more transparency and disclosure, potentially including the opportunity for periodic dialogue between a company's auditor and its shareholders.

Interviewees were also asked to identify alternative remedies that had not already been discussed. This generated a number of ideas, including the following.

– Contingency planning by regulators and competition authorities for the situation in which one of the Big Four collapsed, to preserve stability in financial markets and avoid a further increase in audit market concentration.

– Liberalisation of the ownership of audit firms, to help mid-tier firms grow more rapidly with the benefit of external capital.

– Examination of how timing issues affect entry barriers—first, whether coordination or monitoring of the timing of re-tendering audits in each sector would be helpful (eg, all bank audits coming up for tender at the same time); and, second, whether a re-distribution of company financial year-ends would reduce the need to invest in large peak-time capacity in an audit firm, which may then be underused at quieter periods unless the relevant staff can be switched to non-audit services.

– Reducing concentration by requiring one or more of the Big Four firms to divest part of their audit activities, returning to a 'Big Six' or 'Big Eight' market as existed in previous decades.

Finally, interviewees were asked whether their preferred remedy package would improve the market outcome. While the set of preferred remedies varies in both mixture and overall force of change, investors surveyed are typically confident that an improvement is possible, albeit not easy to achieve. The general expectation is that increased competition (not necessarily competition on price) and choice should ultimately result in better audit quality, independence and innovation, thereby serving the needs of investors.

Oxera would like to thank all those who participated in the interviews for their valuable and insightful comments.

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1 Introduction

1.1 Objectives and remit

In June 2012 audit firms BDO and Grant Thornton jointly commissioned Oxera to conduct research on investors' views, to provide evidence for the Competition Commission (CC) investigation into statutory audit services to large companies in the UK.

The views of investors are of particular importance because they are the ultimate customers of the audit process. Investors rely on the independent auditor to verify that a company's financial statements are true and fair. Therefore, their views form an essential input into understanding the market for statutory audits.

Oxera has been involved for a number of years in academic and policy issues relating to the policy debate on the statutory audit market, publishing reports on competition and choice for the then Department of Trade and Industry and the Financial Reporting Council in 2006,[2] and on ownership structures of audit firms for the European Commission in 2007.[3] In 2010, Oxera Director, Dr Gunnar Niels, gave evidence to the House of Lords Economic Affairs Committee in relation to the audit market.[4]

This report is structured as follows:

– the remainder of this section describes Oxera's survey methodology;

– section 2 presents the views of investors in relation to market outcomes, covering topics such as audit quality and the differences between audit firms; and

– section 3 presents the views of investors on the likely impact of potential remedies that the CC may consider in the event of an adverse effect on competition (AEC) finding. The remedies discussed with investors include those proposed at the European level, and those discussed by the Office of Fair Trading (OFT) in its Market Investigation Reference.[5]

1.2 Methodology and data sources

1.2.1 Sample selection

Oxera invited a large number of institutional investors to participate in the survey: 23 UK investment firms and 35 UK pension funds. Investors were selected according to size as measured by the value of funds/assets under management, with the addition of one small pension fund contacted and interviewed on the suggestion of an interviewee to cross-check the views of large pension funds. To complement the views of individual institutional investors, the three major associations were also invited to participate: the Association of

[2] Oxera (2006), 'Competition and choice in the UK audit market', prepared for the Department of Trade and Industry and Financial Reporting Council, April.

[3] Oxera (2007), 'Ownership rules of audit firms and their consequences for audit market concentration', prepared for DG Internal Market and Services, October.

[4] House of Lords Select Committee on Economic Affairs (2010), 'Auditors: market concentration and their role: evidence: Volume 2: Evidence', second report of session 2010–11, pp. 90–102, October.

[5] European Commission (2011), 'Proposal for a regulation of the European Parliament and of the Council on specific requirements regarding statutory audit of public-interest entities', Brussels, November 30th, COM(2011) 779; Office of Fair Trading (2011), 'Statutory audit—Market investigation reference to the Competition Commission of the supply of statutory audit services to large companies in the UK', October, OFT1357MIR.

British Insurers, the Investment Management Association and the National Association of Pension Funds. All three associations were interviewed.

Of the 58 investors contacted, representatives from 11 investors agreed to participate in the survey, more or less evenly split between investment managers and pension funds, as did the three associations contacted. Of those 47 investors that chose not to participate, many explained that they considered that, owing to the type of investment activities undertaken by their firm, they were not relevant to the survey or did not have much to say about the issues raised. This was usually because they operated as a fund of funds, and hence had delegated decisions to invest in particular companies to an external fund manager. Others were unable to participate in the research owing to other commitments, including holidays (most of the interviews were conducted during July 2012).

The 11 investors who participated include some who, as far is Oxera is aware, have previously presented evidence to the CC or made public statements about their views on the audit market (as have the three associations), but also a large number who have not done so. The interviewees included both individuals who focus on corporate governance matters within their organisation, and those whose main role is portfolio management and making investment decisions.

In terms of value of funds/assets under management, the coverage of the survey is high:

– the funds under management by the participating investment firms account for 56% of the total value of funds under management by the top ten largest UK investment firms, and 27% of the top 100;

– half of the top ten (by funds under management) of UK investment firms were interviewed. Their assets under management range between £20 billion and £40 billion;

– the assets under management by the pension funds that participated account for 34% of the total value of assets under management by the top ten largest UK pension schemes, and 15% of the top 100;

– three of the top ten pension funds were interviewed; plus one in the top 20 and one that is a relatively small pension fund (with assets under management in the order of £2 billion). Excluding the small pension fund, the assets under management of each of the pension funds interviewed are between £5 billion and £35 billion.

1.2.2 Process and structure of the interviews

In advance of each interview, an introductory note was sent to the participant giving them the relevant context and the list of questions to be discussed during the interview. This introductory note is reproduced in the appendix.

Each interview lasted one hour on average, and was conducted either face to face (seven of the 14) or over the phone (the other seven). In many cases participants were contacted again after the interview to verify points made.

The questions asked can be grouped into two categories:

– **market outcomes**: investors' views on the audit market as it currently stands. Topics covered included quality of audit services, the relative capabilities of the different auditors, and the extent of choice available;

– **remedies**: investors' views on the likely impact of potential remedies, and their advantages and disadvantages.

1.2.3 Reporting of the interviews

For confidentiality reasons, the names of the individual investor entities participating in the interviews can be disclosed only to the CC, and their responses are reported and summarised on an anonymous basis. Further details on each interview can be made available to the CC if required.

This report intentionally does not give percentages to summarise the views of investors (eg, ‘60% of investors believe that ...’). In some instances, Oxera reports how many interviewees gave a particular answer, but more often reports views as ‘a majority’ or ‘a minority’. This is for two reasons. The first is that the research was conducted as in-depth interviews with discussion of the subtleties of each interviewee’s opinion, and not as a ‘tick-box’ exercise, meaning that categorising answers as an unreserved ‘yes’ or ‘no’ is not always possible. The second reason is that although the sample selection process was neutral and the participants together represent a large proportion of investment funds in the UK, it is not claimed that they are necessarily a representative sample of the population of investors. To avoid false precision, the responses have not been weighted by size.

2 Market outcomes

This section summarises the views of investors in relation to the current provision of statutory audit services. 13 questions were asked on the following three broad areas:

– overall impressions of the audit market;
– audit quality; and
– differences between audit firms.

The questions asked on each of these areas and the views expressed by interviewees are reported in turn below.

2.1 Overall impressions of audit market

The first few questions asked about investors' overall impressions.

1. What are the expectations of the audit process, from an investor's perspective—both at the level of an individual investment and for well-functioning capital markets?
2. Does the market for statutory audits for larger companies currently deliver on these expectations?
3. [If 'No' to question 2, then] In which respects does the market fail to deliver?
4. [If 'No' to question 2, then] What do you think is the source of the market failures?

Source: Oxera survey of investors.

In terms of what the audit process is expected to provide, there is consensus among the investors surveyed, described by one respondent as follows:

> the audit process is expected to provide a fair and true, independent and objective assessment of the financial accounts. As part of this, the auditor is expected to perform an assessment of the controls of the organisation, to inform their determination on whether they can rely on the financial statements.

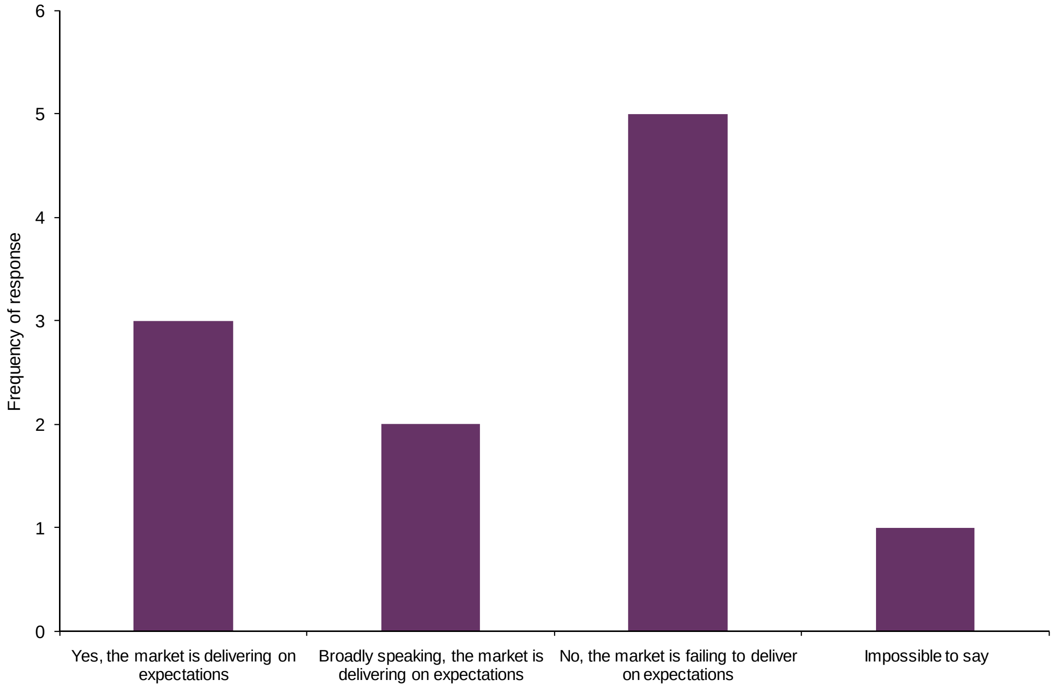
Two investors referred to there being two aspects of the audit process: the 'external aspect'—the signals to shareholders on what the critical issues are—and the 'internal aspect'—the review of a company's controls and accounts, and consequential pressure instilled.

There is also broad agreement that investors' ability to rely on the independence and objectivity of an auditor—and therefore on the audited financial statements of listed companies—is central for well-functioning capital markets.

In terms of whether the market is actually delivering on investors' expectations, there is significant variation in the views expressed: some investors consider that the market is failing to deliver what is needed, and made this point quite strongly; others remain confident in the current quality of audit services. According to one investor, it is impossible to determine whether the market is delivering because the audit process is opaque.

The views expressed by the individual investors (not the three associations) are illustrated in Figure 2.1. As regards the associations, one noted that investors are divided on this issue, with some having considerable confidence in the quality of audits and others having serious concerns. The other two associations consider that, broadly speaking, the market is delivering, but that there are concerns about a number of detailed aspects of the current audit system.

Figure 2.1 Does the market for statutory audits for larger companies currently deliver on these expectations?



Source: Oxera analysis of survey responses.

Several investors—including those who consider that the market is delivering and those who consider that it is not—referred to statistics that support their judgements. One referred to the low rate of failed audits as a sign that the market is delivering, while another investor referred to the discrepancy in recent years between the (low) number of qualified audits for EU financial institutions and the (high) number of such financial institutions receiving some form of liquidity or debt guarantee support as a sign that the audit market is failing to deliver.

In terms of sources and examples of market failure, all associations, and all but one of the investors, identified some areas of concern, which can be summarised as follows.

– **The limited number of players**—the concentration of the market and how this affects independence and/or choice are concerns shared by seven investors and all three associations (see also section 2.3.3 below).

– **Impact on audit quality of non-audit services**—the majority of investors surveyed identified the provision of non-audit services to an audit client as a potential source of conflict of interest.

– **Asymmetric information between the shareholders and companies/auditors**—a number of investors consider that binary reporting and low levels of disclosure inhibit the shareholder's ability to judge the quality of an audit. They would like to see much higher levels of disclosure and transparency. However, two investors prefer the straightforward nature of the binary audit opinion, and wonder how more gradation of auditor opinion would work in practice.

– **Split between the buyer of audit services (the company) and the beneficiary (the shareholder)**—one investor noted that the resulting conflict of interest is 'prevalent', and two other investors noted that it is of concern. According to one investor: 'Auditors do not seem to consider they are accountable to shareholders. Rather, auditors seem to consider that, as they are appointed by company management, this is to whom they are accountable.'

– **Barriers to entry**—investors identified a number of barriers to entry, including a perception bias favouring the Big Four (see also section 2.3.2 below), the detail of the accounting and auditing standards rule books, and the common financial year-end, which increases the capacity required at peak times.

– **Regulatory capture**—one investor considers the tolerance of an oligopoly market structure and the lobbying efforts by the very large audit firms to be signs of regulatory capture. Another investor is concerned by the length of time required to resolve any legal action taken against an auditor in the UK.

2.2 Audit quality

Three questions were asked in relation to audit quality.

5. How would you define ‘audit quality’?
6. Do you feel that you can judge the quality of an audit?
7. Would you support companies paying more for audit services that were of higher quality and/or more independent?

Source: Oxera survey of investors.

Various definitions were given of audit quality, although there are common themes to the responses:

> Audit is high quality when it is objective, where an auditor applies judgement, scepticism and formulates their own opinion and reports that opinion, including any qualifications, to the market.

> A good quality audit will uncover where things are not right. This will involve high quality interaction between auditor and the company.

None of the investors surveyed feels able to judge fully the quality of an individual audit from the audit report, and almost all would prefer increased disclosure to investors. For example, according to one investor:

> We cannot see the specific procedures the auditor undertakes, we do not know the materiality threshold they use, or the extent to which parts of the company’s accounts, identified as high-risk, have been subject to specific procedures.

However, in the absence of more detailed disclosure, four investors use measures and proxies to try to assess the reliability of an auditor’s report and the company’s financial accounts, as follows.

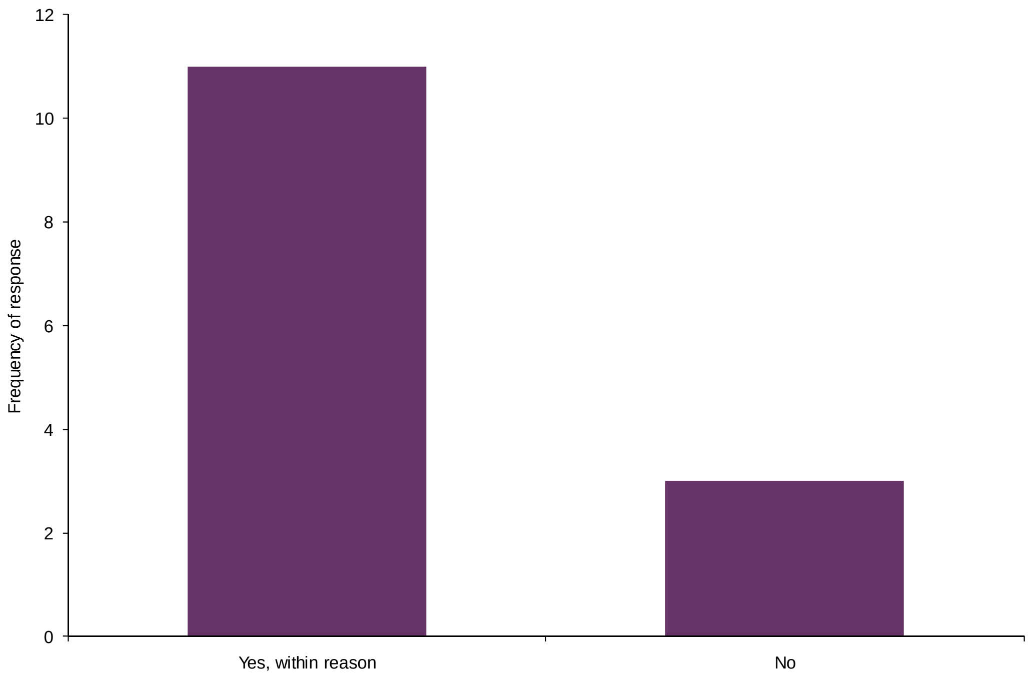
– **Measures to assess independence and objectivity of the auditor**—three investors suggested that the ratio of audit to non-audit revenues could be used to assess the independence of an auditor. Other measures mentioned include the length of tenure of the auditor, whether the accounting practices appear particularly aggressive, and whether the non-audit activities undertaken by the auditor are contrary to any regulatory guidelines, such as those from the UK Financial Reporting Council (FRC).

– **Methods to assess the quality of the investigation undertaken by the auditor**—one investor noted that checks can be made as to whether there is appropriate disclosure in the audit opinion, and that any queries about a particular company audit might be checked with the investor’s own auditor (for example, to ascertain whether aggressive accounting practices are being used).

– **Methods to assess the auditor firm's compliance with professional standards**—several investors use the assessments provided by audit oversight entities, such as the Audit Inspection Unit (AIU) in the UK and the Public Company Accounting Oversight Board in the USA (PCAOB).

The final question on audit quality asked whether the investor would support companies paying more for audit services that were of higher quality and/or more independent. As shown in Figure 2.2, the majority of investors would support such a change. Five investors also highlight concerns about what they currently perceive as a degree of cost-cutting by audit firms and how this might affect the quality of audit. One reason cited by investors willing to support companies paying more for higher quality is that when audit fees are considered relative to the loss the company could incur if something goes wrong in the audit process, audit fees appear small.

Figure 2.2 Would you support companies paying more for audit services that are of higher quality and/or more independent?



Source: Oxera analysis of survey responses.

This is not to say that all investors are insensitive to the cost of audits—several investors question whether an increase in costs is required to improve audit quality, or think that the cost of auditing is currently high owing to a lack of competition. One investor surveyed considers that audit fees should not increase any further. Another investor considers that providing more detailed narrative reporting on areas of challenge would not impose significant additional costs to the auditor, but would be of value to investors. A further view expressed by one investor is that restricting the amount of non-audit work undertaken by the auditor should not impose any additional costs, but would remove a potentially important source of conflict of interest, and thereby enhance the independence of the auditor.

2.3 Differences between auditors

There were three themes to the questions asked in relation to the differences between auditors: identity, capability and choice.

Identity of the auditor

8. To what extent (if any) does the identity of the audit firm matter for your investment decisions?

Different capabilities of auditors

9. Do you feel that you have a good understanding of the relative capabilities of different audit firms (including those outside the Big Four)?
10. Do you regard non-Big Four audit firms as competing in the market for statutory audits for large companies? If not, why not?
11. Do you think there is a gap between the Big Four and other audit firms? If so, what is the nature of that gap, and does it apply to all audits of FTSE 350 companies or only to a sub-set of those companies? (Discuss whether any gap is a matter of perception or genuine difference in capability.)

Choice

12. Is there enough choice in this market?
[If 'No' to question 12, then] What benefits would more choice bring?

Source: Oxera survey of investors.

2.3.1 Identity of the auditor

For a minority of the investors surveyed, the identity of the auditor rarely registers when making investment decisions—in some cases even when voting over the re-appointment of an auditor at an AGM. Typically, the minority of investors who have little interest in the identity of the auditor also consider that the audit market is delivering on expectations.

For the majority of the investors participating in this survey, the identity of the audit firm is noted in investment decisions, but is not expected to change those decisions. This is largely because nearly all companies are using recognised auditors, and therefore the situation of seeing an unfamiliar auditor name almost never arises. The group of recognised auditors is wider than the Big Four—one investor described the group as including up to 8–10 audit firms and another investor as including up to 15 audit firms, although more typically the recognised group of firms was seen as the Big Four and a small number of mid-tier firms.

Situations in which the identity of the auditor might raise concerns about the reliability of the auditor's report were described as follows:

– an auditor outside the Big Four auditing the accounts of one of the top 15–30 companies in the FTSE 100;
– an auditor outside the Big Four auditing the accounts of a 'truly multinational' company—defined by one investor as a company with 80–90% international operations;
– when revenue to the audit firm from the company being audited accounts for a significant proportion of the audit firm's total revenues;
– if the auditor has recently changed;
– if the auditor appears to be conflicted.

One investor also noted that where an audit firm is not already well known to an investment analyst, the analyst would undertake additional due diligence to ascertain the reliability of the auditor, although this rarely results in a change of investment decision.

2.3.2 Different capabilities of auditors

The majority of investors do not feel they have a precise understanding of the relative capabilities of different audit firms. The following reasons were given for this—in some cases both reasons were cited by the same investor:

– a lack of differentiation between auditors, in particular between the Big Four;
– a lack of transparency and/or disclosure to shareholders regarding any differentiation between auditors.

A common theme that emerges is the value placed on engagement with auditors. Those investors who feel they have a good understanding of the relative capabilities of different auditors explained that such an understanding has, at least in part, been developed through direct dialogue with different auditors. In addition, several of the investors who do not consider that they understand fully the relative capabilities of different auditors suggested that audit firms could provide more information to investors. One investor identified a number of aspects that would be of particular value to investors in assessing the reliability of different auditors:

- staff qualifications;
- resources;
- evidence of international reach;
- proportion of the firm's revenue derived from particular clients; and
- audit partner remuneration and the incentives to hold on to particular clients.

All investors and associations identified some aspects over which the capabilities of different auditing firms might vary, as follows:

- international reach;
- overall capacity;
- capacity in specialist areas;
- an ability to remain financially independent of larger clients.

The areas over which investors consider the capability of different audit firms to vary are reflected in their responses to question 11. None of the investors or associations surveyed considers that there is a genuine gap between the capabilities of the Big Four and other large audit firms in relation to the audit of most FTSE 350 companies, but all think that a gap may exist in relation to the audit of very large, very specialist, or truly multinational companies.

11. Do you think there is a gap between the Big Four and other audit firms? If so, what is the nature of that gap, and does it apply to all audits of FTSE 350 companies or only to a sub-set of those companies?

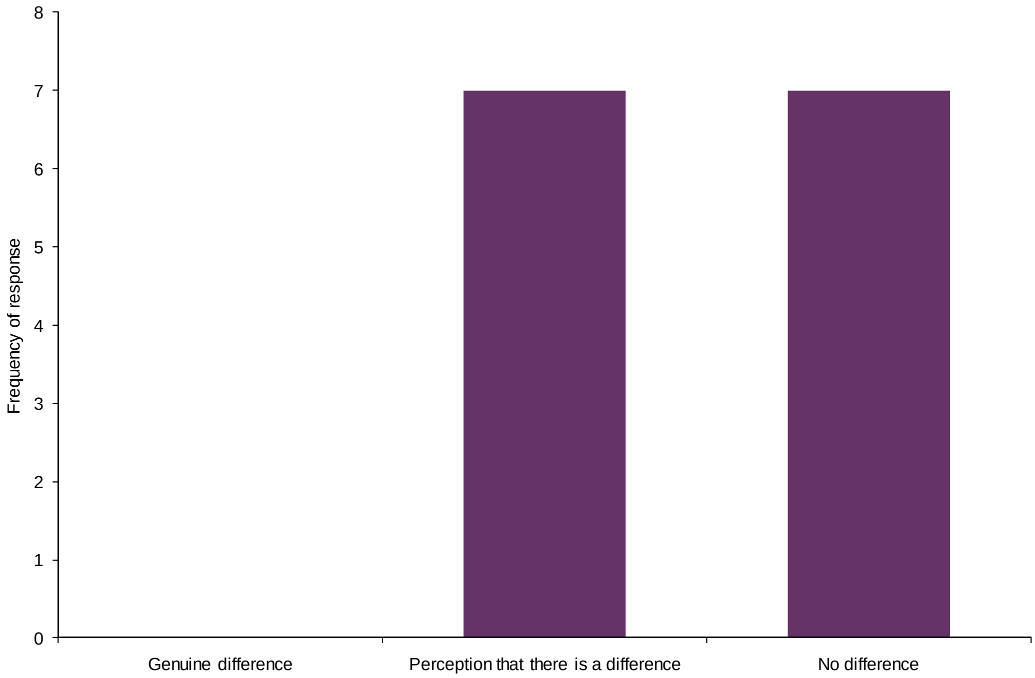
Source: Oxera survey of investors.

Investor views on a 'genuine gap' can be broadly summarised as follows:

- for the top 15 or top 30 companies in the FTSE 100, investors see a genuine capability gap;
- for most other FTSE 100 companies, investors do not believe a genuine capability gap applies;
- for FTSE 250 companies, investors do not see a genuine capability gap, with very limited exceptions.

Half of those surveyed think that there is a perceived gap, as distinct from a genuine gap, between the Big Four and other large audit firms in relation to FTSE 250 audits, as shown in Figure 2.3.

Figure 2.3 Do you think there is a difference between the capabilities of the Big Four and other audit firms in relation to the audit of FTSE 250 companies?

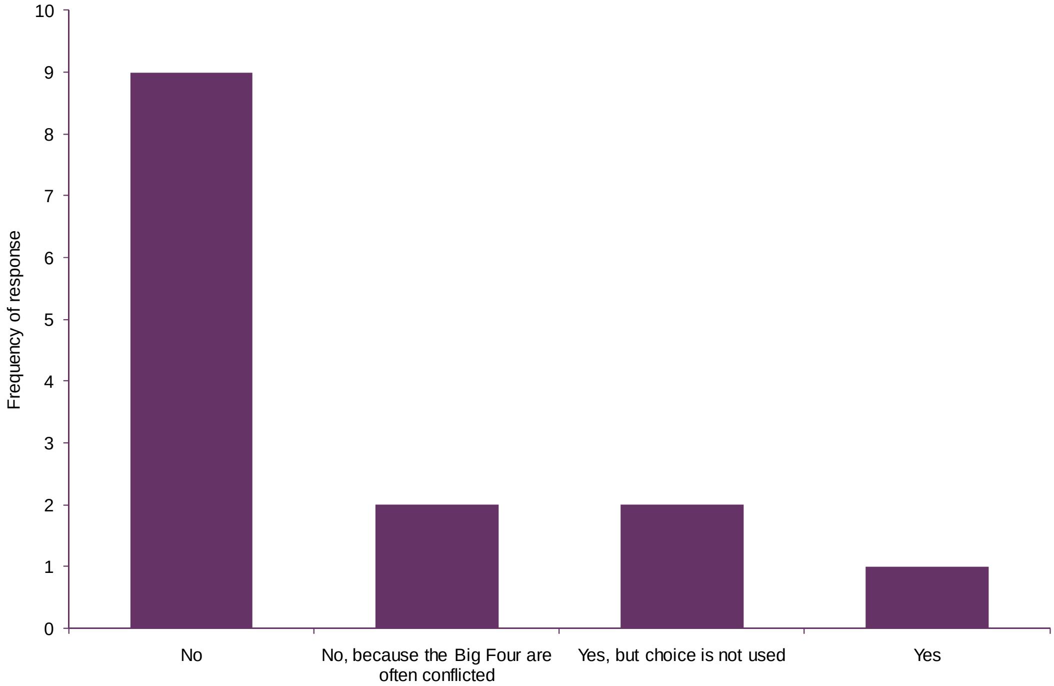


Source: Oxera analysis of survey responses.

2.3.3 Choice

All the associations and all bar one of the investors surveyed consider there to be a problem with choice in the audit market. For two investors the problem is not a lack of alternative audit firms, but audit committees and companies not using the choice available. For two of the associations, the problem is predominately that choice is limited because often at least one of the Big Four is conflicted. For the remaining eight investors and one association, no caveat is provided; the current level of choice is simply described as insufficient. These views are summarised in Figure 2.4.

Figure 2.4 Is there enough choice in this market?



Source: Oxera analysis of survey responses.

The investors surveyed expect that increased choice could bring the following types of benefit:

– increased market resilience;
– increased market confidence;
– increased differentiation;
– greater incentives to change auditor, and therefore more switching;
– improved audit quality;
– more innovation;
– better audit pricing.

3 Potential remedies

This section summarises the views of the investors surveyed in relation to the role of regulatory intervention in the audit market.

The first question asked whether intervention by the CC was required. This was followed by a series of questions on specific types of intervention suggested by parties in the context of the current regulatory debates about audit services, which can be grouped as follows:

– independence and/or separation of audit firms;
– rotation and/or tendering of audit firms;
– joint and/or shared audit;
– other potential remedies, such as removing ‘Big Four only’ clauses from financing arrangements.

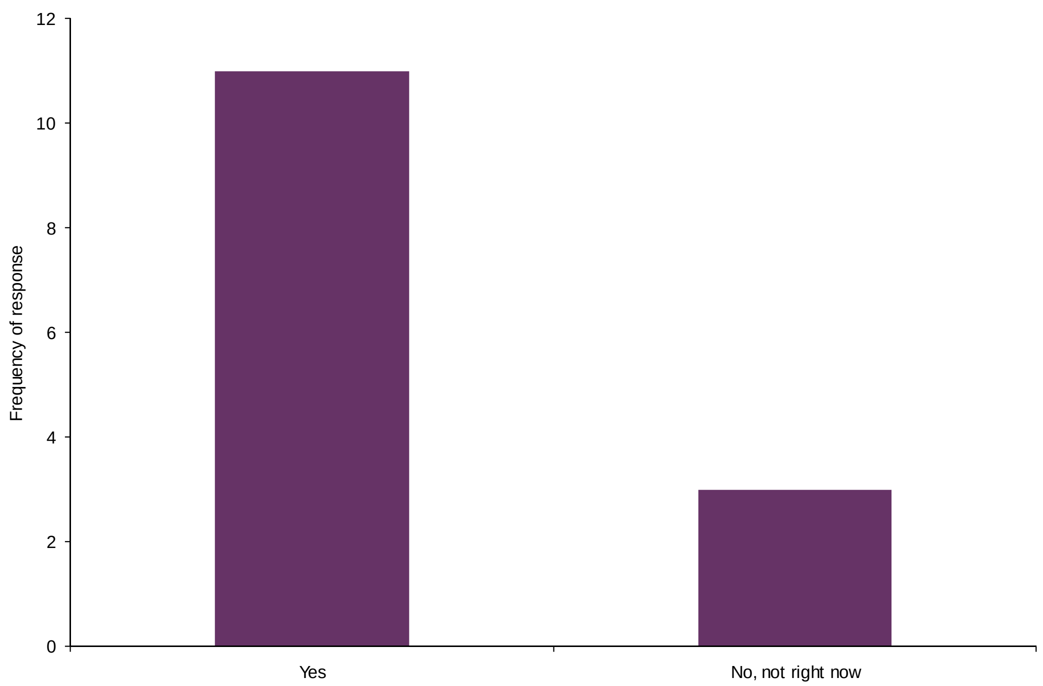
The final questions asked whether the investor is in favour of any alternative remedies, and the expected impact of the chosen remedy package.

This section again follows the structure of the questionnaire.

3.1 Intervention by the Competition Commission

All the associations and the majority of investors surveyed consider that there is a role for CC intervention in the market for statutory audit services of large companies—see Figure 3.1.

Figure 3.1 Does the market require intervention by the Competition Commission?



Source: Oxera analysis of survey responses.

Intervention by other regulatory bodies was not a direct question in this survey, but was a topic discussed by several investors, who hold mixed views. One investor (who is also in support of CC intervention) highlighted the benefits of international coordination and therefore intervention at a global level. Another investor considers that the CC is the appropriate authority to intervene because the problem is a competition issue and therefore regulation, even at an international level, would be less effective.

As set out in more detail below, several investors, including those in support of intervention by the CC, recognise the need for careful evaluation of policy options to avoid any unintended consequences.

The three investors that are not convinced that the market requires CC intervention also consider the current level of choice to be sufficient (although, for two of them, this choice is not being used). Should one of the Big Four audit firms collapse, these investors are of the opinion that the case for intervention should be reviewed.

3.2 Potential remedies

The potential remedies investors were asked to consider can be categorised into four groups, as summarised in the box below. The views expressed in relation to each group of remedies are summarised in the following sub-sections.

Independence or separation of audit firms

15. Do you support structural separation (audit-only firms)?
16. Do you support further mandatory restrictions on non-audit services performed by an auditor?
17. Do you support further restrictions (on a 'comply or explain' basis) on non-audit services performed by an auditor?

Rotation or tendering of audit firms

18. Do you support mandatory rotation of audit firms?
19. Do you support mandatory re-tendering of audit services?
20. Do you support a requirement for re-tendering of audit services on a 'comply or explain' basis?

Joint or shared audit

21. Do you support mandatory joint audit?
22. Do you support shared audit?

Other remedies

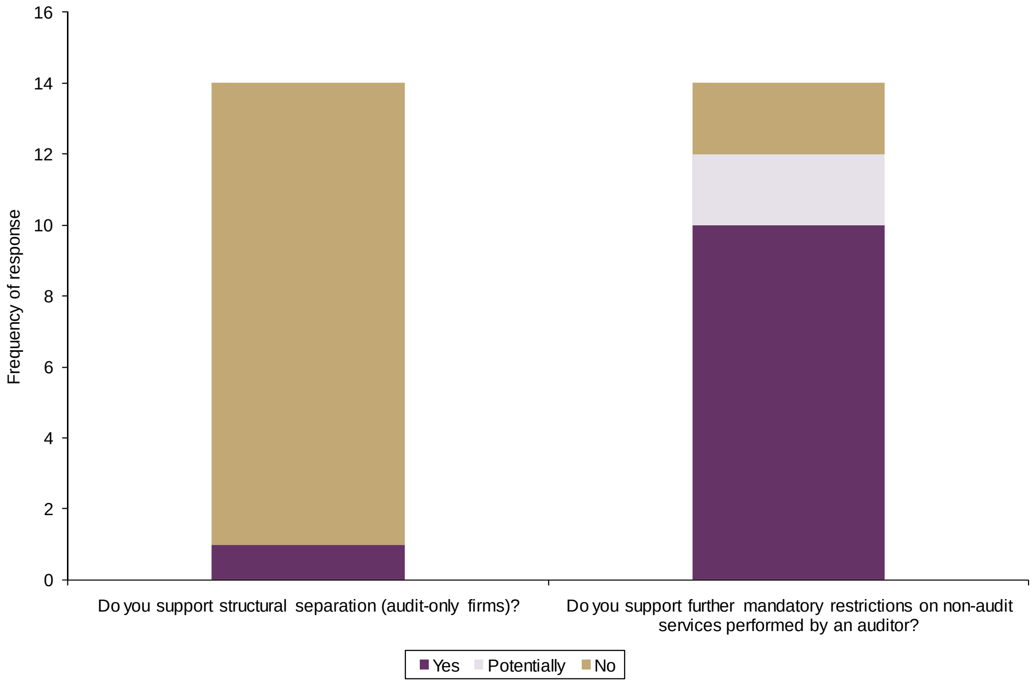
23. Do you support the removal of 'Big Four only' clauses in financing arrangements?
24. Do you support changes to the process of auditor selection—eg, greater involvement of investors? If so, what changes would you like to see?
25. Are there any remedies we have not discussed that you consider would improve the market outcome?

Source: Oxera survey of investors.

3.2.1 Independence or separation of audit firms

As shown in Figure 3.2, almost all investors and all associations are against structural separation of audit firms, but the majority of participants (including all associations) support further mandatory restrictions on certain non-audit services.

Figure 3.2 Views of participants in relation to independence and mandatory restrictions on non-audit services



Source: Oxera analysis of survey responses.

Several investors consider that there can be important benefits from an audit firm also providing certain non-audit services to a client. For example, a number of investors consider that it is efficient for an auditor to also provide services such as tax compliance and regulatory reporting. Other investors are concerned that audit-only firms could become less attractive to potential recruits, which could potentially reduce the quality of audit staff.

One of the investors surveyed is, however, strongly in support of audit-only firms, and considers this remedy to be particularly important to ensure an auditor's independence. This investor gave the opinion that restricting non-audit services without structural separation could compromise choice and competition in the audit market, by preventing firms that already provide non-audit services to a company from pitching for audit work with that company.

Investors and associations are generally in favour of further mandatory restrictions, so long as a carefully designed list of prohibited services is prescribed, rather than a blanket ban on all non-audit services. A few participants cited the European Commission's draft list as an appropriate approach, but note that there is still significant scope for further refinement.[6] The types of service that investors generally have concerns about an auditor performing include:

– services that the auditor later has to sign off—which may include, for example, valuation services, certain tax advice, bookkeeping or preparation of accounting records and financial statements;
– services where there may be an indirect conflict of interest—eg, the search and selection of senior company management.

A few investors consider that a 'comply or explain' rule on non-audit services is a possible approach; however, only one of them feels that this is necessarily a preferred approach over a clear ban on auditors carrying out certain non-audit activities.

[6] European Commission (2011), 'Proposal for regulation of European Parliament and of the Council on specific requirements regarding statutory audit of public-interest entities', Article 10, November.

Three investors and one association prefer a financial cap, with one identifying an appropriate maximum ratio of non-audit revenue to audit revenue as 1:2. Other investors also consider a financial cap to be a possible pragmatic approach to limit activities that do not in themselves pose a direct conflict of interest for an auditor, but which may lead to a conflict in cases where the fees for such activities are large compared with audit fees.

The two investors who are against a mandatory restriction on the non-audit services provided by an auditor both consider that the market is currently delivering on their expectations and that there is sufficient choice. Another investor is concerned that a mandatory proscribed list could result in the conclusion that any service not on the restricted list is suitable for the audit firm to undertake, when a proper application of judgement might conclude that such a service is inappropriate.

3.2.2 Re-tendering

All of those surveyed support more re-tendering of audits. Investors and associations alike expect more frequent re-tendering to improve the quality of audits, for three reasons.

– The potential new auditor can provide a valuable third-party review of the accounting principles and assumptions currently in place for the audit committee.

– The audit committee would step back periodically and reflect upon whether it is satisfied that the current auditor is independent and objective.

– The company and the audit committee would review the alternative audit firms more thoroughly and frequently than is currently the case, which could help overcome some of the perception gaps.

Several of the investors recognise that re-tendering is not a simple or inexpensive process, either for the company tendering the work or for the audit firms pitching for the work. One investor is concerned that too many re-tenders could be at the competitive disadvantage of smaller audit firms. More generally, it is recognised that the appropriate period for re-tendering should not be too short, with one investor suggesting that the deadline for mandatory re-tendering should be determined by the audit committee rather than externally. Other investors suggested periods of 5–10 years for re-tendering, referring to FRC proposals for re-tendering to occur at least every 10 years.[7] As to whether re-tendering could be enforced on a 'comply or explain' basis, rather than being mandatory, investors were divided, but generally more support was expressed for the mandatory option.

3.2.3 Rotation of audit firms

Most investors were against mandatory rotation of audit firms. However, three investors consider that mandatory rotation is required to improve the functioning of the market, and another investor and two associations consider that mandatory rotation is a relevant back-stop if mandatory re-tendering fails to increase significantly the turnover of audit firms. For mandatory rotation, periods of between 10 and 20 years were cited as appropriate by those investors in favour of this remedy.

Several of the investors and associations surveyed have concerns about mandatory rotation. These include:

– poor-quality audit in the first year of tenure, as the new auditor has not yet become familiar with the specific complexities of the company being audited;
– poor-quality audit in the final year of tenure, as the audit firm cannot be re-appointed and is perhaps focusing on pitching for new clients;

[7] Financial Reporting Council (2012), 'Revisions to the UK Corporate Governance Code and guidance on audit committees', Consultation document, April.

– insufficient/inadequate audit resources available at the pre-specified time of rotation ('flooding of the market'—ie, a demand/supply imbalance);
– inappropriate timing of pre-specified rotation (eg, in a crisis);
– removal of control from the audit committee to choose the most appropriate audit firm.

However, investors in support of mandatory rotation provide the following counterarguments.

– In relation to concerns about audit quality in the first year, one investor referred to audit firm pitch documents, which indicate that the learning curve is steep and audit risk manageable. Another wondered whether rotation would introduce a beneficial incentive on companies not to introduce overcomplicated accounting practices. Others suggested that a period of overlap between the outgoing and incoming auditor could help resolve the quality concern.

– In response to concerns about audit quality in the final year, some investors consider that the outgoing auditor would have good incentives to provide high quality, as the incoming auditor would uncover any mistakes made by the outgoing auditor, and thereby potentially expose the outgoing auditor to legal liability.

– In response to flooding of the market, investors suggest that staging of rotations would be sufficient to overcome this problem.

An alternative to mandatory rotation suggested by one investor is senior audit team rotation. Rather than rotating only the audit partner, this investor suggested rotating all team members responsible for decision-making. The investor considers that this remedy would avoid the disruption of audit firm rotation and still achieve the advantages intended by mandatory rotation in terms of peer review and maintaining the independence of the auditor.

3.2.4 Joint or shared audit

A joint audit is where two (or possibly more) auditors produce a single audit report for a company and thereby share responsibility for the audit of the company equally—each auditor signs off the account. A shared audit also involves multiple auditors, but only one—the primary auditor—signs off the accounts, relying on any work undertaken by the other auditors. Often, in a shared audit, the other auditors are responsible for auditing certain subsidiaries of the company.

Few of the investors surveyed had reflected upon the remedies of mandatory joint audit or shared audit to the same extent as alternative remedies such as mandatory rotation. In this context, none of the participants expressed strong support for mandatory joint audits, but a minority of participants consider that there could be advantages from encouraging more joint audits. Investors expressed some concerns about joint audits, including whether two audit firms would coordinate effectively, and whether two auditors would delay any investigations into auditor liability.

In relation to shared audits, investors did not express strong views. The general view that came across is that if the company prefers to have a shared audit, investors would not necessarily object. However, there are some concerns in relation to shared audits, including whether potential gaps in the responsibilities of each audit firm would emerge, and whether they would have any effect on changing the perceived status of non-Big Four audit firms.

Two participants have a specific preference for joint audit over shared audit, while another has a specific preference for shared audit over joint audit.

3.2.5 Other remedies

The investors and associations were also asked for their opinions in relation to the following remedies:

23. Do you support the removal of 'Big Four only' clauses in financing arrangements?

24. Do you support changes to the process of auditor selection, eg, greater involvement of investors? If so, what changes would you like to see?

Source: Oxera survey of investors.

All of the associations and all except one of the investors consider that 'Big Four only' clauses should be removed. The investor who disagrees feels that such a remedy would be impossible to enforce, and that lenders should be allowed to mandate which auditor the borrower should use. Three of the investors in favour of removing such clauses also consider it important to protect the ability of lenders to place appropriate limits on borrowers, but that legal drafting could accomplish this without referring to 'anti-competitive Big Four-only' clauses.

Two other investors are concerned that removing the explicit clauses might not be sufficient, and refer to tacit clauses—eg, in the broker's verbal advice—that could also limit competition.

In terms of the auditor selection process, many investors are happy to rely on the audit committee to act as the agent of shareholders, but several suggested changes to the process as follows.

– Four investors recommended increased disclosure by the audit committee and rights for the shareholders. Two investors referred to the Australian law that provides an explicit right for shareholders to pose oral questions on the conduct of the audit, the content of the audit report, accounting policies and auditor independence.[8] The Australian statute also allows shareholders to put written questions to auditors before the AGM via the company on the conduct of the audit and the content of the audit report.

– Two investors also suggested that shareholders should become involved in the auditor selection process earlier, and one investor suggested a formal connection with the tendering process.

– Five investors recommended providing shareholders with more information to verify that the audit committee has carefully assessed the quality and independence of the proposed auditor.

– Two investors suggested that shareholders take a role in selecting the audit committee.

Investors and associations were also asked to identify any alternative remedies that had not already been discussed; these are summarised in Table 3.1.

[8] The Australian statute: Section 250RA Corporate Law Economic Reform Program (Audit Reform & Corporate Disclosure) Act 2004, commonly called CLERP 9.

Table 3.1 Alternative remedies suggested by investors and associations

Remedy	Issues raised by investors	Number of investors suggesting that this remedy be considered
Contingency planning	Should another large audit firm collapse, how would its bankruptcy be handled? Should limits be imposed on the extent to which one audit firm can acquire the resources of another?	4
Financial cap on non-audit services	What is the appropriate ratio of non-audit revenue to audit revenue, from a particular client?	4
Coordination or monitoring of the timing of re-tendering audits in each sector (eg, all bank audits coming up for tender at the same time)	Might this remedy create greater competition among the Big Four and encourage new entry?	1
Removal of common financial year-end	Do similar financial year-ends for several companies create a capacity barrier to entry for audit companies? If so, how can financial year-ends be re-distributed?	1
Greater disclosure about auditor capabilities	What information is relevant to an investor? How can this be communicated to investors?	2
Review of audit ownership rules	Would additional capital coming into smaller firms from outside help open up competition? What would the implications be for auditor liability?	2
Mandatory break-up of large audit firms into smaller firms	What is an appropriate market share cap to apply? What would the implications be for auditor liability?	2
Audit team rotation	At what level of seniority should auditing staff be rotated, and with what frequency?	1

Source: Oxera analysis of survey responses.

3.3 Benefits of chosen potential remedies

Investors were asked how they expected their preferred measures to improve market outcomes for investors, both at the level of assurance for a particular investment, and in terms of the general functioning of capital markets. In general, investors consider that their chosen remedies could improve market outcomes by increasing competition. To that extent, several responses to this question reflect the participants' earlier responses to the question on the benefits of increased choice and include increased market resilience.

A minority of investors noted that increased choice and competition are a means to better audit quality. This does not mean that they do not consider increased choice and competition to be important, only that they are an intermediate step rather than the final outcome.

Several investors are concerned that a CC intervention might not go far enough. Three of these investors emphasised the need for their preferred remedy packages rather than any watered-down interpretation. For two of them, break-up of large audit firms into smaller firms is considered central to improving market outcomes, and for another, mandatory auditor rotation is the central remedy.

Overall, while the set of preferred remedies varies in both mixture and overall force of change, investors surveyed are confident that an improvement is possible, albeit not easy to achieve. The general expectation is that increased competition (not necessarily competition on price) and choice should ultimately result in better audit quality, independence and innovation, thereby serving the needs of investors.

A1 Introductory note sent to participants

Introduction

Thank you for agreeing to participate in Oxera's investor interview programme. Oxera's research will provide evidence for the Competition Commission (CC) inquiry into statutory audit services to large companies in the UK. The research is designed to capture in a structured way the views of investors as important stakeholders in this market. We have designed the research with the aim that, although conducted independently from the CC, it will complement the interactions that the CC has already had with several investors.

This note provides a list of questions for discussion between Oxera and interview participants. Section 2 provides a list of questions relating to market outcomes and section 3 provides questions on potential remedies.

The interview will take the form of a structured discussion based around the questions in sections 2 and 3. The purpose of the questions is to explore your views and generate discussion.

Market outcomes

1. What are the expectations of the audit process, from an investor's perspective—both at the level of an individual investment and for well-functioning capital markets?

2. Does the market for statutory audits for larger companies currently deliver on these expectations?

3. [If 'No' to question 2, then] In which respects does the market fail to deliver?

4. [If 'No' to question 2, then] What do you think is the source of the market failures?

5. How would you define 'audit quality'?

6. Do you feel that you can judge the quality of an audit?

7. Would you support companies paying more for audit services that were of higher quality and/or more independent?

8. To what extent (if any) does the identity of the audit firm matter for your investment decisions?

9. Do you feel that you have a good understanding of the relative capabilities of different audit firms (including those outside the Big Four)?

10. Do you regard non-Big Four audit firms as competing in the market for statutory audits for large companies? If not, why not?

11. Do you think there is a gap between the Big Four and other audit firms? If so, what is the nature of that gap, and does it apply to all audits of FTSE 350 companies or only to a sub-set of those companies? (Discuss whether any gap is a matter of perception or genuine difference in capability.)

12. Is there enough choice in this market?

13. [If ‘No’ to question 12, then] What benefits would more choice bring?

Remedies

14. Does the market for statutory audits for large companies require any form of intervention by the Competition Commission?

    [for all remedies questions below, ask as binary choice question and then as follow-up:

    [if answered Yes] ask: ‘What are the advantages of this remedy? Do you see any drawbacks of this remedy?;

    [if answered No] ask: ‘What are the drawbacks of this remedy? Do you see any advantages of this remedy?]

Independence / separation

15. Do you support structural separation (audit-only firms)?

16. Do you support further mandatory restrictions on non-audit services performed by an auditor?

17. Do you support further restrictions (on a ‘comply or explain’ basis) on non-audit services performed by an auditor?

Rotation / tendering

18. Do you support mandatory rotation of audit firms?

19. Do you support mandatory re-tendering of audit services?

20. Do you support a requirement for re-tendering of audit services on a ‘comply or explain’ basis?

Joint/shared audit

21. Do you support mandatory joint audit?

22. Do you support shared audit?

Other

23. Do you support the removal of ‘Big Four only’ clauses in financing arrangements?

24. Do you support changes to the process of auditor selection—eg, greater involvement of investors? If so, what changes would you like to see?

25. Are there any remedies we have not discussed that you consider would improve the market outcome?

Benefits of chosen remedies

[If ‘Yes’ to any of the remedy questions] How do you think these measures which you support will improve market outcomes for investors, both at the level of assurance for a particular investment, and in terms of the general functioning of capital markets?

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