Report on Auditor Clauses in Loan Agreements

Prepared for the Competition Commission by

Dr Richard Baylis
Cardiff Business School
Cardiff University
Aberconway Building
Colum Drive
Cardiff
CF10 3EU
BaylisRM@cardiff.ac.uk

Professor Mark Clatworthy
Cardiff Business School
Cardiff University
Aberconway Building
Colum Drive
Cardiff
CF10 3EU
ClatworthyMA@cardiff.ac.uk

Professor Christopher Pong
Nottingham University Business School
University of Nottingham
Nottingham
NG8 1BB
Chris.Pong@nottingham.ac.uk

Executive Summary

1. This report was commissioned as part of the Competition Commission's inquiry into the Statutory Audit Services Market amid claims that clauses in corporate loan agreements requiring borrowers to have their financial statements audited by one of the Big 4 audit firms (Big 4 clauses) potentially represent a barrier to entry for non-Big 4 firms. Research being conducted by the authors into US corporate lending agreements (where data are publicly disclosed) revealed that some form of auditor clause appeared in virtually all lending agreements, and around half of these were clauses specifying that the borrower use a Big 4 firm (though usually with a residual element to the clause stating another nationally recognised firm could be used).

2. In order to examine the situation in the UK, the Competition Commission conducted a survey of major participants in the market for syndicated loans (i.e. lenders, the Loan Market Association [LMA], and solicitors) to assess the prevalence, nature and significance of Big 4 clauses. Responses were received from ten banks, eleven law firms, and the LMA. In addition, the Competition Commission asked the three main ratings agencies about the extent to which audited accounts and auditors' identity influence the ratings they supply.

3. The main findings from the survey were that the documentation/templates provided by the LMA represent a widespread basis for corporate lending agreements. This finding is supported by the responses from banks, solicitors and the LMA itself. Importantly, of the two main sets of LMA documentation, only one – the Leveraged Loan documentation - contains a Big 4 clause. In this clause, which is optional but often remains intact, auditors are *defined* as one of the Big 4 firms. There were, however, examples of names of non-Big 4 auditors being added to the clause. The LMA Investment Grade documentation contains no such clause. The main reasons for this clause centre around the expectation of lenders and borrowers that the LMA documentation will be used, the familiarity of the Big 4 to international lenders (who often participate in syndicated loans) and the importance of high quality audit of financial covenants in high leverage transactions.

4. What is unclear from the responses is precisely when the Leveraged Loan documentation will be used. Some responses suggest it is used for high leverage transactions and for sub-Investment Grade loans, while others suggest it will only be used for high leverage loans. If this documentation is used for companies with sub-Investment Grade ratings, the ratings agencies' responses imply that this could affect a non-trivial proportion (at least 17) of the FTSE 350. This is a conservative estimate, since companies with no rating are more likely to be sub-Investment grade. The available data suggest that US agreements may have Big 4 clauses in them, even for Investment Grade loans/borrowers.

1. Introduction and Background

5. The presence of clauses in debt contracts requiring borrowers to have their financial statements audited by one of the Big 4 auditors (i.e., Deloitte, Ernst and Young, KPMG and PwC) has attracted the attention of numerous bodies concerned with competition in the statutory audit services market, including the House of Lords Economic Affairs Committee and the Office of Fair Trading. Such clauses have been alleged to be anti-competitive since they may restrict companies' ability to choose non-Big 4 auditors and may represent a barrier to entry to important audit markets for non-Big 4 audit firms. As shown in the Competition Commission Issues Statement, they have also led to a perception that some lenders will only consider extending credit to companies having their financial statements audited by one of the Big 4.

6. Although there is widespread anecdotal evidence on these clauses and on the potentially harmful consequences that flow from them, to date, there has been a lack of reliable evidence on the nature of the clauses, on how often they occur and on the conditions under which they are most likely to appear.[1] Prompted by the regulatory interest in these clauses and the significance of the corporate debt market, the authors of this report commenced a research project involving a systematic analysis of corporate lending agreements and a detailed examination of auditor clauses. However, UK companies are not required to disclose lending agreements, so data were collected for a sample of US firms (these agreements are filed with the Securities and Exchange Commission and are thus made publicly available). As reported by Sufi (2007), the syndicated loan market represents a primary source of finance for most large companies: almost 90% of the largest US industrial companies obtained syndicated loan finance between 1994 and 2002. Saunders and Steffen (2011) provide statistics demonstrating that the UK syndicated loan market is also highly active for both public and private companies and the Bank of England (2012) estimates gross syndicated lending to UK non-financial companies in 2011 to be almost £100 billion.

7. There are some suggestions in the academic literature that debt providers are 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.

8. A preliminary analysis by the authors of 44 US lending agreements suggested that Big 4 clauses were widespread, but in many cases, the auditor in the clause was the incumbent. In addition, some clauses also referred to mid-tier audit firms. More recent and more comprehensive analysis (discussed in more detail below) revealed that virtually all contracts examined had some form of auditor identity clause and in around 50% of cases, this either specifically or generically referred to a Big 4 auditor. The remainder were clauses referring to 'nationally recognised' auditors. The analysis of US data also revealed that there are many UK banks participating in the US market as international syndicate members.

[1] For instance, Hinks (2011) compares such clauses with the Loch Ness Monster – 'much talked about but never proven'.

9. It is possible, however, that US-based results are not representative of the UK market, so to examine these issues in the context of the UK loan market, the Competition Commission administered a survey of key market participants, namely UK lenders (i.e., banks), the European trade association for syndicated loans (the Loan Market Association [LMA]), credit ratings agencies and solicitors. The combined survey responses produced considerable evidence that standard documentation provided by the LMA is largely responsible for contract design and since some of the templates (those for sub-investment grade or leveraged loans) contain clauses defining auditors as one of the Big 4, it seems unsurprising that they persist across a significant number of agreements. What is unclear is how pervasive they are for FTSE 350 companies, since there is ambiguity about when an agreement will be based on documentation which initially includes a Big 4 clause.

10. The remainder of the report sets out the evidence from the authors' ongoing investigation of the US syndicated loan market, and then presents the main results from the CC survey of banks, the LMA, ratings agencies and solicitors. It concludes with a brief discussion of the evidence overall and identifies potential areas where more evidence might be beneficial.

2. Evidence from US syndicated Loan Agreements

11. Since the initial response to the Issues Statement, the authors have extended the analysis of US firms to a larger sample to produce a more informed and reliable response. In particular, 232 contracts for 2008 and 2010 have now been examined and a summary of the main results is presented in Table 1. It is evident that syndicated loan agreements relate to very large transactions. In 2010, the average size of loan/facility is $686 million, with the largest being in excess of $7 billion.

Table 1
Descriptive Statistics for US Sample

	2010	2008
Sample	n = 143	n = 89
Total borrowing of sample	$98 billion	$41 billion
Average contract value	$686 million	$460 million
Largest contract value	$7.2 billion	$5 billion
Smallest contract value	$5 million	$1 million

12. While the situation in the US may not be identical to the UK, a significant proportion of the contracts (over 30% in 2010, as noted in Table 2 below) involve UK banks as participants in the loan syndicates (though these data were not available for the full sample).

Table 2
Frequency of UK Lenders participating within US led Syndicates

	2010 (n = 135)	2008 (n = 88)
Number of contracts where a UK Lender was a member of the Loan Syndicate	50 (37.0%)	24 (27.3%)

13. To assess the prevalence of and nature of auditor clauses, each lending agreement was reviewed to identify whether any clause was present. From this review, 3 types were identified:

Big 4 – The clause will either specifically or generically require an Auditor considered to be one of the Big 4 Auditors, as illustrated below:

Bill Barrett Corporation
"reported on by Deloitte & Touche LLP or other independent public accountants of recognized national standing"

McAfee Inc.
"audited and accompanied by a report and opinion of a "Big Four" accounting firm or another independent certified public accountant of nationally recognized standing reasonably acceptable to the Required Lenders"

Non-Big 4 – The clause will detail a specific auditor, but one named outside of the Big 4:

Global Geophysical Services Inc.
"audited and accompanied by a report and opinion of UHY, LLC or another independent certified public accountant of nationally recognized standing reasonably acceptable to the Administrative Agent"

Nationally recognised – The only requirement is that the Auditor is of a national standard:

Baker Hughes Inc.
"audited by independent certified public accountants of recognized national standing reasonably acceptable to the Lenders"

14. As reported in Table 3, of the US contracts reviewed, over 95% contained a clause covering the identity of borrowers' auditors, whether specific or general. Of the overall sample, more than 50% required a Big 4 auditor, compared with only 3% requiring one outside of the Big 4 group. Even though the remaining population (approximately 40%) did not require a specific auditor, the level of clauses requiring a Big 4 auditor is significant.

Table 3 Frequency of Clauses Referring to Specific Auditors in US Agreements		
	2010 (n = 143)	2008 (n = 89)
Number of contracts where an auditor clause was in place	136 (95.1%)	87 (97.8%)
Number of contracts where an auditor clause was in place requiring either a specific or generic 'Big 4' auditor	75 (52.4%)	47 (52.8%)
Number of contracts where an auditor clause was in place requiring a 'non Big 4' auditor	5 (3.5%)	3 (3.4%)
Number of contracts where an auditor clause was in place requiring a 'nationally recognised' auditor	56 (39.2%)	37 (41.6%)

As acknowledged above, however, the US-based results might not be representative of the UK market.

3. Evidence from Competition Commission Survey

15. In order to assess the position in the UK, the Competition Commission sent out questionnaires to major participants in the UK syndicated loan market, namely the LMA, lenders (banks), ratings agencies and legal advisors (solicitors).

3.1 Sample

16. Consistent with the US analysis, the focus of the investigation was syndicated loan agreements. In the case of the banks surveyed (representing lenders), Bloomberg was used to identify the top providers of syndicated loan finance to UK and Irish companies between 2009 and 2011, and the largest ten of these organisations (understood to represent approximately 63 per cent of the total value of syndicated loans originating during that period) formed the basis for the sample. The banks so identified are set out in Table 4 below. Responses were received from all ten banks.

17. Information was requested from legal advisors of syndicated loan providers likely to advise on the drafting and content of loan agreements. The Legal 500 was used to identify the top advisors for investment grade debt and syndicated loans. This included 11 firms and all were written to. A response was received from all of these firms. In addition, the Loan Market Association – the trade association for participants in the syndicated loan sector – was written to.

18. Finally, information was sought from the three major rating agencies: Fitch Ratings Ltd; Moody's Investors Service Ltd; and Standard & Poor's Financial Services LLC. Each was asked about which companies in the FTSE 350 they provide ratings for and the extent to which audited accounts and auditors' identity influence the ratings they supply. All three provided responses. A summary of those contacted in the survey is provided in Table 4 below.

Table 4 Market Participants Contacted by the Competition Commission[†]		
Banks Contacted	Legal Advisors Contacted	Ratings Agencies Contacted
RBS	Allen & Overy LLP	Fitch Ratings
Barclays Bank plc	Clifford Chance LLP	Moody's
Lloyds Bank, Wholesale Banking & Markets	Linklaters LLP	Standard & Poor's
HSBC Bank PLC	Freshfields Bruckhaus Deringer LLP	
BNP Paribas Group	Herbert Smith LLP	
JP Morgan Chase	Slaughter and May	
Citi	White and Case LLP	
Société Générale, London Branch	CMS Cameron McKenna LLP	
Deutsche Bank, London Branch	Hogan Lovells International LLP	
Crédit Agricole Corporate and Investment Bank London Branch	SNR Denton	
	Norton Rose LLP	
Every organisation contacted provided a response.		

3.2 Responses to the Competition Commission Survey

3.2.1 The Loan Market Association (LMA)

19. The LMA was established in 1996 with the key objective of improving liquidity, efficiency and transparency in the primary and secondary syndicated loan markets in Europe, the Middle East and Africa. Its members include a wide range of lenders and law firms, as well as other market participants such as ratings agencies and service providers.. In order to aid efficiency in the contracting process, the LMA produces standardised documentation designed to form the basis of lending agreements for syndicated loans. This is an important function since these documents are often lengthy, complex and (as shown above) relate to highly significant economic transactions. Although, according to the LMA, the documentation is designed to reflect 'market practice', they point out in their response that 'all LMA recommended forms are a starting point only and are subject to negotiation on a deal by deal basis'.

20. A major finding from the CC survey is that some of the documents produced by the LMA include a clause defining the term 'auditors' for the purpose of the loan. This clause, however, is only present in the documentation for 'Leveraged' loans and not in the 'Investment Grade' documentation.

21. The LMA Leveraged auditor clause states:

> 'Auditors means [one of PricewaterhouseCoopers, Ernst & Young, KPMG or Deloitte & Touche] or any other firm approved in advance by the Majority Lenders (such approval not to be reasonably withheld or delayed).'

When asked for the reasons for inserting such clauses, the LMA responded: '*The clauses that are included in LMA documentation in relation to the borrower's auditors reflect market practice. They are the provisions that lenders commonly require and,*

in the case of the Investment Grade Facility Agreement, that borrowers are willing to accept.'

The square brackets in the clause are significant because the LMA states its documents are a starting point only and subject to negotiation; furthermore, where something appears in square brackets, this is an indication that the text included is a suggestion. The LMA states in its response '*It is made clear in the Users' Guides that not including something in square brackets is not to be considered as a departure from the LMA form*.' The sample of clauses provided by the banks [below] suggests that although it is a 'default' clause subject to routine removal, it remains prevalent in Leveraged loan transactions.

22. An important issue determining the presence of Big 4 clauses is therefore which of the sets of LMA documentation is used: Investment Grade or Leveraged. Some evidence (including that contained in evidence from the banks) suggests that companies with ratings below BBB- are treated as 'Leveraged' and thus will have such clauses in their lending agreements (see eg the response of [✂][2]). A briefing document provided for the CC by an advisor with working experience of this sector (Annex 1), however, states that the Investment Grade documentation will usually be the starting point for FTSE 350 companies and provisions will be included from the Leveraged documentation only when credit quality is low. It is asserted in this briefing document (though without supporting evidence) that the auditor clause is less likely to be amended since it is not perceived as contentious or restrictive in practice because the company has no intention or wish to use an auditor that was not previously permitted. Evidence from one of the law firms also supports this view. Freshfield Bruckhaus Deringer noted: '*It is also usually the case that the auditors used by the borrower at the time the facilities are entered into are taken into consideration and if the existing auditors are acceptable to the syndicate of banks, they are included in the definition of "Auditors"*'.

Key Findings:

23. **LMA documentation is widely used as the basis for lending agreements and of the two main types (Investment Grade and Leveraged), only the Leveraged documentation contains a clause defining auditors as one of the Big 4 auditors.**

24. **This clause is inserted in a way that makes it easy to amend/remove, but other evidence (below) suggests it is often left as it is.**

25. **Though most FTSE 350 companies are likely to have lending agreements based on Investment Grade documentation, it is not clear exactly when a syndicated loan agreement will be based on Leveraged documents or Investment Grade documents.**

3.2.2 Banks

26. Banks were asked a number of questions concerning the nature and prevalence of auditor clauses inserted into lending agreements and the reasons for inserting them (where relevant). Banks' responses indicated that auditor clauses are commonly

[2] Although this bank said that the policy is not invariably applied in all "leveraged" loan facilities: it will consider each case on its merits, taking into account any representations made by borrowers in the course of negotiations, which could lead to the auditor clauses being modified or even removed altogether in appropriate cases.

inserted into their lending agreements, though this is attributable to the widespread use of the LMA documentation and therefore typically occurs only where the borrower is not considered of Investment Grade.

27. As Table 5 shows, the vast majority of the nine banks responding stated that they relied initially on the LMA documentation and provided extracts from the agreements with some reference to the type of auditor used by the borrower (either as a Big 4 auditor or as an internationally recognised auditor).

Table 5 Reliance of Banks on LMA Documentation (n = 10)	
Stated Reliance on LMA Documents	Did not State Reliance on LMA Documentation
8	2

28. Importantly, however, even the two banks that did not explicitly state they relied on LMA documentation did refer to these documents in their responses to the survey and it was implicit that they would be relied upon in some agreements. One bank ([✂]) noted that auditor clauses may be inserted for leveraged acquisition finance transactions because they are included in the LMA precedent loan agreement. [✂] reproduced an auditor clause identical to the one contained in the LMA leveraged finance loan documentation, as an example of the type of auditor clause it used in many syndicated loan agreements with leveraged finance borrowers (which were not 'large corporates').

29. The banks' responses indicate that it is rare for a lender to require a borrower to change auditor because of a contractual clause (see Table 6 below). Lenders did not envisage circumstances where the clause would require a change in auditor (one commented that this would take place before the agreement was drawn up). One bank ([✂]) did note that in states outside the EEA where best practices may not conform to international accounting standards, participating banks may require the use of "international auditors" , but this is not relevant for the FTSE 350 companies that are the main focus of the CC's current investigation. HSBC noted that in its experience, borrowers entering into large leveraged financed transactions will typically already have appointed one of PwC, KPMG, Deloitte or E&Y in any event. It said that where highly leveraged transactions were entered into by mid-market borrowers, it was common for HSBC to accept a wider definition of auditor (e.g. at the request of the borrower).

Table 6 How Often do Clauses Require Borrower to Switch Auditor (n = 10)	
Do not Typically Require Borrower to Change Auditor	Did not Respond to Question Directly
9	1

30. When asked about differences in the clauses used in lending agreements and the circumstances under which different ones would be used, all respondents either cited the LMA templates or provided examples of different clauses of a similar nature to the LMA Leveraged Loan clause (i.e. specifying that any one of the Big 4 or another independent international accounting firm appointed with advance approval of the lender). There was not a direct response in all cases, but for some, there were clauses that cited the borrower's existing auditor. Furthermore, in the clauses provided, there were four examples of the LMA auditor clause being adapted to include auditors outside the Big 4. For instance, the clause in the loan agreement

provided by Lloyds in the loan to [✂] includes the Big 4, plus Grant Thornton and BDO Stoy Hayward (in addition to the 'residual' element of the clause)[3]. It was also interesting when reviewing these clauses, however, to note an example (in the [✂] agreement) where the Big 4 auditors and firms of international standing were seemingly viewed as synonymous:

'Auditors' means Deloitte & Touche LLP or such firm of independent public accountants of international standing which is appointed with the approval in writing of Agent (which appointment is hereby given in relation to PwC, Ernst & Young and KPMG (or any amalgamation or successor of any of them) to audit the annual consolidated accounts of the Company).

31. The departure from the wording of the LMA template in this clause leaves it as an example of one that might well create a reluctance to switch out of the Big 4 (Deloitte were [✂]'s auditors at the time of the agreement).

32. Further evidence that the insertion of auditor clauses is not driven by auditors or borrowers is provided by banks' responses. As Table 7 below shows, not one bank was able to identify circumstances where a borrower or borrower's auditor asked for a clause to be inserted.

Table 7 Banks being Asked to Insert Auditor Clauses by Borrower/Auditor	
Identified Circumstances where Borrower/Borrower's Auditor asked for Auditor Clause to be Inserted	Did not Identify Circumstances where Borrower/Borrower's Auditor asked for Auditor Clause to be Inserted
0	10

33. Furthermore, there have been no changes to policy over time. As shown in Table 8, all banks responding either had seen no change over the last five years or had no policy in the first place (one bank – Citi – requires financial statements to be prepared by an independent auditor but did not have a policy relating to the identity of the auditor.).

Table 8 Changes in Banks' Policy on Auditor Clauses	
Stated Change in Policy on Auditor Clauses in the Last Five Years	Stated No Change in Policy on Auditor Clauses in the Last Five Years or Has no Policy
0	10

34. An additional finding from the banks is that although they not the subject of this research, bilateral loan agreements either do not contain auditor clauses or the same practice was used as for syndicated loans, as Table 9 reveals.

Table 9 Banks' Use of Auditor Clauses in Bilateral Loan Agreements		
Agreements do not Contain Auditor Clause	Same as Syndicated Loans	No Response
4	5	1

[3] It also allowed for any other firm approved by the "majority lenders" to be appointed.

Key Findings:

35. **Banks rely heavily on LMA documentation, so auditor clauses are typically confined to Leveraged Loans/sub-Investment Grade loans and are not requested by borrowers or their auditors.**

36. **Where auditor clauses are used, they do not typically require borrowers to change auditors.**

37. **Bilateral agreements are often similar to syndicated loan agreements with respect to auditor clauses.**

38. **Banks' policies on auditor clauses have not changed over the last five years.**

3.2.3 Solicitors

39. The results from the solicitors very clearly confirmed the widespread use of the LMA templates. There was universal acknowledgement that Leveraged Loans would typically contain an auditor clause, and this was attributed to the use of the LMA documentation for these transactions. Law firms involved in the syndicated loan market were asked whether they used a template as a basis for their syndicated loan agreements (subject to modification), if so, whether any clauses related to borrowers' auditors were included and the reasons for including any such clauses. As reported in Table 10 below, all firms used a template based to some degree and further analysis showed that this was invariably the LMA documentation.

Table 10
Solicitors' Responses on Templates and Auditor Clauses (n = 11)

	Yes	No
Used template for syndicated loans	11	0
Inserted auditor clauses in last 5 years (for any grade of debt)	10	1

40. Norton Rose confirmed that it used LMA documentation in line with market practice and although this documentation did not generally contain any provisions relating to the borrower's choice of auditor, one exception was identified: the LMA standard form leveraged finance multicurrency syndicated loan agreement. Such loans are considered to be "sub-investment grade loans" requiring higher levels of protection against risk by lenders compared with other types of syndicated loans. One firm ([✂]) indicated that the Leveraged documentation would be used for high-leverage transactions (and even for some sub-Investment Grade loans, the CC briefing document suggests that the Investment Grade documents would probably be used for FTSE 350 companies, perhaps with some tighter restrictions than the standard template). In addition, one firm (Freshfields Bruckhaus Deringer) reported that it adds the name of the borrower's existing auditors to the template (subject to such auditors being acceptable in the opinion of the lenders).

41. When asked about the reasons for including such clauses, several firms cited the fact that the LMA reflected market practice and thus what both lenders and borrowers expect to see (similar to the response of the LMA itself). The efficiency involved in using the LMA documentation, the familiarity of the named auditors to lenders (which are often international, as shown in the US analysis) and the

importance of audit quality for the financial covenants in the agreements in leveraged transactions were also cited as reasons for their inclusion.

42. A useful feature of this part of the survey was that solicitors were asked about the extent to which their practice with syndicated loan agreements reflected what they did with bilateral loans. It was noted (as it was by the LMA) that the LMA does not produce documentation for bilateral loans, yet there was strong evidence that the practice was very similar. Although three firms reported that bilateral loan agreements did not contain auditor identity clauses, seven of the eleven reported that they used the same approach as for syndicated loans.

Key Findings:

43. **The LMA documentation was relied upon as a basis for negotiating syndicated loans by all law firms surveyed, so the Leveraged documentation is likely to contain auditor clauses.**

44. **The reasons for including auditor clauses mainly include reflecting market practice, offering familiarity to (often international) lenders and ensuring high quality of audit of financial covenants.**

45. **The practice for bilateral loans seems similar to that for syndicated loans, so it is likely that auditor clauses do not appear in Investment Grade documentation and may appear in Leveraged agreements.**

3.2.4 Ratings Agencies

46. The Competition Commission survey obtained valuable information from the three main credit ratings agencies: Fitch, Moody's and Standard and Poor's (S&P). Each was asked about which companies in the FTSE 350 they provide ratings for and the extent to which audited accounts and auditors' identity influence the ratings they supply. These questions were not asked in the context of clauses in loan agreements, and they were not asked to comment on such clauses in particular. The agencies stated that they use information in the audited accounts and the additional documentation provided by the agencies indicated that such information is crucial. Moody's said that information in the audited accounts was important, but was not the only source of information in its rating process.

47. S&P supply ratings for 91 of the FTSE 350 (but did not, in their reply, report which ones). Their Analytical Methodology document states that they rely on companies' audited financial statements and 'the inherent checks and balances in the financial reporting process', but S&P also stated that '*The identity of a company's auditor has no bearing on Standard & Poor's analysis*'. S&P's Analytical Methodology notes that in the context of delays in filing financial reports, restatements of financial statements, material weaknesses in financial statements and related investigations, such issues lead to other adverse results, including among other things, auditor changes, and that the impact of which must be closely evaluated in the ratings process.

48. Responses of Fitch and Moody's, however, both indicate that auditor identity can potentially influence the credit rating decision. Moody's said that because audited accounts are an important source of information, the adequacy of resources, experience and independence of the auditor must be sufficient. In the vast majority of cases, the identity of the auditor is not a concern, but in a very small number of

cases, it has had concerns about the abilities of the chosen auditor. They also provided details of the firms in the FTSE 350 that they provide ratings for, as shown in Table 11 below.

Table 11 Responses of Ratings Agencies			
	Fitch	Moody's	Standard & Poor's
No. of ratings in FTSE 350	66	81	91
No. sub-Investment Grade	8	15	N/A
Does auditor identity affect analysis?	Yes	Yes, for minority of cases	No
Do ratings change after auditor switch	Not aware of any	Not aware of any	No

Note: Fitch data accurate as of 20 April 2012.

49. Moody's stated that audited accounts are an important information source and that EU credit rating regulation requires information used by rating agencies to be of sufficient quality and from reliable sources. Moody's noted that in a small minority of cases, the identity of the audit firm is important, since the incumbent might not be sufficiently reliable, independent or well-resourced to perform the audit role adequately. Moody's also stated that a lack of satisfaction with the auditor's level of capability and/or independence may result in withdrawal of a rating or a refusal to provide one in the first place. This is in accordance with Moody's policy that '*employees must refuse to provide a rating when there is a lack of reliable data, or the quality of information is not satisfactory or raises serious questions as to whether Moody's can provide a credible rating*' and with their policy of withdrawing ratings where the information to support the rating is insufficient to effectively assess the creditworthiness of the company or obligation.

50. It is important not to overstate the importance of this issue, since Moody's were not aware of any FTSE 350 ratings change in the last three years and it is not normally an issue for concern; however, they did point out that '*there are circumstances where the reliability of the audit firm could have an impact on Moody's decision to rate or maintain an existing rating*.'

51. Fitch's response discussed a hypothetical case of a very small audit firm auditing a very large company to illustrate that in principle, auditor size and capability does matter, though it acknowledged the difficulty of defining procedures and policies around this issue. Fitch then noted that in practice, auditor identity would be discussed at a rating committee meeting and judgement exercised. In its rating criteria, Fitch discussed an 'asymmetry' surrounding accounting and audit integrity (as part of corporate governance issues more generally), pointing out that where they are deemed adequate or strong they have no impact, but where there are perceived deficiencies, these may result in a negative impact on ratings. Fitch's rating criteria also state that where financial statements based on either IFRS or US GAAP are not available, its choice of whether to rely on local GAAP accounts depends partly on the quality of the auditor.

52. Although the tone of the correspondence implied that auditor identity might not be a major issue in practice, in principle, it is clearly important for two of the three agencies. There is no suggestion, however, that audit firms immediately outside the Big 4 would be a cause for concern. Furthermore, the responses suggested that in

itself, a change in auditor would not have much impact upon ratings (though the factors associated with the switch might).

Key Findings:

53. **Ratings agencies provide ratings for under a third of FTSE 350 companies, at least 17 of which are rated below Investment Grade (based on Fitch and Moody's data).**

54. **Auditor identity potentially affects ratings analysis for two of the three agencies.**

55. **Auditor switching *per se* seemingly has little impact on ratings.**

4. Discussion and Further Issues

56. The significance of the transactions involved in the syndicated loan market and the well-known use of financial covenants in lending agreements should make it unsurprising that lenders and ratings agencies are concerned about the size, capabilities and independence of auditors of the borrower's financial statements to some degree. It is clear from the US analysis that syndicated loan agreements routinely include clauses relating to the identity of the auditor.

57. The predominant finding of the Competition Commission's survey of participants in the syndicated loan market is the importance of the LMA documentation. It seems that the largest firms' agreements would not typically contain clauses specifying which auditors borrowers should employ.

58. Determining precisely when the Leveraged documentation is used is difficult since the definition of a leveraged syndicated loan is itself ambiguous and even where it is used synonymously with sub-investment grade loans, this does not necessarily mean that companies with sub-Investment grade ratings will have their loans based on the Leveraged documentation.

59. On the one hand, the fact that few FTSE 350 companies would have their agreement based on the Leverage documentation with an auditor clause in the agreement (though ratings agencies' responses coupled with some of the banks' responses suggested that some might) would suggest that this potential barrier to entry to the audit market for these firms is not as serious as first thought. On the other hand, although there have been few changes in policy over the last five years, any move by the LMA to include such a clause in the Investment Grade documentation would create a systemic change, potentially making such clauses almost universal.

60. An important question is: what drives the presence/absence of these clauses in the LMA documentation in the first place. Some of the comments in the responses suggested that one of the reasons that many contracts *do not* include these clauses is because of the expectation that large listed firms would already have a Big 4 auditor. The high Big 4 concentration in the FTSE 350 therefore seems partly responsible for the absence of these clauses and it might be inferred that a lack of concentration could lead to an increase in these clauses (though this is not supported by any data).

61. For the Leveraged LMA documentation, which does contain a clause that seems to remain in many contracts (despite being optional), a possible factor is that, as found

in US studies (e.g. Yago and McCarthy, 2004), pricing grids in lending agreements are often linked to accounting ratios (rather than bond ratings, which may not exist for these firms). If this is the case, in addition to the importance of the covenants discussed by the legal advisors' responses, the quality of the accounting information has direct cash flow implications for lenders, making the perceived quality of the auditor especially important.

62. The extent to which the US equivalent of the LMA includes auditor clauses in standard documentation (and the extent to which this is used by market participants) is unclear. The US equivalent of the LMA – the Loan Syndications and Trading Association (LSTA) – produces some standard documentation, though this is only available to members (or to non-members at a cost of $1000). The LSTA Credit Agreement Guide includes a standard term stating only that the financial statements should be provided, 'all reported on by [✂] or other independent public accountants of recognized national standing', implying that the incumbent auditor is inserted. However, closer inspection of actual US lending agreements revealed that auditor clauses are not limited to sub-Investment Grade ratings for US companies. For example, an agreement for a loan to Harris Corporation[4] in 2008 (at that time rated Baa1 by Moody's) included a clause that borrowers should supply 'a report and opinion of Ernst & Young LLP, Deloitte & Touche USA LLP, PricewaterhouseCoopers LLP, KPMG LLP or another independent certified public accountant of nationally recognized standing reasonably acceptable to the Required Lenders.'

63. Despite searches of the literature and reference to modern banking and finance texts, it has not been possible to ascertain whether UK firms will be affected by these US practices because even where UK firms wish to raise finance denominated in US dollars, Eurodollar loans may be obtained in London. That is, UK firms may not necessarily come into contact with US banks and therefore US lending agreements to raise dollar denominated loan finance, even though for very large transactions, a US bank may be lead arranger for the syndicate. This issue may be worthy of further investigation with practitioners and those involved directly in the market.

References

Bank of England (2012) *Trends in Lending*, July.

Hinks, G. (2011) "Restrictive Clauses and the Loch Ness Monster", *Accountancy Age*, February 4.

Mansi, S., Maxwell, W. and Miller, D. (2004) "Does Auditor Quality and Tenure Matter to Bond Investors? Evidence from the Bond Market" *Journal of Accounting Research*, 42(4):755-793.

Pittman, J. and S. Fortin (2004) "Auditor Choice and the Cost of Debt Capital for Newly Public Firms", *Journal of Accounting and Economics*, 37: 113-136.

Saunders, A. and Steffen, S. (2011) "The Costs of being Private: Evidence for the Loan Market", *Review of Financial Studies*, 24(12): 4091-4122.

Sufi, A. (2007) "Information Asymmetry and Financing Arrangements: Evidence from Syndicated Loans", *Journal of Finance*, 62(2): 629-668.

Yago, G. and McCarthy, D. (2004) "The US Leveraged Loan Market: A Primer", *Milken Institute Working Paper*.

[4] Harris Corporation is a US-based international communications and information technology company listed on the NYSE with revenue in 2011 of almost $6 billion.

Annex 1

Briefing paper on the use of a definition of 'auditors' in bank loan facility agreements

Summary

1. This paper describes the type of company likely to have a loan facility that restricts its choice of auditor, focusing particularly on FTSE 350 constituents. The observations in the paper are based on a CC staff member's experience of the UK loan market from previous employment at a UK bank.

2. Loan facility agreements for investment-grade borrowers are very likely to be based on the Loan Market Association (LMA) investment-grade document, which does not contain an auditor definition. Loan facility agreements for private-equity-backed leveraged buyouts (LBOs) are very likely to be based on the LMA leveraged loan document, which does contain an auditor definition. Between these ends of the credit spectrum it is difficult to be definitive because loan terms are negotiated between a borrower and its banks. The style of loan facility agreement for FTSE 350 companies which do not have an investment-grade credit rating will be influenced by the size and creditworthiness of the company, the purpose of the loan facility and any precedent documents.

3. The auditor definition that may be contained in a loan agreement is not perceived as contentious by bankers or banking lawyers and its inclusion (or otherwise) in a loan agreement is rarely a heavily negotiated point. When an auditor definition is included banks are generally willing to expand the definition to include other firms in addition to the Big 4 if requested.

Loan Market Association template documents

4. The LMA template investment-grade loan facility agreement (the LMA investment-grade document) was developed to facilitate the negotiation of loan facility agreements for investment-grade companies. The document does not define who a borrower may use as its auditors.

5. The LMA template leveraged loan facility agreement (the LMA leveraged document) was developed to facilitate the negotiation of loan facility agreements for private-equity-backed LBOs (and not for non-investment-grade corporate lending). The document defines who a borrower may use as its auditors as follows: 'Auditors means [any one of PricewaterhouseCoopers, Ernst & Young, KPMG and Deloitte and Touche] or such other firm approved in advance by the Majority Lenders.' The reference in the above definition to 'Majority Lenders' means that approval to use an alternative auditor would need to be given by lenders whose aggregate commitments in the loan facility are at least 66⅔ per cent of the total loan commitments. In relation to private-equity-backed LBOs, the author's experience was that a request from a borrower to include other major audit firms in the definition would rarely be contentious.

6. The LMA template documents are widely used as the starting point for negotiating syndicated loan facility agreements, although there is no requirement that the LMA templates should be used. Advantages for borrowers and banks of using the templates include:

(a) avoiding spending time drafting loan agreements from scratch;

(b) avoiding negotiating standard 'boilerplate' clauses; and

(c) giving confidence to underwriting banks that the form of the loan agreement (but not necessarily to commercial terms) will be acceptable to banks looking to participate in the loan syndication.

7. The LMA working group which drafted the LMA investment-grade document included banks, lawyers and the Association of Corporate Treasurers (ACT) which represented borrowers' interests. As a consequence of the ACT's involvement, the LMA investment-grade document is considered to be generally acceptable to banks and borrowers.

8. The LMA working group which drafted the LMA leveraged document had no representation on behalf of borrowers because private equity firms tend to prefer to negotiate their own deals. As a consequence the LMA leveraged document does not have the same degree of 'buy-in' from borrowers as the LMA investment-grade document. While the template is widely used as a starting point, leveraged loan agreements are generally more heavily negotiated than investment-grade loan facilities.

Loan agreements for FTSE 350 companies

How widely used are syndicated loans?

9. Most companies in the FTSE 350 or with loan facilities in excess of £30 million, borrow in the syndicated loan market or have club facilities. Club facilities are small syndicates comprised mainly of relationship banks. These arrangements are preferred to bilateral facilities because:

(a) the loan exposure is divided between a number of banks;

(b) banks do not want excessive exposure to a single borrower;

(c) borrowers are more aware (post-Lehman) that a bank may default and that there is a risk in having only one banking relationship;

(d) borrowings are on common terms and are therefore easier for a borrower to manage; and,

(e) there is less administration for the borrower as the agent bank handles payments to and from the banks and distributes financial information to the lenders.

Investment-grade document or leveraged document?

10. There are 67 companies in the FTSE 350 that have an S&P investment-grade credit rating.[5] Loan facility agreements for these companies are very likely to be based on the LMA investment-grade document, which does not contain an auditor definition.

11. There are 13 companies in the FTSE 350 that have an S&P sub-investment-grade credit rating[6].

[5] Source: Bloomberg.

12. The author's view is that the main factors that determine whether a non-investment-grade FTSE 350 company is likely to have a loan agreement based more on the LMA investment-grade document or on the LMA leveraged document, are as follows:

(a) For FTSE 350 companies, the starting point for loan documentation is likely to be the LMA investment-grade document. As noted in paragraph 5, the LMA leveraged document was developed for private-equity-backed LBOs, not for listed companies. For those companies whose credit quality is considered to be weak, or when a company's financial leverage is rising because it is increasing its borrowings to finance a sizable acquisition, banks may base the loan agreement on the LMA investment-grade document but include some provisions from the LMA leveraged document. Such provisions would probably relate to credit matters, for example, financial covenants, other undertakings (such as restrictions on acquisitions or disposal of assets) and information reporting. It is less likely that the auditor definition would be included in the loan agreement in these circumstances as a FTSE 350 company is likely already to be using a Big 4 firm.

(b) An exception to using the LMA investment-grade document might occur when the company has been a private equity backed LBO that has undertaken an initial public offering (IPO) and still has relatively high financial leverage. In these circumstances, the loan facilities may be based on the precedent leveraged loan agreements from pre-IPO, or the banks may pre-agree certain amendments that will become effective upon the IPO occurring. The focus in these cases is usually on pricing (the interest margin), the frequency of the financial reporting requirements and credit-related matters. The auditor definition is less likely to be amended because it is not perceived as contentious or restrictive in practice, because the company has no intention or wish to use an auditor that was not previously permitted.

13. Corporate banking tends to distinguish between 'large' companies and 'mid-market' companies:[7]

- For large companies,[8] the starting point for loan facility agreements will be the LMA investment-grade document.

- For mid-market companies,[9] the more creditworthy companies (which have modest leverage and a stable business) are likely to use the LMA investment-grade document. The loan facility agreements for unlisted and more highly financially leveraged companies may be based on the LMA leveraged document, especially when the loan facilities are being put in place for a significant acquisition. The author estimates that roughly half of mid-market borrowers have loan facility agreements that contain an auditor definition. The author's view is that a request from a company to include other major audit firms in the definition of auditors would rarely be contentious. Expanding the definition to permit 'auditors of international standing and repute' is also unlikely to be a problem.

---

[6] Source: Bloomberg.

[7] These terms do not have precise definitions and how they are applied will depend on each bank's market segmentation.

[8] Large companies are assumed here to be listed companies with turnover in excess of £1 billion.

[9] Mid-market companies are assumed here to be listed and unlisted companies with turnover in the range of £250 million to £1 billion and borrowings in the range of £30 million to £750 million.