

STATUTORY AUDIT SERVICES MARKET INVESTIGATION

Notice of provisional findings made under Rule 10.3 of the Competition Commission *Rules of Procedure*

1. On 21 October 2011, pursuant to section 131 of the Enterprise Act 2002 (the Act), the Office of Fair Trading referred to the Competition Commission (CC) for investigation and report the supply of statutory audit services to large companies in the UK.¹

Provisional findings

2. The Market Reference Group (the Group) appointed to consider this reference has provisionally found, on the statutory questions it has to decide pursuant to section 134(1) of the Act, that there are features of the relevant market(s) that, either alone or in combination with each other, prevent, restrict or distort competition such that there is an adverse effect on competition (AEC).
3. The Group has provisionally identified the following as relevant features of the market:
 - (a) Barriers to switching:
 - (i) companies face significant hurdles in comparing the offerings of an incumbent firm with those of alternative suppliers other than through a tender process;
 - (ii) it is difficult for companies to judge audit quality in advance due to the nature of audit; and
 - (iii) companies and firms invest in a relationship of mutual trust and confidence from which neither will lightly walk away as this means the loss of the benefits of continuity stemming from the relationship.
 - (b) Company management face significant opportunity costs in the management time involved in the selection and education of a new auditor.
 - (c) Mid Tier firms face experience and reputational barriers to expansion and selection in the FTSE 350 audit market.
 - (d) Auditors have misaligned incentives, as between shareholders and company management, and so compete to satisfy management rather than shareholder demand, where the demands of executive management and shareholders differ.
 - (e) Auditors face barriers to the provision of information that shareholders demand (in particular from the reluctance of company management to permit further disclosure).

¹ Under the terms of reference, 'statutory audit services' means an audit conducted by a person appointed as auditor under Part 16 of the Companies Act 2006, and 'large companies' means companies that may be listed from time to time on the London FTSE 100 and FTSE 250 indices.

4. The Group has provisionally found that the features listed in (a) to (c) above give rise to an AEC, either individually or in combination, by weakening a company's bargaining power outside the tender process. Incumbent auditors therefore face less competition for their ongoing engagements than they would were the company more willing to switch thereby reducing rivalry. The features listed in (d) to (e) above give rise to an AEC as auditors, by being insufficiently independent from executive management and insufficiently sceptical in carrying out audits, compete on the wrong parameters for appointment as statutory auditor and fail to respond to the demands of shareholders.
5. As a result of the AEC, the Group has provisionally found that companies are offered higher prices, lower quality and less innovation (and differentiation of offering) than would be the case in a market without the features, and shareholders and investors (as potential future shareholders) have demand which is unmet.
6. The Group's reasons are set out in full in the provisional findings report, which will be published shortly, and are summarized in the summary of the provisional findings report which we have published today (see note (i) below).

Next steps

7. The Group now invites interested parties to submit reasons in writing as to why these provisional findings should or should not become final (or, as the case may be, should be varied).
8. These reasons should be received by the Group no later than **21 March 2013**.
9. The Group will have regard to any such reasons in making its final decisions on the statutory questions.
10. The Group is also publishing a notice of the actions which it considers might be taken by the CC to remedy the adverse effects provisionally identified, comments on which should be received in writing no later than **18 March 2013**.

(signed) LAURA CARSTENSEN
Group Chairman
22 February 2013

Notes

- (i) A copy of this notice and the summary of the provisional findings report have been placed on the CC website today. The CC proposes to publish the provisional findings report on its website shortly. The published version of the provisional findings report will not contain any information which the Group considers should be excluded from the report, having regard to the three considerations set out in section 244 of the Act.
- (ii) Comments should be made in writing to:

Inquiry Manager, Audit Market Investigation
Competition Commission
Victoria House
Southampton Row
London
WC1B 4AD

Or by email to: auditors@cc.gsi.gov.uk.