

STATUTORY AUDIT SERVICES MARKET INVESTIGATION

Notice of possible remedies under Rule 11 of the *Competition Commission Rules of Procedure*

Introduction

1. On 21 October 2011, the Office of Fair Trading (OFT) referred the supply of statutory audit services to large companies in the UK to the Competition Commission (CC) for investigation. The reference was made under [sections 131](#) and [133](#) of the Enterprise Act 2002 (the Act).
2. In its provisional findings, a summary of which was published on 22 February 2013, the CC has provisionally found an adverse effect on competition (AEC) within the meaning of [section 134\(2\)](#) of the Act. Section 13 of the provisional findings identifies those features that give rise to the AEC and the resulting detrimental effects on customers.
3. Where the CC finds that there is an AEC, it has a duty, under [section 134\(4\)](#) of the Act, to decide whether it should take action and/or whether it should recommend others to take action to remedy, mitigate or prevent the AEC or any resulting detrimental effects on customers. If the CC decides that such action is appropriate it must also decide what action should be taken and what is to be remedied, mitigated or prevented. In deciding these questions the CC has a duty to achieve as comprehensive a solution as is reasonable and practicable to the AEC and any resulting detrimental effects on customers, as set out in [section 134\(6\)](#) of the Act.
4. This Notice of possible remedies (the Notice) sets out and invites comments on possible actions which the CC might take in order to remedy, mitigate or prevent the AEC or any resulting detrimental effects on customers. Prior to deciding what, if any, action should be taken and by whom, the CC will take into account all comments received in response to this Notice and consult further. The parties to this investigation and any other interested persons are requested to provide any views in writing, including any suggestions for additional or alternative remedies that they wish the CC to consider, by 18 March 2013.

Provisional findings on the AEC

5. In summary, we have 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;
 - (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
6. We 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.²

Criteria for consideration of remedies

7. When deciding whether any remedial action should be taken and, if so, what that action should be, the CC will consider how comprehensively the possible remedy options—whether individually or as a package—address the AEC and/or its resulting detrimental effects on customers, and whether they are reasonable and practicable.³ The CC will assess the extent to which different remedy options are likely to be effective in achieving their aims, including whether they are practicable and when they are likely to have effect (ie whether they are timely).⁴ The CC will be guided by the principle of proportionality in ensuring that it acts reasonably in making decisions about remedies. The CC will therefore assess the extent to which different remedy options are proportionate, and in particular it will be guided by whether a remedy option:
- (a) is effective in achieving its legitimate aim;
 - (b) is no more onerous than needed to achieve its aim;
 - (c) is the least onerous if there is a choice between several effective measures; and
 - (d) does not produce disadvantages which are disproportionate to the aim.⁵
8. The CC may also have regard to the effects of any remedial action on any relevant customer benefits, as defined in [section 134](#) of the Act, arising from a feature or features of the market giving rise to the AEC.⁶

¹ Summary of provisional findings, paragraph 31.

² Summary of provisional findings, paragraph 32.

³ CC [Guidelines for market investigations, consultation draft](#) (CC3 revised), June 2012, paragraph 322.

⁴ Ibid, paragraphs 327 & 330.

⁵ Ibid, paragraphs 335–337.

9. In the event that the CC reaches a final decision that there is an AEC, the circumstances in which it will decide not to take any remedial action are likely to be rare but might include situations in which no practicable remedy is available, where the cost of each practicable remedy option is disproportionate to the extent that the remedy option resolves the AEC, or where relevant customer benefits accruing from the market features are large in relation to the AEC and would be lost as a consequence of any appropriate remedy.⁷

Implementation

10. As already noted,⁸ where the CC reaches an AEC finding it will need to decide on whether action should be taken by itself, or recommended for action by others. The CC may take action itself by making an order or accepting undertakings. In market inquiries the CC normally acts through orders rather than undertakings given the multiplicity of parties involved.
11. Recommendations may be appropriate where other bodies have jurisdiction and/or where action would be an effective part of a sectoral regulator's responsibilities. The CC would expect to work closely with the Financial Reporting Council (FRC), the relevant sectoral regulator for audit and financial reporting, in considering appropriate remedial action and means of implementation.
12. In certain instances, implementation of remedial action may incorporate elements of both recommendation and direct action by the CC. This may be appropriate where, for example, the CC could take action itself but the more efficient outcome would be for the regulator or other authority responsible for the area to take action based on the CC recommendation. In this circumstance, the CC may make a recommendation but reserve power to act by undertaking or order if the relevant regulator or authority was unable to reach agreement with the parties affected on the specified issue.
13. In addition to the interaction of possible CC remedies with existing UK regulatory institutions or measures, the possible remedies may also interact with proposals currently being discussed by the EU regarding the external audit market. Under the general principle of the primacy of EU law, particular CC measures will be subject to any EU regulations/directives that emerge in this area. If the final outcome of EU proposals is not known by publication of the CC's final report, then remedies set out in the report may be subject to material change.

Possible remedies on which views are sought

14. We are seeking views on the remedies set out in this Notice and any other remedies which parties to the investigation or other interested persons consider would effectively and proportionately address (ie remedy, mitigate or prevent) the AEC or resulting detrimental effects identified in the provisional findings.
15. In order to focus our analysis during the remedies phase of our investigation we have distinguished in this Notice between those remedies which we believe are likely to be appropriate (ie effective and proportionate) and those which we believe are not. At this stage we are only minded to consider further those remedies in the first category but we will consider further the remedies in the second category and other proposals

⁶ See paragraphs 91 & 92 for a discussion of relevant customer benefits.

⁷ [Guidelines for market investigations, consultation draft](#), op cit, paragraph 347.

⁸ Paragraph 3 above.

if parties are able to provide relevant evidence and reasoning as to why these alternatives would be appropriate.

16. We first set out, in paragraphs 17 to 64, those remedies which we believe are most likely to be effective and which we are therefore exploring further. We invite views on the most appropriate means of specifying and implementing these remedies and the effectiveness and proportionality of these measures. We then set out in paragraphs 65 to 88 our reasoning regarding those remedies which we believe are not likely to be effective and/or proportionate and which, therefore, we are not currently minded to consider further.

Remedies we are exploring

17. In this section we consider seven remedies which are designed to address the AEC. These are:
 1. mandatory tendering;
 2. mandatory rotation of audit firm;
 3. expanded remit and/or frequency of Audit Quality Review team (AQRT)⁹ reviews;
 4. prohibition of 'Big 4 only' clauses in loan documentation;
 5. strengthened accountability of the External Auditor to the Audit Committee (AC);
 6. enhanced shareholder-auditor engagement; and
 7. extended reporting requirements.

We discuss each of these possible remedies in turn.

Remedy 1: Mandatory tendering

18. This remedy would ensure that companies assess the quality, price and innovation of their existing auditor, compared with other options, in a structured manner on a more frequent basis.
19. We are aware that under the FRC's recently revised UK Corporate Governance Code, FTSE 350 companies should put the external audit contract out to tender at least every ten years or explain why they have not done so.¹⁰ We consider that a greater frequency of tendering may be required to address effectively the AEC we have found.
20. We consider that the optimal period of tendering will reflect a balancing of the costs of the tender process and the benefits to be obtained from increased frequency of tendering. We propose two options of tender periods for comment, namely five and seven years, but are open to considering other periods if supported by relevant evidence. We envisage that under our proposed system, tendering significantly before the end of the set period would be relatively unusual.

⁹ The Audit Quality Review team replaced the Audit Inspection Unit in the FRC's revised structure (of 2 July 2012).

¹⁰ Financial Reporting Council, 'The UK Corporate Governance Code' (September 2012), paragraph C.3.7.

21. We propose that the increased frequency of tendering should have mandatory force and we do not currently favour a comply or explain provision as this may undermine compliance with this remedy.
22. We also propose that tendering should be conducted on an 'open book' basis in which tendering firms would have access to relevant information from the company and the files of the incumbent auditor to enable the firms to have an accurate understanding of the company's control environment and all significant audit issues. Such an arrangement would go beyond current regulations¹¹ in which a new auditor can obtain requested information from an outgoing auditor. An 'open book' basis should reduce the risks of switching following a tender and may also reduce the costs of tendering.
23. We consider that this proposed remedy would address the AEC by:
- (a) overriding current barriers to more frequent tendering by companies and increasing the possibility of switching which would increase companies' bargaining power and the incentives for auditors to compete;
 - (b) providing greater opportunities for non-Big-4 audit firms to tender for FTSE 350 audits and reducing current barriers to entry and expansion; and
 - (c) reducing the incentives of auditors to compete to satisfy management, rather than shareholder, demand by limiting the influence of management on re-tendering by providing, other than in unusual situations, a settled period of auditor appointment.
24. We note that in tenders analysed in our investigation to date, audit firms have been willing to expend significant resources in mounting tender bids given the infrequency of tenders and the long duration of assignments that could be reasonably expected from a winning bid.¹² We envisage that under a more frequent system of tendering, resources expended by firms in mounting bids and companies in assessing bids would be reduced in view of the greater frequency of tendering and by facilitating provision of information (eg from the prior year audit files) to increase the efficiency and reduce risks of the tender process.
25. We are also considering whether this remedy should be combined with streamlining other regulatory requirements in order to enhance the cost-effectiveness of our remedies package. For example, it might be appropriate to combine this remedy with a change to the current requirements on engagement partner rotation so that these are aligned with the mandatory tender period. This would avoid costs and disruption of rotation mid-term.

Issues for comment 1

26. **Views are invited on the specification, effectiveness and proportionality of this remedy and, in particular, on the following:**
- (a) **What an appropriate time frame for requiring mandatory tendering might be, given the bounds suggested above?**

¹¹ Audit regulation and guidance 3.09 issued by the Institute of Chartered Accountants in England & Wales, the Institute of Chartered Accountants of Scotland and the Institute of Chartered Accountants in Ireland, issued 2008, revised June 2012.

¹² Provisional findings, Appendices 23 and 24.

- (b) Whether and for what reason the measure may be subject to ‘comply or explain’ implementation?**
- (c) How a valid ‘tender’ and its constituents should be defined, including whether and how best to provide access to relevant information on an ‘open book’ basis?**
- (d) What costs and benefits would arise as a result of this remedy?**
- (e) What should be the requirements for phasing in this remedy? For example, those companies with the longest period since last tender may be required to tender first within a specified period.**
- (f) Whether there are any other relevant considerations to be taken into account in evaluating and implementing this remedy?**

Remedy 2: Mandatory rotation of audit firm

- 27. Mandatory rotation requires that after a specified period of time FTSE 350 companies must change their audit firms after a tender process. We consider that increased rotation of audit firms is desirable to ensure greater independence of the audit firm from management and provide the benefit of a fresh approach to the audit of a company.
- 28. We consider that the optimal time frame for mandatory rotation will be based on a judgement which weighs up the benefits of independence and a new firm providing a fresh approach against the potential costs of switching from a firm that has built up experience of auditing the particular company. We consider that this remedy is related to remedy 1 (mandatory tendering) and could be specified as a variant to it. For example, we may envisage a formulation whereby mandatory tendering (as in remedy 1) were required after a number of years, but if the same firm were retained then there would be a back-stop date by which time the firm had to be rotated: this might be after, for example, two tender periods.
- 29. Bearing in mind the above considerations we particularly seek views on rotation periods of seven, ten and 14 years but are open to considering other periods if supported by relevant evidence.
- 30. We consider that rotation of auditors should take place after a tender process conducted on an ‘open book’ basis as specified for remedy 1 (mandatory tendering).
- 31. We consider that this proposed remedy would address the AEC by:
 - (a) realigning the incentives of auditors to compete to satisfy shareholder demand as this may be currently constrained by a desire from the audit firm to maintain the audit for long periods of time and/or an ingrained firm approach to conducting the company’s audit;
 - (b) reducing barriers to non-Big-4 audit firm selection by providing greater opportunities for non-Big-4 audit firms to tender for FTSE 350 audits and reducing current barriers to entry and expansion; and
 - (c) removing (by overriding) current barriers to more frequent tendering by companies. This will increase companies’ bargaining power and increase competition between auditors.

32. In addition, we are considering whether this remedy should be combined with streamlining other regulatory requirements in order to enhance the cost-effectiveness of our remedies package. For example, it might be appropriate to combine this remedy with a change to the current engagement partner rotation requirements such that they are aligned with the tender/switching periods.
33. During the course of our inquiry we have not received any significant evidence to suggest that a FTSE 350 company's choice of audit firm is normally substantially constrained. However, we recognize that there may be valid instances where the choice of audit firm is substantially constrained making it impractical to switch auditor at that time and in such instances we consider there may need to be a mechanism whereby the FRC grants relief from the requirement to switch auditor.

Issues for comment 2

34. **Views are invited on the specification, effectiveness and proportionality of this remedy and, in particular, on the following:**
 - (a) **What an appropriate time frame for requiring mandatory rotation might be, given the bounds suggested above and how this might relate to mandatory tendering periods if this were also to be pursued?**
 - (b) **Should any such measure be subject to a waiver from the regulator (FRC) if a company's choice of auditor was substantially constrained and how would such a waiver operate?**
 - (c) **How a valid 'tender' and its constituents should be defined as a prelude to rotation, including whether and how best to provide access to relevant information on an 'open book' basis?**
 - (d) **What costs and benefits would arise as a result of this remedy?**
 - (e) **What should be the requirements for phasing in this remedy? For example; those companies with the longest period since last rotation may be required to rotate first within a specified period.**
 - (f) **Whether there are any other relevant considerations to be taken into account in evaluating and implementing this remedy?**

Remedy 3: Expanded remit and/or frequency of AQRT reporting

35. This remedy would ensure that FTSE 350 companies had better (ie more frequent, tailored, comparable, transparent) information on the quality of FTSE 350 audits provided by audit firms. This would facilitate comparability of companies' existing auditors with other options.
36. We are aware that currently the FRC's AQRT reports on the performance of audit firms on a periodic basis (ie annually for Big 4 firms, and every two years for other firms) based on a sample of audits of Public Interest Entities. Currently results are reported for all reviews collectively and a subsample of FTSE 350 audit results is not provided. We note that a FTSE 350 company's audit is assessed, on average,

relatively infrequently.¹³ AQRT reports are the only independent assessment of audit quality that is readily available in the audit market.

37. We consider that greater frequency and granularity of AQRT reporting would provide greater transparency of audit quality and more timely and reliable identification of emerging trends and issues. Companies would receive a more frequent company-specific review of their audit but would also benefit alongside shareholders from a more tailored set of publicly available results regarding the performance of all firms in the market.
38. An expanded AQRT reporting remedy could be designed in a number of different ways. We would expect to liaise closely with the FRC to consider the most effective means of enhancing the current reporting system with relevant stakeholders. This might involve changes to both the scope and frequency of the reporting and would be subject to further consultation.
39. We consider that this proposed remedy would address the AEC by:
 - (a) reducing barriers to switching through increasing transparency and providing companies with better information on audit firms' performance on quality in the FTSE 350 audit market. This increases the ability of companies to compare the offerings of suppliers and therefore increases incentives for audit firms to compete on quality; and
 - (b) reducing the role of executive management in the audit process by providing shareholders with more information as to the quality of their company's auditor. This would create a more direct link between auditor and shareholder and encourage audit firms to compete on satisfying shareholder demand.
40. We consider that this remedy might also help to enhance the effectiveness of other remedies designed to facilitate switching.

Issues for comment 3

41. **Views are invited on the specification, effectiveness and proportionality of this remedy and, in particular, on the following:**
 - (a) **How the AQRT's remit should be designed in terms of enhanced scope and frequency. For example;**
 - (i) **How frequently should FTSE 350 company audits be reviewed (and whether this should differ between FTSE 100 and FTSE 250 companies)?**
 - (ii) **Should the AQRT be required to published FTSE 350 results separately from other Public Interest Entity results?**
 - (iii) **Should the AQRT be required to change the scope of its review and if so, how? For example; should the AQRT be required to revisit key audit judgements based on the information then available?**
 - (iv) **How could AQRT reporting be expanded to allow better comparison of Big 4 and non-Big-4 firms?**

¹³ See the provisional findings, paragraph 9.122.

- (b) **How should any expanded remit of the AQRT be funded?**
- (c) **What costs and benefits would arise as a result of this remedy?**
- (d) **Whether there are any other relevant considerations to be taken into account in evaluating and implementing this remedy?**

Remedy 4: Prohibition of contractual clauses in template documents limiting choice to the Big 4 firms

- 42. This remedy would remove a limitation to competition for non-Big-4 firms by removing contractual restrictions on the use of non-Big-4 firms. We are aware that in template leveraged loan documentation (eg that provided by the Loan Management Association), auditors are defined as one of the Big 4 firms. These clauses, which are optional but are often adopted without amendment, effectively mandate the use of a Big 4 audit firm for the duration of the loan agreement. We consider that prohibition of such clauses could, in combination with other remedies, help to address some of the adverse features that we have found in the audit market although it may not by itself have a substantial impact.
- 43. We consider that this proposed remedy would address the AEC by:
 - (a) increasing companies' willingness to switch by providing particular companies with an increased pool of possible auditors.
 - (b) Reducing barriers to entry by removing template restrictions on non-Big-4 firms being retained or selected as auditors and reducing the role of reputation as a barrier to entry for non-Big-4 firms.
- 44. We consider that this remedy may enhance the effectiveness of other remedies designed to facilitate switching.

Issues for comment 4

- 45. **Views are invited on the specification, effectiveness and proportionality of this remedy and, in particular, on the following:**
 - (a) **The range of documents to which this prohibition should be imposed and how the prohibition could be best implemented. For example: are there documents in addition to Loan Management Association lending agreements that this prohibition should cover?**
 - (b) **What costs and benefits would arise as a result of this remedy?**
 - (c) **Whether there are any other relevant considerations to be taken into account in evaluating and implementing this remedy?**

Remedy 5: Strengthen accountability of the External Auditor to the AC

- 46. This remedy would reduce the influence of executive management in the relationship with the external auditor by strengthening the accountability of the external auditors to the AC. We have found that currently the Finance Director (or Financial Controller or equivalent) has an influential role in the conduct of the company's relationship with external auditors notwithstanding the authority of the AC and Audit Committee Chair (ACC) on audit issues. The Finance Director (or equivalent) has a key role in

dialogue regarding scope of audit, fees, reappointment and resolution of audit issues and normally requires a 'no surprises' policy in items taken to the AC, ie prior discussion is required with the Finance Director.¹⁴

47. We consider that in practice the external auditors appear to have a strong reporting line to the Finance Director and a more distant, often mediated, reporting line to the ACC. We consider that the influence of the Finance Director (and executive management more generally) on external auditors should be diminished as far as practicable and the accountability, in practice, of external auditors to the AC should be strengthened.
48. This remedy would require the audit engagement partner (AEP) to report directly to the ACC such that only the AC and the ACC would be able to negotiate audit fees, initiate tenders for audit work, require a replacement of an AEP, authorize the external audit firm to carry out any non-audit assignments or conduct any other major aspect of the external audit relationship. We consider that the Finance Director's role in selection and reappointment of the company's auditors should be limited to the minimum necessary. Much of the day-to-day interaction of auditors with finance staff and the Finance Director during the conduct of the audit would be largely unchanged. However, the ACC would be the first point of contact if a material audit issue arose rather than only being consulted after the Finance Director. In effect, the conduct of reporting relationships should be free of any material influence of the Finance Director on external audit such that the AC/ACC is solely and unambiguously the client of the AEP.
49. We consider that the ACC (and potentially, and to a lesser extent, AC members) would need to commit more time to their roles in order to facilitate this reporting line, otherwise there could be a strong tendency for the audit team to bypass the ACC and to continue reporting to the Finance Director. This would require an appropriate adjustment to the remuneration of these individuals and an appropriate increase in the resources (budget and staff) allocated to AC activities.¹⁵
50. We consider that this proposed remedy would address the AEC by:
 - (a) increasing the influence of the AC on the audit process by aligning external audit resources with the AC's particular responsibility to the shareholders; and
 - (b) increasing the independence of the external auditor from executive management (and reducing the influence of executive management on the audit process).
51. This remedy would realign auditors' incentives with those of shareholders such that auditors are incentivized to compete to satisfy shareholder demand rather than management demand.

Issues for comment 5

52. **Views are invited on the specification, effectiveness and proportionality of this remedy and, in particular, on the following:**
 - (a) **How this remedy could be practically specified and implemented? For example, what change to ACC availability and remuneration would be**

¹⁴ See provisional findings, paragraphs 9.68 & 9.69.

¹⁵ Our intention is not to distort the current collective legal responsibilities of the directors of a company.

necessary for ACCs to take on an enhanced role effectively? How should this measure be specified to avoid circumvention?

- (b) Whether this remedy could be implemented as an extension to the current guidance on the role of the AC? How this could be implemented without affecting the current collective legal obligations of the directors of a company?**
- (c) What costs and benefits would arise as a result of this remedy?**
- (d) Whether there are any other relevant considerations to be taken into account in evaluating and implementing this remedy?**

Remedy 6: Enhanced shareholder-auditor engagement

53. This remedy would seek to address the distortion in demand whereby audit firms compete largely for the demand of executive management because it would enhance the role of shareholders in relation to decisions on the choice of auditor. Currently whilst shareholders vote annually on the appointment of the auditor, they do so with limited information on auditor performance and limited options for change (particularly given the timing of the vote). In practice we found that shareholders have limited influence over the choice of auditor and have limited opportunities to engage with auditors.
54. We propose the introduction of measures that seek to increase shareholder involvement in auditor accountability and reporting. We would expect to liaise closely with the FRC, major FTSE 350 shareholders and shareholder representative groups in shaping a suitable remedy. This would include discussion of components such as changing voting requirements on audit issues and/or changing the possible process of dialogue between shareholders and the ACC, or shareholders and auditors. Options could include:
- (a) Changing shareholder voting requirements to include an option to vote for holding a tender for external audit.
 - (b) Votes to reappoint the audit firm could require an enhanced level of support (ie more than a simple majority) if it was proposed that an auditor should remain in place after a mandatory tender.
 - (c) Requiring the AEP to present directly to shareholders at AGMs (or other open shareholder forums) on the conduct and outcome of the audit.
 - (d) Requiring the ACC to have a dedicated Question and Answer agenda item at AGMs (or other open shareholder forums) in which he/she answered questions directly on audit or financial reporting.
55. We consider that this proposed remedy would address the AEC by incentivizing external auditors to compete to satisfy shareholder demand as the influence of shareholders in the auditor selection decision is increased through:
- (a) providing shareholders with enhanced opportunities to influence auditor reappointment decisions through voting at AGM's;
 - (b) providing shareholders with more information on the audit process and judgements such that they are better able to assess audit quality and, therefore, better able to vote on auditor reappointment decisions; and

(c) as a consequential effect of increasing the influence of shareholders, we consider that this would decrease the influence of management in the auditor selection decision.

56. An enhanced shareholder-auditor engagement remedy could be designed in a number of different ways. We note that consideration needs to be given to ensuring that all shareholders, and not just a subset, have the potential to benefit. At this stage, we have not formed any settled views on these issues.

Issues for comment 6

57. **Views are invited on the specification, effectiveness and proportionality of this remedy and, in particular, on the following:**

- (a) **What are considered to be the most effective means of enhancing shareholder engagement on audit and financial reporting issues?**
- (b) **Suggestions as to how such means could be achieved.**
- (c) **What costs and benefits would arise as a result of this remedy?**
- (d) **Whether there are any other relevant considerations to be taken into account in evaluating and implementing this remedy?**

Remedy 7: Extended reporting requirements—in either the AC's or auditor's report

58. This remedy would override the reluctance of management to disclose information about the audit process and would thereby enhance transparency. This in turn is expected to improve the ability of companies and shareholders to judge audit quality, thus reducing switching costs and improving the ability of shareholders to influence the auditor selection decision.
59. In the course of our inquiry it has become apparent that there is significant institutional investor dissatisfaction with the relevance and extent of reporting in audited financial reports. We are aware that there are ongoing discussions within the industry led by regulatory bodies such as the FRC and International Auditing and Assurance Standards Boards as to whether and how audit reports and financial statements can be enhanced to increase their value to shareholders. We support the broad view for enhanced disclosure and consider that this would help to address adverse effects that we have found.
60. We recognize the ongoing work of the FRC with regard to increasing the value of audit reports to shareholders and we consider that the FRC is best placed as the specialist sectoral regulator to progress these discussions and resolve shareholder concerns.
61. An extended reporting requirement remedy could be designed in a number of different ways. We would need to consider the most effective means of providing shareholders with the information that some demand, whilst recognizing that demand across shareholders is not uniform. At this stage, we have not formed any settled views on these issues and how the CC could best facilitate enhanced reporting.
62. We consider that this proposed remedy would address the AEC by overcoming the reluctance of management to permit further disclosure of information about the audit process, which adversely affects competition by restricting the ability of companies

and shareholders to judge audit quality. We consider that the proposed remedy would:

- (a) afford shareholders more information about audit quality to better exercise their rights at AGMs and otherwise to influence the auditor appointment decision; and
- (b) increase the visibility of audit quality, thus affording companies an opportunity to appraise the quality of audit firms that are not its incumbent auditor, thereby reducing the barriers to switching (by reducing the risks and/or increasing the benefits of switching).

63. This remedy would seek to address barriers auditors face to the provision of information that shareholders demand. If other remedies are likely to address this feature effectively then this would obviate the need for this remedy.

Issues for comment 7

64. **Views are invited on the specification, effectiveness and proportionality of this remedy and, in particular, on the following:**

- (a) **How the CC may best support the FRC in establishing enhanced reporting and whether there are other avenues, including direct measures by the CC, that should also be pursued?**
- (b) **What should be the scope and form of enhanced reporting proposals? For example:**
 - (i) **whether further disclosure should be made via the AC's report or the auditor's report;**
 - (ii) **what the content of the additional disclosure should be. For example, should this be some form of commentary as to how the company's interpretation of the accounting standards compares with the norm; or commentary on the main topics of debate between auditor and management; or something else; and**
 - (iii) **what guidance as to the form of the disclosure should be required.**
- (c) **What costs and benefits would arise as a result of this remedy?**
- (d) **Whether there are any other relevant considerations to be taken into account in evaluating and implementing this remedy?**

Remedies that we are not currently minded to consider further

65. In this section we set out a number of remedies that we currently consider would be ineffective or disproportionate in addressing our provisional AEC and which, accordingly, we are not currently minded to consider further unless evidence and reasoning to the contrary are put to us. We invite views on these remedies, including whether some or all of them should be given further consideration.

66. These potential remedies are:

- (a) constraining non-audit service provision by the auditor;
- (b) joint or major component audit;

- (c) shareholder group responsibility for auditor reappointment;
- (d) FRC responsibility for auditor appointment; and
- (e) independently resourced Risk and Audit Committee.

(a) Constraining non-audit service provision by the auditor

- 67. We considered a remedy whereby the independence of auditors may be increased through restricting the provision of non-audit services by the external auditor.
- 68. We considered two options for increasing independence by restricting non-audit service provision. These were (a) prohibiting the external auditor from supplying all but audit-related work; or (b) recognizing existing restrictions on the supply of non-audit services by external auditors and seeking to tighten these existing regulations by, for example, introducing a limitation on non-audit fee income that may be earned by the auditor as a percentage of the audit fee.
- 69. If audit firms have substantial levels of non-audit work with the same client then, in principle, the prospective loss of such non-audit work could be a possible factor which would impair the independence of auditors from management. The intention of limitations on non-audit work would be to increase the quality of audit judgements as independence from management should be increased if auditors have less ability/ incentive to try to win non-audit work and if management are not in a position to offer or withhold non-audit work to auditors.
- 70. The potential conflict of interest in external auditors providing non-audit services is recognized in corporate governance measures, particularly the operation of ACs, and in professional guidelines. We noted in our case studies¹⁶ that there was significant sensitivity to these issues. Different companies had different views as to what type of, and how much, non-audit work could be carried out by the auditor. Currently there is flexibility in the regulations which allows differences in approach whilst recognizing the potential of large non-audit engagements to impair the independent perspective of auditors.
- 71. In our investigation we found that audit was profitable in its own right and generated comparable margins to other services provided by audit firms. We therefore had no evidence to suggest that audit was a 'loss leader' whose viability was dependent on facilitating non-audit business, which in turn, might undermine the independence of audit.
- 72. We also found in the course of our investigation that providing non-audit services was a key means by which non-incumbent audit firms could provide company management with experience of their expertise and obtain insight to support potential switching of the audit assignment. Prohibition of providing non-audit services (as opposed to limiting the level of such services) may therefore undermine a means of facilitating switching from incumbent auditors.
- 73. Whilst we recognize the potential for the provision of non-audit services to impair the independence of audit, we consider that in the light of our findings in this inquiry to date and existing controls, we are not currently minded to consider significant additional restrictions on the provision of non-audit services by auditors.

¹⁶ Provisional findings, Appendix 2.

(b) Joint or component audit

74. We considered a remedy whereby companies would be encouraged to use joint or major component auditors, with the aim of increasing companies' visibility of audit firms' offerings, such that bargaining power was increased. At this stage we have not formed a view as to whether joint or major component audit has a beneficial effect on independence or not, nor whether it would be likely to reduce barriers to entry to the reference market.
75. We considered that encouragement of joint or component audit would need to be effected either via a requirement or recommendation for firms to have joint (or major component) audits or in combination with other possible remedy options such as mandatory tendering (or rotation). For example, the requirement to tender every X years could be extended to a requirement to tender every X+Y years for those companies with joint or major component auditors.
76. We noted that to date there had been limited appetite for joint or component audit by companies or institutional investors; and that this did not appear to be driven by the regulations (as we found no significant evidence that current regulations were restricting use of major component auditors). Our evidence (albeit limited to date) on this suggests that companies regard joint audit as an added complication and cost which may impair accountability for the audit.
77. We considered that the benefits of imposing a requirement for joint or component audit (eg greater visibility of firms' capabilities) could likely be more effectively achieved through remedy options such as mandatory tendering (remedy 1) and enhanced frequency/remit of AQRT reporting (remedy 3).
78. For these reasons, we are not minded to consider this remedy further.

(c) Shareholder group responsible for auditor reappointment

79. We considered a remedy whereby a group of shareholders would be appointed to select the auditor, with the aim of addressing the provisional AEC through ensuring a direct link between shareholders and auditors which could reduce independence concerns.
80. A group of shareholders would be appointed to represent all shareholders in selecting an auditor (either annually or when there is a tender process). This could be a stronger position for shareholders than having the AC members represent them because the shareholder group would not sit on the board and would therefore not be subject to the pressure of a unitary board. It would also be stronger than the current situation with a shareholder vote on appointment as the shareholder group would have more active involvement in the process (ie be involved in any tender process etc).
81. However, we had a number of concerns about such a remedy, namely that (a) the effectiveness relies on the shareholder group being able accurately to assess auditor options (ie be the expert buyer); (b) in practice if only certain shareholders engaged with this group then it might be that only their interests were represented. At the moment the AC members (and other non-executive directors) are there to represent all shareholders and not a specific sub-set; (c) it is unclear how/whether this would complement or replace existing ACs and (d) such an arrangement would have to overcome incentives for shareholders to freeride on the involvement of others.

82. Given the prospective limitations of the remedy we considered that it would be an inferior substitute for ACs for this function, particularly if ACs are strengthened further in accordance with remedy 5. We are therefore not minded to consider this remedy further.

(d) FRC responsible for auditor appointment

83. We considered a remedy whereby the FRC would be required to appoint auditors for FTSE 350 companies to ensure that shareholder interests were appropriately represented and/or auditor-management familiarity was not a factor in auditor appointment decisions.
84. We considered that quality may be enhanced if independence concerns were addressed, although a lack of familiarity of the FRC with the particular circumstance of individual companies might result in ineffective appointments. Such a role would also require a major expansion in the activities of the FRC .
85. We therefore considered that other remedy options such as strengthened accountability of the external auditors to the AC (remedy 5) were likely to be more effective. For these reasons, we concluded that unless other remedy proposals proved unworkable or ineffective then we would not consider this particular option further.

(e) Independently resourced Risk and Audit Committee

86. We considered a remedy whereby Risk and Audit Committees were mandated to procure independent advice on the conduct of the audit. This might be considered analogous to pension fund trustees receiving independent advice on how pension fund investment managers have performed. This could address the provisional AEC as ACs would be better able to assess the judgement and quality of detailed work of the auditors and would increase the independence of the auditors from management.
87. However, we noted that there was nothing to prevent ACs currently from obtaining such advice if they thought this was necessary and yet there were few occasions where this was done. We also considered the costs of such a measure and are wary of imposing additional layers of regulation if other more cost-effective measures are available. We considered that remedy 5 which strengthens the accountability of the external auditors to the AC was likely to be a more cost-effective option in strengthening the resourcing of the AC and incentivizing auditors to compete to satisfy shareholder rather than management demand. For these reasons we are not minded to consider this remedy further.

Issues for comment 8

88. **The CC invites views on all these possible remedies which we are not minded to consider further and on any other possible remedies that we have not included in this Notice which interested respondents consider may be effective in addressing the AEC we have provisionally found. Where respondents are of the view that these remedies could be effective, they are asked to submit evidence to support their views and in particular provide views of the costs and benefits of the measures and any other relevant factors that they consider significant to the evaluation of the measures in addressing the AEC we have provisionally identified.**

Packages of remedies

89. As part of our assessment, we will consider implementation of remedial measures as a package of remedies. and the possible interaction of measures in such a package. We seek to implement packages of remedies that are mutually reinforcing in their effect and facilitate a comprehensive solution to the AEC.

Issues for comment 9

90. **Views are invited as to whether any particular combinations of remedy options would be likely to be effective in addressing the AEC we have provisionally found. Views are also sought as to whether there are any particular combinations of remedies which are likely to interact adversely in reducing effectiveness or otherwise lead to undesirable outcomes.**

Relevant customer benefits

91. The CC may also have regard to the effects of any remedial action on any relevant customer benefits within the meaning of [section 134\(8\)](#) of the Act arising from a feature or features of the market giving rise to the AEC. Relevant customer benefits must comprise one or more of: lower prices, higher quality or greater choice of goods or services or greater innovation in relation to such goods or services. Relevant customer benefits must also clearly result from one or more features and be unlikely to have come about absent the feature or features concerned.
92. If the CC is satisfied that there are relevant customer benefits deriving from a market feature that also has adverse effects on competition, the CC will consider whether to modify the remedy that it might otherwise have imposed or recommended. When deciding whether to modify a remedy, the CC will consider a number of factors including the size and nature of the expected benefit and how long the benefit is to be sustained. The CC will also consider the different impacts of the features on different customers:
- (a) It is possible that the benefits are of such significance compared with the effects of the market feature(s) on competition that the CC will decide that no remedy is called for. Given, however, that the CC will have found adverse effects on competition this is not likely to occur frequently.
- (b) Alternatively, the CC, may choose a different remedy. In this situation, the CC will have to weigh the disadvantage of a less effective remedy to the competition problem against the benefits that result from the feature concerned.

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93. **Views are invited on the nature, scale and likelihood of any relevant customer benefits within the meaning of the Act and on the impact of any possible remedies on any such benefits.**

Next steps

94. The parties to this investigation and any other interested persons are requested to provide any views in writing, including any suggestions for additional or alternative remedies that they wish the CC to consider, by 18 March 2013 either by email to auditors@cc.gsi.gov.uk or by writing to:

Inquiry Manager
Statutory Audit Investigation
Competition Commission
Victoria House
Southampton Row
LONDON
WC1B 4AD

95. If necessary, the CC may publish a supplementary notice requesting views on particular issues on remedies that emerge from consultation (see also Note below).

(signed) LAURA CARSTENSEN
Group Chairman
22 February 2013

Note: This Notice is given having regard to the CC's provisional findings, a summary of which was published on 22 February 2013. The parties to the investigation or other interested persons have until 21 March 2013 to respond to those provisional findings. In the light of any responses by the parties or by other interested persons, the CC's findings may change and the CC may consider other possible remedies, if appropriate.