AUDIT MARKET INVESTIGATION

The framework for the CC's assessment and revised theories of harm

Introduction

1. This working paper sets out the CC's proposed framework for the assessment of competition in the supply of audit services to FTSE350 companies. In developing this framework we recognized the need to understand the economic function of audits and their regulation in considering: *(a)* how weak competition in the supply of audit services might affect the product and service provided to FTSE 350 companies; and *(b)* what the consequences of this might be and for whom.

2. This paper is a development of the CC's Issues Statement published in December 2011.[1] In this working paper:

   (a) we set out briefly our understanding of the product or service provided when a statutory audit is carried out, its economic role (ie why and who demands such audit services), why the supply and demand for these services are regulated as they currently are (in particular the requirement for the independent auditing of accounts in accordance with certain specified standards) and we identify further possible principal agent problems created by regulation; and

   (b) against this background, we consider the role of competition. We set out key characteristics of the demand and supply of audit services that may be contributing to the characteristics of the market described in the Issues Statement, we revisit and refine our theories of harm and we consider the possible adverse outcomes that might be present in the market as a consequence of weak competition.

[1] www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/111207_issues_statement_final.pdf.

3. This paper sets out a framework for analysis: detailed analysis and supporting evidence will be presented in further papers.

The audit service and its demand

The audit service mandated by law

4. A statutory auditor must carry out investigations and form an opinion as to: *(a)* whether adequate accounting records have been kept by the company, and returns adequate for their audit have been received from branches not visited by the auditor; *(b)* whether the company's individual accounts are in agreement with the accounting records and returns; and *(c)* in the case of a quoted company, whether the auditable part of the company's directors' remuneration report is in agreement with the accounting records and returns.[2]

5. The auditor must state clearly in the report: *(a)* whether in his or her opinion the annual accounts give a true and fair view of affairs as at the end of the financial year of the company; *(b)* whether in his or her opinion the accounts have been properly prepared in accordance with the relevant financial reporting framework, the requirements of the Act and, where applicable, article 4 of the International Accounting Standards Regulation; *(c)* whether the report is unqualified or qualified; and *(d)* whether there are any matters to which the auditor wishes to draw attention by way of emphasis without qualifying the report.[3]

6. The auditor has a duty of reasonable care in carrying out the audit of the company's accounts. This duty of care is owed to the company as a whole in the interests of its shareholders. No duty is owed directly to individual shareholders. This is because the

[2] www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/law_regulation_wp_final_for_publication.pdf, paragraph 3.42.
[3] www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/law_regulation_wp_final_for_publication.pdf, paragraph 3.39.

shareholders' interests are protected by the duty owed to the company. No duty is owed to creditors.[4]

7. In the remainder of this section we consider the economic role of audit services, ie why there is a demand that such an audit be carried out (regardless of any legal requirement to commission a statutory audit). In the following section we consider why this might be a legal requirement. In this discussion we introduce and explain several relevant concepts including: the principal-agent problem, information asymmetries, misalignment of objectives,[5] moral hazard, and adverse selection.

The economic role of audit services

8. In large companies, shareholders delegate the management of the business to managers, in the form of executive directors. The standard explanation of the demand for audits is that the audit provides *(a)* shareholders with assurance on the reliability of the information required to monitor the performance of that management, and *(b)* management and the Board with a means of signalling to current and potential future investors the quality and reliability of the information the management and the Board provide.

9. We consider these arguments in more detail below. In this context, when we refer to 'management' we primarily mean the senior executive management which includes the CEO (or equivalent) and the Finance Director.

Shareholder demand

10. The shareholder demand for an audit arises from a combination of factors:

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[4] www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/law_regulation_wp_final_for_publication.pdf, paragraph 3.49.

[5] In the economic literature the term 'conflict of interest' is often used to describe a situation where an individual or corporation is able to exploit a position for personal gain. We use instead the term 'misalignment of objectives' because 'conflict of interests' has specific meaning in the regulation of professional and financial services.

(a) shareholder interests may not be aligned with those of managers and managers are better informed than shareholders on the performance of the company managed by them. Managers could act to the detriment of shareholders if their interests are misaligned and there is such information asymmetry; and

(b) shareholders may have an incentive to free-ride on the control on management exercised by other shareholders. The problem is essentially one of coordination: while each shareholder has an interest in shareholders monitoring the performance of the company and its management, none may have sufficient interest individually to justify the time and costs involved. The more fragmented the shareholding, the greater the problem. In these circumstances there is a danger that the interests of large shareholders may be furthered at the expense of smaller ones (large shareholders will individually have more incentive to exercise control and may be able to coordinate their efforts) and/or that shareholders as a whole under-invest in monitoring management.

11. The first of these points is formalized in the principal-agent theory applied to corporate governance. An agency relationship arises when one or more principals engage another person to act on their behalf. The shareholder-management relationship is an example of this. For such relationships to work well, the principal must be able to ensure that the agent acts sufficiently in the principal's best interests. Problems arise where there is both a misalignment of objectives, and there are information asymmetries (typically the agent is better informed than the principal).[6]

12. A misalignment of objectives is the term we use to describe situations where an individual or organization has incentives to exploit a professional or official capacity in some way contrary to the interests of someone to whom it has obligations or duties.

[6] Where interests align, the agent will act in the principal's interests regardless of information asymmetries; where there are no information asymmetries, the principal can effectively supervise the agent regardless of misaligned interests.

13. In the literature these circumstances are said to give rise to two problems, 'moral hazard'[7] and 'adverse selection'.[8]

14. For shareholders, the potential detriment arising from these problems would be poorer returns on that investment arising from their inability to monitor effectively the performance of management, an exposure to dishonest behaviour by management, and an increase in the cost of capital for the company reflecting the effect that this has on the market-wide (rather than company-specific) risks faced by potential investors. For managers the detriments might be lower benefits (see paragraph 18 below). The detriment for the economy more generally would be a misallocation of resources and sub-optimal levels of investment, since in the face of such difficulties, investors may choose not to invest in equities.

15. These problems may be exacerbated by the highly fragmented ownership of shares in FTSE 350 companies. Rarely will one shareholder, or a small group of shareholders, have a controlling interest in the organization. This gives shareholders an incentive to free-ride on the effort made by others in monitoring the activities and performance of management, resulting in a less than desirable amount of effort expended by shareholders as a whole in the oversight of the company and its management.

16. These free-rider problems do not arise with concentrated ownership, since the majority shareholders capture most of the benefits associated with his monitoring

[7] Moral hazard problems arise from shareholders not being able to observe the actions of management—hidden actions—and where managers have the incentive to behave in ways that are undesirable for shareholders. Such problems arise after a shareholder has invested in the company. An example could be an incentive for managers to engage in activities without shareholder approval that have the potential to generate higher returns for the manager but at a greater risk (perhaps not compensated by return) to the shareholder.

[8] Adverse selection problems arise where management is better informed than shareholders and has the opportunity to exploit this to its advantage. The problems arise before a potential investor has invested in a company. For example, potential shareholders may not be in a position to determine whether a company is being well or badly managed.

efforts. In these circumstances, the problem instead may be more one of dominant shareholders exercising control at the expense of minority investors.

17. These problems may be mitigated by the provision of independently verified information that allows shareholders to monitor the activities and performance of managers.

Management demand

18. Management also can benefit from an audit. It amounts to a mechanism by which managers can signal the reliability of the financial reports as a basis for shareholders to assess the performance and integrity of managers. Accordingly, independently audited financial reports can contribute to management establishing a reputation for competence and integrity. Absent such assurance, shareholders might be expected to anticipate the principal-agent risks and factor these into the executive compensation and, as a result, the managers would also suffer losses as a consequence of the inability of shareholders to effectively monitor their performance.

19. The same principal agent problems as those discussed above of a misalignment of objectives, hidden information and hidden actions also exist within corporations. These problems are likely to be exacerbated by the size and complexity of FTSE 350 companies. Auditors in the process of carrying out an audit have contact with many individuals and scrutinize activities across the organization and, as a result, make observations and gain knowledge of the business. Some finance directors have described auditors to us as the ‘eyes and ears’ of senior managers. This is related to the ‘Information hypothesis’ on the demand for audits described in the literature, ie that the independent auditing of financial accounts improves the quality of the information and because the information is more reliable, it is more useful to internal decision-making by management.

20. Accordingly, the management of the company may also gain from the reports that the auditor provides into the functioning of the company. Further, they may benefit from the wider knowledge and experience provided by auditors, for example, of how the company's procedures and practices compare with established best practice.

Why are audits regulated as they are?

21. The existence of the demands described above suggests that auditing would exist absent regulatory requirements, since both shareholders and managers benefit from the provision of and access to independently verified information on the financial performance of the company. Some types of audits are carried out on a voluntary basis, such as environmental audits. We also note, however, that in all developed economies audit is mandatory, which seems to indicate a consensus that the incentives of managers, and shareholders, to commission audits would be insufficient to ensure that social demand for independently audited accounts is satisfied. Given this, we considered why there is a mandatory requirement on companies to buy statutory audits.

22. We consider that regulation requires: *(a)* that the financial statements of certain companies are independently audited and published and *(b)* that the audit is conducted in accordance with certain principles and standards. In particular, for the purposes of this paper, we note that the key features of this regulation are: the requirement for an audit; the duties and responsibilities of the auditor; the duties and responsibilities of management, audit committee and shareholders; and the professional qualifications and conduct of auditors.

23. On this basis, we consider that the principal aims of regulation are to ensure that FTSE 350 company accounts are audited in accordance with accepted standards; that this information is publically available at the end of the financial year; that

auditors provide a specified level of assurance on the reliability of the accounts; that these audits are carried out by firms and individuals who are appropriately qualified; and to promote the independence of the auditor.

24. There appear to be three main arguments for such regulation:

(a) the public good features of published and independently verified financial statements for publically listed companies and the associated risks of free-riding by shareholders;

(b) the positive externalities associated with the preparation and publication of independently verified financial statements; and

(c) the network benefits associated with the preparation of financial statements in accordance with certain principles and standards.

In addition, the carrying out of an audit supplements one principal-agent problem (ie shareholders-managers) with another (shareholders-auditors). Certain regulatory provisions supplemented by professional standards are aimed at ensuring that auditors act in the interests of shareholders. We take these four points in turn.

Public goods and free riding

25. The publication of annual reports and accounts that have been independently verified has features of what are described in the literature as public goods. These are products or services the use of which is both non-excludable and non-rivalrous in that, once created, individuals cannot be effectively excluded from its use and use by one individual does not significantly reduce availability to others. The provision of public goods is often subject to a free-rider problem, ie individuals can make use of a good or service without contributing to its creation. The effect of this could be a sub-optimal level of investment in a product and, in the extreme, a failure of the market so that the good or service is not provided at all.

26. As explained above, in the case of public companies, small shareholders would have an incentive to free-ride on the control on management exercised by others. This would include any investment that other shareholders may make in audit services. The problem is essentially one of coordination: while each shareholder has an interest in an audit being undertaken, none may have sufficient interest to justify its cost. Privately forging the agreement necessary to overcome this coordination problem may be very difficult if not impossible where there is a large number of shareholders. The result could be an underinvestment in the auditing of accounts.

Positive externalities

27. The availability of financial information on the performance of companies in which users can have trust is essential to effective corporate governance and the efficient operation of the financial markets. As such the benefits from the provision of audited accounts go beyond those to shareholders in individual companies. Managers and shareholders of an individual company could not be expected to take account of these positive externalities.

28. The OECD said that effective corporate governance system, within an individual company and across an economy as a whole, contributes to providing the confidence that is necessary for the proper functioning of a market economy.[9] As a result, the cost of capital is lower and firms are encouraged to use resources more efficiently, thereby underpinning growth. When this trust is undermined, lenders and investors are said to lose their appetite for risk, and shareholders to sell their equity, resulting in lost value and reduced availability of capital. The principles of corporate governance of transparency and accountability are said to be crucial to the integrity and legal credibility of our market system.

[9] OECD Corporate Governance and responsibility, foundations for market integrity, 2002.

29. In addition to providing information for participants in financial markets, we consider that the information provided by audits and the discipline on management that results may benefit other stakeholders including customers, employees and suppliers. For example suppliers may use such information to assess the credit worthiness of a customer, and customers to assess the value of any guarantees or after sale commitments. Customers and suppliers may use information provided by financial statements in assessing the case for supplier/client specific investment.

30. We consider these wider benefits to be reflected in the history of audit regulation in the UK. The obligation on most companies to carry out a statutory audit, introduced by Companies Act 1900, is seen to be a *quid pro quo* for the privilege of limited liability for all companies from the smallest SMEs to the largest multinational.

31. The Companies Act 1976 introduced a provision which, for the first time was expressly directed towards the protection of interested third parties. It required an auditor who was removed from post or who resigned to make a statement setting out the relevant circumstances (or confirming that there were no relevant circumstances). This statement is not only to be brought to the attention of the members of the company, but also to the attention of the creditors of the company, and must be deposited at Companies House (and so made public).

32. Due diligence reports, reporting accountant reports and analyst reports also provide financial information. There are not, however, substitutes for published, independently audited financial statements. Due diligence and accounting reports are prepared for particular purposes: due diligence reports are prepared for a potential acquirer of a company or its assets; and reporting accountant reports in preparation for IPOs. The information may also not be widely available outside the company or its advisers. Analyst reports add value by bringing together and analysing various

sources of information. These other types of financial reporting will often be based on or reconciled to the published annual report and accounts or other audit outputs.

Requirement for accounts to be audited in accordance with specified principles and standards

33. The regulation of the provision of statutory audits requires: that auditors provide a specified level of assurance on the reliability of the accounts; that these audits are carried out by firms and individuals who are appropriately qualified; and that auditors comply with certain standard aimed at protecting their independence.

34. That stakeholders can be confident that audited accounts have been prepared in accordance with accepted accounting standards is essential to the trust that they can have in the information provided.

35. Moreover, the more widely understood the particular accounting standard adopted, the more valuable the financial statements. This is a network benefit from compliance with established principles and practices. For example, that auditors are required to comply with certain practices aimed at protecting independence which are widely understood increases the trust that shareholders and other users of audited financial statements can place in their reliability. Given the large number of organizations involved (including providers, companies, shareholders and other users, and professional bodies and regulators), achieving this outcome without regulation could be difficult; another example of a coordination problem.

36. In the 1960s the Rolls Razer collapse and the takeover of Associated Electrical Industries (AEI) by General Electric Corporation (GEC) showed the limitations of the then current auditing arrangements to deal with the wide variations in accounting practices in use at that time. In 1970 the Accounting Standards Steering Committee (later to become the Accounting Standards Committee) was created and it issued

standards for financial reporting in an attempt to combat this problem. The Companies Act 1989 gave the first UK statutory recognition of accounting standards which are defined as statements of standard accounting practice issued by prescribed bodies.

37. For these reasons we consider that a reputation acquired by audit firms for sound judgement in the application of accounting standards will be a key factor in the value of the audit output within the company (including its shareholders) and to the wider market value of audited financial statements.

38. Further, absent regulation, we consider that whilst the shareholders and management could commission audits it could be difficult for management to demonstrate their integrity and that of the auditor they had appointed. In particular, it is unclear that in an unregulated world such audits would be distinguishable from other forms of advertising. This could be seen to be a weakness of environmental auditing. There might also be a perverse effect of signalling to investors that the management was disreputable and needed therefore to demonstrate their integrity. Management might see the cost (financial and in terms of management time) of an audit as insufficient to justify the benefit to it, and would not adequately take into account the benefit to shareholders. Rivalry from companies not commissioning audits (or incurring the relevant costs) might drive out those commissioning audits (this is the adverse selection problem described above at footnote 6).

Supplementary principal-agent problems

39. The requirement for an audit supplements one principal-agent problem ie that of shareholders-managers with another, in particular shareholders-auditor. Auditors (and managers) are better informed than shareholders, for example, on the effort made in carrying out the audit and the degree to which auditors challenge

management. If managers are influential in the appointment of the auditors, there may be an incentive for auditors to direct their efforts to responding to management demand rather than shareholder demand. If shareholders are not involved in the appointment of auditors and/or auditors do not have direct contact with shareholders, there may be no means by which auditors can understand the demands of shareholders.

40. Such problems may again be exacerbated by the fragmented shareholding typical of FTSE 350 companies. The ability or capacity for an individual shareholder to exercise control over the auditor will be limited. In practice, shareholders are not involved in the appointment of auditors and have very limited or no direct contact with the auditors, or say in the audit process.

41. This problem may be mitigated by the role of reputation for professional integrity (ie an integration of personal values such as honesty and diligence with professional skills and expertise) in the demand for audit services. In particular, the value of independently audited financial statements depends on the trust that stakeholders can place in the opinion of the audit firm. In these circumstances, the potential for a technical audit failure to damage a firm's reputation and the consequences this could have for individuals and the firm could motivate firms to undertake high quality audits. Individual auditors or audit firms may, however, have an incentive to free ride on the efforts of others, for example by not investing sufficiently in training. In this respect the reputational benefits to the audit profession as a whole created by the professional standards and behaviour of auditors have characteristics of a public good. The Auditing Practice Board publishes Ethical Standards, which are concerned with the integrity, objectivity and independence of auditors and supplement the legal

duties of auditors.[10] These professional standards supplement the legal duties of auditors as set out in the Companies Act 2006.

42. The development of UK corporate governance has instituted a further remedy to this principal (shareholder)—agent (auditor) problem in the form of the increased prevalence and influence of audit committees whose task is to protect the interests of shareholders and ensure that audits are conducted for their benefit rather than for the (possibly) conflicting interest of management. However, this introduces further principal-agent issues unless the objectives of the shareholders and the members of the audit committee are sufficiently aligned.

43. The problems that shareholders face in monitoring the performance of the managers of a company also arise with the monitoring of its audit committee. Such concerns may, however, be mitigated by the professional integrity of the AC members and that they put at risk their own reputation if they get it wrong.

44. Other regulatory solutions may provide further examples of principal agent problems (eg the role of professional bodies and of the FRC). Each of these bodies is meant to protect the interests of shareholders, but in each case the shareholder is poorly placed to determine how effectively they complete their mission.

45. In summary, the publication of independently verified company accounts has an economic value beyond the private benefits to the shareholders and the management of a company. This means that the private incentives of shareholders and managers, who may collectively agree on the benefits of an independent audit,

[10] For the purposes of these standards, 'integrity' covers not only fairness, candour, honesty etc, but also wider matters such as conflicts of interest. 'Objectivity' excludes bias, prejudice and compromise, as well as extending to conflicts of interest. 'Independence' is seen as being related to 'objectivity' and covers matters such as employment, business and personal relationships between auditor and audited entity, as well as relationships with third parties whose interests may conflict with those of the audited entity.

will be less than the total benefits to all stakeholders. The result could be underinvestment in audit services or a product that does not meet the needs of certain stakeholders. A legal requirement for FTSE 350 companies to be audited to certain specified standards and a specified level of public disclosure of information is a solution to this problem.

46. In practice there are multiple principal-agent problems in the relationships within and between a company, its management, shareholders and other stakeholders.[11] The legal requirement for statutory audits is one element in the regulation aimed at addressing such market failures. In particular, the requirement for a statutory audit operates in conjunction with other legal and regulatory provisions concerned with promoting effective corporate governance and trust and confidence in financial reporting and markets. For example, stock market listing rules and insider trader regulations seek to prevent the existence and exploitation of privileged access by existing shareholders, management and others to information on the future prospects of the company.

The role of competition

47. The analysis above provides a context for our investigation. In particular that an audit is a way to mitigate the problems arising from possible misalignments of objectives and information asymmetries in the relationship between managers and shareholders, and that for wider public policy reasons this market is regulated. Applicable regulation requires an audit to be carried out and sets minimum standards.

[11] See the Kay Review, which specifies those relating to investing in equities more broadly: www.bis.gov.uk/assets/biscore/business-law/docs/k/12-917-kay-review-of-equity-markets-final-report.pdf.

48. The CC's task is to consider whether there are features that adversely affect competition in the supply of statutory audit services to FTSE 350 companies. This requires us to consider the contribution that competition can be expected to make in satisfying the demands of various stakeholders and whether there are features of regulation or otherwise that adversely affect this competition.

49. It appears to us that there are some fundamental characteristics of the supply of audit services to FTSE 350 companies which are important to understanding the markets and in particular the behaviour of customers and rivalry between auditors. We *(a)* set these out below. In the light of this discussion, we *(b)* revisit our theories of harm, as set out in the Issues Statement, revise them, and *(c)* consider the potential consequences for the provision of audit services to FTSE 350 companies of weak competition for shareholders and other stakeholders.

Key characteristics of the supply of audit services

50. As said above, it appears to us that there are certain fundamental characteristics of the supply of audit services to FTSE 350 companies and their interactions which are important to understanding the behaviour of customers and rivalry between auditors. These characteristics are:

(a) the nature of the audit product;

(b) the presence of information asymmetries and the misalignment of objectives in the supply of the audit product; and

(c) the cost structure in the delivery of audit services.

51. In the paragraphs below we explain briefly why we think these features may be important.

Nature of the audit product

52. We consider the defining characteristics of the statutory audit of FTSE 350 companies to be: the mandatory requirement for these audits; that some aspects of the quality of the product are determined by regulation; and the bespoke nature of each engagement. The implications of these are considered below.

Mandatory requirement for a statutory audit

53. As discussed above, that FTSE 350 companies are audited is a legal requirement and the audit must be conducted to certain minimum standards.

54. The mandatory requirement means that industry demand is inelastic: companies must buy and there can be no demand-side substitution to a different product in response to poor quality or high prices. The size of the market (in terms of the number of engagements) is therefore determined by regulatory requirements and the characteristics of the FTSE 350 companies (ie the size and complexity of the engagements). As such, to gain market share firms must win audit engagements from rivals.

55. The (total) welfare loss (in a static model) associated with a restriction of competition typically arises from consumers buying less of a product than is socially efficient (allocative inefficiency). In this market the demand for statutory audit is inelastic. The welfare loss would arise in the supply of capital, in particular investors supplying less capital overall than is socially efficient, or inefficiency in the economy arising from the mis-allocation of capital. We also assess the wider economic consequences if competition in the supply of audit services fails to satisfy the demands of customers, for example, by providing insufficient information or assurance.

56. The regulatory framework also sets certain minimum requirements in the purpose of an audit, the duties of an auditor and the output of the audit and firms are required to demonstrate compliance with the ISAs. These standards will affect the scope for competition on some aspects of the audit product provided. We will consider in a working paper on the nature and strength of competition in this market.

Bespoke product

57. The statutory audit for a particular FTSE 350 company is specific to that company, reflecting a range of factors including: industrial sector; the structure of the organization; the geographic interests of the company; and the financial structure. These and other factors determine the sector or other expertise required to carry out the audit, the number of locations in the UK and elsewhere where an audit needs to be carried out; the nature of the company risk profile; the sampling and other aspects of the audit methodology and so on.

58. This bespoke nature of FTSE350 company audits has implications for competition. First, it makes the comparison of audit fees more difficult as account needs to be taken of a wide range of factors that may explain differences in audit fees. This is reflected in the responses to the CC customer survey. We were told that audit fees were benchmarked against companies in the same sector and companies which were for other reasons, such as their size, considered to be reasonable comparators. If third parties cannot judge the quality of an audit, then this makes any bench-marking exercise harder.

59. In the working paper on the nature and strength of competition we investigate the effect that this feature of the product may have on competition on audit fees, in particular the bargaining position of FDs and ACCs in the negotiation of fees. We also consider the aspects of the audit product that are visible to various parties.

60. Second, it may increase the costs to audit firms of bidding for an audit engagement and to companies of switching auditor. Such switching costs may reduce rivalry between audit firms and raise barriers to entry to the relevant market. In particular, for firms to be in a position to bid for a FTSE350 audit, and have a reasonable chance of winning, they need a certain level of understanding of the business. If a company switches auditor, the new auditor needs a period to familiarize itself with the business. These features may benefit the incumbent auditor or other audit firms that are already familiar with the company, possibly as a result of providing non-audit services. These matters are also considered in the working paper on switching costs.

61. Third, it may lead to differentiation between audit firms based on geographic or sector capability, as they specialize towards the requirements of specific types of companies.

Information asymmetries and the misalignment of objectives in supply of FTSE350 audits

62. In considering the background to the demand and legal requirement for audits we considered information asymmetries in the shareholder-manager relationship. We now turn to considering the potential implications of any information asymmetries in the quality of the audit product, in particular technical quality, ie the reliability and usefulness of the audit reports and opinion.

63. As already mentioned, in the working paper on the nature and strength of competition we will consider the extent to which various aspects of the product are visible to the various stakeholders. Our initial view is that for any particular FTSE350 audit, the management and ACC of the company have a high degree of visibility on many aspects of the technical quality of the audit and the quality of service.

64. For shareholders and other stakeholders including lenders, customers and employees, our initial view is that what matters to them is the technical quality of the audit report (in particular the probability of detection of misstatement and the likelihood of reporting this). Any interest in the quality of services would tend to be limited to the potential impact on technical quality.[12] These stakeholders will have various sources of information on which they may form a judgement on technical quality including: regulatory requirements, duties and obligations; AIU reports; direct experience and knowledge of the audit firm; and the reputation of the audit firm.

65. We investigate the following further:

(a) whether the management is better informed than the auditor on the fundamentals and facts of a company (an auditor will not know what they have not found), and auditor knows better than the management and the ACC the work undertaken in carrying out the audit (although the asymmetry of information will vary with the time available and the effort made by the management and ACC in understanding what the audit team did, for example, on the extent of substantive testing); and

(b) whether other stakeholders have significantly less information available to them than the company and its shareholders to assess the technical quality of the audit.

66. We shall also consider the potential for information asymmetries in the technical quality of an audit to reduce the incentives of FDs and ACCs to negotiate a reduction in the audit fee (or to change auditor) given a perceived risk that this could send adverse market signals, ie that a lower fee is a reflection of lower technical quality.

[12] Shareholders have an interest in efficient audit service delivery, just as they have an interest in the efficiency of all aspects of the business.

67. The potential for any information asymmetries to distort competition would be reduced if the interests of *(a)* the auditors are aligned with those of shareholders and *(b)* shareholders with those of other stakeholders in the company (as they could rely on the audit committee and ACC in protecting the interests of shareholders to also protect their interests).

68. With regard to the relationship between shareholders and auditor (both individuals and the firm), the literature recognizes a risk that the desire on the part of auditors to maintain good relationships with managers with whom they have regular contact,[13] and whose views may be decisive in future decisions on the appointment of an audit firm or individuals allocated to a audit team, would affect their willingness to challenge management. We note that much of the regulation is concerned with ensuring the independence, professionalism and integrity of the audit firm, for the benefit of shareholders as a whole. In addition, as mentioned above, this risk may be mitigated by the potential damage to an audit firm's reputation, and individual auditors, of mistakes resulting from a failure to retain independence.

69. With regard to the relationship between shareholders and other stakeholders, circumstances might arise in which management and/or shareholders may have an incentive to hide bad news, for example, from lenders to maintain borrowing arrangements, from employees to retain talent, suppliers to maintain credit arrangements, and customers who may be concerned about the ability to fulfil orders and honour after sales commitments.

70. We investigate in the case studies and the survey, the potential consequences of the interaction between these information asymmetries and the misalignment of

[13] For example, see *Agency theory and the role of the audit* by the Audit Quality Forum.

objectives for competition in the supply of audit services to FTSE350 companies, and will present the evidence in working papers.

Cost structure

71. We consider that the cost structure for the provision of audit services to FTSE350 companies could have implications for competition. For example, with regard to the supply of audit services to clients in a particular sector, the fixed costs to an audit firm of acquiring the necessary sector expertise, relative the value of audit engagements in the sector, could be a factor in determining the number of audit firms that can profitably compete for these audits. In other words, certain industry sectors may only be sufficiently large to support a small number of firms with appropriate expertise.

72. In addition, sunk costs in the provision of audit services to FTSE350 companies, such as investment in IT systems, technical and sector expertise and reputation gained over time could create an incumbency or first mover advantage. Similarly, economies of scale and scope could put smaller firms at a competitive disadvantage. All these issues are considered in a series of working papers relating barriers to entry.

Theories of harm revisited and revised

73. The Issues Statement contained following theories of harm:

(a) ToH1: The audit market is highly concentrated (with limited rivalry among suppliers) and there are high barriers to entry with the result that the four largest firms have market power.

(b) ToH2: The four largest firms could bundle together services in order to create barriers to entry in the market for statutory audit and in related markets.

(c) ToH3: The behaviour of the FTSE350 companies in the appointment of auditors and the management of this relationship may have the effect of weakening rivalry

between audit firms (for example by tendering infrequently), or distorting competition by creating incentives for firms to focus their competitive efforts on satisfying the demands of those making the audit engagement decisions (ie company management including audit committees), rather than those of shareholders and other stakeholders.

(d) ToH4: Specific features of the market may make it particularly prone to risks of regulatory failures which could lead to a reduction or distortion of competition in the market.

(e) ToH5:Tacit coordination between the four largest firms results in less competition in certain sectors.

(f) ToH6: Information asymmetries and the misalignment of objectives of interest adversely affect audit quality and allow the four largest firms to maintain market power.

74. Based on evidence gathered and analysis undertaken to date, we are currently most actively pursuing two principal theories of harm.

Customer behaviour and market structure produce adverse outcomes

75. The first of these is a traditional competition theory of harm which captures ToH1 and ToH3 as set out above, relating to the conduct of FTSE350 companies in the appointment and reappointment of their auditors, and the structure of the market. In investigating this theory of harm we will consider factors relating to demand and supply, and how they interact.

76. On the demand side we intend to assess whether search costs, switching costs or other barriers exist which make it less likely (than absent any such barriers) that a FTSE350 audit engagement will be tendered or that a FTSE company will switch auditor, resulting in less intense competition between auditors for these

engagements. We also intend to consider whether information asymmetries make it more difficult for management to assess the value for money or the quality of the audit product or service provided by their auditor which can also have a damaging effect on competition. In particular, we consider if the following suggestions are correct:

(a) Price does not drive tendering if statutory audit is a bespoke product so that it is difficult for a company to assess whether its audit fee is competitive, and an audit fee is a relatively small element of the total costs of a FTSE350 company so that any price benefit of a switch may be limited. It may be that the FD is concerned about price, but the other person influential in (re)appointment decisions, the ACC, is mainly concerned with quality, so this dampens any incentive to switch on cost grounds.

(b) Switching auditors incurs costs for companies (in particular regarding the time costs of senior management in running a tender, educating new auditors and possibly enhanced risk of mistakes by a new auditor) in relation to the potential gains from switching.

(c) At certain times switching may be impossible if other activities take precedence, or corporate reasons require a stable audit function (eg when a company is involved in refinancing, restructuring or major acquisitions), or undesirable if it appears to signal that the company is troubled or its financial statements are not reliable.

(d) Certain aspects of audit quality are not readily observable by those deciding to (re)appoint auditors (the ACC and FD), which means that any quality gain from switching is not readily observable, which dampens incentives to switch on quality grounds. This feature of the product may also dampen the incentives to switch on cost grounds if the company perceives a risk of signalling lower audit quality to the market.

(e) The Big 4 background of most ACCs and CFOs may limit the population of auditors they perceive to be able to deliver appropriate quality of audit and reputation of audit.

77. On the supply side, we will investigate the extent of rivalry between audit firms before, during, and after tenders run by FTSE350 companies.

78. We will also investigate the nature and extent of barriers to entry to those not currently auditing FTSE350 companies and barriers to expansion to those firms that currently audit a very small number of FTSE350 companies, possibly as a consequence of economies of scale and scope and the role of reputation in the appointment of auditor.

79. The outcome of restricted or distorted competition may be that prices that are too high, quality sub-optimal and innovation too low. As noted, output is mandated by statute, and so cannot be below competitive levels.

Principal agent issues

80. Under our revised second theory of harm, we consider possible problems arising in the supply of audit services to FTSE 350 companies as a result of specific features of this market that have the effect of distorting competition between audit firms in respect of some aspects of the audit product or service, broadly under the heading of principal-agent issues.

81. In particular, we will assess if the disconnect between the demand (from shareholders and other stakeholders) and supply (in terms of the product delivered by auditors) means that auditors direct their competitive efforts to satisfying the demands of those making the purchasing decisions (ie company management) and

whether those demands are sufficiently different from the shareholder demand as to amount to a distortion of competition.

82. We will consider the potential for rivalry between audit firms to be able bridge any such a gap between the financial information stakeholders would like audits to provide and that which is currently being provided, and whether there are features of the regulation of audits that are preventing this from happening. We also assess the wider economic consequences if competition in the supply of audit services fails to satisfy the demands of customers, for example, providing insufficient information or assurance.

83. We will investigate the following suggestions:

(a) In FTSE350 companies the FD, AC and ACC are primarily responsible for the appointment of the auditor and so it is their preferences, perceptions and behaviour that are critical to determining when and on what criteria audit firms compete. Shareholders and other stakeholders have in practice no real influence in the selection of the auditor.

(b) The ACC is a regulatory remedy to the principal-agent problem between managers and shareholders whose task it is to protect the interests of shareholders and ensure that audits are conducted for shareholders' benefit rather than for the (possibly) conflicting interest of management. However, this introduces further principal-agent issues unless the objectives of the shareholders and the members of the audit committee are sufficiently aligned. The time and resources available may limit what these individuals can achieve.

(c) An audit is an 'experience' good as some aspects of the product cannot be known with certainty before it is delivered. Each FTSE350 audit is different, reflecting the characteristics of the company including the size and structure of the company, the sectors in which it operates, the geographic spread of its

interests etc. Even after the event, the AC, shareholders and other stakeholders may have not have visibility on certain aspects of the product. This means that their perceptions of the quality of the audit report and audited accounts are based on variables that they can observe, such as the identity of the firms, rather than the underlying quality of the audit. Accordingly, management and ACC decisions to (re)appoint an auditor may be based on indicators or proxies for unobservable variables, rather than the underlying quality of the audit.

(d) The potential for a misalignment in the interests of those appointing the auditor (and managing this relationship) and those who use the output of the audit. For example for management, their working relationship with the auditor and the efficiency with which an audit is conducted will be important, whereas shareholders will be primarily concerned with the quality of the information provided by the audit outputs.

(e) The nature of a statutory audit is determined to an extent by legislation and the regulation which specifies certain minimum requirements in relation to the duties of the auditor, the conduct and qualifications of the auditor, and the output of the audit. Firms are also required to demonstrate compliance with the ISAs.

84. These features may have implications for competition in the supply of FTSE350 audits. In particular:

(a) there may be a distortion of competition to the extent that information asymmetries have the effect of encouraging auditors to compete on variables used by FDs and ACCs in their decisions to (re)appoint an auditor rather than on variables important to the company's shareholders and other investors (actual and potential);

(b) there may be very limited incentives for auditors to strive to meet certain demands of the company's shareholders and other investors, the effect of which could adversely affect the efficient operation of financial markets;

(c) information asymmetries may mute the incentives of those responsible for appointing auditors to behave in ways that would encourage more intense competition on audit fees and other variables; and

(d) what are intended by the regulation to be minimum standards may in practice be maximum standards for the audit outputs because there is no incentive for firms to compete to provide an audit product that exceeds these standards.

85. Under both theories of harm we consider the effect that regulation may have on competition. In relation to the first, we will investigate the potential for regulation to create or raise barriers to entry, and for strategic behaviour by certain firms to lobby for regulation that would be favourable to them (regulatory capture). If regulation were distorting firms' incentives to provide shareholders with what they wanted, this would be relevant to the second theory of harm.

Potential consequences of weak competition

86. We consider that weak competition could have an adverse effect on all aspects of the audit product and its delivery on which the audit firms may compete. We consider this in a working paper to follow on the nature and strength of competition. In particular, weak competition could soften the incentives of audit firms to reduce audit fees; ensure that audits are carried out effectively and efficiently; and to invest in their people, expertise and systems. The result would be higher audit fees, a reduced quality of service; and a reduction in the quality of the audit report and opinion. These ideas are captured in our revised first theory of harm.

87. We also investigate whether the audit process and reports are satisfying the demands of shareholders and other stakeholders (principally other investors) in relation to audits and, if not, how competition might contribute to bridging these gaps. For example, whether audit reports provide stakeholders with the level of disclosure

that they demand. We recognize that the purposes for which the various stakeholders need financial information may differ and that these demands may be conflicting. We are also aware that there are other means by which the financial markets are provided with the information they need including due diligence. These ideas are captured in our revised second theory of harm.

88. In summary, we consider that there are four broad aspects of a FTSE350 audit: the audit fee paid by the company; the technical quality of the audit reports and the accuracy of the audit opinion; the provision and quality of additional commentary and insights provided by the audit team in the process of conducting the statutory audit; and the quality of the service provided by the audit team to management and audit committees in carrying out the audit.

89. We think that weak competition may adversely affect each of these aspects, and will investigate.

90. We also consider that high audit fees would have the potential to create incentives for firms to make excessive investments in marketing and other activities in order to win FTSE 350 audit clients. Such activities might be aimed at establishing reputation or building relationships with potential clients. We consider that such activity could weaken competition by raising barriers to entry.