

STATUTORY AUDIT SERVICES MARKET INVESTIGATION

Overview

Introduction

1. This note gives an overview of progress on the Statutory Audit Services Market Investigation to date, reprises the theories of harm that we are investigating most actively, links the working papers that we have published or are preparing for publication to the theories of harm that we are investigating, and identifies areas for further work.
2. It publishes some initial views at this stage, to allow parties to tailor future submissions and identify further evidence. However, such views should not be taken to be findings or conclusions in any relevant sense, regardless of the vocabulary used.

Progress to date

3. The OFT made its reference to us for an investigation into the supply of statutory audit services to large companies in the UK on 21 October 2011.¹
4. Based on a review of the OFT's reference, and evidence available at that date, we published an Issues Statement in December 2011.² This contained six theories of harm, and noted issues around the possible exit of one of the four largest audit firms (Deloitte, Ernst & Young (EY), KPMG, PricewaterhouseCoopers (PwC), collectively referred to as the Big 4 firms):
 - (a) The audit market is highly concentrated and there are high barriers to entry with the result that the Big 4 firms have market power.

¹ www.competition-commission.org.uk/our-work/statutory-audit-services.

² www.competition-commission.org.uk/our-work/statutory-audit-services.

- (b) The Big 4 firms could bundle together services in order to create barriers to entry in the market for statutory audit and in related markets.
 - (c) Customer conduct limits competition, in particular by tendering infrequently.
 - (d) 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) Tacit coordination between the Big 4 firms results in less competition in certain sectors.
 - (f) Information asymmetries and conflicts of interest adversely affect audit quality and allow the four largest firms to maintain market power.
5. We also noted the concern about possible adverse effects should one of the Big 4 firms exit the market.

Evidence

6. We have published background papers on:
- (a) the applicable law and regulation;³
 - (b) the development of statutory audit;⁴ and
 - (c) the firms that currently supply audit services to large companies.⁵
7. We have also:
- (a) assembled a database regarding firms' engagements, and the frequency with which companies switched auditors;⁶
 - (b) commissioned a survey;⁷
 - (c) commissioned a review of relevant academic literature;⁸

³ www.competition-commission.org.uk/our-work/statutory-audit-services/analysis/working-papers.

⁴ www.competition-commission.org.uk/our-work/statutory-audit-services/analysis/working-papers.

⁵ www.competition-commission.org.uk/our-work/statutory-audit-services/analysis/working-papers.

⁶ www.competition-commission.org.uk/our-work/statutory-audit-services/evidence/audit-public-dataset.

⁷ www.competition-commission.org.uk/our-work/statutory-audit-services/evidence/cc-commissioned-survey.

- (d) undertaken ten case studies and have spoken with investors in those companies;⁹ and
- (e) issued a large number of questionnaires to elicit information that informs our working papers, and held hearings.¹⁰

Analysis

8. Following our December 2011 Issues Statement, based on the evidence that we have gathered and further analysis, we published revised theories of harm.¹¹ In this we said that we are now most actively pursuing two theories of harm, a more ‘traditional’ competition theory, and one arising particularly from the principal-agent issues in the provision of statutory audit services to large companies.
9. Both theories may lead to adverse outcomes in that prices are too high, quality sub-optimal and innovation too low. Under our second revised theory, we are also considering whether demand for information from shareholders and other stakeholders is not satisfied. Such possible adverse outcomes are considered in paragraphs 32 to 37.
10. We note that to date we have received little evidence to support a theory of harm based on either:
- (a) tacit coordination among the Big 4 firms;¹² or
 - (b) bundling of audit and non-audit services by the Big 4 firms.¹³
11. We continue to consider the possible exit of one of the Big 4 firms.

⁸ www.competition-commission.org.uk/our-work/statutory-audit-services/evidence/cc-commissioned-research.

⁹ www.competition-commission.org.uk/our-work/statutory-audit-services/evidence/case-studies.

¹⁰ www.competition-commission.org.uk/our-work/statutory-audit-services/evidence/summaries-of-hearings-held-with-parties.

¹¹ www.competition-commission.org.uk/our-work/statutory-audit-services/analysis/working-papers.

¹² www.competition-commission.org.uk/our-work/statutory-audit-services/analysis/working-papers

¹³ Our reasoning and evidence is contained in a working paper in preparation.

Revised Theory of Harm 1

12. This is set out in paragraphs 75 to 79 of our Framework working paper (which should be read in full). In summary, it considers issues of:
- (a) limited effective rivalry between the Big 4 firms for engagements, with particular reference to factors that inhibit large companies from switching auditors; and
 - (b) limited competitive pressure from firms that are not currently supplying statutory audit services to large companies or are providing such services only to a limited extent. In particular, such issues include consideration of barriers to entry or expansion of would be rival firms; and
 - (c) adverse outcomes (paragraphs 32 to 37).
13. We summarize the evidence that we have with regard to each below, by reference to other evidence or working papers we have published or anticipate.

Limited rivalry

14. To assist our assessment:
- (a) we have set out our views of the relevant market;¹⁴
 - (b) based on our database, we have calculated switching rates among large companies;¹⁵
 - (c) we have reviewed our case studies;
 - (d) we have considered the submissions by audit firms regarding their own competitive strategies;¹⁶
 - (e) we analysed documents submitted by firms that they had prepared for tenders for audit engagements (Auditor selection working paper);¹⁷

¹⁴ www.competition-commission.org.uk/our-work/statutory-audit-services/analysis/working-papers.

¹⁵ www.competition-commission.org.uk/our-work/statutory-audit-services/analysis/working-papers.

¹⁶ www.competition-commission.org.uk/our-work/statutory-audit-services/analysis/working-papers.

¹⁷ www.competition-commission.org.uk/our-work/statutory-audit-services/analysis/working-papers

- (f) we have assessed the switching costs for companies associated with running a tender and inducting a new auditor (Switching costs working paper¹⁸); and
- (g) we have considered the nature and strength of competition in the supply of statutory audits more broadly.¹⁹

15. Based on these, our initial view is that there is a distinct market for the supply of statutory audit services to companies that may be listed from time to time on the FTSE 350. In particular, it is our initial view that the provision of statutory audit services to these companies constitutes a separate market from the supply of the same services to private and smaller listed companies. Further, we consider the provision of statutory audit services to be a separate market from the provision of other services that might be provided by audit firms. We consider the relevant geographic market to be national.
16. The Big 4 firms supply the overwhelming majority of audits to FTSE 350 companies.
17. Companies switch auditor infrequently. Switching is typically provoked either by dissatisfaction with the current auditor (in terms of quality and occasionally price), reasons of good corporate governance, or by corporate activity (such as merger or acquisition). Company management do not tend to be very price sensitive: audit fees tend not to be large in the overall budgets of FTSE 350 companies, and price may be seen as a proxy for quality.
18. Management see costs but limited benefits to switching in a situation where their auditor is performing competently. An engagement can be lost by a firm if it fails to

¹⁸ www.competition-commission.org.uk/our-work/statutory-audit-services/analysis/working-papers.

¹⁹ Nature and strength of competition working paper, to be published.

satisfy management in terms of price or quality, but it is difficult for another firm to force the pace of competition, and certainly cannot force a company to tender.

19. When tenders for FTSE 350 audit engagements are held, they produce competition among the Big 4 firms, although on occasion either Mid Tier firms are also invited to participate, or not all of the Big 4 firms participate.
20. Accordingly, while there is rivalry among the Big 4 firms, this can only take place at the behest of company management. Further (and possibly stating the obvious), year by year, management can and do have other priorities than running a voluntary tender or informal benchmarking process for their audit services. There may be significant inhibitions to management considering switching.

Barriers to entry

21. We published a framework for our assessment of restrictions on entry or expansion.²⁰ We have conducted individual analysis of:
 - (a) experience and reputation;²¹
 - (b) economies of scale and scope;²²
 - (c) international networks;²³
 - (d) clauses in loan agreements (commissioned from Cardiff Business School);²⁴
 - (e) liability, insurance and settlements;²⁵ and
 - (f) the paper on Switching costs (see paragraph 14(f)) is also relevant.
22. Our initial view is that there is a virtuous circle that benefits the Big 4 firms, in that in tendering for engagements they can point to an established client base, an extensive

²⁰ www.competition-commission.org.uk/our-work/statutory-audit-services/analysis/working-papers.

²¹ Working paper to be published.

²² Working paper to be published.

²³ www.competition-commission.org.uk/our-work/statutory-audit-services/analysis/working-papers.

²⁴ www.competition-commission.org.uk/our-work/statutory-audit-services/analysis/working-papers.

²⁵ www.competition-commission.org.uk/our-work/statutory-audit-services/analysis/working-papers.

international network and numerous candidate audit engagement partners with directly relevant experience. This increases their chances of success, and success in a tender reinforces each of those factors.

23. Our initial view is that the circle operates in reverse for Mid Tier firms. Some of them equally have extensive international networks (albeit with smaller member firms), but cannot point to the same level of experience of auditing large companies. It also appears that there is some risk of prejudice against non-Big-4 firms from those companies which such Mid Tier firms appear to have the capability to audit. The lack of price sensitivity of management (see paragraph 17) undermines one possible entry strategy, namely low cost provision. Equally, management aversion to shared audits (due to the convenience and efficiency of using a single firm worldwide) means that Mid Tier firms cannot demonstrate their capability by initially auditing say, one subsidiary or territory.
24. Our initial view is that there are barriers to entry and expansion that limit the ability of Mid Tier firms to constrain the competitive offerings of the Big 4 firms.

Revised Theory of Harm 2

25. Our second theory of harm is set out at paragraphs 80 to 85 of our Revised framework working paper (which should be read in full).²⁶ In our initial view, audit was introduced as a means of verifying the financial statements produced by company management, for the benefit of shareholders. We think that remains an important role, but it is also a wider public good, and plays a role in maintaining trust and confidence in equity markets more generally. We also think that it benefits company

²⁶ www.competition-commission.org.uk/our-work/statutory-audit-services/analysis/working-papers.

management, as a source of somewhat independent information regarding the large, complex and international companies they manage.

26. We note the inherent conflict in the role of auditor: auditors are chosen, paid and dismissed by company management, yet their role is to scrutinize management reports objectively. We think that the extensive regulation regarding auditor 'independence' is a regulatory response to that conflict.
27. Under this second theory, we are in particular investigating if a 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 audit committees) and whether those demands are sufficiently different from shareholder demand as to amount to a distortion of competition.
28. Accordingly, we are investigating whether there are information asymmetries and misaligned incentives between those supplying the audit service and those for whose benefit it is conducted.
29. At this stage, our initial view is that:
 - (a) Shareholders have little or no influence in the decision to appoint or reappoint auditors. We have identified no instance of shareholders forcing a company to tender its audit engagement or successfully opposing the (re)appointment of an auditor.
 - (b) Shareholders have little or no direct say in the extent of the reports produced by auditors and the information that they provide.

(c) Auditors have little or no interaction with shareholders or other stakeholders when planning or executing an audit, and shareholders have little or no visibility of the audit process other than the audit opinion.

(d) Auditors have no liability to individual shareholders should they be negligent in the performance of their duties. Their liability is to the shareholders as a body.

(e) Management (ie finance directors) and Audit Committee Chairs (ACCs) have greater visibility of the work of auditors than shareholders, but even this may be incomplete.

30. Accordingly, we think there is a clear information asymmetry between shareholders (as principals) and auditors (as agents).

31. In light of the points in paragraph 29, we are continuing to assess whether or not the interests of Auditors and ACCs are sufficiently aligned with those of shareholders and broader stakeholders for principal-agent problems not to arise in practice. It appears that the institution of the ACC is a regulatory response to the principal agent problem—but the ACC is itself another agent.

Possible adverse outcomes

32. Either theory of harm may produce adverse outcomes. We have sought to assess outcomes in terms of price and quality.

33. With regard to price, the data we have available was not conducive to a price concentration analysis that would yield reliable results concerning a causal relationship between concentration and the level of fees.²⁷ We considered various

²⁷ www.competition-commission.org.uk/our-work/statutory-audit-services/analysis/working-papers.

ways of undertaking a firm-level profitability analysis, but equally did not find these fruitful.²⁸

34. We have been able to assess the profitability over time of individual engagements. It appears that in general engagements are initially less profitable, and rise in profitability for about five years at which point profitability plateaus. This might be due to firms' familiarization costs being absorbed by those firms.²⁹ It was apparent (from our case studies and survey), that price is a secondary consideration to quality.
35. With regard to quality, we have undertaken a qualitative assessment, based on submissions received, our survey evidence of investors and our case studies. We have not assessed directly the quality of individual audits. We can observe objectively certain differences in capability (such as the extent and depth of international networks). Equally, some non-Big-4 firms have told us that they could not audit certain companies on a sole basis.
36. We are considering this further, and in particular are looking for evidence of tenure effects, ie whether audit engagements deteriorate over time (in terms of price, quality or any other competitive variable).
37. We note that we have heard many views from companies, investors and non-Big-4 firms that there is insufficient choice. We have not so far seen evidence of a strong link between market concentration and outcomes such as price and quality.

²⁸ Working paper on Profitability analysis, to be published.

²⁹ Working paper on Profitability analysis, to be published.

Exit of Big 4 firm

38. As a competition authority, we are concerned with the competitive process and outcomes for customers and ultimately consumers, rather than with the fate of any one supplier.
39. So far, we have considered the likelihood of a Big 4 firm exiting as part of consideration of international networks.³⁰ It is apparent that the network structure means that the legal liabilities of any one firm cannot be carried to another jurisdiction for a specific audit failure. However, the collapse of Arthur Andersen suggests that legal liability is not the only significant risk. It was the loss of reputation that appears to have caused Andersen's collapse. In this sense we think the importance of reputation in this market heightens the risk of a collapse.
40. However, the likelihood of exit of a UK firm may be overstated: for the network to collapse there must be significant failure in a significant jurisdiction. Member firm failures in a large economy such as Japan have not proved fatal to Big 4 networks and their UK member firms. Nonetheless, the consequences of such collapse may be severe (as the example of Arthur Andersen shows).
41. Accordingly, we continue to assess the possibility of exit, particularly in light of our views of barriers to entry and expansion. While the exit of a firm might not of itself be a competition concern (in line with paragraph 38), if the likely consequence of such exit were increased concentration (ie to three from four large firms), it could result in an unfavourable outcome in competition terms.

³⁰ www.competition-commission.org.uk/our-work/statutory-audit-services/analysis/working-papers.