AUDIT MARKET INVESTIGATION

Restrictions on entry or expansion

Introduction

1. This paper sets out the framework we intend to use for considering restrictions on entry and expansion in the audit market, and explains how we will approach the analysis of individual strands within this framework.

2. We first briefly discuss the CC's general framework for the analysis of restrictions on entry and expansion, before turning to a discussion of the specific factors affecting entry in the supply of statutory audit services to large companies, in particular FTSE350 companies. These factors are broadly classified as *(a)* intrinsic factors; *(b)* strategic actions; *(c)* first mover/incumbency advantages and the importance of reputation; *(d)* factors arising from the regulatory system; and *(e)* clauses in loan agreements and other forms of pressure from advisors.

Framework

3. The prospect of timely entry or expansion on a sufficiently large scale is important to an assessment of competition, as it can counter adverse effects arising from other sources (eg weak rivalry, horizontal coordination or vertical relationships). It can be a significant competitive constraint on market incumbents, since if entry is easy (ie may be effected rapidly and with low risk), incumbent firms would be unable to exercise market power without attracting entry.

4. A barrier to entry and expansion may be defined as any feature of the market that gives incumbent suppliers a cost or other advantage over efficient potential entrants. Such restrictions may prevent entry altogether, delay it for a long period, or may increase costs and risks to an extent that entry is not expected to be profitable. In the

latter two cases, entry is possible, but unlikely in practice. In all three cases, the outcome is that the threat of entry is too remote to constrain the competitive conduct of incumbents.

5. In some circumstances restrictions on entry may have a positive effect, for example if they increase incentives to innovate or achieve important goals outside the scope of competition policy. We may weigh any positive impacts up in deciding to what extent restrictions on entry may lead to an AEC, because they prevent the benefits of entry materializing.

6. We have not so far identified absolute restrictions on entry in this market (for example lack of access to essential inputs). Rather entry appears theoretically possible. It may not occur in practice on a sufficient scale[1] if potential entry strategies are insufficiently profitable or have payback periods that are too long to incentivize the necessary investment.

7. We have identified the following key factors affecting a hypothetical entrant's expected post-entry profits:

   (a) Revenue expectations:

   (i) the expected timing and quantum of post-entry revenues is likely to be affected by the prospects of winning audit engagements (itself a product of the frequency of tender opportunities, the probability of being invited to tender, and the probability of winning a tender if invited to bid);

   (ii) the likely level of audit fees for tenders won (taking into account the reactions of incumbents ie the fees they would bid in competitive tenders, that the entrant would likely have to match or beat);

[1] We observe that around ten FTSE350 companies are audited by firms other than the Big 4. However, these companies appear to be unrepresentative of other FTSE350 companies in one respect or another; eg they may be less complex; less international; or rejected by the Big 4 on risk grounds.

(b) cost expectations:

(i) the extent of sunk investment required to enter but which cannot be recovered on exit. This may include investment in specific assets (eg software that has no alternative use), or advertising, PR, client acquisition costs (including tendering), additional and specialist staff costs.

(ii) economies of scale and scope may impose a minimum efficient scale on a new entrant, and may increase sunk investment costs and execution risks (ie the risk that the entry strategy is not successful because insufficient market share is achieved).

8. In a standard discounted cashflow investment appraisal, investment decisions may be considered by forecasting expected future annual revenues and costs to produce annual net cash flows. These cash flows are typically negative in early years (as investments are made) and positive in later years (as they pay off). Each annual cash flow is discounted to present values using a discount rate which should represent the opportunity cost of capital appropriate for the risk of the project. If the resulting net present value is positive, the project is expected to be profitable.[2]

9. The level of expected returns required to induce entry in this market may be higher than would otherwise be the case due to the ownership structure of audit firms (partnerships). Investors typically require compensation for risks that they cannot reduce through holding a diversified portfolio of investments. However, the ability of individual partners to diversify sufficiently their investment in the audit firm may be limited and they may therefore require a higher cost of capital because of this.

10. Investors may also be concerned with the time over which the initial investment is expected to be repaid (ie the payback period). The payback period may be too long

[2] Alternatively the IRR may be calculated for a given set of cashflows. An IRR above the opportunity cost of capital indicates that the project is expected to be profitable.

to incentive investment by existing partners who may have relatively short investment horizons.[3]

11. Setting out a hypothetical 'entry model' of the nature described above can be a useful tool by which to examine how individual factors may affect entry incentives and by which to analyse the interplay of numerous factors acting together to affect the profitability of entry.

12. We categorize the factors affecting the profitability of entry as follows:

(a) intrinsic factors such as economies of scale and scope and switching costs;

(b) strategic factors;

(c) first mover/incumbency advantages;

(d) factors arising from the regulatory system; and

(e) Auditor Clauses in Loan Agreements and other forms of pressure from advisors (eg banks, ratings agencies, legal advisors).

13. We now discuss each category in relation to the audit market.

Intrinsic factors

Economies of scale

14. Economies of scale imply average costs decline with some measure of output (eg number of audits or size of audit) and this may put smaller firms at a cost disadvantage and mean that they are unable to match the prices of larger firms when tendering.

15. A further reason for this may be the presence of learning by doing effects whereby costs decline with the length of service provision. If costs decline over time,

[3] The extent to which the partnership structure affects investment incentives is discussed later in this paper.

prospective entrants may not be able to match the prices of an incumbent firm when tendering.

16. Economies of scope exist where average costs are reduced by the supply of other services, for example, the provision of non-audit services so that firms providing a narrower range or of non-audit services are at a cost disadvantage.

17. In the audit market, distinguishing between economies of scale and scope may not be clear. For example, if the average cost of delivering an audit for a FTSE 350 company declines with the number of non-FTSE 350 audit clients that a firm has, this might be considered to an economy of scale associated with the number of audit engagements, or an economy of scope associated with the range of clients across which a firm provides audit services.

18. Generally economies of scale arise where there are fixed costs associated with the provision of a good, and economies of scope where there are fixed costs common to the delivery of different products. Whether these costs are sunk is relevant to the assessment of barriers to entry.

19. Economies of scale/scope occur as a result of the nature of the costs that are incurred in providing the activities in question. The higher proportion of costs that can be shared across a range of output or between service lines, the more likely there are to be economies of scale/scope.

20. In the provision of audit services, a high proportion of the costs are composed of the staff and partners working on the audit engagement. We are conducting an econometric analysis of audit staff costs to investigate how engagement-related staff costs vary with output as follows:

(a) staff costs vs client size;

(b) staff costs vs number of audit engagements in a given sector;

(c) staff costs vs number of audit engagements overall;

(d) staff costs vs extent of provision of non-audit services to client;

(e) staff costs vs length of time firm has worked with client; and

(f) staff costs vs length of time firm has worked in sector.

21. Depending on the results of the econometrics we may conclude that:

(a) there are economies of scale and scope in engagement level staff costs that give rise to an intrinsic barrier to entry and hence may be an explanatory factor behind the observed high concentration in the provision of audit services; or

(b) there are no economies of scale in engagement level staff costs or the results are ambiguous.

22. In the latter case we may still find that there are economies of scale and scope related to costs other than engagement-level staff costs. We will consider the nature of these costs and the levels of these costs in our assessment of firm level profitability. We will compare the levels of these costs between mid-tier and large firms. If appropriate, we may decide to include some or all of these costs in our econometric analysis.

23. They include:

(a) marketing costs including thought leadership activities, lobbying, direct advertising, PR etc;

(b) costs of winning new business (eg client acquisition teams, costs of tendering (including the costs of failed tenders);

(c) systems capability, eg audit software and IT systems;

(d) compliance/internal controls costs;

(e) staff recruitment and retention costs including staff development and training programmes;

(f) other back office costs; and

(g) insurance costs.

24. Learning by doing may contribute to barriers to entry in several ways.[4] In relation to costs (as described above) we will investigate the relationship between engagement level staff costs and tenure as auditor and experience in the sector. We will also consider the effect of learning by doing on the ability of the four largest firms to forecast the costs and risks of an audit assignment. If new entrant firms are less able to judge these matters based on prior experience this may have the effect of *(a)* raising their risks of taking on the audit in comparison to the incumbent firms and *(b)* reduce the reliability of the new entrants' fee estimates.

Switching costs

25. Switching costs in this market may be relatively high in terms of management time (both that of the FD and his team, and that of other senior finance staff around the organisation) required to initiate and run a tender process and, if a new auditor is selected, to get the auditor up to speed. Becoming fully acquainted with a company may also take some time (between one and three years) which may introduce a higher risk of error or omission during this period. The size of the audit fee in relation to the company's overall budget is relatively small, so the potential gain from switching may be outweighed by these switching costs.

26. Generally we would expect companies to consider the potential cost of switching against the expected benefits such as lower fees or better quality of service. If the

[4] In this paragraph we describe the mechanism by which learning by doing may affect the costs and risks of entry; under 'First mover advantages and reputation' (paragraph 35 ff) we describe a more general incumbency advantage derived from pre-existing large client experience.

costs are high and/or the expected benefits low, this could explain the infrequency of tender opportunities observed in the FTSE350 audit market. This is important for entry because it decreases the profitability and increases the payback period of any entry strategy.

Strategic barriers to entry

27. Strategic barriers to entry may result from existing firms in the market acting to deter entry. In this section we consider three possible actions under this heading: *(a)* bundling and tying; *(b)* raising endogenous sunk costs; and *(c)* signalling aggressive competitive response.

28. An example of a possible action of this type is bundling or tying audit services with other audit-related or non-audit services permitted by the rules on auditor independence. In our Issues Statement we noted that this could take the form of 'pure bundling' (ie refusing to supply any of the individual services separately); mixed bundling (audit and non audit services are available separately or bundled together at a lower price than the sum of the individual prices), or tying (ie one of the services is available individually but the other is available only if bought in a bundle).[5]

29. We have to date gathered little evidence to support a theory of 'pure bundling'. However, we will assess evidence from our survey or case studies as well as looking at the number of FTSE350 companies that do not buy any other services (or only a small amount) from their auditors. Evidence on mixed bundling will be obtained by

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

comparing audit fees[6] between companies who purchase a high level of other services and those that do not.

30. In relation to 'tying', again we have to date gathered little evidence to support a theory that audit firms are engaging in a deliberate strategy of refusing to supply certain audit-related or non-audit services to non-audit clients. We note that the success of such a strategy would depend on the firm having market power in relation to these other services; this is not obvious (eg companies appear to have more choice of suppliers for non-audit services than for the statutory audit).

31. Other strategic actions could include increasing sunk costs of entry by spending on discretionary advertising and marketing activity or R&D designed to lower the marginal cost of producing each unit. Such 'endogenous sunk costs' may be described as[7] investments a firm can make in those things that can either increase the value of the firm's product to customers, such as advertising or improvements in product quality from product innovations, or lower its marginal cost of producing each unit, such as process innovations. Thus they reflect investment in advertising, marketing, and R&D. Sutton's theory is that in markets that are expanding, incumbent firms will have incentives to increase endogenous sunk costs to maintain market concentration.

32. Shimon (2008) describes the process as follows:

> The key to the model is that a firm can choose to invest in endogenous sunk costs, and because an investment of a given size and cost increases the profitability of each unit sold (ie the price-cost margin) by a fixed amount, the benefit from investing in endogenous sunk costs

[6] Audit fees will be compared controlling for billable hours using revenue recovery rates; ie the proportion of billable hours at standard charge-out rates covered by the audit fee.
[7] Shiman, D R, *The Intuition Behind Sutton's Theory of Endogenous Sunk Costs* (2008).

increases with the quantity sold. Therefore as the market size and firms' output increases, their incentive to invest in endogenous sunk costs also increases. However, because most of the benefits of this investment derive from the perceived quality advantage obtained relative to other firms in the market, if all firms invest equally in endogenous sunk costs, the investment produces little or no increased industry profits in the long run. The competitive advantage gained by each firm's investment in advertising and quality is largely negated when other firms also make this investment. The result is an arms race of investment in advertising, product improvements and cost reductions by all firms, fuelled by an expanding market. Indeed, firm profitability can actually fall in the long run in an expanding market if the additional profit gained from the increased volume of sales is exceeded by the increase in investment in exogenous sunk costs. And any firm that tries to avoid making this collectively-unprofitable investment will be driven out of the market, because it will lose enough sales to competitors that made the investment to make it unprofitable to stay in business. Thus competitive pressures drive firms to make investments in quality and advertising which in the long run mostly serve to raise the cost of participating in the market.

33. We will consider further the extent to which this is relevant to the FTSE350 audit market; however, it seems likely that it may be a factor in understanding the growth and concentration of audit firms over time.

34. Signalling on the part of an incumbent that it would respond aggressively to new entrants may be a strategy to prevent entry. This may include targeting clients of mid-tier firms who have potential to move into FTSE350 with aggressively priced tenders

(that has been referred to as 'low-balling'). We have heard some allegations of this sort of behaviour but to date have not been given specific examples. If this action were widespread, we might expect to see lower than average margins on audits won from mid-tier firms.[8]

The first mover or incumbency advantage and the importance of reputation

35. A first mover advantage may result from the established position of incumbent firms, in that experience and reputation gained through successfully providing large clients with an audit service over a long period of time, reinforced by marketing and thought-leadership, creates a self-reinforcing or 'virtuous' circle. Any strategic actions associated with raising sunk costs of entry discussed above may benefit incumbents by reinforcing a first mover advantage.

Reputation

36. Reputation appears to be a key factor behind the choice of a Big 4 auditor. The inability of mid-tier firms to match the reputation of the incumbent firms appears to be a key reason why their chances of winning tenders FTSE350 audits may be lower than necessary to make entry profitable. Reputation of the audit firm may be particularly important for clients with high visibility in the capital markets, for whom credibility of financial reporting is highly important.[9]

37. Reputation may be particularly important against a background of information asymmetry and principal-agent problems. Reputation may serve as a proxy for capability and quality in this market because quality is difficult to observe otherwise.[10] This may be the case for individuals making the purchasing decision (the FD and the

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[8] One would need take account of the fact that the margin (or equivalently, the recovery rate) would be likely to be lower than average in the immediate period after winning the client, due to learning by doing effects.
[9] Our Initial Literature Review discusses the literature on the subject of audit demand. http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/initial_review_of_relevant_academic_literature_in_the_audit_market.pdf.
[10] ibid.

ACC) and even more so for the investors whose visibility of the audit process is considerably less.

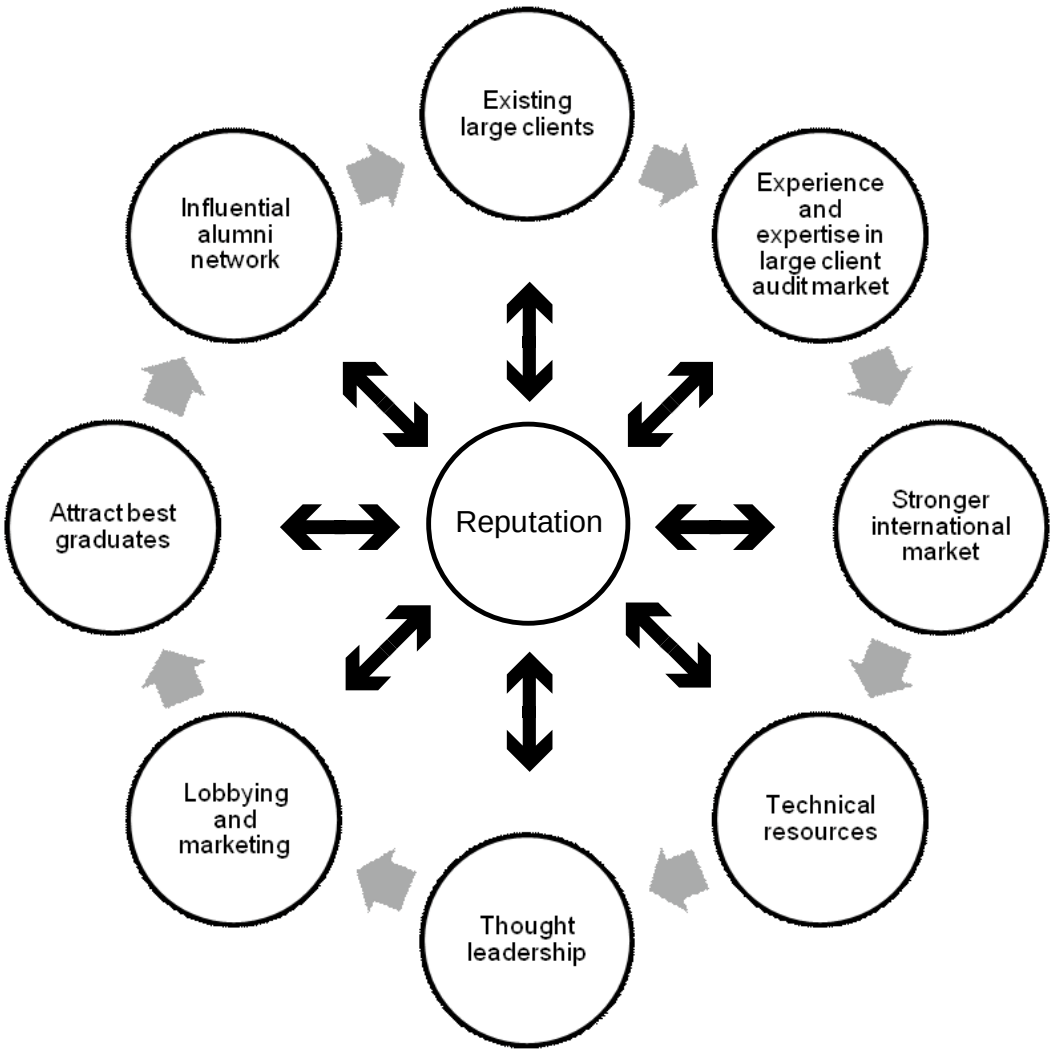
38. Reputation may be built up over a long period of time and reinforced through strategic actions such as marketing and branding. To the extent that reputation is an accurate reflection of capacity, quality, expertise, and efficiency, it allows companies to distinguish between potential suppliers of audit services and select the most appropriate for their needs. However, if it is not an accurate reflection, then any inaccuracy may distort companies' decisions as to choice of auditor, and so amount to an entry barrier to the efficient potential entrant that lacks the 'reputation' of the four largest firms.

39. The diagram below illustrates the various factors contributing to the establishment and maintenance of the reputation of a large firm. The virtuous circle exists because the factors follow on from one another and are self-reinforcing. A firm with existing large listed clients can demonstrate experience and claim expertise in the large listed client audit market. In particular, the firm is more likely to be able to demonstrate to a client that it has sufficient human and intellectual capital if it has experience of clients of a similar size; with equally complex operations; operating in a similar sector; and in the same geographical locations. It is more likely to be able to offer the client an audit team with the relevant experience gained through working on other clients. Equally, a vicious circle may exist that serves to exclude new entrants: the lack of client base leads to a lack of experience and perceived expertise, and so the virtuous circle illustrated below operates in reverse.

40. This is not limited to technical expertise—there may also be value in having a network of clients of a similar size because the audit service (at least from the FD's perspective) is not limited to the opinion on the accounts but may also include the

provision of more general advice eg on sectoral trends, trends in accounting standards and corporate reporting etc, or opinions on capability of members of the finance team. This may favour large firms with broad experience of other large clients and particularly clients in the same sector.[11] The size of the firm in its own right may be an important factor. Size may be seen as a signal of quality since larger firms have reduced incentives to lower audit quality opportunistically in order to retain any single client.[12]

FIGURE 1



Source: CC

[12] See Beattie (2012) and DeAngelo (1981a).

41. We now discuss the mechanisms by which the other contributory factors are reinforced by the first mover/incumbency advantage, in terms of *(a)* international networks effect; *(b)* technical resources; *(c)* thought leadership; *(d)* lobbying; *(e)* attracting talent; and *(f)* influential alumni network.

International network effect

42. A network effect is usually used to describe the phenomenon whereby a product of service becomes more valuable the more people use it. We consider that this effect may be relevant to the audit market because companies value the experience and global reach that accrues to audit firms having a large number of international clients.

43. In this industry, it is the case that a multi-national audit client will require audit services in multiple jurisdictions and tenders are typically awarded to one firm for the global audit. A client with a global presence may be won by the US or UK office and will generate income for other firms in the network, wherever the client has a presence. This income is known as ‘referred income’.

44. An established base of global clients means that larger firms have a substantial amount of referred fee income which is shared between the network. The higher the referred income the greater the ability of the global firm to attract and retain the best international firms and to dictate membership rules and quality standards. A lower quantum of referred income means that the threat of removal of this income stream is less powerful. High referred income reduces the possibility of a firm being poached by another network. We have heard evidence of mid-tier firms losing member firms to Big 4 networks.

45. The strength and quality of the international network appears particularly valuable to large audit clients with a global presence.

46. It appears that international networks are self-reinforcing and may produce a barrier to entry which is hard for non Big 4 firms to replicate.

Technical resources

47. Technical resources may include specialist knowledge of particular accounting standards; industry accounting practice; actuarial knowledge necessary for pensions accounting and reporting; tax knowledge; knowledge of international accounting standards, tax etc. The extent and depth of this specialist knowledge may be greater for firms who have had greater experience of auditing large/complex/international (ie FTSE 350) companies.

Thought leadership

48. Thought leadership is a form of marketing employed by audit firms to demonstrate superior understanding and insight into financial reporting and related issues and to enhance the reputation of the firm. It includes publication of books and other written material (some of which may be published on a regular basis; others ad-hoc in response to topical issues); organization/sponsoring/participation in seminars and conferences (eg Breakfast Briefings on the latest accounting standards, or the implications for companies of the latest budget; participation in ICAEW conferences on trends in corporate reporting); and contributing expert opinion on matters of corporate reporting and governance to government and the media (eg fielding experts to speak on The Money Programme, or the Today Programme; contributing to Select Committees and government reports). The more experience a firm has in auditing, and providing other services to large listed clients the more credible and in demand its pronouncements (written or oral) are likely to be. In addition there may be a significant cost associated with this type of activity.

Lobbying

49. By lobbying we mean the participation in the regulatory or political process in order to influence it in some way to the advantage of the firm. Firms may undertake various activities with this end in mind; including offering staff on secondment to the relevant regulatory or government agency;[13] writing letters on topical issues and submitting material in response to consultations; networking with relevant individuals; and engaging in the types of activities listed under thought leadership with a view to influencing Government/regulators. It is likely that firms with experience in the large listed audit market will have greater influence by virtue of their perceived gravitas and stature (ie reputation). But whether or not the lobbying succeeds in its ambition to influence policy to the advantage of the firm, the process of interacting and forging relationships with Government and standard setters may enhance the firm's reputation.

Attracting talent

50. FTSE350 audit clients are a powerful draw for attracting graduates to the firm. The trainee auditor can expect to gain exposure to top management (the Financial Controller, the Group Treasurer etc), an understanding of the structure and business operations of, and the key business issues faced by, the UK's largest commercial organizations. The auditor may also have opportunities to travel overseas to visit foreign subsidiaries; and to work on secondment in the firms' international offices. Larger audit clients may also afford staff greater management opportunities because audit teams tend to be larger. Big firms may also offer higher starting salaries, better training programmes, greater rewards on promotion/partnership, and superior career development opportunities[14].

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[13] http://www.guardian.co.uk/politics/2012/jul/10/lobbying.
[14] PwC, KPMG and Deloitte all feature in the Sunday Times 25 best large companies to work for 2012.

Influential alumni network

51. Working on FTSE350 audit clients gives staff valuable experience with which to take up positions of influence in industry and government/regulators on leaving the audit firm. Many FTSE350 FDs and Audit Committee Chairs are ex-Big 4; as are many of the senior staff in the FRC, ICAEW, and other industry bodies.

Regulatory barriers to entry

52. In our paper on Regulation,[15] we noted that this is a market in which quality (both technical and independence) is highly regulated. These standards apply equally to all firms, both incumbents and new entrants.

53. We are considering various ways in which the regulatory framework may act to restrict entry or expansion, in particular by:

    (a) *Increasing complexity (and globalization) of accounting standards.* There is some disquiet in the profession that accounting standards, particularly US standards, are more complex than necessary.[16] This is considered by some to play into the hands of the larger firms and increase the barriers to entry for smaller firms.[17]

    (b) *Limited ability of the auditor to differentiate itself in the audit report.* The binary nature of the audit opinion may give investors very limited ability to judge the quality of the audit process. This inability to measure quality may increase the importance of auditor reputation and thus favour incumbent firms.

    (c) *Partner rotation requirements.* For listed companies, audit engagement partners may only act for five years (this is typically referred to as 'rotation') and cannot

[15] http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/law_regulation_wp_final_for_publication.pdf.
[16] See for example PwC http://www.pwc.com/us/en/point-of-view/reducing-complexity.jhtml and Memorandum to HoL Inquiry of Professor Vivien Beattie, Professor Stella Fearnley and Tony Hines, 3 October 2010, Section 2.2.
[17] See, for example, Auditors: Market Concentration and their role—Economic Affairs Committee—Supplementary memorandum by Professor Stella Fearnley (ADT 51) Section 3 http://www.publications.parliament.uk/pa/ld201011/ldselect/ldeconaf/119/10101204.htm.

participate[18] in that audit for another five years. The engagement quality control review partner and key partners involved[19] in the audit may only act as the engagement quality control review partner or be involved in the audit for seven years. Anyone who has acted as engagement quality control review partner cannot participate in that audit for another five years, and any key partner cannot participate in that audit for another two years. The audit engagement partner must review the safeguards in place to address the auditor's objectivity and independence where partners and staff in senior positions have been involved in the audit for more than seven years.

(d) *Auditor liability.* Current regulations concerning the ability of auditors to enter into agreements with client firms to limit audit firm liability appear to be ineffective. In practice, no such agreements appear to have been entered into in the UK by the Big 4 or other firms to limit liability for statutory audits for public listed companies. Liability imposes a cost on audit firms. This cost is likely to be proportionate to the size of the company since the profits at stake will govern the cost of insuring the potential loss.

(e) *Audit firm ownership.* Most audit firms[20] are LLPs (although they may be public or private limited companies). The Companies Act[21] dictates that the majority of voting rights must be held by qualified individuals or registered auditors;[22] the majority of the management board, committee or other body must also be qualified individuals or registered auditors. There is now considerable uniformity with respect to the rules on ownership structure and composition of the management board of audit firms across Member States of the EU. Oxera

[18] 'Participate' includes providing quality control for the engagement, advising or consulting with the engagement team or the client regarding technical or industry specific issues, transactions or events, or otherwise directly influencing the outcome of the audit engagement. It does not include responding to queries in relation to any completed audit engagement.
[19] 'Involvement' is only defined in the case of key partners involved in the audit, who are defined as a partner, or other person in the engagement team (other than the audit engagement partner or engagement quality control reviewer), who either is involved at the group level and is responsible for key decisions or judgements on significant matters or risk factors that relate to the audit of that audited entity, or is primarily responsible for the audit of a significant affiliate of the audited entity.
[20] All Big 4 and mid-tier with the exception of RSM Tenon.
[21] Schedule 10, part 2.
[22] That is, a member of the ICAEW, ICAS and/or the ICAI, or a member of the ACCA.

published a report for DG Internal Market and Services in October 2007 entitled 'Ownership rules of audit firms and their consequences for audit market concentration'. It noted that restrictions on access to capital represent one of several potential barriers to entry into the market for large audits: in general, the analysis revealed that financial capital was often of limited use for the majority of audit firms that have limited investment plans, but that capital was found to be critical for firms seeking to expand into the market for larger audits. The report concluded that the relaxation of the current ownership and/or management rules could give firms the possibility of access to cheaper outside capital and that this could create new entry opportunities, albeit the impact of any change in this area would need to be considered alongside the impact of other barriers to entry. In addition Oxera considered that the potential negative effects on independence from changes to ownership rules could be mitigated. However, this is a complex area. Audit firms, including non Big 4 firms, have not cited access to capital as a barrier to entry.

(f) *Rules on component auditors and joint audits.* ISA 600 'Reliance on the work of other auditors' establishes standards and guidance for a principal auditor reporting on the financial statements of an entity is using the work of another auditor (a 'component auditor') who has reported on one or more components included in the financial statements of the entity. ISA600 is silent on the matter of joint audits, in which the company appoints two audit firms to jointly produce a single audit report, thereby sharing responsibility for planning and executing the audit. Joint audits or reliance on the work of component auditors from a different firm or network to the group auditor is not common in the UK, but could be a way for mid-tier firms to gain experience and build reputation in the FTSE350 audit market.

(g) *Independence rules on client size.* There are specific restrictions governing the proportion of fees an audit firm may receive from one audit client (relative to the

annual fee income of the audit firm or the part of the firm by reference to which the audit engagement partner's profit share is calculated). Where the total fees for both audit and non-audit fees receivable from a listed company by the audit firm regularly exceed 10 per cent of the annual fee income of the audit firm (or 15 per cent for non-listed companies), the firm must not act as auditor and must either resign or not stand for reappointment, as appropriate. Where the proportion is between 5 and 10 per cent for a listed company (or between 10 and 15 per cent for non-listed companies), the audit engagement partner must consider appropriate safeguards to eliminate or reduce the threat to the auditor's objectivity and independence. Appropriate safeguards might include reducing the non-audit work undertaken (in the case of a listed company), or applying independent internal quality control reviews (in the case of a listed or unlisted company). Preliminary analysis by the CC suggests that these regulations would be unlikely to affect the ability of non-Big-4 firms to tender for FTSE350 audits other than the very largest clients. However, this analysis is not yet complete.

(h) *Other independence requirements, eg banking relationships.* We have heard for example that the firm itself or the staff of an audit firm may be prohibited by independence rules (including those of the SEC) from having bank accounts with a bank that is an audit client; this could potentially reduce the ability of an audit firm to tender for certain audits or introduce substantial costs in doing so.

(i) *Requirement for audit committee to approve change of auditor.* Some commentators have suggested that the conservative nature of the audit committee acts as a further barrier to mid-tier firms winning FTSE350 audits.

(j) An issue raised by the OFT[23] is that choice may be restricted by regulations concerning the ability of firms to supply certain non-audit services to audit

[23] Oft1357 5.66.

clients,[24] such that a significant proportion of FTSE350 companies find that one or more of the Big 4 audit firms are conflicted out. The OFT cites anecdotal evidence from FTSE100 companies that Big 4 firms sometimes decide not to bid for an audit or bid solely to preserve reputation.[25]

Auditor clauses in loan agreements and other forms of pressure from advisors

54. We have heard evidence from non-Big-4 firms that providers of capital (for example banks and private equity houses) place pressure on companies to switch to a Big 4 auditor. This pressure can be exerted through clauses in loan agreements or investment agreements; or through 'informal vetos' which are expressed orally in meetings but not documented.[26]

55. This may, alongside other factors discussed in this paper, encourage companies to switch to a Big 4 auditor as they grow in size through acquisition or raise equity capital for expansion and may discourage companies from switching auditor to a mid-tier firm.

56. We decided to focus our investigations in this area on loan agreements, rather than on the less tangible 'informal vetos' which are by nature hard to substantiate. We would welcome further, specific evidence of such informal vetos.

57. We sent questionnaires to a selection of lending institutions and legal firms to ask them about the presence of auditor clauses in loan agreements. We asked Cardiff Business School (CBS) to analyse the responses for us and write a report on the matter, including a summary of CBS's own research into US loan documentation.

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[24] We describe these regulations in our Law and Regulation working paper http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/law_regulation_wp_final_for_publication.pdf.
[25] See Oxera 2006 Interviews with market participants.
[26] See PKF hearing summary, paragraph 6 and 13.

Our current understanding is that such clauses are common in sub-investment grade or leveraged loan agreements and typically state that the borrower must use an auditor of international standing such as one of the Big 4. Such clauses are less common in agreements for investment grade debt.

58. We considered whether to investigate the presence of auditor clauses in bond documentation; however, we did not think that such clauses would be likely to occur in prospectuses for public debt. This is because the prospectus typically names the incumbent auditor.

59. This does not mean that there is no pressure to use a Big 4 auditor when raising public debt. We wrote to the ratings agencies on this matter. Two out of three agencies said that they would take into account the identity of the auditor when rating a company's debt to some extent,[27] and this may support a view that the cost of debt is higher when using a non-Big-4 auditor.

60. We are considering the implications of the above to our assessment of barriers to entry. It is particularly difficult to ascertain the extent to which such clauses and vetos are justified by a real (rather than perceived) difference in quality between the Big 4 and non Big 4 firms.

Next steps

61. Based on the above, we plan to consider further:

(a) audit firm profitability, including comparisons of audit firm costs;

(b) engagement level profitability;

[27] See Report of Cardiff Business School (as at 17 August 2012 not yet published but to be published shortly).

(c) modelling the profitability of entry to the market for the provision of statutory audits to large companies. We are considering the use of a model such as that proposed by Oxera (2006), and may conduct our own analysis;

(d) economies of scale and scope in an econometric assessment of audit staff costs;

(e) the competitive effects of international networks;

(f) the competitive effects of liability, insurance and settlements;

(g) switching costs;

(h) bundling, as a possible barrier to entry;

(i) reputation and its effect on auditor selection; and

(j) the effects of the regulatory framework on smaller firms' ability to enter the market for FTSE350 audits.