

AUDIT MARKET INVESTIGATION

The life cycle of FTSE 350 companies

Introduction

1. In this paper we consider the movement of companies between different index designations¹ and how this was associated with observed instances of switching auditors in the years they were active in the public data set. We requested data for 712 companies that were part of the FTSE 350 index at some point during 2001 to 2011. The analysis below is based on 695 companies.

2. The first section focuses on the movements of all companies throughout the whole period. We find that approximately one-third of companies have remained in the same index designation and another third of companies have only moved index designation once. We find that the majority of companies that have entered the FTSE 350 index have come from the other listed designation rather than from being a private company: 305 companies moved into the FTSE 350 index at some point from the other listed designation, compared with 60 companies moving from being private to the FTSE 350 index directly.

3. The second section looks at the observed switching of audit firm and changes in index designation as we consider whether companies were more likely to switch from a Mid Tier firm to a Big 4 firm at the time of listing or moving into the FTSE 350. We look at instances where companies have changed index designation and see if this coincides with a change of audit firm.

¹ The index designations used in the Public data set are FTSE 100, FTSE 250, Other listed and Private.

4. We calculated that 71 per cent of switches occurred when a company was in the FTSE 250 index or the other listed designation, and that 74 per cent of switches were between Big 4 audit firms. The highest proportion of switches from a Mid Tier firm to a Big 4 firm is found among other listed designation companies. We considered the proportion of switches occurring in the year before or the year of a change of index designation: we calculated that these switches accounted for 39 per cent of all switches. We calculated that more companies switched audit firm around the time of moving out of the FTSE 350 index or delisting compared with companies moving into the FTSE 350 or listing. We found that the largest proportion of switches from Mid Tier firms to Big 4 firms (among switches that coincided with changes in index designation) were in the year before, or the year of, a move from the FTSE 350 to other listed status. We repeated the analysis for a wider time gap between switching and moving index designation with broadly similar results.
5. Lastly, we considered the interaction between deal activity, switching audit firm and moving index designation. We calculated that 20 per cent of switches occurred in the same year as a company undertook some deal activity and 33 per cent of switches had deal activity in either the year before, the year of, or the year after the switch. We consider scenarios where a company undertook deal activity and subsequently switched auditor and then also changed index designation. We calculated that 3.8 per cent of switches coincided with deal activity and a move from other listed status to the FTSE 350 index (for the first time). We also calculated that 2.4 and 0.5 per cent of switches were preceded by deal activity and followed by a move to private status from the FTSE 350 index and other listed status respectively.

Movement between index designations

6. In this section we consider the movements of companies between each different index designation. We look at the number of movements each company had, the

companies that have always been in the FTSE 350 index and the number of companies moving between each index designation.

7. We had data for 695 companies over the period 2001 to 2011. We considered index designation changes for companies between quarters. Based on the company status in the first recorded quarter: 53 per cent of companies were FTSE 350, 33 per cent were other listed and 14 per cent were private.

8. Table 1 shows the number of changes between FTSE 350, other listed and private index designations for each company during this time. Approximately one-third of companies remained in the same index designation throughout the period.

Approximately another third of companies changed index designation only once.

TABLE 1 Number of changes between FTSE 350, Other listed and Private index designations

	0	1	2	3	4	5	6
Number of changes	225	233	135	62	29	9	2
Proportion of companies (%)	32.4	33.5	19.4	8.9	4.2	1.3	0.3

Source: CC.

9. Of the 225 companies that remained in the same index designation, 208 (30 per cent of the total sample) were always part of the FTSE 350 index.² Within this group of companies: 26 per cent were always in the FTSE 100, 40 per cent were always in the FTSE 250 and 16 per cent moved both from the FTSE 250 into the FTSE 100 and vice versa. These results are displayed in Table 2.

² We would expect this as the data request was for companies that had been part of the FTSE 350 index during 2001–2011. The other 17 companies may not have been identified as being part of the FTSE 350 index at any time due to some aspect of the CC's data-cleaning process.

TABLE 2 **Companies that have always been in the FTSE 350**

	<i>Number of companies</i>	<i>Proportion of companies %</i>
FTSE 350 only	208	100
FTSE 100 only	55	26
FTSE 250 only	83	40
FTSE 250 to FTSE 100 (permanent)	25	12
FTSE 100 to FTSE 250 (permanent)	12	6
Movement between FTSE 100 and FTSE 250	33	16

Source: CC.

10. Table 3 shows the number of companies that moved between each index designation and the number of those companies that made the same movement more than once. For example, 305 (44 per cent) companies moved from other listed to FTSE 350 and 57 of these companies moved from other listed to FTSE 350 more than once.

TABLE 3 **Movement between Index designations**

	<i>Number of companies</i>	<i>Number of companies making the movement more than once</i>
Private to Other listed	41	0
Private to FTSE 350	60	0
Other listed to FTSE 350	305	57
FTSE 350 to Other listed	256	47
FTSE 350 to Private	57	1
Other listed to Private	30	0

Source: CC.

11. Table 3 shows that the majority of movement into and out of the FTSE 350 index was with the other listed designation. There were 365 companies that moved into the FTSE 350 index: 84 per cent of which moved from the other listed designation and 16 per cent of which were private companies.
12. There were 41 companies which moved from private to other listed designation. Forty of these companies subsequently moved from the other listed designation to the FTSE 350 index (not shown in Table 3). We calculated that 305 companies moved into the FTSE 350 index from the other listed designation and 256 companies moved

into the other listed designation from the FTSE 350 index. While not reported in Table 3, we calculated that 168 companies (24 per cent) had movements both into and out of the FTSE 350 index from the other listed designation.

13. The data in Table 1, Table 2 and Table 3 suggests that there has not been substantial movement of companies between index designations during the last ten years.

Switching audit firm prior to listing and entering the FTSE 350

14. In this section we consider instances of a company switching auditor in the years leading up to becoming a listed company and/or the years leading up to joining the FTSE 350 index.

15. We identified 208 instances where companies switched audit firms, which occurred across 187 companies. Table 4 shows the index designations of companies during the year they switched: the majority of companies switched when they were either FTSE 250 or other listed companies.

TABLE 4 Index designation of companies in the year the audit firm was switched

	<i>FTSE 100</i>	<i>FTSE 250</i>	<i>Other listed</i>	<i>Private</i>
Number	19	67	82	40
Proportion (%)	9	32	39	19

Source: CC.

16. Subsequent results make a distinction between switches between audit firms of different type. We categorize different types of switches as: between the Big 4 audit firms (74 per cent of switches), a Big 4 audit firm to a Mid Tier firm (8 per cent), Mid Tier firm to Big 4 firm (15 per cent) and Mid Tier firms to Mid Tier firms (2 per cent).
17. Table 5 shows the proportion of switches for each index designation accounted for by switches between different types of audit firms. For example, 100 per cent of

companies that were in the FTSE 100 at the time of switching audit firm switched from a Big 4 audit firm to another Big 4 audit firm.

TABLE 5 Proportion of index designation switches between different audit firm types

	Total number of switches	Big 4 to Big 4 %	Big 4 to Mid Tier %	Mid Tier to Big 4 %	Mid Tier to Mid Tier %
FTSE 100	19	100	0	0	0
FTSE 250	67	79	3	16	1
Other listed	82	65	13	20	2
Private	40	73	10	13	5

Source: CC.

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18. The proportion of switches accounted for by switches from Mid Tier firms to Big 4 firms is largest among other listed companies relative to other index designations (20 per cent). We note that the smallest proportion of switches between Big 4 firms is among other listed companies (65 per cent).
19. In Tables 6 and 7 we consider the number of switches that have occurred around the time a company has moved between index designations to attempt to estimate the proportion of switches that could be driven by movement between index designations. In Table 6 we look at the proportion of switches that occurred in the year before, or the year in which a company moved index designation. In Table 7 we widen this period to include up to two years before moving index designation to one year after.
20. When considering movements from the other listed designation to the FTSE 350 (and vice versa) and the FTSE 250 to FTSE 100, we consider separately the first occasion a company made the movement and other occasions on which a company made the movement. It is likely to be of greater significance when a company moves into the FTSE 350 (or FTSE 100) for the first time (although we note that approximately two-thirds of companies made zero or one index movement (see paragraph 8)).

21. It is also important to note that a company may have had more than one index designation movement in the period around a switch, therefore the index designation movements in Tables 6 and 7 cannot be treated as mutually exclusive. For Table 6, where we consider the year before and the year of a change of index (a two-year period) of the 208 switches, 61 per cent did not coincide with a change of index designation, 30 per cent had one change and 10 per cent had two changes. For Table 7, where we consider a wider period for the switch and change of index designation to occur (a four-year period), 44 per cent of switches did not coincide with a change of index designation, 38 per cent had one change and 18 per cent had two or more (a maximum of five) changes.

TABLE 6 Proportion of switches between different types of audit firms occurring in the year before or the year of a change of index designation

	<i>Big 4 to Big 4</i>	<i>Big 4 to Mid Tier</i>	<i>Mid Tier to Big 4</i>	<i>Mid Tier to Mid Tier</i>
Total number of switches	154	17	32	5
				<i>per cent</i>
<i>Index designation movement</i>				
Private to Other listed	1.3	0.0	0.0	0.0
Private to FTSE 350	1.3	0.0	3.1	0.0
Other listed to FTSE 350 (first occasion)	9.1	11.8	9.4	20.0
Other listed to FTSE 350 (other occasions)	1.9	0.0	0.0	0.0
FTSE 250 to FTSE 100 (first occasion)	2.6	5.9	0.0	0.0
FTSE 250 to FTSE 100 (other occasions)	0.6	0.0	0.0	0.0
FTSE 100 to FTSE 250	5.2	0.0	0.0	0.0
FTSE 350 to Private	9.7	0.0	0.0	0.0
FTSE 350 to Other listed (first occasion)	12.3	5.9	3.1	0.0
FTSE 350 to Other listed (other occasions)	4.5	5.9	12.5	0.0
Other listed to Private	4.5	5.9	6.3	20.0

Source: CC.

22. Table 6 tells us, for example, that 154 (out of 208) switches were from a Big 4 firm to another Big 4 firm, and of these switches 1.3 per cent occurred in the year before or the year in which a company moved from being a private company to the other listed designation.
23. It is also noticeable that a higher proportion of switches occurred in the year before or the year of a company moving 'down' an index (ie from FTSE 100 to FTSE 250, FTSE 350 to other listed or listed to private). The proportion of switches from a Mid

Tier firm to a Big 4 firm is higher for movements from the FTSE 350 to other listed status compared with from other listed status to the FTSE 350. This pattern is also observed for switches between Big 4 firm audit firms. This suggests that it is not necessarily the case that Big 4 Firms target Mid Tier clients in advance of FTSE 350 listing (any more so than Big 4 firms target other Big 4 firm clients).

TABLE 7 Proportion of switches between different types of audit firms occurring in the two years before, the year after or the year of a change of index designation

	<i>Big 4 to Big 4</i>	<i>Big 4 to Mid Tier</i>	<i>Mid Tier to Big 4</i>	<i>Mid Tier to Mid Tier</i>
Total number of switches	154	17	32	5
				<i>per cent</i>
<i>Index designation movement</i>				
Private to Other listed	1.3	0.0	0.0	0.0
Private to FTSE 350	2.6	5.9	6.3	0.0
Other listed to FTSE 350 (first occasion)	16.2	11.8	15.6	40.0
Other listed to FTSE 350 (other occasions)	5.8	0.0	3.1	0.0
FTSE 250 to FTSE 100 (first occasion)	6.5	5.9	3.1	0.0
FTSE 250 to FTSE 100 (other occasions)	0.6	0.0	0.0	0.0
FTSE 100 to FTSE 250	6.5	0.0	0.0	0.0
FTSE 350 to Private	11.0	5.9	0.0	0.0
FTSE 350 to Other listed (first occasion)	15.6	5.9	6.3	20.0
FTSE 350 to Other listed (other occasions)	7.8	5.9	12.5	0.0
Other listed to Private	5.8	5.9	9.4	20.0

Source: CC.

24. Table 7 tells a broadly similar story to Table 6, but noticeably more instances of switching are associated with index designation movements given the wider time frame considered. It should also be noted that given the wider time period there is a higher proportion of switches with more than one index designation move in the period around switching (see paragraph 21). The main difference compared with Table 6 is that the proportion of Mid Tier to Big 4 switches associated with a move from the other listed designation to the FTSE 350 for the first time increased to 15.6 per cent from 9.4 per cent.

Merger activity and switching audit firm

25. For the companies under consideration we have Dealogic data, which provides the annual value of deal activity for each company. In this section we aim to identify instances of switching which could have been driven by merger activity as opposed

to any other trigger to switch audit firm. It must be noted that there are limitations to using the deal activity data: we cannot tell how substantial the value of deal activity is relative to the size of the company and/or the type of companies that were acquired. If the companies in the sample are the larger acquiring companies they may have kept their existing auditor, therefore we would not observe the switch of audit firm for the acquired company.

26. In the sample of 695 companies we calculated that 61 per cent engaged in deal activity in at least one year. We calculated that 40 per cent of companies engaged in deal activity in at least a quarter of the years in which they were active, 17 per cent of companies engaged in deal activity in at least half the years in which they were active and 6 per cent of companies engaged in deal activity in at least three-quarters of years in which they were active.
27. We calculated that of the 208 instances of switching identified, 20 per cent occurred in the same year as some deal activity undertaken by the company and 27 per cent occurred with deal activity in the year before or year of a switch. Table 8 shows the proportion of switches where the company also engaged in deal activity in the years around the switch. For example, 33 per cent of switches occurred when there was merger activity in either the year before, the year of, or the year after the switch.

TABLE 8 **Proportion of switches with merger activity in the years around switching**

	<i>Number</i>	<i>Proportion %</i>
Total number of switches	208	100
<i>Merger activity</i>		
Year of switch	41	20
Year of switch/up to 1 year before switch	56	27
Year of switch/up to 2 years before switch	71	34
Year of switch/up to 3 years before switch	81	39
Year of switch/up to 1 year before switch/up to 1 year after switch	68	33
Year of switch/up to 2 years before switch/up to 1 year after switch	81	39
Year of switch/up to 3 years before switch/up to 1 year after switch	90	43

Source: CC.

28. We lastly consider instances of switching that occurred with a change of index designation and deal activity in the adjacent years. Table 9 shows the proportion of switches with a change of index designation in the year of or year after a switch, and merger activity in the year of or year before a switch.

TABLE 9 **The proportion of switches with a change of index designation in the year of, or year after a switch, and merger activity in the year of, or year before a switch**

Total number of switches	208
	%
<i>Index designation movement</i>	
Private to Other listed	0.0
Private to FTSE 350	0.0
Other listed to FTSE 350 (first occasion)	3.8
Other listed to FTSE 350 (other occasion)	0.0
FTSE 250 to FTSE 100 (first occasion)	1.0
FTSE 250 to FTSE 100 (other occasion)	0.0
FTSE 100 to FTSE 250	1.9
FTSE 350 to Private	2.4
FTSE 350 to Other listed (first occasion)	1.9
FTSE 350 to Other listed (other occasions)	1.4
Other listed to Private	0.5

Source: CC.

29. Given the relatively specific circumstances we are considering, the proportion of switches that coincided with deal activity before the switch and an index designation move after the switch is low. We calculated that 3.8 per cent of switches coincided with deal activity and a move from other listed status to the FTSE 350 index (for the first time). We also calculated that 2.4 and 0.5 per cent of switches were preceded by deal activity and followed by a move to private status from the FTSE 350 index and other listed status respectively. The proportions in Table 9 are consistent with the proportions in Table 6 (where we do not consider merger activity).