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Inquiry Manager
Audit Market Investigation
Competition Commission
Victoria House
Southampton Row
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12th January 2012

Dear Sir/Madam,

Re. STATUTORY AUDIT SERVICES MARKET INQUIRY

Further to the Statement of Issues (published 7th December 2011) on the Competition Commission's Audit Services Market Enquiry, and to our letter dated 4th November 2011, we are writing to provide some preliminary findings from our research into restrictive auditor clauses in corporate lending agreements. These clauses, which (it has been argued) require borrowers to have their financial statements audited by a big 4 auditor, and thus represent a potential barrier to entry for firms outside the big 4, have attracted a great deal of attention from various parties, including the House of Lords Economic Affairs Committee, the OECD, the OFT, European regulators and the professional accounting and financial press.

We have so far examined 44 credit agreements. Although our evidence suggests that clauses referring to big 4 auditors are widespread, in most cases, the auditor in question is the incumbent. Indeed, we observe a small number of clauses referring to mid tier firms. Importantly, we do find that some contracts (around 7%) contain a 'generic' big 4 clause (which is presumably the most pernicious type of clause from a market competition point of view) and, in one case, this is associated with a switch from a mid-tier firm to a big 4 auditor. We also find that most clauses have a residual element stating that auditors that are 'nationally recognized' are acceptable.

Our research aims to examine both the prevalence and the nature of restrictive auditor clauses in credit agreements. While they have received considerable attention, so far, the evidence on the incidence and scope of big 4 clauses remains anecdotal. To investigate this issue, we obtained lending (syndicated loan) agreements filed in 2010 with the US

Securities and Exchange Commission (SEC). (Although the sample size may seem small, identifying and collecting data from the contracts is very time consuming and, as noted above, the research is still at an early stage.) It is unfortunate that disclosure of such agreements is not mandatory in the UK. While the Financial Reporting Council encourages firms to disclose such agreements, by its own admission, progress towards full disclosure by UK firms is so far limited.

While we acknowledge that the situation in the US may not be identical to the UK, we defend our use of US contracts as a proxy for UK contracting behaviour on the bases that a) the UK and US financial and accounting environments are similar, as is the level of concentration of the big 4 in the audit market; and b) a significant proportion of the contracts (over 30%) we examine involve UK banks as participants in the loan syndicates.

We initially obtained 50 lending agreements from the SEC, but due to incomplete data on the Compustat and Audit Analytics databases (which, *inter alia*, record the present and past auditor), our sample size fell to 44. We emphasize that this evidence is preliminary and we are in the process of collecting more data. As can be seen in Table 1 below, the majority (59%) of lending agreements contain clauses requiring companies to have the financial statements on which the financial covenants are based audited by a big 4 auditor.

Table 1
Frequency of Clauses Referring to a Big 4 Auditor (n = 44)

Big 4 Auditor Reference	*No Big 4 Auditor Reference*
26 (59%)	18 (41%)

The statistics in Table 1 do not show a complete picture, however. This is because, of the clauses referring to a big 4 auditor, 23 (i.e., 88% of the 26) refer to a *specific* auditor and in all cases where a specific big 4 auditor was mentioned in the contract, the auditor was the incumbent. To the extent that the average duration of the loans in the contracts we examine is around 4 years, such clauses may promote inertia in audit switching. In respect of the 18 contracts with no reference to a big 4 auditor, it is noteworthy that 2 required audit reports from non-big 4 firms (McGladrey & Pullen and BDO).

Of the clauses in Table 1 that referred to a big 4 auditor, only 3 contained a 'generic' big 4 clause requiring the borrower to have their financial statements audited by any of the big 4. For instance, the agreement for a loan to Harris Corporation stated that financial statements must be:

> *"audited and accompanied by a report and opinion of Ernst & Young LLP, Deloitte & Touche USA LLP, PricewaterhouseCoopers LLP, KPMG LLP or another independent certified public accountant of nationally recognized standing reasonably acceptable to the Required Lenders"*

Even though these generic big 4 clauses are not as prevalent as those specifying a particular big 4 firm (i.e. the borrower's existing auditor), they may well cause companies to switch to a big 4 firm. In the case of Medassets, the contract required an audit report by:

> *"a 'Big Four' accounting firm or other Registered Public Accounting Firm of nationally recognized standing reasonably acceptable to the Administrative Agent"*

Importantly, in 2009, before this contract was written, this firm was audited by BDO – a mid tier firm. The financial statements drawn up for the year to 31/12/2010, however, were audited by KPMG. While one out of 44 might seem rare in or sample, it is important to recognize that this switch took place amongst only four non-big 4 auditors in 2009 and hence represents a 25% switch rate.

A final point to note when considering the statistics in Table 1 is that the majority of credit agreements (75%) contain residual elements to the auditor clauses stating that firms 'of nationally recognized standing' are permissible.[1] These elements do allow non-big 4 firms to audit the borrower's financial statements: we observed one mid tier auditor remaining in place in the presence of such a clause. Naturally, more data will be necessary before drawing reliable conclusions about whether this tolerance of mid-tier firms as being 'nationally recognized' represents a convention among lenders or is an idiosyncratic case.

We stress that the results above are preliminary and based on a relatively small sample.[2] There are important questions remaining (for instance, whether particular lenders specify particular auditors and whether the nature of restrictive clauses is associated with debt pricing, as has been conjectured in the accounting and financial press) and such issues will be the subjects of our further research.

We intend to keep you informed of developments as our study progresses and would of course be delighted to discuss these issues with you should you require any further information.

Yours sincerely,

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[1] We found no differences in the proportion containing such residual elements between contracts with and without big 4 clauses.
[2] Despite the sample size, our results should be unbiased, since the sample of contracts was chosen randomly.