

Competition Commission Audit Market Investigation

Response to Issues Statement

We welcome this review of the market for auditing services. As we indicated in discussions with the OFT, we have concerns about whether there is effective competition in this market and we believe that it would be of significant assistance to investor confidence in UK corporate reporting generally for there to be a clearly competitive market for audit services, and for that competition to be on the basis of audit quality.

By way of background, Hermes is one of the leading asset managers in the City of London. As part of our Equity Ownership Service (Hermes EOS), we also represent many clients – both pension schemes and other long-term investors – from the UK and around the world on issues of public policy which may affect the value of their investments in the financial markets.

We believe that much of the analysis in the Issues Statement is fair and raises important issues. Our comments which follow are intended to add further areas and issues which we believe that the Competition Commission should have in mind. We avoid simply repeating comments in the Issues Statement with which we agree.

Higher concentration than is apparent

We understand that certain companies which name their auditor as a firm not among the Big 4 hire this firm solely to carry out the audit of the holding company, while the audit of the operating companies (often overseas) is in fact performed by a Big 4 audit firm. This is not transparent to the shareholders as under current regulations only the holding company auditor needs to be disclosed (we note current proposals from the PCAOB in the US to require additional disclosure of other firms involved in the audit), and it means that the level of concentration is higher in practice even than the headline statistics indicate. Having said this, we have only limited insight into those cases where this occurs (given the lack of transparency) but have the impression that it tends to be the case at companies below the FTSE 350 on which the Competition Commission is currently focusing.

The wrong client

Auditors consider the company which they are auditing the client, and always refer to it in this way. Indeed, it is notable that the Issues Statement itself falls into the trap of repeating this fallacy (for example, at paragraph 9(e)). From a practical perspective, the audited entity does appear to be the auditor's client: it hires the auditor and has the closest relationship with the audit team. However, as the Issues Statement rightly lays out, the role of the auditor is not to work for the audited entity at all; its role is to carry out a function, mandated by law, for the shareholders. The shareholders should be respected and regarded as the client; yet the auditor has no contact with the shareholders and provides only the most perfunctory report on its work to those for whom the work is done.

In the context of this general misapprehension as to who is the client for whom the auditor works, it is perhaps not surprising that the market for audit services does not function effectively and with appropriate competition.



In many instances the relationship of the auditor with the audited entity is mediated by the audit committee but this role is not universally well performed, and even where it is most audit committees will leave a good deal of the decision-making in the relationship to the finance staff. In particular, the CFO or FD – as a leading UK auditor remarked to us recently – has an effective veto over any appointment put forward by the audit committee. Given the leading role of the finance staff at the audited entity in the relationship – precisely those in relation to whom the auditor is supposed to be providing assurance – it is perhaps unsurprising that any competition that does occur will only vanishingly rarely be with regard to audit quality.

Lack of visibility of audit quality

Audit quality is currently invisible to the consumers of audit services, the shareholders. Current audit reporting, the only end product visible to shareholders, does the profession a profound disservice by being more about what the auditor does not do (much of the report is expressly designed to limit the auditor's liability) than about what the auditor has specifically done in this audit. The UK's Auditing Practices Board (of which I am a member) has written a local version of ISA 700, the auditor reporting standard, with the express aim of encouraging more flexible and informative auditor reporting, but sadly this opportunity is not being seized.

This means that shareholders have no visibility on audit quality and cannot promote the use of firms which provide higher quality audits. In the absence of the consumers of audit services having insight into quality, there is limited competitive pressure on the profession to compete in the area of audit quality.

There is an implication in the Issues Statement that the level of standards and guidance about the audit leaves limited scope for competition on audit quality. We disagree with this view, and believe that while there are detailed and specific standards (the ISAs, which other than ISA 700 the Auditing Practices Board has adopted more or less wholesale into the UK) these are a minimum threshold and competition can certainly occur in relation to quality which goes beyond this minimum level. The fact that there appears little appetite among the firms to exceed this minimum is, we believe, evidence of the failure of competition to work effectively in this market rather than evidence that the standards of themselves limit the scope for competition.

Where competition is never allowed to bite

The Issues Statement notes the extent of non-audit services provided to audit clients. Almost of more significance to the issue of competition is the level of non-audit services provided to non-audit clients. For the dirty little secret of the audit market is that often the Big 4 have only limited interest in seeking to win audit mandates. Under the Ethical Standards the auditor is barred from providing many non-audit services, and this means that a Big 4 firm might be required to give up existing sources of income and profit if it were to win an additional audit mandate. This further encourages the noted and notable ossification in audit mandates.

This unwillingness to compete is reinforced by the lack of tendering of audit mandates. In combination they mean that competition is rarely allowed to bite in the audit market.

Overall, our firm view is that the audit market is one with significant barriers to entry, dysfunctional purchasing behaviour carried out by agents rather than the ultimate consumer of the service, who receives no or limited insight into the quality of the service received. There is scope in the current framework to enhance quality but thus far these have been unheeded, which seems to us evidence of the failure of competition in this market.

We would be pleased to have further dialogue on these issues if that would be of assistance to the Commission. We are also very willing to share our thoughts on potential interventions which may help to increase competition in the audit market.

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