

## STATUTORY AUDIT SERVICES MARKET INVESTIGATION

### Summary of hearing with Group A held on 13 May 2013

#### Provisional findings—opening comments

1. Group A said that the firms it represented would like to take on a greater share of FTSE 350 audits than they had currently. They were already set up systemically to be able to do that, without the need for any major investment.
2. There was no impediment to Group A firms taking on consultancy work presently carried out by the biggest firms for FTSE 350 companies but there existed a level of subliminal institutional bias against Group A firms, which the Competition Commission (CC) had also identified in paragraph 5 of the CC's Notice of possible remedies and concluded that this was a very difficult to address. Group A considered that the potential remedies that the CC had identified, with which it had no essential quarrel, did not go far enough to address the issue of removing barriers to entry.
3. Group A had a fuller concern that the remedies the CC had proposed were not well aligned with the issues and problems that the CC had identified.
4. It was Group A's view that absent a degree of regulatory intervention beyond that already taken into consideration there would not be significant change to the status quo in the short, medium or longer term.

#### Financial Reporting Council changes

5. The commercial strategies of the firms that made up Group A had not changed since the recent changes introduced by the Financial Reporting Council (FRC) regarding tendering every ten years on a 'comply or explain' basis. Group A firms were not confident, notwithstanding this change, that they would have the opportunities to obtain a share of the FTSE 350 market sufficient to justify further investment. Any investment decision in this area was a matter of a rational assessment of investment and return. Group A considered that the FRC's changes would primarily move audits around between the Big 4 firms.
6. Even though the new requirement should help firms to identify when audit tenders were likely to take place, two issues remained. One was that it was unclear what proportion of companies would 'comply' as opposed to 'explain'. The second issue was whether smaller firms would have the same opportunity as the larger ones actually to win audits, which would require fair and open tendering and selection processes.
7. Group A said that corporate crises, such as just having been taken over or losing a Finance Director, would be an acceptable explanation for not tendering. Similarly some Group A firms considered that an organization being very big and complex and so having a limited choice of auditor would also be an appropriate explanation. However, the interpretation of what constituted a corporate crisis could be subjective from one organization to the next. Group A would be concerned if organizations were labelling inappropriate events under this category to avoid holding tenders. Group A considered that there needed to be a limit on the number of times a company could explain to prevent any company from persistently explaining.

8. Even if companies opted to comply rather than explain, Group A firms would not be confident about the return on making large-scale investments to compete in the tenders because they did not believe they would have a fair chance of winning the engagement.
9. Group A noted the CC's analysis which showed that the non-Big-4 firms were invited to about one-third of the tenders but did not win anything like that percentage. Group A said that just having a comply or explain approach would not determine investment decisions. Group A would be looking for other remedies and ideas that would encourage the market to open up beyond its current remit.
10. It was Group A's view that in the current climate, where it believed there was a subliminal institutional bias against non-Big-4 firms, even if they were invited to participate in a tender process, they were unlikely to win engagements. It would take a brave Audit Committee (AC) and a brave management to select someone they did not know very much about. Group A considered that the issue was not only about doing more audits but also about delivering non-audit services (NAS), which it considered it was more than capable of doing in a cost-efficient way. It would be helpful if the relationship between an audit firm and the company's management could be weakened to allow more firms to build relationships with companies and being able, through positive discrimination means, to demonstrate competence through the provision of non-statutorily licensed services would underscore confidence-building.
11. However, Group A acknowledged that the Mid Tier firms would welcome the opportunity to be involved in more tenders, which could potentially result in two outcomes. One would be actually to win some audits on merit and the other would be to get greater exposure to the ACs which would benefit all in the decision making. This would help in both audit and non-audit services to demonstrate Group A's credentials and its ability to engage.

## **Joint audits**

12. Joint audits would enable it to reach higher up the market than would otherwise be possible. It believed that all of the non-Big-4 firms had indicated that there were a number of companies that they would not be happy auditing on a sole basis, but would feel more comfortable auditing on a joint basis. It was important to penetrate the top end of the market which was where it thought there was systematic risk. Joint audit at the top of the market would also address the risk raised by the FRC of four firms going to three.
13. There was a very high concentration of fees towards the top end of the market and joint or shared audit would be an essential element to introduce competition throughout the FTSE 350 in the near term.
14. Group A considered that joint or co-audit would make a difference at the top end of the market because there would be a greater tendency than in the case of sole audits for ACs to look beyond the Big 4 at other firms for the provision of audit services. It would open up the market and allow ACs to retain the perceived comfort of a Big 4 name. If the norm became actually to appoint a Big 4 auditor and a Mid Tier firm as joint auditor this would give much better exposure to companies of Mid Tier firms.
15. In Group A's view, joint audit would benefit the market because it would allow non-Big-4 firms to enter the top end of the market straightaway. Joint audit encouraged more non-Big-4 firms to have a greater share of the market which would bring an increase in competition. The presumption was that if there were benefits for the

market as whole then individual companies and investors would also benefit. There would be more challenge to judgements and it was new players that generally brought innovation rather than existing players in the market. It would also increase the perception of auditor independence.

16. Group A noted the French model on joint audit and pointed out that whilst there were a number of significant listed companies in France that were jointly audited by two Big 4 firms, there were also quite a significant number that were audited by a Big 4 and a non-Big-4 firm, so that model had been established there. Group A did not think that there was likely to be as much institutional bias just towards the Big 4 in joint audit.
17. Group A noted that whilst the proportion of the audit fee share was less than the proportion of the CAC 40 clients for those firms that had joint audit clients in France, the French system required there to be a balanced share between the two auditors which would not normally be worse than a 70:30 split. Under such a system, there was unlikely to be a risk of the 'minority' auditor just to be there as a form of tokenism.
18. Joint auditors were unlikely to sign a joint opinion with joint liability if they were not comfortable with the work of the co-auditor. Equally, joint auditors would be obligated to carry out the same level of audit quality and each firm would be placing reliance on the other and each would want to be comfortable with the other's work, irrespective of the complexity or technical nature of the work each firm was undertaking.
19. Some firms of Group A had experienced joint audit and noted that over time their proportion of the joint audit had increased for some clients. However, even if this was not the case, it considered that the joint audit model was still sustainable.
20. Group A noted the differences between joint audit and shared audit, highlighting that shared audit was governed by ISA 600. This required the group auditor to understand the processes and controls of the component auditor. Group A noted that from its experience, shared audits between Group A firms/networks and Big 4 firms/networks worked effectively irrespective of whether Group A was the group auditor or component auditor in the relationship. Group A acknowledged that working with component auditors might lead to some challenges in conducting the audit, the level and degrees of which would vary, depending more on the jurisdiction in which the component audit was located rather than whether they were a Big 4/non-Big-4 firm/network.
21. If joint or shared audit was progressed as a remedy, the profession would adapt accordingly to ensure that the quality of the audit was maintained or improved further because it considered the profession was very adept at responding to change.

### **Auditor liability**

22. There had been a number of models postulated for statutory limitation of liability that had not gained a lot of ground. This was possibly because of a lack of political will and also because of the perspective of the companies being audited, which was a powerful lobby. In its view this issue needed to be revisited by government. Group A indicated its support for a system of proportionate liability.

## **Restrictions of non-audit services**

23. Group A considered that preventing the FTSE 350 auditor from providing as many NAS to its client could be very helpful in increasing competition in the audit market.
24. The FRC had indicated that it was not a competition regulator therefore it would not seem logical to leave it to the FRC to decide what the appropriate level of NAS were for an auditor to provide its client.
25. There was no reason why the level of NAS that were provided should be limited not only by consideration of auditor independence but also on the grounds of competition. Some investors had advocated a figure of 50 per cent. The area of NAS allowed could be drawn more tightly, or limits on the total could be set.
26. A limitation of NAS could only enhance competition because companies would have to use different suppliers. It might be that a number of firms would be quite comfortable for a number of years providing NAS to a client where they were conflicted from being involved in the audit. This would give more companies within the FTSE 350 a perspective on using other suppliers, which would be a positive result.
27. ACs should publically communicate their policy with respect to NAS, indicating their views on the types of work they were prepared to commission from particular firms or categories of firm. This would allow shareholders an opportunity to express concerns if they had any.
28. Group A considered that the Mid Tier could quite capably and credibly provide some of these services, providing companies with potentially more choice, increased competition and consequently more competitive pricing and value.

## **Closing remarks**

29. Group A stressed the importance of ensuring that the remedies introduced new players into the market which would provide benefits in terms of innovation and in terms of addressing the issue of the risk of one of the Big 4 firms unexpectedly leaving the market.
30. There was a disproportionate balance in the remedies towards switching costs and those sorts of issues as opposed to the wider issue of introducing new competition into the market in order to influence price and innovation.
31. Group A also said that most of the issues that were being looked at were around how to encourage companies to avail themselves of perceived benefits of switching as opposed to whether to switch outside of the limited number of existing firms.