Submission by Andrew Laing
On the Competition Commission's Investigation into the Statutory Services Audit Market
30 November 2012

The big four/five account for over 98% of audit and non-audit fees in the CC Audit Dataset with audit only fees similarly dominated by the big four/five. Growth in statutory audit related revenues has been significant for the big four in what is ***now worth GBP1 billion p.a***. Growth is evident in the small ten, but the smallest auditors are struggling to grow sustainably. Inflation is not the source of growth. The big four are growing fast, with PWC by far the biggest for audit and non-audit services. Grant Thornton and BDO are by far the largest of the small ten and have also been growing fast. Some smaller players are also growing including PKF and CV. Growth has come from higher unit costs of statutory audit services, ***particularly in the big bank and mining industries***. Four of the five biggest industries are highly concentrated with only a few massive companies, meaning competition and an appearance of a conflict of interest is difficult to assess. But companies vary rarely change their auditors. The biggest firms generally stick with their auditor for the full decade. When change of auditor does occur fees can go up or down reflecting that price and quality of service applicable to firms' changing needs may be a trigger for switching. (Analysis is provided in Attachment on page 4.)

To assess the level of competition in the auditing field <u>it is important to distinguish audit services as a private good and as public good</u>. As private good, the purchaser is basically: i) paying to comply with laws; but also; ii) provide positive "signals and assurances" to external and internal stakeholders that what they – the company's directors – are saying in the firm's financial statements (not budgets) is actually the truth. This second motive is what started the whole auditing industry where regulation was absent and asymmetric information[1] was prevalent.

The following issues are provided for the Competition Commission's consideration noting the importance of assessing competition within the context of both private and public goods:

- **Asymmetric information is arguably still a major problem**, especially around global and national systemic risks.
- **There may be strong conflicts of interest in the provision public goods**. For example there may be strong incentives to misrepresent the truth due to the principle agent problem – in this case auditors are being paid by the auditee.
- **There may be some conflicts of interest in the provision of private goods**. For example, intimate knowledge of a firm by one auditor can be theoretically used to the detriment of the firm when and if the auditor also provides non-auditing services to a competitor firm. This may for example produce incentives for the firm to not change auditors.
- **There may be moral hazard problems**. For example, certainty of audit work from a concentrated market may lead to less than optimal innovation and low quality audits. The moral hazard in this case is reversed: e.g. not enough risks being taken in being too truthful as well as strong incentives to cut audit input costs and lower quality – This is applicable given that ***it is currently difficult to assess a good quality and thorough audit from a bad quality and superficial audit***).

[1] Where the firm knows a lot more about the truth in operations than shareholders, regulators and consumers.

- **The size of the audit market and hence the level of competition may be adversely affected by industry market size.** Consequently, a natural monopoly may be in place when the industry is small in firms but large in value with significant barriers to entry (e.g. banking and mining industries).
- **External statutory audit information is non-rival and non-excludable** (when made public): Shareholders, regulators, academics and other stakeholders can use the information basically for free. (Related issue - competitors can also use information without cost which can promote competition but could stifle innovation and cause a race to the bottom).
- **Positive externality problems emerge in the provision of private auditing services**. For example, more robust auditing and against better accounting, auditing, budgeting, risk quantification standards could lead to less than optimal provision by the private sector since the value of positive externalities are not priced in properly nor transparently (unless mandated by a law or 3rd party payer mechanisms).
- **Audit standards should be developed that ensure an auditor can produce a quality audit in one year.** If a firm's operations are too complex, auditors should be clearly explaining in detail the level of complexity as well as the risks of financial management operations. If it takes five (5) years to understand a firm well and improve the quality of audit as the big auditors claim, then there appears to be a major problem with the standards for the provision of information prior to audit and other auditing standards. Consequently, work needs to be accelerated to establish an audit complexity index and better audit standards.
- **Audit transactions cost do not seem to be a major problem** given that audit costs still represents a very small fraction of turnover.
- **Weaknesses in Accounting Standards**. Examples include: Multidimensional accounting is not well developed. Budgets are not required to be produced in the same way as financial statements leading to non-optimal transparency. Standard setting may also be subject to influence by vested interests including through funding of standard setting bodies.
- **Weaknesses in Auditing Standards:** Issues include accounting standard issues above. In addition, auditing standards are particularly weak on assessing company level systemic risk of irregularities etc.
- **There is a strong case for the mandatory separation of internal and external auditing services**, given the linkages to audit and related revenues and conflicts of interests and moral hazards.
- **Many of the issues raised are global** – further efforts need to be made in appropriate forums such as the G-20.
- **Transparency of audit operations is weak.** The data collected by the CC should arguably be a regulatory requirement and published and updated annually.

A few possible policy options for the CC's consideration follow:

- **Start with improving transparency:**
    - **Audit database maintained, expanded and made very accessible to the public** including mandatory reporting of audit fees, person days, type of audit or service etc.
    - **Quality of audit services to be assessed and tracked** – ***Towards three audit related indices: quality of audit, quality of auditor, and audit complexity.***

- **Greater supervision of audit operations** with detailed rolling cycle reporting of compliance with (ideally enhanced) auditing and other standards.
- **Regulatory requirement to price audit services better** according to a classification standard (e.g. for different types of audits and the component which has a private benefit and another which has "community service obligation/public good elements".

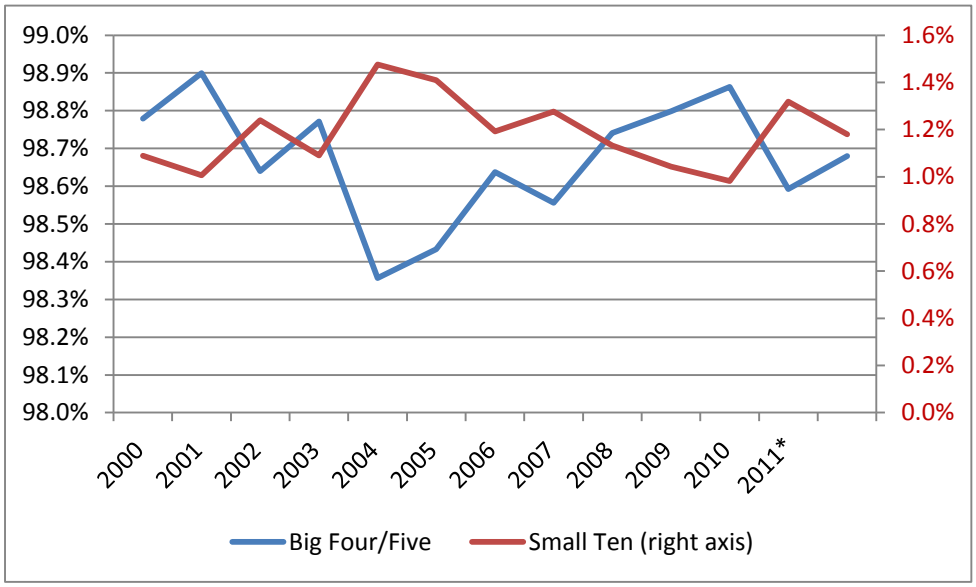
- **Explore 3rd party payer options for public good component of audit services**
  - **Use of Taxation** – from general revenue or hypothecated tax (e.g. a FTSE tax, specific industry tax of systemic importance. This would basically be a modification of the Tobin tax: tax transactions on approved or unapproved products using differential tax rates, thus providing government with additional policy tools to influence speculation, support longer term goals and monitor systemic risks).
  - **Use of self-levy to raise audit funds for particular industries** and where auditors are selected at random every 3-7 years.
  - **Lottery for auditor not linked to self-levy** but would be subject to audit quality standards as determined by company being audited (requiring quality audit indices).
- **Consider the use of random audits of systemically important audits** by the Supreme Audit Institution and other supervisory bodies.
- **Consider making it mandatory to change an auditor after a certain period s.t. size of industry and company** – if it takes 5 years to properly understand a company then there is a serious problem. Audits should be reporting that things are too complex if they are very complex. Consequently, there is a need for an audit complexity index. There would also be a need to allow some reward for outstanding service (e.g. high scores on quality of auditing index, solid history of audited statements being correct prior to firm failure etc).
- **Consider a regulatory separation of external audit and internal audit-like services** (including non-audit consulting).

Attachment

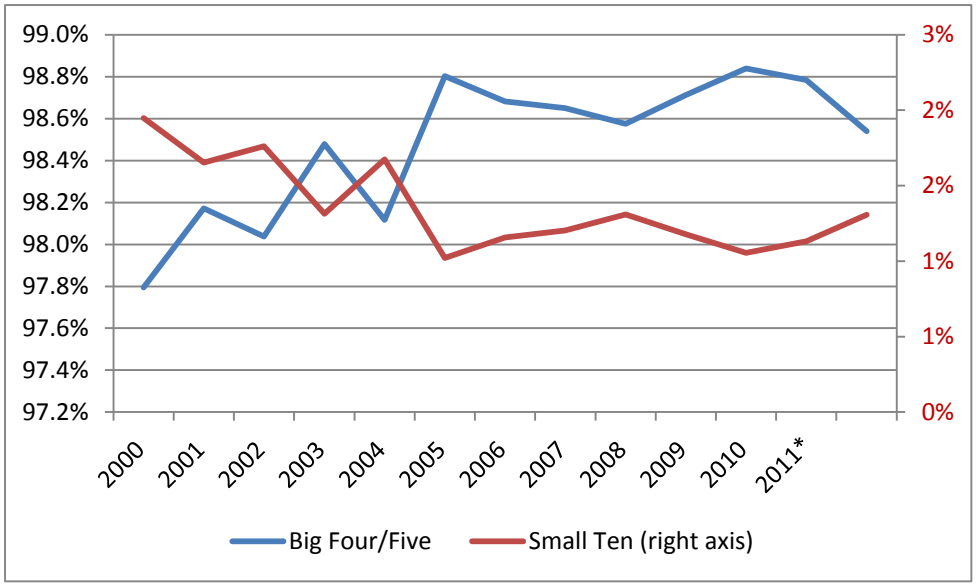
CC Statutory Audit Services Database analysis

All figures in GBP '000 unless otherwise stated.
Data Source: Competition Commission Statutory audit services market investigation database

The big four/five account for over 98% of audit and non-audit fees in the CC Audit Dataset

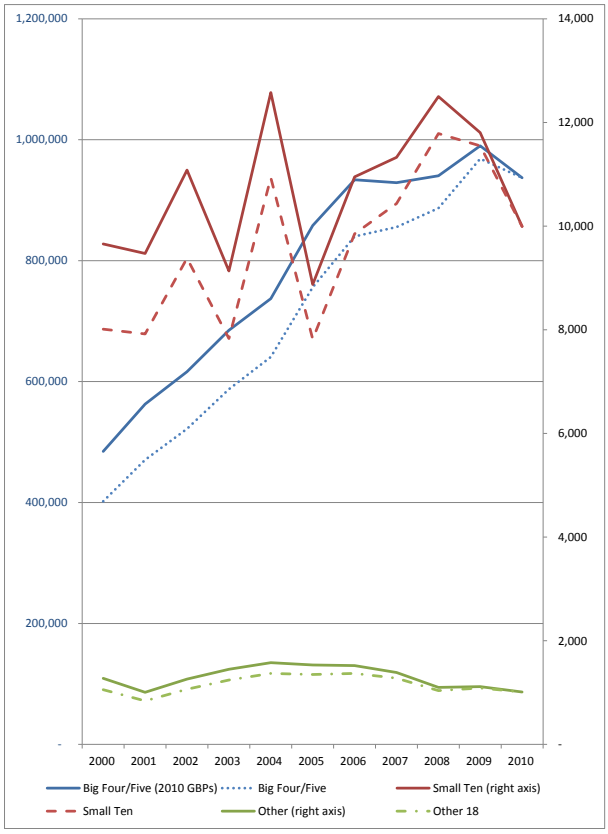


Audit only fees are similarly dominated by the big four/five.

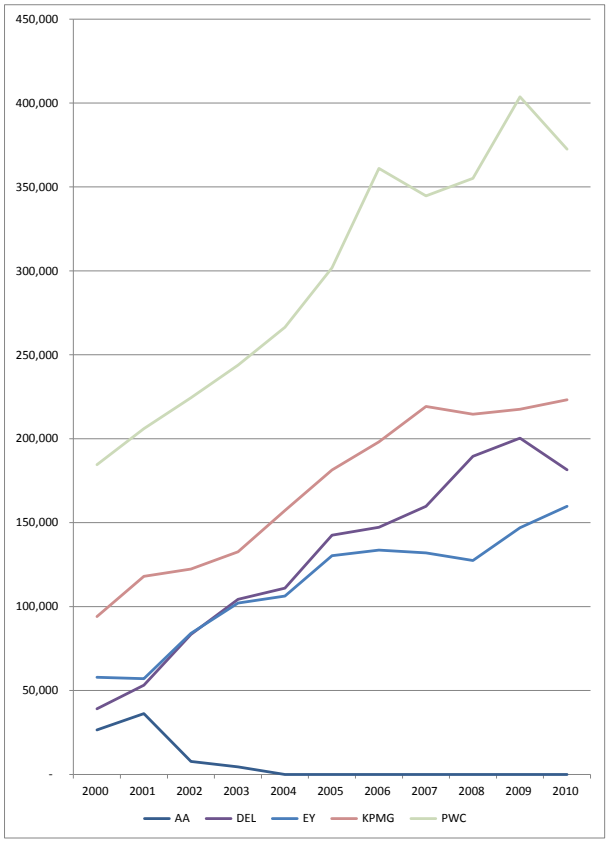


Growth in statutory audit related revenues has been significant for the big four in what is now worth GBP1 billion p.a. … Growth is evident in the small ten, but the smallest auditors are struggling to grow sustainably.

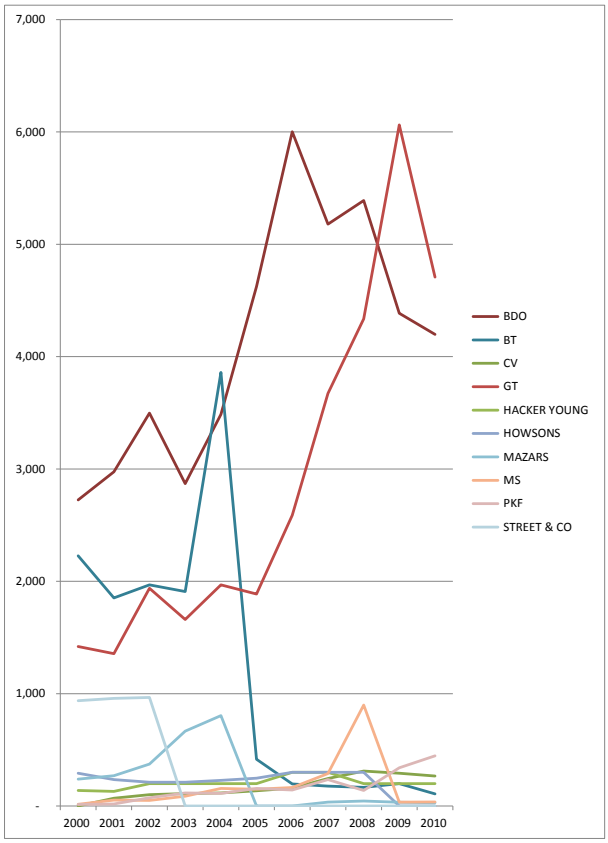
Adjusting for inflation does not account much for the significant revenue growth



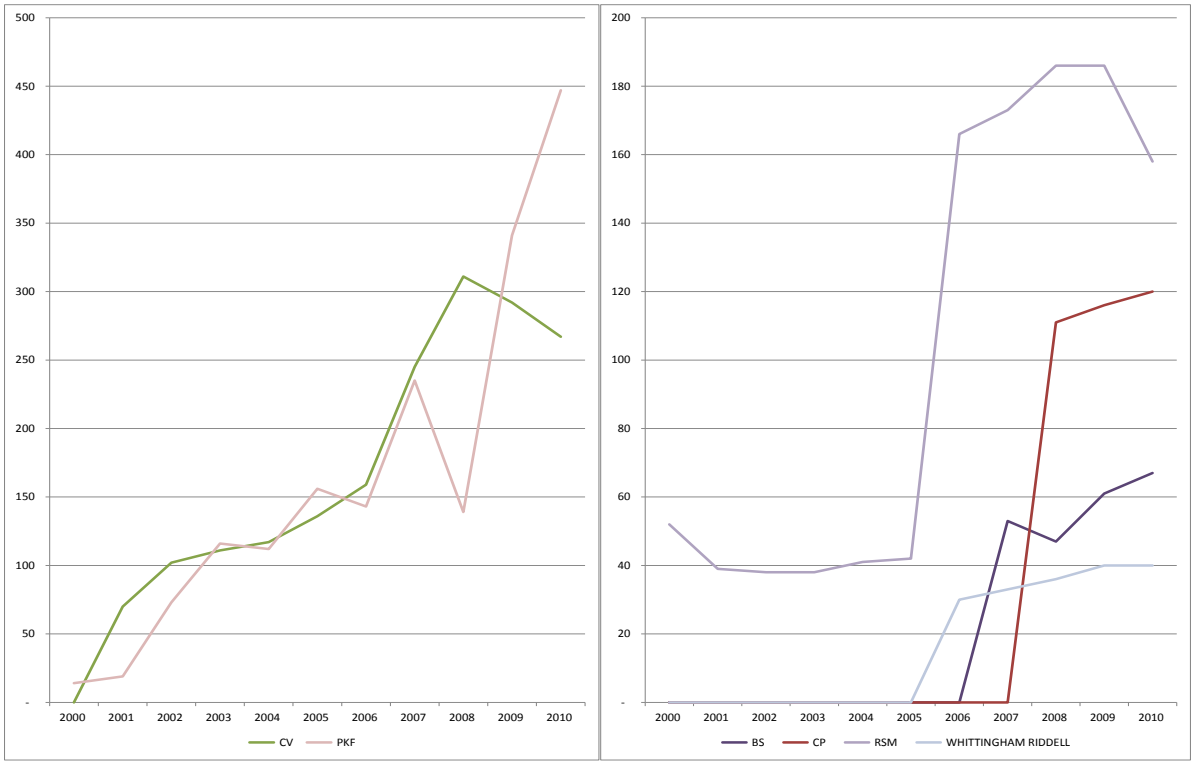
The big four are growing fast, with PWC by far the biggest for audit and non-audit services



Grant Thornton and BDO are by far the largest of the small ten and have also been growing fast



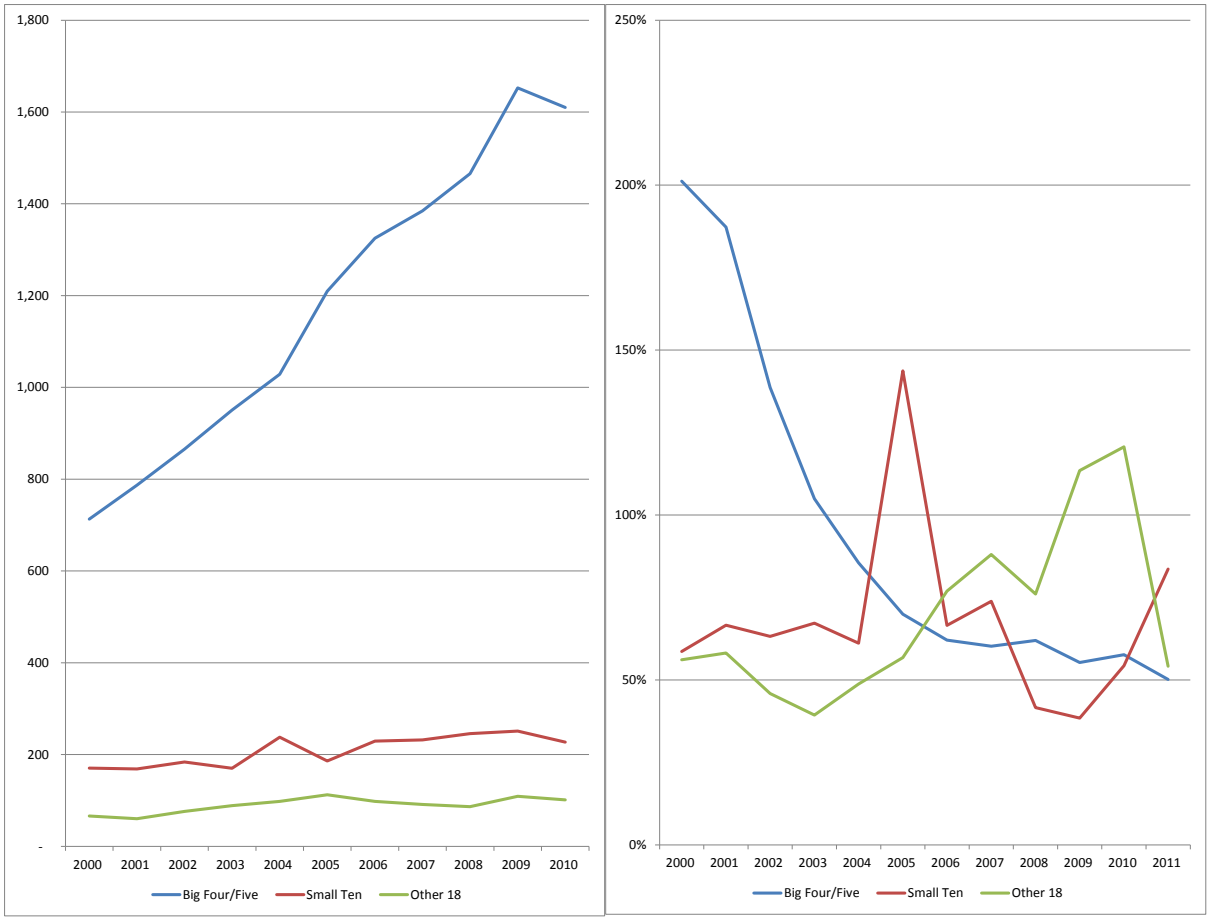
Some smaller players are also growing including PKF and CV



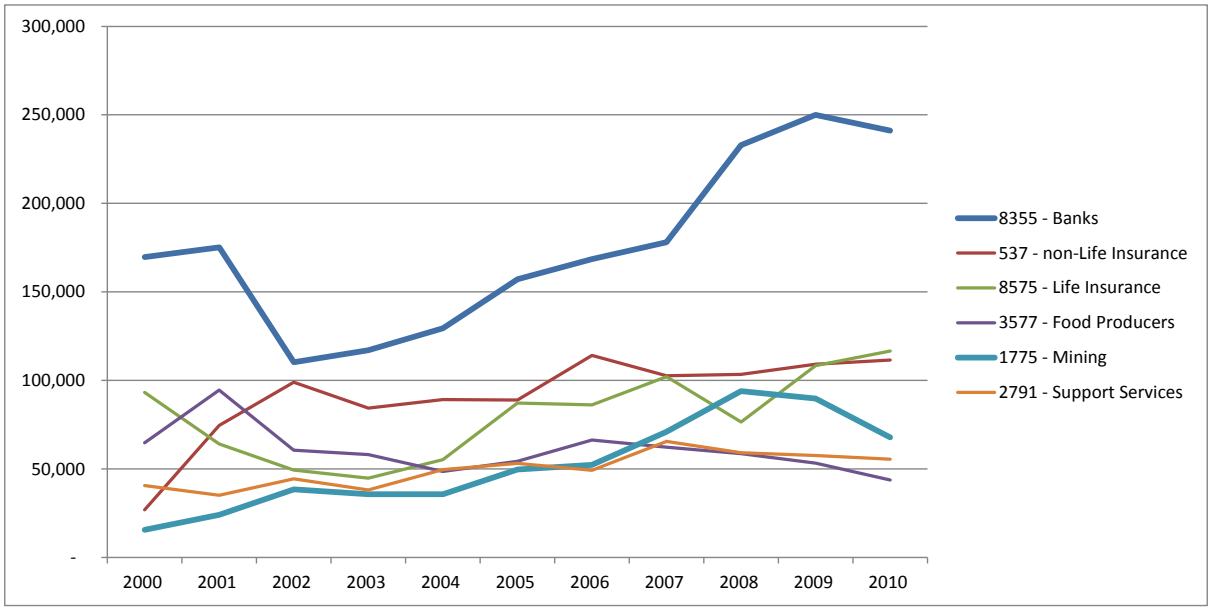
Growth has come from higher unit costs of statutory audit services

Average cost per audit and non-audit activity

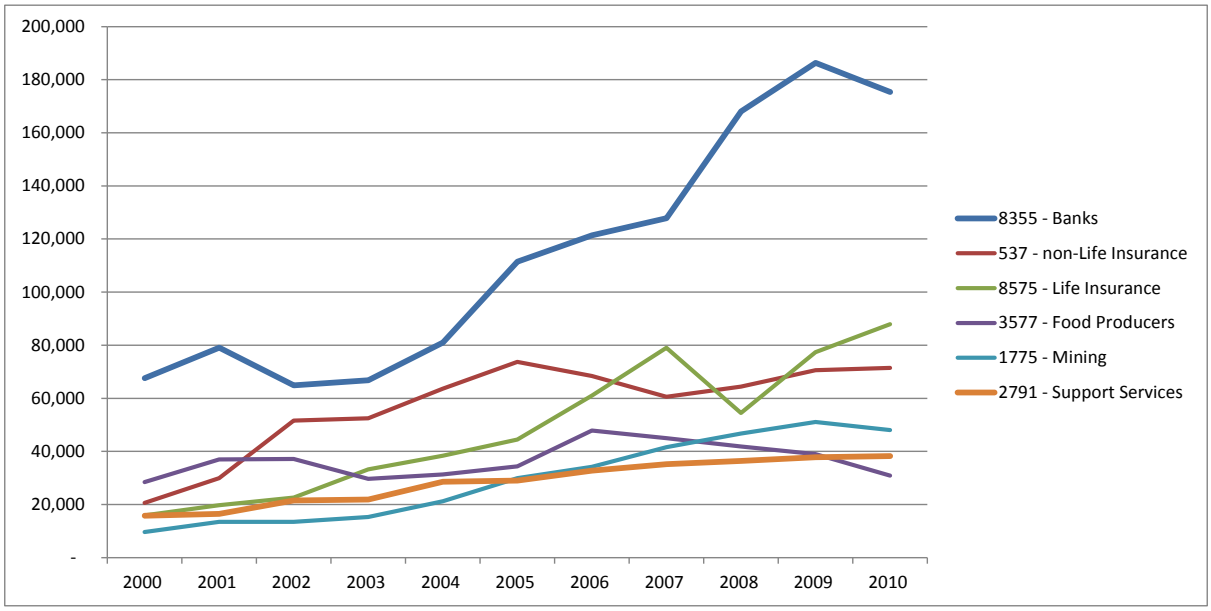
% of non-audit services to audit services



Statutory Audit and non-audit revenues are growing fast in the big bank and mining industries



The banking industry is dominating growth in audit only revenues.



Four of the biggest industries are highly concentrated with only a few massive companies; meaning competition and an appearance of a conflict of interest is difficult to assess.

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
8355 - Banks											
No of firms	12	13	11	11	11	11	10	10	10	8	8
Number of Audit firms	3	3	3	3	3	3	3	3	3	3	3
Company to Auditor Ratio	4.0	4.3	3.7	3.7	3.7	3.7	3.3	3.3	3.3	2.7	2.7
537 - non-Life Insurance											
No of firms	2	3	3	3	3	3	3	3	3	3	3
Number of Audit firms	2	2	2	2	2	2	2	2	2	2	2
Company to Auditor Ratio	1.0	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5
8575 - Life Insurance											
No of firms	8	8	8	8	8	8	10	10	9	10	10
Number of Audit firms	3	3	3	3	3	3	3	3	3	3	3
Company to Auditor Ratio	2.7	2.7	2.7	2.7	2.7	2.7	3.3	3.3	3.0	3.3	3.3
3577 - Food Producers											
No of firms	17	20	20	20	20	20	21	21	19	19	17
Number of Audit firms	6	6	6	6	6	6	6	6	6	6	6
Company to Auditor Ratio	2.8	3.3	3.3	3.3	3.3	3.3	3.5	3.5	3.2	3.2	2.8
1775 - Mining											
No of firms	4	5	6	6	9	9	10	11	11	10	10
Number of Audit firms	3	4	5	5	5	5	5	5	5	5	5
Company to Auditor Ratio	1.3	1.3	1.2	1.2	1.8	1.8	2.0	2.2	2.2	2.0	2.0
2791 - Support Services											
No of firms	34	35	36	37	37	37	37	38	36	36	34
Number of Audit firms	8	8	8	7	7	6	7	7	7	7	5
Company to Auditor Ratio	4.3	4.4	4.5	5.3	5.3	6.2	5.3	5.4	5.1	5.1	6.8
Biggest Industries											
No of firms in biggest industries (audited)	77	84	84	85	88	88	91	93	88	86	82
Number of Audit firms	9	9	9	8	8	8	8	7	7	7	7
Company to Auditor Ratio	8.6	9.3	9.3	10.6	11.0	11.0	11.4	13.3	12.6	12.3	11.7

But companies vary rarely change their auditors

Bank Industry	Audit	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Alliance & Leicester PLC	DEL	1,100	1,700	3,300	1,600	2,000	1,500	3,500	1,600	3,000	-	-
Bank of Scotland PLC	KPMG	4,800	6,600	-	-	-	-	-	-	-	-	-
Barclays PLC	PWC	58,600	38,000	22,000	21,000	22,000	37,000	57,000	56,000	61,000	61,000	67,000
Bradford & Bingley PLC	KPMG	3,800	1,800	1,900	1,300	1,100	1,800	1,700	1,400	2,500	1,400	1,100
	PWC	-	-	-	-	-	-	-	-	-	-	-
Egg PLC	KPMG	551	806	1,503	618	828	696	-	-	-	-	-
Halifax Group Ltd	KPMG	6,000	14,000	-	-	-	-	-	-	-	-	-
HBOS PLC	KPMG	-	23,000	11,700	9,500	11,600	11,600	11,200	11,400	15,700	-	-
HSBC Holdings PLC	KPMG	26,957	26,102	25,719	29,937	35,763	44,450	36,306	41,034	49,250	50,895	50,691
Lloyds Banking Group PLC	PWC	43,000	34,000	10,500	19,700	20,900	13,600	19,200	18,200	22,100	61,700	59,100
Northern Rock A M PLC	PWC	1,700	1,600	1,800	1,300	2,100	2,500	1,500	2,700	2,000	2,010	1,600
RBS Group PLC	DEL	9,000	12,506	12,200	14,000	15,700	29,300	23,000	31,400	58,800	53,900	43,200
Santander UK PLC	DEL	7,800	7,700	9,900	12,200	10,400	6,200	6,800	4,900	5,100	6,500	6,000
Standard Chartered	KPMG	6,300	7,359	9,661	5,938	7,098	8,525	8,261	9,346	13,402	12,628	12,430

Firms in the big five industries that changed their auditors:

Life Insurance: **Friends for Life** change their auditor once every 4-5 years and fees increased. **Pearl Group** changed in

2006 and fees doubled.

Food Processing: **Cadbury** changed in 2002 with no change in fees in year of change. **Findus Group** changed in 2009 with no change in fees in year of change. **Geest** changed in 2005 and fees reduced by two thirds. **Northern Foods** changed in 2003 with no change in fees in year of change. **Robert Wiseman Diaries** changed in 2003 with no change in fees in year of change. **Samworth Brothers** changed in 2010 with an increase in fees. **Vestey Group** changed in 2003 with a reduction in fees.

Mining: **Anglo Pacific Group** changed in 2007 with an increase in fees.

Support Services: **13 of the 55 companies changed their auditor once** with costs going up or down.

Andrew Laing
30 November 2012

Andrew Laing is an experienced public economist with particular knowledge of advising on financial management and accountability policy. He currently works as an independent consultant economist. He worked as staff for AusAID, as Assistant Director General of the Economics and Service Delivery Branch and Sr Public Finance Associate, and for the World Bank as a Senior Public Sector Specialist and Country Economist in Timor-Leste, Cambodia and Iraq. He has worked for various consulting firms delivering programs and analytical assistance on behalf of ADB, AusAID, DFID, IMF, NZAid, SIDA, UN, UNDP, USAID and the World Bank. He has delivered high quality products including: PEFA reviews, fiduciary and development risk assessments, cost-effectiveness analysis, security sector expenditure review, economic evaluation, budget process and system design, and change management. His work experience has been rendered in different positions in both public and private sectors in economic evaluation and in researching and consulting posts. Andrew has provided high level policy and financial advice, coordinated research and development on various projects in various countries and regions. He has direct experience with the following countries/territories: Afghanistan, Australia, Cambodia, Indonesia, Ireland, Iraq, Lao PDR, Liberia, Pakistan, Papua New Guinea, Sri Lanka, Timor-Leste, Tokelau, Turks and Caicos Islands, United Kingdom, United States, Vietnam and West Bank and Gaza.

Andrew Laing is an Australian and British Citizen. He is married to an Irish citizen, has two children and currently lives in Paris.

There are no conflicts of interests to declare. This paper is a rapid independent assessment and was undertaken in one day. The assessment was unfunded. Views expressed in this paper only reflect those of the author.

Caveat: Rapid analysis of CC dataset was undertaken in half day (30/11/12). Review has been limited. Consequently there may be some errors, though the narrative is unlikely to be materially different. Further research is warranted.