

Inquiry Manager
Statutory Audit Investigation
Competition Commission
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Statutory audit services investigation: further possible remedy

Your press notice dated 5 June 2013 invited comments on a further proposed remedy which would give the Financial Reporting Council (FRC) a secondary duty to promote competition between firms providing audit services to FTSE 350 companies. You also asked whether our reports on audit inspections could assist competition by making more information available in such a way that our reports enabled better comparisons to be made.

Our principal concern is that investors should have good quality information to help them assess and choose between investment opportunities. Objective information on audit quality contributes to this but is only part of the picture and of the tools available to the FRC including our responsibilities with respect to governance, reporting and professional conduct. We are therefore concerned about being given, unlike other regulators, an objective which only relates to part of our responsibilities and not to the overall competition for capital. We cannot, for example, be put in a position in which we feel pressure to hold back from regulatory action against a firm or a company because such action could damage the reputation of an audit firm and hence its ability to compete in the market. For these reasons, such a duty can only be secondary. We understand that this is all as you propose, but then we question its usefulness. The FRC's overarching economic mission is to promote high quality corporate governance and reporting to foster investment. Competition clearly plays an important part in this mission, the ultimate objective of which is economic growth; it does not need to be overlaid upon. We also note that as we are not established as a statutory body with statutory objectives, a competition duty would not fit well into our constitution.

In relation to your suggestions about more extensive and transparent audit inspection, the FRC has been concerned about competition and choice in the audit market for some time and encouraged the OFT's referral to you. Our concerns are that the lack of movement in the audit market in terms of limited retendering and switching has meant there has been

insufficient pressure to raise quality and innovate; and that the lack of choice also creates a risk to market stability in the event of four major firms becoming three. We therefore support the thought behind your suggestion that audit committee chairs and investors have as much objective information as possible for judging audit quality and for mounting an effective retendering exercise. However, in our view, our current arrangements go a long way in delivering such information and the proposed extension of our work would not enhance competition. Nor would it be cost effective.

We say this because we are confident that we are already the most transparent audit regulatory body in the world. This is based on the fact that most similar organisations do not publish reports on each firm and those that do release much more limited information. Unlike others we also give detailed reports to Audit Committee Chairs on the inspection of the audit of their company. Audit Committees and investors therefore have access to a great deal of information on the largest firms and, increasingly, this is reviewed in tender exercises.

It is true that our reports on each firm are not strictly comparable in terms of the audit scores because we select audits for inspection on the basis of risk not to produce representative samples. Nevertheless our reports are carefully reviewed before publication to ensure consistency and fairness to each firm and include much information about our exploration of common themes. We do not believe that the creation of reports based on strictly representative samples would therefore add much.

It would also be expensive. In order to ensure that our selection of audits for inspection was representative to an 80 per cent confidence level in the FTSE 350 for the Big Four alone we calculate that we would need to undertake nearly 200 inspections, six times as many as at present. We would need in addition to continue our inspections of smaller company audits, increasing our total number of inspections to around 250, two and a half times our current level. Our total inspections cost would therefore rise from nearly £3.5 million to £9 million.

In addition, comparative samples could not be made for non-Big Four firms in the FTSE 350 because they only audit 13 companies in this category and a number of those are atypical businesses (e.g. investment trusts). In consequence we would have to explain that our reports on those firms were unrepresentative and probably therefore do more harm than good.

We have a further concern that any attempt to put a league table of auditors into the market will result in a battle with the firms on the grades of individual audits, hence enhancing their defensiveness and distracting from their focus on promoting audit quality.

Finally, whilst responding to the Competition Commission's recommendations, we would draw to your attention the fact that we will need to respond to the European Commission's demands to reduce the amount of inspection work delegated to the professional bodies, which will also increase the burdens on the audit quality inspection work that we currently undertake.

In summary we have serious doubts as to the remedy's likelihood of success. Notwithstanding the above, however, we are willing to review ways in which we could enhance our reporting in order to increase its usefulness to audit committees and investors in relation to changing auditors in addition to improving quality. We would do this in due consultation with stakeholders on what information they would like to see.

*Yours sincerely,
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