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Statutory Audit Investigation
Competition Commission
Victoria House
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4 April 2013

Dear Sir

Statutory Audit Investigation – Notice of Potential Remedies

I am writing to you on behalf of the 'Group A' firms (the 'mid-tier', ten next-largest firms, beyond the 'Big 4', Grant Thornton, and BDO)[1].

The Group A firms welcome the Commission's report and its provisional findings as regards the FTSE350 audit market. We support the need for change in who audits public interest entities *but*

(1) we are concerned that the suggested mechanisms for effecting it are unlikely, either individually or collectively, to achieve the purpose,

(2) we emphasise the need to ensure that any mechanisms introduced in the wake of the Commission's work are consistent with sound broader public policy objectives - there must be no 'law of unintended consequences', specifically, changes ought to be targeted exclusively on that top segment of the listed market so that current market-provision does not affect current entitlement to dual-provision of audit/other advice and help to *smaller* listed/AIM/unlisted with regulation as they are the engine-room for job creation, and

(3) we further submit that the current market-model is inherently vulnerable[2] – there is an inevitability around the loss of one or more of the major players that is counter-intuitive for those regulating the profession to suggest, as they do, that mere encouragement to behavioural change is an effective surrogate for regulatory intervention.

[1] Baker Tilly, Crowe Clark Whitehill, Haines Watts, Kingston Smith, Mazars, Moore Stephens, RSMTenon, Saffery Champness, and Smith & Williamson.

[2] the Financial Reporting Council is repeatedly on record that one of its biggest concerns about market concentration is the likely short and long-term impact of one of the Big 4 firm being forced out of it, by reason of litigation or other cause.

Whereas we appreciate that the jurisdiction of the Commission is less catholic than legislators' and regulators', we urge consideration of the regulatory intervention mechanisms we suggest below. The light-touch remedies favoured by the Financial Reporting Council are not consistent even with its own analysis of the problem - in terms of the risk of a Big 4 firm leaving the market, we should be actively trying to prevent the situation arising, through less concentration, rather than merely planning around being able to live with the event.

We note from the Commission's report that "as a result of the [current adverse effects on competition], [it] provisionally found that companies are offered higher prices, lower quality and less innovation and differentiation of offering than would be the case in a (competitive market)".

We have been making this point for years, whereas the dominant firms have been lobbying hard to maintain the *status quo*. History shows it is the new players that reform markets, not existing ones.

We support the Commission's provisional conclusions that there are barriers to entry facing the non-Big 4 firms. The overbearing influence of the Big 4 firms on the market, with around 66% of FDs and 60% of audit committee chairs coming from that background as well as their control of 99% of FTSE350 audit fees, lead to aberrant end-user behaviour.

Whilst supporting most of the provisional findings, we believe the projected remedies need to be widened, by adding mandatory co-audit (joint/shared audit) and placing tougher limits on the provision of non-audit services, targeted exclusively at the FTSE 350 level.

Our support for co-audit, especially at the upper end of the FTSE100, is set out in the attached EGIAN[3] paper: it provides a way of introducing a non-Big 4 firm which can build up its share in the early years. Joint audit has the merit of the 'four eyes' principle and provides continuity when one of the auditors changes, and Shared Audit also provides immediate market capacity.

Neither joint nor shared audit would require legislative change to give effect to it as both are currently permissible but due to resistance from the dominant players, and the institutional bias that currently exists in the market place, they will need to be mandated or, at the very least, strongly encouraged through incentives if they are to be adopted in practice.

It would also be helpful to tackle auditor-liability issues, in order to implement the mechanism(s) seamlessly. We exhort the Commission accordingly, and can offer practical suggestions in this regard too.

[3] Attached. Most, but not all, of Group A are affiliated to EGIAN, but all of Group A support the submission to the Commission on co-audit.

Leading investors are worried about the amount of non-audit services provided to listed/public interest audit clients (and their concern is limited to that *stratum* alone, not the SME sector) and their impact on independence, and we should listen to their concerns.

They suggest a 50% cap on non-audit fees. 30 FTSE100 and 83 FTSE250 are above this level, ie around a third and 72 are above 70%. Non-Big 4 firms need opportunities to get to know FTSE350 companies better, and to allow management to build confidence in them, by working with them on non-audit issues.

On mandatory tendering and firm rotation, simply relying on the application of 'comply and explain' is not enough – it is, at best, incapable of prediction whether encouragement to behavioural change would work and the portents are not favourable – the vintage Financial Reporting Council 'Market Participants' Group' recommendations have demonstrably failed as a catalyst - and represents too complacent an approach.

We therefore urge a fundamental consideration of the kind of regulatory intervention mechanism we have suggested.

T M McMorrow
Secretary
the Group A firms