UNIVERSITÄT DUISBURG ESSEN

MERCATOR SCHOOL OF MANAGEMENT

Department for Accounting and Auditing
Prof. Dr. Annette G. Köhler

Inquiry Manager, Audit Market Investigation
Competition Commission
Victoria House
Southampton Row
London
WC1B 4AD

Lotharstraße 65

47057 Duisburg (Germany)

Phone +49 (0) 203 379 –2644
Fax +49 (0) 203 379 – 1792
E-Mail annette.koehler@uni-due.de

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by electronic submission (auditors@cc.gsi.gov.uk)

Dear Madam/Sir,

Statutory Audit Services Market Investigation

Notice of possible remedies under Rule 11 of the Competition Commission Rules of Procedure

I would like to thank you for the opportunity to provide the Competition Commission with my comments on the *Notice of possible remedies under Rule 11 of the Competition Commission Rules of Procedure* (hereinafter referred to as "the notice"). Based on my own research on the structure of the audit market in Germany, I would like to comment on the suggested **"Remedy 2: Mandatory rotation of audit firms"**.

A. General remarks:

(1) I believe that the barriers to switching suppliers of audit services described in the notice hold for any market for large service providers and are not restricted to the audit market, since they are caused by

- transaction costs prior to the choice of a transaction partner (both on the demand and supply side); and
- the nature of the service (e.g. experience good).

(2) Given these market characteristics, *ceteris paribus* long audit tenure is an efficient market solution.

(3) The key question is therefore whether audit quality varies with tenure. However, empirical evidence is mixed and therefore does not provide adequate evidence as to whether the costs related to auditor change will be outweighed by the benefits of a potential increase in audit quality; there may even be a potential decline in audit quality. From an economic perspective, *prima facie*, mandatory rotation cannot be justified.

(4) This leads to the question whether there are *indirect* beneficial effects of mandatory auditor rotation. The *Competition Commission* posits that mandatory rotation would impose auditor changes on entities that would otherwise not have changed their auditor, which would lead to additional *competitive behaviour* prior to the selection and engagement of a new auditor. As already pointed out, the effects of this additional competitive behaviour on the quality of the audit provided by the new auditor are unclear. However, at least in Germany there is clear empirical evidence on the effects of (voluntary) auditor change on the structure of the audit market for listed entities: audit market concentration increased by a shift of market share from Non-Big4 to Big4 audit firms. Mandatory rotation may therefore have unintended negative consequences for the Non-Big4 audit firms in the UK.

B. Comments on para 31 of the note with considerations on how mandatory auditor rotation would address adverse effects on competition:

(a) "realigning the incentives of auditors to compete to satisfy shareholder demand as this may be currently constrained by a desire from the audit firm to maintain the audit for long periods of time and/or an ingrained firm approach to conducting the company's audit"

The competitive situation of auditors in a tender is always the same – irrespective of tenure limitation. Even if one assumes that the provisional finding of the Competition Commission, that auditors have misaligned incentives and compete to satisfy management rather than shareholders, is true, there is no evidence that the imposition of restrictions on tenure would change these incentives.

(b) "reducing barriers to non-Big-4 audit firm selection by providing greater opportunities for non-Big-4 audit firms to tender for FTSE 350 audits and reducing current barriers to entry and expansion"

Imposing auditor change *per se* does not necessarily reduce current barriers to entry and expansion or provide greater opportunities for Non-Big4 audit firms to actually have their tender offers accepted – Non-Big4 audit firms would simply have greater opportunity to tender for audits, but along with the Big4. Empirical evidence for German listed entities shows that auditor changes in the last years have significantly lead to a decrease in the market share of Non-Big4 (see in more detail Section C below).

(c) "removing (by overriding) current barriers to more frequent tendering by companies. This will increase companies' bargaining power and increase competition between auditors"

Mandatory auditor rotation will impose transaction costs on companies that they would otherwise not have encountered – that is, cost barriers are not removed at all. Company bargaining power remains unchanged too, since companies can change their auditor whenever they like under the regime currently in place.

C. Issues for Comment(f): Other relevant considerations

The introduction of mandatory auditor rotation is likely to have unintended negative consequences for Non-Big4 audit firms and decrease their market share even further. This conclusion can be drawn from evidence relating to auditor changes in Germany. The evidence is as follows:

Based on publicly available data for all publicly listed companies for the years 2005 through 2010 (omitting the financial sector as well as insolvent companies and companies that are undergoing liquidation) that prepare consolidated financial statements in accordance with IFRS, a total of 2593 company-year observations were analyzed. In this period 242 voluntary auditor changes were observed (see Table 1).

	Company size categories based on balance sheet totals			
Auditor change direction	Less than 100 million EUR	100 to 500 million EUR	Over 500 million EUR	Total
B4 to B4	21	31	28	80
B4 to NB4	36	9	4	49
NB4 to NB4	41	10	0	51
NB4 to B4	28	24	10	62
Total	126	74	42	242*

*Table 1: Number of auditor changes, differentiated by direction of the auditor change and company size categories based on the balance sheet totals of the audited companies (*numbers for 2010 incomplete).*

On a net basis, to the disadvantage of the non-Big Four,13 more engagements shifted from the non-Big4 to the Big4 than from the Big4 to the non-Big4. From a market concentration perspective however, the shift in market volume measured by audit fees is also of interest. Given the audit fees of the companies included in the study in the last year before the auditor change (see Table 2) the shift in market volume becomes apparent.

Direction of auditor change	Total	Minimum	Maximum
B4 to B4	97,258.34	29.80	40,500.00
B4 to NB4	6,019.22	25.00	495.00
NB4 to NB4	5,219.70	17.29	441.00
NB4 to B4	24,299.50	28.00	7,000.00

Table 2: Audit fees of the companies included in the study in the last year before the auditor change (in thousands of EUR)

While approximately EUR 6 million of fee volume was shifted from the Big4 to the non-Big4, an approximately four times larger fee volume of around EUR 24.3 million was shifted from the non-Big4 to the Big4. The difference of EUR 18.3 million represents approximately 47% of the total audit fees of the non-Big4 included in this study for the year 2005!

The results show how difficult it was for Non-Big4 audit firms to defend market share. In order to have Non-Big4 benefit from mandatory auditor rotation, at least in Germany tendering behavior by audit firms or auditor selection behaviour by companies would have to change fundamentally. It is not clear why such a change in behaviour should occur. A similar analysis for the UK audit market would be helpful to evaluate the potential effects of restricting audit tenure in the U.K. Under the assumption that decision making behaviour in the audit markets in Germany and the UK is not fundamentally different, the introduction of mandatory auditor rotation is likely to have unintended consequences for the structure of the UK audit market.

I hope that you find my comments useful and would be very pleased if you were to contact me with any questions that you may have.

Yours sincerely,

Prof. Dr. Annette G. Köhler