Statutory Audit Services Market Investigation

Provisional decision on remedies

I should like to respond to your invitation to comment on the provisional decision on remedies.

My response is purely in a personal capacity. However, as background, I have extensive experience at board level and on Audit Committees over the last 19 years. I am currently chairman of a listed UK company and chairman of the audit committee of another UK listed company. Previously, I was CFO of a FTSE 100 company and have previously served as audit committee chairman on three other significant listed companies. However, whilst being a qualified accountant, I have never worked for any audit firm. As both an executive and non-executive director, I have previously instigated two Statutory Auditor tenders.

I very much welcome now the Competition Commission's greater recognition of the role of the Audit Committee in preserving the relationship with, and integrity of, the role of the statutory auditor. However, the most significant remedy now being proposed is, in fact, one that will tend to reduce the power of the Audit Committee and have significant unintended consequences, that are likely to lead to further adverse effects on competition in this market.

Retendering of external audit is almost universally accepted as being a useful discipline on both auditors and companies. However the Competition Commission is proposing an intrusive and draconian implementation in 5 yearly compulsory cycles. Reading both the lengthy documents published and extensive consultation disclosed, it is striking that the Commission has struggled to find any other party to agree with 5 yearly mandatory tendering. Even those, especially the mid tier auditors, who have most to gain, seem not to support such a short time period. The Commission seems strangely silent on this striking fact.

The issue is not whether periodic tendering is beneficial. It is solely whether it needs to be mandatory and whether the time period needs to be as short as 5 years. Taken together this is a severe remedy that demands a clear and unequivocal justification as both necessary and proportionate.

Mandatory vs Comply and Explain

For the Commission to require mandatory rather than the usual UK governance of Comply or Explain, suggests that the Commission believes that the latter would not work on its own. However all the evidence received by the Commission shows that there is a high degree of confidence by all parties, including the specialist regulator, the FRC, that it does already work. The Commission provides no alternative evidence.

The Commission explains;

"In general, the CC prefers to act by Order where appropriate, as an Order is binding and we can make it directly, so it is more likely to be effective in addressing the identified AEC" (para 3.159)

"To ensure effective implementation it may be necessary to incorporate the measures in an Order rather than being subject to the lighter standard of comply or explain." (para 3.414)

It is odd then that the Commission then intends to rely on Comply or Explain to cover the two year possible extension period for mandatory tender.

The only benefit of mandating this period is to force companies to do something that they might not otherwise do. The downside is that it is a straight jacket that may not suit all situations. Whilst I welcome the provision of a possible 2 year extension, the Commission appears to assume that companies float along in a steady state with occasional 'crises' that, if they happen on the five year cycle, will go away within a year or so. In fact many companies have difficult trading situations that last longer than 2 years or face different crises that can occur within a couple of years.

That is why Comply or Explain gives a Board the ultimate sanction of saying that it cannot risk the distraction of an audit tender, and is prepared to justify this to shareholders and face their possible sanction if they disagree. Can the Commission guarantee, for example, that a company would not be faced, perhaps, with a takeover bid a year or so after facing a previous 'crisis'? In my experience, one 'crisis' is quite likely to be followed by another.

The case for insisting on legal compulsion seems not to have been adequately made by the Commission.

5 year cycle vs 7-10 years

The apparent justification for a 5 year cycle per se is to coincide with the rotation of the audit partner. This seems a somewhat weak reason. The argument that doing so least favours the incumbent, as a new Audit Partner will not have accumulated experience, seems irrelevant unless the objective is change rather than simply tender. An incumbent always has the benefit – and curse – of familiarity. All other commentators consistently argue that a 7 to 10 year cycle is a more appropriate one.

The best justifications for a tender are dissatisfaction with either the quality or value of the existing service, or a desire to benchmark whether others can do better. If a 5 year cycle were mandated, companies will obey that cycle. This however diminishes one of the useful sanctions an Audit Committee has; the one to institute a tender when it is unhappy. A 10 year cycle, for example, would allow plenty of opportunity for an Audit Committee to bring forward a tender if it felt that this would benefit the company and send a signal about the incumbent, with a much more salutary effect on the latter.

Even the Commission admits;

(We) "*consider it to be a matter of judgement as to the appropriate interval between tenders.*" (para 3.154)

In fact the Commission provides neither evidence nor structured argument that 5 years is better than 10.

"We think ten years to be too long a time for an audit engagement not to be subject to the high level of scrutiny and competition that takes place within a rigorous tender

process." (para 3.154)

This appears to be an expression of opinion rather than a conclusion based on evidence.

Unintended consequences

The Commission seems not to have fully thought through the unintended consequences of such frequent routine tendering.

1. Companies are very different. Whilst a retender may be a minor issue for a UK-based manufacturer, for example, the complexity would be vastly greater for a multinational financial services firm. It is revealing that the Commission does not properly discuss whether the complexity of companies should impact on a 'one size fits all' mandatory regime.
2. Similarly, auditors are bound to approach large complex audits differently to smaller ones. If an audit requires hundreds of staff in many different countries, the attractiveness of bidding by an audit firm will be directly related to whether it thinks that it has a significant chance of winning. If winning an audit means that it has to recruit a lot of extra staff, that could be made redundant at short notice 5 years later, the audit firm would undoubtedly think hard about whether it wants to win.
3. The willingness to bid will also be heavily affected by whether the audit firm has significant non-audit work that it would lose. The Commission doesn't seem to have fully thought through the number of tenders that might involve Big 4 companies with significant non-audit work that could potentially affect their desire to participate in a tender.
4. The prospective audit bidder will make great efforts to find out whether a tender is for real, with a change likely, or whether it's a 'regulatory' tender just to satisfy the Commission. This would be a rational strategy for any prospective bidder.
5. The bidding costs for auditors will be high, whether the Commission's estimates of up to £24m pa are right or not. This will prove a relatively larger factor for non-Big 4 firms. Whether they bother to bid against a Big 4 incumbent will be a significant issue for them. It is inconceivable that they won't make major efforts to find out whether it's worth their scarce resources. Whatever their initial enthusiasm may be, it would be unhelpful for these players to have to fund large fruitless bidding costs.
6. The Remedies do not address the fundamental issue of there being an oligopoly of the Big 4. There is no evidence that tenders, let alone frequent ones, reduce Big 4 market share.
7. On the contrary, having a 'fixed' 5 year routine cycle will probably increase the power of the oligopoly. The temptation of the Big 4 to develop an implicit 'Buggins Turn' to large audits to avoid wasteful tendering effort will be strong. This will be exacerbated by the inevitability that one or two of the other firms will have lucrative non-audit work that reduces their desire to bid for a particular audit.
8. Perhaps the Commission could apply some sequential game theory to the tendering process, which might explore the issue of increased incentives for implicit collusion amongst a small number of players repeatedly playing the same game to a fixed timetable.
9. With so many routine tenders happening every year, it would not be surprising to see audit firms putting less effort and less competitive pricing

into each. They would not only have to recover additional bidding costs but would have less worry about losing a tender. There will be another one along shortly and anyway, the tender will repeat in five years time. The Commission's belief that costs will fall seems particularly poorly argued.

For all of these reasons, I believe that there is a substantial risk that having short fixed term tenders, as proposed by the Commission, is itself likely to result in an adverse effect on competition in the statutory audit market. Unnecessary mandating of such an arbitrary 5 year time period would simply reinforce this.

Simon Laffin