

Statutory audit

Consultation on the OFT's provisional decision to make a market investigation reference to the Competition Commission of the supply of statutory audit services to large companies in the UK

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1 EXECUTIVE SUMMARY

- 1.1 The OFT is proposing to refer the supply of statutory audit services to large companies in the UK to the Competition Commission (CC) for a market investigation. This paper sets out our reasons and gives interested parties the opportunity to make representations.
- 1.2 Audit is a vital service for most UK companies and external audit is a legal requirement for most companies over a certain size. We estimate that the audit fees for the FTSE 350 in the UK in 2010 were at least £600 million.¹ More significantly, the quality of audit services is a useful tool for assuring investors of the financial health of UK companies and helping to ensure an efficient allocation of capital in the UK economy. It is important therefore that this market is competitive and delivers efficient outcomes in terms of price, quality and innovation.
- 1.3 The OFT has been concerned for some time that the supply of audit services to large companies in the UK is highly concentrated, with low levels of switching and substantial barriers to entry and expansion, as well as barriers to exit.² As such, the OFT is concerned that the market may not be working well for customers.
- 1.4 In 2010, the top four firms (PwC, KPMG, Deloitte, Ernst & Young, collectively referred to as the Big Four) earned 99 per cent of audit fees paid by FTSE100 companies and 98 per cent of fees paid by FTSE250 companies. One firm, PwC, earned 47 per cent of FTSE100 companies' audit fees.
- 1.5 The OFT considers that concentration in the auditing of some specific industry sectors such as banking, mining, and utilities may be substantially higher. Further limits on the choice of auditors available to

¹ Data sourced from FAME with OFT analysis. This consists of an estimate of the total value of audit fees using 296 companies from the FTSE 350 which had accounts for 2010 available in the FAME database in July 2011.

² The OFT has been keeping the accountancy and audit market under review since November 2002. See www.of.gov.uk/news-and-updates/press/2002/pn_79-02

companies may also arise from regulatory requirements, or from a desire to avoid employing an auditor used by a competing company while still using a Big Four auditor.

- 1.6 We have concerns that companies only switch auditors very infrequently. OFT analysis of FAME data between 2002 and 2010 showed average annual switching rates of 2.3 per cent for FTSE 100 and 4.2 per cent for FTSE 250 companies. This shows that the average switching frequency for FTSE 100 companies is every 43 years, and for FTSE 250 companies is every 24 years. A previous study found similar results.³ In addition, the rate at which companies tender their audit contract appears to be low.
- 1.7 Non-Big Four audit firms can face substantial barriers to entry in terms of gaining relevant experience, establishing their reputation, overcoming switching costs and inertia, surmounting regulatory barriers and banking requirements, taking on liability risks, and raising capital to finance expansion. The OFT is concerned that these barriers to entry and expansion restrict competition in the supply of statutory audit to large companies in the UK. Only one FTSE 100 company has a non-Big Four auditor.
- 1.8 In competing to audit companies with substantial overseas operations, non-Big Four firms face the additional hurdle of accessing networks of auditors in foreign countries. This barrier has the potential to increase in significance as more companies acquire foreign subsidiaries or operations.
- 1.9 Finally, there is a widespread concern that current levels of concentration in this market could increase further in the event of the failure of a Big Four firm. The OFT shares this concern.
- 1.10 Most of these concerns are not new. Over the past decade the OFT has participated in a number of projects which have considered these

³ *Competition and choice in the UK audit market*, April 2006, Oxera, commissioned by the DTI and the FRC. Hereafter this document will refer to the Oxera report.

problems and possible solutions to them. In particular, in 2006, the Financial Reporting Council's (FRC) Market Participants Group introduced initiatives designed to open up the market for the provision of auditing services to large firms. However, by the FRC's own admission, these industry-led initiatives have had minimal impact. The House of Lords Select Committee on Economic Affairs also noted that, 'Attempts to introduce greater competition into the audit market have so far failed.'⁴

1.11 On 17 May 2011, the OFT announced that it had provisionally decided that these competition concerns passed the statutory test for a market investigation reference to the CC. In doing so, the OFT also noted a need to collect further evidence on whether there was a reasonable prospect that appropriate remedies would be available to the CC in the event that a reference was made and where the CC found one or more adverse effects on competition. This would be to allow the OFT to reach a decision on whether or not to make a reference to the CC of this market.⁵

1.12 To address this question, the OFT held meetings with around 30 interested parties, including providers of audit services, users of those services and regulatory bodies. We note that there is a very widespread view that something could be done to improve competition in this market. We believe that there is a reasonable chance that appropriate remedies would be available to the CC should it find problems in the market. We are satisfied that the other criteria governing the exercise of the OFT's discretion to refer are also met.

1.13 For these reasons the OFT has provisionally decided to exercise its discretion to refer this market to the CC. The consultation on this provisional decision runs until 9 September 2011.

⁴ House of Lords Select Committee on Economic Affairs, *Auditors: Market concentration and their role* (30 March 2011), page 14. Hereafter this document will refer to the 'House of Lords Inquiry' and the 'House of Lords report'. See:

www.publications.parliament.uk/pa/ld201011/ldselect/ldeconaf/119/119.pdf

⁵ See: www.of.gov.uk/news-and-updates/press/2011/59-11

2 THE OFT'S PROPOSAL TO MAKE A MARKET INVESTIGATION REFERENCE

- 2.1 Under Section 131 of the Enterprise Act 2002 (EA02), the OFT may make a market investigation reference to the Competition Commission (CC) where it has reasonable grounds for suspecting that any feature, or combination of features, of a market in the UK for goods or services prevents, restricts or distorts competition in connection with the supply or acquisition of any goods or services in the UK or a part of the UK.
- 2.2 Section 131(2) states that a feature of the market is to be construed as a reference to:
- The structure of the market concerned or any aspect of that structure.
 - Any conduct (whether or not in the market concerned) of one or more than one person who supplies or acquires goods or services in the market concerned.
 - Any conduct relating to the market concerned of customers of any person who supplies or acquires goods or services.
- 2.3 This does not mean the OFT is obliged to make a reference in relation to every market which it believes meets the threshold set out in Section 131. Rather, the OFT has a discretion whether to make a reference.
- 2.4 Section 133 of the EA02 requires the OFT to describe the goods or services to which a reference relates. In this case we propose to refer the market for the supply of statutory audit services to large companies within the UK.
- 2.5 In guidance published in March 2003 the OFT said it would make references to the CC only when the reference test set out in Section 131 of the EA02 and, in its view, each of the following criteria have been met:

- It would not be more appropriate to deal with the competition issues identified by applying the Competition Act 1998 (CA98) or using other powers available to the OFT.
- It would not be more appropriate to address the problem identified by means of undertakings in lieu of a reference.
- The scale of the suspected problem, in terms of its adverse effect on competition, is such that a reference would be an appropriate response to it.
- There is a reasonable chance that appropriate remedies will be available.

Consultation on the provisional decision on reference

2.6 Under Section 169 of the EA02, when the OFT is considering whether to make a decision on a reference to the CC it must first consult, so far as practicable, any person on whose interests the decision is likely to have a substantial impact.

2.7 This paper sets out the reasons for the OFT's provisional decision to refer to the CC the market for statutory audit for large companies in the UK. We invite comments on this provisional decision by 9 September 2011. Comments should be sent to:

Peter Hill
Fourth Floor
Office of Fair Trading
Fleetbank House
2-6 Salisbury Square
London EC4Y 8JX

2.8 Alternatively, they can be sent to: auditconsultation@oft.gsi.gov.uk

3 BACKGROUND

3.1 In 2002, the OFT issued a statement setting out its view that the audit market structure was in transition (with the acquisition by Deloitte & Touche of Andersen UK having been recently reviewed and cleared by the European competition authorities), and that the market was already the subject of various reviews.⁶ The OFT therefore decided against further investigation or a reference to the CC. Since then, the OFT has been keeping the sector under review, holding periodic meetings with market participants and reviewing publications. The OFT has also been an active participant in external regulatory initiatives or inquiries in relation to competition in the audit market. In particular:

- The OFT has provided advice to the Government on the implications for competition in the audit market of proposals to permit auditors to limit their liability by way of negotiated caps and contributed to the UK's submission to the OECD roundtable on competition and regulation in auditing and related professions in June 2009.
- The OFT has, since 2002, liaised with the Department for Business, Innovation and Skills (BIS) and the Financial Reporting Council (FRC) in relation to concerns regarding this market. In 2006, the FRC and the Department of Trade and Industry (DTI) commissioned a report from Oxera into issues of competition and choice in this market in the UK. Following this, in October 2006, the Market Participants Group (MPG) was established within the FRC. It comprised investors, companies and audit firms, and sought to address the issues identified. In October 2007, the MPG published 15 recommendations intended to allow the audit market to work more efficiently and, in the medium to long-term, to increase audit choice in the UK. The FRC's recommendations sought an 'increase in the propensity of non-Big Four firms to offer to audit public interest entities (the supply side)' and an 'increase in the propensity for

⁶ *Competition in audit and accountancy services – A statement by the OFT*. See: www.of.gov.uk/shared_of/press_release_attachments/accountancy.pdf

public interest entities to select non-Big Four firms as auditors (the demand side)⁷.⁷ Specifically, the recommendations included efforts to make investment by non-Big Four firms more feasible, to reduce the risks associated with choosing to appoint a non-Big Four firm, and to improve the accountability of boards for their auditor selection decisions.

- More recently, the OFT made a submission to the House of Lords Select Committee on Economic Affairs inquiry into 'Auditors: market concentration and their role'. The OFT made a written submission to the Committee in September 2010,⁸ gave oral evidence in November 2010,⁹ and made an additional written submission in March 2011.¹⁰ In December 2010, the OFT also made a submission¹¹ to the EC in response to the consultation on its Green Paper.¹² In both its House of Lords and EC submissions, the OFT highlighted concerns regarding certain aspects of the audit market and noted that there were significant issues around competition and choice in the market (including low levels of switching, high market concentration, and potentially high fees).

3.2 Despite the various initiatives over the past decade, the OFT continues to have significant concerns about competition and choice in the audit market. In particular, The Fifth Progress Report on the implementation of

⁷ 'Choice in the UK Audit Market – Interim Report of the MPG' – April 2007:

www.frc.org.uk/documents/pagemanager/frc/Visio-Choice%20MPG%20Interim%20Report%20web.pdf

⁸ See: www.ofg.gov.uk/shared_ofg/markets-work/OFT_submission_to_HoL_on_aud1.pdf

⁹ See: www.publications.parliament.uk/pa/ld201011/ldselect/ldconaf/119/119ii.pdf (Page 172 onwards)

¹⁰ See: www.ofg.gov.uk/shared_ofg/markets-work/Auditors-role.pdf

¹¹ See: www.ofg.gov.uk/shared_ofg/markets-work/OFT_submission_to_EC_on_aud1.pdf

¹² See: http://ec.europa.eu/internal_market/consultations/2010/green_paper_audit_en.htm. The aim of the consultation was said to be: 'a debate on the role of the auditor, the governance and the independence of audit firms, the supervision of auditors, the configuration of the audit market, the creation of a single market for the provision of audit services, the simplification of rules for Small and Medium Sized Enterprises (SMEs) and Practitioners (SMPs) and the international co-operation for the supervision of global audit networks.'

the MPG recommendations (published in June 2010) stated that there was 'little indication that concentration in the audit market is reducing or is likely to reduce in the near future.'¹³ Further, as Baroness Hogg (Chair of the FRC) stated in evidence to the House of Lords inquiry on 9 November 2010, 'whatever benefits there may have been from this work, [market] concentration is as great as ever'.¹⁴ The concerns set out by the OFT in its submissions to the House of Lords inquiry, and in response to the EC Green Paper, have not diminished.

- 3.3 On 30 March 2011, the House of Lords Select Committee on Economic Affairs published the report of its inquiry into 'Auditors: market concentration and their role'. The concerns expressed in the report concerning concentration, levels of switching and potential barriers to entry confirmed many of the issues highlighted in the OFT's submissions to the inquiry. The conclusions and recommendations in this report included the following:

'Identification of the shortcomings of the large-firm audit market is easy enough. It is clearly an oligopoly with all the attendant concerns about competition, choice, quality and conflict of interest...

The Big Four's domination of the large firm audit market in the UK is almost complete: in 2010 they audited 99 of the FTSE 100 largest listed companies, which change auditors every 48 years on average...

The Committee considers that good audit is essential to business and finance. It welcomes the Financial Reporting Council (FRC)'s efforts to improve competition and choice in the audit market and to streamline the regulatory framework but shares the FRC's view that they have not led to any great improvement. The Committee recommends several measures which should be of benefit in

¹³ See: www.frc.org.uk/press/pub2288.html

¹⁴ See: www.publications.parliament.uk/pa/ld201011/ldselect/ldeconaf/119/10110905.htm.

reducing the dominance of the Big Four but concludes that these in themselves are unlikely to be enough.

The Committee makes three main recommendations:

- first, a detailed investigation of the large-firm audit market by the Office of Fair Trading, with a view to an inquiry by the Competition Commission so that all the interrelated issues surrounding concentration, competition and choice can be thoroughly examined in depth and in the round. The Committee recognises that the global reach of the Big Four and of their clients goes beyond the scope of a national competition authority. But when London is both the incubator of at least some of the Big Four and one of the world's leading financial centres, it seems right for the UK to take a lead'.¹⁵

3.4 The OFT has considered the full range of evidence available to it and the knowledge accumulated from keeping this market under review and providing evidence to the House of Lords Inquiry before reaching a provisional decision in relation to this market.

3.5 On 17 May 2011, the OFT announced that it had provisionally decided that there are competition problems in the audit market that pass the statutory test for referral to the CC. The OFT also announced that it would be discussing with interested bodies whether, in practice, potential remedies exist that could allow the CC to resolve these problems.

¹⁵ House of Lords Inquiry report, abstract, pages 5-6.

4 PROCESS FOLLOWED TO REACH THIS PROVISIONAL DECISION

- 4.1 In many cases, the OFT conducts a market study before reaching a provisional decision on whether or not to refer a market to the CC.
- 4.2 The OFT concluded that in this instance it did not require a market study to reach the provisional decision that the Section 131 threshold has been met. This is because the OFT has been keeping this market under review for some time and participating in regulatory and policy processes described in paragraph 3.1. It has therefore developed a good understanding of the performance of the market and notes that information has been readily available. Rather, the OFT noted that it needed more information to determine whether or not to exercise its discretion to make a market investigation reference, so it undertook a further short period of work.
- 4.3 Accordingly, in its provisional decision on the test in Section 131 of the Enterprise Act 2002, which was announced on 17 May 2011, the OFT noted that it would discuss with interested bodies whether, in practice, potential remedies exist that could allow the CC to resolve these problems. The aim of these discussions was to provide evidence to inform the exercise of the OFT's discretion over whether or not to make a reference of this market to the CC, given the differences of opinion about the availability of remedies to the OFT's long-held concerns in this market.
- 4.4 These discussions have consisted of roundtable and bilateral meetings which the OFT held during June and July 2011 with around 30 interested parties.
- 4.5 The views expressed in the roundtable and bilateral meetings have been important to the OFT in reaching its provisional decision on the exercise of its discretion to refer this market. Annexe A to this document provides a summary of some of the key points from the views expressed to the OFT during this process.

- 4.6 Following this process, the OFT has now reached a provisional decision to exercise its discretion to make a reference of the market to the CC.

5 THE AUDIT MARKET IN THE UK

- 5.1 A large number of companies in the UK are required by Part 16 of the Companies Act 2006 to have their annual accounts externally audited. Annual accounts consist of financial statements that are a representation of the position of the company at the time of the statement and also report on previous activities of the company. The over-arching aim of the audit is to provide assurance that the firm's financial statements represent a true and fair view of the company.
- 5.2 Auditors of public companies are appointed by members of those companies (that is, shareholders), by ordinary resolution, except where directors of companies have powers to appoint an auditor. For public companies, members normally appoint auditors at an accounts meeting. Members can also appoint an auditor where the directors had power to appoint an auditor, but failed to make an appointment.¹⁶
- 5.3 A company's auditor must make a report to the company's members on all annual accounts of the company. For public companies, these reports are to be laid before the company in a general meeting.¹⁷
- 5.4 In practice, the UK Corporate Governance Code (2010)¹⁸ gives audit committees a key role in the process of auditor selection. According to the principles and provisions of the Code, audit committees should make recommendations to the board, which the board can then put forward for shareholder approval at the general meeting, regarding the appointment, reappointment or removal of external auditors. The Code states that all listed companies should have an audit committee comprising independent non-executive directors. The audit committee is responsible for overseeing the selection process of appointees as external auditors, and agreeing on the fees and terms and conditions of the audit.

¹⁶ Companies Act 2006, Part 16, Section 489(4).

¹⁷ Companies Act, 2006, Part 16, Section 495(1).

¹⁸ FRC (2010): The UK Corporate Governance Code, para C.3.2

- 5.5 There are a large number of audit firms in the UK which are able to carry out statutory audits of companies. However, there are few audit firms which audit the financial statements of the largest companies in the UK. Currently these audits are carried out almost exclusively by four large audit firms, PwC, KPMG, Deloitte, and Ernst & Young, collectively known as the Big Four.
- 5.6 There are a large number of smaller audit firms which carry out work for smaller listed and unlisted companies in the UK. The largest of these firms that have some clients in the FTSE 350 are often referred to as mid-tier auditors. There are several examples of mid-tier auditors, which include Grant Thornton, BDO, RMS Tenon and Mazars.
- 5.7 A number of audit firms, including the Big Four, are network firms which are networks of independent firms located in different countries around the globe which all have the same brand.
- 5.8 There has been a gradual process of consolidation in the audit market in the UK, although this was quicker in the 1980s and 1990s with the Big Eight becoming the Big Five by 1998. The most recent large merger involved Deloitte & Touche purchasing assets of Arthur Andersen in 2002, when Arthur Andersen collapsed.

Market definition

- 5.9 The OFT's guidance on market investigation references states that,
- 'In making a market investigation reference to the CC, the OFT must specify the goods or services for whose supply or acquisition competition is adversely affected. This will require some consideration of the definition of the relevant market...The effects on competition of

some feature may be clear enough that firm conclusions on the definition of the relevant market by the OFT are unnecessary.¹⁹

Product market

- 5.10 **Statutory audit:** In the UK, the majority of companies, including all medium and large companies are required to have their financial statements audited by a qualified auditor.²⁰ The role of the statutory audit is to provide reassurance to investors, regulators (where appropriate), the company's management and other interested parties that the financial statements are a true and fair view of the company's financial activities and position.
- 5.11 Statutory audits in the UK are typically undertaken by accountancy firms and need to be undertaken by members of one of six professional bodies.²¹ It is the individual auditors' responsibility for signing off audits of financial statements, rather than the responsibility of audit firms.
- 5.12 **Demand and supply side substitutability:** There are no direct substitutes for either a statutory audit of financial statements, or the individuals that are qualified to undertake such audits.
- 5.13 There are a number of different methods by which the accuracy and reliability of financial statements could be examined. However, given the statutory requirement for medium and large companies to have their financial statements audited externally, these different methods would

¹⁹ *Market Investigation References – Guidance about the making of references under Part 4 of the Enterprise Act* (March 2006). See:

www.offt.gov.uk/shared_offt/business_leaflets/enterprise_act/offt511.pdf

²⁰ The requirement and exceptions are contained in Part 16 of the Companies Act 2006.

²¹ These organisations are the following:

- Association of Chartered Certified Accountants
- Chartered Institute of Management Accountants
- Chartered Institute of Public Finance and Accountancy
- Institute of Chartered Accountants in England and Wales
- Institute of Chartered Accountants in Ireland
- Institute of Chartered Accountants in Scotland

be complementary to the requirement for a statutory audit for medium and large companies rather than acting as a substitute product.

- 5.14 Moreover, while other individuals without a relevant professional qualification might be able to undertake the specific tasks of a statutory audit, any such work would not meet the requirements on companies within the Companies Act 2006.
- 5.15 It is therefore appropriate that the relevant service to consider is statutory audit provided by appropriately qualified auditors in line with the Companies Act 2006.
- 5.16 **Market segmentation – statutory audits for large companies:** The scale and complexity of auditing large companies is likely to be significantly more than auditing smaller and medium sized companies.
- 5.17 This extra complexity in terms of audit can arise for a number of reasons including the following:
- **International activity of the company and its subsidiaries:** Many of the largest listed companies have significant overseas activities, either similar activities to those in the UK, or in some cases different activities. These can be part of the main company or part of a subsidiary. These relationships for the largest listed firms can be very complex and require an auditor to consider the activities from a number of countries and a number of subsidiaries.²²
 - **Complexity of the operations:** Some of the largest listed companies can be involved in a large number of different related and unrelated activities and the size of these companies can give rise to complex relationships between these different parts of the business which

²² The Oxera report's survey of Audit Committee Chairmen mentions 'International Coverage' frequently as a factor influencing auditor selection. In addition, the FRC's Market Participants Group considered the Big Four to have the perception of more extensive and more integrated networks than non Big Four firms. This also noted that companies tend to prefer to have the same audit firms across the countries where they operate.

would not be seen with smaller and medium sized listed companies.²³

- **The need for industry-specific knowledge:** The audits of some large companies may require an auditor to have detailed knowledge of a particular industry or sector, to ensure it is familiar with specific practices, regulatory or other matters.²⁴ For example, some financial services may require an auditor to have particular detailed knowledge and expertise to undertake an effective and informed audit of the relevant financial statements.

5.18 These elements mean that the nature, scale and scope of the work of auditors when considering large listed companies would be different to that for smaller and medium sized companies where such difficulties would be less likely to arise, or only to arise to a lesser extent. This is supported by the difference in the audit firms which carry out the audits of large and small companies.

5.19 We note that the House of Lords Economic Affairs Committee did not carry out a formal market definition exercise as part of its inquiry, however, references to the market in its report refer to, 'The large-firm audit market in the United Kingdom'.²⁵

5.20 Support for a market for large company audit can be found from the analysis undertaken by the EC in its analysis of the merger between Price Waterhouse and Coopers & Lybrand in 1998,²⁶ and confirmed by the EC's analysis of the merger between Deloitte & Touche and Andersen (UK) in 2002.²⁷ Specifically, in 2002, the EC noted that:

²³ The Oxera report's survey of Audit Committee Chairmen found that 'Technical Accounting Skill' is cited frequently as a factor influencing auditor selection.

²⁴ The Oxera report's survey of Audit Committee Chairmen found that 'Sector specific expertise' is cited frequently as a factor influencing auditor selection.

²⁵ House of Lords report, paragraph 14.

²⁶ Case No IV/M.1016 – Price Waterhouse/Coopers & Lybrand, 20 May 1998.

²⁷ Comp/M.2810 – Deloitte & Touche/Andersen (UK), 1 July 2002.

'In case IV/M.1016 of 20.5.1998 – Price Waterhouse/Coopers & Lybrand, the Commission identified the main reasons for which it is considered that audit and accounting services to quoted and large companies form part of a separate product market: the necessity for such companies to have audit and accounting services provided by a firm with the necessary reputation in the financial markets (in the case of quoted companies), the geographic breadth to cover the companies' needs worldwide (in the case of multinationals), the depth of expertise in the particular sector (large companies in general and, in particular, regulated sectors such as banking and insurance) and significant resources (all large companies).'²⁸

5.21 In 2002, the EC noted the following:

'No categorisation defining exactly the sample of companies for the market for audit and accounting services for quoted companies is available. However, several categorisations can be considered to provide a sample representing the best approximation for the relevant market. These samples are in particular FTSE 100, FTSE 350, and turnover threshold of \$250 million and \$1 billion.'²⁹

5.22 In addition, support for markets consisting of the FTSE 100 and FTSE 250 companies can be found from a 2007 report by Oxera for DG Internal Market and Services.³⁰

5.23 It is difficult however to establish a precise threshold for what constitutes a large company in this context. As part of its evidence submitted to the Select Committee on Economic Affairs of the House of Lords, the OFT restricted its evidence to covering the auditors of the FTSE 350 companies. We conclude that audits of the FTSE 350

²⁸ Ibid.

²⁹ Ibid.

³⁰ *Ownership Rules of audit firms and their consequences for audit market concentration*, Oxera, October 2007, prepared for DG Internal Market and Services.

companies may be an appropriate boundary of the market for audits of large companies.

- 5.24 Furthermore, we conclude that there may be separate smaller markets, for example for audits of the FTSE 100 companies.
- 5.25 We do not, however, discount the possibility that this market may extend further and encompass a greater number of companies.
- 5.26 **Market segmentation – sector specialists:** It is also possible that separate markets exist for some particular industry sectors. There are some industry sectors that have more complex auditing requirements and greater need for sector specific expertise than others, for example banking and insurance. OFT analysis found that concentration is higher in some industry sectors with two of the Big Four supplying more than 80 per cent of audit services for banks and building societies; mining and quarrying; manufacturing; and electricity, gas and water supply sectors. The OFT has not undertaken a detailed analysis of this issue or reached a definitive conclusion on the extent to which separate markets exist for certain industry sectors.

Geographic market

- 5.27 A defined geographic market identifies the appropriate spatial dimension for assessing the boundaries of competitive constraints for the products or services being considered.
- 5.28 Statutory audit services are statutory services described in the Companies Act 2006. As such, these specific services are provided purely within the UK. There are, however, standards, rules and regulations governing the provision of statutory audit services that are developed at an EU wide level to ensure similarity of the nature of statutory audit throughout the EU.
- 5.29 In addition, auditors themselves are not typically able to act in other countries purely as a result of qualifications and professional body membership in the UK. Therefore, audit firms need a presence in the country in which they are intending to operate. This ensures they are

able to assess the activities of the company in that country and comply with country-specific legislation on statutory audit, as well as to ensure that they are knowledgeable about related legislation and other relevant practices.

5.30 Large international companies are likely to be keen to employ the same audit firm in the different countries in which they operate. Smaller listed companies however are likely to seek only a national audit firm. Furthermore, some smaller and medium size companies may seek audit services within a more limited geographic range, on either a local or regional basis, to fit with their operations, and there are small and medium size auditors that can supply statutory audit services on this basis. We consider that there may be chains of substitution for statutory audit services within a country that mean the relevant geographic market is wider than regional or local and may be national in scope. Evidence of chains of substitution would need to be investigated further to reach a definitive conclusion on this point.

5.31 Our analysis of supply-side substitution is consistent with that undertaken by the EC in 1998 and confirmed in 2002 which indicated that these markets were national in scope:

'(T)he Commission has stated...that these markets are national in scope. The reasons given were in particular significant national differences for the services' main features such as the specific professional expertise required, applicable regulations, and the relevant laws'.³¹

5.32 This view is also consistent with the conclusions of the 2007 report by Oxera for DG internal Market and Services.³² The OFT does not consider that there have been sufficient changes in regulation, legislation or supply and demand-side substitution for statutory audit in the UK or EU

³¹ Comp/M.2810 – Deloitte & Touche / Andersen (UK), 1 July 2002.

³² *Ownership Rules of audit firms and their consequences for audit market concentration*, Oxera, October 2007, prepared for DG Internal Market and Services.

which would mean that the geographic market is now wider than previously stated, despite the desire among some large companies to use the same audit firm in different countries. Therefore, in conclusion, the appropriate geographic frame of reference for statutory audits of large companies is for these to be examined on a UK-wide basis.

6 FEATURES OF THE MARKET WHICH PREVENT, RESTRICT OR DISTORT COMPETITION

6.1 The OFT considers that there are features, both individually and in combination, that prevent, restrict or distort competition in the market for the supply of statutory audit services to large companies in the UK. Section 131(2) of the Enterprise Act 2002 states that a feature of a market is to be construed as a reference to:

- the structure of the market concerned or any aspect of that structure
- any conduct (whether or not in the market concerned) of one or more than one person who supplies or acquires goods or services in the market concerned or
- any conduct relating to the market concerned of customers of any person who supplies or acquires goods or services.³³

6.2 The features identified by the OFT are the following:

6.3 **There is little incentive for companies to switch auditor.** Audit fees are not the main drivers of auditor selection and switching because they are relatively small in terms of the overall corporate budget. Studies have found that the level of the audit fee is a relatively unimportant influence on auditor selection (particularly for large companies).³⁴

6.4 In addition, technical audit quality is difficult to discern and this may mean that it is difficult for Finance Directors and audit committees to

³³ Section 131(3) of the Enterprise Act 2002 notes that conduct includes any failure to act and any unintentional conduct.

³⁴ Sources include:

- The Oxera report, pages 30-31, and 33. Oxera's survey of audit committee chairs found that only nine of the 50 audit committee chairs surveyed cited price as a determinant of the choice of auditor.
- *An assessment of the implications for competition of a cap on auditors' liability*, OFT 741, 2004, page 8.

distinguish between the audits of different suppliers in terms of their technical quality.³⁵

6.5 Regulatory standards may also accentuate the difficulty of differentiating the technical quality of an audit. Several commentators have said that auditing has moved towards a rules based, tick box exercise with a diminished role for the auditor's judgement.³⁶ Accounting academics also reported concerns 'about the ability of non-accountants on audit committees to understand the IFRS [International Financial Reporting Standards] accounting model' and 'many complaints about excessive complexity',³⁷ which may make it harder still to discern technical audit quality. It can be even more difficult for some shareholders, the ultimate customers of audit, to assess the technical quality of audits given asymmetries in information and expertise.

6.6 Where the scope for differentiation in technical quality is perceived to be limited, companies may view audit simply as a regulatory hurdle, rather than as something that is capable of adding value. Instead differentiation may take place on the basis of perceived quality of the audit firm, seen through reputation, service level or the nature of non-audit services provided.

6.7 **It can be costly for companies to switch auditor.** The main switching costs are:

- Substantial management and audit committee time is required to put an audit out to tender and select a new auditor.

³⁵ Sources include:

- Power, Michael (2003) Auditing and the production of legitimacy in Accounting, Organizations and Society journal.
- The Oxera report, pages 24-5, and 88.
- FRC (Market Participants Group) Final Report (October 2007) page 28.

³⁶ Memorandum to House of Lords Inquiry of Professor Vivien Beattie, Professor Stella Fearnley, and Tony Hines, 3 October 2010, sections 2.1, 4.3 and 6.2. See also the Oxera report, page 29.

³⁷ Memorandum to House of Lords Inquiry of Professor Vivien Beattie, Professor Stella Fearnley and Tony Hines, 3 October 2010, section 2.2.

- The time company management will have to invest in bringing the auditor up to speed during the period it takes a new auditor to gain an understanding of the business in order to audit it.³⁸
- The potentially higher risk of a new auditor making mistakes initially.

6.8 Academics told the House of Lords inquiry that companies 'are reluctant to change auditors because of the cost of doing so'.³⁹ This echoed the view expressed by the FRC Market Participants Group.⁴⁰ Ernst & Young confirmed that '[c]ompanies do not change their auditors very often because running tenders and changing auditors is costly. It takes time for auditors to build up knowledge of the company and to form strong relationships with the audit committee, both essential factors in ensuring audit quality.'⁴¹

6.9 PwC estimated switching costs for the company being audited at between £500,000 and £1m. This was considered not to be substantial 'in the overall context' but is taken into account in terms of a cost that might not need to be incurred if the client is satisfied with the quality of the work.⁴²

6.10 There is also a cost to audit firms in tendering which may also impede the switching process. This may vary dependent on the size of the client, with higher costs for international and more complex clients.

³⁸ Sources include:

- KPMG's submission to the consultation on the EC's Green Paper, 8 December 2010, q.18, pages 29-30. It states that 'significant management time is... taken up in both the tendering process itself and briefing a new firm of auditors'.
- The Oxera report, pages 48 and 49. Oxera's survey of audit committee chairs found that management time is the most significant factor discouraging switching.

³⁹ Memorandum to the House of Lords Inquiry of Professor Vivien Beattie, Professor Stella Fearnley and Tony Hines, 3 October 2010, section 2.3.

⁴⁰ FRC (Market Participants Group) Final Report, October 2007, page 30.

⁴¹ Letter to House of Lords inquiry, 24 September 2010, appendix paragraph 6.

⁴² Mr Ian Powell of PwC in answer to Q245 of House of Lords inquiry, 23 November 2010.

- 6.11 **The market shows low levels of tendering and switching.** OFT analysis of FAME data between 2002 and 2010 showed average annual switching rates of 2.3 per cent for FTSE 100 and 4.2 per cent for FTSE 250 companies. This implies that the average switching frequency for FTSE 100 companies is every 43 years, and for FTSE 250 companies is every 24 years.⁴³
- 6.12 We acknowledge that high switching rates might not be efficient in the large firm audit market where there are costs of switching both for audit firms and their clients. Nevertheless, switching at these low levels is indicative of limited competition and may also restrict the ability of entrants to compete for audit contracts.
- 6.13 There is little publicly available data on the frequency with which audit contracts are put out to tender. One of the Big Four auditors was cited in Oxera's 2006 report as being aware of only 28 of the FTSE 100 companies having held competitive tenders in the previous 15 years.⁴⁴ In a recent submission KPMG stated that its FTSE100 audit clients have issued a total of 13 tenders since 2002, during which time it has had between 20 and 23 clients in the FTSE100 each year.⁴⁵ PwC said that 'the expense involved in the tendering process, as well as the dislocation, cost and quality risk involved in bringing in a new auditor' meant 'large companies do not choose to put their audit out to tender very frequently'.⁴⁶
- 6.14 However, some large audit firms have said that it is possible for competitive pressure to be felt even in the absence of tenders. Thus

⁴³ These figures and those quoted subsequently or depicted in graphs for concentration, market shares or fee levels are derived from FAME, a database of company accounts information drawn from data held at Companies House. The analysis covers firms that were members of the FTSE 100 or FTSE 250 as at June 2011 and for which accounts data were available from FAME.

⁴⁴ The Oxera report, page 43.

⁴⁵ KPMG letter to the OFT of 13 July 2011. KPMG noted that it collected some information from KPMG audit partners of FTSE 100 companies by means of a questionnaire. KPMG recognised that this exercise was necessarily informal and to a degree anecdotal, however it had no reason to believe that the data obtained was not broadly representative of the market as a whole.

⁴⁶ Memorandum to House of Lords Inquiry, 24 September 2010, paragraph 15.

companies are sophisticated buyers and experienced negotiators that are expected to review audit contracts regularly. In a recent submission to the OFT, KPMG stated that around three quarters of its FTSE100 audit clients had formal processes in place to review the audit fees they pay and since 2000 around half of them had conducted extensive reviews which went beyond regulatory requirements, with price cited as one reason in around half of these reviews.⁴⁷ Such reviews might lead to changes by the incumbent audit firm (for example to the audit team or a reduction in price) without formal tendering.

- 6.15 However, the OFT considers that a company may not be able properly to assess the audit services supplied to it without inviting other audit firms to participate in a tendering process. Without doing this, it may not be able to solicit rival offerings given the cost of preparing these and thereby to undertake a meaningful comparison of the offerings (including prices) of different audit firms. In addition, the lack of proper tendering may also limit the ability of firms outside the Big Four to compete for audit contracts.
- 6.16 Some have argued that an adequate degree of competition is achieved through the tender process. For example, the Hundred Group of Finance Directors noted the 'high level of competition demonstrated during an audit tender process... in terms of emphasis of approach and on audit fees paid'.⁴⁸ Accounting academics giving evidence to the House of Lords inquiry also stated that 'the market appears to function in a competitive manner'.⁴⁹
- 6.17 However, the OFT considers that the limited switching and the apparent infrequency of tendering are both indicative of limited competition in this market, and themselves serve to restrict competition by limiting the opportunities for new audit firms to compete for clients. This restriction

⁴⁷ KPMG letter to the OFT of 13 July 2011.

⁴⁸ Letter from Mr Peter Williams to House of Lords Inquiry, 27 September 2010, paragraph 6.

⁴⁹ Memorandum to the House of Lords Inquiry of Professor Vivien Beattie, Professor Stella Fearnley and Tony Hines, 3 October 2010, section 8, q.11; and oral hearing, 12 October 2010.

on competition is particularly apparent when seen in combination with the barriers to entry considered elsewhere in this Chapter.

- 6.18 **In choosing an auditor, companies focus on existing size or reputation, which imposes a barrier to entry to non-Big Four auditors.** Given that audits are characterised by asymmetric information and there are only indirect indicators of quality (such as attributes of staff), buyers often focus on service level, brand and reputation. In particular, companies may consider that selecting auditors on the basis of existing size or reputation will satisfy investors and avoid both the need to consult them and the risk of being blamed for appointing the wrong auditor in the event of problems arising.⁵⁰ Thus they may not choose an auditor on the basis of maximising the value added by the audit, or its value for money.
- 6.19 There seems to be little difference in reputation between the Big Four, but a larger difference between the Big Four and mid-tier firms. As a result, mid-tier auditors may struggle to compete even on the basis of a better value or higher quality proposition.
- 6.20 **Larger auditors possess certain attributes necessary for auditing large companies.** These attributes are difficult for other firms to acquire so may also constitute barriers to entry. In addition to size (in so far as this is perceived as an indicator of quality, as discussed above) these include:

⁵⁰ Sources include:

- FRC (Market Participants Group) Final Report, October 2007, page 28.
- The Oxera report, pages 28-29, 31-32 and 34-35. Oxera's survey of audit committee chairs found that 'reputation of firm' is the second most frequent reason for not considering a mid-tier firm and 'credibility with relevant stakeholders in the event of an audit problem' is the fifth most frequently cited reason for not considering a mid-tier firm.
- Academics told the House of Lords inquiry that there is 'a widespread perception supported by many research studies that audit firm size is a proxy for audit quality'. (Memorandum to the House of Lords Inquiry of Professor Vivien Beattie, Professor Stella Fearnley and Tony Hines, 3 October 2010, sections 2.3 and 4.1.)

- An extensive, integrated international network.⁵¹ Companies prefer to have the same audit firm across the countries where they operate, or into which they are planning to expand. The Hundred Group of Finance Directors said that 'the importance of 'global reach' in an audit firm is imperative... The barriers to entry for a global audit firm are high and require a certain 'critical mass' to be effective.'⁵²

The Big Four are generally perceived to have more extensive and more integrated international networks than non-Big Four firms, including branding, common audit methodologies and quality standards, knowledge sharing and governance arrangements. Academics told the House of Lords inquiry that evidence suggested that once a company grows above a certain size or has international subsidiaries, the non-Big Four firms do not have such effective global networks.⁵³ There is also a perception that auditing standards discourage the use of auditors from more than one network.^{54, 55}

- Greater experience of auditing complex businesses.⁵⁶
- Relevant sector experience.⁵⁷ As well as being a factor in its own right, sector specific knowledge and experience may enhance firms'

⁵¹ The Oxera report, pages 30-32 and 34-36. In the survey of audit committee chairs 'international coverage' is cited frequently as a factor influencing auditor selection and indeed is the most frequent reason for not considering a mid-tier firm.

⁵² Letter from Mr Peter Williams to House of Lords inquiry, 27 September 2010, paragraphs 8-9.

⁵³ Memorandum to the House of Lords Inquiry of Professor Vivien Beattie, Professor Stella Fearnley and Tony Hines, 3 October 2010, section 7.5.

⁵⁴ FRC (Market Participants Group) Final Report, October 2007, page 32.

⁵⁵ The Hundred Group of Finance Directors told the House of Lords Inquiry that current requirements under ISA600 are interpreted as a requirement for group auditors to audit the majority of a group's global subsidiaries. This in turn will preclude smaller firms from competing in the global arena. Letter to the House of Lords Inquiry from Mr Peter Williams, 27 September 2010, paragraph 9.

⁵⁶ The Oxera report, page 37. Oxera's interviews with large-scale companies found that Big Four staff are more experienced in auditing 'complex businesses'.

ability to provide value-added services such as advice on industry best practice, trends and potential improvements to company processes.

- Enhanced familiarity with latest developments in complex regulatory standards.⁵⁸ There is a perception that the Big Four are better placed than mid-tier firms to provide information on the latest developments in international accounting standards. Thus the FRC Market Participants Group set out its view that companies which wish to benefit from expertise on accountancy regulation may assume that they need to deal with the Big Four.⁵⁹ The FRC concluded that the Big Four's involvement in the regulatory and standard-setting bodies was 'more prominent'.⁶⁰ By contrast, there can be a significant sunk cost for smaller firms to stay abreast of developments in international accounting standards. Indeed, academics told the House of Lords inquiry that '[t]he drive for global accounting standards and the complexity of the standards themselves plays to the strengths of the larger firms and increases the barriers to entry to the global market for smaller firms.'⁶¹
- The Oxera report noted a general view that the Big Four are better placed than mid-tier firms to provide additional services related to the audit, including advice on best practice across industries and countries. Additional services can be highly valued by audit

⁵⁷ The Oxera report, pages 30-32 and 34. 'Sector specific expertise' is cited frequently in the survey of audit committee chairs as a factor influencing auditor selection.

⁵⁸ The Oxera report, page 24.

⁵⁹ *FRC (Market Participants Group) Final Report*, October 2007, page 24.

⁶⁰ *FRC (Market Participants Group) Final Report*, October 2007, page 24. The FRC reported that:

- The International Accounting Standards Board had one practicing member, who was from a Big Four firm, and the International Auditing and Assurance Standards Board had 18 practicing members, of whom eight were from Big Four firms, one was from a large non-Big Four firm and two were from smaller practices.
- Similarly, within the UK both the Accounting Standards Board and the Auditing Practices Board did not have practicing members from large non-Big Four firms.

⁶¹ Memorandum to the House of Lords of Professor Vivien Beattie, Professor Stella Fearnley and Tony Hines, 3 October 2010, section 8.1.

committee chairmen and Finance Directors and a factor determining choice of auditor. The OFT also notes that auditors are prevented from auditing a company if fees (audit and non-audit) exceed 10 per cent (15 per cent for non-listed companies) of the audit firm's total fee income.⁶² This may disadvantage smaller firms in offering audit and additional services to a company in combination.

- Existing links with Finance Directors and audit committee chairmen. Those selecting or influencing the selection of auditors are more likely to have experience of working with the Big Four.⁶³
- The ability for the Big Four to recruit higher calibre staff attracted by the audit firm's reputation and their extensive training programmes.⁶⁴

6.21 Some large audit firms have made the point that they have developed several of the attributes described above in order to meet the demand for greater capacity on the part of audit firms which has been brought on by the growth of major companies.⁶⁵ This capacity has been created at least in part by mergers. Thus a report by London Economics found that the main drivers of mergers between audit firms were the growing geographical spread of clients and the need to broaden industry and technical expertise, as well as moves to computer-based accounting methods and new auditing methods which required large capital commitments.⁶⁶ Similarly, accounting academics submitting evidence to

⁶² Ethical Standard 4 (revised), paragraph 25, UK Auditing Practices Board.

⁶³ FRC (Market Participants Group) Final Report, October 2007 page 5.

⁶⁴ The Oxera report, page 37.

⁶⁵ Sources include:

KPMG's submission to the consultation on the EC's Green Paper, 8 December 2010, q32, page 46; and PwC's memorandum to House of Lords inquiry 24 September 2010 paragraph 7. Although we note that Ernst & Young said that only the very biggest companies require the geographic reach and industry specialisation of the Big Four. See: letter to House of Lords inquiry, 24 September 2010, paragraph 3 of appendix.

⁶⁶ Study on the Economic Impact of Auditors' Liability Regimes (MARKT/2005/24/F), Final Report To EC-DG Internal Market and Services By London Economics in association with Professor Ralf Ewert, Goethe University, Frankfurt am Main, Germany, p 34
http://ec.europa.eu/internal_market/auditing/docs/liability/auditors-final-report_en.pdf

the House of Lords inquiry reported that 'Business has become more global and such businesses need the scope (and scale) of global audit firms. Firms have also merged over time to become more effective and profitable.'⁶⁷

- 6.22 However it seems that it is difficult for smaller audit firms to develop the necessary attributes such as reputation, experience, expertise and resources to undertake large audits because of the difficulty of securing large audit contracts in the first place – potentially a vicious circle. So many of these attributes can be seen as significant first mover or incumbency advantages which are difficult for potential new entrants to overcome.
- 6.23 In addition, Oxera found that, while operating in the FTSE 100 and FTSE 250 segments can in principle be profitable, the initial expansion in the short term (beyond a small number of clients) is problematic due to significant barriers to entry, which raise the cost of market entry. In its analysis, the investment and sunk costs required to gain a significant foothold in the supply of audit services provided to FTSE 250 companies in terms of reputation, expertise and international networks may very well exceed the potential returns, with significant risks when competing against incumbents and a long payback period.⁶⁸ PwC also said that 'the market is not sufficiently attractive to other potential suppliers of large audits in terms of the investment-risk-reward payoff to encourage investment.'⁶⁹ On top of this, the increase in risk from taking on a significant client under current liability arrangements may further reduce the attractiveness of new entry or expansion by smaller firms.⁷⁰

⁶⁷ Memorandum of Professor Vivien Beattie, Professor Stella Fearnley and Tony Hines, 3 October 2010, section 8, q.1.

⁶⁸ The Oxera report, pages 109-110.

⁶⁹ Memorandum by PwC to House of Lords Inquiry, 24 September 2010, paragraph 17. PwC stated that it was an indication that prices are not excessive in relation to the costs and risk of supply and hence that the market is working effectively. We contend as stated in the paragraph above that this may very well be due rather to risks reflecting the difficulty of competing against incumbents, together with a long payback period.

⁷⁰ *FRC (Market Participants Group) Final Report*, October 2007, page 22.

6.24 **Smaller auditors can find it difficult to raise capital for expansion.**

Avenues for raising capital are limited by:

- The requirement for a firm to be majority-controlled⁷¹ by chartered accountants.⁷² Given the multidisciplinary nature of many audit firms, a sizeable proportion of partners and owners are not auditors, which limits firms' ability to raise equity finance without restructuring.⁷³
- Their partnership structure, as investment may not be attractive to older partners due to the limit that retirement imposes on the period in which they can receive a return on investment. This may make it unlikely that all partners would agree to the investment required.⁷⁴

6.25 **Banks may impose conditions requiring the use of a Big Four auditor in their dealings with companies of a certain size.** Various key participants in the market and witnesses have referred to the existence of such conditions or covenants. For example, the Association of Chartered Certified Accountants told the House of Lords inquiry that banks invariably include requirements in lending agreements for listed companies to use one of the Big Four.⁷⁵ Likewise, the FRC concluded that there was sufficient anecdotal evidence of banking covenants to require a further investigation of this issue.⁷⁶ However, we understand

⁷¹ This relates to the exercise of control according to voting rights and by the firm's management board.

⁷² The legal rules relating to the control of audit firms are contained in Part 2 of Schedule 10 of the Companies Act 2006. These requirements flow from Article 3 of Directive 2006/43/EC on statutory audits.

⁷³ FRC (Market Participants Group) and comment by Bruegel (a stakeholder), *Choice in the UK Audit Market: Briefing Paper for Second Stakeholder Meeting*, Financial Reporting Council, September 2006, paragraph 35.

⁷⁴ The Oxera report, pages 97 and 110; and the FRC (Market Participants Group) Final Report, October 2007, page 18.

⁷⁵ Memorandum to the House of Lords Inquiry by the Association of Chartered Certified Accountants, 19 October 2010.

⁷⁶ Supplementary memorandum to the House of Lords Inquiry by Baroness Hogg and Mr Stephen Haddrill, Financial Reporting Council, 9 November 2010.

that in at least some cases, such requirements may be softer than contractual agreements.

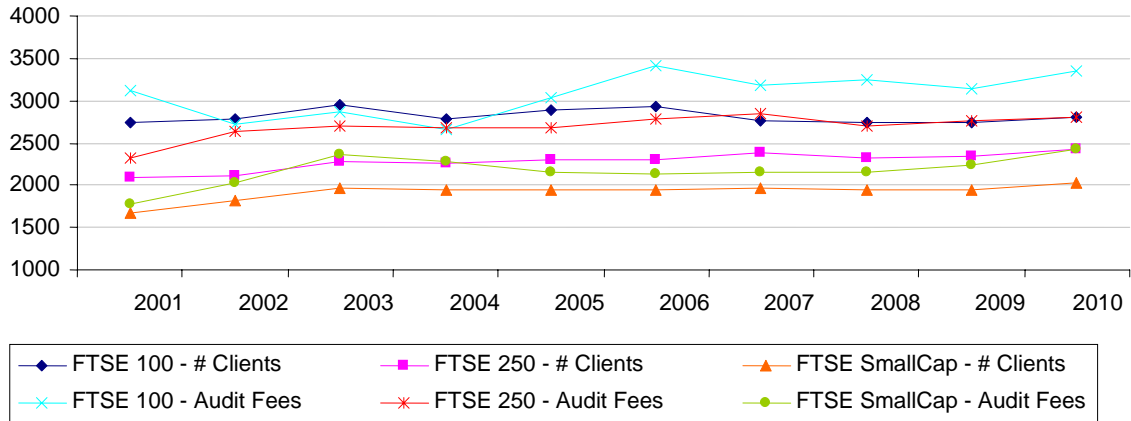
- 6.26 **The market exhibits high concentration.** Measuring concentration using the Herfindahl-Hirschman Index (HHI) according to audit fees levied in 2010, the figures are 3,343 for the FTSE 100 and 2,807 for the FTSE 250. A HHI figure in excess of 1,800 is typically considered to represent a highly concentrated market.
- 6.27 In 2010 the Big Four earned 99 per cent of the audit fees levied for FTSE 100 companies, and 98.5 per cent for FTSE 250 companies. PwC alone earned 47 per cent of FTSE 100 companies' audit fees.⁷⁷ By way of further illustration, the Big Four audited all but eight of the 207 companies in the FTSE 250 for which we have accounts.
- 6.28 Concentration is higher in some specific industry sectors including banks and building societies; mining and quarrying; manufacturing; and electricity, gas and water supply. Two of the Big Four earned more than 80 per cent of audit fees from FTSE 350 companies in these sectors in 2010.
- 6.29 As shown in Figure 1 below, concentration has been consistently high over the last 10 years.⁷⁸

⁷⁷ These figures were calculated for FTSE 100 and FTSE 250 companies as at June 2011.

⁷⁸ Measured by HHI between 2001 and 2010 for FTSE 100 and FTSE 250, by number of clients and audit fees.

Figure 1: Audit concentration – number of clients and audit fees

Concentration – measured by HHI



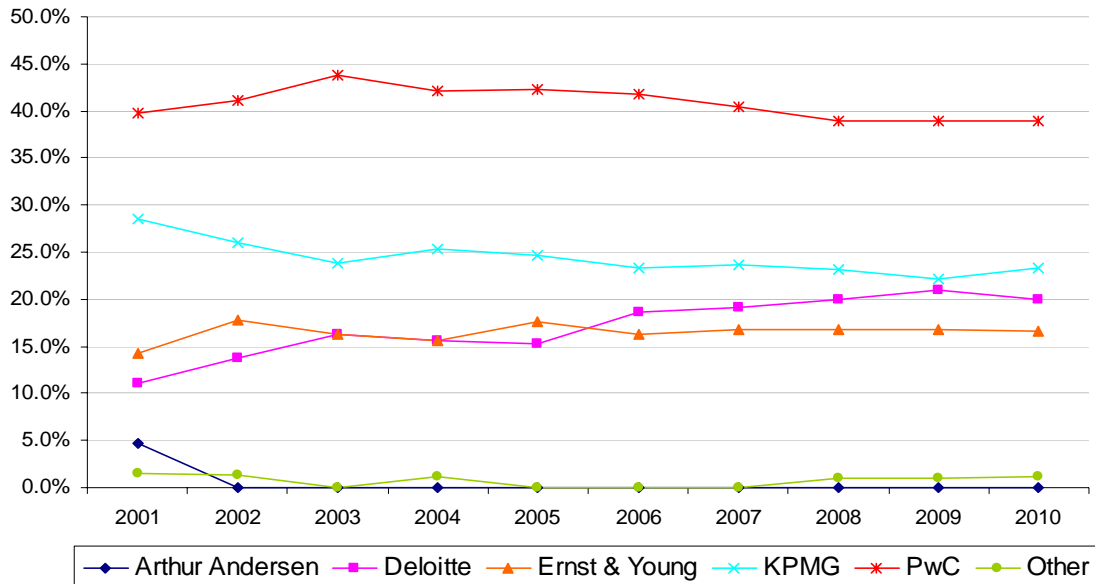
Source: FAME database with OFT analysis

6.30 Moreover the market shares of each of the Big Four in the FTSE 100 and FTSE 250 have been largely stable at least as far back as 2003 (see Figures 2 and 3 below).⁷⁹ We note that Deloitte has increased its market share in both FTSE 100 and FTSE 250 groups since 2001 but much of that growth arose between 2001 and 2003, the period during which Arthur Andersen collapsed and merged with Deloitte & Touche.⁸⁰

⁷⁹ Calculated according to number of clients to avoid distortion due to variation in fee levels. Arthur Andersen audited some FTSE 100 and FTSE 250 companies until 2002.

⁸⁰ See paragraph 5.5 and COMP/M.2810 – Deloitte & Touche/Andersen (UK), 1 July 2002.

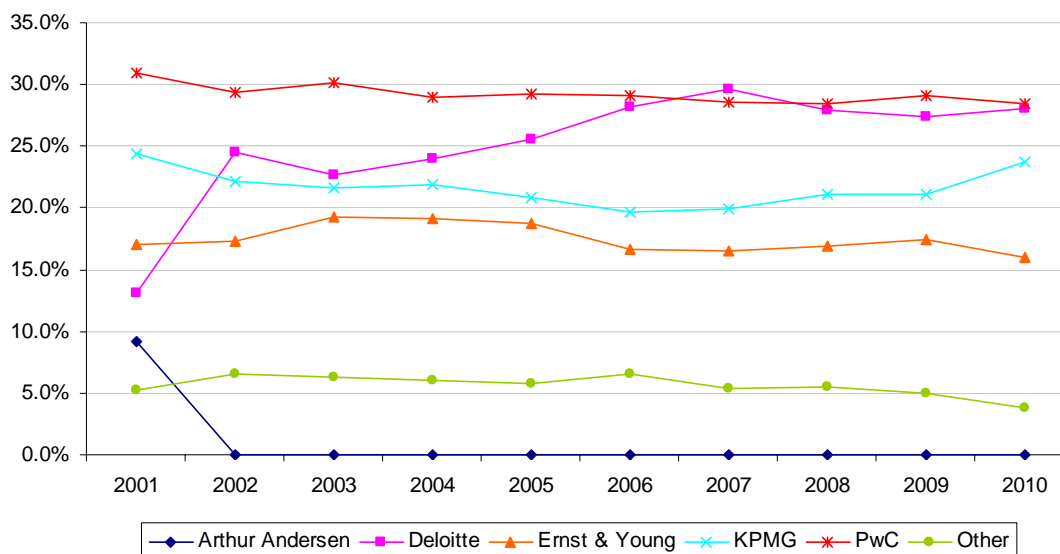
Figure 2: Share of supply of audit for the FTSE 100 Companies



Note: Share of supply by number of clients.

Source: FAME database with OFT analysis.

Figure 3: Share of supply of audit for the FTSE 250 Companies



Note: Share of supply by number of clients.

Source: FAME database with OFT analysis.

6.31 As noted in paragraph 6.20 above, there has been a trend for audit firms to develop greater capacity in response to demands from clients for scale and scope to undertake large audits. However, the OFT does not consider this trend limits the market to four large audit firms. Several parties either single out the approval of the merger that created PwC for the current high concentration⁸¹ or blame the failure of Arthur Andersen for exacerbating it.⁸²

⁸¹ BDO told the House of Lords Inquiry that the merger of Price Waterhouse and Coopers and Lybrand in 1997 followed the 'merger mania' of the 1980s and many were surprised that it was allowed to proceed given that it resulted in an immediate 42 per cent market share for PwC. See memorandum of BDO, 23 September 2010, appendix q.1.

⁸² Sources include:

- KPMG acknowledged that 'concentration was exacerbated by the regulatory response to the problems of Arthur Andersen which led to its collapse'. Memorandum to House of Lords Inquiry, 28 September 2010, paragraph 1.1. This memorandum also refers to a letter from KPMG's Joint European Chairman John Griffith-Jones to the FT on 15 September 2006

6.32 There is some evidence, in line with the Oxera Report, that auditors with higher shares of supply (in a given sector and year) can charge higher audit fees and that an increase in concentration in the provision of audit services (in a given sector and year) is associated with an increase in the level of audit fees, when holding other relevant factors constant.⁸³

6.33 **Companies may have further limits on the choice of auditors that they can appoint.** In addition to the limits on choice of auditors that arise from high concentration and barriers to entry, some companies' choice can be limited by other considerations.

- For multi-national companies, choice may also be restricted by regulation in a variety of countries, such as the USA's Sarbanes-Oxley Act of 2002, which limits the ability of public reporting companies to appoint as their auditors firms who supply them with certain types of non-audit services.⁸⁴ Thus Oxera found that one in eight FTSE350 companies has two audit firms conflicted out as alternatives to their current auditor, leaving them only one alternative among the Big Four. One in eight uses all the Big Four firms, restricting their effective short term choice of auditor to

which said 'We agree that in an ideal world there would be more than four 'big' audit firms... the solution lies in the creation of a successful fifth firm.'

- Ernst & Young also noted that concentration has been driven by growth of multinational companies and audit firms' corresponding need for global networks, increasing litigation risk and the demise of Andersen in 2002. It referred readers to the Oxera report for more detail. Letter to House of Lords Inquiry, 24 September 2010, paragraph 1 of appendix.

⁸³ This was found in testing the robustness of results from the Oxera report. We applied the same model to an updated dataset and considered criticisms of the original results. Our findings are robust across the time periods and models considered by ourselves and Oxera. However we cannot rule out that auditors with high shares of supply (in a given industry sector and year) charge higher fees because they offer a higher quality product. We also note that it is possible that results are driven by a large number of data errors in the FAME database, although we consider this to be unlikely.

⁸⁴ This applies especially to large multinational companies which tend to have relationships with all the Big Four companies across a range of audit and non-audit services. Sources include: The Oxera report, page 81; and Ernst and Young, and PricewaterhouseCoopers, *Choice in the UK Audit Market: Briefing Paper for Second Stakeholder Meeting*, Financial Reporting Council, September 2006, paragraphs 38 and 39.

zero.⁸⁵ Oxera found that it may be more profitable for audit firms to supply non-audit services and that certain FTSE100 companies said that Big Four firms sometimes decide either not to bid for an audit or to bid solely to preserve reputation.⁸⁶

- Rules on banking relationships prevent a firm auditing a company that either it or its staff bank with. Oxera found that audit firms say that the prospect of changing every auditor's financial arrangements, from current accounts to personal pensions, means that an audit firm will almost certainly never bid to audit a potential client its staff bank with. Thus many significant financial services organisations have their effective choice reduced by at least one audit firm.⁸⁷
- Further, choice may be limited by commercial considerations, for example companies not wanting to employ auditors that work closely with competitors. Oxera found that for a minority of companies this appears to be a significant issue, especially in the oil and gas and media fields.⁸⁸
- It has also been said that audit firms may have internal policies that prohibit them from taking an audit appointment where a substantial proportion of the company's subsidiaries are audited by other firms.⁸⁹

6.34 These factors, coupled with the barriers to entry by non-Big Four firms, mean that the choice of auditor may effectively be restricted to only one

⁸⁵ The Oxera report, survey of audit committee chairs, page 81.

⁸⁶ The Oxera report, interviews with market participants, page 83.

⁸⁷ The Oxera report, interviews with market participants, page 84.

⁸⁸ The Oxera report, interviews with market participants, page 83. This found examples of limited choice for this reason.

⁸⁹ This is based on the presumption that group auditors will place reliance on the audit opinions provided by such other firms, rather than undertake their own work independently of the statutory audits. Source: Independent Audit Limited, strategic governance consultants, *Choice in the UK Audit Market: Briefing Paper for Second Stakeholder Meeting*, Financial Reporting Council, September 2006, paragraph 37.

or two firms for some companies and certain industry sectors. In particular, several UK financial services companies have only one audit firm likely to bid in a tender and thus no choice of auditor in the short run.⁹⁰ Oxera found that more than one third of FTSE350 companies believe their company does not have sufficient choice of auditor.⁹¹ Ernst & Young have said 'there should be more choice in the large listed company audit market'.⁹²

6.35 In conclusion, the audit market for large companies in the UK is highly concentrated, with substantial barriers to entry and low levels of switching. In addition, taken together, the combination of high market concentration, high barriers to entry and low rates of tendering and switching gives rise to a stable market with limited opportunities for rivalry and few changes in market shares over time.

6.36 Moreover there are concerns that concentration might increase further. The significant barriers to entry described above are likely to make it difficult for smaller firms to replace one of the Big Four firms if it were to exit the market. Thus the current features of the market entail the possibility of further increases in concentration and exacerbation of existing competition problems in future.

⁹⁰ The Oxera report, interviews with market participants, page 84.

⁹¹ The Oxera report, page 85, survey of audit committee chairs. The problem of choice was also picked up in interviews with market participants conducted by Oxera.

⁹² Letter to House of Lords inquiry, 27 September 2010, paragraph 1.

7 APPROPRIATENESS OF A REFERENCE

7.1 It is the OFT's view that the Section 131 test for making a reference is met and, therefore, the decision on whether to make a reference rests on the exercise of the OFT's discretion.

7.2 The OFT's guidance on market investigation references⁹³ sets out four criteria, all of which must be met before the OFT will exercise its discretion to make a reference to the CC.

- Alternative powers: it would not be more appropriate to deal with the competition issues identified by applying the Competition Act 1998 or using other powers available to the OFT, or where appropriate, to sectoral regulators.
- The scale of the suspected problem: the adverse effect on competition is significant, such that a reference would be an appropriate response to it.
- Availability of remedies: there is a reasonable chance that appropriate remedies will be available.
- Undertakings in lieu of a reference: it would not be more appropriate to address the problem identified by means of undertakings in lieu of a reference.

7.3 The OFT's assessment of each of these four factors follows.

Alternative powers

7.4 The market features identified by the OFT do not relate to the conduct of any individual market participants, save for those consuming the service. These features do not, therefore, suggest anti-competitive

⁹³ *Market Investigation References – Guidance about the making of references under Part 4 of the Enterprise Act*, March 2006.

conduct which might be in breach of the Competition Act 1998 or Articles 101 or 102 of the TFEU.

- 7.5 Allegations concerning possible requirements of some banks in lending agreements for one of the Big Four auditors to be used the firm borrowing money is a different type of feature, which would appear to consist of unilateral conduct by the bank concerned rather than conduct suggestive of clear definitive breaches of the Competition Act 1998.
- 7.6 The OFT has seen no evidence to date of any breach of the Competition Act 1998 which would make using competition law enforcement powers more appropriate in this market. Nor, in light of the FRC's own admission of the effectiveness to date of its work to increase competition in this market, do we consider that OFT recommendations to sectoral regulators would be appropriate at this stage.
- 7.7 Overall, the nature of the features described and the absence of evidence to date of breaches of competition law lead the OFT to conclude that it would not be more appropriate to use other powers available to the OFT or sectoral regulators to address the OFT's concerns in this market.
- 7.8 The OFT notes that the EC has published a Green Paper on audit and is likely to make certain draft legislative proposals by the end of 2011. In May 2011, the European Parliament's Legal Affairs Committee adopted its final report on the Commission's Green Paper, indicating the Parliament's support for reform in the audit sector. The OFT considers that while there is some potential for overlap between the market features that are of concern to the OFT and the scope of the activity in the EC, the OFT has specific competition concerns about the operation of the market for statutory audit in the UK which are not within the scope of the EC's work.⁹⁴ Also, the EC's approach is not solely, focused on competition concerns, but also on issues of audit quality,

⁹⁴ These issues include the extent of dynamic rivalry between existing audit firms and how to increase the levels of rivalry among them.

independence, and on lessons from the financial crisis. Finally, to the extent that there may be some overlap between the scope of a CC inquiry and any proposals from the EC, the OFT sees merit in having the CC input its expertise into the EU legislative process.

- 7.9 The OFT considers, therefore, that that EC could not be expected to resolve in full all the OFT's concerns, or to address UK specific concerns that are not analogous to or replicated in other member states. Further, the OFT considers that there are significant benefits to be gained from the CC's involvement in the EC's processes, and in any other international developments.

Scale of the problem

- 7.10 The OFT considers that a reference would be an appropriate response in this market given both the scale and the complexity of the suspected problems identified. This view is reached for two reasons. First, the size of the market is significant and estimated to be at least £600m per year. Second, a significant proportion of the market is affected by the features that prevent, restrict or distort competition, which appear to apply to most large UK companies as customers.
- 7.11 Specifically in relation to bank covenants, we have reasonable grounds to suspect that these are used by banks, and the views we have received imply that this issue affects a significant proportion of the market. We do not, however, have definitive evidence of the scale of the problem that these covenants represent.
- 7.12 More generally, we note that the features identified as adversely affecting competition are unlikely to be short-lived. As noted above, the OFT has been keeping the audit market under review since 2002, while the FRC, through its Market Participants Group, has, over a number of years, monitored and sought improvements to choice and competition in the market, with only minimal improvements being seen to date.

Availability of remedies

- 7.13 It is not for the OFT to determine which remedies would and would not be appropriate. Rather its role is to assess whether there is a reasonable chance that appropriate remedies will be available to the CC in the event that it finds one or more adverse effects on competition in this market. In the event of a reference, it is for the CC to perform an independent investigation and to decide what remedy or remedies is capable of achieving as comprehensive a solution as is reasonable and practicable to any adverse effects and any detrimental effects on customers.
- 7.14 The OFT discussed potential remedies in this context as part of the process of roundtable and bilateral meetings described in more detail in Annexe A.
- 7.15 Two broad categories of potential remedies were discussed: remedies designed to address the barriers to entry and the degree of rivalry between suppliers of audit; and those designed to increase transparency and empower purchasers of audit to exercise choice in the market. This distinction has been a useful basis for considering potential remedies available to the CC, although the OFT notes that there is overlap between the two categories: for example, remedies designed to empower purchasers to exercise choice in the market may also have a positive impact on the degree of rivalry between audit firms.
- 7.16 **Reducing barriers to competition and increasing rivalry:** These potential remedies typically have the aim of increasing rivalry among audit firms or reducing the barriers to effective competition. They may seek to do so by, for example, creating more players in the market, or creating greater opportunities for mid-tier firms to gain large company audit experience and build their capacity to compete effectively with larger audit firms.
- 7.17 Potential remedies in this area identified as part of this process included:
- **Splitting audit work:** This involves splitting audit work for a company between auditors from different audit firms. This may be through either a joint or split audit process.

- **Changing the ownership structure of audit firms:** Different rules may allow for greater access to capital to allow the business to grow in size.
- **Limiting individual firms' shares of the market:** This may be considered to help prevent an increase in concentration among the larger audit firms with the aim of encouraging resources to move from larger to smaller audit firms.
- **Removal of covenants in bank loans specifying the auditor to be used:** The removal of such covenants may lead to companies appointing a wider range of auditors.

7.18 **Increased transparency and empowering purchasers:** These potential remedies typically have the aim of improving transparency and information provision around audit selection policies and practices, to stimulate engaged and effective buyer behaviour, and to promote a culture of choice that is not limited only to the larger audit firms.

7.19 Potential remedies in this area identified as part of this process included:

- **Increased frequency of audit tendering and greater public information on tenders and audit contracts:** This may encourage tendering of audit contracts from companies.
- **Increased transparency around audit appointments for shareholders:** This may allow shareholders to have more information on the details of the audit appointment and reasons for seeking or not seeking to tender the audit contract.
- **Increased power for shareholders:** This could involve giving shareholders more information and the ability to more easily exert power over the choice of audit firm used by large companies.
- **Handover processes between outgoing and incoming auditors:** A common way for outgoing auditors to transfer key information about a client to incoming auditors might be one way to reduce the cost of switching auditor.

- 7.20 We received a range of views on the costs and effectiveness of these and other potential remedies relating to the two categories set out above. We note however that there was a degree of consensus among stakeholders in favour of some measures, particularly some of those designed to increase transparency and empower purchasers.
- 7.21 The OFT also notes that:
- Addressing barriers to entry, increasing rivalry and improving transparency in markets is a central objective of many CC remedies.
 - The CC has devised remedies that are similar to some of the examples above to address these issues in other markets.
 - Some of these potential remedies have either been considered or implemented in audit markets in other countries.
- 7.22 We do not suggest that the examples above are the only potential remedies which might be available to the CC if it determines that one or more adverse effects on competition exist. In addition, we note that the choice of any remedies by the CC, would involve a detailed assessment of the benefits and costs (including the possibility for unintended consequences) of the potential remedies.
- 7.23 Many participants argued the case for UK competition authorities examining the issues and potential remedies in this market alongside the EC, including gathering information around the potential effects of remedies especially when there is currently perceived to be a lack of available evidence. We have heard views which support the CC seeking to influence developments internationally through the detailed information that its inquiry processes would produce. Participants making these arguments often noted the size and importance of the UK audit market and the UK's leading role in driving corporate governance developments internationally.
- 7.24 The OFT notes that this is a complex sector, with substantial levels of regulation concerning audit existing in legislation, regulations and guidance at a UK and a wider level. We consider that the CC is well

placed in terms of its resources, transparent processes and information-gathering powers to consider the complexities of this market. We also consider that, following such consideration, the CC could make a useful contribution to actual or potential action by others, such as the EC.

- 7.25 **Conclusion:** We consider that there is a reasonable chance that appropriate remedies will be available to the CC in the event of a reference, should it conclude in the course of its inquiry that there are one or more adverse effects on competition. In the case of the potential remedies set out above, for example, we believe that most if not all are within the power of the CC to implement, and where necessary could be supplemented by recommendations to others, for example the UK Government or the EC.

Undertakings in lieu of a reference

- 7.26 The OFT has power under Section 154 of the Enterprise Act 2002 to accept undertakings in lieu of a reference to the CC. The OFT's current view is that, given the number and nature of the features which the OFT suspects are having an adverse effect on competition in this market, the broad nature of these features, and the view expressed above that determining appropriate and proportionate remedies is in itself complex, the OFT may not be able to judge with certainty whether undertakings in lieu of a reference would address effectively all the problems that may exist and achieve as comprehensive a solution as is reasonable and practicable.
- 7.27 The OFT will, however, consider any proposals for undertakings in lieu of a reference made during the course of this consultation.

8 CONCLUSION

- 8.1 In conclusion, the OFT considers that the test in Section 131 of the Enterprise Act 2002 is met, that is there are reasonable grounds to suspect that there are features of the market for statutory audit of large firms in the UK which prevent, restrict or distort competition.
- 8.2 We have identified features of the market including, limited incentives for switching auditor, the high cost of switching auditor, a focus on established reputation creating a barrier to entry, advantages in auditing large clients which are held by large auditors, the limited choice of auditor for companies, barriers to expansion for smaller auditors, and the imposition of bank covenants concerning the choice of auditor. We also identify low levels of tendering and switching and high concentration with stable market shares for large auditors going back as far as 2003.
- 8.3 It is our provisional view that these features, either individually or in combination, restrict, prevent or distort competition.
- 8.4 In relation to the OFT's guidance governing the exercise of its discretion to make a reference:
- We consider that it would not be more appropriate to use alternative powers in this case, given that we have neither seen nor received any evidence to suggest breaches of competition law and given that the work of the FRC has to date, by its own admission, not significantly improved competition and choice in this market.
 - Analysis of the scale of the problems, shows that the market size is around £600 million per annum, and as noted above, the OFT has long-standing concerns in this market, which originated with the collapse of Arthur Andersen in 2002. The features identified are unlikely therefore to be short-lived.
 - We consider that the broad nature of these features means the OFT may not be able to judge with certainty whether some undertakings in lieu of a reference would address effectively all the problems that may exist and achieve as comprehensive a solution as is reasonable

and practicable. We will however consider any proposals for undertakings in lieu of reference made during the course of this consultation.

- In relation to the availability of remedies, we consider that there is a reasonable chance that appropriate remedies will be available to the CC in the event of a reference, should it conclude in the course of its inquiry that there are one or more adverse effects on competition.

8.5 For these reasons the OFT has provisionally decided to exercise its discretion to refer this market to the CC.

ANNEXE A – ROUNDTABLE AND BILATERAL MEETINGS

1. During June and July 2011, the OFT held three roundtables and a significant number of bilateral meetings with around 30 interested parties on the availability of potential remedies in the large firm audit market. A complete list of participants is given below.
2. The OFT heard views from a range of parties, spanning the users of audit (institutional investors and shareholders, business and the chairs of audit committees), regulators and government, audit professional bodies, academics and consultants. We also met with a range of large audit firms, including each of the Big Four as well as with a further five firms. We also received written submissions from a number of parties, typically following meetings held with them.
3. The OFT has benefited greatly from these discussions, and would like to thank all parties for their participation.

Summary of meetings

4. The broad debate across all meetings was characterised by differences of opinion regarding a number of potential remedies. Parties often differed in their views on whether adverse or unintended consequences would flow from certain measures, for example increasing cost or damaging audit quality. However, we identified a significant convergence of opinion on the respective merits of certain potential remedies.
5. As regards a small number of potential remedies discussed, a clear picture of widespread scepticism emerged, sometimes due to fears of negative consequences, and at other times because of doubts that the remedies would have any pro-competitive effects.
6. Elsewhere, the OFT heard much to suggest that effective remedies might be constructed and implemented in the UK. There was near unanimity that certain potential remedies represented sensible ideas, with some prospect for beneficial changes to the competitive dynamics of the market over time.

7. The OFT has heard arguments, from across the range of parties we have spoken with, supporting the need for a single, joined-up assessment of the issues in this market. We have heard widespread support for the UK competition authorities acting in this market and considering these issues, including by gathering information and data around the potential effects of remedies and remedy packages where there is a lack of available evidence, for example, on the impact on costs of joint or shared audits, on the likely responses to greater audit tendering, and on the existence and coverage of restrictive banking covenants.

Views of some specific potential remedies

8. **Splitting audit work:** On joint and shared audits, some participants considered these potential remedies might have profile raising and capacity building benefits for non-Big Four firms. Others however thought that businesses would be resistant to such arrangements, and there were concerns raised around increasing costs and reducing audit quality or direct auditor accountability. Some participants thought that there might be benefits from joint/shared audits as regards contingency planning for the potential sudden exit of a Big Four firm from the market.
9. **The growth of smaller audit firms:** Some participants were clearly of the view that entry and expansion in the large firm audit market was largely down to audit firms' own appetites for resource investment and risk-taking. However, a number of participants identified changes which might make firm growth easier, including access to investment funds, and reducing auditor risk by limiting liability. On liability reform, a number of participants indicated the need for careful design and proportionate liability limits to avoid unintended consequences and imbalances between the Big Four and other audit firms.
10. **Limiting individual firms' shares of the market:** Many participants were of the view that caps on market shares would reduce choice in the market, at least in the short term, as businesses become further constrained in their selection of auditors. However, some other participants were of the view that a limit on market shares was a credible and workable intervention, especially looking at the short to mid-term. A number of participants

queried the logic of interventionist supply side remedies which left buyer behaviour untouched.

11. **Regular public tendering of audit contracts:** A number of participants saw increased tendering, alongside increased transparency and reporting of appointment decisions to shareholders, as beneficial in creating a culture, or an expectation of switching. Other participants indicated that tenders can increase costs to business and auditors alike, and that a more regular 'parade' of auditors does not necessarily mean a greater pool of potential firms to choose from. Where tenders do occur, many thought the bid competition to be fierce. Also, attendees referred to the threat of tenders as a competitive stimulus in itself.
12. **Increased transparency of audit appointments:** There was broad support for a number of potential remedies around the provision of greater information to shareholders on auditor appointment processes and decisions. As noted above, these potential measures often overlapped with the notion of greater tendering and raising expectations of greater switching, with fuller explanation where this does not occur. Some participants expressed concern about standardised text in the audit report stifling genuine transparency and information provision.
13. **Increased power for shareholders:** Discussions often noted the binary nature of the formal approval of auditor appointments by shareholders, and a number of participants posited how shareholder engagement might be increased. Some participants queried the level of shareholder engagement (outside the more active shareholder organisations), while some thought that a greater formalisation of the shareholder voice would be required.
14. **Handover processes between outgoing and incoming auditors:** There was broad support for more work around improving the co-operation and interaction between outgoing and incoming audit firms. A number of participants thought this might reduce the costs of switching and reduce the risks of audit quality dropping off as a new auditor is appointed.
15. **Removal of covenants in bank loans specifying the auditor to be used:** The existence of such banking covenants split opinion, with many parties

clearly stating that they do exist and that they have evidence of instances where auditor selection has been limited by them. Others queried how widespread they are and thought that 'black and white' covenants may be less prevalent than 'softer' practices whereby banks encourage or recommend, rather than contractually require, that Big Four auditors be selected. Nevertheless, participants unanimously agreed that any restrictive covenants should be removed. Some attendees thought them to be symptomatic of wider, perhaps less easily solvable, issues of reputation and perception.

16. Other potential remedies were also discussed and a number of participants expressed:

- Scepticism about the practicalities of structural remedies and the 'break up' of audit firms given their 'human assets' (that is, partners) and international networks.
- Support for contingency arrangements (including exit plans and living wills) for the failure of a Big Four audit firm.
- Reservations regarding mandatory rotation where this does not have any beneficial effects on underlying buyer behaviour, or where a rotation around the Big Four (or a mutual 'client swap') would be the likely result.
- Doubts that the Audit Commission or the NAO might be transformed, perhaps along with a non-Big Four firm, into a large private audit firm.
- Strong reservations around removing the mandatory audit requirement of mid-tier companies (which might have the effect of destroying the 'bread and butter' work of the smaller audit providers).
- The view that financial reporting and auditing standards may have become overly complex, and that their simplification might remove/reduce a barrier to entry and growth for non-Big Four audit firms.

- A desire for international merger regime co-operation and greater scrutiny of the acquisition of smaller audit firms by larger competitors, and the impact of these acquisitions on the smaller firms' international networks.
- Mixed views on the effects of greater restrictions on auditors providing audit clients with 'non-audit' services.

List of participants

17. Over a series of roundtable and bilateral meetings, conducted in June and July 2011, the OFT met with the following organisations and individuals:

- Association of British Insurers
- Aviva Investors
- Baker Tilly UK Audit LLP
- Department for Business, Innovation & Skills
- BDO LLP
- David Challen (Chairman of the Audit Committee, Anglo American plc)
- Chartered Accountants Ireland (formerly the Institute of Chartered Accountants in Ireland)
- Chartered Financial Analyst (CFA) Society of the UK
- Deloitte LLP
- European Commission (DG-Markt)
- Ernst & Young LLP
- Professor Stella Fearnley (Bournemouth University)
- Financial Reporting Council
- Financial Services Authority
- Grant Thornton LLP
- Hermes Investment Management Limited
- The Hundred Group
- ICAEW
- Institute of Chartered Accountants of Scotland
- Investment Management Association
- KPMG LLP
- Mazars LLP
- Pensions & Investment Research Consultants Limited

