

Statutory audit

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 making a market investigation reference to the Competition Commission (CC) of the supply of statutory audit services to large companies in the UK. This paper sets out our reasoning and analysis of the market, and our response to consultation responses received.
- 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, high quality audit 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 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 has low levels of switching due to high switching costs and therefore competition in the market is restricted. There is also high concentration and a lack of choice in the market, which is likely to persist given the high barriers to entry and expansion.²
- 1.4 In 2010, the four largest firms (PwC, KPMG, Deloitte, and 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, as not all the Big Four are present throughout such sectors. Additional restrictions on the choice of auditors available to companies may arise from regulatory requirements, as well as a desire 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

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 auditor 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 4.0 per cent for FTSE 250 companies.³ The average switching frequency for FTSE 100 companies calculated on the basis of these average annual switching rates is every 43 years and for FTSE 250 companies is every 24 years. A previous study found similar results. In addition, the frequency with which companies tender their audit contracts appears 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 audits to large companies in the UK. Only one FTSE 100 company has a non-Big Four auditor.
- 1.8 In bidding for audit contracts of 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 The figure cited in the consultation document was 4.2 per cent which is the simple average of the annual switching rates we calculated. Weighting for the number of companies for which we have data in each year yields a figure of 4.0 per cent.

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 (2010) also noted that, '[a]ttempts 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.⁵ 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 was to allow the OFT to reach a decision on whether or not to make a reference to the CC of this market.⁶
- 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 noted that there was 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 The OFT consulted on its provisional decision to make a market investigation reference from 29 July to 9 September 2011. Responses

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 The test is set out in section 131 of the Enterprise Act 2002 (EA02).

⁶ See: www.of.gov.uk/news-and-updates/press/2011/59-11

from 20 organisations or individuals were received. They set out a variety of different views on the features identified, the appropriateness of a reference and some possible remedies.

- 1.14 In addition, the OFT has considered the fact that the European Commission is preparing draft legislation on a number of matters relevant to the audit industry across the EU. Given the UK's leading position in the global audit sector, the OFT sees considerable merit in a UK-focused inquiry by the CC that runs alongside this EU process, given that: a thorough competition analysis by the CC could help inform the EU process; and that the CC would be able to consider UK-issues or supplementary measures that might not be addressed at the EU level.
- 1.15 In conclusion, having carefully considered the responses it has received to its consultation, the OFT has decided that the test for marking a market investigation reference has been met, and that it should exercise its discretion to refer this market to the CC.

2 THE OFT'S DECISION 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 are referring 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 The OFT's consultation ended on 9 September 2011.
- 2.8 The OFT received responses from two individuals, and 18 organisations, including one organisation that requested its previous comments on this subject be considered as its response to this consultation. The responses provided a variety of views on the provisional decision and comments on the features identified by the OFT and the exercise of its discretion to make a reference.
- 2.9 The OFT has considered all responses in detail, and this document takes into account all the responses we received. A list of organisations which responded to the consultation can be found at Annexe B.

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.⁷ 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

⁷ *'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)'.⁸ 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 2010,⁹ gave oral evidence in November 2010,¹⁰ and made an additional written submission in March 2011.¹¹
- In December 2010, the OFT also made a submission¹² to the EC in response to the consultation on its Green Paper.¹³ 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). The OFT continues to liaise with the EC over its draft legislative proposals, expected to be published in November 2011.

⁸ '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

⁹ See: www.ofg.gov.uk/shared_ofg/markets-work/OFT_submission_to_HoL_on_aud1.pdf

¹⁰ See: www.publications.parliament.uk/pa/ld201011/ldselect/ldconaf/119/119ii.pdf (Page 172 onwards)

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

¹² See: www.ofg.gov.uk/shared_ofg/markets-work/OFT_submission_to_EC_on_aud1.pdf

¹³ 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.'

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 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.'¹⁴ 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'.¹⁵ 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 refer to concentration, levels of switching and potential barriers to entry, and 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

¹⁴ See: www.frc.org.uk/press/pub2288.html

¹⁵ See: www.publications.parliament.uk/pa/ld201011/ldselect/ldeconaf/119/10110905.htm.

recommends several measures which should be of benefit in 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'.¹⁶

3.4 The OFT 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 passed 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. The OFT held a number of roundtable and bilateral discussions with relevant stakeholders in May and June 2011. Details of those that participated can be found in Annexe A.

3.6 On 29 July 2011, the OFT published its provisional decision to make a market investigation reference to the CC.¹⁷ Chapter 4 of the consultation

¹⁶ House of Lords Inquiry report, abstract, pages 5-6.

¹⁷ See www.offt.gov.uk/shared_offt/markets-work/oft1357.pdf.

document explained the process that the OFT followed to reach its provisional decision. This provisional decision was the subject of a consultation which closed on 9 September 2011.

4 THE AUDIT MARKET IN THE UK

- 4.1 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 the previous activities of the company. The over-arching aim of statutory audit is to provide assurance that the financial statements represent a true and fair view of the company.
- 4.2 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.¹⁸
- 4.3 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.¹⁹
- 4.4 In practice, the UK Corporate Governance Code (2010) gives audit committees a key role in the process of auditor selection.²⁰ 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.

¹⁸ Companies Act 2006, Part 16, Section 489(4).

¹⁹ Companies Act, 2006, Part 16, Section 495(1).

²⁰ FRC (2010): The UK Corporate Governance Code, paragraph C.3.2

- 4.5 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 the Big Four.
- 4.6 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.
- 4.7 A number of audit firms, including the Big Four and several others, are network firms which are networks of independent firms, typically Limited Liability Partnerships, which have firms located in different countries around the globe all of which share the same brand.
- 4.8 There has been a gradual process of consolidation with large audit firms merging with other large audit firms. Before 1987 the eight largest international audit firms active in the UK were:
- Arthur Andersen
 - Arthur Young & Co
 - Coopers & Lybrand
 - Ernst & Whinney
 - Deloitte, Haskins and Sells
 - Peat Marwick Mitchell
 - Price Waterhouse
 - Touche Ross.
- 4.9 These eight international audit firms became six in 1989 when Ernst & Whinney merged with Arthur Young to become Ernst & Young, while later in the year, Deloitte, Haskins & Sell merged with Touche Ross to become Deloitte & Touche.²¹

²¹ The brand name of this organisation differed across different countries until the mid 1990s.

- 4.10 The big six became the big five in 1998, when Price Waterhouse merged with Coopers & Lybrand to form Pricewaterhouse Coopers (PwC).
- 4.11 Most recently, in 2002, the collapse of Enron led to Arthur Andersen, its auditor, being sold to other large auditors. In the UK this was to Deloitte, while in other countries this was to Ernst & Young or PwC.

Market definition

- 4.12 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.'²²

Product market

- 4.13 **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.²³ 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.
- 4.14 Statutory audits in the UK are typically undertaken by accountancy firms and need to be undertaken by members of one of six professional

²² *Market Investigation References – Guidance about the making of references under Part 4 of the Enterprise Act* (March 2006). See:

www.of.gov.uk/shared_of/business_leaflets/enterprise_act/oft511.pdf

²³ The requirement and exceptions are contained in Part 16 of the Companies Act 2006.

bodies.²⁴ It is the individual auditors' responsibility for signing off audits of financial statements, rather than the responsibility of audit firms.

- 4.15 **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.
- 4.16 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 be complementary to the requirement for a statutory audit for medium and large companies rather than acting as a substitute product.
- 4.17 Moreover, while other individuals without a relevant professional qualification, or with a similar overseas 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.
- 4.18 We received no consultation responses that commented on the substitutability or otherwise of audit services. We therefore conclude that the relevant service to consider is statutory audit provided by appropriately qualified auditors in line with the Companies Act 2006.
- 4.19 **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.

²⁴ 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

4.20 This extra complexity can arise for a number of reasons including the following:

- **International activity of the company and its subsidiaries:** Many of the largest companies listed in the UK 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 companies can be very complex and require an auditor to consider the activities from a number of countries and a number of subsidiaries.²⁵
- **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 would not be seen with smaller and medium sized listed companies.²⁶
- **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.²⁷ 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.

²⁵ 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.

²⁶ The Oxera report's survey of Audit Committee Chairmen found that 'Technical Accounting Skill' is cited frequently as a factor influencing auditor selection.

²⁷ The Oxera report's survey of Audit Committee Chairmen found that 'Sector specific expertise' is cited frequently as a factor influencing auditor selection.

4.21 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 fact that predominantly different audit firms carry out the audits of large and small companies in the UK.

4.22 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'.²⁸

4.23 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 1998,²⁹ and confirmed by the EC's analysis of the merger between Deloitte & Touche and Andersen (UK) in 2002.³⁰ Specifically, in 2002, the EC noted that:

'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).'³¹

4.24 The EC also noted the following:

²⁸ House of Lords report, paragraph 14.

²⁹ Case No IV/M.1016 – Price Waterhouse/Coopers & Lybrand, 20 May 1998.

³⁰ Comp/M.2810 – Deloitte & Touche/Andersen (UK), 1 July 2002.

³¹ Ibid.

'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.'³²

- 4.25 In addition, support for markets consisting of the FTSE 100 and FTSE 250³³ companies can be found from a 2007 report by Oxera for DG Internal Market and Services.³⁴
- 4.26 It is difficult 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.
- 4.27 **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.
- 4.28 Comments from respondents to the consultation on the product market definition were very limited. Some noted that the market excludes unlisted and smaller listed companies while no evidence was provided to

³² Ibid.

³³ Collectively known as the FTSE 350.

³⁴ *Ownership Rules of audit firms and their consequences for audit market concentration*, Oxera, October 2007, prepared for DG Internal Market and Services.

support such assertions. However others simply stated that the boundary was correctly identified.

- 4.29 We conclude that audits of companies which may, from time to time, be listed in the FTSE 350 represents an appropriate boundary of the market for audits of large companies. Furthermore, we conclude that there may be separate smaller markets, for example for audits of the FTSE 100 companies.
- 4.30 The OFT considers that the market is defined appropriately, noting that unlisted companies can be very different in their structure and complexity to large listed companies. The market is also defined consistently with EU merger analysis as well as being consistent with the breadth of evidence of concerns available to the OFT. Consequently, the OFT does not consider it appropriate to revisit this in the light of consultation responses.
- 4.31 The OFT notes that it is open to the CC to ask the OFT to vary the terms of its reference in the event that this is considered necessary.³⁵

Geographic market

- 4.32 A defined geographic market identifies the appropriate spatial dimension for assessing the boundaries of competitive constraints for the products or services being considered.
- 4.33 Statutory audit services are statutory services described in the Companies Act 2006. As such, these specific services are provided purely within the UK. The OFT does note, however, that there are 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.

³⁵ Under section 135(2) EA02.

- 4.34 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.
- 4.35 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 supply side substitution for statutory audit services within a country that mean the relevant geographic market is wider than local or regional and may be national in scope. Evidence of this supply side substitution would need to be investigated further to reach a definitive conclusion on this point.
- 4.36 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'.³⁶

³⁶ Comp/M.2810 – Deloitte & Touche/Andersen (UK), 1 July 2002.

- 4.37 This view is also consistent with the conclusions of the 2007 report by Oxera for DG Internal Market and Services.³⁷
- 4.38 A small number of consultation responses considered that there was an international market in audit, given that the same auditors are used by international companies. Such comments were typically raised in arguments that this international dimension would mean action to address the features OFT has identified should be taken only on an international basis, rather than in the UK as well.
- 4.39 The OFT notes the previously defined markets in this area have been national in scope and 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 which would mean that the geographic market is now wider than previously stated. This is irrespective of the desire among some large companies to use the same audit firm in different countries. Whether or not the market is international in scope, in a market investigation reference, the CC will be concerned with the UK aspects of the market and its performance. As noted in more detail later, there is enough that is distinct about the national market to make a reference to the CC worthwhile. As to the analysis of possible local or regional markets, the OFT has not considered the boundaries of any such possible relevant geographic markets in detail, noting that it is for the CC to consider whether to undertake a more detailed market definition exercise.
- 4.40 Therefore, the OFT considers that the appropriate geographic frame of reference for statutory audits of large companies is for these to be examined on a UK-wide basis.

³⁷ *Ownership Rules of audit firms and their consequences for audit market concentration*, Oxera, October 2007, prepared for DG Internal Market and Services.

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

- 5.1 The OFT notes that the test which it is required to meet in order to have power to make a reference to the Competition Commission is whether it has reasonable grounds for suspecting that any feature or combination of features of a market in the UK restricts, prevents or distorts competition in connection with the supply or acquisition of any goods or services in the UK (or a part of it).
- 5.2 A number of responses to the consultation considered that the OFT had not considered a very wide range of evidence in its provisional decision, nor consulted sufficiently widely with the industry.³⁸
- 5.3 In response, the OFT notes previous remarks by Sir Christopher Bellamy, the then President of the Competition Appeals Tribunal, in the appeal of the Association of Convenience Stores (ACS) v OFT in 2005 in relation to the nature of the test in Section 131 EA02. He stated,

'...the OFT stage, is not intended to be a deep and prolonged investigation in which every avenue is exhaustively looked at? That is for the CC stage.'³⁹

³⁸ The OFT notes that it has undertaken a number of steps to engage with stakeholders in this work. In addition to a six-week public consultation, in which the OFT was open to receiving responses from any individual or company that wished to comment on the provisional decision, the OFT specifically sought information from users of audit services, contacting 12 Audit Committee chairs of large companies, however, only one responded and met with the OFT. Previously to this, the OFT held a number of roundtable and bilateral discussions which included representatives of shareholder and institutional investors as consumers of audit services. The OFT considered that this evidence, together with information from regulators, Government, academics, a range of audit firms, and previous studies and investigations were sufficient to meet the section 131 test as set out in the EA02. Details of participants in this process and respondents to the public consultation can be found in Annexe A and B respectively.

³⁹ ACS v OFT: Case Management Conference (2005).

'There is, if we may say so, some risk that one may mistake the height of the hurdle which s.131(1) presents. It is a 'reasonable ground to suspect' test. The scheme of the Act is that a full investigation is carried out at the stage of the Competition Commission not at the stage of the OFT, although admittedly the OFT has to address the matter sufficiently to decide whether there are reasonable grounds 'to suspect', and sufficiently in order to consider the question of undertakings under s.154 of the Act in lieu of making a reference.'⁴⁰

5.4 Given its role in conducting a first phase investigation which requires only a reasonable suspicion test, as set out above, the OFT is satisfied that it has sufficient evidence to support its assessment and conclusions in order to meet this test, that is 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.

5.5 The OFT notes that 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.⁴¹

⁴⁰ ACS v OFT: Final Ruling (2005).

⁴¹ Section 131(3) of the Enterprise Act 2002 notes that conduct includes any failure to act and any unintentional conduct.

- 5.6 The OFT also notes from its guidance, 'prevention, restriction or distortion of competition...should be interpreted broadly to encompass any reduction or dampening of actual or potential competition.'⁴²
- 5.7 The OFT has been concerned for some time that the supply of audit services to large companies in the UK has low levels of switching due to high switching costs and therefore competition in the market is restricted. There is also high concentration and a lack of choice in the market, which is likely to persist given the high barriers to entry and expansion.
- 5.8 The features identified by the OFT are the following:
- 5.9 **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, but may still have some effect on switching together with other factors. Studies have found that the level of the audit fee is a relatively unimportant influence on auditor selection (particularly for large companies).⁴³
- 5.10 In addition, the OFT notes there is evidence which suggests that the technical quality of an audit is difficult to discern, and as a result, it may be difficult for Finance Directors and audit committees to distinguish between different suppliers in terms of their technical quality.⁴⁴ A

⁴² Paragraph 4.2 from, *Market investigation references, Guidance about the making of references under Part 4 of the Enterprise Act*, March 2006.

⁴³ 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.

⁴⁴ 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.

number of consultation responses asserted that companies pay attention to audit quality, and one response in particular, noted that the factors which underpin quality include technical skills, international capabilities, professional scepticism and independence.

- 5.11 The OFT notes that the factors identified are limited to being indicators of quality, which may or may not be accurate and technical audit quality itself cannot be observed easily by customers and those not involved in the statutory audit process itself. This makes it difficult for audit committees and Finance Directors to determine accurately whether one audit firm would produce a higher quality audit than another.
- 5.12 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.⁴⁵ 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',⁴⁶ 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.
- 5.13 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 which may not align with the quality of the statutory audit carried out.

⁴⁵ 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.

⁴⁶ Memorandum to House of Lords Inquiry of Professor Vivien Beattie, Professor Stella Fearnley and Tony Hines, 3 October 2010, section 2.2.

5.14 **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.
- 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.⁴⁷
- The potentially higher risk of a new auditor making mistakes initially.

5.15 Academics told the House of Lords inquiry that companies 'are reluctant to change auditors because of the cost of doing so'.⁴⁸ This echoed the view expressed by the FRC Market Participants Group.⁴⁹ 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.'⁵⁰

5.16 PwC estimated switching costs for the company being audited at between £500,000 and £1m.⁵¹ 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

⁴⁷ 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.

⁴⁸ Memorandum to the House of Lords Inquiry of Professor Vivien Beattie, Professor Stella Fearnley and Tony Hines, 3 October 2010, section 2.3.

⁴⁹ FRC (Market Participants Group) Final Report, October 2007, page 30.

⁵⁰ Letter to House of Lords inquiry, 24 September 2010, appendix paragraph 6.

⁵¹ The OFT notes that in 2010, the simple average of FTSE 100 audit fees was £5.2 million, while this was £618,000 for the FTSE 250.

quality of the work.⁵² One audit firm responding to our consultation noted that while there are costs incurred in switching, this did not prevent companies from switching in practice. The OFT's analysis and view of switching rates is addressed in the following feature, which suggests that switching rates are low in this market.

5.17 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.

5.18 **The market shows low levels of tendering and switching.** OFT analysis of FAME data⁵³ between 2002 and 2010 showed average annual switching rates of 2.3 per cent for FTSE 100 and 4.0 per cent⁵⁴ for FTSE 250 companies. The average switching frequency for FTSE 100 companies calculated on the basis of these average annual switching rates is every 43 years and for FTSE 250 companies is every 24 years.⁵⁵

5.19 A number of respondents to the consultation considered possible reasons for the low levels of switching, including that companies may not have wished to change auditor while financial reporting regulations were changing during recent years, or when financial conditions are difficult, such as in the recent recession. Others noted that levels of switching have risen recently. In response to these comments and in order to show whether this is the case, the following two tables and

⁵² Mr Ian Powell of PwC in answer to Q245 of House of Lords inquiry, 23 November 2010.

⁵³ The figures quoted here and subsequently and 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.

⁵⁴ The figure cited in the consultation document was 4.2 per cent which is the simple average of the annual switching rates we calculated. Weighting for the number of companies for which we have data in each year yields a figure of 4.0 per cent.

⁵⁵ These inferences assume that companies that left the FTSE indexes between 2002 and 2010 and those whose accounts are not available on FAME do not switch auditors at a systematically different rate to those who remained in and whose accounts are available; and that companies stay in the indexes sufficiently long for calculation of an average time between switching auditors to be meaningful.

chart show the background data used to generate the results stated in paragraph 5.18.

Table 1: Switching among FTSE 100 companies¹

Number of companies:	2002	2003	2004	2005	2006	2007	2008	2009	2010
Companies that did not switch auditor	67	71	80	82	81	87	90	92	86
Companies that switched auditor	2	5	0	2	3	1	0	1	3
Total	69	76	80	84	84	88	90	93	89

Note 1: Both tables 1 and 2 and figure 1 use data which excludes the effect of the merger between Deloitte and Arthur Andersen in 2002 from data on switching.

Source: OFT analysis of FAME data

Table 2: Switching among FTSE 250 companies¹

Number of companies:	2002	2003	2004	2005	2006	2007	2008	2009	2010
Companies that did not switch auditor	148	159	171	181	186	188	199	212	194
Companies that switched auditor	15	9	6	2	8	12	5	6	6
Total	163	168	177	183	194	200	204	218	200

Source: OFT analysis of FAME data

Figure 1: Switching among FTSE 100 and 250 companies¹



Source: OFT analysis of FAME data

- 5.20 As tables 1 and 2 and figure 1 show, the level of switching varies year by year. However, while it has increased slightly in recent years, specifically since 2008, it appears to have done so from a very low starting point. Overall, since 2002, there does not appear to be a clear and consistent trend.
- 5.21 The OFT notes that trends can be very difficult to discern in practice due to the small sample of companies switching and similarly, it is difficult to determine with any accuracy the causes of movements seen until such movements become established trends over a number of years.
- 5.22 Some consultation responses highlighted and we acknowledge that very 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, we consider that switching at the low levels seen currently, particularly when considered collectively with the other features we identify, is indicative of limited competition and may also restrict the ability of entrants to compete for audit contracts.
- 5.23 In relation to the frequency of tendering, 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.⁵⁶ In a recent submission to the OFT, 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.^{57, 58} 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'.⁵⁹ The OFT considers that this evidence indicates that the frequency of tendering is low.

- 5.24 One response to the consultation noted that auditors engage in fierce competition for tenders, while other responses also noted that some tender bids might be discounted to take into account, to some extent, the income that could be earned before the contract is tendered again. The OFT notes that it has no evidence on the level of competition which is generated by individual tenders in this market, but notes that the infrequency of tenders being carried out, as well as the limited number of audit firms which are either invited or are able to compete effectively, represent both a prevention and a restriction of competition in this market.
- 5.25 Some large audit firms have said both in consultation responses and previously that it is possible for competitive pressure to be felt in the absence of formal tenders. They consider companies to be sophisticated buyers and experienced negotiators, with significant buyer power 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

⁵⁶ The Oxera report, page 43.

⁵⁷ 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.

⁵⁸ The OFT notes that extrapolating this would imply around 50 tenders taking place among Big Four audit firms, while table 1 shows 17 FTSE 100 companies switched auditor since 2002.

⁵⁹ Memorandum to House of Lords Inquiry, 24 September 2010, paragraph 15.

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.⁶⁰ 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.

- 5.26 The OFT considers that a company may not be able properly to assess the competitiveness, indicators of relative quality and the suitability of audit services being offered in any such informal processes without inviting other audit firms to participate in a tendering process, and in so doing, creating a credible threat that they will change auditor. In the absence of competing bids from audit firms, it may not be able to undertake a meaningful comparison of the offerings (including prices) of different audit firms. Incumbent audit firms may be expected to offer incentives to companies in a variety of ways to seek to avoid a competitive tender of an audit contract, however, the nature and extent of any such incentives may well differ significantly from that obtainable in an open and competitive tender, such that these non-tender processes would not necessarily be representative of a competitive market outcome and would therefore be insufficient to mitigate harm to customers in this case. Incumbent audit firms may rely on switching costs as a deterrent to companies setting up formal competitive tender processes. Moreover, the lack of formal tendering may also limit the ability of firms outside the Big Four to compete for audit contracts for large companies.
- 5.27 Some consultation responses noted that companies would be able to achieve a good outcome from non-tender discussions due to their buyer power. The OFT considers that the exercise of buyer power is predicated on the ready availability of alternative options and the credibility of a threat to change supplier. It also tends to increase with the proportion of a supplier's revenue for which the buyer accounts. In the case of audits of large firms, the market is concentrated, and as discussed later in this chapter there are further reasons which may restrict the practical

⁶⁰ KPMG letter to the OFT of 13 July 2011.

choices facing companies. In addition, large companies do not have the choice of not undertaking a statutory audit. Overall, these factors are likely to limit any buyer power they are able to exert on audit firms.

- 5.28 Some stakeholders have noted, both before and in consultation responses, 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'.⁶¹ Accounting academics giving evidence to the House of Lords inquiry also stated that 'the market appears to function in a competitive manner'.⁶²
- 5.29 However, notwithstanding the competition which occurs for the small number of tenders which take place, the OFT considers that the apparent infrequency of tendering, together with the consequential very low levels of switching are both individually and collectively indicative of there being limited competition in this market. They also serve to restrict competition by limiting the opportunities for any auditor, particularly new and non-incumbent auditors, to compete for clients. These restrictions on competition are particularly apparent when seen in combination with the barriers to entry considered elsewhere in this Chapter.
- 5.30 **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.⁶³ Thus they may not choose an auditor on the

⁶¹ Letter from Mr Peter Williams to House of Lords Inquiry, 27 September 2010, paragraph 6.

⁶² 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.

⁶³ Sources include:

basis of maximising the value added by the audit, or its value for money. Despite this, one audit firm which responded to the consultation stated that its reputation was derived from the quality of the audits which it carried out and noted that if this quality were to deteriorate, its reputation would suffer as a consequence.

- 5.31 The OFT notes that in this market where competition is limited, it can be particularly difficult to assess the quality of an audit firm's offering accurately, therefore it can similarly be difficult to determine when such quality has deteriorated. The OFT also notes evidence set out in paragraph 5.12 in relation to regulatory standards making it more difficult to determine quality of audit services.
- 5.32 The OFT notes that in terms of reputation, there seems to be little difference 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 what may be a higher quality proposition.
- 5.33 The OFT is aware that concerns were raised by the Audit Inspection Unit in its Annual Report for 2010/11, in relation to the performance and quality of work undertaken by a wide range of large audit firms. The report, published in July 2011, does not feature in the analysis or reasoning underlying this decision, but is not inconsistent with the OFT's concerns.⁶⁴

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- 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.)

⁶⁴ This report states:

5.34 **Larger auditors possess certain attributes necessary for auditing large companies.** The OFT notes that it can be difficult for small firms to expand to achieve these attributes, through expansions, or mergers and acquisitions. These attributes may therefore 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:

- An extensive, integrated international network.⁶⁵ 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.'⁶⁶

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

'The AIU continues to have concerns that firms focus primarily on the specific requirements of the Standards and do not give sufficient attention to the underlying principles. It is clear from the AIU's review of appraisals and partner admission procedures that senior audit staff at some firms continue to believe that success in the selling of non-audit services to audited entities is a significant contributory factor to promotion and remuneration decisions. Further action is needed to change this perception.

Another general concern is the potential implications of an increased emphasis within a number of major firms on achieving greater efficiencies in the conduct of audit work. Firms need to ensure that initiatives of this nature do not have an adverse effect on audit quality. Similarly, the culture within firms must strike an appropriate balance between strategies to grow the business and the need to maintain and improve audit quality.'

⁶⁵ 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.

⁶⁶ Letter from Mr Peter Williams to House of Lords inquiry, 27 September 2010, paragraphs 8-9.

effective global networks.⁶⁷ There is also a perception that auditing standards discourage the use of auditors from more than one network.^{68, 69}

- Greater experience of auditing large and complex businesses which can increase the efficiency with which large audits can be undertaken.⁷⁰
- Relevant sector experience.⁷¹ As well as being a factor in its own right, sector specific knowledge and experience may enhance firms' 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.⁷² 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.⁷³ The FRC concluded that the Big Four's involvement in the regulatory and standard-setting bodies was 'more prominent'.⁷⁴ By contrast, there

⁶⁷ Memorandum to the House of Lords Inquiry of Professor Vivien Beattie, Professor Stella Fearnley and Tony Hines, 3 October 2010, section 7.5.

⁶⁸ FRC (Market Participants Group) Final Report, October 2007, page 32.

⁶⁹ 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.

⁷⁰ The Oxera report, page 37. Oxera's interviews with large-scale companies found that Big Four staff are more experienced in auditing 'complex businesses'.

⁷¹ 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.

⁷² The Oxera report, page 24.

⁷³ FRC (Market Participants Group) Final Report, October 2007, page 24.

⁷⁴ FRC (Market Participants Group) Final Report, October 2007, page 24. The FRC reported that:

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.'⁷⁵

- 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 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, however the OFT notes that this is to ensure impartiality in audit firms.⁷⁶ 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.⁷⁷
- The ability for the Big Four to recruit higher calibre staff attracted by the audit firm's reputation and their extensive training programmes.⁷⁸

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- 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.

⁷⁵ Memorandum to the House of Lords of Professor Vivien Beattie, Professor Stella Fearnley and Tony Hines, 3 October 2010, section 8.1.

⁷⁶ Ethical Standard 4 (revised), paragraph 25, UK Auditing Practices Board.

⁷⁷ FRC (Market Participants Group) Final Report, October 2007 page 5.

- 5.35 Some large audit firms have argued that they have invested in the development of 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.⁷⁹ These points were also made in a number of consultation responses.
- 5.36 In response to consultation comments in this area, the OFT notes that while there are typically a number of different ways in which firms can invest and expand to serve growing clients with expanding requirements, it is of particular interest that much of the changes in the audit market in the UK have arisen through mergers and acquisitions, including those involving members of the big eight acquiring or merging with one another to create the big four. These transactions are described in Chapter 4.
- 5.37 While large audit clients may well have sought investment, it may be doubtful that customers would have wanted all these transactions to take place, given their collective effect on concentration.⁸⁰ We do note however, that given the restrictions on ownership of audit firms, audit firms may resort to mergers as a form of growth more frequently than in other markets.
- 5.38 Some consultation responses from large audit firms have also noted that the high concentration has arisen in part from the collapse of Arthur Andersen, which suggests that not all consolidation resulted from user preferences.

⁷⁸ The Oxera report, page 37.

⁷⁹ 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.

⁸⁰ We note that some of these individual transactions were approved by the European Commission under EU merger control.

- 5.39 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.⁸¹ Similarly, accounting academics submitting evidence to 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 be become more effective and profitable.'⁸²
- 5.40 It appears 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. Investment on the scale of the mergers and acquisitions between the large audit firms would not be attractive to smaller audit firms unless they had at least some large clients in the first place.
- 5.41 The difficulties faced by smaller audit firms may increase the extent to which these attributes of large audit firms can be seen as significant first mover or incumbency advantages which are difficult for smaller audit firms and other potential entrants to overcome.
- 5.42 In support of this view, we note that 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 expansion. 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

⁸¹ 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

⁸² Memorandum of Professor Vivien Beattie, Professor Stella Fearnley and Tony Hines, 3 October 2010, section 8, q.1.

international networks may very well exceed the potential returns, with significant risks when competing against incumbents and a long payback period.⁸³ 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.'⁸⁴ 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.⁸⁵

5.43 **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-controlled⁸⁶ by chartered accountants.⁸⁷ 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.⁸⁸
- Their partnership structure, as investment may not be attractive to older partners due to the limit that retirement imposes on the period

⁸³ The Oxera report, pages 109-110.

⁸⁴ 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.

⁸⁵ *FRC (Market Participants Group) Final Report*, October 2007, page 22.

⁸⁶ This relates to the exercise of control according to voting rights and by the firm's management board.

⁸⁷ 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.

⁸⁸ 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.

in which they can receive a return on investment. This may make it unlikely that all partners would agree to the investment required.⁸⁹

- 5.44 A number of audit firms of different sizes agreed in consultation responses that the structure and control of audit firms may limit their ability to invest and grow.
- 5.45 **Banks may impose conditions requiring the use of a Big Four auditor in their dealings with companies of a certain size.** Various stakeholders 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.⁹⁰ Similarly, the FRC concluded that there was sufficient anecdotal evidence of banking covenants to require a further investigation of this issue.⁹¹ However, we understand that in at least some cases, such requirements may be softer than contractual agreements.
- 5.46 Some respondents to our consultation queried the extent to which these are being used in practice, including one comment that these may be used sporadically, rather than systematically. However, one respondent noted that it had found loan documentation that stated that the auditor should be PricewaterhouseCoopers, Ernst & Young, KPMG or Deloitte & Touche or any other firm approved in advance.
- 5.47 There was widespread agreement that where these conditions are in place, some form of action should be taken, either to remove them, or to consider whether they are justified, and that, where used, such conditions should be transparent. Some respondents queried whether

⁸⁹ The Oxera report, pages 97 and 110; and the FRC (Market Participants Group) Final Report, October 2007, page 18.

⁹⁰Memorandum to the House of Lords Inquiry by the Association of Chartered Certified Accountants, 19 October 2010.

⁹¹ Supplementary memorandum to the House of Lords Inquiry by Baroness Hogg and Mr Stephen Haddrill, Financial Reporting Council, 9 November 2010.

action could be taken on a voluntary basis on this issue without the need for a reference to the CC.

- 5.48 The OFT notes that, as one of a number of features, these conditions, to the extent they are used, could act as a restriction of competition. It would therefore be efficient for this feature to be considered alongside the others identified in this market investigation reference.
- 5.49 **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.
- 5.50 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.⁹² 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.
- 5.51 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.
- 5.52 As shown in Figure 1 below, concentration has been consistently high over the last 10 years.⁹³ Some respondents to our consultation noted that the shares of the Big Four have not been static over recent years and consider that this shows competition is active as they are exchanging market share.

⁹² These figures were calculated for FTSE 100 and FTSE 250 companies as at June 2011.

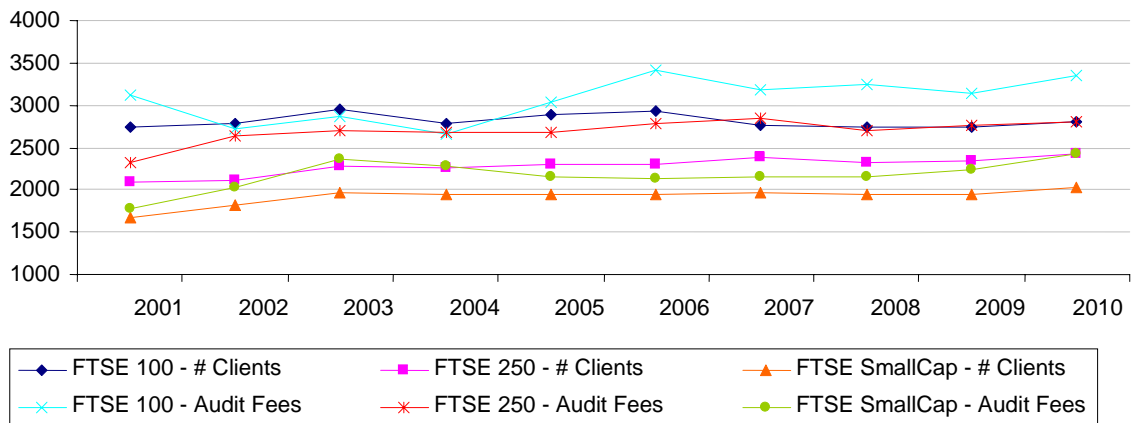
⁹³ Measured by HHI between 2001 and 2010 for FTSE 100 and FTSE 250, by number of clients and audit fees.

5.53 The OFT notes that there are relatively limited changes in market shares over time for the FTSE100 with more changes being apparent for the FTSE250, although both have been relatively stable.⁹⁴ These changes are the result of the low number of tenders that take place for these clients. We note that Deloitte has increased its market share in both FTSE 100 and FTSE 250 groups since 2001. Part of this was from the merger with the collapsed Arthur Andersen in 2002, but a greater proportion has come through organic growth.⁹⁵ This can be seen in figures 3 and 4 below.

5.54 Moreover, the OFT notes that changes in market share are limited almost exclusively to being between the Big-Four audit firms, which continues to show high concentration in this market.

Figure 2: Audit concentration – number of clients and audit fees

Concentration – measured by HHI

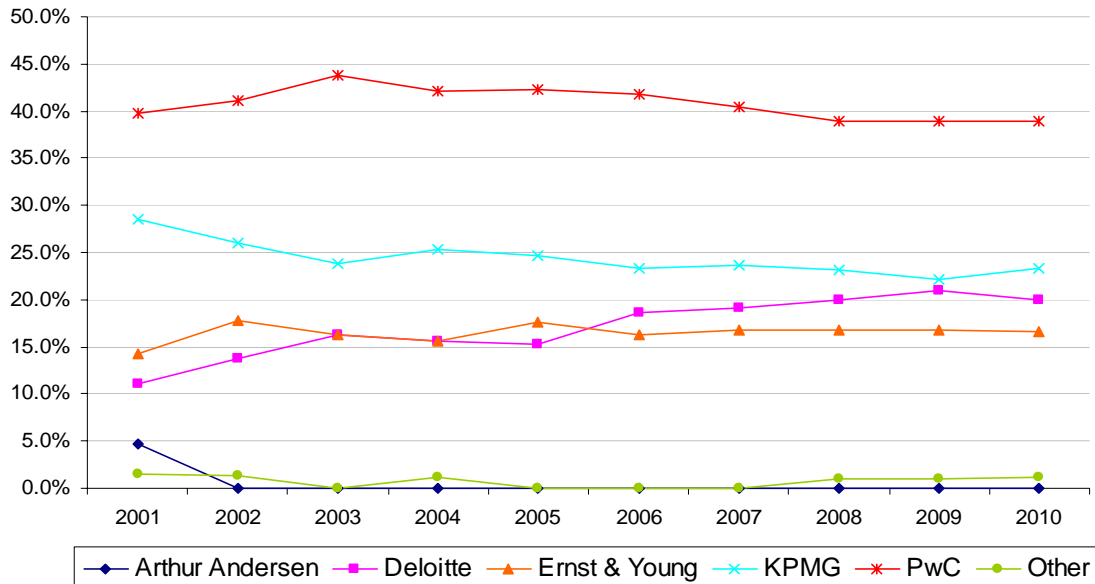


Source: FAME database with OFT analysis

⁹⁴ 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.

⁹⁵ See paragraph 5.5 and COMP/M.2810 – Deloitte & Touche/Andersen (UK), 1 July 2002.

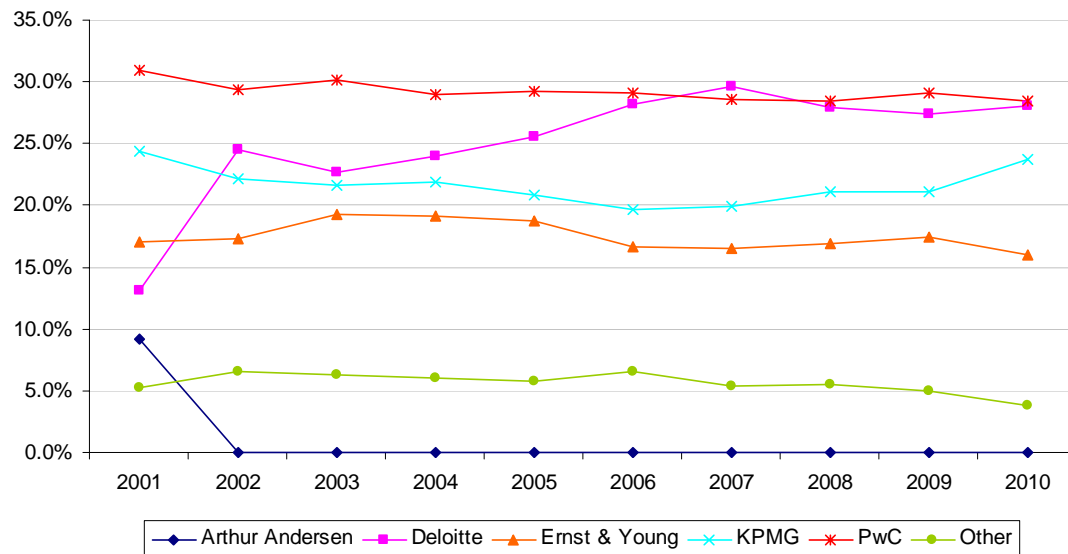
Figure 3: Share of supply of audit for the FTSE 100 Companies



Note: Share of supply by number of clients.

Source: FAME database with OFT analysis.

Figure 4: Share of supply of audit for the FTSE 250 Companies



Note: Share of supply by number of clients.

Source: FAME database with OFT analysis.

5.55 A number of consultation responses noted that high market shares were not an accurate assessment of detriment arising in a market and one response also noted that market shares were not a useful measure of market power due to audit services in the UK being a bidding market.

5.56 In response to the consultation comments about bidding markets, we note that the issue of whether markets with bidding processes suffer the same detriment from high concentration that others do has been considered in a paper by Paul Klemperer.⁹⁶ This describes five characteristics of ideal bidding markets, which are:

- competition is 'winner take all'
- competition is 'lumpy'. That is, each contest is large relative to a supplier's total sales in a period
- competition begins afresh for each contract and for each customer
- entry of new suppliers into the market is easy, and
- a bidding system or bidding process is involved.

5.57 This paper notes that 'neither many auctions, nor many more informal bidding processes, satisfy all these extreme assumptions, and once we relax any of them we are quickly back into the familiar world of problems of dominance and unilateral and coordinated effects.'⁹⁷

5.58 The OFT's assessment of this market and the features identified in this chapter show that entry is not easy, the extent to which competition is lumpy in the sense envisaged could be questioned, and in theory at least, there may be some asymmetric information held by incumbent auditors such that a bidding process in such a concentrated market may not result in a competitive outcome. Consequently, this market does not

⁹⁶ Bidding Markets, Paul Klemperer, June 2005, published by the Competition Commission.

⁹⁷ Bidding Markets, Paul Klemperer, June 2005, published by the Competition Commission.

appear to meet the strict criteria to be considered as an ideal bidding market, where competition policy should be different to other markets.

- 5.59 The OFT notes that 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 international audits. Several parties either single out the approval of the merger that created PwC for the current high concentration⁹⁸ or blame the failure of Arthur Andersen for exacerbating it.⁹⁹ In practice, as noted in Chapter 4, there have been a number of mergers between the large international audit firms, and while individual transactions may not have had a substantial effect on competition, collectively, they have had been more significant in increasing concentration, reducing the Big Eight to the Big Four.
- 5.60 The OFT's consultation document noted the results of our econometric analysis of whether audit fees and market concentration were inter-related. The results stated were that there was 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

⁹⁸ For example, we note that 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, question one.

⁹⁹ 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 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.

year) is associated with an increase in the level of audit fees, when holding other relevant factors constant.¹⁰⁰

- 5.61 A number of consultation responses addressed the analysis published by the OFT in support of this work, noting flaws in the dataset, methodology and assumptions made by the OFT in carrying out its analysis.
- 5.62 To provide some additional background information, some of the work in this area has included the following:
- The Oxera report undertaken for the DTI and FRC examined how audit fees and concentration were inter-related. This noted evidence that 'higher concentration has led to higher audit fees'.^{101, 102}
 - PwC provided a critique of the Oxera report which had been provided to the DTI, Treasury, POB, FSA, FRC and European Commission in 2006. In this, Oxera's econometric modelling and conclusions were strongly contested by PwC whose own analysis suggested that the audit fees charged by PwC after the merger of Price Waterhouse and Coopers & Lybrand were on average slightly

¹⁰⁰ 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.

¹⁰¹ The Oxera Report, Executive Summary, page i.

¹⁰² At a FRC Stakeholder Meeting held on 26 April 2006 it was suggested that the level of increase in audit fees shown in the Oxera Report had been overstated. Following that meeting the FRC commissioned further analysis of audit fees from a team at Edinburgh University. This analysis found that despite efforts to identify and remove errors from the available data on audit fees it is inevitable that some inaccuracies will remain. It also found that estimates of the rate of increase in fees vary depending on how companies are selected for inclusion in the analysis.

lower than those charged by the two firms separately prior to the merger.¹⁰³

- The OFT has recently become aware that BDO commissioned work in this area from Enterprise LSE, although the OFT has not seen supporting analysis. BDO states that the key findings of this noted, 'a direct link between concentration in the audit market and higher audit fees, specifically in relation to UK listed companies'.¹⁰⁴
- The OFT carried out its own econometric analysis on switching and audit fees, as well as concentration and audit fees to inform its work on the audit market during 2010 and 2011. This was based on the analysis conducted by Oxera in 2006. The OFT found some evidence in line with the Oxera Report as noted above.

5.63 In response to consultation comments on this subject, the OFT considers it beneficial to have carried out its analysis in this area, even though the findings may be disputed. This is one area where the detailed processes and analysis of the CC could be used to determine definitively whether and if so how concentration and audit fees may be linked. The OFT notes that this is one piece of evidence and is not determinative in the decision to make a market investigation reference to the CC.

5.64 Separately, we note that given the high barriers to entry, if one of the Big Four were to fail, we consider that it may be difficult for any of the mid-tier firms to seek to capitalise on this position, and consequently, there is a risk that concentration may increase. This would lead to a commensurate reduction in choice for large companies. Some consultation responses noted that the problems of switching audit firm would become significantly more difficult if this were the case.

¹⁰³ Competition and Choice in the UK audit market – a review of the Oxera report, PwC, August 2006.

¹⁰⁴ Enterprise LSE's Research Report – Concentration, Auditor Switching & Fees in the UK Audit Market, published by Dr Thomas Kittsteiner and Dr Mariano Selvaggi, April 2008. The OFT has not seen this report and the information on this was sourced from the BDO website: www.bdo.uk.com/about-us/competition-and-choice/research-summary

- 5.65 The OFT notes that while it is very difficult to foresee specific events, including possible audit firm failure and the implications of this, or the action that may be taken by relevant authorities, there remains a significant risk that the failure of an audit firm (in the event that this happened) could result in higher concentration in the market. Stakeholder concerns in relation to this point were typically focused on the problems of finding a competitive outcome with so few large audit firms in the market, particularly given the existing restrictions on choice outlined below.
- 5.66 **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.¹⁰⁵ 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 zero.¹⁰⁶ 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.¹⁰⁷

¹⁰⁵ 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.

¹⁰⁶ The Oxera report, survey of audit committee chairs, page 81.

¹⁰⁷ The Oxera report, interviews with market participants, page 83.

- 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.¹⁰⁸
- 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.¹⁰⁹
- 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.¹¹⁰
- One response to the consultation noted that the current audit standards tend to encourage companies to use one audit firm network for its audit in different countries due to the ease of compliance.

5.67 The OFT notes that these factors do not necessarily operate in isolation and there will be companies for which a number of the factors above would apply. For example, a company which engages one of the Big Four as its auditor may have a second one of the Big Four providing

¹⁰⁸ The Oxera report, interviews with market participants, page 84.

¹⁰⁹ The Oxera report, interviews with market participants, page 83. This found examples of limited choice for this reason.

¹¹⁰ 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.

some non-audit consultancy services. Where its main competitors are audited by another of the Big Four auditors, this company would have minimal choice of large auditors, which could restrict its ability to negotiate a competitive audit contract.

- 5.68 These factors are particularly significant given the presence of the barriers to entry discussed elsewhere, so that where rivals among the Big Four are limited, barriers to entry prevent other auditors from offering a suitable solution in many cases. There is evidence of this concern from the Oxera report which notes that 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.¹¹¹ Oxera also found that more than one third of FTSE350 companies believe their company does not have sufficient choice of auditor.¹¹² Ernst & Young has said 'there should be more choice in the large listed company audit market'.¹¹³
- 5.69 **In conclusion and based on the evidence before it, the OFT considers that analysis of this market shows it to be highly concentrated, with low levels of switching and tendering of audit contracts, and to exhibit high barriers to entry and expansion.** Furthermore, we note there appears to be widespread concern about its functioning and the choice available.

¹¹¹ The Oxera report, interviews with market participants, page 84.

¹¹² 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.

¹¹³ Letter to House of Lords inquiry, 27 September 2010, paragraph 1.

6 APPROPRIATENESS OF A REFERENCE

6.1 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.

6.2 The OFT's guidance on market investigation references¹¹⁴ 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.

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

Alternative powers

6.4 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

¹¹⁴ *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.

- 6.5 Allegations concerning possible requirements of some banks in lending agreements for one of the Big Four auditors to be used by 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.
- 6.6 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.
- 6.7 A number of responses to the consultation raised questions about the suitability of a reference to the CC for a number of reasons which are considered in the following paragraphs.
- 6.8 One consultation response noted that many of the perceived concerns relating to the structure of the market were already being addressed through market-based changes, or could be implemented by the FRC on a voluntary basis. The OFT does not share these views, and noted that both are at odds with the stated views of the FRC itself, in its Fifth Progress Report on the implementation of the MPG recommendations, its evidence to the House of Lords Economic Affairs Committee and its response to the OFT's recent consultation.
- 6.9 The FRC's response to our consultation welcomes the provisional decision to refer the audit market to the Competition Commission and expresses the view that audit regulators do not have the tools to address effectively concentration in the market. The FRC also states that voluntary action by market participants is insufficient. This is true even where voluntary action is driven forward and transparently reported through an organised regulatory superstructure (that is, the FRC's Audit Choice project and the constituent work of the MPG).
- 6.10 The OFT shares the FRC's conclusion that the issue of market concentration is most appropriately examined by a competition authority.

- 6.11 One consultation response refers to legislation being more appropriate than a CC inquiry in addressing perceived issues in the audit market. We address both national and supranational legislation below.
- 6.12 First, as regards UK-specific audit legislation, the OFT notes that recommendations for national legislation might follow from, or be informed by, a Competition Commission inquiry, and that the CC itself has order-making powers. The benefit, in the case of legislation initiated by the CC is that it would be based on a thorough analysis of its impact on competition, as well as its ability to solve any competition problems identified in the market.
- 6.13 Second, as regards supranational audit legislation, particularly that initiated by the European Commission following its Green Paper on audit policy earlier this year, the OFT has received a number of consultation responses that supported a Competition Commission inquiry into the UK audit market contemporaneous to the EU legislative process. The OFT also received some comments critical of such a contemporaneous examination, noting that this may be disruptive to, interfere with or be counter-productive to the EC's proposed reforms.
- 6.14 The OFT notes that further evidence and analysis of the impact on competition of measures applied to the UK market may be useful to be considered in legislation. In this environment, and given that the EU is preparing draft legislative measures, it considers it valuable for the CC to be carrying out an investigation at this point. This should allow the CC to feed its analysis of competition in the UK audit market, and of the effects of potential measures, into the legislative process in the EU, both as the CC develops its thinking and formally reaches its findings. The OFT considers that the market investigation process is sufficiently flexible to enable the CC to ensure that its analysis of evidence and, if appropriate, remedies relating to the UK market is available to assist with

the consideration of proportionate and appropriate remedies across the EU.¹¹⁵

- 6.15 Finally, a number of consultation responses suggested that certain remedies might be brought about by the OFT directly, perhaps by seeking voluntary change or undertakings from market participants. In this regard, we refer to our earlier remarks regarding the limited success of the work of the FRC's Market Participants Group, conducted along the same lines, while adding that it is far from clear how the OFT could provide firmer, non-voluntary, structured remedies in the absence of order-making powers similar to those available to the Competition Commission. The OFT concludes that it is not appropriate in this market to consider recommendations to industry, Government or independent regulators to resolve the OFT's concerns.

Scale of the problem

- 6.16 The OFT notes that the value of the market for statutory audit of FTSE 350 companies in the UK is at least £600 million annually, which is based on audit fees earned. Given the size and significance of this sector for large listed companies in the UK, we consider that even small restrictions on competition would be likely to have a significant effect in a market this large. Similarly, we note that small improvements in the competition framework in this market could generate substantial benefits for customers of audit services.
- 6.17 The OFT considers that all features, with the exception of the presence of bank covenants, would affect the whole market as defined in Chapter 4. The feature on bank covenants may be likely to cover at least part of the defined market.
- 6.18 The OFT also notes that the features it has identified are not likely to be transient. The OFT has had concerns about competition and

¹¹⁵ The CC must reach its decisions and publish its report within a maximum of two years although, where appropriate, the CC will aim to complete investigations in 18 months or less.

concentration in this market for some time, as detailed in Chapter 3, and consequently it expects that the features identified will persist for some time, unless considered by a reference to the CC.

- 6.19 A number of consultation responses noted that the OFT had not identified significant consumer detriment in its provisional decision. The following section provides the OFT's view on detriment underlying the provisional decision and this decision. The OFT considers that the suspected adverse effects on competition are likely to have a significant detrimental effect on customers through the potential for higher prices, lower quality, less choice or less innovation.
- 6.20 Customer detriment is difficult to discern and quantify in this market, because audit quality, the attribute on which customers of the audit product primarily seek to judge it, is difficult to discern, as noted in Chapter 5.
- 6.21 The OFT notes that the customers of audit services effectively covers three different groups, which are:
- the corporate customers that purchase audit services, including Finance Directors and Audit Committee Chairmen
 - the shareholders that own the company that ultimately pay for the audit and
 - the broader investment or capital market including institutional shareholders that may consider audit reports of a wide range of companies as part of investment decisions.
- 6.22 The features which may restrict competition identified in chapter 5 would be expected to be reflected in adverse effects on these various customers of audit services. Such detriment may take various forms:-
- 6.23 First, it is clear that the quality of audits is a concern. The House of Lords report drew a distinction between quality of audit per se (which it said was generally recognised to be high) and 'concerns about market concentration and about the scope, relevance, quality and regulation of

traditional audit' which 'were exacerbated by the financial crisis of 2007-09 when bank audits were seen to fail to give warning of imminent collapse, and seem simply to have monitored compliance with the law rather than prudence'.^{116, 117}

- 6.24 Second, reduced competition, in general might be expected to lead to higher prices. We report above (paragraphs 5.60 to 5.63) that research in this area is not determinative in the decision to make a market investigation reference. We do note that exploring this would be one area where the detailed processes and analysis of the CC could be useful.
- 6.25 Third, higher concentration undoubtedly results in less choice of audit firm. This is because there are fewer large audit firms that can provide some degree of competitive constraint on the incumbent audit firm and a reduced chance that a company might switch to an alternative provider. We note that this is in addition to the restriction on choice faced by some companies resulting from the various factors described in paragraph 5.66 above. As a result some FTSE350 companies will have a choice of substantially fewer than four audit firms.
- 6.26 Fourth, restricted competition may be likely to reduce the level of innovation in this market. While one might expect this to be limited in a risk averse and regulated market such as this, the high concentration and lack of switching may be likely to have limited this further. Moreover, particular features adversely affecting competition including the focus on established size and reputation, the difficulty of discerning audit quality and the complexity and difficulty of regulatory standards to be complied with may be particularly likely to stifle innovation.
- 6.27 Finally, the high level of concentration and barriers to entry in this important market where companies are required to undertake a statutory audit to demonstrate the robustness of their financial reporting, make

¹¹⁶ House of Lords Report, paragraph 7.

¹¹⁷ The OFT also notes the recent Audit Inspection Unit report noted concerns in this area, although, as noted in Chapter 5, this does not inform the OFT's conclusions.

problems of market stability and risks to the financial system more likely in the event that one of the Big Four firms was to fail. Any consequent increase in concentration would be expected to lead to further detriment of the forms outlined above.

- 6.28 The OFT notes that, given the difficulties in assessing detriment in relation to audit quality and price, the main elements of customer detriment identified in this section is that there is very limited choice of auditor for many companies, as set out in detail in Chapter 5, and there are concerns from companies in relation to choice, particularly in the event that this choice deteriorated. Given the barriers to entry and expansion, further deterioration in choice in the event of a market failure could create detriment as to quality, price and innovation.

Availability of remedies

- 6.29 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 would be capable of achieving as comprehensive a solution as is reasonable and practicable to any adverse effects and any detrimental effects on customers.
- 6.30 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.
- 6.31 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.

6.32 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.

6.33 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.

6.34 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.

6.35 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.

6.36 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 in our roundtables and bilateral meetings. We note however that there was a degree of consensus among stakeholders in such meetings in favour of some measures, particularly some of those designed to increase transparency and empower purchasers.

6.37 Most respondents to the consultation made specific comments about the suitability, appropriateness or proportionality of specific remedies, including those measures identified by the OFT, while some responses commented on the list of measures annexed to the House of Lords' inquiry report.¹¹⁸ Comments included that some measures might:

- have an adverse effect on the quality of audit services provided

¹¹⁸ More general comments on whether remedies could be implemented by other means are considered in the Alternative powers section of this chapter.

- have unintended consequences and not achieve their aims
- increase the cost of audits for customers or
- be disproportionate in their effect relative to the problems they seek to remedy.

6.38 The OFT notes that most, but not all, consultation responses highlighted at least some measures which could be considered by the CC in the event that it found one or more adverse effect on competition. The OFT has considered all the responses in relation to specific measures in detail, and while many of the measures previously considered by the OFT or highlighted earlier in this Chapter do have potential or actual downsides, we note that benefits may outweigh these, however, we note that this is for the CC to determine.

6.39 In response to comments about the downsides or potential downsides to any measure, the OFT notes that its role is not to assess individual measures in detail, but to have regard to the test as set out in paragraph 6.29.

6.40 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.

6.41 Furthermore, and to respond to concerns in consultation responses, 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. We note that this detailed assessment would consider the full range of costs and benefits that may occur, including effects on quality, unintended consequences as well as the impact on the cost of audit services and benefits that may accrue to companies, auditors and the full range of customers.

Interaction with EU legislative process

6.42 The OFT has also considered the question of whether the EU legislative process may affect the ability of the CC to decide what remedy or remedies would be capable of achieving as comprehensive a solution as is reasonable and practicable to any adverse effects and any detrimental effects on customers.

6.43 The OFT considers it appropriate to make a market investigation reference as it is unlikely that the EU legislative process would address fully the OFT's concerns, as there appear to be 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.¹¹⁹ The OFT considers that the EU legislative process could not be expected to address any UK specific concerns that may arise and that are not analogous to or replicated in other Member States. UK specific issues could include some of the following:

- the relationship between audit partners and Finance Directors/Audit Chairs in the UK, and the cross-overs between these positions
- the make-up and attitudes of UK shareholder/investor groups
- the relationship between UK banks and borrowers, and whether lenders encourage borrowers to appoint Big Four firms

¹¹⁹ These issues include the extent of dynamic rivalry between existing audit firms and how to increase the levels of rivalry among them.

- the Companies Act provisions on audit, and the effect of the transition from UK GAAP to IFRS standards
- the experiences of smaller firms and growing firms in the UK, and what happens when non FTSE 350 companies step up to the FTSE main board
- the role of the FRC and UK audit regulation, and
- the operation and impact of FTSE 100, 250, AIM, etc..

6.44 Also, the EC's approach is not solely focused on competition concerns, but is mainly concerned with audit quality, independence and on lessons from the financial crisis. In this regard, the CC and EU processes could be considered as complementary in nature. The OFT considers that there are significant benefits to be gained from interaction between these two processes.

6.45 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. However, the nature of the legislative proposals to follow is not clear at this stage. Once published, the proposals will be subject to negotiation in the European Parliament and the Council of Ministers. The proposals will require the approval of EU Member States before being implemented.

6.46 The OFT notes that there is precedent for the Monopolies and Mergers Commission (MMC, the predecessor to the CC), inputting its analysis and views regarding European legislation. In 1990, the Director General of Fair Trading made a reference to the MMC of the supply of new cars in the UK.¹²⁰

¹²⁰ See: www.competition-commission.org.uk/rep_pub/reports/1992/313newmotorv1.htm#summary

- 6.47 Further, the OFT observes that the audit market has been undergoing review, or has been subject to initiatives for reform, for many years. As such, there has been no point, since the OFT announced its ongoing 'watching brief' of the audit market in 2002, at which the OFT would have been able to make a MIR when other regulatory or legislative measures were not under consideration. Indeed, looking forward, we could point to a number of further stages at which clarity might potentially be lacking on the impact and effect of the national implementation of the EC's proposed audit legislation.
- 6.48 In summary, the OFT considers that there may be valuable cross-overs and synergies between the CC's inquiry and the EU legislative process. The OFT does not share the concerns of a number of consultation responses about the timing and risk of the two work-streams being potentially counter-productive or for the CC to be seen as interfering in the EU legislative process.

Undertakings in lieu of a reference

- 6.49 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,

During the course of its inquiry, the MMC liaised with the European Commission and sought its views on the interpretation of the existing block exemption Regulation 123/85, which laid down conditions to which agreements between car suppliers and dealers must conform.

During the MMC new cars inquiry, the European Commission conducted its own major inquiry into new car prices, and the two investigations were progressed in parallel. The MMC inquiry thus reacted to a number of significant 'externally generated' changes, including moves by the European Commission aimed at easing the free movement of cars between the markets of member states. Finally, the MMC's report dealt at some length with the provisions of EC law, including describing the legislation in some detail. It also made certain recommendations to the Government on certain aspects on which the Secretary of State might wish to engage with the European Commission (particularly around the interpretation of the block exemption Regulation).

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.

6.50 The OFT has received no offers of undertakings in lieu of reference.

7 CONCLUSION

- 7.1 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.
- 7.2 We consider that analysis of this market shows that there is little incentive to switch auditor, with such switching being costly for companies concerned. We find that the market has low levels of tendering and switching and that companies focus on the existing size or reputation of auditors which imposes a barrier to entry for non-Big Four auditors. We find that larger auditors possess certain attributes necessary for auditing large companies and smaller auditors can find it difficult to raise capital for expansion. We find that the market exhibits high concentration, and companies have further limits on the choice of auditors that they can appoint. We are also aware that Banks may impose conditions requiring the use of a Big Four auditor in their dealings with companies of a certain size.
- 7.3 In summary, we consider that analysis of this market shows it to be highly concentrated, with low levels of switching and tendering of audit contracts, and to exhibit high barriers to entry and expansion.
- 7.4 It is our view that the features we identify in Chapter 5, either individually or in combination, restrict, prevent or distort actual and/or potential competition.
- 7.5 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 we do not consider that recommendations to industry, Government or independent regulators would be an appropriate action in this market.

- Analysis of the scale of the market, 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 appear unlikely therefore to be short-lived. The OFT has identified a range of sources of potential customer detriment in this market: concerns around audit quality; the potential for reduced competition to lead to higher prices; higher concentration leading to restricted choice; risks of increased detriment across the board if there is further market concentration; and the potential for reduced innovation resulting from high concentration, lack of switching and other characteristics of the market. The OFT has identified in particular very limited choice of auditor for many companies, particularly in the event that choice deteriorates further. Given the barriers to entry and expansion, further deterioration in choice in the event of a market failure could create detriment as to quality, price, and innovation.
- 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.
- We also consider that there may be valuable cross-overs and synergies between the CC's inquiry and the EU legislative process. Analysis undertaken by the CC to feed into the EU legislative process.
- The OFT has received no offers of undertakings in lieu of reference in this case.

7.6 The OFT has undertaken a number of roundtable and bilateral meetings with relevant stakeholders in this market and carried out a six-week consultation on its provisional decision to make a market investigation reference. The OFT has considered in detail all the views presented to it and considers that these do not alter either the decision to have passed

the test in Section 131 or the exercise of its discretion to make a market investigation reference.

- 7.7 Taking into account all of these views and evidence, the OFT has decided that it has reasonable grounds for suspecting that the test for making a market investigation reference to the CC under section 131 EA02 has been met in relation to the features outlined above in the market for statutory audits of large companies in the UK, and for the reasons described in Chapter 6 and summarised above, has 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
- Professor Michael Power (London School of Economics)
- PricewaterhouseCoopers (PwC)
- PKF (UK) LLP
- Railways Pension Trustee Company Limited

- Royal London Asset Management
- Standard Life Investments Limited

ANNEXE B – STATUTORY CONSULTATION ON THE PROVISIONAL DECISION

1. The OFT carried out a statutory consultation on its provisional decision to make a market investigation reference of this market to the CC for the six weeks until 9 September 2011.
2. The OFT received submissions during this period from the following 20 organisations or people:
 - 100 Group of Finance Directors
 - 'A' Group of Auditors
 - ACCA
 - Baker Tilley
 - BBA
 - BDO
 - Chartered Accountants Ireland
 - Deloitte
 - Ernst & Young – asked for previous comments to be considered as its response
 - FRC
 - Grant Thornton
 - ICAEW
 - Kingston Smith
 - KPMG
 - Mazars
 - PwC
 - RPMI Railpen
 - The Audit Commission
 - Two individuals
3. The submissions provided a variety of responses in relation to the provisional decision, with some responses supporting this, while others disagreed with the decision.
4. The OFT refers to some of the arguments made in some submissions in the relevant section of the decision document with the OFT's response.

ANNEXE C – TERMS OF REFERENCE

1. The OFT, in exercise of its powers under Sections 131 and 133 of the Enterprise Act 2002 (the Act), hereby makes a reference to the CC for an investigation into the supply of statutory audit services to large companies in the UK.
2. The OFT has reasonable grounds for suspecting that a feature or a combination of features of the market or markets for the supply of statutory audit services to large companies in the UK prevents, restricts or distorts competition.
3. For the purposes of this reference, statutory audit services means an audit conducted by a person appointed as auditor under Part 16 of the Companies Act 2006. Large companies means companies that may be listed from time to time on the London FTSE 100 and FTSE 250 indices.