COMPETITION COMMISSION

Statutory audit services for large companies market investigation

A report on the provision of statutory audit services to large companies in the UK

15 October 2013

Website: www.competition-commission.org.uk

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The Competition Commission has excluded from this published version of the Final report information which the inquiry group considers should be excluded having regard to the three considerations set out in section 244 of the Enterprise Act 2002 (specified information: considerations relevant to disclosure). The omissions are indicated by [✄]. Some numbers have been replaced by a range. These are shown in square brackets. Non-sensitive wording is also indicated in square brackets.

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Summary

The reference

1. On 21 October 2011, the Office of Fair Trading (OFT) made a reference to the Competition Commission (CC) for an investigation into the supply of statutory audit services to large companies in the UK. Under the terms of reference, 'statutory audit services' means an audit conducted by a person appointed as auditor under Part 16 of the Companies Act 2006 (Companies Act), and 'large companies' means companies that may be listed from time to time on the London FTSE 100 and FTSE 250 indices. The reference was made under sections 131 and 133 of the Enterprise Act 2002 (the Act).

2. We were required to determine whether any 'feature' or combination of 'features' of any relevant market 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,[1] ie results in an 'adverse effect on competition' (AEC).[2]

Background

3. Under the Companies Act, FTSE 350 companies must keep adequate accounting records and the directors of a large company must not approve the accounts unless they are satisfied that they give a true and fair view of the company's financial position. The accounts must be audited and external auditors must give either an 'unqualified' report (ie that the accounts are presented fairly in all material respects and in the auditors' opinion give a true and fair view of the financial state of the company) or a 'modified' report. A modified report may contain either 'an emphasis of matter' (which does not affect the auditors' opinion) or matters which do adversely affect the auditors' opinion. The duties of auditors are owed to the company in the interests of the shareholders.

4. Statutory audits are extensively regulated. Auditors' reports are prepared in accordance with an International Standard on Auditing[3] and use standard and formulaic wording. Statutory audit services must be supplied by auditors which are registered with a supervisory body. In addition, the Financial Reporting Council (FRC)—the UK's independent regulator responsible for promoting high-quality corporate governance and reporting—monitors the quality of audits through its Audit Quality Review team (AQR team) and is the independent disciplinary body for accountants and accountancy firms.

5. We considered the purpose of audits. The issue facing shareholders is that, although they collectively own the company, it is the directors and officers (management) who run the company (a relationship termed by economists as 'principal–agent'). Further, shareholders have significantly less information than management of the company regarding its performance and financial standing. Such an information asymmetry may deter investment, as it creates uncertainty for shareholders and provides scope for management to act in ways that might not always be in the best interests of shareholders. This may result in a conflict of interest between the shareholders (the principals) and the management (the agents).

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[1] See section 134(1) of the Act.
[2] As defined in section 134(2) of the Act.
[3] ISA (UK and Ireland) 700, The independent auditor's report on financial statements.

6. We found that audits are intended to provide assurance to shareholders that the financial reports prepared by the directors give a 'true and fair' view of the financial state of the company. Accordingly, although in practice the directors are most responsible for selection of the audit firm, we found that the shareholders are the primary customers of the audit, and it is their interests that we bore principally in mind during our investigation.

7. Due to the possible conflict of interest between management and shareholders, FTSE 350 companies have Audit Committees (ACs) to help with corporate governance issues relating to audit. ACs monitor and review internal audits and the effectiveness of external audits, thereby protecting to some extent the interest of shareholders. Although ACs may also recommend to management the appointment or replacement of external auditors, management is highly influential in the conduct of a company's audit relationship.

Market characteristics

8. We found that the relevant market was a single market for the supply of audit services to FTSE 350 companies, and not separate markets for audit services to segments of this group. The overwhelming majority of such audits are prepared by one of four firms[4] of auditors: Deloitte LLP, EY LLP, KPMG LLP and Pricewaterhouse Coopers LLP (collectively, the Big 4 firms), although some FTSE 350 companies are audited by other firms such as BDO LLP and Grant Thornton UK LLP. Under the Companies Act, a company may only engage an auditor for one year. However, in practice firms are frequently and repeatedly reappointed, and some FTSE 350 companies have not switched auditor for many years. We found that 31 per cent of FTSE 100 companies and 20 per cent of FTSE 250 companies have had the same auditor for more than 20 years, and 67 per cent of FTSE 100 companies and 52 per cent of FTSE 250 companies for more than ten years. During the course of our investigation, the FRC amended its UK Corporate Governance Code to the effect that FTSE 350 companies should put their audit engagements out to tender at least every ten years, although the guidance allows any such tender to be delayed if the company can explain why it is not doing so.

9. The switching rates we observed were not determinative of whether or not there was an AEC. We investigated the FTSE 350 statutory audit market to inform our assessment of competitive conditions within the relevant market. With regard to prices, we found that companies which had gone out to tender or switched their auditors had, on average, obtained a relative price reduction, albeit one that eroded over approximately three years.

10. We were not able to reach a conclusion on whether audit firms were making profits above competitive levels or otherwise in this market. This was on account of difficulties in valuing capital employed; the intangible nature of the asset base in this market; difficulties in cost allocation (as firms offered both audit and non-audit services (NAS)); and difficulties in identifying costs due to the partnership ownership structure. We identified a number of companies from which audit firms appeared consistently to earn above-average profit.

11. With regard to quality of statutory audits, it was difficult to identify an objective external metric to allow reliable comparisons between audits. However, the reports produced by the AQR team identified a range of issues (of varying degrees of gravity) regarding quality and auditor scepticism.

[4] References to 'firm' are to the audit firm and references to 'company' are to the entity which is audited.

12. Finally, it appeared that there was some unmet demand, in that shareholders and potential future shareholders sought more information regarding the audit and audit process than was currently provided by the audit report and the annual report and accounts.

Features of the market

13. A ‘theory of harm’ is a hypothetical explanation of how characteristics and uncompetitive outcomes may arise in a market. We framed our investigation of whether there are features of the relevant market which can be expected to harm competition by identifying a number of such theories of harm. We decided whether or not a theory of harm was borne out by gathering, analysing and assessing the available evidence.

14. We considered whether audit firms had some market power over their client companies. To do this we assessed companies’ willingness (or not) to switch auditor and the extent to which companies can exert bargaining power in their negotiations with audit firms. We also considered how well auditors represent shareholders’ interests and the extent to which competition was directed at satisfying executive management whose interests may differ from those of shareholders. We did not look at each of these theories of harm in isolation, but considered whether there were links between them. We also considered theories of harm related to coordinated effects, bundling and regulatory distortions.

15. In identifying the competitive effect of possible features of the market, we sought to apply a theoretical benchmark of a ‘well-functioning market’ to determine how the market may be judged to be performing. We took into account all the evidence we found during our investigation when deciding whether any features or combination of features resulted in an AEC.

Firms’ market power and companies’ willingness to switch auditor

16. Under our first theory of harm, we investigated why companies (acting on the advice of their executive management and ACs) did not switch auditor more frequently and whether there were barriers to entry, expansion and selection of audit firms in the market.

17. In particular, we considered whether information asymmetries and switching costs affected companies’ bargaining power with respect to their auditors, so that companies’ bargaining power was insufficient to ensure that prices, quality, rates of innovation and differentiated offerings were offered at competitive levels. We assessed the situation both outside and within a tender process, and found that conditions of competition were significantly different in the two situations.

18. Each audit engagement is negotiated individually, so there is no prevailing market price that could protect those companies that might be in a weaker bargaining position. We considered other factors that might weaken a company’s bargaining position and, conversely, factors that might weaken the bargaining position of the audit firm in any negotiation.

19. We identified three factors that could make a company reluctant to contemplate switching auditor and so weaken its bargaining position. First, company management face significant opportunity costs in the management time involved in the selection and education of a new auditor. In particular, we received evidence that running a tender process is onerous in terms of management time, and companies must invest

considerable time in educating a new auditor regarding its specific circumstances. Second, companies and firms invest in a relationship of mutual trust and confidence from which neither will lightly walk away as this means the loss of the expected benefits of continuity stemming from the relationship. In particular, the loss of the expertise and knowledge of the incumbent arising from a loss of continuity may lead to reduced efficiency in the conduct of the audit and increased risk in the technical quality of the audit in the early years of the incoming firm. Third, companies face difficulties in judging audit quality in advance due to the nature of audit, which means that companies cannot calculate accurately the benefits that going out to tender and switching would bring. This means that any incumbent has an advantage against the uncertainty of what an alternative auditor might provide. This means that companies do not put their audits out to tender as frequently as they would if they did not face such costs.

20. We found that an incumbent audit firm enjoys advantages in that it has opportunities to respond to dissatisfaction expressed by the company (although issues of particular gravity will usually lead to an immediate switch). This gives the audit firm some leeway within which to position its offer before it faces a genuine threat of the company switching.

21. Audit firms told us that, when newly appointed, they made considerable investments in companies during the early years of an engagement (in terms of additional hours). We were told that it took perhaps two to three years before an audit firm fully understood the complexities of a company, but that this investment led to increased quality and efficiencies from which companies benefited. We were told that audit firms had much to lose should a company switch, in terms of income, reputation, and the ability to win further engagements. This meant, they said, that companies were able to ensure that their audit services were offered competitively, even outside a tender process. We considered these submissions carefully, but were not persuaded that the scale of such losses was sufficient to remove the power held by that incumbent firm, given the opportunities the incumbent has to mitigate the risk of these losses occurring.

Barriers to entry, expansion and selection

22. We investigated why audit firms other than the Big 4 firms were not more successful in winning audit engagements of FTSE 350 companies. We found potential customers looked for a substantial track record of experience of auditing FTSE 350 companies when selecting auditors, and only the Big 4 audit firms could demonstrate such experience (and therefore might appear to be the 'safe' option). We considered that the use of 'Big 4 clauses' in some loan agreements (which specified or favoured the use of a Big 4 audit firm) added to the reputational barriers that Mid Tier audit firms face. We did not consider such barriers to be insurmountable, given appropriate investments. We considered that low levels of tendering and the difficulty of predicting the timing of any tender opportunity had hindered the ability of firms to make such investments.

Auditors' serving shareholders' interests

23. Under our second theory of harm, we investigated how well auditors represented shareholders' interests and the extent to which competition was focused on satisfying executive management whose interests may differ from those of shareholders, leading to lack of appropriate scepticism on the part of the external auditors and/or unmet demand for better information as regards the audit process from shareholders.

24. We were satisfied that both management and auditors generally aim to perform their respective functions diligently and effectively. Nevertheless, we took into account the importance of audit as a safeguard that company accounts give shareholders a 'true and fair' view of a company's financial position. We investigated whether auditors sufficiently represented shareholders.

25. It appeared that shareholders, despite their legal rights, played very little role in any decision to appoint or reappoint an auditor, while in contrast executive management was influential. We considered how well the interests of executive management and shareholders were aligned with respect to audit. While, broadly, we found that each has an interest in the auditors detecting issues likely to lead to a material misstatement of accounts, we considered that each might, on occasion, have different incentives in how issues requiring judgement were treated. In particular, we found that at times executive management had incentives to manage reported financial performance to accord with expectations and present accounts in an unduly favourable light. We found that, in general, shareholders would have no such interest.

26. We found that the incentives on auditors to accommodate executive management included the wish to be reappointed, with the direct benefit of the income of the engagement, and the indirect benefit to reputation and experience from retaining an engagement that might allow an audit firm to win further engagements.

27. We also found that auditors had incentives to challenge executive management. In particular, we were told that loss of reputation (in terms of being seen as susceptible to executive management influence) would be very damaging to an audit firm. Audit firms make significant internal efforts to maintain quality and are subject to external regulation by the FRC and professional bodies. Under the UK Corporate Governance Code, ACs monitor and review the effectiveness of the audit. However, we were not satisfied that these countervailing factors or ACs were sufficient to align the incentives of audit firms and shareholders.

28. We balanced these factors and considered the evidence that we had observed regarding the scepticism and independence of auditors. We concluded that any loss of auditor objectivity or scepticism in conducting a given audit would not easily be detectible, and so it was possible that such loss of independence occurred without being known by shareholders. We found that a loss of scepticism could arise because competition between audit firms was focused towards satisfying demand from executive management including instances where this demand is not fully aligned with the interests of shareholders. We also considered that this was the explanation for the unmet shareholder demand that we identified.

Other theories of harm

29. We considered whether the market conditions were conducive to coordination or that Big 4 audit firms engage in tacit collusion; that they bundle audit and NAS together in order to raise barriers to entry or expansion to other audit firms; that they target the customers of Mid Tier audit firms with particularly low prices; or that they are able to exercise undue influence over the formation of regulation or on regulatory bodies through their extensive alumni networks. We did not identify sufficient evidence to support these other theories of harm.

Findings regarding features and an AEC

30. Taking all these considerations into account, we identified the following as relevant features of the market:

    (a) barriers to switching:

    (i) company management face significant opportunity costs in the management time involved in the selection and education of a new auditor;

    (ii) companies and firms invest in a relationship of mutual trust and confidence from which neither will lightly walk away as this means the loss of the benefits of continuity stemming from the relationship. In particular, the loss of the expertise and knowledge of the incumbent arising from a loss of continuity may lead to reduced efficiency in the conduct of the audit and increased risk in the technical quality of the audit in the early years of the incoming firm; and

    (iii) companies face difficulties in judging audit quality in advance due to the nature of audit which means that companies cannot calculate accurately the benefits that tender processes and switching would bring;

    (b) Mid Tier audit firms face barriers to entry, expansion and selection in the FTSE 350 statutory audit market. Mid Tier firms face experience and reputational hurdles which, together with the infrequency and unpredictability of opportunities to tender, affects their incentives to make the necessary investments to overcome such hurdles;

    (c) the ability of executive management to influence external auditors in how they conduct and report their audit; and

    (d) the information asymmetry between shareholders and audit firms, so that shareholders have little information regarding the investigation carried out by the auditor.

31. We found that the features listed in paragraph 30*(a)* gives rise to an AEC either individually or in combination by weakening a company's bargaining power outside the tender process. We think that these features are pervasive throughout the FTSE 350 statutory audit market but their effect will be uneven across companies. How a feature or combination of features impacts on an individual company's strength of bargaining power will vary over time and depend on its particular circumstances.

32. We found that the feature listed in paragraph 30*(b)*, either individually or in combination with the other features, gives rise to an AEC as it has the effect of reinforcing current market positions, and hindering the emergence of new or strengthened rivals and so damages potential competition. It reduces the potential competitive constraints firms can exercise on rivals. It weakens companies' bargaining power since companies may have a lesser range of outside options available to them.

33. We found that the features listed in paragraphs 30*(c)* and *(d)* give rise to an AEC as they have the effect of giving firms incentives and the ability to respond to the interests of executive management and firms may therefore compete to satisfy a demand that is not fully aligned with shareholders' interests. Firms therefore may not compete on the right parameters.

34. As a result of the AEC that we found, we think that companies are offered higher prices, lower quality (including less sceptical audits) and less innovation and differentiation of offering than would be the case in a well-functioning market.

Remedies

Summary

35. The main aspects of the remedy package that we decided to implement are:

(a) FTSE 350 companies must put their statutory audit engagement out to tender at least every ten years. While we considered the FRC's 'comply or explain' provisions carefully, we do not think that a company should be able to delay tendering beyond ten years. Those unwilling to risk some unforeseen event occurring in the final permitted year may choose to go out to tender before then. We think that many companies would benefit from going out to tender every five years but if they choose not to, then the AC should set out in the AC Report section of the Annual Report in which financial year it next plans to go to tender and why going out to tender in that year is in the best interests of shareholders.

(b) The AQR team should review every audit engagement in the FTSE 350 on average every five years, although it should have discretion to review audits that it perceives to be particularly low risk less frequently. The AC should report to shareholders on the findings of any AQR team report concluded on its company during the reporting period, stating the grade awarded and how both the AC and auditor are responding to the findings.

(c) The AQR team should review and report on the firms in its scope on an annual basis, where such firms conduct sufficient public interest entity (PIE) audits for this to be practicable.

(d) Provisions in loan agreements which restrict a company's choice of auditor to lists or categories should be prohibited, although parties may require that any auditor should meet objectively justified criteria.

(e) An advisory vote should be introduced on the AC Report, and amendments to the UK Corporate Governance Code and Stewardship Code should be made to further encourage shareholder engagement.

(f) Measures should be introduced to strengthen the accountability of the external auditor to the AC, including a stipulation that only the AC is permitted to negotiate and agree audit fees and the scope of audit work, initiate tender processes and make recommendations for appointment of auditors and authorize the external audit firm to carry out NAS. The AC may receive submissions from executive management regarding these matters. It may establish a materiality threshold below which executive management may instruct the audit firm to conduct NAS.

(g) The FRC should amend its articles of association to include an object to have due regard to competition.

Rationale for remedies

36. The remedy package includes measures to improve the bargaining position of companies and encourage rivalry among audit firms; measures to enhance the influence of the AC in a company's relationship with its external auditors; and

measures to promote shareholder engagement in the audit process. These remedies work in combination to promote competition and to ensure that competition is directed towards satisfying the demands of shareholders.

37. We found that tender processes were thorough, fair, and transparent processes in which the AC had an influential role, ensuring that shareholder interests are given appropriate weight and which strengthen the incentives of audit firms to offer a competitive product. We consider it to be a matter of judgement as to the appropriate interval between tender processes. We note the FRC's judgement that five years was the appropriate interval for rotation of an Audit Engagement Partner (AEP) to ensure their objectivity and independence and we saw no grounds to alter it. We were persuaded of the benefits of aligning the interval between tender processes with AEP rotation, as this provides a break in the audit relationship at which the AC can make an informed choice of audit partner, and if it wants, switch audit firm without incurring more disruption than is necessary, and would limit the advantage that the incumbent firm derives from being able to offer an AEP with pre-existing experience of the company.

38. Our view is that five years is an appropriate interval at which to subject the audit relationship to scrutiny and challenge for many (perhaps even most) companies, and that going out to tender at this interval would increase company bargaining power and ensure a competitive service between tender processes. As the period since the last tender process increases, we think that an increasing proportion of companies would realize benefits from going to tender. However, we noted the views of significant numbers of companies, audit firms and, in particular, investors and the FRC that such an interval may be too frequent, largely on the basis of the costs this would impose on firms and companies, the risk that such frequency may undermine the intensity of competition that a tender process provokes and the quality of audit that a firm could deliver. Given these submissions, we decided that companies must go out to tender at least every ten years. Given our considered view that five years is the appropriate interval for many companies, we think that any company that does not decide to go out to tender after five years should set out in its AC Report, in which financial year it next plans to hold a tender process, and why going out to tender in that year would be in the best interests of shareholders. The AC Report should be subject to an advisory vote.

39. We decided to take further steps to increase the influence of the AC in the relationship with the external auditors. These steps include: enhancing the accountability of the auditor to the AC and enhancing the accountability of the AC to shareholders. The increased influence of the AC in combination with more frequent tender processes should help ensure that competitive outcomes are achieved and that shareholders can be more confident that their interests have been at the forefront of any tender process and subsequent appointment decision, as well as throughout the ensuing audit relationship.

40. Information is important to the ability of shareholders to hold ACs to account in representing their interests, and our remedies in this area reinforce the FRC's recent changes to the AC Report and to ISA 700 to encourage greater disclosure by ACs and auditors. We decided to require the AC to report on the results of any AQR during the period and to require companies to hold an advisory vote on sufficiency of the disclosures in the AC Report. We consider that these measures will encourage meaningful disclosure, promote high-quality audit, and enable shareholders to better appraise the effectiveness of the AC.

41. In designing an effective package of remedies, we sought to ensure that the measures work in combination to produce the necessary incentives to ensure that

competition works well. Our remedies designed to increase AC influence will work in combination with more frequent tender processes to ensure that competition is better focused on shareholder demand and, in particular that audit quality and scepticism is given appropriate weight. Our remedy package will also promote information flow between companies and investors in relation to external audit and thus allow ACs to understand shareholder concerns better, and so better act on them.

42. We consider that our package of remedies is likely to increase choice, as both Big 4 and Mid Tier firms will have increased incentives to develop and expand their capabilities in order to win engagements. We consider that measures to prohibit restrictions on auditor appointment in loan agreements, in combination with more frequent tender opportunities, will encourage firms other than the Big 4 firms to invest in the capabilities necessary to win FTSE 350 engagements, particularly those engagements lower down the scale of complexity and international breadth.

43. We considered the role of the FRC carefully in formulating our remedy proposals, and we note that it has evolved over time into a regulator that is increasingly well equipped to provide high-quality independent regulation to the audit market. We found that the work of the AQR team was well regarded, considered carefully by audit firms and companies, and so we found that it had an important role in promoting competition between audit firms. We welcomed the recent changes to the UK Corporate Governance Code to increase tendering and expand AC reporting, and changes to ISA 700 to expand auditor reporting, as we see them as beneficial steps towards promoting competition.

44. However, we considered that further steps were required to increase the resources of the AQR team, and to encourage transparency of AQR grades. We considered that a change to the FRC's objects so that the FRC should have due regard to competition would ensure that it places appropriate weight on the role of competition in facilitating high-quality audit. We would necessarily be reliant on the FRC to take our recommendations forward, and to ensure that it secures the appropriate funding to facilitate this. In doing so we consider that the FRC will further strengthen its role as an accountable, transparent, and independent regulator of the audit industry.

45. We expect that the above measures taken together as a package will be effective and proportionate in remedying the AEC. We expect this remedy package to result in a substantially improved environment for competition in the FTSE 350 statutory audit market.

46. We decided not to pursue the following remedies:

(a) mandatory switching;

(b) further constraining NAS provision by the auditor;

(c) joint or major component audit;

(d) shareholder group or FRC responsibility for auditor reappointment; and

(e) independently resourced Risk and AC.

47. We gave careful consideration to whether mandatory switching should be introduced. Our view is that while mandatory switching would address concerns expressed by some investors about very long tenures, our remedy package addresses the AEC more effectively whilst delivering similar benefits and avoiding some of the costs associated with mandatory switching, and in particular the weakening of competition

that would result from the incumbent firm being excluded from the tender process. As a result, we decided not to impose mandatory switching as a remedy to the AEC that we found.

48. We also decided against introducing measures to further constrain NAS, to further encourage or mandate joint/shared audit provision, to provide for shareholder or FRC appointment of auditors, and to establish an independently resourced Risk and Audit Committee. We decided that including any of these measures in our remedy package would not add significantly to its effectiveness in addressing the AEC that we found, and may add to the costs incurred. However, as noted above (paragraph 35(f)), ACs may establish a materiality threshold below which executive management may instruct the audit firm to conduct NAS.

49. The measures we are prescribing impose some additional costs principally arising from the increased activities of the FRC with respect of the AQR team, which we estimate to be in the order of £1 million to £2 million a year plus any opportunity costs incurred by the firms in engaging with the AQR team. We believe that under the existing requirements many companies would choose to tender every ten years. However, some companies might have chosen to extend this period in certain circumstances and there may be some additional cost for these companies. As the changes have only recently been introduced the level of compliance with the current regulations under the Code is not known but, we believe that the costs incurred by companies and firms are unlikely to exceed £3 million a year.

50. Our remedy for ACs to take on responsibility for more aspects of the audit relationship will incur either cash or opportunity costs for those ACs which do not undertake those duties at present. However, some of this increased AC activity will reduce the burden on FDs. We estimate that a 10 per cent increase in AC workload would cost approximately £3 million if there were no benefits to FDs. We have estimated the upper bound of costs for these three remedies at £8 million and, including those remedies for which we are not able to estimate the cost, we do not believe the total cost of our remedies package to exceed £10 million a year.

51. On the other hand we consider that the benefits of our remedy package are considerable. In our judgement, we think that an increase in competition and a refocusing of competition towards shareholder demand should increase audit quality and have important beneficial effects on shareholder value. We place considerable weight on the resultant public benefits for the UK economy. An audit market in which shareholders can have increased confidence will assist in promoting the UK's corporate governance regime as a centre of excellence and will encourage investment in UK companies. It is not feasible to quantify the size of such benefits with precision, however, in our considered judgement, they are likely to exceed the costs of our remedy package by a substantial margin.

52. In view of the above considerations, we decided that our package of measures represents as comprehensive a solution as is reasonable and practicable to the AEC and the resulting detrimental effect on customers that we found.

Findings

1. The reference

1.1 On 21 October 2011, the OFT, in exercise of its powers under sections 131 and 133 of the Act, made a reference to the CC for an investigation into the supply of statutory audit services to large companies in the UK. Under the terms of reference, 'statutory audit services' means an audit conducted by a person appointed as auditor under Part 16 of the Companies Act, while 'large companies' means companies that may be listed from time to time on the London FTSE 100 and FTSE 250 indices.[5]

1.2 Our statutory remit was therefore to assess competition in the market or markets for the provision of statutory audits to large companies. We were required to determine whether any feature or combination of features of each relevant market 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.[6] Any such prevention, restriction or distortion of competition, amounts to an AEC.[7] We elaborate on this in paragraphs 8.1 to 8.6.

1.3 The full text of the reference is set out in Appendix 1.1, together with a description of the steps we have undertaken in the course of our investigation. We had to report by 20 October 2013. These are our findings.

2. Our evidence and its use

2.1 We sought evidence by various means to inform our inquiry.

Case studies

2.2 We initially selected ten companies for case studies. We also conducted interviews with two investors who each invested in a majority of the case study companies and collectively invested in all ten case study companies. Prior to selecting our subjects, we published a notice that set out how we intended to select case study subjects, inviting comments from interested parties. We were interested in the experience of large companies concerning competition in the provision of statutory audits. We received nine responses to our notice. We conducted interviews with the FD (or equivalent), the Audit Committee Chair (ACC) and the Audit Engagement Partner (AEP) for each company. For some of the case studies, we also interviewed the AEP of the company's previous auditor or the previous ACC of the company. In total we conducted 37 interviews. Following publication of our provisional findings, we conducted further case studies, interviewing 13 new companies and holding further interviews with one of our initial case study companies.

2.3 The cases studies are at Appendix 2.1 in anonymized form: the company names have been replaced with letters. We refer to them (using the allocated letters) throughout these findings, and take them to be illustrative rather than representative.

[5] We refer to those collectively as the 'FTSE 350'.
[6] See section 134(1) of the Act.
[7] As defined in section 134(2) of the Act.

Surveys

2.4 We engaged a market research agency (IFF Research) to carry out a survey to collect information from decision makers (ie FDs and ACCs) at companies which were subject to a statutory audit regarding, but not limited to: the relationship they had with their auditor; how the auditor was selected; why they might switch auditor in the future; and what constituted quality in terms of the statutory audit (we refer to this survey as our 'first survey'). We also engaged the market research agency to conduct a follow-up survey with ACCs who had indicated in the first survey that they did not mind being contacted again (we refer to this survey as our 'follow-up survey').

2.5 The surveys and key statistics are at Appendices 2.2, 2.3 and 2.4, and we refer to them as necessary.

Hearings

2.6 In addition to the 37 interviews held as part of the case studies, we held hearings with ten auditors during the course of the investigation, and with twelve other interested stakeholders such as investors. Hearing summaries are published on our website.

Public data set

2.7 In order to capture an accurate record of publicly available data on listed and unlisted companies such as turnover, assets etc, we discussed with parties options to create an appropriate data set. Parties submitted a proposal to construct a common data set of companies that were members of the FTSE 350 in the period 2001 to 2011. This was then extended to cover companies in the Top Track 100 in the period 2006 to 2011. We undertook a comprehensive processing and cleaning exercise to ensure that the data set was as accurate as possible in the time available to construct it. The final record was published on our website.

2.8 We recorded for each company in each quarter whether it was in the FTSE 100 index, FTSE 250 index, listed but not in the FTSE 350 index or whether it was privately owned. When we refer to 'private companies' in this document we therefore refer to companies that were either in the Top Track 100 in the period 2006 to 2011 or were selected on the basis of being part of the FTSE 350 at some point in the period 2001 to 2011 but were also privately held at some point in that period (ie we are not referring to all private companies).[8]

Information requests

2.9 We issued detailed information requests to the main parties and client data requests to all UK audit firms that audited a FTSE 350 or Top Track 100 company in the period 2006 to 2011. This included 15 audit firms in total. The data request was developed following a series of data meetings with audit firms to ensure consistency in the data that could be provided.

2.10 Following the publication of our Notice of possible remedies, we sent a questionnaire to a selection of 43 investors and shareholder representatives. The purpose of the questionnaire was to solicit the views of investors on the remedies that we had outlined.

[8] See also Appendix 2.5.

Submissions

2.11 We received submissions from interested parties (either own-initiative, or in response to documents we published, such as our issues statement or working papers), and have published non-confidential versions on our website.

Academic research

2.12 We commissioned Professor Vivien Beattie of Glasgow University to conduct a review of academic literature relevant to the audit market.[9] We also commissioned Cardiff Business School to assist us in considering the prevalence of clauses in loan agreements that specify the auditor that a borrower may engage (see Appendix 2.6).

2.13 We draw on these sources of information as appropriate throughout, and have aimed to balance evidence where it conflicted. We note that, to a greater extent than in many market investigations, the nature of the evidence base we could use meant that clear-cut distinctions between competing explanations for a number of issues were hard to determine. In these situations, we applied our judgement on the weight to be attached to the evidence relied on to reach our findings, having regard to all the evidence available, to the applicable standard, namely the balance of probabilities.

2.14 We noted Deloitte's submission that we should not systematically err on the side of finding a concern in circumstances in which it would be appropriate for us to give market participants the benefit of the doubt,[10] which we took to mean that we should weigh all evidence appropriately.[11] We also considered carefully PwC's submission that we had made serious errors in evaluating primary facts.[12] However, we were also aware of the perspectives that various parties had in making submissions, and took them into account where appropriate as we assessed the weight to attach to available evidence.

3. An introduction to the legal framework for statutory audit services

3.1 In order to establish the legal framework within which statutory audit services are supplied, this section describes:

(a) companies' and directors' duties to prepare accounts (paragraphs 3.3 to 3.8);

(b) who must commission an audit (paragraphs 3.9 and 3.10);

(c) who may supply an audit and their functions (paragraphs 3.11 to 3.16);

(d) auditors' duties and what amounts to 'audit failure' (paragraphs 3.17 to 3.24);

(e) the role of the AC (paragraphs 3.25 to 3.27);

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[9] www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/initial_review_of_relevant_academic_literature_in_the_audit_market.pdf.

[10] Deloitte response to provisional findings, paragraph 6.2.

[11] Since our findings are based on the balance of probability standard, 'benefit of the doubt' is a concept that does not, in a strict sense, apply.

[12] In particular, PwC said that there were many instances in the provisional findings where the CC exercised its judgement to support its two theories of harm where: *(a)* where there was no clear evidence available but the CC nonetheless relied on supposition to reach clear and definitive provisional conclusions; *(b)* the CC evaluated the evidence selectively and inconsistently, relying on a source of evidence where it supported the two theories of harm but dismissing alternative explanations of the same evidence that points to the market functioning effectively and ignoring evidence that clearly points in favour of the pro-competitive explanation; and *(c)* broad findings were supported only by a small number of parties, yet other views that suggest the market working effectively have been ignored or discounted. See PwC response to provisional findings, paragraph 2.26.

(f) the regulatory supervision of auditors (paragraphs 3.28 to 3.34); and

(g) auditing as just one part of corporate governance (paragraph 3.35).

3.2 Appendix 3.1 contains a more detailed description of the legal and regulatory framework.

Companies' and directors' duties to prepare accounts

3.3 Companies must keep accounting records which disclose with reasonable accuracy at any time the financial position of the company at that time.[13] These records must contain entries of all sums of money received and expended by the company, a record of the assets and liabilities of the company and statements of any stock held by the company at the end of each financial year.[14]

3.4 The directors of every company must prepare 'individual accounts' for the company (unless it is exempt) for each of its accounting years.[15] In preparing these financial statements, the directors are required to:

(a) select suitable accounting policies and then apply them consistently;

(b) make judgements and accounting estimates that are reasonable and prudent; and

(c) state whether the accounts have been prepared in accordance with International Accounting Standards (IAS) or in accordance with section 396 of the Companies Act .

3.5 The directors of a company must not approve accounts unless they are satisfied that they give a true and fair view of the assets, liabilities, financial position and profit or loss of the company, or (in the case of group accounts) of the undertakings included in the consolidation as a whole.[16]

3.6 IFRS International Accounting Standard 1 'Presentation of Financial Statements'[17] requires executive management to make an assessment of 'going concern' (ie that the company is able to pay its debts as they fall due over the 12 months following the reporting date) and prepare the company's financial statements on that basis.[18]

3.7 The Companies Act requires the preparation of a Directors' Report, which is included with the annual report and financial statements,[19] and all non-small companies must prepare a business review of how the directors have promoted the success of the company, which includes a 'fair review of the company's business' and 'a description of the principal risks and uncertainties facing the company'.[20] The FRC interprets this to require a statement of whether a company is a going concern.[21]

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[13] Section 386(2)(b) of the Companies Act.
[14] Section 386(3) of the Companies Act.
[15] Section 394 of the Companies Act as amended by the Companies and Limited Liability Partnerships (Accounts and Audit Exemptions and Change of Accounting Framework) Regulations 2012 (SI 2012/2301).
[16] Section 393 of the Companies Act.
[17] IAS 1, paragraph 25. http://eifrs.ifrs.org/eifrs/bnstandards/en/2012/ias10.pdf (registration required)
[18] International Accounting Standards form part of the IFRS suite of standards.
[19] Section 415 of the Companies Act.
[20] Section 417 of the Companies Act .and SI 2008/410, Schedule 7.
[21] Financial Reporting Council, Going Concern and Liquidity Risk: Guidance for Directors of UK Companies 2009.

3.8 Directors have additional obligations for accounts under the UK Listing Authority's Listing Rules (Listing Rules) and Disclosure and Transparency Rules. In particular, the directors must state explicitly that the business is a going concern, together with supporting assumptions or qualifications.[22]

The obligation to commission an audit

3.9 Companies have a duty to commission statutory audits each financial year.[23] The Companies Act defines a statutory audit[24] as an audit conducted by a person appointed as a statutory auditor, that is to say an audit conducted by a person appointed by a company[25] in accordance with the provisions of the Companies Act or other specified legislation (see Appendix 3.1, paragraph 14). The appointment or reappointment is usually made formally by the shareholders by ordinary resolution in the annual general meeting. Shareholders may also dismiss an auditor at any time by passing an ordinary resolution at a general meeting.

3.10 An auditor of a public company holds office as auditor for one year only. The auditor may then be reappointed for a further period of one year upon passing of a resolution by the shareholders.[26] This process of annual reappointment may be repeated in each subsequent year until the directors propose appointment of a different auditor.

The auditor and auditing functions

3.11 An individual or audit firm[27] is eligible to be appointed as a statutory auditor if the individual or audit firm is a 'fit and proper person',[28] who is a member of a recognized supervisory body (see paragraph 3.33) and is eligible for appointment under the rules of that body.[29]

3.12 The two main functions of a statutory auditor are: *(a)* to obtain audit evidence and conduct an audit in accordance with International Standards on Auditing (UK and Ireland); and *(b)* make a report to the company's shareholders on the annual accounts of the company identifying the financial reporting framework and the auditing standards that have been applied and, in particular, expressing an opinion on whether the annual accounts give a true and fair view of the state of affairs of the company at the end of the financial year, and of the profit or loss of the company for the financial year. This report must be laid before the company in a general meeting in the case of a public company.

3.13 An auditor has a general right of access to information for the purpose of preparing this report. This includes a right of access to the company's books, accounts and

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[22] Listing Rules 9.8.6R(3).
[23] Under section 475 of the Companies Act, as modified in the case of limited liability partnerships by article 33 of the Limited Liability Partnerships (Accounts and Audit) (Application of Companies Act 2006) Regulations 2008 (SI 2008/1911). Until 6 April 2008, the duty was on an auditor to audit the accounts, not on the company. An exemption from the duty to commission an audit is available for certain companies—dormant companies, certain subsidiaries and small companies that qualify and do not exceed certain turnover and balance sheet thresholds—see Appendix 3.1, paragraph 15.
[24] Section 1210(1) of the Companies Act.
[25] Under section 485 (private companies) or section 489 (public companies) of the Companies Act.
[26] Section 491(1)(b) of the Companies Act.
[27] For these purposes, 'firm' means any entity, whether or not a legal person, which is not an individual, and includes a body corporate, a corporation sole and a partnership or other unincorporated association: section 1261(1) of the Companies Act.
[28] Schedule 10, paragraph 8, of the Companies Act.
[29] Individuals who have retained Companies Act 1967 authorization, but are not otherwise eligible for appointment, may only audit an unquoted company (section 1222 of the Companies Act) in the cases to which the Companies Act section 1222 applies (individuals retaining only Companies Act 1967 authorization).

vouchers and a right to require any officer or employee of the company to provide such information or explanation as the auditor thinks necessary.[30]

3.14 The report must state clearly: *(a)* whether in the opinion of the auditor the annual accounts give a true and fair view of the state of the company's affairs and of its profit or loss as at the end of the financial year of the company; and *(b)* whether in the opinion of the auditor the accounts have been properly prepared in accordance with the relevant financial reporting framework, the requirements of the Companies Act and, where applicable, Article 4 of the International Accounting Standards Regulation.[31] This opinion must cover the 'going concern' statement provided by the directors (see paragraph 3.8).

3.15 The auditor's report includes an opinion on the financial statements which must be either unqualified or qualified, and must include a reference to any matters to which the auditor wishes to draw attention by way of emphasis without qualifying the report.[32] 'Qualified'[33] means that the report does not state the auditor's unqualified opinion that the accounts have been properly prepared in accordance with the Companies Act.

3.16 If the auditor is of the opinion that: *(a)* adequate accounting records have not been kept; or *(b)* the company's individual accounts are not in agreement with the accounting records and returns, then that fact must be stated in the report.[34] If the auditor is of the opinion that the accounts are not in agreement with the accounting records, or if the auditor fails to obtain the information and explanations needed for the audit, this must be stated in the report.[35] The auditor must also state if the requirements[36] as to disclosure in the accounts of directors' benefits, remuneration, pensions and compensation for loss of office are not complied with, or requirements[37] are not complied with as to information concerning the auditable part of the directors' remuneration report.

Auditors' duties and audit failure

3.17 The substance of an auditor's role and to whom the auditor owes a duty have been considered by the courts. The legal position is that the duties of an auditor are founded in contract and the extent of the duties undertaken by contract must be interpreted in the light of the relevant statutory provisions and the relevant Auditing Standards. The duties are duties of reasonable care in carrying out the audit of the company's accounts. They are owed to the company in the interests of its shareholders. No duty is owed directly to the individual shareholders. This is because the shareholders' interests are protected by the duty owed to the company.[38]

3.18 Case law shows that the auditor must do more than check the arithmetical accuracy of the balance sheet. Lord Denning said:

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[30] Section 499 of the Companies Act.
[31] Section 495 of the Companies Act.
[32] ISA 705 uses the term 'modified' not 'qualified', and establishes three types of modified opinion: qualified opinion; adverse opinion; and disclaimer of opinion. Where the auditor expresses a qualified opinion due to a material misstatement in the financial statements, ISA 705 requires the auditor to state that in the auditor's opinion, except for the effects of the matters described, the financial statements give a true and fair view or have been prepared in all material respects in accordance with the applicable financial reporting framework.
[33] Section 539 of the Companies Act.
[34] Section 498(2) of the Companies Act.
[35] Section 498 of the Companies Act.
[36] Under section 412 of the Companies Act.
[37] Under section 421 of the Companies Act.
[38] *Moore Stephens (a firm) v Stone Rolls Limited (in liquidation) [2009] 1 AC 1391,* Lord Phillips of Worth Matravers.

> An auditor is not to be confined to the mechanics of checking vouchers and making arithmetical computations. … His vital task is to take care to see that errors are not made, be they errors of computation, or errors of omission or commission, or downright untruths. To perform this task properly, he must come to it with an inquiring mind—not suspicious of dishonesty, I agree—but suspecting that someone may have made a mistake somewhere and that a check must be made to ensure that there has been none.[39]

3.19 The auditor must conduct the audit in such a way as to make it probable that material misstatements in financial documents will be detected.[40]

3.20 ISA 200 describes the level of assurance that an audit provides as 'reasonable assurance':

> Reasonable assurance is a high level of assurance. It is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk (that is, the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated) to an acceptably low level. However, reasonable assurance is not an absolute level of assurance, because there are inherent limitations of an audit which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor's opinion being persuasive rather than conclusive.[41]

3.21 Accordingly, while the conditions of legal liability or of a breach of applicable regulations are defined, there does not appear to be a generally accepted definition of 'audit failure'. In terms of legal culpability, audit failure occurs where financial statements are not free from material misstatements as a result of fraud or error and that error has not been identified by the auditor. Whether the auditor may be liable for any such failure is determined under the principles set out in paragraphs 3.17 to 3.19.

3.22 However, even if there is no question of legal liability, where a company discovers that its reported accounts are 'wrong', then it must issue a restatement.[42] It became apparent to us (during the course of our case study hearings and hearings with audit firms) that all parties (whether auditor, FD or AC) were highly motivated to avoid such restatements. While they might prove necessary for purely technical reasons (as happened at Company H[43]), restatements must always be explained, generally arouse suspicion, and may cause adverse effects on share prices (at least in the short term). In more significant cases, they publicly reveal weaknesses in a company's control systems or more substantial problems (as happened at Company A[44]). From our discussions with investors, it became apparent that they were wary of change and did not like surprises, and a restatement could amount to both.

3.23 Even where no restatement proves necessary, a user of a set of financial statements may have expectations regarding the accuracy of those financial statements. The role of the auditor is to provide reasonable assurance that accounts are free of material errors, therefore as part of planning and performing an audit, auditors must

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[39] *Fomento (Sterling Area) Limited v Selsdon Fountain Pen Co Ltd [1958] 1 WLR 45 (HL)*, p61.
[40] *Barings plc v Coopers & Lybrand [1997] 1 BCLC 427*, CA, Leggatt LJ.
[41] International Standard on Auditing (UK and Ireland) 200 – Overall objectives of the independent auditor and the conduct of an audit in accordance with International Standards on Auditing (UK and Ireland), paragraph 5.
[42] Under section 454 of the Companies Act and IAS 10: http://eifrs.ifrs.org/eifrs/bnstandards/en/2012/ias10.pdf. (registration required)
[43] Appendix 2.1, Company H, paragraphs 42 & 43.
[44] Appendix 2.1, Company A, paragraphs 27, 28, 117–119.

establish a suitable level of materiality.[45] However, users of the financial statements may not appreciate the nature of materiality or the legal and regulatory requirements of audit and may expect audited financial statements to be completely free of error.[46] Any difference between a user's expectation of the nature of an audit and the audit in practice has been referred to as the 'expectation gap'. We consider this issue further in paragraphs 7.226 to 7.264, where we assess if there is a demand from shareholders that is not currently met by audit.

3.24 The financial statements should present the financial performance and position of a company accurately not only at the reporting date, but also taking into account information that becomes available before the financial statements are authorized for issue by the board.[47] However, events may occur after the reporting date or the date that the financial statements are authorized for issue. In such circumstances, users' perceptions of the accuracy of the financial statements and the perceived quality of the audit may be affected if these events are not reflected in the financial statements. As a result, the expectation gap may lead to a perception of audit failure if users of the financial statements expect that the auditor should have either detected or foreseen such events. Examples occurred during the 2008 banking crisis where companies with audited accounts (which included 'going concern' statements) subsequently needed bailing out.

The Audit Committee

3.25 ACs were first proposed by the Cadbury Report on corporate governance in 1992.[48] The Cadbury Report considered that the benefits of ACs, if operated effectively, would include strengthening the position of the external auditor, by providing a channel of communication and forum for issues of concern and providing a framework within which the external auditor can assert his independence.[49] Since 1994, the Listing Rules have required listed companies to appoint an AC or to explain why they do not have one.

3.26 The AC consists of a group of non-executive directors drawn from the board of a company, and is chaired by one of them, the ACC. According to guidance produced by the FRC (see paragraphs 3.28 to 3.31), while all directors have a duty to act in the interests of the company, the AC has a particular role, acting independently from the executive, to ensure that the interests of shareholders are properly protected in relation to financial reporting and internal control.

3.27 The AC is responsible for (among other things) making recommendations to the board as to the appointment and reappointment of external auditors, monitoring the effectiveness of the external audit process and reviewing the independence and objectivity of external auditors (with particular regard to external auditors supplying NAS). Appendix 3.1 provides further details on the role of ACs, and we return to the issue of the role of ACs in Sections 9 and 11.

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[45] ISA (UK&I) 320 'Materiality in planning and performing an audit' states that an error is considered material if it could 'reasonably be expected to influence the economic decisions of users'.
[46] ISA (UK&I) 320 'Materiality in planning and performing an audit' states that an auditor is able to assume that users of financial statements understand that they are audited to a level of materiality.
[47] Such information may affect the assumptions used in accounting estimates. For example, if a court case relating to events before the reporting date concludes after the reporting date but before the financial statements are authorized for issue, the value of any provision or disclosed contingent liability relating to the case would need to be amended. How such information should be used is governed by IAS 10 'Events after the reporting period'.
[48] *Financial Aspects of Corporate Governance* (December 1992). The report recommended that companies should establish an AC, comprising at least three non-executives.
[49] *Financial Aspects of Corporate Governance* (December 1992). Appendix 2.3, item 4.

Regulatory supervision of auditors

Financial Reporting Council

3.28 The FRC is the UK's independent regulator responsible for promoting high-quality corporate governance and reporting in order to foster investment. It has statutory and non-statutory responsibilities, in relation to audit. See further Appendix 3.1, paragraphs 145 to 201.

3.29 The executive functions and objectives of the FRC are carried out by two divisions: Codes and Standards, and Conduct. Both carry out work relevant to this investigation.

3.30 The FRC's Codes and Standards Division develops and maintains standards and guidance for Audit and Assurance engagements which are performed in the public interest within the UK and Republic of Ireland. It also seeks to influence the development of international auditing and assurance standards and policy developments that are relevant to its remit.

3.31 The FRC's Conduct Division undertakes a number of activities relevant to auditors:

(a) The AQR team (formerly known as the Audit Inspection Unit)[50] monitors the quality of the audits of listed and other major public interest entities and the policies and procedures supporting audit quality at the major audit firms in the UK.

(b) The FRC is the independent disciplinary body for accountants and accountancy firms (including auditors and audit firms) in the UK. Its Professional Discipline team deals with cases of potential misconduct which raise or appear to raise important issues affecting the public interest in the UK.

(c) The Professional Oversight team has a number of statutory responsibilities delegated to the FRC by the Secretary of State for Business, Innovation and Skills, and by agreement with the six chartered accountancy bodies (see below), the team also exercises independent oversight of the regulation of the accountancy profession by the professional accountancy bodies.

The professional accounting bodies

3.32 Accountancy as such is not subject to statutory regulation in the UK and there are a large number of private bodies that represent and regulate groups of accountants.

3.33 Audit firms which wish to be appointed as a statutory auditor in the UK must be registered with, and supervised by, a Recognised Supervisory Body.[51] The Recognised Supervisory Body must have procedures in place to register and de-register statutory auditors and supervise work undertaken by these individuals and firms, and to this end it carries out four main tasks: audit registration; audit monitoring; arrangements for the investigation of complaints; and procedures to ensure that those eligible for appointment as statutory auditor continue to maintain an appropriate level of competence. See further Appendix 3.1, paragraphs 207 to 210.

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[50] Throughout these findings we use the term AQR team, even if at the relevant time it was still the AIU.
[51] These are the: Association of Chartered Certified Accountants (ACCA); the Association of Authorised Public Accountants (AAPA) (now part of the ACCA); the Institute of Chartered Accountants in Ireland (CAI); the Institute of Chartered Accountants in England and Wales (ICAEW); and the Institute of Chartered Accountants of Scotland (ICAS).

3.34 Individuals responsible for audit at registered firms must hold an audit qualification from a Recognised Qualifying Body, which award the qualifications necessary to undertake audit work.[52] Under the procedures followed by ICAEW, ICAS and CAI, an individual who wishes to undertake audit work must hold an audit qualification and be approved as a 'Responsible Individual'. See further Appendix 3.1, paragraph 209.

Auditing is just one part of corporate governance

3.35 We note that the requirement for a statutory audit operates in conjunction with other legal and regulatory provisions concerned with promoting effective corporate governance and trust and confidence in financial reporting and markets. For example, Listing Rules and insider trader regulations seek to prevent the existence and exploitation of privileged access by existing shareholders, executive management and others to information on the future prospects of the company. The FRC publishes the UK Corporate Governance Code which sets out standards of good practice in relation to board leadership and effectiveness, remuneration, accountability and relations with shareholders (further detail is contained in Appendix 3.1, paragraphs 238 to 245, and its Annexes B and C).

3.36 We consider that the greater the trust and confidence in financial reporting and markets, the more effective will be the corporate governance of companies leading to greater productivity and a lower cost of capital for companies operating within our reference market. We return to this issue in paragraphs 14.20 to 14.23.

4. The suppliers of statutory audit services

4.1 Having set out what an audit is (in legal terms) in Section 3, this section introduces the main suppliers of statutory audit services to large companies. It describes:

(a) the audit firms and their international networks (paragraphs 4.4 to 4.11); and

(b) how the market consolidated (paragraphs 4.12 to 4.22).

4.2 Appendix 4.1 provides a brief portrait of each of nine larger audit firms which have provided statutory audit services to large[53] listed companies in the UK in turn: Baker Tilly UK Holdings Ltd[54] (Baker Tilly), BDO LLP (BDO), Deloitte LLP (Deloitte), Ernst & Young LLP (EY), Grant Thornton UK LLP (GT), KPMG LLP (KPMG), Mazars LLP (Mazars), PKF (UK) LLP (PKF) and Pricewaterhouse Coopers LLP (PwC).

4.3 We refer to Deloitte, EY, KPMG and PwC as 'the Big 4 firms', and the others in this list as the 'Mid Tier firms', although other audit firms may be of similar competitive strength to some of these non-Big-4 firms.

The audit firms and their international networks

4.4 Eight of the UK member audit firms discussed here are incorporated as Limited Liability Partnerships (LLPs). The exception, Baker Tilly, operates through a group of companies limited by shares and LLPs, with the audit function contained within a specialist LLP. An LLP is a body corporate and is much like a company limited by

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[52] There are currently five: ACCA, ICAEW, CAI, and ICAS and the Association of International Accountants (AIA).
[53] By 'large' in this context we are including a wider group of companies than just FTSE 350 companies (Mazars has not audited a FTSE 350 company in the last five years) and we are not using the definition of large companies set out in our terms of reference .
[54] Statutory audit is provided by Baker Tilly UK Audit LLP.

shares, but rather than being owned by shareholders it is owned by its members (partners).[55] A partnership or members' agreement will also usually state the method by which profits will be distributed among the partners.[56] Under UK law, a member of an LLP can be an individual, a company or another LLP.

4.5 The Big 4 firms are members of international networks of broadly similar scale. In 2011 each operated in approximately 150 territories, comprising and employing between 145,000 and 182,000 partners and staff in total, and their combined global revenues ranged between £14,500 million and £18,500 million. The individual networks and their UK audit firms are compared in Table 4.1 below. The member firms of the networks share a name, brand, a commitment to audit quality standards and common methodologies but member firms remain legally separate, and are typically independently owned and controlled. Member firms are brought together by common membership of a central network body or entity. The EY network differs through its greater level of 'global integration' from other Big 4 firms (see Appendix 4.1).

4.6 Most of the other larger audit firms (Baker Tilly, BDO, GT and PKF) are also members of networks (Mazars by contrast has adopted a global 'integrated partnership').[57] The legal structure of these networks is broadly similar to those of the Big 4 firms. In 2011 these networks had member firms in between 69 and 135 countries.[58] The number of staff and partners employed globally by these networks ranged from 13,000 to 49,000 and their combined global revenues ranged between £815 million and £3,573 million. The individual networks and their UK firms are compared in Table 4.1 below.

4.7 For all of the audit firms covered by this section, there is a central coordinating entity (the 'network body').[59] Seven of the nine network bodies are incorporated in the UK as companies limited by guarantee.[60] Individual national firms become members of the network by being members of the network body (or by contract). The relationship between the member firms and the network will be determined by a legal agreement between each member and the network body, as well as the constitutional documents of the network body. Pursuant to these documents member firms agree to be bound by policies set by the network body. Some networks have different types of member firm. The terminology used to describe the different types of membership differs in each firm. In all of the nine networks discussed in this section, the UK firm is a full member of the network, and is subject to all of the network's policies, branding, methodology and quality assurance requirements. Other national firms, particularly in developing markets, may be 'affiliate firms' which carry out audit work on behalf of the member firms, but which may not necessarily be subject to the full policies of the network. There is variation between networks regarding the number of territories covered by networks rather than affiliate firms.

4.8 There is no pooling of profits at an international level with the exception of Mazars, and to a small extent KPMG UK. The amount paid to the network body by each

[55] The nature of being a 'member' in a company limited by guarantee and in an LLP differs on the point of ownership.
[56] The actual remuneration received by each partner in the firms is based on a number of elements such as the nature of the portfolio and responsibility held, as well as a performance assessment based on a 'balanced scorecard', and will be subject to review by a remuneration panel of some form.
[57] Mazars is included in the comparisons of networks.
[58] Mazars' integrated partnership is arranged around a central network entity, Mazars SRCL. In each country there will be a separate legal entity, which is owned by its partners. These local firms have signed a cooperation agreement with Mazars SRCL. The members (partners) of a firm will also be members of Mazars SRCL. The majority of Mazars UK partners are partners of Mazars SRCL, and these partners share profits with other partners globally; Mazars member firms are also members of the Praxity alliance of independent firms, which provides additional coverage.
[59] In this report, 'the network body' refers to the central entity that coordinates and provides services to firms.
[60] KPMG International is a Swiss Cooperative, which is the equivalent of a Company Limited by Guarantee, and Mazars SCRL is similarly the Belgian equivalent.

member firm to fund the network body's running costs is based on the level of revenue that a member firm generates.

The UK firms in context

4.9 Table 4.1 shows that the UK firms each generate revenues that equate to between 8 and 16 per cent of the aggregate revenues of the member firms of their respective networks. With the exception of the Mazars network, the US member firms are significantly larger, generating approximately 30 per cent of revenues received by member firms.[61]

TABLE 4.1 **UK firms and networks, 2011**

	Baker Tilly	*BDO*	*Deloitte*	*EY*	*GT*	*KPMG*	*Mazars*	*PKF*	*PwC*
Revenue:									
Global (£m)	1,900	3,573	18,270	14,520	2,331	14,400	815	1,521	18,520
—UK (£m)	179	280	2,098	1,465	377	1,707	109	108	2,461
—UK significance (%)	9.4	7.8	11.5	10.1	16.1	11.9	13.4	9.4	13.3
Number of staff:									
—Global	25,000	48,767	181,566	152,000	30,000	145,000	13,000	15,000	161,000
—UK	1,844	2,615	12,761	10,800	3,692	11,230	1,209	1,500	17,079
International presence:									
—Countries	120	135	153	146	100	152	68(+14)	125	154

Sources: Annual reports for UK firms and International Network; corporate websites.

Notes:
1. Global revenues are converted to GBP using average interbank (EUR or USD)/GBP exchange rate for the 12 months to 31/5/12 and are for a general indication of the scale of the UK firm.
2. Mazars is part of the Praxity alliance, which has some geographic overlap with Mazars and provides a presence in a number of additional countries and also a greater presence, in some countries, such as in the USA where Mazars and other Praxity firms have formed joint ventures.
3. The geographic coverage of individual firms varies, particularly with respect to Northern Ireland, the Channel Islands, the Isle of Man and non-UK/British Isles subsidiaries.
4. In the KPMG network, KPMG Europe LLP (and its constituent member firms) is larger than the US member firm.
5. BDO and PKF have merged in the UK and member firms of the two networks have also agreed similar mergers in other territories.

4.10 Table 4.2 shows a breakdown of the source of statutory audit revenue, with the four largest UK firms deriving between [✂] and [✂] per cent of their statutory audit revenue from FTSE 350 audit clients, whilst the other firms derived between [✂] and [✂] per cent of their statutory audit revenue from the FTSE 350.

TABLE 4.2 **Statutory audit revenue, 2011**

£'000

	Baker Tilly	*BDO*	*Deloitte*	*EY*	*GT*	*KPMG*	*Mazars*	*PKF*	*PwC*
FTSE 100	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
FTSE 250	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Other	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Total	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Proportion of audit revenue from FTSE 350 (%)	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]

Source: 'Other Business Info' submitted by parties.

Note: Baker Tilly did not supply information in the format requested. In 2011, Baker Tilly had no FTSE 350 clients.

[61]Source: review of US firms' corporate websites. Mazars UK is the second largest firm in the network after Mazars France.

4.11 The networks via their member firms serve a number of large, international clients and audit work relating to subsidiaries of these clients may be undertaken on behalf of the group auditor by other member firms in the same network.[62] Member firms generate referred income as a result of another member firm winning the group audit.[63]

The emergence of the Big 4 firms

Networks

4.12 The international networks of the current UK firms emerged from the late 19th century through two routes:[64]

(a) Organic expansion. This was a strategy used by Price Waterhouse (established in the UK) and Arthur Andersen (established in the USA). Each firm established new, legally separate partnerships in overseas territories which were then used to service the international needs of their overseas clients. Price Waterhouse also acquired small pre-existing firms in overseas territories, which were managed by expatriate Price Waterhouse partners.

(b) Acquisition and strategic alliances with pre-existing audit firms. Audit firms in different countries formed alliances to facilitate cooperation on behalf of their respective clients by providing international coverage without the need to finance permanent overseas operations. As each would service the other's clients on an agency basis, this was mutually beneficial. Over time the two firms might create an international network.

Merger activity—international networks and effect on the UK

4.13 Over the course of the 20th century, international networks developed. By the 1980s, there were eight networks that were recognized as being larger than any others and were referred to as the 'Big 8'. All had member firms in the UK.[65,66]

4.14 A merger of two networks would require the member firms of both networks in each country to agree to create a single firm in each territory, with a new set of network arrangements.[67] If a member firm in a territory chose not to merge, it would effectively be excluded from the network.[68]

4.15 The most significant period of merger activity began in 1987 with Peat Marwick strengthening its position as one of the eight large firms by merging with the relatively new European network of KMG.[69] Figure 4.1 provides an overview of the merger activity between the international networks beginning in this period.

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[62] For example, half of Deloitte's FTSE 350 audit fees are paid to overseas member firms to audit the subsidiaries of Deloitte's clients (Deloitte's non-confidential initial submission, p2).

[63] However, as noted in paragraph 4.18, when international networks have merged, such as Deloitte Haskins and Sells and Touche Ross, not all member firms have transferred into the combined network.

[64] See Figure 4.1 in paragraph 4.15 for an overview of merger activity from 1987 to 2002.

[65] The eight were Peat Marwick, Ernst & Whinney, Deloitte, Haskins & Sells, Arthur Young & Co, Touche Ross, Price Waterhouse, Coopers & Lybrand and Arthur Andersen. A significant element of the Arthur Andersen practice was devoted to servicing UK subsidiaries of US companies, rather than UK-owned companies.

[66] Deloitte was established in the UK in1845 and opened a New York office in 1880.

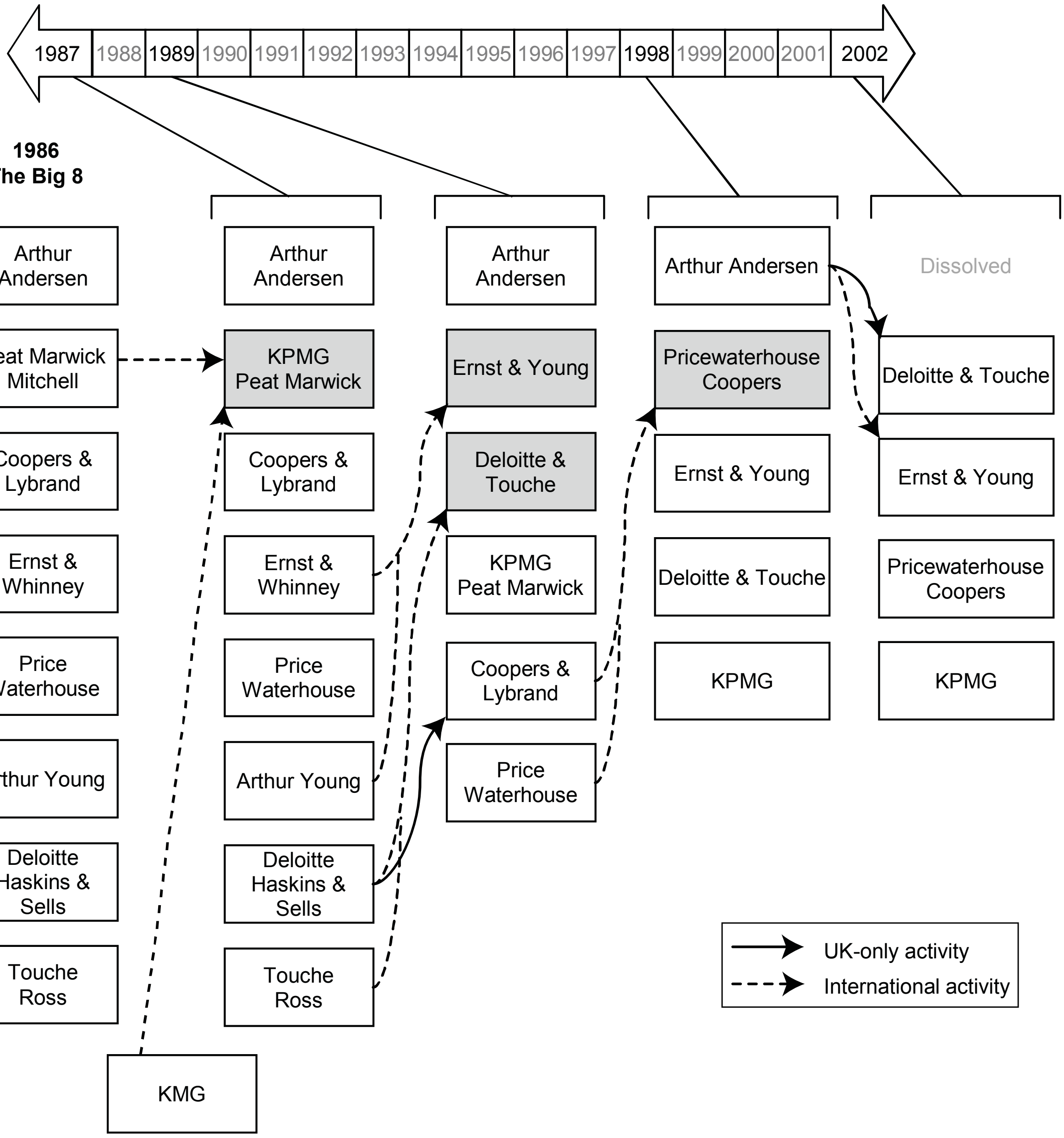
[67] Prior to the advent of LLPs in 2000, a merger of partnerships would essentially require a redrafting of a partnership agreement to decide on the respective value of capital introduced by each of the firms and the subsequent division of profit. There would not necessarily need to be any financial consideration paid.

[68] Deloitte in the UK joined Coopers & Lybrand rather than merge with Touche Ross into a combined network.

[69] KMG was not one of the Big 8.

FIGURE 4.1

Merger activity of international networks, 1987 to 2002



Source: Adapted from Figure 1, GAO, *Audits of Public Companies, 2008.*
Note: In the UK the member firm of the Deloitte network traded as Touche Ross between 1992 and 1996.

4.16 Most of the 'Big 8' international networks originated from a founding firm in the UK.[70] The Arthur Andersen, Arthur Young and Ernst and Whinney networks developed from a US base, expanding through their cooperation with pre-existing UK firms before continuing international expansion elsewhere.

[70] Ernst & Whinney resulted from a UK and a US firm cooperating, with the establishment of the UK firm pre-dating the US firm, Ernst & Ernst, by some 50 years.

4.17 Mergers between the 'Big 8' began in 1989 with the creation of the present day Deloitte network, followed a few months later by the EY network, creating a period in which there were the 'Big 6' firms, which lasted until 1998.[71]

4.18 The Deloitte & Touche network was formed from the merger initiated in the USA, of the firms of Deloitte, Haskins & Sells and Touche Ross. The merged international network was named DRT International (Deloitte Ross Tohmatsu International). Most of the member firms in both networks followed suit and merged their own practices in their domestic territory. However, several firms chose not to merge. The UK firm of Deloitte Haskins & Sells chose not to merge with the UK Touche Ross firm, but instead merged with Coopers & Lybrand (which initially traded as Coopers & Lybrand Deloitte, and did not drop 'Deloitte' from its name until June 1992). Touche Ross was not allowed to use the Deloitte name in the UK until 1 February 1996 when it was renamed Deloitte & Touche. The international network changed its name in 1992 from DRT International to DTTI (Deloitte Touche Tohmatsu International), and in 1998 to DTT (Deloitte Touche Tohmatsu). In September 1997, the international networks of Coopers & Lybrand and Price Waterhouse announced plans to merge, and as a result the member firms in each network (including in the UK) made preparations to merge. The European Commission began a merger inquiry.[72]

4.19 In October 1997, EY and KPMG announced plans to merge, apparently in reaction to the threat of a very large combined rival. A combined EY and KPMG would have been larger than the proposed merged Price Waterhouse/Coopers & Lybrand. However, the planned EY/KPMG merger was abandoned by the networks.

4.20 The Price Waterhouse/Coopers & Lybrand merger received approval from the European Commission, and the PricewaterhouseCoopers network was created.[73]

4.21 The last major structural change in the large company audit market occurred in the aftermath of the collapse of Enron in 2002 and the breakup of Arthur Andersen. The actions of Arthur Andersen, both in its audit procedures and subsequent actions (such as allegations of destruction of evidence), led clients to desert and member firms to leave the Arthur Andersen network. Initial discussions for Arthur Andersen member firms to join the KPMG network ultimately failed. Most international member firms of Arthur Andersen then joined the EY network, merging with local member firms. In the UK, however, Deloitte & Touche acquired the assets and some of the partners and staff of Arthur Andersen.[74]

4.22 The Baker Tilly, BDO, GT, Mazars and PKF networks have not been created as the result of any significant international merger activity between existing networks. Their geographic expansion has been driven by identifying independent firms in countries without a network presence to join the network, or creating new practices in those countries. However, they have been involved in UK mergers. On 7 November 2012, BDO and PKF announced that they intended to merge and operate under the BDO brand as part of the BDO International network and on 28 March 2013, BDO announced that the merger had been completed.[75]

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[71] Deloitte, EY, KPMG, Arthur Anderson, Coopers & Lybrand and Price Waterhouse.
[72] Case No IV/M.1016 – Price Waterhouse/Coopers & Lybrand.
[73] As part of its inquiry, the European Commission had considered the merger in conjunction with the KPMG/EY merger and its preliminary findings suggested that had the EY and KPMG merger not fallen through voluntarily, the proposed transactions together would be 'consistent with a hypothesis of collective dominance' (paragraph 110 of European Commission findings).
[74] The transaction was subject to European Commission scrutiny: http://ec.europa.eu/competition/mergers/cases/decisions/m2810_en.pdf.
[75] www.bdo.uk.com/press/bdo-and-pkf-merger-completes.

5. The economic function and characteristics of an audit

5.1 We have introduced the legal framework of audit (Section 3) and described the principal suppliers of statutory audit and how they emerged (Section 4). In order to understand how competition operates and may operate in the supply of statutory audit, this section sets out our view of:

(a) the economic function of audit (paragraphs 5.3 to 5.17);

(b) why audit services are regulated as they are (paragraphs 5.18 to 5.41); and

(c) the key characteristics of the supply of audit services (paragraphs 5.42 to 5.67).

5.2 These issues are key to understanding how competition in the supply of audit services works currently and how we think any AEC may have arisen, and so are necessary background to the theories of harm that we developed.

The economic function of audit

5.3 In large companies, shareholders delegate the management of the business to managers, in the form of executive directors. We think that the audit provides:

(a) shareholders with assurance on the reliability of the financial information prepared by management that shareholders require to monitor the performance of the business and its management; and

(b) management with a means of signalling to current and potential investors the quality and reliability of the information that it provides.

5.4 We consider both these demands in more detail below. In this final report, when we refer to 'management' we primarily mean the senior executive management which includes the Chief Executive Officer (CEO) (or equivalent) and the FD (or Chief Financial Officer (CFO)). While it is the directors of the company who have overall accountability for producing financial reports, in practice the FD (and his or her staff) are responsible for their production.

Shareholder demand

5.5 In our view, shareholder demand for audit arises mainly as a result of principal–agent issues, but that demand may be affected by freeriding. We explain what we mean by both terms in the next two subsections.

Principal–agent issues

5.6 An agency relationship arises when one or more persons (the principals) engage another person to act on their behalf (the agent). The shareholder–management relationship is an example of this: shareholders engage managers to act on their behalf. For such relationships to work well, the principal must be able to ensure that the agent acts sufficiently in the principal's best interests.

5.7 However, problems can arise where there is both a misalignment of interests, and there are information asymmetries (ie one party knows more than the other: typically the agent is better informed than the principal). A misalignment of interests is the term used to describe situations where an individual or organization has incentives to exploit a professional or official capacity in some way contrary to the interests of someone to whom it has obligations or duties. Where interests align, the agent will act in the principal's interests regardless of information asymmetries. Where there are no information asymmetries, the principal can effectively supervise the agent regardless of misaligned interests.

5.8 Misaligned interests and information asymmetries may give rise to two problems, 'moral hazard' and 'adverse selection'. Moral hazard problems arise from shareholders not being able to observe the actions of management (hidden actions) and where managers have the incentive to behave in ways that are undesirable for shareholders. Such problems may arise after a shareholder has invested in the company. An example could be an incentive for managers to engage in activities without shareholder approval that have the potential to generate higher returns for the manager but at a greater risk (perhaps not compensated by return) to the shareholder. Adverse selection problems arise where management is better informed than shareholders and has the opportunity to exploit this to its advantage. The problems arise before a potential investor has invested in a company. For example, potential shareholders may not be in a position to determine whether a company is being well or badly managed.

5.9 For individual shareholders, the potential detriment arising from a misalignment of interests and information asymmetries would be a reduction in the value of their investment arising from sub-optimal decision making or dishonesty by management. Problems regarding misaligned interests and information asymmetries depend on the extent of the misalignment or asymmetry. Neither issue is binary: either might be present to a greater or lesser extent.

5.10 Accordingly, shareholder demand for an audit arises from the likelihood that shareholder interests may not be well aligned with those of managers and managers can pursue their own interests as they are better informed than shareholders about the company (since managers are involved day-to-day while shareholders are necessarily more remote). It is in shareholders' interests to have reliable financial information about the company, so that they can accurately appraise its performance and that of its managers, and so take well-informed decisions.

Freeriding

5.11 Further, individual shareholders may rely on what they believe is the control on management exercised by other shareholders (ie to 'freeride'). This means that while each shareholder has an interest in monitoring the performance of the company and its management, none may have a sufficient individual interest to justify the time and costs required. In these circumstances, there is a danger that shareholders as a whole underinvest in monitoring management and/or the interests of large shareholders may be furthered at the expense of smaller ones (since large shareholders individually have more incentive to exercise control and may be better able to co-ordinate their efforts).

5.12 Incentives to freeride may be exacerbated by the highly fragmented ownership of shares in FTSE 350 companies. Rarely will one shareholder, or a small group of shareholders, have a controlling interest in the organization. The result could be that no shareholder has sufficient incentives to monitor the activities and performance of management, resulting in a less than desirable amount of effort expended by shareholders as a whole in the oversight of the company and its management.[76]

5.13 These principal–agent and freeriding problems may be mitigated by the mandatory provision of independent verification that assures shareholders that they can rely on the financial information provided by management in their monitoring of the activities and performance of managers: in other words, an audit.

Management demand

5.14 In this subsection, we explain why we think that company management can benefit from audit, and so create a demand for it.

5.15 Management also can benefit from an audit since it amounts to a mechanism by which shareholders can gain confidence in financial reports. Without such assurance, shareholders might be expected to anticipate principal–agent risks (ie that managers may act in their own rather than shareholders' interests). Accordingly, independently audited financial reports can contribute to management establishing a reputation for competence by allowing shareholders to assess more accurately the performance of a company and so, by implication, of its management.

5.16 Further, auditors in the process of carrying out an audit have contact with many individuals and scrutinize activities across the organization and, as a result, make observations and gain knowledge of the business. Although companies have internal audit functions and management can access internal information, some FDs or CFOs have described auditors to us as the 'eyes and ears' of senior managers, as they provided management with information or alerted them to issues that they discovered as they carried out their investigations.[77]

5.17 Accordingly, the management of the company may also gain from the reports that the auditor provides into the functioning of the company, provided as a by-product of the audit service. Further, they may benefit from the wider knowledge and experience provided by auditors, for example of how the company's procedures and practices compare with established best practice.

Why are audits regulated as they are?

5.18 Given the demand for audit we identified (in paragraphs 5.3 to 5.17) from shareholders and management stemming from the principal–agent problem, we considered why audits are regulated as they are, since if the demand was adequate, audit should be provided even without regulation.

5.19 The form of regulation regarding the preparation of accounts, the conduct of audits and the accounting profession generally has evolved since 1844 in relation to perceived shortcomings typically due to specific cases of corporate fraud and misreporting, and to take account of increases in international trade (see Appendix 5.1). The regulation of the provision of statutory audits has developed in terms of content, form, who may undertake audit, and how it is supervised (both internally in the company in terms of ACs, and externally in terms of the institutional architecture) (as detailed in Appendices 3.1 and 5.1).

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[76] These freerider problems do not arise with concentrated ownership, since the majority shareholders capture most of the benefits associated with their monitoring efforts. In these circumstances, the problem instead may be more one of dominant shareholders exercising control at the expense of minority investors.
[77] For example, see Appendix 2.1, Case study B, paragraph 39.

5.20 Regulation now requires that: the financial statements of certain companies are independently audited and published; and that the audit is conducted in accordance with specified principles and standards. In particular, this regulation specifies the duties and responsibilities of the auditor, management, ACs and shareholders; and the professional qualifications and conduct of auditors.

5.21 There appear to be three main reasons for such regulation:

(a) The risks of freeriding by shareholders (see paragraph 5.11) and adverse selection (see paragraph 5.26) of published and independently verified financial statements for publicly listed companies means that without such regulation there may not be sufficient investment in auditing.

(b) There are the broader benefits (ie public good elements) associated with the preparation and publication of audited financial statements that would not be taken into account if there were not such regulation (see paragraphs 5.29 to 5.38).

(c) Auditing financial statements in accordance with certain principles and standards gives substance to the obligation to undertake an audit and makes the assurance provided more valuable as financial statements of different companies are easier to compare (ie there are 'network benefits'—see paragraph 5.39).

5.22 However, the carrying out of an audit which aims to address one principal–agent problem (ie shareholders–managers) introduces another (shareholders–auditor). Certain corporate governance and regulatory provisions supplemented by professional standards are aimed at ensuring that auditors act in the interests of shareholders.

5.23 We develop these four points (namely the three reasons for regulation and the principal–agent problem introduced by audit) in turn.

Freeriding and adverse selection

5.24 The existence of the demands of shareholders and management described above suggests that auditing would exist absent regulatory requirements, since they both benefit from the independent verification of the financial performance of the company reported by management. Some types of audits are carried out on a voluntary basis, such as environmental audits.

5.25 As explained above (paragraph 5.11), in the case of public companies, small shareholders would have an incentive to freeride on the control on management exercised by other shareholders. This would include any investment that other shareholders may make in audit services. The problem is essentially one of coordination: while each shareholder has an interest in an audit being undertaken, none may have sufficient interest to justify its cost. Privately forging the agreement necessary to overcome this coordination problem may be very difficult if not impossible where there are a large number of shareholders. The result could be an underinvestment in the auditing of accounts.

5.26 Management might see the cost (financial and in terms of management time) of an audit as too high to justify the benefit to it, and would not adequately take into account the benefit to shareholders. Companies not commissioning audits (and so not incurring the relevant costs) might have a competitive advantage over those voluntarily commissioning audits (this is the adverse selection problem described in paragraph 5.8).

5.27 Accordingly we do not think that these demands would be sufficient to generate optimal levels of investment in the verification of financial reports and the output might not be considered trustworthy.

5.28 Further, without regulation, while shareholders and management could commission audits it would be difficult for management to demonstrate their own integrity and that of the auditor they had appointed. In particular, it is unclear that in the absence of regulation such audits would be distinguishable from forms of advertising. There might also be a perverse effect of signalling to investors that the management was disreputable and needed therefore to demonstrate their integrity (which amounts to adverse selection: the audit would have the opposite effect of that intended).

Broader benefits of audit

5.29 While the auditors' duties are to the company and to its shareholders as a body (see paragraph 3.17), the publication of independently verified company accounts has an economic value beyond the private benefits to the shareholders and the management of a company.

5.30 The availability of financial information on the performance of companies which users trust is widely perceived to be important (for instance, by the Organisation for Economic Co-operation and Development (OECD)) to effective corporate governance and the efficient operation of the financial markets, including debt as well as equity markets. As such, the benefits from the provision of audited accounts go beyond those to shareholders in individual companies.

5.31 The OECD said that an effective corporate governance system, within an individual company and across an economy as a whole, contributes to providing the confidence that is necessary for the proper functioning of a market economy.[78] As a result, the cost of capital is lower and firms are encouraged to use resources more efficiently, thereby underpinning growth. When this trust is undermined, lenders and investors are said to lose their appetite for risk, and shareholders to sell their equity, resulting in lost value and reduced availability of capital. The principles of corporate governance of transparency and accountability are said to be crucial to the integrity and legal credibility of our market system.

5.32 The publication of annual reports and accounts that have been independently verified has some elements of 'public goods'. Once such products or services have been created, individuals cannot be effectively excluded in their use, and use by one individual does not significantly reduce availability to others. The provision of public goods is often subject to a freerider problem, ie individuals can make use of a good or service without contributing to its creation.

5.33 The effect of this could be too little investment in a product or even a failure of the market so that the good or service is not provided at all, since the benefits of an independent audit for shareholders and managers will be less than the total benefits to all stakeholders. The result could be underinvestment in audit services or a product that does not meet the needs of certain stakeholders. A legal requirement for companies to be audited to certain specified standards and a specified level of public disclosure of information is a solution to this problem.

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[78] OECD Corporate Governance and responsibility: Foundations for market integrity, 2002.

5.34 We consider that the broader benefits of audit are recognized to some extent in the history of audit regulation in the UK.[79] The obligation on most companies to carry out a statutory audit, introduced by Companies Act 1900, may be seen as a quid pro quo for the privilege of limited liability for companies.

5.35 The Companies Act 1976 introduced a provision which was directed towards the protection of interested third parties. It required an auditor who was removed from post or who resigned to make a statement setting out the relevant circumstances (or confirming that there were no relevant circumstances). This statement must be brought to the attention of the members of the company, its creditors, and must be deposited at Companies House (and so made public).

5.36 There may be alternative sources of information regarding companies. Due diligence reports, reporting accountant reports and analyst reports also provide financial information regarding specific companies. These are not, however, substitutes for regular published, audited financial statements. Due diligence and accounting reports are prepared for particular purposes and are not always publicly available: due diligence reports are prepared for a potential acquirer of a company or its assets; and reporting accountant reports in preparation for Initial Public Offerings. The information contained in these reports may not be widely available outside the company or its advisers. Analyst reports may be prepared for debt or equity investors by bringing together and analysing various sources of information and rely heavily on the audited financial information.

5.37 KPMG considered that the provision of audit services was an important part of the economy and the governance of corporate life. It said that an effective assurance industry, of which statutory audit comprised an integral part, was important to the robust and efficient operation of financial markets. However, it objected to our reference to such broader stakeholders and benefits, on the basis that its legal duties lie to the company and its shareholders only.[80]

5.38 We accept that KPMG has accurately reported the legal duties of audit firms. In practice, via Individual Savings Accounts and stakeholder pensions, very large numbers of people are directly, or via investment funds indirectly, shareholders. However, we think that audit does have a broader purpose (as noted in paragraphs 5.29 to 5.36).

Requirement for accounts to be audited in accordance with specified principles and standards

5.39 An obligation to conduct an audit without specifying its content might prove meaningless. That shareholders can be confident that audited accounts have been prepared in accordance with accepted accounting standards is essential to the trust that they can place in the information provided. Further, the more widely understood the particular accounting standard adopted in undertaking an audit, the more valuable the assurance it provides, and it makes accounts of different companies easier to compare. This is a 'network benefit' deriving from compliance with established principles and practices. For example, that auditors are required to comply with certain practices aimed at protecting independence which are widely understood increases the trust that shareholders and other users of audited financial statements can place in their reliability. Given the large number of organizations involved (including audit

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[79] Although we note that KPMG contested this: KPMG response dated 11 September 2012 to CC's working paper 'The frameworks for the CC's assessment and revised theories of harm, paragraph 2.1.3.
[80] KPMG response dated 11 September 2012 to CC's working paper 'The frameworks for the CC's assessment and revised theories of harm', paragraphs 2.1.2, 2.1.3.

firms, companies, shareholders and other users, and professional bodies and regulators), achieving this outcome without regulation could be very difficult. This is another example of a coordination problem.

Supplementary principal–agent problems

5.40 The requirement for an audit aims to address the principal–agent problem of shareholders–managers. However, it introduces another principal–agent relationship, ie shareholder–auditor. Auditors (and managers) are better informed than shareholders, for example on the effort made in carrying out the audit and the degree to which auditors challenge management. Managers are influential in the appointment of the auditors and there may therefore be an incentive for auditors to be influenced by management demand which may differ from shareholder demand.

5.41 The development of UK corporate governance has instituted a further remedy to this principal (shareholder)—agent (auditor) problem in the form of the increased prevalence and influence of ACs formed of non-executive directors whose task is to protect the interests of shareholders in relation to financial reporting and internal control. We assess the possible principal-agent problem between shareholders and auditors and the role of the AC in Section 11.

Key characteristics of the supply of audit services

5.42 The analysis above (regarding the economic role of audit and the reasons for its regulation) provides a context for our investigation and background necessary to understand our theories of harm set out in Section 8. Audit is designed to mitigate the problems arising from possible misalignments of interests and information asymmetries in the relationship between managers and shareholders. Regulation has developed to ensure that audit is carried out at least to minimum standards in order to overcome freerider problems and for wider public policy reasons.

5.43 We consider that there are some fundamental characteristics of the supply of audit services to FTSE 350 companies which are important to understand the behaviour of customers and the nature and extent of rivalry between auditors. These characteristics are:

(a) the nature of and conflict inherent in the auditing role, since the auditor should both investigate a company's records sceptically on behalf of shareholders, but also seeks to maintain a good working relationship with that company's management;

(b) the commercially sensitive nature of the information to which auditors for FTSE 350 companies must have access;

(c) that preparation and auditing of financial accounts require the exercise of judgement;

(d) that each audit is bespoke;

(e) that audit is to some extent an 'experience' good (ie its quality may only be ascertained in retrospect) for the company's management, but for shareholders it is a 'credence' good (ie the quality of the audit may not be seen even in retrospect); and

(f) the statutory audit product is mandatory.

5.44 In the paragraphs below, we explain why we think each of these characteristics is important, and *(g)* consider firms' relevant submissions.

Nature of and conflict inherent in auditing role

5.45 Audit originated as a way of providing assurance to shareholders that the management of the companies in which they held shares was accurately reporting the state of the company it managed. Auditors do this by conducting (possibly intrusive) investigations into the company to enable them to form an opinion as to whether the financial reports prepared by company management are a true and fair account of the state of the company. Their findings and opinion might have serious consequences for the company, if the auditor does not accept that the reports prepared by management are true and fair, or if he or she requires significant changes to the accounts in order to agree that they are true and fair.

5.46 However, it is the company, via its management, that selects the auditor. This conflict (that auditors must win and retain engagements from companies in order to generate revenue, but simultaneously objectively scrutinize the company's reports) has been present since the introduction of audit in its modern form. This conflict may not be particularly apparent where the performance of a company is in line with expectations. However, where there is a gap between market expectations and company performance or a company is otherwise under financial pressure, this conflict may generate significant contradictory incentives.

5.47 Auditors that we spoke to during the course of our case studies told us that this was a central challenge of their role: to establish sufficiently close and effective working relationships with the management of companies to enable efficient execution of the audit, yet to retain sufficient distance to be able to investigate thoroughly and to challenge accounting treatments that they considered incorrect. In their view, they sought to reconcile this conflict by maintaining professional integrity whilst fostering good working relationships.

5.48 PwC said:

> There is significant investment by both ourselves and the company in the relationship. For us, this involves learning about the company's business in the UK and around the world and dedicating a large number of people to the audit in circumstances where there is no guarantee that the relationship will be renewed each year. For the company, this involves building a relationship of openness, trust and confidence and taking the benefit of the advice and support of the audit firm, as well as recognising that a crucial aspect of the auditor role is always to challenge, and at times to be critical. Because of this, the relationship is not without tension. For us the preservation of independence and maintenance of professional scepticism are overriding requirements and this sometimes means asking difficult questions and giving the company messages it would prefer not to receive.[81]

5.49 Although we accept that good relationships are compatible with a thorough investigation, for any audit firm, it has both a financial interest in maintaining its relationship (and the associated income) and a countervailing interest in maintaining its reputation for integrity (by investigating thoroughly and reporting openly), since losing that

[81] PwC response to issues statement dated 12 January 2012, paragraphs 2.52, 2.53.

reputation would invalidate its opinion and its livelihood. We consider these financial and reputational interests further in Sections 9 and 11.

The commercially sensitive nature of the information to which auditors must have access

5.50 An audit entails detailed examination of a company's commercially confidential financial information that is not publicly available. The auditor is given privileged access to such information in order to enable the audit to be completed. However, the information remains confidential to the company and auditors may not disclose it without company consent.

5.51 If a company were prepared to share more information with its shareholders, shareholders would be less reliant on the audit, since any shareholder would be able to perform its own analysis of this information.[82] However, such disclosure would be likely to aid commercial rivals. It might also lead to inefficient duplication as all shareholders would have to conduct their own analysis. For the reasons explained above, the outcome might also be insufficient investment by shareholders in the analysis of a company's financial performance, and some shareholders being better informed than others. Additionally, there would be loss of the expertise and insight provided by auditors.

5.52 We note that rules designed to prevent insider trading constrain how companies (and auditors) communicate potentially sensitive information to shareholders and non-shareholders. Further, management do not have incentives to disclose more information than they are required to by regulation. We investigate this issue in paragraphs 11.106 to 11.121.

Financial accounts require judgement

5.53 Financial accounts in practice are not the product of a straightforward arithmetical process but require the application of judgement and policies to the particular circumstances of the company in such areas as: the timing of recognition of income, capitalization of costs, amortization of costs over multiple periods and recognizing losses or potential impairment of asset values. The exercise of judgement is guided by the use of accounting standards, but these still leave significant areas of discretion. The audit of financial accounts is similarly subject to factors of judgement, as the auditor gathers sufficient evidence in order to be able to form an opinion as to whether the reports prepared by the company are 'true and fair'.

5.54 As PwC said:

> For many of the issues that arise in an audit—particularly those involving valuations or assumptions about the future—there is often no single right answer, so the auditors bring their judgement and experience to bear. … The words 'opinion' and 'true and fair' are deliberately chosen to show that judgement is involved. They underline the fact that the auditor's report is not a guarantee.[83]

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[82] Subject to the freeriding problem identified above.
[83] Demystifying audit: www.pwc.com/us/en/pwc-investor-research-institute/publications/demystifying-audits.jhtml.

Bespoke product

5.55 In addition to the judgemental basis of accounts (and audit opinions regarding them), the statutory audit for a particular FTSE 350 company is specific to that company, reflecting a range of factors including: industrial sector; the structure of the organization; the geographic interests of the company; the nature of internal financial controls and the financial structure. These and other factors determine the sector or other expertise required to carry out the audit; the number of locations in the UK and elsewhere where an audit needs to be carried out; the nature of the company risk profile; the sampling and other aspects of the audit methodology and so on. Firms have, however, developed systems and processes to standardize audits to the extent they are able, and while some audit partners become specialist in certain sectors, others we spoke to had audited companies in a wider range of sectors.

5.56 In Section 9 we investigate the effect that this characteristic of the product may have on competition.

Audit is an 'experience' good for management and a 'credence' good for shareholders

5.57 An experience good is one where it is only possible to determine its quality in retrospect. Audit (like many services) is such a good, since a company cannot be certain of how well any potential auditor will perform in advance. This results, in particular, from the bespoke nature of audits referred to in paragraph 5.55 and the various aspects of audit (outlined in paragraphs 6.8 to 6.22) that are not apparent in advance. However, all the companies with which we are concerned must commission an audit every year. This means that they do have experience of their current auditor (although certain aspects of the audit process may not be visible to them). Equally (as a company), they do not have direct experience of the audit service that a rival auditor might offer (unless they have switched recently). We consider the knowledge that the individuals who choose a company's auditor may in fact have of their own and other auditors in Section 9.

5.58 Shareholders, given their lack of access to sensitive financial information and to the detail of the audit process, do not have visibility of the quality of the service provided even in retrospect. For them it is a 'credence' good: since they cannot determine quality directly, they must judge by other criteria.

5.59 This experience and credence nature of audit means that their reputation is very important to audit firms, and we return to that in Sections 9, 10 and 11.

The audit product is mandatory

5.60 As discussed above (paragraphs 3.9 and 3.10), it is a legal requirement that FTSE 350 companies are audited and the audit must be conducted to certain minimum standards.

5.61 The mandatory requirement means that industry demand is inelastic: companies must buy and they cannot buy something else if only poor quality or high prices were available (ie there can be no demand-side substitution away from statutory audit, see paragraph 14.11). The demand for FTSE 350 company audits is therefore determined by regulatory requirements and the characteristics of these companies (ie the size and complexity of the engagements). As such, to gain market share firms must win audit engagements from rivals, or win and retain the engagements of companies that enter the FTSE 350.

5.62 If auditors were not supplying output at competitive quality, for individual shareholders there might be a reduction in the value of their investments as a consequence of the poorer-quality information available to shareholders on the performance of management. More generally, there might be a wider detriment to the economy if investors were to supply less capital or there was a misallocation of capital. Given the credence nature of the audit product (see paragraphs 5.57 and 5.58), doubts among investors regarding the quality of a small number of audits could seriously undermine their trust in the information provided by statutory audits.

5.63 We return to these characteristics throughout and in particular Sections 9, 10, 11 and 13. However, before turning to the competitive attributes of audit and the relevant market in which suppliers compete in Section 6, we consider the submissions firms made on the fundamental characteristics of audit.

Firms' submissions

5.64 We received detailed submissions from Deloitte and PwC.[84] Comments made by other firms are captured by these.

5.65 Deloitte said that there were other aspects of the market that seemed more central to a proper understanding of the market for FTSE 350 audits (than those we listed in paragraph 5.43). In particular:

(a) *The nature of audit quality.* Deloitte said that management and investors valued both technical and service quality, and technical quality could not be adequately delivered without also delivering service quality.

(b) *Audit risk.* Deloitte said that auditors faced potentially unlimited liability for audit quality failures which led to loss to investors, and that this risk was magnified due to the size of the companies and the level of complexity of their operations. If auditors were to align themselves with management at the expense of investors, this would be extremely risky.

(c) *The informed and expert nature of buyers.* Deloitte said that ACCs and FDs had expert backgrounds, committed large amounts of time to understanding and monitoring the audit and hence had strong visibility over the quality and performance of the audit.

(d) *The mechanisms for aligning the interests of shareholders, directors and auditors.* Deloitte said that the interests of investors, directors, management and auditors were well aligned in relation to the delivery of a high-quality audit. Directors were very conscious of their duties and responsibilities to shareholders including as regarded financial reporting and audit.

5.66 PwC disagreed with the suggestion that any information asymmetries led to a misalignment of objectives. PwC also said that a more fundamental characteristic of the market was the existence of at least four well-resourced and highly experienced suppliers (ie the Big 4 firms) offering services to a customer base that at any specific time consisted of a limited number of the largest and most sophisticated companies in the country (if not worldwide), which were themselves experienced purchasers of goods and services.

[84] See Deloitte response, paragraphs 2.5, 2.13, 2.20 & 2.28, and PwC response, paragraph 4, to the CC working paper on 'The framework for the CC's assessment and revised theories of harm'.

5.67 We consider all the points made in our assessment. In particular, we consider:

(a) the nature of audit quality in our assessment of bargaining power in Section 9;

(b) the liability to which auditors are exposed in our assessment of incentives on auditors in Section 11;

(c) the backgrounds and experience of FDs and ACCs and the resources available to them in our assessment of bargaining power in Section 9, and how well auditors satisfy shareholder demand in Section 11;

(d) the extent to which the interests of the management, ACCs, investors and auditors are aligned primarily in the assessment of how well auditors satisfy shareholder demand in Section 11; and

(e) the choice of firms available to companies and the capabilities of these firms in our assessment of bargaining power in Section 9.

6. The audit product and the market relevant to our investigation

6.1 In Section 3 we set out the legal obligation on companies to commission an audit and outlined the relevant legal requirements, and in Section 5 we set out what we think is its economic role, and key characteristics. This is background necessary to understanding the nature of the product and its supply. We now turn to considering competitive conditions in theory and practice.

6.2 Accordingly, in this section we:

(a) provide a description of what appear to be the main attributes of the product delivered by an auditor when it audits a FTSE 350 company, including a summary of the views of parties on the definition of audit quality (paragraphs 6.3 to 6.22); and

(b) define the market relevant to our investigation (paragraphs 6.23 to 6.30).

Description of an audit

6.3 In Section 3, we defined the relevant product in statutory terms. However, as KPMG pointed out, the statutory definition says no more than that an audit is a task performed by a statutory auditor.[85]

6.4 The audit report itself is typically a short, formulaic opinion signed by an identified Audit Engagement Partner (AEP) on the letterhead of his or her firm and which is published in the company's annual report. However, this is only the end-product of a process that is tailored to the particular company. It must be sufficiently rigorous for the auditor to be able to form an opinion in line with applicable law and regulation, and fulfil the auditor's duties. Depending on the company, it may be a lengthy, complex and intense process. For instance, Deloitte said:

> the audit engagement for a FTSE 350 company will involve personnel from across Deloitte (not just the audit function), with the number of man hours spent in the thousands. Furthermore, the highly international nature of the large majority of FTSE 350 companies' businesses means

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[85] KPMG response dated 4 May to 'Law and Regulation' working paper, Appendix 1.1, comment on paragraph 3.6.

that there will be a significant degree of interaction with the auditors of foreign subsidiaries (normally other DTTL entities, given the client demand for consistency of audit across the international business). The audit process and team will operate at all levels of the audited entity, visiting the group's locations, liaising with all key members of staff (far beyond the finance function) and will need to understand and challenge the business model with a high degree of expertise.[86]

6.5 However, we note BDO's submission that the supply of audit services to FTSE 350 companies is not homogeneous and includes a wide variety of companies, such as [✂] which employs fewer than 200 people and had many characteristics of small owner-managed businesses, and retail companies which were relatively straight-forward to audit.[87]

6.6 In this section, we use a broad description of the audit process as a framework to capture the elements of an audit. Our aim is not to define an audit in a specific way, but rather to ensure that in conducting our analysis, we properly assess all the ways in which audit firms may be able to compete in providing an audit, ie to vary their offerings in order to win or retain engagements.

6.7 The results of the case studies, our first survey and submissions from audit firms indicate that there are four broad product attributes of a FTSE 350 audit (and therefore dimensions of the product across which firms may compete to win engagements), which we discuss in turn:

(a) the audit fee paid by the company;

(b) the technical quality of the audit and the accuracy of the audit opinion;

(c) the provision and quality of additional commentary and insights provided by the audit team to management and the AC in the process of conducting the statutory audit; and

(d) the quality of the service provided by the audit team to management and ACs in carrying out the statutory audit.

Fee

6.8 The fee is the price the company pays for the audit service. It is negotiated between company and auditor, taking into account the scope and complexity of the audit and market conditions. Accordingly, it may vary significantly. The fee is published, although the published fee may also include some audit-related services such as interim reviews.

6.9 In 2010 the published real audit fees (in March 2005 prices) for FTSE 350 companies were in the ranges of £0.014 million to £44.5 million. The median fee was £0.58 million.[88]

6.10 All firms said that the proportion of the audit fee accounted for by audit-related services varied significantly by client and was estimated to be in the range of 0 to

[86] www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/deloitte_initial_submission.pdf, p13.
[87] www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/bdo_hearing_summary_13_feb_12_excised.pdf, paragraph 18.
[88] Appendix 2.4, Table 3 (paragraph 32).

around 30 per cent, with averages of between 10 and 20 per cent.[89] Such services include reviews of interim financial information, reporting on regulatory returns and reporting to a regulator on client assets.[90]

Technical quality of the audit and opinion

6.11 De Angelo (1981)[91] proposed a definition of audit quality as: the market-perceived joint probability that an auditor will both *(a)* discover a breach in the client's accounts and *(b)* report the breach. We interpret a 'breach' to include the variety of factors that could lead to a possible material misstatement of accounts including inaccurate recording, inappropriate application of accounting policies and overly aggressive accounting judgements. We consider that the technical quality of the audit encompasses this definition but should not be limited to it.[92] The first part of the De Angelo definition relates to the effectiveness of audit scrutiny, whereas the second part highlights the requirement for sufficient independence of the auditor. Both aspects are required if shareholders are to rely on the audit opinion.

6.12 We see *(a)* scepticism, *(b)* objectivity, *(c)* integrity, and *(d)* independence as aspects of audit quality. Within the profession, they have become terms of art to some extent. Our understanding is summarized as follows.

Scepticism

6.13 Professional scepticism is a mindset of an auditor that is alert to the possibility of error and critically assesses audit evidence presented. ISA 200 (Overall objectives of an audit) defines scepticism as 'An attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence'. The FRC provides guidance on professional scepticism:[93]

> the appropriate application of professional scepticism in the audit requires a mindset which rigorously questions and challenges management's assertions with a degree of doubt that reflects the expectations of shareholders (and other stakeholders) for whose benefit it is performed. All judgments made in the course of the audit should be founded on the perspective of the shareholders (and other stakeholders). That mindset demands the sort of hard evidence – to back each audit judgment and, ultimately, the board's assertion that the financial statements give a true and fair view – that would be convincing and persuasive to shareholders (and other stakeholders), given the auditor's risk assessment.[94]

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[89] Appendix 6.1, paragraph 16.
[90] Appendix 6.1, paragraph 14.
[91] DeAngelo, L E (1981a), 'Auditor size and audit quality', *Journal of Accounting and Economics*, 3(3): 93–199.
[92] While we found this definition attractive, probability *(a)* cannot be calculated: the unknown unknowns (ie what the audit failed to detect) necessarily mean that the denominator of the fraction is uncertain. Probability *(b)* may be somewhat clearer, since it may be more visible if an auditor discovered something but did not report it. There should be a paper trail that might be uncovered, but when this might happen, and by whom, is uncertain. The 'market-perceived' aspect, however, means that this definition does not amount to probability calculation, but rather amounts to a more general assessment of an auditor's reputation.
[93] www.frc.org.uk/getattachment/1aecac64-6309-4539-a6d9-690e67c93519/Briefing-Paper-Professional-Scepticism.aspx.
[94] ibid, p12

Objectivity

6.14 Objectivity is the fair and balanced reasoning of relevant evidence. 'Ethical Standard 1: integrity, objectivity, and independence' (ES1) states: 'Objectivity is a state of mind that excludes bias, prejudice and compromise and that gives fair and impartial consideration to all matters that are relevant to the task in hand, disregarding those that are not.'[95] 'The auditor's objectivity requires that an impartial opinion is expressed in the light of all the available audit evidence and the auditor's professional judgment. Objectivity also requires that the auditor adopts a rigorous and robust approach and is prepared to disagree, where necessary, with the directors' judgments.'[96]

Integrity

6.15 With regard to integrity, ES1 states: 'It is essential that auditors act, and are seen to act, with integrity, which requires not only honesty but a broad range of related qualities such as fairness, candour, courage, intellectual honesty and confidentiality'.[97]

Independence

6.16 Independence is being free of circumstances which might be perceived to impair any of the above:

> Independence is freedom from situations and relationships which make it probable that a reasonable and informed third party would conclude that objectivity either is impaired or could be impaired. Independence is related to and underpins objectivity. However, whereas objectivity is a personal behavioural characteristic concerning the auditor's state of mind, independence relates to the circumstances surrounding the audit, including the financial, employment, business and personal relationships between the auditor and the audited entity and its connected parties.[98]
>
> The need for independence arises because, in most cases, users of the financial statements and other third parties do not have all the information necessary for judging whether the auditor is, in fact, objective. Although the auditor may be satisfied that the auditor's objectivity is not impaired by a particular situation, a third party may reach a different conclusion.[99]

6.17 With regard to threats to independence, there is extensive regulation, in particular ES1[100] which describes the importance of integrity, objectivity and independence for an auditor; ways of complying with ethical standards (policies and procedures, leadership, ethics partner); identification and assessment of threats and safeguards; and engagement quality control review. (See further Appendix 3.1, paragraphs 81 to 88.)

6.18 While we broadly accept De Angelo's definition (see paragraph 6.11), we think that a fuller definition of the technical quality of an audit also includes the quality of internal reporting to senior management and the AC that may assist them in audit planning

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[95] ES1, paragraph 10.
[96] ibid, paragraph 12.
[97] Ethical Standard 1, paragraph 7.
[98] ibid, paragraph 13.
[99] ibid, paragraph 14.
[100] FRC Ethical Standard ES1

and their assessment of the quality of the audit and in providing further disclosure of information to shareholders. This information indirectly contributes to the usefulness of the audit report and opinion to the shareholders. Such internal reporting might include reporting of the audit methodology such as sampling methods and materiality thresholds, risk and control assessment and areas where auditors were required to exercise judgement on accounting treatments.

Additional reporting and commentary

6.19 This takes two forms: *(a)* additional commentary and reporting in relation to the audit itself that might be provided to managers and the AC; and *(b)* the commercial and operational insights provided by auditors as a by-product of the process of carrying out an audit. Auditors in the process of carrying out an audit have contact with many individuals and scrutinize activities across the organization and, as a result, make observations on, and gain knowledge of, the business. The management of the company may also gain from the wider knowledge and experience gained by auditors—for example, how the company's procedures and practices compare with established best practice.

Service

6.20 This captures those aspects of the audit process which, if not handled efficiently and effectively, will impose additional non-fee costs on the company or result in delays and disruption. Service is largely concerned with the efficiency with which an audit is conducted, including: the amount of management time taken up with explaining the corporate structure, activities and accounting treatments, systems and practices to the audit team; how quickly and effectively the audit team responds to matters raised by management and/or the AC; the level of disruption to the normal operation of the company; the timeliness in raising issues with management and providing audit clearance; and the ability of the audit team to establish good working relationships with staff, management and AC.

Firms' submissions on definition of audit quality

6.21 Deloitte, EY, KPMG and PwC commented on the definition of audit quality in various submissions.[101] We consider their key points to be:

(a) The De Angelo definition of audit quality does not capture key elements of audit quality and a broader understanding of audit quality should also recognize the drivers of technical quality and importance of service quality. A quality audit is said to be one where the audit opinion was appropriate in the circumstances and the engagement was conducted in line with applicable professional standards.

(b) Empirical studies have found that important factors in audit quality include: communication between the auditor and the AC; the quality of the working relationship with the audit team and partner; the reputation, integrity and technical competence of the firm; and the technical competence and sector experience of the audit partner; and the professional integrity of the audit team.

(c) High quality requires: professional scepticism and judgement in determining the scope of the work required; an ability to apply accounting standards appropriately

[101] See, for instance, Deloitte, EY, KPMG and PwC responses to our 'Law and Regulation' working paper.

to complex businesses; sector expertise and experience; and the ability to challenge management.

(d) Auditors are required to exercise judgement on key aspects of an audit such as: the risks of material misstatement of results or financial position; the procedures needed to respond to those risks; the adequacy of a company's financial system and controls; the impact of change on the business; the reasonableness of judgements and estimates made by the business; the risk of management bias; the sufficiency and appropriateness of audit evidence and the conclusions to be drawn from this; and the appropriate way to approach dealings and discussions with management and the board.

(e) The quality of audit service is differentiated by factors such as the exercise of judgement based on knowledge and experience, building and sustaining rapport, engendering trust and being skilful in influencing people, and managing an audit team efficiently, which can be very large and spread over multiple jurisdictions.

(f) Clients value the insights that the auditor may be able to provide as a by-product of carrying out an audit, such as the effectiveness of operating and financial management systems. Also, clients often have need for the auditor to report on a variety of other matters, for example in relation to client money, prudential returns, tax computations or other matters that are largely performed by the existing audit team (audit-related services).

6.22 We consider that the issues raised by these comments are captured by the description of an audit given above in paragraphs 6.7 to 6.20. We use that description of the different attributes of audit in understanding the dynamics of competition in the supply of audits to large companies.

Market definition

6.23 Defining the relevant market in a market investigation assists the CC to identify the market participants and products that might be central to the identification of features that have an AEC. It therefore provides a framework for the assessment of the effects on competition of features of a market.[102]

6.24 The identification of the relevant market does not limit the factors the CC considers in conducting its assessment of whether a feature or combination of features may give rise to an AEC. We have taken into account constraints from outside the market and any segmentation within it.[103]

6.25 We find that the relevant product market in this investigation is the provision of statutory audit services to companies that are currently, or have recently, been listed on the London FTSE 100 and FTSE 250 indices (collectively known as the 'FTSE 350'). Appendix 6.1 presents supporting evidence. In summary:

(a) Statutory audit is mandatory so there can be no demand-side substitution away from a statutory audit.

(b) Demand-side characteristics: auditing FTSE 350 companies is likely to (but may not always) differ from that of other companies in terms of complexity, inter-

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[102] *Guidelines for market investigations: Their role, procedures, assessment and remedies, CC3 (Revised)* (CC3), paragraph 132.
[103] CC3, paragraph 133.

national scope and the demands of companies in terms of degree of challenge required of the auditor; its ability to detect misstatements; and the independence of the audit firm.

(c) Supply-side characteristics: four suppliers account for the great majority of FTSE 350 audits, while the auditing of companies with other index designations is less concentrated.

(d) Our definition is in line with product markets identified by the European Commission, in the provision of audit and accounting services, in its investigation into the merger between Price Waterhouse and Coopers & Lybrand,[104] and the later merger between Deloitte & Touche and Andersen UK.[105]

6.26 We did not apply a hypothetical monopolist test to define the product or geographic boundaries of the market as we did not consider this test to be helpful in this case. The test is used to help with identifying the constraints that would prevent a hypothetical monopolist from exercising market power, in particular those imposed by the ability of customers to switch to alternative products in response to high prices or poor quality. As noted above, statutory audit is mandatory so there can be no demand-side switching away from statutory audit to other products. In any event, we considered the competitive constraints that apply to firms within our analysis of companies' willingness to switch auditor and their bargaining power (see Section 9).

6.27 While some FTSE 350 audits may be more complex than others and some require certain sector or other expertise (which suggests that not all auditors may be able to provide statutory audit services to every company within the FTSE 350), we decided not to define separate markets within the supply of audit services to FTSE 350 companies. However, we stress that this did not stop us assessing competition within sub-segments of the FTSE 350 and we considered these whenever relevant. Given that the terms of supply are individually negotiated for each audit engagement by the audit firm and company and the bespoke nature of audits, we found it useful at times to think of each company separately, to ensure that we bore in mind the competitive conditions facing each.

6.28 Submissions that we received broadly accepted the market definition set out in paragraph 6.25 as a pragmatic view, but stressed the importance of considering different conditions that may prevail within subsections of this overall market. BDO in particular warned about the dangers of over-attribution, ie the specific demands of particularly large and complex companies with regard to their audits did not apply throughout the FTSE 350.[106] KPMG recognized the difficulties of market definition in this case and said that we should focus on ensuring that in our broader analysis we took into account the competitive constraints imposed by audit firms providing statutory audit services that fell outside of whatever definition of the relevant market we arrived at.[107]

6.29 We are also aware that, for some companies, certain competitive constraints in the provision of audit services may start to take effect when a company becomes fully listed (as opposed to when it becomes sufficiently large to be a member of the FTSE 350), for example due to external pressure from financial advisers or lenders.

6.30 We find that the relevant geographic market is national on the basis that the statutory framework is set by UK legislation. By this definition, we mean that UK-based firms

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[104] *Case No IV/M 1016—Price Waterhouse/Coopers & Lybrand*, 20 May 1998.
[105] *Case No COMP/M 2810—Deloitte & Touche/Andersen UK*, 1 July 2002.
[106] BDO, response to the 'Market definition' working paper, paragraphs 1.2 & 1.3.
[107] KPMG, response to the 'Market definition' working paper, paragraph 1.1.4.

are not generally competing with audit and accountancy firms based outside the UK for the supply of statutory audit services to FTSE 350 companies. The exception to this is FTSE 350 companies that are not based in the UK. These tend to be audited by a firm based in the country in which the company is based, supporting our view that markets are national. Further detail is also in Appendix 6.1.

7. Market characteristics and outcomes

7.1 We investigated the way in which the competitive process operated in the relevant market. Outcomes of the competitive process in their different forms in a market (such as prices and profitability, levels of innovation, product range and quality) can provide evidence about how it is functioning. Evaluating these outcomes helps us to determine whether there is an AEC in the relevant market, and if so, the extent to which customers may be harmed by it.[108] In carrying out this assessment, our Market Investigations Guidelines indicate that we should consider whether or not these are the sorts of outcomes that we might expect to see in the theoretical benchmark of a 'well functioning market'. This is not an idealized, perfectly competitive market, rather we use the term in the sense, generally, of a market without the features that we consider may be causing an AEC.[109] See paragraph 8.7.

7.2 Although the outcomes of the competitive process may differ in character, there may be linkages between them and as a result, we have not considered them in isolation. Moreover, such findings are not in themselves causes of competitive harm. They are indicators, not features of the market for the purpose of the AEC test.[110]

7.3 In particular, we examined the following:

(a) structure, tenure and switching rates in the relevant market (paragraphs 7.6 to 7.30);

(b) prices charged by firms and the profitability of firms, their partners and specific engagements (paragraphs 7.31 to 7.113);

(c) indicators of audit quality (paragraphs 7.114 to 7.150);

(d) auditor scepticism, objectivity, integrity and independence (paragraphs 7.151 to 7.189). We note that these are aspects of audit quality. However, given their significance and the possibly different causes of any adverse effects, we considered them in a separate subsection;

(e) innovation (paragraphs 7.190 to 7.225); and

(f) unmet demand regarding the product audit firms provide (paragraphs 7.226 to 7.264).

7.4 We then set out our views (paragraphs 7.265 and 7.267). We consider these observed outcomes in the context of our competitive assessment and analyse the most likely explanations for why they have arisen in Sections 9, 10 and 11. These set out our analysis of the theories of harm that we considered during this market investigation.

7.5 In this market it proved difficult to find reliable measures that, in themselves, would provide a clear indication of how well competition was working, and there were alternative potential explanations for each of the outcomes we observed (see paragraphs 8.23 and 8.24). In Sections 9, 10 and 11, we explored the evidence that may help to distinguish between these competing explanations, and by taking all the evidence in the round we reached our conclusions on whether or not competition is working effectively in the market for statutory audit services for large companies in the UK. As noted (paragraphs 2.13 and 7.267), finding the likely explanation for the

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[108] CC3, paragraph 103.
[109] CC3, paragraph 30.
[110] CC3, paragraph 126.

outcomes was not straightforward and has required the exercise of judgement in weighing the evidence.

Structure, tenure and frequency of tendering or switching

7.6 We reviewed the OFT's findings[111] and conducted our own data-gathering exercise. Our findings follow regarding:

(a) structure;

(b) tenure; and

(c) frequency of tendering or switching.

7.7 We *(d)* set out our views below.

Structure

7.8 Between 2001 and 2010 the Big 4 firms consistently had a share of over 95 per cent[112] of FTSE 350 audits and over 99 per cent of FTSE 350 audit fees. The supply of statutory audit services appears to have been less concentrated for non-FTSE-350 companies: the Big 4 firms had a share of over 80 per cent of audit engagements between 2001 and 2010 of non-FTSE-350 companies in the public data set, accounting for 90 per cent of fees.[113]

7.9 The shares of individual auditors remained broadly stable over time both in terms of number of FTSE 350 engagements and the value of FTSE 350 engagements. PwC had the highest share of audit fees (ranging from 41 to 46 per cent between 2001 and 2010).[114,115]

TABLE 7.1 **Shares of FTSE 350 audit engagements, 2001 to 2010**

per cent

	2001	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*
PwC	38	37	37	36	36	35	33	33	31	31
Deloitte	14	21	20	22	24	24	26	26	26	25
KPMG	25	24	24	22	21	22	22	21	22	23
EY	13	15	15	17	17	17	16	17	17	17
BDO	1	1	1	1	1	2	1	2	2	1
GT	1	1	1	1	1	1	1	2	1	2
Arthur Andersen	8	0	0	0	0	0	0	0	0	0
Other	1	1	1	1	0	0	0	0	0	0
Big 4	97	97	97	97	98	97	97	96	96	97

Source: CC.

[111] www.oft.gov.uk/shared_oft/markets-work/oft1357MIR. Footnotes omitted.
[112] Includes Arthur Andersen 2001–2003.
[113] Appendix 2.4, Annex 1, Figures 3, 4, 9, 10. The public data set includes only a subset of UK companies, namely those that were in the FTSE 350 or the Top Track 100 at some point during the period.
[114] We note that there are some differences between the shares of audit engagements and shares of audit fees for firms in individual years, more so when considering industry shares in Tables 7.3 and 7.4 below. Where there are a small number of engagements, the individual market shares are sensitive to the relative sizes of the engagements.
[115] Appendix 2.4, Annex 1.

TABLE 7.2 **Shares of FTSE 350 audit fees, 2001 to 2010**

per cent

	2001	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*
PwC	46	43	44	42	41	45	41	41	42	41
Deloitte	12	15	15	17	18	17	18	21	21	18
KPMG	23	24	24	24	24	23	27	24	22	24
EY	11	17	17	17	17	15	13	13	14	16
BDO	0	0	0	0	0	0	0	0	0	0
GT	0	0	0	0	0	0	0	0	0	0
Arthur Andersen	7	0	0	0	0	0	0	0	0	0
Other	0	0	0	1	0	0	0	0	0	0
Big 4	99	99	100	99	100	100	100	99	100	100

Source: CC.

7.10 The number and presence of suppliers varied across industries. While there were only a small number of banks and telecommunications companies within the FTSE 350, only three (PwC, Deloitte and KPMG) of the Big 4 firms supplied audit services to these FTSE 350 companies in 2010. EY also had only a 5 per cent share of industrial company audits in 2010. Considering shares of audit fees (rather than number of engagements), there were a larger number of industries where only three auditors had a share greater than 5 per cent in 2010. In the consumer goods and oil and gas industries, there were two suppliers accounting for the vast majority of audit fees (more than 95 per cent) in 2010. Tables 7.3 and 7.4 below show the market shares in terms of number of engagements and share of audit fee by industry in 2010.

TABLE 7.3 **Industry shares of FTSE 350 audit engagements, 2010**

Industry	*Total No*	*PwC %*	*Deloitte %*	*KPMG %*	*EY %*	*BDO %*	*GT %*	*Big 4 %*
Financial services	75	32.0	25.3	16.0	21.3	1.3	4.0	94.7
Consumer services	64	29.7	26.6	18.8	20.3	1.6	3.1	95.3
Industrials	61	27.9	31.1	34.4	4.9	1.6	0.0	98.4
Consumer goods	26	53.8	11.5	26.9	7.7	0.0	0.0	100.0
Oil & gas	21	33.3	28.6	9.5	28.6	0.0	0.0	100.0
Technology	17	35.3	17.6	17.6	29.4	0.0	0.0	100.0
Insurance	17	35.3	11.8	23.5	29.4	0.0	0.0	100.0
Mining	16	18.8	31.3	12.5	31.3	6.3	0.0	93.8
Basic materials	9	22.2	33.3	33.3	11.1	0.0	0.0	100.0
Utilities	9	33.3	33.3	22.2	11.1	0.0	0.0	100.0
Health care	8	12.5	37.5	37.5	12.5	0.0	0.0	100.0
Real estate	8	25.0	0.0	37.5	12.5	12.5	12.5	75.0
Telecommunications	7	28.6	42.9	28.6	0.0	0.0	0.0	100.0
Banks	5	40.0	20.0	40.0	0.0	0.0	0.0	100.0
Total	343	31.5	25.4	22.7	17.2	1.5	1.7	96.8

Source: CC.

TABLE 7.4 **Industry shares of FTSE 350 audit fees, 2010**

Industry	*Total* £m	*PwC* %	*Deloitte* %	*KPMG* %	*EY* %	*BDO* %	*GT* %	*Big 4* %
Financial services	42.4	40.9	18.0	8.6	32.0	0.3	0.2	99.4
Consumer services	92.0	28.8	47.3	10.0	12.4	0.5	1.2	98.3
Industrials	100.6	30.0	20.2	45.1	4.4	0.3	0.0	99.7
Consumer goods	72.3	76.5	1.9	20.8	0.8	0.0	0.0	100.0
Oil & gas	83.7	52.6	3.9	0.5	43.0	0.0	0.0	100.0
Technology	19.8	43.7	23.7	3.1	29.5	0.0	0.0	100.0
Insurance	94.5	14.4	6.6	31.5	47.5	0.0	0.0	100.0
Mining	54.2	27.1	19.6	27.7	24.8	0.8	0.0	99.2
Basic materials	8.4	10.6	55.9	25.1	8.4	0.0	0.0	100.0
Utilities	23.2	72.1	8.0	18.6	1.3	0.0	0.0	100.0
Health care	30.5	54.1	9.7	29.8	6.4	0.0	0.0	100.0
Real estate	2.0	34.9	0.0	36.0	2.2	15.2	11.8	73.0
Telecommunications	25.0	41.7	42.0	16.3	0.0	0.0	0.0	100.0
Banks	168.7	47.3	19.7	33.0	0.0	0.0	0.0	100.0
Total	817.3	41.0	18.5	23.9	16.3	0.2	0.2	99.6

Source: CC.

7.11 PwC said that given constant changes in the composition of the FTSE 350, failure to compete actively would lead to market share loss.[116] A presentation on PwC's website records around 330 companies that have exited the FTSE 350 over the period from 2001 to 2010.[117]

7.12 We agree that there has been considerable movement in and out of the FTSE 350 companies,[118] and that this movement could cause a firm's share of FTSE 350 engagements to change, but not necessarily to fall. Existing clients might enter as well as leave the FTSE 350 index. This movement means that the set of FTSE 350 engagements across which firms are competing changes over time.

Tenure

7.13 The tenure of existing auditors was longest among FTSE 100 companies. In particular, we found that the current auditor was appointed for more than ten years at 67 per cent of FTSE 100 companies. This compared to 52 per cent of FTSE 250 companies.[119] We also found that 31 per cent of FTSE 100 companies had audit engagements exceeding 20 years compared with 20 per cent of FTSE 250 companies.

7.14 As regards 147 companies which have been in the FTSE 350 for ten years, and for which we have ten years' data, 82 per cent have not switched auditor in the last ten years.

7.15 This is consistent with our first survey results. 55 per cent of the FTSE 100 companies in the survey had not switched auditor for more than ten years, compared with 40 per cent of FTSE 250 companies in the survey. The results also suggest that length of auditor tenure is longer for FTSE 350 companies than for other companies. Only 21 per cent of FTSE 350 companies have an auditor with tenure of five years or less compared with 39 per cent for non-FTSE 350 companies. Over 55 per cent and 40 per cent respectively of FTSE 100 and FTSE 250 companies have auditors with

[116] PwC pre-provisional findings closing submission, paragraph 24.
[117] www.pwc.co.uk/en_UK/uk/who-we-are/ftse350/index.html.
[118] Appendix 2.4, paragraphs 105–110.
[119] Appendix 2.4, Figure 10 (paragraph 71).

tenures of more than ten years compared with 29 per cent of non-FTSE 350 companies.[120]

7.16 Where we did not have information on the date of the first year of an audit engagement, we assumed it to be either the first year for which data was submitted or the year 2000 where data was submitted for each year.[121] GT said that this assumption resulted in a significant underestimate of average auditor tenure by failing to take into account accurately those audits which had been in place for much longer than the period under consideration.[122] BDO and Mazars made the same point.[123, 124] We acknowledge this point in Appendix 2.4,[125] and for this reason have not given estimates of average auditor tenure. Rather, using the public data set and the survey results, we looked at evidence on the proportion of companies with tenure of more than the specified number of years (see paragraphs 7.13 and 7.14 above).

Frequency of tender processes or switching

7.17 There were 83 instances where a FTSE 350 company switched auditor (excluding those where companies switched from Arthur Andersen following its collapse and instances where a company changed to/from a joint audit) over the ten-year period from 2001 to 2010.

Switching rates

7.18 Annual switching rates among FTSE 350 companies ranged between 1.5 and 3.5 per cent between 2001 and 2010 (excluding switching by Arthur Andersen clients). The average annual switching rate among FTSE 350 companies was 2.4 per cent. The average annual switching rate for FTSE 350 companies was lower than for non-FTSE-350 companies, which varied between 2.8 and 8.2 per cent.[126]

Discussion

7.19 The decision to switch auditor could be triggered for different reasons.[127] We were primarily interested in the frequency of switching for reasons such as cost or quality (rather than external or merger activity reasons) as an indicator of the willingness of companies to switch auditor to gain a better offer. We consider the triggers for switching further in paragraphs 9.222 to 9.227.

7.20 We could not observe directly the reasons why companies decided to switch auditor. However, further analysis suggests that around 20 per cent of switching (excluding switching associated with the collapse of Arthur Andersen) by companies in the FTSE 350 during the period 2001 to 2011 was associated with movement into the FTSE 350 in the year of or the year before switching. We estimated that between 16 and 33 per cent was associated with merger and acquisition activity.[128] There

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[120] Appendix 2.2, paragraph 28 & Table 7.
[121] Appendix 2.4, paragraph 69.
[122] GT response to the 'Descriptive statistics' working paper, paragraphs 2.1 & 2.2.
[123] BDO response to the 'Descriptive statistics' working paper, paragraph 1.2.
[124] Mazars response to the 'Descriptive statistics' working paper, paragraph 4.
[125] Appendix 2.4, paragraph 73.
[126] Appendix 2.4, Table 4 (paragraph 41).
[127] For example, a company might decide to switch auditor if it believes it is paying too high a fee, receiving too low a level of quality or for reasons of good corporate governance. A company may also change auditor due to external reasons (for example, the collapse of Arthur Andersen) or the desire for a single auditor after the merger of two companies with different auditors.
[128] We define switching events associated with merger and acquisition activity *(a)* using estimates provided by the firms and *(b)* to be those events where a company had been involved in some merger activity in the year of or the year before a switch of

were also a small number of switches where the company moved to or from joint audits. Overall these factors were associated with around one-half of switches. These results indicated that many observed switches in auditor by FTSE 350 companies may have been for reasons other than a desire on the part of the company to gain a better offer.

7.21 We were also interested in the proportion of engagements for which there had been an open competition for the engagement. We considered that this was less likely to have been the case where the switch in the auditor was: *(a)* as a result of the collapse of Arthur Andersen (as we know that much of Arthur Andersen's audit business transferred to Deloitte); *(b)* associated with merger and acquisition activity; or *(c)* due to a move to or from a joint audit (for the same reason). If we excluded these events, we estimated that there were between 52 and 70 (depending on the definition used of merger and acquisition activity) occasions when FTSE 350 companies switched auditor in the last ten years (ie direct switches).[129]

7.22 Based on information provided by parties, we estimated that there had also been about 33 occasions when a FTSE 350 engagement was put out to tender but this did not result in a switch in the auditor in the period 2001 to 2010.[130]

7.23 Given these results, we estimated that there had been between 85 and 103 competitive tender processes over the last ten years for existing FTSE 350 engagements. Audit firms were able to provide us with information relating to 52 tender processes for FTSE 350 engagements over the five-year period 2007 to 2011.[131]

Firms' submissions

7.24 PwC said that a more rigorous approach was important to the analysis of how competition worked in the sector, and therefore classified switches and tender processes into three categories: *(a)* direct switches; *(b)* consequential switches, where a company changed its auditor as a consequence of another decision (eg following the demise of Arthur Andersen or where the relevant company was taken over by another company that was not in the data set but where the original company remained in the data set following the company takeover); and *(c)* tender processes without switches.[132]

7.25 We agreed that the circumstances in which companies switched auditors and the frequency of tender processes, whether or not this resulted in a change in auditor, were important to our assessment of our theories of harm (see in particular paragraphs 9.222 to 9.229, 9.291 and 9.292, 10.7 to 10.9 and 10.39).

7.26 GT said that the structure of the large company audit market was not consistent with the characteristics of a market which enjoys healthy competition.[133] It provided further evidence regarding high concentration and levels of tendering or switching.[134] It said that the observed levels of tendering or switching meant that competitive constraints on incumbent auditors were more muted than would otherwise be the case and also

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auditor. We consider that the latter may overstate the extent of switching resulting from merger and acquisition activity as the data used includes all deals including small acquisitions of non-FTSE-350 companies that would have been unlikely to give rise to a need for a FTSE 350 company to review its external audit appointment. See Appendix 2.4, paragraph 45, for further details.

[129] Appendix 2.4, Tables 5 & 6.
[130] Appendix 2.4, paragraph 62.
[131] Appendix 7.1, paragraph 2.
[132] PwC submission, 'An econometric analysis of the prices of large company audits', paragraph 1.5(i) & (ii), 7 December 2012.
[133] GT views on provisional findings, paragraph 1.4.
[134] ibid, paragraphs 1.5–1.8.

made it extremely difficult for GT and other suppliers of audit services to destabilize the competitive advantage of the four largest audit firms and grow market share.[135]

7.27 KPMG said that it was completely incorrect for us to characterize the market outcomes we identified as themselves indicative of an AEC, as they were not themselves associated with any direct customer detriment and are entirely consistent with competitive outcomes.[136]

7.28 PwC considered structure, tenure, frequency of tendering or switching to be market characteristics rather than a reflection of the outcome of the competitive process, and said that in order to determine whether these characteristics were indicative of an AEC, we should test them against what the CC normally regards as outcomes of the competitive process—ie prices and profits, quality and innovation.[137]

7.29 Our views regarding what we can draw from observations in the market are set out in paragraphs 7.4, 7.5 and 7.30.

Our view

7.30 Our view was that the evidence we observed on the levels of concentration, the stability of market shares, the length of audit firm tenure, the frequency of switching (in particular the rates of switching driven by an attempt to gain a better offer), and frequency of competitive tendering for engagements, needed to be considered in the context of our competitive assessment (see Sections 9, 10, and 11) and as part of our overall assessment of whether an AEC results from a feature or a combination of features in the FTSE 350 statutory audit market.

Price and profitability

7.31 We attempted to assess whether prices charged and profits earned by the Big 4 firms appeared to be above those that should prevail in a competitive market. We considered:

(a) the evolution of fee levels (paragraphs 7.32 to 7.43);

(b) the effect of switching and tenure on engagement profitability and prices (paragraphs 7.44 to 7.70);

(c) undertaking a price-concentration analysis (paragraphs 7.71 to 7.75); and

(d) profitability, at levels of firms' FTSE 350 engagements, partner, business line and engagement (paragraphs 7.76 to 7.109).

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[135] ibid, paragraph 1.9.
[136] KPMG response to provisional findings, paragraph 2.2.2.
[137] PwC response to provisional findings and Remedies Notice, Annex 1 paragraphs 3 & 4.

Evolution of fee levels

CC analysis

7.32 We investigated the evolution of fee levels over time using the public and engagement data sets.[138] We found that both the average and median total audit fees in 2005 prices[139] as recorded in the public data set increased over the period 2001 to 2010, by 23 and 52 per cent respectively.[140] We did not have sufficient information to analyse how the fees per hour or the firms' gross margin developed over this period.

7.33 We had more detailed information on fees for the UK part of audits for the years 2006 to 2011 from the engagement data set. We found that over this period the average total UK audit fee in 2005 prices decreased by 18 per cent and the average number of engagement hours decreased by 5 per cent.[141] Average total UK audit fees in 2005 prices decreased for both FTSE 100 and FTSE 250 companies. The average number of engagement hours decreased for FTSE 250 companies, but for FTSE 100 companies we noted a small increase. We were unable to determine what drove this difference.[142]

7.34 We further found that over the period 2006 to 2011 the average fee per hour in 2005 prices decreased by 17 per cent.[143] We observed a decrease in the average fee per hour in 2005 prices for both FTSE 100 and FTSE 250 companies, [✂].[144] Further analysis showed that the observed decrease was to a large extent driven by our inflation adjustment using the all-items CPI.[145]

7.35 In addition to evaluating deflated fees per hour, we compared the development of the average nominal fee per hour with that of a measure for the average nominal staff costs per hour.[146] Staff costs are the main direct cost factor for the provision of statutory audit services. This analysis showed us that for FTSE 350 companies both average nominal fees and staff costs per hour remained roughly stable over the period observed.[147] As a result a simple measure of the gross margin per hour[148] remained roughly stable as well.[149]

Firms' submissions

7.36 PwC and KPMG noted that the analysis of total audit fees over the period 2001 to 2010 did not control for changes in scope, even though the period saw varying levels of M&A activity and numerous changes to the regulatory environment such as the

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138 See Appendix 2.5 for a complete description of these data sets. An important difference between these data sets is that the public data set only records companies' total audit fee, whereas the engagement data set contains detail on the UK audit fee and the related amount of engagement hours by staff grade.
139 For this analysis we applied an inflation adjustment, or 'deflated' the monetary variables. This was done using the all-items consumer price index (CPI) as published by the Office for National Statistics (ONS). This price index has 2005 as its base year.
140 See Appendix 7.2, paragraph 11.
141 The analysis was based on a sample that excluded the highest and lowest 5 per cent of engagements in terms of fee per hour, by year and firm. See Appendix 7.2, paragraph 22.
142 See Appendix 7.2, paragraph 26.
143 This is the average engagement fee per hour across the set of engagements considered. The fee per hour is calculated by dividing the engagement fees by engagement hours separately for each engagement. See Appendix 7.2, paragraphs 3 & 22.
144 See Appendix 7.2, paragraph 71*(c)*,
145 See Appendix 7.2, paragraph 71*(c)* & Figure 7.
146 See Appendix 7.2, paragraphs 42–50.
147 We investigated the underlying composition of grade levels in the audit teams and the industry mix for the set of engagements analysed and found no changes that significantly impacted the average fee or cost per hour.
148 The measure is calculated by deducting the average labour cost per hour from the average engagement fee per hour, and expressing the result as a fraction of the average engagement fee per hour. The resulting number expresses the gross margin made on each engagement hour as a percentage of the average fee per hour.
149 See Appendix 7.2, paragraphs 48–50.

introduction of IFRS.[150,151] PwC, Deloitte and KPMG further noted that the sample underlying the analysis was changing over time.[152]

7.37 PwC said that average fees per hour in 2005 prices had fallen due to large company buyer power and intense competition between audit firms.[153] Deloitte said that the reduction in the average numbers of hours per audit and in the fee per hour in 2005 prices was evidence that companies receive good outcomes in this market.[154]

7.38 PwC, KPMG, and Deloitte did not consider our comparison of average nominal fees per hour and average nominal staff costs per hour to be appropriate,[155] and said that staff costs per hour had decreased in 2005 prices. They observed that gross margins remained stable from 2006 to 2011, and said this meant that cost savings in real terms were passed on to companies and that therefore the audit market is competitive.[156,157,158]

7.39 PwC said that it faced substantial and ongoing inflation in its staff costs, and managed increasing salary per head by controlling headcount and increasing chargeable hours per head in order to keep staff costs per hour flat.[159] KPMG said that it kept tight control on pay rises across its business over the period analysed, and it has used more off-shore staff to deliver parts of its audit engagements.[160]

7.40 Oxera (on behalf of BDO) and GT said that the degree of cost pass-through in a market is affected by several factors, such as whether efficiencies are achieved in fixed costs or variable costs, whether efficiencies are firm-specific or industry-wide, and the degree of competition. It further said that the evidence on trends in audit fees is not sufficient to determine the degree of competition, as we do not control for all these factors.[161,162]

7.41 Oxera and GT further said that judged by structural indicators such as switching rates and market shares, conditions of competition had remained approximately the same from 2001 to 2010. It said that therefore it was difficult to link changes in fees to competition analysis.[163,164]

Our view

7.42 In our view the evidence we saw on the evolution of fee levels is inconclusive regarding the presence of an AEC resulting from a feature or a combination of features in the FTSE 350 statutory audit market. Total fees have increased over the period from 2001 to 2010, but could have been driven by regulatory changes. Over the period

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[150] See PwC response to the WP 'Evidence on trends in audit fees', paragraph 15.
[151] See KPMG response to the WP 'Evidence on trends in audit fees'.
[152] See parties' response to the WP 'Evidence on trends in audit fees'.
[153] See PwC response to the WP 'Evidence on trends in audit fees', paragraph 8
[154] See Deloitte response to the WP 'Evidence on trends in audit fees', paragraphs 2.1 & 2.2.
[155] EY said that our the cost measure we used is not reliable, and that therefore it is more prudent to draw conclusions on the development of fees per hour deflated using a price index than comparing nominal fees per hour to the nominal average staff cost per hour. See EY's response to the WP 'Evidence on trends in audit fees', p2.
[156] See PwC response to the WP 'Evidence on trends in audit fees', paragraph 14.
[157] See KPMG response to the WP 'Evidence on trends in audit fees', paragraphs 1 & 2.
[158] See Deloitte response to the WP 'Evidence on trends in audit fees', paragraph 3.2.
[159] See PwC response to the WP 'Evidence on trends in audit fees', paragraphs10.b and 13b
[160] See KPMG response to the WP 'Evidence on trends in audit fees', paragraphs 3.7 & 3.8.
[161] See Oxera response to the WP 'Evidence on trends in audit fees', paragraphs 2.2 & 2.4.
[162] See GT response to the WP 'Evidence on trends in audit fees', paragraphs 2.2 & 2.4.
[163] See Oxera response to the WP 'Evidence on trends in audit fees', paragraphs 3.3–3.7.
[164] GT added that rather than illustrative of effective competition, it considers the real fee increase for FTSE 350 audits since 2001 suggestive of a lack of competition. See GT's response to the WP 'Evidence on trends in audit fees', paragraphs 3.3–3.7.

2006 to 2011 the main cost factor per hour (ie direct staff costs[165]) has been stable in nominal terms, which was associated with stable nominal audit fees per hour over a period without structural changes.

7.43 We cannot evaluate the extent to which the stable costs in nominal terms were driven by efforts by the firms, and therefore represent an efficiency that was 'passed on'. Similarly, while the decrease in average total engagement hours observed from 2006 to 2011 may in part be related to efficiencies achieved by the firms, as the decrease was observed only for FTSE 250 companies, we cannot be sure that was the main driver for the development.

The effect of switching and tenure on engagement profitability and prices

Profitability and tenure

7.44 We investigated the effects of switching and tenure on engagement profitability and prices, although the short time frame (we have at most six data points for each firm/company relationship) and the level of switching limits the confidence we can have in the results of our analysis. However, the data indicated that:

(a) Profitability broadly increased over the first five years of an engagement and auditors achieved greater profitability from engagements with tenures of over five years.

(b) Profitability of engagements did not continue to rise with tenure indefinitely, but appeared to become stable after five years.

(c) There was no indication that Big 4 firms consistently offered very low initial prices (referred to by some Mid Tier firms as 'low-balling'[166]) to reduce engagement profitability to zero (ie only covering direct costs) or incurred a loss in the first years of an engagement before increasing fees significantly in subsequent years.[167]

7.45 Some firms (Deloitte, KPMG and PwC) stated that the observed lower profitability in early years of engagements was consistent with their experience as they bore the cost of getting up to speed and understanding the business of the company, reducing audit risk, and improving efficiency (as well as offering a reduced price). GT noted that this could also reflect various other factors, such as an incumbent taking advantage of its position and reducing the level of resource devoted to an engagement (that is, once appointed offering a lesser service in the belief that a client would be unable or unwilling to switch again in the short run).[168]

7.46 Some firms said that the analysis partly depended on assumptions on partner cost. EY did not consider the measure of profitability used in our engagement profitability

[165] Calculated based on the amount of hours per staff grade allocated to the engagements considered, and the average staff costs per hour for each of the staff grades.
[166] ie Big 4 firms offered to undertake audits for certain companies at low rates in order to win the clients of those Mid Tier firms, and that this excluded those Mid Tier firms from the market in a way that was anti-competitive.
[167] Appendix 7.3, paragraphs 183–184.
[168] GT response to CC working paper 'Engagement level profitability analysis', 5 December 2012, paragraph 1.3.

analysis to be appropriate.[169] BDO and GT noted that the stable level of profits over the period may indicate an increased likelihood of excess profits.[170]

7.47 The fact that engagement profitability increases over the early years of an auditor's tenure is consistent with our analysis on the additional work undertaken by a new audit firm as it becomes familiar with its new client (see Appendix 7.4, paragraphs 86 to 90).

Prices

7.48 For companies that switched auditor during the period for which we collected data, we investigated the percentage real change in total audit fee in the years after switching auditor.[171] The main sample for this analysis consisted of direct switches,[172] where the company remained in the FTSE 350 both before and after the switch. We consider 'direct switches' to be those not associated with the collapse of Arthur Andersen, merger and acquisition activity and moves to or from joint audits.

7.49 We focused on this sample for two reasons. First, we consider these switching events most likely to have followed a competitive tender for the engagement (see paragraphs 7.19 to 7.21). Second, merger and acquisition activity and moves into and out of the FTSE 350 may trigger changes in the complexity and scope of the audit. By eliminating switching events that coincide with this, it becomes less likely that any observed fee changes are driven by something other than the switch.

7.50 For direct switches we found that audit fees generally decreased in real terms the year after a switch and returned to the previous fee level in the third year after switching. The median company obtained a 17 per cent real decrease in fee in the first year after switching, but by the third year saw a 2 per cent real increase (compared with the fee before switching). There was considerable variation in the changes of audit fee: in the first year after switching auditor, fee changes ranged in real terms from an 84 per cent decrease to a 141 per cent increase. 78 per cent of these direct switching events resulted in a real reduction in fee in the first year after switching and 48 per cent in the third year.[173,174]

7.51 In addition to switches, we also looked at occasions where there was a competitive tender but the incumbent retained the engagement. For such events we observed a small real increase in the median audit fee of 2 per cent in the first year following the tender, and that 48 per cent of these companies obtained a reduction in audit fee in the first year.[175] However, as the sample was much smaller than that of direct switches (29 vs 55), it is unclear how much weight we can put on this result.

7.52 Deloitte labelled the descriptive statistics on the changes in fees after switching a 'portfolio view'. It said that the situation specific nature of each audit fee trajectory means that no valid general conclusion can be drawn without investigating each case

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[169] EY believed the calculation of cost per hour of labour understated the hourly cost and thus overstated profits and also identified that the analysis did not include indirect costs. EY response to CC working paper 'Engagement level profitability analysis', 29 November 2012.
[170] BDO response to CC working paper 'Engagement level profitability analysis', 5 December 2012, paragraph 5; GT response to CC working paper 'Engagement level profitability analysis', 5 December 2012, paragraph 1.4.
[171] See Appendix 2.4 paragraphs 52–58.
[172] We based the label 'direct switch' on terminology used by PwC (see paragraph 7.24).
[173] Appendix 2.4, Table 11.
[174] We found similar effects on a sample excluding only switches associated with the collapse of Arthur Andersen and moves to or from joint audits, both in terms of the percentage real change in total audit fee and the percentage real change in total audit fee per £1 million turnover. See Appendix 2.4, paragraphs 52–58.
[175] Appendix 2.4, Table 10.

separately.[176] Therefore Deloitte presented an analysis of a set of switches to Deloitte from 2006 to 2008, and concluded that companies either do not exhibit the aggregate trend or there was a range of alternative drivers behind the pricing trajectory.[177, 178] Deloitte concluded that there was substantial 'noise' in audit price changes, and that any analysis that failed to control for this could not provide robust results.[179,180]

7.53 KPMG said that the range in audit fee changes found after direct switches was enormous. It said that such variation in the data suggested that other factors also have a strong bearing on the observed fee changes, and that an analysis that fails to control for other relevant factors can provide no robust results.[181] EY made a similar point and said that changes in the scope and complexity of any audit may account for significant changes to the audit fee.[182]

7.54 KPMG did not consider the median value informative about the typical price change after a change in audit firm. Further it did not see how we could be confident that there are sufficient observations in the sample where other factors do not significantly affect fees. Finally it noted that it was inconsistent to place weight on a smaller amount of observations in the 3rd and 4th years after a direct switch, while placing less weight on the 29 tenders without a switch.[183]

7.55 The descriptive statistics suggested to us that on average companies have achieved reductions in fees after switching. In particular we observed that the majority of companies that switched saw a reduction in their audit fee. However, we recognize that there might be numerous other factors influencing fees around switching events.

7.56 The importance of controlling for additional factors is even greater for the descriptive statistics of years 2 to 5 after switching. Scope could change substantially over time, even if there was no merger activity. Further, the number of observations with two to five years of data after switching becomes increasingly small. We next consider analysis that PwC conducted that aimed to control for such factors.

- *PwC's submissions on the effect of tender processes or switching on price*

7.57 PwC submitted an econometric analysis of the prices of large company audits[184] that included a range of different factors to explain the price of audits.[185] It said that econometrics enabled a much more rigorous analysis of empirical data than simple descriptive statistics.[186] PwC aimed in particular to explain how the price of audits evolved after a direct tender or switch.[187]

7.58 PwC's analysis found that the price of audits fell following direct tenders or switches, but that these price effects were temporary. The analysis estimated that in the first

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[176] See Deloitte response to the WP 'Review of evidence on the price effects of switching', paragraph 2.1.
[177] ibid, paragraph 2.16.
[178] The alternative drivers Deloitte listed were scope changes (concrete examples given were M&A activity, the inclusion of more subsidiaries in the audit perimeter, and additional audit work as a result of the financial crisis) and the impact of exchange rates movements and inflation. ibid, paragraph 2.10.
[179] ibid, paragraph 3.2.
[180] We note that 6 out of the 13 switches Deloitte analysed were not in our sample of direct switches, which included the cases where Deloitte suspected data errors.
[181] See KPMG response to provisional findings, paragraph 2.3.2.8.
[182] See EY response to provisional findings and Remedies Notice, paragraph 2.2(a).
[183] See KPMG response to the WP 'Review of evidence on the price effects of switching', annex 1, paragraphs 7 to 14.
[184] The report is called 'Econometric analysis of the prices of large company audits' and was reviewed and endorsed by Professor Andrew Chesher of University College London.
[185] The analysis used the public data set developed for the CC's investigation.
[186] See PwC analysis, paragraph 2.4.
[187] ibid, paragraph 4.3.a.

and second year after tendering or switching, companies enjoyed an audit price reduction of 9 per cent and 8 per cent respectively, relative to the price obtained if no tender or switch had occurred.[188] It obtained indications of a price reduction of 4 per cent in year 3 and a price increase of 3 per cent in year 4.[189]

7.59 PwC interpreted these results to show that prices decline immediately on tender or switch and then, in relative (not absolute) terms, 'rise' in the following three years. It said that after the immediate price reduction, prices rise at the rate of about 3 per cent per annum relative to the price that would have been obtained if the company had not tendered or switched. It further said that from 2006 to 2011 the real prices that have been obtained by companies that do not tender or switch have themselves been falling.[190]

7.60 PwC analysis that included observations for banks and financial services companies[191] found slightly larger short-run price effects.[192] This adjusted model estimated that in the first and second year after tendering or switching, companies enjoyed an audit price reduction of 13 per cent and 12 per cent respectively, relative to the price obtained if no tender or switch had occurred.[193,194] It obtained indications of a price reduction of 9 per cent in year 3 and a price decrease of 1 per cent in year 4.[195] We preferred the specification including banks and financial service companies as we consider the sample more representative, but note that PwC said that it preferred the specification excluding them due to data problems with one of the variables.[196]

7.61 With respect to scope and complexity, PwC's econometric analysis controlled for asset value, turnover, merger activity, and takeover switches. It also included the previous year's audit fee, which should capture company specific effects, even if these change over time. To control for risk PwC included a 'loss' dummy and the ratio of inventory to assets.[197] Finally the model included year dummies to capture market developments over time such as regulation and general cost changes.

7.62 PwC said that companies that voluntarily tendered or switched might have been self-selecting (ie that those with particularly high fees might have been those that tendered or switched).[198] We agree that the audit fee level itself could also have had an effect on the likelihood of a direct tender or switch. Therefore we cannot conclude that anyone who tendered or switched would realize the estimated gains, but rather that the average company that tendered or switched did.

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188 The estimated price effects were calculated taking into account the dynamic structure of the model specification, which included the previous year's audit fee as an explanatory factor for this year's audit fee. Such a dynamic structure implies that effects estimated for a specific year partially carry forward into the next year, and so forth.

189 The estimated price effects in years 3 and 4 were not statistically significant.

190 See Annex 1 to PwC response to provisional findings and Remedies Notice, dated 22 March 2013, paragraph 19(a).

191 These observations are excluded from PwC's preferred model due to missing inventory data. We calculated that such observations account for around 20 per cent of the total number of observations and around 30 per cent of the audit fees. However, with pragmatic assumptions and a slightly altered specification, PwC managed to resolve the data issue.

192 The point estimates for the price effects of the model including observations for banks and financial service companies are larger than those obtained by the model excluding them, even though the difference between the estimates is not statistically significant.

193 The estimated price effects were calculated taking into account the dynamic structure of the model specification, which included the previous year's audit fee as an explanatory factor for this year's audit fee. Such a dynamic structure implies that effects estimated for a specific year partially carry forward into the next year, and so forth.

194 We calculated these numbers based on PwC estimates. See Appendix 7.5, paragraph 34.

195 The estimated price effects in years 3 and 4 were not statistically significant at the 5% level, but the effect for year 3 was significant at the 10% level.

196 See PwC analysis, paragraph 3.13, and PwC response to the WP 'Review of evidence on the price effects of switching', Annex 1, paragraph 10.

197 This variable received a notional constant value for banks and financial service companies. PwC explained that the value employed does not matter in the 'company specific effects' model as the estimates are based entirely on within company variation in fees and other variables. See PwC analysis, paragraph E.2.

198 See PwC analysis, paragraph 4.20.

7.63 We note that the relative price decrease PwC estimated for the first year after tendering or switching on the sample including banks and financial services companies is similar to, but smaller than the median price decrease we observed for direct switches in our descriptive statistics (13 vs 17 per cent). One potential reason for this is the fact the PwC's analysis jointly considered both direct switches and tenders that did not result in a switch. Another potential reason is the fact that PwC's sample was not restricted to FTSE 350 companies, but included all companies in the public data set.[199]

7.64 PwC also presented results for a 'industry and index effects' model, and concluded from its findings that, in the long run, companies that tendered or switched did not obtain lower prices than companies that did not tender or switch.[200] We consider that there are caveats to this analysis (see Appendix 7.5, paragraphs 72 to 86), which therefore did not convince us that there are no benefits to tendering or switching.

- *Other firms' submissions on the effect of tender processes or switching on price*

7.65 KPMG noted that PwC's analysis estimated a smaller decrease in audit fees after a tender or switch than we found in the descriptive statistics. It said this showed that when other relevant factors were controlled for, the magnitude of the price effect that we observed decreased.[201]

7.66 KPMG did not consider the variables included by PwC to be sufficient to control for audit scope, quality or costs. It said that a failure to adequately control for scope implied that the results of the PwC analysis were not a 'price pattern', but rather a 'pattern in revenue' displaying the development of total audit fees. It further said that a failure to control for audit quality in particular implied that we could not assess the competitiveness of the audit fee.[202]

7.67 KPMG said there were many drivers of audit scope, such as global reporting complexity, differing accounting standards and diverse company structures.[203] It further said that as part of the tender process a company may decide to define a narrower scope for its audit, for example by limiting audit-related services. KPMG noted that PwC's model includes fees for audit-related services, the scope of which can vary enormously and not in relation to any of the controls used for audit scope.[204]

7.68 We consider that PwC's econometric analysis[205] provides interesting insights in the relative price development after tendering or switching. It is a helpful extension to the descriptive statistics, as it controlled for various observable factors that co-determine the level of audit fees. We consider that given the available data and the nature of the industry, PwC's 'company specific effects' model took into account those factors that it reasonably could.

7.69 However, we acknowledge that the model likely does not control for all relevant factors that determine the audit fee, and some of these omitted variables might bias

[199] We estimated that if the sample was restricted to direct tenders and switches of FTSE 350 companies only, the estimated price effect would be slightly greater but similar. See Appendix 7.5, paragraph 47.
[200] See Annex 1 to PwC response to the provisional findings and notice of possible remedies, 22 March 2013, paragraphs 19(b) & 20(a)(ii).
[201] We discuss potential reasons for this difference in paragraphs 7.60 & 7.63.
[202] See KPMG response to the WP 'Review of evidence on the price effects of switching', paragraphs 2.3.2.2 & 2.3.2.5. KPMG made a similar point with regards to the descriptive statistics—see ibid, paragraphs 2.2.1 & 2.2.2.
[203] ibid, paragraph 2.3.2.4.
[204] ibid, paragraph 2.3.2.4.
[205] Here we refer to the 'company specific effects' model only.

the results.[206] Another issue is the potential selection bias (ie it was those companies that suffered high prices that were more likely to tender or switch).

- *Our view*

7.70 We found that in the first year after a direct switch the median real fee change is a 17 per cent decrease. Econometric analysis submitted by PwC found a relative[207] price effect of 13 per cent in the first year after the tender process or switching, but also indicated that this price benefit eroded over the course of the following three years. We consider this evidence in combination with other evidence in paragraphs 7.110 to 7.113 and paragraphs 7.265 to 7.267.

Price concentration analysis

7.71 For the reasons given in Appendix 7.6, while we had data to carry out a price concentration analysis (PCA), we were not persuaded that the results would be reliable. In particular, we were not able to identify a way of overcoming problems arising from the fact that the number of separate economic markets that we could identify would be too small to investigate any relationship between concentration and price. We also had concerns around missing supply- and demand-side variables, and the implications they would have for our ability to draw robust conclusions. In the light of these shortcomings, we decided not to pursue this line of investigation.

Firm submissions

7.72 Several firms agreed that a PCA analysis was not suitable and would not produce robust results.[208,209] However, Oxera, on behalf of BDO and GT, acknowledged the empirical challenges, but said that there might be ways to mitigate their effect. It said that qualitative evidence might help evaluate the direction and size of any problems resulting from omitted costs variables. It also suggested that financial services might be considered a treatment group (in which, for exogenous, institutional reasons, the number of competitors is lower and hence the product market concentration is higher), with all other sectors considered the control group.[210] Oxera agreed that more narrowly-defined markets based, for example, on industry sector might not constitute separate economic markets. Nevertheless Oxera said that there was value in considering such an analysis. In summary, Oxera thought that a detailed review of the many existing PCA studies in audit would be informative, and that some form of PCA remained feasible and potentially valuable, albeit perhaps less conclusive than in other applications.[211]

7.73 We were not persuaded that Oxera had proposed ways of overcoming the missing variable problems. We agreed that the engagement level data would provide further information on costs, but there might remain significant omitted cost and other factors. More importantly, we did not agree that an analysis based on a small number of separate markets or on market definitions which were not reflective of demand- and supply-side conditions could be informative. For further details, see Appendix 7.6.

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[206] For example, engagement-specific quality changes over time.
[207] Relative to if the company had not tendered or switched.
[208] PwC response to five working papers concerning audit prices, engagement level profitability, costs, tenure and switching.
[209] KPMG response to PCA working paper.
[210] www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/pca_oxera.pdf.
[211] ibid.

7.74 Mazars noted that there had been a substantial rise in audit fees for FTSE 100 companies, and that the rise was far higher than for FTSE 250 companies or other listed companies, all of which were required to move from UK GAAP to IFRS in the period. Mazars said that, given that switching rates were lower in the FTSE 100 than the FTSE 250 and the opportunities for switching auditors generally thought to be less, the rise in fees might be thought to be the result of high concentration and low competition, which was more marked in the FTSE 100 than other parts of the listed market.[212]

7.75 We did not accept that the evidence was sufficient to draw such a conclusion. Concentration[213] in the FTSE 100 audit market has remained stable over the last ten years, and there are other possible explanations. For example, the change from UK GAAP to IFRS may have been more costly for FTSE 100 companies than FTSE 250 companies.[214]

Profitability

7.76 Profitability can indicate whether prices in a market are too high. In assessing profitability for the purposes of a market investigation, we seek to measure economic profits of the business activity in question, which can differ in important respects from accounting profits for various reasons which we discuss further below. Most notably, accounting profits may not take into account the value of capital employed and the cost of that capital.

7.77 We considered the relevant revenues, costs and capital base of FTSE 350 statutory audit engagements. In practice, firms do not have stand-alone FTSE 350 audit businesses, and audits of FTSE 350 companies are conducted by firms which also undertake audits of a variety of other companies as well as providing other types of work.

7.78 We distinguished between engagement profitability, which is concerned with the profitability of an individual audit engagement, and the profitability of FTSE 350 audits in aggregate, which is concerned with the profitability of the FTSE 350 audit service as a whole, or of the audit and Assurance service line within the firm. At the engagement level, it is the audit fee and the staff and partner costs of delivering that audit which are most important.[215] When considering the profitability of the audit business in aggregate, costs which are shared across the business such as IT systems, back office and support staff and accommodation costs also become relevant.

7.79 We had difficulty in accurately factoring in partner costs (and staff costs to a lesser extent) in our assessments of engagement level profitability, because firms did not capture the costs of individual partners or staff on engagements (we comment on this absence in paragraph 7.112). Hence our assessments of engagement level profitability are a measure of profits taking into account staff and partner hours spent on the audit at representative (or average) rates. They do not take into account other costs which are not directly incurred on an engagement basis.

7.80 In the next subsections, we consider profitability at the level of:

(a) firms' FTSE 350 audit engagements in aggregate;

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[212] Mazars response to 'Descriptive statistics' working paper, paragraph 3.
[213] Market concentration was calculated based on audit firms' shares of audit fees.
[214] See KPMG response to 'Descriptive statistics' working paper, Appendix 1 & Figure 6.
[215] Non-staff costs comprise 4 to 7 per cent of the audit fee. Appendix 7.3, Annex 2.

(b) partner;

(c) business line; and

(d) individual engagement.

7.81 We also *(e)* considered evidence relating to engagements of above-average profitability.

Firms' FTSE 350 audit engagements in aggregate

7.82 We are interested in whether the profits from FTSE 350 audit engagements for firms representing a substantial proportion of the market have exceeded the appropriate cost of capital over a sustained period.[216] We considered whether we could obtain appropriate data from the firms' management accounts to assess the profitability of FTSE 350 statutory audits. There were a number of issues to consider in assessing profitability, including: *(a)* cost allocation; *(b)* partner remuneration; *(c)* capital base; and *(d)* the appropriate benchmark cost of capital.

7.83 We encountered significant problems with each of these issues. In the case of large professional services firms, much of the asset base is intangible in the form of clients, reputation, human and intellectual capital, and much of this capital (and other types of costs) is shared with other service lines, and we found no reliable way to identify or measure the appropriate costs. Further, the partnership structure of firms gives rise to difficulties because partner remuneration is a combination of salary and profit share and it is difficult to differentiate between the two in a reliable manner. Lastly, there is no established framework for measuring the cost of capital given the nature of partners' investments in the firm.

7.84 We set out in detail our consideration of these issues and the views of firms in Appendix 7.2, paragraphs 14 to 76. In summary, there were significant uncertainties attaching to each of the four issues identified in paragraph 7.82, which precluded us from generating economic profitability measures on which we could rely. Due to the multiple layers of uncertainty, particularly the difficulty of measuring the appropriate asset base and an appropriate measure of partner cost, we did not undertake detailed economic profitability calculations using return on capital employed (ROCE). PwC proposed an adjusted return on sales (adjusted ROS) type analysis[217] but we considered that this measure was subject to the same difficulties and uncertainties as ROCE, if it were to be used in an economically meaningful way. In particular, in our view, it does not avoid the need to identify an economically meaningful asset base and measure of partner cost. KPMG proposed a ROCE model, however we did not consider that the assumptions that it included for partner salary, cost allocation, asset base or cost of capital were sufficiently robust or would not be obtainable on a comparable basis for all firms[218]. As a result, we were not persuaded by the analysis that PwC and KPMG had undertaken that there was not an excess return in the market on the basis of the adjusted ROS/ROCE calculations that they submitted (see further Appendix 7.2). We were unable to conclude, based on analysis of profitability, whether firms had earned profits above the cost of capital on their provision of FTSE 350 audit services.

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[216] CC3, paragraphs 116–119.
[217] For details of PwC's proposed adjusted ROS calculation, see Appendix 7.3.
[218] We discuss these issues in greater depth in Appendix 7.3, paragraphs 80–93.

Profits per partner

7.85 We considered trends in profits as an indicator of changes in the competitive environment. We considered the total remuneration earned by audit and non-audit partners for the largest six firms over the eight-year period from 2003 to 2011 (see Appendix 7.3, paragraphs 111 to 136). The data indicated that there was no systematic difference in remuneration per partner for audit and non-audit partners. Over the eight-year period, three out of four of the Big 4 firms had seen an increase in audit partner remuneration in real terms. However, in recent years (since 2007/08) remuneration per partner had fallen in real terms.

7.86 We considered whether it was possible to benchmark partner remuneration to establish whether the absolute level could be said to be too high or too low. We considered analysis submitted by PwC (see Appendix 7.3, paragraphs 117 to 120). Its average total remuneration per audit partner was £[✂] in 2011. It conducted a benchmarking exercise and found that on average, its partners might be able to earn £[✂] in comparably 'sized' roles within the finance functions of UK companies. PwC provided information to indicate that the median benchmarked salary for each of its four 'partner levels' ranged from £214,000 to £876,000. PwC's benchmarking indicated that the role performed by its most junior grade of partner corresponded to the Head of Internal Audit or Financial Controller at a company with revenues of £1–£5 billion and its most senior partners were benchmarked to the Group FD of listed companies with a market capitalization of £1–£3 billion.[219]

7.87 It explained the difference as reflecting remuneration being calculated based on the total profits of the multidisciplinary firm, where partners had a mix of audit and non-audit roles and other responsibilities, the significant intangible asset base that PwC had built up over time from its reputation for quality and an element to reflect the financial investment in the business that the partners had made (we note that average capital investment in the firm is currently £[✂]).[220]

7.88 We considered that the difference between the benchmarked salary and the total remuneration is equivalent to a return on invested capital, which in theory should equal the opportunity cost of capital multiplied by the market value of the average partner's share of the firm's capital. For the reasons discussed above, we have not been able to evaluate the market value of the firm's capital base or the opportunity cost of capital in this market. Hence we are not able to conclude from this information that Big 4 firms are earning profits above the competitive level. (See Appendix 7.3.)

Business line profitability

7.89 We considered the relative profitability of each firm's service lines in detail. We found that Assurance[221] (as a business line within firms predominantly comprising audit and audit-related services), on the basis of the cost allocation choices of the parties, had comparable margins (both gross and net) to other service lines (see Appendix 7.3, paragraph 167).

7.90 Some Big 4 firms submitted that their Assurance business was their highest risk line of service (in terms of the potential damage to a firm's reputation and unlimited

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[219] See Appendix 7.3, Table 1.
[220] www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/mph_summary_pwc.pdf, paragraph 8.
[221] The firms all report an Assurance business unit/service line that encompasses their statutory audit work and several other services, not all of which are similar to statutory audit work. The components of the Assurance business unit/service line differ between the firms.

financial liability if the audit work is criticized (see Appendix 7.3, paragraphs 157 to 166)). Deloitte, in particular, said that Assurance having comparable margins with other service lines was evidence of a lack of excess profit in the market (see Appendix 7.3, paragraph 158).

7.91 We do not think that audit partners face an unusually high degree of risk. We found that the risks were capable of mitigation: the incidence and amount of claims paid out by firms was low, and claims were rarely made against individual partners. We found that firms were able to obtain adequate levels of professional indemnity insurance, but in the exceptional event that a negligence claim succeeded against a firm and was not fully covered by insurance, the partners' liability is generally limited to the amount of their capital contribution to the firm. See further Appendix 7.7.

7.92 Further, Assurance (including audit) was a relatively stable income stream in comparison with other service lines because of the low switching rates we had observed and the statutory requirement to purchase an audit annually. Having weighed the evidence, we were not persuaded that the risks of conducting audit business were unusually high. (See paragraph 7.91 and Appendix 7.3 paragraph 169)

7.93 Taking into account the similar margins on audit work and non-audit work, the similar levels of partner remuneration for audit and non-audit partners, and our view that audit was not a significantly more risky line of business, we concluded that firms earned levels of profitability on audit and assurance work that were broadly equivalent to those earned on other service lines. We did not find evidence that audit was a loss leader or was subsidized by NAS.

Engagement profitability

7.94 A key measure of engagement level profitability used by the firms was the proportion of scale rate revenues recovered by fees, ie the 'revenue recovery rate' (RRR). It appeared that no firm (Big 4 or Mid Tier) calculated a profit per engagement that closely reflected actual costs. The focus for management in using RRR is in comparing relative performance of engagements (between one another and over time) rather than indicating absolute levels of profitability of engagements. The firms' measures of RRR were not comparable with one another, due to the differences in firms' scale rates.[222]

7.95 We considered the average profitability (using only direct costs[223]) as a percentage of income from statutory audit engagements within firms in respect of a number of characteristics to understand whether any characteristics of the market might indicate that competition and competitive pressures varied with respect to different categories of company. We were unable to establish a reliable measure of partner labour cost for individual firms and we have based partner labour cost on director costs.[224] Detail is contained in Appendix 7.3, paragraphs 174 to 189.

7.96 On this basis (ie margin as described in paragraph 7.94), with respect to the index classification of the client company (eg FTSE 100/250 or other), we found that:

(a) FTSE 100 audits were on average more profitable than FTSE 250 audits by between two and six percentage points.

[222] Scale rates will differ both because of differing underlying cost bases but also because a scale rate will include an amount of headroom which relates to potential profit.
[223] Labour costs on average accounted for 93 per cent of all direct, engagement-specific costs in the period 2006–2011.
[224] A partner's hourly labour cost is calculated at twice the equivalent cost of a director.

(b) The profitability of engagements within the FTSE 100 and the FTSE 250 had remained broadly consistent over the period 2006 to 2011.

(c) The average engagement profitability of non-FTSE 350 audit engagements was on average greater than for FTSE 250 engagements but lower than for FTSE 100 audit engagements.

7.97 With regard to industry sector, companies were classified in one of the following industries: oil and gas, basic materials, industrials, consumer goods, health care, consumer services, telecommunications, utilities, financials or technology. We found that the average profitability of FTSE 350 engagements when grouped by industry for the period 2006 to 2011 varied by some 12 percentage points (the average profitability of engagements for each of the ten industry groupings was between 53.0 and 64.6 per cent).

7.98 'Industrials' industry engagements consistently achieved the lowest average audit margins, whilst 'Financials' industry audits achieved the highest average engagement profitability.[225]

7.99 In terms of firms' views:

(a) BDO noted that profits calculated in aggregate were greater than the average profit of individual engagements and thus indicated that larger engagements were likely to be more profitable.[226]

(b) Deloitte noted that [✂] engagements were typically less profitable than [✂] engagements.[227]

(c) EY considered that our measurement of profitability was flawed because of the nature of cost rates used (and a number of firms identified that the assumption on partner cost affected the findings of the analysis).[228]

(d) KPMG observed that the differences in the engagement margins that were earned across the different market segments were very low.[229]

(e) PwC expressed doubt as to the reliability of observations on the relative profitability engagements by market segment (ie that FTSE 100 audits appeared more profitable than FTSE 250 audits and that top track audits were somewhere in between) as there were a number of aspects the analysis did not take into account: (i) FTSE 100 audits generally demanded more time from senior (and therefore more costly) partners; (ii) indirect costs were not controlled for whereas they were particularly relevant for audits of the larger and more complex companies (eg software); and (iii) the benchmark group of non-FTSE 350 companies was incomplete. PwC presented some additional external evidence from its Transparency Report.[230]

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[225] These industry classifications are per the Industry Classification Benchmark, developed by Dow Jones and FTSE. There are further sub-classifications, which the engagements have not been analysed by due to the potentially large number of categories and low number of corresponding data points.
[226] BDO response to CC working paper 'Engagement level profitability analysis', 5 December 2012, paragraph 6.
[227] Deloitte response to CC working paper 'Engagement level profitability analysis', 3 December 2012.
[228] EY response to CC working paper 'Engagement level profitability analysis', 29 November 2012.
[229] KPMG response to CC working paper 'Engagement level profitability analysis', 4 December 2012, paragraph 1.3.
[230] For the purposes of transparency, PwC voluntarily publishes audit operating profit margins in addition to audit revenues in its Transparency Report. See Annex 4 of PwC's submission 'Observations on the assessment of audit profitability' (7 August 2012).

Engagements of above-average profitability

7.100 In examining engagement level profitability, we considered the characteristics of the most profitable FTSE 350 engagements. For each firm we identified a number of FTSE 350 engagements that had a profitability that was stable over time and on average more than five percentage points higher than the firm's average FTSE 350 engagement profitability over the period 2006 to 2011. Using the public data set and our first survey results, we investigated the characteristics of these more profitable audit clients compared with those of other FTSE 350 companies.[231]

7.101 We found that the higher engagement-profitability clients were more likely to be in the FTSE 100, to be active in the financial sector, and to have larger total assets than other clients in the FTSE 350.[232] In particular:

(a) Among the group of companies with higher engagement-profitability, 45 per cent were FTSE 100 companies while this was 26 per cent for the other companies.

(b) A greater proportion of higher engagement-profitability companies than other companies were active in financial services (29 per cent vs 20 per cent), insurance (8 per cent vs 4 per cent), and real estate (8 per cent vs 1 per cent).

(c) 4 per cent of the higher engagement-profitability companies were in the group with the lowest 20 per cent of total assets in 2010, whereas this was the case for 23 per cent of the other companies.

(d) 32 per cent of the higher engagement-profitability companies were in the group with the highest 20 per cent of total assets in 2010, whereas this was the case for 18 per cent of the other companies.

7.102 Our first survey results indicated that, compared with other FTSE 350 clients, these higher engagement-profitability clients: had a higher average turnover; were less likely to switch auditor in response to a substantial price increase; and were less likely to have been approached by rival firms. We noted that there were no significant differences between higher engagement-profitability and other FTSE 350 clients in terms of the importance of the international network, sector-specific expertise and experience of the auditor, and the proportion of the fee that is accounted for by non-UK activities.[233]

7.103 The parties said that the profitability measure we relied on to identify the higher engagement-profitability companies suffered from measurement error, which could introduce a bias in the selection of the higher profitability engagements. The arguments they presented can be summarized as follows:

(a) we had not correctly captured direct costs:

(i) EY said that our cost estimates for staff were based average staff costs within grade bands, which can understate the costs of conducting complex audits which may require staff with more experience or expertise.[234]

[231] See Appendix 7.3, paragraphs 187–189, and Annexes 3 & 4 for further details.
[232] A Pearson's chi-squared test rejected independence between the higher-profitability indicator and index designation, industry segment, and total assets category. See Appendix 7.3, Annex 3, paragraphs 4–6.
[233] See Appendix 7.3, Annex 3, paragraphs 11–16.
[234] See EY response to provisional findings and Remedies Notice, paragraph 2.2(c).

(ii) KPMG and PwC said that we did not properly measure the cost of partner time, which introduced a bias as more complex audits (such as those in the FTSE 100) require more and more senior partner time.[235,236,237]

(b) KPMG said we did not control for indirect costs, and that in particular more complex engagements may require greater investments.[238,239]

7.104 Deloitte, KPMG, and PwC further said that engagement profitability is variable and that it is a normal outcome that some engagements are more profitable than others.[240,241,242] PwC said that this variability reflects factors such as the specific needs of the company, the point in the audit lifecycle, and the outcome of company specific negotiations.[243] EY and KPMG said there might be factors that can explain differences in profitability, such as risk and complexity.[244,245] KPMG pointed out we have not controlled for these or other factors in our analysis.[246,247]

7.105 We recognize that, where an engagement requires more specialized staff, staff costs may be higher. This also applies to the seniority of partner time. We do not have data on salary variations within pay grade, [✂].[248,249] Further, the distribution of the share of partner hours[250] on higher profitability engagements is not significantly different from that on other FTSE 350 engagements.[251]

7.106 To the extent that some types of indirect costs are driven by certain engagements in particular, we would expect them to be allocated to these engagements.[252] We consider it unlikely that allocating indirect costs would change relative profitability substantially. For the reasons listed above, we have no reason to believe that our selection of higher engagement-profitability companies is significantly biased.

7.107 We further note that the higher engagement-profitability are more than 5 percentage points more profitable than the firms' FTSE 350 engagements overall. We consider this provides a margin for error.

7.108 As to profitability being related to risk and complexity, we note that Deloitte, KPMG, and [✂] said that the pricing of audits does not include risk premiums.[253,254,255] Rather, higher risk on engagements is addressed through additional resources, and we expect the same principle to apply to more complex audits. Therefore such engage-

[235] See KPMG response to provisional findings, paragraph 2.4.2.10 & 2.4.2.11.
[236] See KPMG response to provisional findings, paragraph 2.4.2.14.
[237] See Annex 1 to PwC's response to provisional findings and Remedies Notice, dated 22 March 2013, paragraph 27(a).
[238] See KPMG response to provisional findings, paragraph 2.4.1.2.
[239] See ibid, paragraph 2.4.2.12.
[240] See Deloitte response to provisional findings, paragraph 5.3(b).
[241] See KPMG response to provisional findings, paragraph 2.4.2.1 & 2.4.2.2.
[242] See Annex 1 to PwC's response to provisional findings and Remedies Notice, 22 March 2013, paragraph 27(b).
[243] ibid, paragraph 27(b).
[244] See EY response to provisional findings and notice of possible remedies, paragraph 2.2(c).
[245] See KPMG response to provisional findings, paragraph 2.4.2.13.
[246] See KPMG response to provisional findings, paragraph 2.4.1.2.
[247] See KPMG response to provisional findings, paragraph 2.4.2.9.
[248] See Appendix 7.3, Annex 2, Table 21.
[249] The jump in staff costs for the director level appeared larger—see Appendix 7.3, Annex 2, paragraph 49.
[250] We also did not find an association between the share of 'senior hours', which includes time recorded for directors, and the higher-profitability indicator.
[251] See Appendix 7.3, Annex 3, Table 7.
[252] The engagement data set contains a field 'Direct non-staff costs (£000)' where this could be recorded.
[253] Deloitte said that the profitability of audits did not include a risk premium. High-risk clients were allocated a 'National Risk Partner' and would most likely be resourced with a more experienced team, who would undertake more work, which may lead to a higher price, but only to represent the increased resource cost. See Appendix 7.8, paragraph 35.
[254] For KPMG, the level of risk attributed to a client affected price but only with respect of the increased level of work needed to mitigate that risk, rather than charging a specific risk/reward premium. See Appendix 7.8, paragraph 159.
[255] [✂] Appendix 7.8 [✂].

ments would likely require a higher number of hours, but we do not expect the relative margin on these hours to be higher.

7.109 We consider that this analysis provides evidence that: *(a)* all firms have some FTSE 350 engagements with a profitability that is stable and more than 5 per cent higher than average for the firm; and *(b)* that these engagements are more likely to be the more complex audits and to be for companies that are less willing to switch auditors (which may itself reflect the complexity of the audit).

Our view on pricing, profitability and switching

7.110 We note that the availability of market indicators is constrained by the bespoke nature of audits, and the positioning of the audit service line within accounting firms. The first limits general pricing details, while the second prevents reliable assessment of the capital employed in the audit business. We think this explains why we have not found good evidence regarding the overall profitability of the Big 4 firms.

7.111 However, we found evidence that:

(a) On average companies that tender or switch firm enjoy a significant, if transient relative price benefit (see paragraphs 7.48 to 7.70).

(b) Firms earned levels of profitability on FTSE 350 audit work that were broadly equivalent to those earned on other service lines. We did not consider audit to be significantly more risky than firms' other service lines. We did not find evidence that audit was a loss leader or was subsidized by NAS. We were not able to assess whether firms were earning excessive profits (see paragraphs 7.76 to 7.99).

(c) There appear to be significant numbers of companies from which the firms enjoy persistently higher profits than average (paragraphs 7.100 to 7.110).

7.112 We were surprised that no firm monitored actual partner or staff costs at an engagement level (instead using average salary costs per grade or notional charge-out rates). We noted that this was consistent practice across Big 4 and Mid Tier firms and we also accepted that for staff grades, it might not make much difference if there were little variation in pay within grades. However, based on what firms told us, it appeared that factoring in the true cost of the partner working on a specific engagement could make a real difference to the results. Some firms said that this was a factor that could negate our result that FTSE 100 audits were more profitable than FTSE 250 audits, because FTSE 100 audits demanded more senior partner time.

7.113 In our view, the fact that firms do not monitor the actual costs of delivering engagements, including an accurate measure of the cost of partner time spent on the engagement, might suggest that profit levels are sufficiently above cost to make close monitoring unnecessary.

Quality

7.114 We set out in paragraphs 6.11 to 6.18 our view, and the views of firms (paragraph 6.21), regarding the definition of quality in the context of an audit process. This definition is not readily susceptible to an objective metric. In this subsection, we consider indicators of the quality of audits in practice, in particular:

(a) company and shareholder views of audit quality;

(b) regulator views of audit quality;

(c) litigation activity and insurance claims; and

(d) firms' views.

7.115 This review provides information regarding the functioning of the market. Aspects of audit quality include the independence, integrity, objectivity and scepticism of the auditor, and as noted given their importance and their particular challenges, we consider them separately in paragraphs 7.151 to 7.188.

Company and shareholder views of audit quality

7.116 Our case study companies (see Appendix 2.1) generally expressed a positive view of their auditor. Minor concerns were raised regarding price,[256] service,[257] or that a firm was still learning about the company.[258]

7.117 In our second set of case studies we identified a number of companies where the FD or ACC had not been satisfied with the audit service which had ultimately led to a tender and in most cases a switch of auditor. The Company U ACC was not convinced that the Audit AEP was giving sufficient time to the company and went to tender to find a more challenging auditor.[259] Company T felt that the company's incumbent auditor had become complacent.[260] The Company K ACC stated they had gone to tender partly because the company was not completely satisfied with the audit service it had been receiving.[261] Company J switched auditors after a series of problems including technical errors, communication issues, and generally poor levels of service.[262]

7.118 Shareholders, as noted in paragraphs 5.50 to 5.52 and 5.58, lack the information necessary to appraise directly the quality of any particular audit, and must rely on company management (and the AC) and the audit firm, and regulators, to ensure the quality of the audit.[263] A number of investors and investor groups observed that AQR from their perspective was the only independent assessment of audit quality.

Regulatory views of audit quality

AQR

7.119 The AQR team was the only external source of information we identified on individual audit reports that had access to detailed information including audit files for PIE in the UK. As noted in paragraph 7.118 this view was also expressed by some investors.

7.120 According to the FRC's website,[264] the AQR team monitors the quality of the audits of listed and other major PIE and the policies and procedures supporting audit quality at the major audit firms in the UK. It monitors and promotes improvements in the quality of auditing of listed and other major PIE. It applies a risk-based approach in selecting individual audits for review, utilizing a risk model covering main market and AIM-

[256] Appendix 2.1, Company B, paragraph 17.
[257] Appendix 2.1, Company J, paragraph 23.
[258] Appendix 2.1, Company A, paragraph 61.
[259] Appendix 2.1, Company U, paragraph 12.
[260] Appendix 2.1, Company T, paragraphs 4 & 20.
[261] Appendix 2.1, Company K, paragraph 19.
[262] Appendix 2.1, Company J, paragraph 43.
[263] See, for an example, Appendix 2.1, BlackRock, paragraph 3.
[264] www.frc.org.uk/Our-Work/Conduct/Audit-Quality-Review.aspx. See Appendix 3.1, paragraph 171.

listed entities.[265] Its reviews of individual audits emphasize the appropriateness of audit judgements key to reaching the audit opinion and the sufficiency and appropriateness of the audit evidence obtained. Its reviews of firm-wide procedures are wide-ranging and include an assessment of how the culture within firms affects audit quality. See further Appendix 3.1, paragraphs 171 to 175.

7.121 The Big 4 firms are subject to inspection on an annual basis by the AQR team and 'Other Major Firms' (which include BDO, GT, Mazars and PKF) on an extended cycle of up to three years.[266]

7.122 The AQR team monitors compliance with what is essentially the regulatory framework for auditing, including the Auditing Standards, Ethical Standards and Quality Control Standards for auditors issued by the FRC's Auditing Practices Board (APB) and other requirements under the audit regulations issued by the relevant professional accounting bodies.

7.123 The AQR team produces both private and public reports:

(a) Private reports on issues arising from review of specific engagements are sent to the relevant audit firms and the professional accounting bodies. Audit firms are expected to provide copies of these reports to the directors of the audit clients concerned. These reports are therefore seen by ACs.

(b) The AQR team publishes individual reports on the inspections of major firms (the Big 4 firms plus six others) on the FRC's website. In the individual report for each major firm, the AQR team bands each audit into one of three categories considering a variety of factors: (i) good with limited improvements required; (ii) acceptable but with improvements required; and (iii) significant improvements required.

7.124 Table 7.5 shows the results by firm of the AQR team inspections for the last three reviews for the six largest firms.[267]

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[265] See Appendix 3.1, paragraphs 173–175.
[266] 'Major firms' are those which audit ten or more entities which fall under the AQR team's scope: www.frc.org.uk/Our-Work/Conduct/Audit-Quality-Review.aspx.
[267] The FRC states that changes to the proportion of audits reviewed falling within each grade from year to year reflect a wide range of factors, which may include the size, complexity and risk of the individual audits selected for review, changes to their areas of particular focus and the scope of the individual reviews. For this reason and given the small sample sizes involved, changes in gradings from one year to the next are not necessarily indicative of any overall change in audit quality at a firm.

TABLE 7.5 **Public results of AQR team inspections of largest six firms for the last three review periods (includes all PIE audits and not just FTSE 350)**

	Number reviews	*Good*	*Acceptable*	*Sig. improvement needed*	*Number reviews*	*Good*	*Acceptable*	*Sig. improvement needed*	*Number reviews*	*Good*	*Acceptable*	*Sig. improvement needed*
		2012/13				*2011/12*				*2010/11*		
Deloitte	14	11	2	1	14	6	7	1	13	9	3	1
EY	12	10	1	1	11	6	3	2	13	5	7	1
KPMG	13	7	6	0	14	6	7	1	14	10	2	2
PwC	14	11	2	1	14	8	5	1	15	7	7	1
		2011/13				*2009/11*				*2008/09*		
BDO	7	2	3	2	8	4	3	1	5	3	2	0
GT	10	5	2	3	10	2	6	2	7	1	6	0

Source: FRC Individual firm audit quality inspection reports.

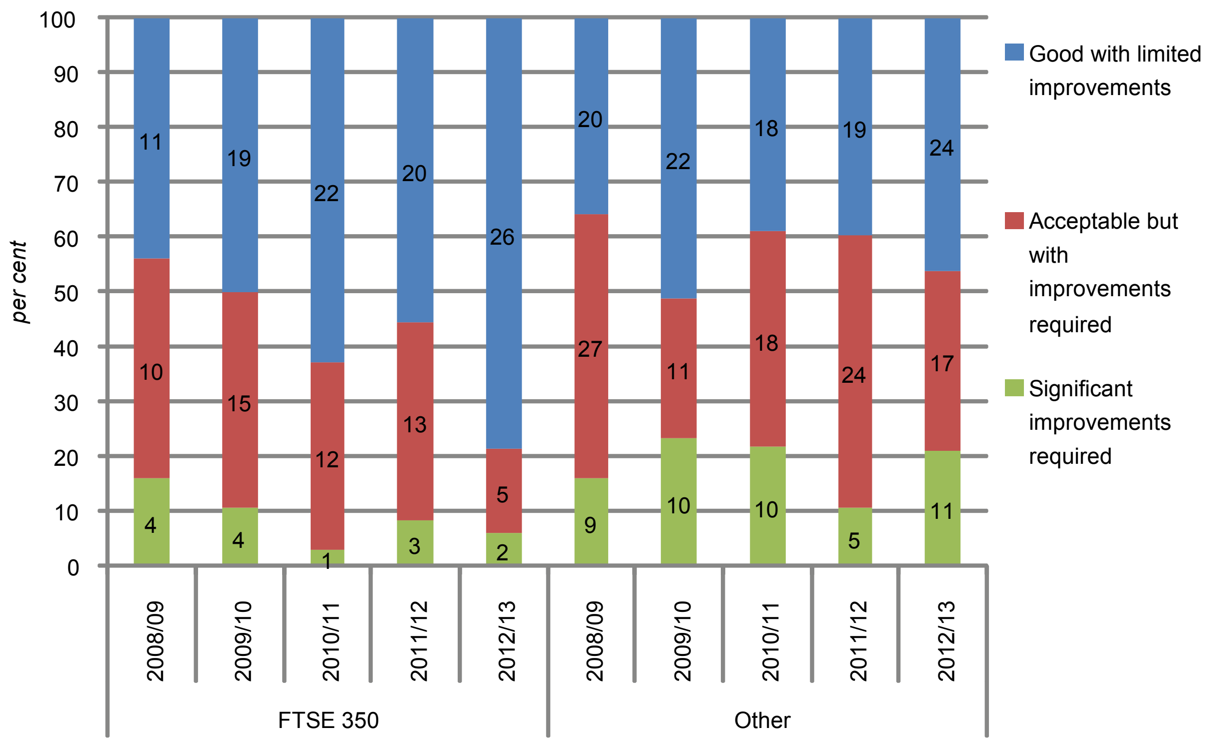
Note: BDO and GT are reviewed biennially, and thus the last three reviews cover a longer period (2008 to 2013) than those of the Big 4 (2010 to 2013).

7.125 In five years (2008/09 to 2012/13) of the 167 FTSE 350 audits reviewed by the AQR team, 14 have required significant improvement [✂].

7.126 The AQR team's file review gradings (excluding public sector and follow-up reviews) for 412 audit engagements reviewed in the 2008/09 to 2012/13 cycles are summarized in Figure 7.1 below.

FIGURE 7.1

AQR team report outcomes, 2008/09 to 2012/13



Source: CC analysis of AQR team annual reports.[268]

7.127 Each of the AQR team's reports on individual firms provided a list of key findings and areas to which the firm should pay particular attention.[269]

7.128 The AQR team raised concerns about audit quality in its annual reports for 2008/09 and 2009/10. A key message of its 2009/10 annual report was the need for audit firms to demonstrate greater professional scepticism. It said that the number of audits requiring significant improvement remained too high and suggested that firms were not always applying significant professional scepticism in relation to some key audit judgements. In 2011/12 the AQR team acknowledged initiatives by the firms to improve scepticism, but that changes in behaviour had not yet been fully achieved. In the 2012/13 report, the AQR team reported that these had resulted in changes in behaviour but not uniformly. The issue of professional scepticism is considered further in paragraphs 7.151 to 7.188.

7.129 In the 2012/13 report the AQR team stated that the inspection results showed an improvement in the overall standard of audit work subject to their inspections and that there had been a continuous improvement in overall audit quality.[270]

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[268] www.frc.org.uk/Our-Work/Conduct/Audit-Quality-Review/Audit-Quality-Review-annual-reports.aspx.
[269] www.frc.org.uk/Our-Work/Conduct/Audit-Quality-Review/Audit-firm-specific-reports.aspx.

7.130 In 2012/13 the proportion of file reviews which required significant improvements was greater for non-FTSE 350 companies than FTSE 350 companies.[271] [✂] [272] It noted that in many FTSE 350 and other large listed company audits a significant amount of the underlying audit work was performed by other auditors, which meant the nature of the audit work reviewed for different companies would vary.[273]

7.131 In 2012/13 the FRC reiterated its comments on the danger of fee pressure exerted by companies on audit firms and identified ACs as having a key role in ensuring that audit quality was not put at risk.[274] The FRC had previously noted the effect of pressure on engagement fees as a result of the current economic conditions:

> In responding to … fee pressures firms have sought efficiencies and a reduction of overall audit hours. These reductions include the application of higher materiality levels which reduce the sample sizes tested and the reduction of the extent of testing in areas of low audit risk. In the context of group audits we have seen instances where materiality applicable to business components has been increased and the number of business components subject to full audit procedures reduced. These factors have caused us to have concerns about the sufficiency of work performed.[275]

7.132 The FRC noted in 2010 the potential effect of fixed fee agreements. It considered that because most audit fees were agreed in advance, any subsequent increase in fee could adversely affect client relationships and this might be an incentive to adhere strictly to the original audit plan.[276]

Litigation activity and insurance claims and cover

7.133 We considered whether legal action against auditors for negligence may be an indicator of the quality provided, although it is also a product of the legal liability regime (see paragraph 3.17) under which auditors are liable to shareholders as a body rather than to any one shareholder for an individual loss.

7.134 In the last ten years, there have been relatively few settled claims of a significant size (£1 million or above). The five larger firms have settled [✂] such claims in this period, with a total value of £[✂] million.

7.135 We set out in Table 7.6 the total value of claims from statutory audit clients against insurance[277] for each firm in each year from 2002 to 2011.

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[270] FRC, Audit Quality Inspections Annual Report 2012–13, p5. The AQR team noted that the issues it found in UK audits were consistent with those found by other regulators internationally.
[271] We understand that in part the greater proportion of issues with non-FTSE 350 companies is partially driven by issues in auditing 'letter box' companies. FRC, Audit Quality Inspections Annual Report 2012–13, p16.
[272] [✂]
[273] FRC, Audit Quality Inspections Annual Report 2012–13, p7.
[274] ibid, p8.
[275] FRC, Audit Quality Inspections Annual Report 2011–12, p8.
[276] FRC, Auditor Scepticism: Raising the Bar, paragraph 29.
[277] We note, however, that firms may choose not to recoup the costs of settling a claim from insurance arrangements and may have an excess or deductible to pay. We also note that the claims may not reflect all costs including legal costs.

TABLE 7.6 **Value of claims against insurance**

	KPMG	*Deloitte*	*EY*	*PwC*	*BDO*	*BT*	*Mazars*	*PKF*
								£'000
2002	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
2003	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
2004	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
2005	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
2006	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
2007	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
2008	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
2009	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
2010	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
2011	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Total value	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]

Source: CC analysis.

Note: PKF data relates only to the period 2006 to 2011.

7.136 The value of claims fluctuates widely from year to year and between firms. However, the number and value of claims has declined over the period 2002 to 2011.

7.137 Firms stated that the decline in claims in recent years was due in part to enhanced quality control measures:

(a) Deloitte stated that the best mechanism to avoid or defend any potentially catastrophic claim or reputational issue was the quality of their work and the integrity of their people.[278]

(b) KPMG stated that the relatively low level of claims in the UK during the last ten years was not inconsistent with the threat of these claims being strong but rather, to a significant extent, a function of the enhanced quality assurance measures the largest audit firms had put in place.[279]

(c) PwC stated that claims by FTSE 350 companies against audit firms had declined over the last 12 years for three reasons: *(a)* a sustained emphasis on quality in the provision of audit; *(b)* enhanced risk management processes; and *(c)* a reasonably stable economic environment (up until 2008). It said that the success of firms in reducing their litigation exposure was testimony to the improved levels of quality in the provision of the audit and to the investment in risk management processes which assist in identifying and resolving potential issues as they arise in individual audits.[280]

7.138 Table 7.7 shows the total value of premiums paid by the firms in relation to PII arrangements with captive or commercial insurers. These relate to all professional business carried out by the firm, including statutory audit. In the period 2002 to 2011 there were significant year-on-year fluctuations in the premiums paid by some firms. However, with the exception of [✂], the value of annual payments of premiums by firms has decreased for all firms.

[278] Deloitte submission, 5 October 2012.
[279] KPMG submission, 5 October 2012.
[280] PwC submission, 19 October 2012.

TABLE 7.7 **Total value of premiums paid**

£'000

	KPMG	*Deloitte*	*EY*	*PwC*	*BDO*	*BT*	*Mazars*	*PKF*
2002	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	
2003	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	
2004	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	
2005	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	
2006	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
2007	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
2008	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
2009	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
2010	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
2011	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]

Source: CC analysis.

Firms' views regarding quality

7.139 Submissions focused on our analysis of the AQR reports, but also covered other topics.

Deloitte

7.140 Deloitte said that the evidence showed that audit quality was high, referring to AQR team reports. It said that these were not intended to represent a balanced scorecard and were skewed towards more risky and complex audits that were not representative of the market as a whole. It was not possible to receive a completely clean review with no recommendations, and the reviews were not designed to assess whether the information being audited was incorrectly reported. Case studies generally expressed a positive view. Deloitte was not aware of a single instance of the AQR team finding an error in an audit report.[281] It cited the most recent FRC audit quality inspection reports (for 2012/13) and said that it showed an improvement in the overall standard of audit work, from a strong base. It said that the report showed that audit quality was higher in the reference market than outside it. Deloitte said that the large majority of audits requiring significant improvement were outside the reference market and were not undertaken by Big 4 firms. There was no comment in the FRC report relating to Deloitte on the topic of professional scepticism.[282]

EY

7.141 EY said that the conclusions reached by the AQR team reflected concerns about some aspects of some audits, and said that we had either misrepresented or misunderstood the level of concern found by the AQR team in its reports. It accepted that there was always room for improvement, and it was the role of the FRC and other bodies to press firms to continue to improve the quality of audit work. It said we had taken a selective approach to gathering and analysing evidence, for instance in not asking companies and their shareholders for their views of quality, and in dismissing firms' explanation for low levels of claims, settlements and premiums (namely high audit quality) without any substantive reasoning.[283]

[281] Deloitte response to provisional findings, paragraphs 5.7 to 5.10.
[282] [✂]
[283] EY response to provisional findings, paragraphs 3.1–3.4.

KPMG

7.142 KPMG said that it had implemented policies and procedures that were designed to maximize audit quality and ensure, to the greatest extent possible, auditor independence and professional scepticism. Nevertheless, as with anything requiring judgement and technical competence, a certain degree of improvement in individual places will always be possible.[284] It said that analysis of data reported by the AQR team showed that the actual number of FTSE 350 audits requiring significant improvement were few when considered in the overall number of audits conducted and the complexity of the audit work involved,[285] and were fewer inside the reference market than outside it.[286] It thought that issues raised by the AQR team often indicated a difference in judgement on the extent of evidence required to support individual assertions, and in its experience, some companies were not significantly concerned by some of the points raised by the AQR team, since they related to documentation of evidence on the file. Some differences or errors of judgement were inevitable given that companies' business models and processes were constantly changing and accounting standards were periodically updated.

7.143 KPMG said that our follow up survey showed that ACCs did not see the AQR team comments as suggestive of material quality defects. AQR team evidence was generally positive and found general satisfaction with the basis on which KPMG made significant audit judgements: over the past three reporting cycles, 2, 1, and 0 respectively of its reports were considered by the AQR team to require 'significant improvement'.[287] It cited the positive views of the ICAEW's QAD, evidence given to the House of Lords Select Committee, and said that examples of corporate failure were not evidence of audit failure. It said that the few claims made against firms indicated an increase in audit quality and improvements in risk management.[288] The effectiveness of KPMG internal reviews ensured KPMG's audit quality.[289] Accordingly, KPMG said that our provisional findings on audit quality appeared to lack substantive evidence,[290] failed to consider relevant evidence or give it due weight, indicated that we had not fully understood the competitive nature of the relevant market and relied selectively on particular evidence while ignoring other evidence that undermined our theory.[291]

PwC

7.144 PwC said that we had sought to base our provisional finding of 'significant, persistent and widespread concerns regarding the quality of audits delivered to FTSE 350 companies'[292] solely on the basis of the AQR team grading system and had failed to appreciate the nuances in the AQR team's reporting, while discounting evidence that we accepted could equally suggest audit quality is high.[293] It noted that the AQR team had never described an audit as 'unacceptable'. We failed to acknowledge that the AQR team had said that it considered that the senior management of the major firms have quality control procedures in place which are generally appropriate to the size of the firms and the nature of their client base; that the AQR team noted a stable

[284] KPMG response to provisional findings, paragraph 2.6.2.1.
[285] ibid, paragraph 2.6.2.2.
[286] ibid, paragraph 2.6.2.5.
[287] ibid, paragraphs 2.6.3.3 & 2.6.3.5.
[288] ibid, paragraph 2.6.4.3.
[289] ibid, paragraphs 2.6.4.4–2.6.4.10.
[290] ibid, paragraph 2.6.5.1.
[291] ibid, paragraph 2.6.5.2.
[292] Provisional findings, paragraphs 7.121.
[293] PwC response to provisional findings, Annex 1, paragraph 28.

or slightly improved results between 2010/11 and the previous year; and that PwC had responded to AQR team concerns.[294]

7.145 PwC noted that the most recent Annual Report (2012/13) showed an improvement in the overall standard of audit work from 2011/12. Only 2 of 33 (6 per cent) FTSE 350 audits examined needed significant improvement. Twenty six (79 per cent) received the highest grade. Of the total inspected (52), 13 required significant improvement, of which 11 related to companies or organizations outside the FTSE 350. Of the 46 audits receiving the highest grade, 39 were conducted by Big 4 firms. Of 8 receiving the lowest grade, 3 were conducted by GT, 2 by BDO, and one by each of PwC, EY and Deloitte. It said that the AQR team's role was to continuously improve audit quality, and the fact that it had done so did not demonstrate that there was 'persistent and widespread' 'audit failure' across the market.[295]

7.146 PwC referred to other indicators of audit quality. It said that reduction in litigation activity showed that audit firms had made a concerted effort to improve their audit processes and standards in the face of very substantial litigation claims in the 1990s and that they had been successful in improving audit quality as a result.[296] It said that we had failed to consider that potential barriers to claims existed in the 1990s, in provisionally attributing the lack of claims to the applicable liability regime. We had not sufficiently recognized the role of the FRRP in proving an objective indicator of quality. There have only been a very small number of FRRP press releases in respect of an adverse finding on an auditor's non-compliance with relevant reporting requirements in a company audit. Of those, we had not recognized that most relate to non-Big-4 audit firms.[297] Finally, we had not placed any weight on evidence from our survey or case studies with regard to companies' views on audit quality. PwC said that the survey results regarding factors important for assessing the quality of an audit and what would trigger a tender showed that companies are satisfied with audit quality.[298]

Our view

7.147 The Big 4 firms responded vigorously to our provisional view that we had identified significant, persistent and widespread concerns regarding the quality of audits delivered to FTSE 350 companies as identified by the AQR team.[299] We note that the FRC considered that it was reasonable for us to have made the findings in our provisional findings regarding professional scepticism and quality, based on the AQR reports that we had seen. The FRC considered that there was room for improvement in this area and the findings we had made chimed with the anxieties that it had[300] and no other party demurred.

7.148 We acknowledge the regulatory context within which AQR team reports are prepared. We consider that the reports provide a sufficiently sound evidential basis in the context of our market investigation from which to form views. The AQR team reports indicate that there are issues surrounding the quality of some audits provided to FTSE 350 companies that it thinks should be addressed, and that the AQR team often identified shortcomings in audit reports that were not identified by the companies (whether FDs or ACs) themselves. In the period 2008 to 2013, the AQR

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[294] ibid, Annex 1, paragraph 30.
[295] ibid, Annex 1, paragraph 31. Quote marks and italics were in PwC submission: we have not identified them as included in our provisional findings. See further paragraph 7.147.
[296] ibid, Annex 1, paragraph 33(a)
[297] ibid, Annex 1, paragraph 33(b).
[298] ibid, Annex 1, paragraph 33(c).
[299] Provisional findings, paragraphs 7.121.
[300] Summary of response hearing with the FRC.

team, as noted above, found 14 instances out of the 167 FTSE 350 audits reviewed where quality was assessed as being either unacceptable or in need of significant improvement.[301] 70 per cent of FTSE 350 audits over this period were identified as requiring some level of improvement to fully comply with the requirements of ISAs.[302] We accept that there has been a trend of improvement, and that the AQR team raises fewer concerns among FTSE 350 companies than other companies and organizations.

7.149 With regard to the low level of claims, settlements and insurance premiums, firms told us that this was a consequence of the high quality of the audits they provided (see paragraphs 7.137, 7.143 and 7.146). We accept that this may explain the levels we observe, equally we think it may be a product of the liability regime (see paragraphs 3.17 and 3.18, and Appendix 3.1), by which firms are only liable to companies under specific conditions. In addition, we note the difficulty, in the UK, of pursuing class-action style litigation by which shareholders may pursue joint claims against audit firms. We note that the liability regime has not changed since the 1990s, when we were told that large claims were made. On balance, we do not think that the low levels of claims, settlements and insurance premiums are sensitive indicators of the quality of audits. See further paragraph 7.165.

7.150 Having carefully considered the submissions that we received, we are satisfied that there are concerns regarding the quality of audits delivered to FTSE 350 companies as identified by the AQR team. We have considered the outcomes observed as part of our overall assessment as to whether or not there is an AEC: see Sections 9, 10 and 11.

Scepticism; objectivity; integrity; independence

Introduction

7.151 As noted (paragraph 7.3*(d)*), we see scepticism, objectivity, integrity, and independence (as defined in paragraphs 6.13 to 6.17) as aspects of audit quality, but such important ones that we consider them in this separate subsection. Each of these four factors contributes to an auditor's professional judgement. We have used 'scepticism' as shorthand to cover scepticism, objectivity and integrity, and note that the definition of independence is concerned with situations and relationships that could raise suspicions that objectivity may be impaired. During the course of our investigation, some respondents and submissions may have used the terms interchangeably rather than in the more rigorous sense set out in paragraphs 6.13 to 6.17.

7.152 In considering whether firms have shown sufficient scepticism, we encountered difficulties in gathering direct evidence. In particular, no AEP and no firm told us that they had lost scepticism. Realistically, they could not, since the value in having an audit comes from the scepticism of the review. To admit a loss of scepticism is to admit that the service provided lacked value.

7.153 However, we have considered the direct and indirect evidence available to us regarding whether auditors can and do fail to demonstrate and document how they have acted with appropriate scepticism. In particular, we considered: *(a)* the effect of AEP rotation; *(b)* the evidence that case studies provide; *(c)* firms' conduct; *(d)* direct evidence of loss of scepticism; and *(e)* firms' internal procedures; *(f)* evidence from

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[301] The grading system has changed over the period.
[302] That is, graded as either 'significant improvements required' or 'acceptable but with improvements required'.

FRC and other regulatory bodies; (g) Firm-specific AQR team reports and firms' internal procedures; and *(g)* firms' submissions.

The effect of AEP rotation

7.154 AEPs may only serve for a single five-year term on any engagement, given the risk that an AEP may become over familiar with the company he or she is auditing.[303] The FRC told us that following the collapse of Enron and WorldCom, the UK Government established the Co-ordinating Group on Accounting and Auditing (CGAA). That comprised two ministers (one from the Treasury and the other from the then DTI), the FSA, the FRC and others. One key recommendation was that the tenure of the AEP should be reduced from seven years to five years. One consideration at the time of the decision to move to a five year rotation period was the fact that that period applied in the USA—and there was thought to be considerable merit in aligning the period in the two major financial centres (and capital markets) given the number of companies that were then listed in both markets (with the result that the lower period applied to all such dual-listed companies).

7.155 No AEP that we spoke to as part of the case studies identified any instance of a significant accounting judgement that he or she had changed on taking over as AEP from another partner of the same firm for a given company. Further, a Big 4 firm told us that it aimed to achieve a 'seamless transition' between AEPs.[304] Other firms also worked hard to ensure smooth transitions.[305]

7.156 However, GT indicated that it would be concerned about compromising the independence of the incoming AEP.[306] It said that from an audit quality stance, it was right that the rotation introduced a fresh pair of eyes. A five-year rotation for the listed companies was perhaps too short as it took a long time to understand the complexity of a FTSE company. It was also only when a company changed its audit provider that it obtained a completely fresh perspective in terms of approach and technical issues.[307]

7.157 The FRC told us that the requirement of 'partner rotation' was to refresh the independence of the audit partner, not the audit firm. It noted that the effectiveness of the rotation was very much dependent on the individual auditor. There was a possibility that if partners had risen through the ranks of the audit engagement team in question, then there may be a less innovative change to the audit.[308]

Case studies

7.158 In our case studies, we heard how certain AEPs had debated issues with management,[309] but we found that firms, individual AEPs and indeed FDs and ACCs were reluctant to criticize either firms or companies' management, and so we lack examples where auditors failed to challenge issues sufficiently. However, Company A provided an example of where the internal and external control measures appear to have gone awry (though not sufficiently for regulatory action to be taken).

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303 Appendix 3.1, paragraph 127.
304 See Appendix 2.1, Company I, paragraph 88.
305 For examples, see Appendix 2.1, Company C, paragraph 111; and Company E, paragraph 106.
306 GT hearing summary, 20 December 2012, paragraph 29.
307 ibid, paragraph 30.
308 See FRC hearing summary, paragraph 9.
309 See, for example, Appendix 2.1, Company G, paragraph 100.

Firms' conduct

7.159 We set out in Appendix 7.8, the efforts that firms expend in maintaining good relationships with company managements. Equally from our case studies, it was apparent that all AEPs saw it as a part of their role to maintain good relationships with FDs.

7.160 The Company A AEP gave the most nuanced description, which we think worth quoting at length. He said that there was a balance to be struck in any audit relationship, as the AEP needed to establish a good working relationship with management as well as with the ACC and the non-executive directors (NEDs). It was necessary to have a good relationship to understand an individual's motivations, as well as having a formal dialogue with them. However, the auditor needed to maintain independence. Accordingly, this was a balancing act between the three parties (auditor, management, ACC) which formed a triangle (paragraph 85 of summary). There was a tension in the triangle relationship, since if the auditors were to share observations with the ACC but not with management, the relationship with management might break down, making the auditors' role more difficult. Communication therefore needed to be managed properly so that the auditor had a good working relationship with management and could get under the skin of the company (paragraph 87 of summary). Auditing was not just about picking up some numbers and confirming them against underlying records. Auditors needed to understand how a set of numbers were put together and what motivated the team who produced them. The auditor needed to understand this so that he knew where the management team might have placed their cards in terms of the range of possible answers, ie whether they had taken an aggressive or conservative approach. This could only be done if the auditor really understood what was going on in terms of the way the management team was actually running the business, the issues it was facing, the pressures it was under, the pressures the non-executives were putting on it, the pressures the shareholders were putting on it, and the structure of the bonus scheme (paragraph 88 of summary).

Direct evidence of loss of scepticism

7.161 We looked at whether auditors may, at times, apply insufficient levels of professional scepticism that may lead them to favour management over the interests of shareholders. Insufficient scepticism on the part of auditors could lead them to accept management representations which turn out to be misleading and, in extreme cases, could lead to a restatement or profits warning, accompanied by a fall in share price, and perhaps a claim against the audit firm for negligence. We note that, in the UK, claims of this nature are relatively scarce, and often are settled out of court with few details publicly available. There are more claims in the USA, but this is a different legal and regulatory environment and the inferences that can be drawn may be limited.

7.162 The US financial reporting scandals of 2001/02, including Enron, Global Crossing, Tyco, HealthSouth and Worldcom, were followed by a wave of regulations on both sides of the Atlantic introducing stricter rules on the provision of NAS to audit clients, as well as tighter corporate governance rules (see Appendix 3.1), in an attempt to prevent similar scandals in the future.

7.163 The UK has had its own financial reporting scandals, for example Equitable Life, London International Group, Independent Insurance, TransTec, Wickes and ERF Holdings. These cases were subject to disciplinary investigations by the FRC, which noted audit failings including instances of over-reliance on management representations, failure to investigate conflicting explanations and failure to obtain appropriate third party confirmations, suggesting that the auditors in these cases were not sufficiently sceptical.[310] We have not considered these cases in detail ourselves and recognize that significant changes have been made to the regulatory regime in the intervening period.

7.164 We considered whether there were more recent examples that could be illustrative of a lack of auditor scepticism, notwithstanding the additional regulatory controls that had been established post-Enron. We found that several cases ([✄]—see Appendix 7.9) were all suggestive of the potential for the auditors to have demonstrated a higher degree of scepticism, whether or not the threshold was reached for a successful claim to be mounted against the firm. We do not consider this list to be exhaustive.

7.165 Claims for negligence are hard to bring against auditors, partly because corporate downfalls may be the result of a combination of events such as fraud, misrepresentation, or misjudgement by management, or unforeseen events, and these may or may not be compounded by a lack of challenge or scepticism by the auditor. The extent to which auditors are implicated in these downfalls is often difficult to prove in court, in part due to the lack of visibility of the audit process, but also due to the relatively high legal hurdle required to bring a claim (as described in paragraph 3.17 to 3.18). Hence we consider that the relatively low incidence of claims against auditors in recent years does not necessarily indicate that there is no problem. In this regard, we note the concerns raised by the Treasury Select Committee, the Financial Services Authority (FSA) and others in relation to the role of auditors in the banking crisis.

Evidence from FRC and other regulatory bodies regarding scepticism

7.166 We had regard to the recent findings of the UK regulatory bodies responsible for audit quality in fully listed companies, the AQR team, which is part of the FRC. The AQR team raised relevant concerns in its annual reports for 2008/09 and 2009/10. A key message of its 2009/10 annual report was the need for audit firms to demonstrate greater professional scepticism. It said that the number of audits requiring significant improvement remained too high and suggested that firms were not always applying significant professional scepticism in relation to some key audit judgements. In 2011/12 the AQR team acknowledged initiatives by the firms to improve scepticism, but that changes in behaviour had not yet been fully achieved. In the 2012/13 report, the AQR team reported that these had resulted in changes in behaviour but not uniformly. In June 2010, in the light of the banking crisis, the FSA and FRC jointly published a discussion paper in which serious concerns were raised over a lack of auditor scepticism. Later that year the FRC published a discussion paper entitled *Auditor Scepticism: raising the bar*.

7.167 Responses to the FRC's discussion paper from investors indicated that a lack of scepticism on the part of auditors continued to be problematic. The Local Authority Pension Fund Forum said that scepticism was not directed to those places where it was most required and that problems occurred wherever there was scope for overstatement of earnings. The International Corporate Governance Network said that a lack of sufficient audit scepticism had been widespread in recent years, including the period leading up to the financial crisis. The Investment Management Association (IMA) said that modifications to the regulatory framework post-Enron had not been fully effective in enhancing auditor scepticism.[311]

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[310] From *Auditor Scepticism: Raising the bar,* FRC, August 2010.
[311] www.frc.org.uk/Our-Work/Publications/APB/Discussion-Paper-Auditor-Scepticism-Raising-the-Ba/Responses-to-Discussion-Paper-Auditor-Scepticism-R.htm.

7.168 We also note that similar concerns have been expressed by the PCAOB in recent years. It released an Audit Practice Alert on the subject in December 2012, noting that it continued to observe instances in which circumstances suggested that auditors did not appropriately apply professional scepticism in their audits. Whilst we acknowledge the particular context in which the PCAOB operates, we consider that it is appropriate to rely on PCAOB concerns within the context of our market investigation.

Firm-specific AQR team reports and firms' internal procedures

7.169 Applicable regulation has developed the requirement regarding independence (see Appendix 3.1, paragraphs 81 to 88). Ethical Standard 1, in particular, states:

> [16] The audit firm shall establish policies and procedures, appropriately documented and communicated, designed to ensure that, in relation to each audit engagement, the audit firm, and all those who are in a position to influence the conduct and outcome of the audit, act with integrity, objectivity and independence.

7.170 Appendix 7.9 details applicable regulation, how firms have responded, and the FRC's view of their efforts. We found that the firms put processes in place to ensure compliance with the regulations but that the AQR team reported areas that individual firms needed to improve across their audit practice (as well as examples of good practice) and some specific cases of engagements where firms had not demonstrated full compliance.

Firms' submissions on independence and scepticism

Deloitte

7.171 Deloitte said it was absolutely committed to maintaining its independence. It said that the provisional findings contained no direct evidence of a loss of independence and there was no basis for their dismissal of our failure to find such evidence. A material loss of independence would have been apparent from the case studies in particular.

7.172 It said that evidence we cited suggesting that company executives can and do influence their incumbent auditor related only to fee negotiations and contained no evidence at all in relation to the auditors conduct of the audit or conclusions reached by the auditor. It said we failed to give any weight to the role of the AC in protecting auditor independence. It said that none of the evidence in the provisional findings[312] or in Appendix 7.9 properly evidenced a lack of auditor scepticism. All firms had disputed that Appendix 7.9 contained evidence of a lack of scepticism. Finally, it pointed out that our view that 'losses of independence do occur' was a very limited conclusion and gives no indication of the scale of the problem. Deloitte said that the evidence provided suggested that it was not significant.[313]

EY

7.173 EY said that our conclusion[314] that auditors are insufficiently sceptical in carrying out audits was unsupported by the evidence.[315] It said that it appeared that our analysis

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[312] In provisional findings, paragraph 7.137.
[313] Deloitte response to provisional findings, paragraph 5.11.
[314] Provisional findings, paragraph 13.7*(a)*.
[315] ibid, paragraph 5.1.

was deduced from the constant vigilance of the expert regulators in this regard and limited instances where it had been found that an auditor could have exercised more challenge on some aspects of some audits.[316] That was an insufficient basis for reaching a general conclusion that auditors are insufficiently sceptical in carrying out audits.

7.174 Professional scepticism was not a 'black and white' issue and there was a balance to be struck between too little and too much.[317] EY said that the six examples cited in the provisional findings (including the one relating to EY) did not concern a lack of scepticism according to the FRC.[318] Accordingly, we had adopted an unreasonable and prejudicial approach to the evidence on the issue. With regard to AQR team reports, EY said that they did not provide evidence of a lack of professional scepticism 'across a large proportion of the market', just in isolated cases and in relation to a specific issue.[319]

GT

7.175 GT said that the very long tenure of audit firms was a concern for many investors who believed more frequent changes of auditor would take away perceptions of potential loss of independence which arise when an audit firm is in place for too long.[320] While the requirement for AEP rotation was an important safeguard for these concerns at a personal level, it was clear that it did not on its own address the perception that a familiarity threat arises between the company and the audit firm.[321] Linked to this was a risk that the use by companies of the audit for the provision of NAS created further concerns over the independence of the auditor and the familiarity of the auditor with management.[322] The Ethics Standards issued by the Audit Practices Board that built on the IFAC Code of Ethics stipulate various requirements regarding the provision of NAS by auditors.[323] However, GT research indicated that companies in the FTSE 350 on average paid non-audit fees of 80 per cent of their audit fee in the period of May 20120 to April 2011, and of these, 73 companies paid more to their auditor for non-audit than audit services.[324] This results in an environment where the auditor becomes increasingly close to management and the closer that relationship becomes and the longer it persists, the greater the risk of a loss of independence is perceived by a number of investors.[325] A by-product of this was that it became increasingly difficult for non-incumbent firms to build relationships and raise their profile with companies.[326]

KPMG

7.176 KPMG said that we had failed to produce sufficient evidence to support our provisional finding that losses of auditor independence and scepticism occur:[327] we had found evidence only of relatively few audit errors, and had little, if any, evidence to suggest that these are caused by a loss of professional scepticism.[328]

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[316] ibid, paragraph 5.2.
[317] ibid, paragraph 5.4.
[318] ibid, paragraph 5.6.
[319] ibid, paragraph 5.6(b).
[320] GT views on the provisional findings, paragraph 1.32.
[321] ibid, paragraph 1.32.
[322] ibid, paragraph 1.34.
[323] ibid, paragraph 1.35.
[324] ibid, paragraph 1.36.
[325] ibid, paragraph 1.37.
[326] ibid, paragraph 1.37.
[327] KPMG response to provisional findings, paragraph 2.7.2.2.
[328] ibid, paragraph 2.7.3.1.

7.177 It said we had inappropriately conflated professional scepticism and auditor independence and had not provided sufficient evidence to support a connection between these concepts and a negative impact on competition in the relevant market.[329] Audit work, particularly in relation to FTSE 350 companies, is complex, involves the exercise of professional judgement and is manually intensive. Accordingly, mistakes may be made and while on occasion this could be indicative of a lack of professional scepticism it by no means indicated that the auditor lacked independence or was otherwise beholden to the interests of management.[330]

7.178 KPMG said we had failed to consider the 'third limb' of audit quality which suggested that an effective relationship between management and audit firm was necessary to produce a high quality audit review.[331] It submitted that that an effective relationship between the AEP and senior management of the company was essential if the audit was to be conducted in a cost-efficient and thorough manner.[332] The production of financial statements for large companies was a complex subjective process often involving many assumptions and judgements. There was therefore a fundamental need for a degree of cooperation as well as challenge in the process that was entirely consistent with there being effective competition allied to independence and scepticism. Indeed if this relationship broke down an audit might become impossible—a fact KPMG had recognized on occasion when it had taken the decision to resign from an appointment.[333]

7.179 KPMG said we had given insufficient weight to evidence which suggested auditors were very protective of their independence and that audit quality on the whole was high.[334] Reputation for independence and integrity was one of the key competitive drivers in the relevant market and any actual or perceived concerns regarding an auditor's independence or professional scepticism would diminish the audit firm's reputation for audit quality and would be incredibly detrimental to its business.[335] We had provided no evidence that firms offering companies a choice of AEP on rotation had been used by companies to undermine auditor independence in practice, and it was not aware of any such case.[336] It said that a 'seamless' transition involved taking measures to ensure that the initial education process was as cost efficient and effective as possible when a change of AEP occurs. It did not mean that the new AEP unquestioningly adopts the opinions and methodology of the outgoing AEP in conducting its initial audit review.[337]

7.180 Finally, KPMG said we had drawn incorrect conclusions from the views of other reporting bodies without testing that evidence itself and without providing our own supportive evidence.[338]

PwC

7.181 PwC said that the balance of the evidence that we had relied on was circumstantial, inconclusive and did not place sufficient weight on the fact that auditors have legal and regulatory duties to remain independent.[339] We had conflated the two separate

[329] ibid, paragraph 2.7.2.2.
[330] ibid, paragraph 2.7.3.4.
[331] ibid, paragraph 2.7.2.2.
[332] ibid, paragraph 2.7.4.2.
[333] ibid, paragraph 2.7.4.4.
[334] ibid, paragraph 2.7.2.2.
[335] ibid, paragraph 2.7.6.2.
[336] ibid, paragraph 2.7.5.5.
[337] ibid, paragraph 2.7.5.6.
[338] ibid, paragraph 2.7.2.2.
[339] PwC response to provisional findings, Annex 1, paragraph 34.

concepts of professional scepticism and independence. Applying the benchmark of a well-functioning market should not lead us to conclude that any lapses of scepticism (or other failing) demonstrate that the market is not producing competitive outcomes.[340] The [✂] examples in Appendix 7.9 that we had disclosed to PwC did not demonstrate a loss of scepticism.[341] Our observations that audit firms seek to manage AEP rotation effectively did not demonstrate a lack of independence.[342]

Our view

7.182 We noted in our provisional findings[343] that while both firms and applicable regulation discuss and provide for auditor independence, this is not in the sense that would be recognized within the meaning of, say, Article 6 of the European Convention on Human Rights,[344] or UK administrative law. That an auditor is both selected and paid for by the company it is scrutinizing would disqualify it from being seen as 'independent' in that rigorous sense.

7.183 We received no submissions challenging this basic point. However, PwC did say that we had mischaracterized how auditors perform their role: auditors are neither corporate advisers nor examining inspectors.[345] To the extent that there was any value in making a comparison between the role of auditor and other bodies that have investigatory powers (which it doubted), it thought that sector regulators would be the better comparator. Like auditors, they saw maintaining proper day-to-day relationships with the businesses they regulate in order to perform their duties effectively was consistent with being willing, ready and able to take actions contrary to the interests of company management.[346] We think that KPMG's submission on its 'third limb' are also relevant in this regard (see paragraph 7.178).

7.184 EY's submission that there could be 'too much' professional scepticism gave us pause for thought.[347] We accept that constant challenge and demands for evidence could be unnecessary and inefficient, but the instances identified by the AQR team were where insufficient scepticism had been demonstrated to meet the requirements of ISAs. We think that the competitive level of scepticism is that which shareholders as a body would demand. However, this is not set by the market, and shareholders are not consulted directly. Rather standards are set by regulation, via a process in which shareholders and others are consulted by the appropriate bodies on a national and international basis (ie the EU, the UK parliament, the FRC, ICAEW, the firms and their networks etc). We are concerned to see that the competitive process is working well to deliver the outcomes specified by regulation, and whether there are features that prevent it from delivering possibly better results more efficiently.

7.185 We identified that companies can influence the composition of the audit team, and on occasion can have the firm's AEP replaced (see paragraphs 9.247, 9.252 and 9.254). We have not identified if this is always in response to inadequate AEP performance or whether it is on occasion to obtain an AEP more amenable to management's views. However, this is a mechanism by which companies can undermine auditor independence.

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[340] ibid, Annex 1, paragraph 35.
[341] ibid, Annex 1, paragraph 35(a), (b).
[342] ibid, Annex 1, paragraph 36.
[343] Provisional findings, paragraph 7.122.
[344] http://www.echr.coe.int/Documents/Convention_ENG.pdf
[345] PwC response to provisional findings, paragraph 2.6.
[346] ibid, paragraph 2.9.
[347] EY response to provisional findings, Annex 1, paragraph 5.4.

7.186 We have also identified that firms have incentives to maintain good relationships with company management (see paragraphs 9.61, 9.223 and 11.46). They put in significant efforts to ensure that AEP rotation is 'seamless', and even offer companies a choice of candidates when an AEP is due to rotate off an engagement. While we note the submissions we received (paragraphs 7.179) in our view, this practice of offering a choice of candidates might adversely affect the AEP's ability to examine the company's accounts independently and sceptically.

7.187 We have also seen that the FRC and other bodies continue to raise concerns regarding a loss of independence and scepticism. Whilst we acknowledge the particular context in which the FRC and other bodies operate, we consider that it is appropriate to rely on their concerns within the context of our market investigation, particularly since there is little evidence available to enable us directly to assess quality.

7.188 We note the extensive regulation that surrounds independence and scepticism (and that it is an obvious and well-recognized concern regarding auditing), but the evidence we have seen leads us to conclude that some losses of auditor independence occur.

7.189 We consider the outcomes that we observed in the context of our overall analysis of whether or not there is an AEC in Sections 9, 10 and 11. Specific paragraphs are 11.76, 11.138 to 11.142, 11.144 to 11.148, 11.191 and 11.194.

Innovation

7.190 Innovation is one of the ways in which firms generally compete: high rates of innovation suggest vigorous competition while sluggish competition suggests that markets are not competitive. The nature of statutory audits is determined to an extent by legislation, originating in both the UK and the EU, and professional standards issued by both UK and international bodies. In particular, the regulatory framework sets certain minimum requirements on the purpose of an audit, the duties of an auditor and the output of the audit, and firms are required to demonstrate compliance with the International Standards on Auditing (ISAs). These standards do not, however, state the method an auditor must use to test specific account areas, or the specific level of testing necessary to reach a conclusion.

7.191 We asked firms various questions relating to innovation as part of a competitive strategy to win or retain clients and the impact of regulation on innovation. The responses to these questions are summarized in Appendix 7.10.

7.192 In this section, we consider:

(a) constraints on innovation;

(b) areas where innovation may be possible;

(c) drivers of innovation;

(d) firms' submissions; and

(e) set out our views.

Constraints on innovation

7.193 The principal purpose of a statutory audit is to provide assurance that the financial statements of a company are accurate (true), and are presented fairly (fair). An auditor prepares a report for inclusion with the companies' published financial statements. The audit report also includes an opinion on whether the Directors' Remuneration Report has been prepared in accordance with the Companies Act and if the Directors' Report and the Corporate Governance Report are consistent with the financial statements.

7.194 Under the 2006 Audit Directive, all statutory audits in the EU must be compliant with ISAs. ISAs prescribe how an audit should be undertaken, albeit at a high level, and state what considerations an auditor is expected to demonstrate in forming an audit opinion, such as when using evidence prepared by another auditor or management's expert as well as broader requirements on documentation.

7.195 The requirements of an auditor's report with respect to the financial statements and the duties of the auditor in reaching those conclusions under the Companies Act can be summarized as follows:[348] an auditor must be satisfied that *(a)* proper accounting records are kept, *(b)* the financial statements are consistent with those records, *(c)* the financial statements are prepared on the basis of financial reporting standards, and *(d)* where any material divergence is found and not corrected, this should be noted in the audit report.

7.196 The format of the audit report is largely standardized. The audit reports issued by the auditors of the FTSE 350 are based on templates issued by the FRC. The scope for variation from this format is limited by regulation.[349] KPMG was the only firm to refer directly to regulation inhibiting it innovating and experimenting with the format of the audit report. We note that the demand for consistency of approach from management, shareholders and regulatory bodies as well as the UK Listing Authority may also be a constraint.[350] Given these restrictions, to the extent that innovation in reporting occurs, it is most likely to take the form of additional sections to the standard audit report.

7.197 The auditor is required to provide additional reports to those charged with governance of a company as required by ISAs over the course of the audit, principally communicating the planned scope and timing of the audit and findings arising from audit work. These requirements can be seen as a minimum level of reporting.[351]

7.198 Acceptable accounting treatments are determined by financial reporting standards, with listed companies required to use IFRS. Those preparing financial statements may adopt different interpretations of those standards, and may adopt 'industry norms' for certain areas such as accounting estimates. However, where a presentation as indicated by IFRS is not considered to be a fair reflection of the economic substance of the balance or transaction, it is possible to adopt alternative accounting policies.[352]

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[348] Auditors are also required to report on the consistency of the annual report with the financial statements and the accuracy of the remuneration report. Companies Act, Part 16, Chapter 3.
[349] These have been issued as Bulletins by the APB with exemplars for different types of company and their group structure.
[350] In addition to regulations set by the FSA acting as the UK Listing Authority, the London Stock Exchange publishes Admission and Disclosure Standards.
[351] The requirements on communicating with those charged with governance are set out in International Standard on Auditing (UK and Ireland) 260 Communication with those charged with governance (ISA 260).
[352] Both HSBC and National Express are examples of companies which have diverged in certain instances from IFRS. The Financial Reporting Review Panel has also stated that it would only challenge a company's choice of accounting policy if it were clearly unreasonable. *True and Fair*, FRC, July 2011.

7.199 If firms wish to innovate their offering, they may need to seek regulatory approval and appropriate consideration by regulators of a proposal may prevent new products being offered in the short term. KPMG's proposal to offer statutory audit within a broader 'extended assurance' product is an example of such a situation (see Appendix 7.10, paragraph 38).

Areas where innovation may be possible

7.200 Regulation is seen by firms as setting the nature of statutory audit and in some respects a set of minimum criteria. However, firms gave evidence of a number of changes in the regulatory environment over the past ten years which have led to changes in the performance of audit, and in some cases these have required innovation in the delivery of individual audit engagements.[353]

Process

7.201 With regard to audit process, the firms identified the following as areas of innovation (see Appendix 7.10, Annex 2, for a summary of submissions):

(a) a standardization of the audit approach (at a firm and network level);

(b) use of industry specialized modules;

(c) the resource mix of staff including 'offshoring';

(d) more sophisticated audit software providing enhanced ability for teams to work remotely and access for international subsidiaries;

(e) the use of Computer Assisted Audit Techniques (CAATs), data mining and analytics; and

(f) increased automation of the audit process, including sample extraction, creation of audit files and variance analysis.

7.202 We consider that these areas of innovation are primarily determinants of cost and operational efficiency. The firms stated that clients demanded a more efficient audit, both on the grounds of audit fee and operational disruption, and this was a driver of innovation. These changes in process appear to have been driven by networks or firms centrally, but are adapted for each individual engagement.

7.203 In the case of data-mining and analytics, the ability of the auditor to employ such techniques is dependent on the nature of a client's systems.[354]

Reporting

7.204 Firms identified the following as possible areas of innovation in output:

(a) enhanced reporting to shareholders (such as further gradation of the audit opinion);

[353] The example of the length of time that listed companies are given to publish their annual reports was provided by Deloitte, which has led to a compression of the post-year-end audit timetable. For reporting periods commencing after 20 January 2007, the deadline for publishing annual reports was reduced from six to four months.
[354] Firms indicated that more advanced analysis, such as 'real-time' testing, was both driven by and dependent on clients' use of Enterprise Resource Planning (ERP) systems.

(b) enhanced reporting to management (controls, risks and business insights) including 'extended audit';

(c) financial reporting benchmarking[355] clearer communication in annual reports to improve the quality of discussions at the AC; and

(d) the quality and flow of the annual report which comprises the directors' report and business review and other disclosures required under the Companies Act (ie the 'front end' of the accounts)[356,357] and extent of disclosures of financial statements to other companies.

7.205 However, in practice innovation has been limited to reporting to management and the AC. See further Section 11 regarding evidence of firms encouraging their clients to prepare extended ACC reports.

7.206 Firms also identified the following as areas for innovation outside the audit process:[358] benchmarking of financial performance; access to knowledge base, thought leadership articles and networking events; partner access for general advice; marketing; and audit-related services.[359]

7.207 We were provided with examples of companies which have included innovation as a section of their invitation to tender when selecting an auditor, which indicates that there is scope to use evidence of innovation when competing in a tender situation.[360] The ability for auditors to encourage the companies they audit to enhance disclosure appears to be limited: their duties are to the company as a whole and they are bound by duties of confidentiality to that company. Further, because such reports are prepared by or on behalf of the AC, the auditor cannot dictate the nature or level of disclosure the AC makes, although it may be able to exert influence. See further Section 11.

Drivers of innovation

7.208 A key driver of innovation in audit process appears to relate to identifying efficiencies in audit approach, which may allow firms either to make cost savings, or to allocate a greater proportion of the hours worked on an audit to areas of greater risk. Identifying efficiencies in process, either in respect of cost (such as offshoring, or delegating a greater degree of non-subjective work to junior staff), or hours worked, all things remaining equal, allows the firms to be better able to compete on cost.

7.209 As discussed above (paragraphs 7.194 to 7.196), we believe that innovation may be restricted by regulation in some respects, but likewise changes in regulation may lead to innovation as firms and companies are forced to respond to these changes. Further, regulation can be changed in response to pressure from firms and companies.

7.210 We understand that the use of Enterprise Resource Planning (ERP) systems by large businesses has increased over time. The audit approach adopted by audit firms for these companies has necessarily changed to respond to the need to test databases

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[355] See Appendix 7.10, paragraph 13.
[356] See Appendix 7.10, paragraph 39.
[357] Appendix 2.1, Company G, paragraph 115.
[358] See Appendix 7.10.
[359] There may be some scope to innovate these, but they will be subject to their own requirements.
[360] KPMG response to CC working paper 'Nature and strength of competition' provides three examples of companies which have included innovation as a section, or part of a section, on an invitation to tender.

with large volumes of transactions. The increased use of data-mining tools and 'analytics' in testing of ERP systems allows the audit team to focus their attention on high-risk or unusual transactions that require subjective assessment. The firms' investment in software that allows some form of interface with ERP systems may allow greater automation of more labour-intensive tasks and lead to efficiencies in approach and a reduction in labour cost.

7.211 The firms indicated that their innovation is driven by client demand for an audit which delivers the greatest value, either on the grounds of cost, its focus on key financial and operational risks or the insights delivered in reporting to management and the AC.[361]

Firms' submissions

Deloitte

7.212 Deloitte said that our provisional findings did not provide support for what an appropriate level of innovation should be.[362] The innovations that we had identified were important and we should not dismiss them on the grounds that they were 'primarily the determinants of cost and operational efficiency'.[363] They were mechanisms directly under the control of auditors, and so capable of operational delivery. Such innovation benefitted companies and investors through quicker, more efficient audits at lower cost (allowing focus on the most important risks). It said that the only area where we said that there was potential for innovation but that insufficient had occurred was reporting.[364] This, however, was not entirely within the auditors' gift, they were constrained by regulation in particular. It noted that this was also the only area in which unmet demand was identified (see further below paragraph 7.250).

EY

7.213 EY also said that our provisional finding that innovation was not at the level we would expect to see in a well-functioning market was not supported by the evidence:[365] we had acknowledged numerous areas in which firms had demonstrated innovation despite the extensive constraints which exist on innovation due to the statutory and regulatory regime in which audits are prepared.

GT

7.214 GT said that the audit process and its deliverables had not evolved significantly and audit quality remained an opaque measure for investors with the result that the end user (the investor) was dissatisfied with the process.[366] There were inevitable difficulties arising from any attempt to evaluate levels of 'innovation' as a consequence of the fact that auditor innovation may be driven by areas such as efficiency of performance or building client relationships and may not correspond to achieving a better of more expansive opinion with regard to the truth and fairness of the financial statements.[367] It said there were differences between the definition of audit quality applied by investors, audit regulators and companies. In its experience companies may

[361] See Appendix 7.10.
[362] Deloitte response to provisional findings, paragraph 5.12.
[363] ibid, paragraph 5.12(a).
[364] ibid, paragraph 5.12(b).
[365] EY response to provisional findings, Annex 1, paragraph 4.1.
[366] GT appendix views on the provisional findings, paragraph 1.40.
[367] ibid, paragraph 1.41.

perceive high audit quality to mean, among others, responsiveness, auditor/director relationships, providing access to directors to a more extensive director network, depth of understanding of the business and the ability to give advice on other services at relatively short notice. Conversely, auditor scepticism can be a less important quality looked for by management.[368] This may result in a tendency to 'over deliver' on measures which are management serving rather than addressing the audit requirements of shareholders and other investors.[369]

KPMG

7.215 KPMG said that we had not defined what levels and type of innovation we had in mind in a benchmark well-functioning market nor a universal demand for additional services which might be met through increased innovation. It said we had failed to provide any probative evidence or coherent arguments to support our view that innovation would be greater absent the features we identified. Similarly, we provided no evidence of any customer detriment associated with any lack of innovation.[370]

7.216 KPMG referred to the examples of innovation we had identified and said that these were substantial, [371] and were both process and product innovations.[372] Further, process innovation was an important part of innovation and was evidence of strong competition to supply information to management, which is an inherent part of the audit product.[373] In many industries where the final product is for regulatory or demand-side reasons relatively standard, process innovation is necessarily the primary form of innovation that providers can invest in.[374] KPMG said that this had led to very substantial benefits for customers: its margins had been maintained and prices fallen in the face of significant increased regulatory burden was evidence of the benefits of process innovation.[375]

PwC

7.217 PwC said that our provisional finding failed to recognize that examples of innovation in the delivery of the audit all create shareholder value by identifying and reducing risks, offering insight on the companies' costs to improve operational efficiency, and improving the quality and lowering the cost of the audit. These were tangible outputs of innovation in the delivery of the audit which had value for shareholders.[376]

Our view

7.218 Based on this, our views on the scope for firms to compete by differentiating themselves through innovation in the product and service offered follow.

7.219 First, we consider that whilst strict compliance with ISAs is likely to be the most cost-efficient way of delivering an audit, it does not prevent firms from determining the type and extent of testing they undertake. There is therefore the possibility of additional testing and reporting, which offers potential for auditors to differentiate their product by offering a greater level of assurance than the standard audit product.

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[368] ibid, paragraph 1.42.
[369] ibid, paragraph 1.43.
[370] KPMG response to provisional findings, paragraph 2.9.1.1.
[371] ibid, paragraph 2.9.2.1.
[372] ibid, paragraph 2.9.2.2.
[373] ibid, paragraph 2.9.2.2.
[374] ibid, paragraph 2.9.3.2.
[375] ibid, paragraph 2.9.3.2.
[376] PwC response to provisional findings, Annex 1, paragraph 39.

Examples of this are KPMG's 'extended audit' and a number of other detailed reports issued by the firms (see Appendix 7.10).

7.220 Second, we note that whilst the aim of an audit has remained broadly similar[377] over time, how that work is documented and the focus of auditing financial statements has changed. However, other than some changes to terminology and structure, the audit report has changed little and its form is constrained by regulation.

7.221 Third, the firms have expressed differing views on the effect of regulation on innovation. There is a perception by some firms that IFRS and ISAs limit innovation by enforcing a checklist format to the audit. We note that ISAs do not state how sufficient and appropriate audit evidence should be obtained and firms and their networks develop their own methodologies. Further, we find scope for innovation in methodologies that allows the development of industry-specific audit approaches.

7.222 Fourth, the firms have innovated in IT and systems, with the larger firms (such as the Big 4 firms, BDO and GT) and their networks investing heavily in audit software. Audit software is used to plan and execute an audit based on a core library of procedures, supplemented with industry-specific tests. Some firms have integrated additional CAATs and data mining and analytics tools into their audit software, whilst other firms choose to use specialist off-the-shelf tools.

7.223 Fifth, some of the Big 4 firms have also started to use service centres either in the UK or overseas to undertake audit procedures and to provide centralized back-office functions to differing degrees. This indicates an ability to innovate the delivery model. This appears to be focused on achieving a cost-efficient staff mix, and all things remaining equal allowing the core audit team to spend a proportionately greater amount of time on subjective audit testing. The use of such centres is not significant at present, but is increasing.

7.224 Finally, other examples of innovation include the development of detailed reports on financial controls such as journal postings, based on an element of automated data interrogation by the systems developed by the firms. As with extended audit arrangements, such reports exceed the requirements of ISAs (in this case ISA 260), as they provide greater insight into how a business is operating rather than the reporting of control failures.

7.225 Firms pointed out that we had not identified how much innovation there would be in a well-functioning market. But our Guidance states that we should assess whether we have evidence of less innovation than we would expect to find in a market absent the features we consider may be causing an AEC. Accordingly in paragraphs 9.340, 13.2 and 13.8 we have considered innovation as part of our overall assessment of whether or not there is an AEC. We think that in a well-functioning market there could be scope for more innovation, for instance to meet any unmet demand, and we turn to considering if there is such unmet demand next.

Unmet demand

7.226 In this Section 7, we have considered various observations in the relevant market in terms of price, quality (including scepticism and independence) and innovation. In this subsection, we set out the evidence that the product delivered does not satisfy the demands of shareholders in terms of information provided by the audit. We consider:

[377] See Appendix 5.1, paragraph 3.

(a) evidence provided to us by shareholders;

(b) evidence provided to us by ACCs;

(c) the evidence provided by the FRC's guidance on ACs and the CC's recent meeting with the FRC;

(d) firms' initiatives; and

(e) firms' submissions.

7.227 We then *(f)* set out our views.

Views of shareholders

7.228 We sent written questionnaires to 18 major equity investors, in addition to speaking with two investors as part of our case studies and holding hearings with Hermes[378] and Institutional Investors.[379, 380] We appreciate that statutory audit is provided for the benefit of shareholders (although others also benefit), and it is in their capacity as shareholders (or their agents) that we were interested in these investors' views.

7.229 Their views are summarized in Appendix 7.11. Information that they would find useful included:

(a) [✂]: an indication of the way in which a firm's accounting policies differ from industry norms and an opinion on the level of disclosure.

(b) [✂]: standardized and detailed disclosure of revenue and profits and assets by region and segment.

(c) [✂]: what issues, if any, the auditors had before issuing a clear opinion.

(d) Barings Asset Management: in terms of standardized required information, there was little scope for more information without further impeding timeliness of information—a working capital report.

(e) Alliance Bernstein: more clearly identify which numbers were fact and which were opinion.

(f) Aberdeen Asset Management: more information could usefully be included on audit outcomes—at present the audit report was 'boilerplate'.

(g) Alliance Trust: the report could describe areas of discussion, but a clean, ie non-qualified, audit suggests resolution.

7.230 Institutional investors that we spoke to thought that the auditor's report could identify issues that had been scrutinized in detail by the company during the audit process, an indication of the most contentious issues, and an identification of the accounting treatments that the auditor thought most aggressive.[381]

[378] See Hermes hearing summary.
[379] This included representatives from the Association of British Insurers (ABI), the Investment Management Association (IMA) and the National Association of Pension Funds (NAPF).
[380] See Institutional Investors hearing summary.
[381] We note that these investors made similar views in their response to the EU Audit Proposals Section 6—proposals on audit report.

7.231 These views are broadly in line with a survey conducted on behalf of GT and BDO for our investigation,[382] but also by PwC in 2011, which found:

> The investment professionals interviewed do not believe they currently receive adequate information about the audit process; they offered suggestions of where more information would be valuable. These areas include: the auditors' debates with management; aggressiveness of accounting treatment; likely areas of material misstatement; and going concern. However, there are understandably significant concerns over the practicalities involved

7.232 Accordingly, we found demand on the part of shareholders for additional information. The main areas of consensus among those who desired more information were the provision of further information on how aggressive approaches to accounting policy compared with industry norm, and the main areas of discussion between the auditor and the company. See Appendix 7.11.

7.233 There were mixed views on how additional information should be provided. Some shareholders felt the auditors could cover more in their reports whereas others felt the AC report was a more appropriate place to set out this information. We also note the concern raised that by making more information public, the quality of discussion between auditor and company may be reduced, if it took place in the knowledge that it would be disclosed.

Views of ACCs

7.234 We asked the ACCs in our follow-up survey what they thought shareholders might want by way of additional information in relation to an audit that they did not get at the moment. Of those that responded (44 per cent), the types of information identified included: the scope of the audit, levels of materiality, key financial risks, areas of accounting judgements, details of the work undertaken by the auditors, issues discussed at the AC, and performance of the business at a more granular level.[383]

7.235 10 per cent of FTSE 350 ACCs we spoke to in the follow-up survey said that they had been approached by shareholders for further information. We asked those who had not been approached why they thought this was the case. The responses suggested that many were of the view that among shareholders there was not a widespread demand for further information. In particular, the reasons given included: there was not a demand for further information; company accounts were already too long; and shareholders were satisfied with the information provided.[384]

7.236 The ACC of case study Company [✄] increased the level of disclosure on the interaction between the company and its auditor through a detailed ACC report. The company AEP believed the reluctance of other companies to publish similar detailed reports was because they wished to gauge market reaction to the disclosures made by other companies first. He also stated that the ACC had been a front runner in the process and the extra disclosure had been driven by the company itself rather than the AEP.[385]

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[382] See survey report.
[383] See Appendix 6.1, paragraph 34.
[384] See Appendix 2.3, paragraph 34.
[385] [✄]

FRC's views

7.237 We note that the revised FRC guidance contains requirements for the contents of the AC's report (a section of annual report and accounts) which appear to recognize that there is a demand from shareholders for further information.[386]

7.238 In 2011, the FRC published a consultation document aimed at enhancing corporate reporting and audit, called *Effective Company Stewardship*. This document included a recommendation that fuller reports by ACs on the approach taken to the discharge of their duties would support the board's declaration that the annual report properly and fairly describes the business and its financial performance.[387]

Firms' initiatives

7.239 Firms acknowledged the demand in the shareholder community for further information.

BDO

7.240 According to BDO, PwC's investor survey 'Audit today and tomorrow' of 2011 showed that investors wanted more reporting on going concerns, more information about issues discussed with ACs, more narrative reporting, and information about the reliability of earnings releases.[388]

Deloitte

7.241 Deloitte stated that it had recognized specific concerns among investors as to the usefulness of audit reporting.[389] Deloitte said that it had actively engaged with investors for a number of years. Deloitte supported the initiatives of the International Auditing and Assurance Board in its efforts to improve audit reporting. Specifically: in its response to the IAASB's consultation,[390] Deloitte supported the following aspects of the Invitation to Comment:

(a) auditor commentary that:

(i) identified and drew attention to those disclosures in the financial statements (including the related notes) that, in the auditor's judgement, might be most important to a user's understanding of the financial statements; and

(ii) highlighted the significance of these matters to the performance of the audit when, in the auditor's judgement, it would be important to users' understanding of the audit;

(b) the suggested auditor statement that addressed the appropriateness of management's use of the going concern assumption;

(c) the suggested auditor statement that addressed whether material uncertainties related to going concern had been identified;

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386 See the FRC's Guidance on ACs, paragraph 5.2.
387 FRC, *Effective Company Stewardship: Enhancing Corporate Reporting and Audit,* January 2011.
388 See BDO hearing summary, paragraph 11.
389 Deloitte response to the WP 'Framework for the CC's assessment and revised theories of harm', paragraphs 5.12 & 5.18.
390 www.ifac.org/sites/default/files/publications/exposure-drafts/comments/Final%20DTTL%20Response%20-%20IAASB%20ITC%20on%20Auditor%20Reporting.pdf.

(d) the suggested auditor statement that addressed the identification of material inconsistencies in other information included with audited financial statements, based on the auditor's reading of the other information for such purpose;

(e) the enhanced descriptions of the responsibilities of management, those charged with governance and the auditor;

(f) the reorganization of the form and structure of the auditor's report, including placement of the auditor's opinion, the auditor commentary section, and other information related to entity-specific matters towards the beginning of the report;

(g) the mandating of the ordering of items in the auditor's report in a manner similar to that shown in the illustrative report unless law or regulation require otherwise; and

(h) the building blocks approach that helped to achieve comparable auditors' reports while still allowing jurisdictions the ability to further tailor auditor reporting requirements in the context of national environments.

7.242 Deloitte also said that in its recent survey of narrative reporting investigating compliance with reported best practice by listed companies, it found that: 98 per cent of relevant companies described the work of the AC in the annual report; 56 per cent of FTSE 350 companies provided detail of key matters considered by the AC such as key accounting assumptions and judgements; and 56 per cent of FTSE 350 companies gave an explanation of their auditor appointment decisions.[391] Deloitte also gave two examples of current reporting best practice, Barclays and Pearson, which gave significant additional information to investors about the work of the AC and the auditor. Other major companies such as BP (which sets out in detail the activities of the AC over the year) and RBS (which explains the issues on which the AC has spent most time over the year and explains in detail its policies with regard to the appointment of its auditor) have been increasing the information provided to investors in the annual report.[392]

EY

7.243 EY said that there was not a commonality of interest within any single category of stakeholder, let alone across the range of different categories of stakeholder. Although some (but not all) institutional investors would like more to be included in the audit report, there was no consensus among institutional investors on what should be included, and therefore there was no clear consistent 'unmet demand'. It said that considerable regulatory attention had been focused on what, if anything, additional features should be included in audit reports, with all interested parties having the opportunity to contribute their views. Significant proposals (which EY generally supported) were under consideration by appropriate regulators. In the absence of any clear evidence of consistent views on 'unmet demand', EY said that it would be inappropriate for the CC to draw any conclusions about the existence of 'features of the market leading to an adverse effect on competition'.[393]

[391] Deloitte response to the WP 'Framework for the CC's assessment and revised theories of harm', paragraph 5.15.
[392] ibid, paragraph 5.15.
[393] EY response to WP 'Views of investors and other stakeholders', paragraph 4.

KPMG

7.244 KPMG said that there was a debate about whether audit firms should provide wider assurance on financial and non-financial matters in addition to the assurance that the historical financial statements provide a true and fair view of the company's financial affairs at a point in time and its profits and cash flows for the period then ended—in particular: communicating how companies create value, the risks they face in doing so, and other key metrics on corporate behaviour.

7.245 KPMG also said that investors had expressed wishes for various improvements to both corporate disclosure and audit reporting, although they had never translated those wishes into any economic imperatives for audit firms to move beyond the statutory minimum. It tended to be corporate governance specialists who made these requests. There was said to be more limited discussion between those making investment decisions, companies and auditors.

7.246 However, KPMG suggested that in the investor community there might be general satisfaction that audits were doing the job that was required and that any changes were not sufficiently important to them. In particular, whilst investors recognized that an audit was essential in ensuring that they had a solid base of historical information against which to benchmark other information received from management and elsewhere, they did not see audits as helpful in predicting the future. As a consequence, companies did not believe that they would receive any benefit from the capital markets from doing more than was required or request their auditors to do.

PwC

7.247 PwC reported that in 2010 its AEPs were asked to approach some audit clients, including all those in the FTSE 100, to encourage them to expand public reporting by their ACs. In particular, PwC suggested they gave further information about the matters that were habitually discussed privately with auditors and management, such as the risks of misstatement included in the audit plan, alternative accounting treatments and matters of judgement. Six of its FTSE 100 audit clients (Barclays, GKN, Man Group, Unilever, BG Group and BT) responded positively by increasing the transparency of reporting on their ACs' activities. In addition, two others who were not PwC's clients at the time ([✂]) had made significant changes to provide greater reporting.

Institutional reports

7.248 In this context, we noted that the House of Commons Treasury Committee in its Ninth Report of Session 2008–09[394] had questioned the value of audits in their current form. For example, the Committee stated:

> [216] Auditors are one component of the web of assurance surrounding financial institutions; they have a responsibility to ensure that financial statements prepared by boards of directors present a 'true and fair view'. We received evidence alleging that auditors failed to fulfil that responsibility, by approving banks' financial statements shortly before those same institutions failed. As Professor Prem Sikka of the University of Essex observed, 'within days of getting a clean bill of health from auditors many banks have simply collapsed'.

[394] www.publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/519/51909.htm.

And the Committee concluded:

> [221] We have received very little evidence that auditors failed to fulfil their duties as currently stipulated. The fact that some banks failed soon after receiving unqualified audits does not necessarily mean that these audits were deficient. But the fact that the audit process failed to highlight developing problems in the banking sector does cause us to question exactly how useful audit currently is.

7.249 Similarly, we noted that the report of the ICAEW, *Audit of Banks—Lessons from the Crisis* (2010), stated:[395]

> The skills of auditors are highly respected and the audit process regarded as essential in imposing discipline upon directors' presentation of financial information. …
>
> The audit report itself, however, was not viewed as providing useful information to users. It was variously described as a statement of compliance with accounting standards and lacking in information content, since unqualified audit reports use standardised wording. … With the growth in size of annual reports and financial statements, it has become more difficult for users to identify the key areas of judgement or risk.

Firms' submissions on unmet demand

Deloitte

7.250 Deloitte said that the only area of unmet demand identified in the provisional findings was from some shareholders for additional reporting and it was working to address this already.[396] It agreed with us that there were regulatory constraints with respect to audit reporting and thought that the demand could be met through regulatory change. There was no evidence that it was a lack of competition that was preventing demand from being met.[397]

GT

7.251 GT agreed that the way in which the supply of statutory audit services had developed over time means that the full needs and requirements of shareholders was not currently being met by the audit product.[398] Comments made by investors to the House of Lords Economic Affairs Select Committee, in the Oxera investor survey and by investors at the ACCA/GT roundtable had all called for change.[399]

KPMG

7.252 KPMG disagreed that the level of unmet demand was inconsistent with a well-functioning market.[400] It said that demand for further information has not in general been sufficiently coherent and significant. Audit firms' obligations are to the shareholders of a company as a group. It was therefore not the role of audit firms to satisfy

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[395] Audit of Banks, 2010.
[396] Deloitte response to provisional findings, paragraph 5.13.
[397] ibid, paragraph 5.14.
[398] GT views on the provisional findings, paragraph 1.45.
[399] ibid, paragraph 1.46.
[400] KPMG response to provisional findings, paragraph 2.10.1.2.

the demands of any individual shareholders. Shareholder demand was differentiated and it was very difficult and rare to obtain consensus among shareholders in general or among the shareholders of a particular company.[401] KPMG thought that the majority of investors were sufficiently satisfied with the information which is being supplied.[402] If there was cogent significant unmet demand then professional investor groups, regulators, or the relevant regulator would ensure that such information was provided.[403] It said that our follow-up survey of ACCs indicated that only 10 per cent of ACCs had been approached by shareholders for more information.[404] The lack of questions directed to auditors at AGMs also suggested that demand for further information may not be significant.[405]

7.253 KPMG said that any unmet demand did not indicate that competition was not working well.[406] The auditor's role is to represent the interests of shareholders as a group, not to respond to the demands of individual shareholders. For each company there was a single, bespoke, audit product. It followed that the product must be designed to meet the demands of shareholders at some average or aggregated level.[407] This was the norm in any market where firms offer (vertically) differentiated products to a diverse customer base. Further, standardization was a necessary feature of the audit market which allowed shareholders to compare and contrast the performance of different companies.[408]

7.254 Finally, companies had a legitimate interest in protecting certain information (particularly commercially sensitive information) and may have an interest in protecting some detailed aspects of conversations between auditors and companies. In such circumstances it would not therefore be appropriate to meet demand for this information.[409]

7.255 In any event to the extent that there is unmet demand, KPMG said it was not within the gift of auditors to meet it: it is the company that has the ultimate control over what information is released to shareholders. Accordingly, this could not be a failure of the audit market, but rather an issue of Corporate Governance and perhaps the effectiveness of regulation permitting the disclosure of certain company information.[410]

7.256 Firms recognize that there is some (albeit not cogent) unmet investor demand and are engaged with investor groups, industry bodies, companies and regulators to establish a consensus of what this demand is and how companies and auditors may best meet it.[411]

7.257 The FRC had revised ISAs including ISA (UK and Ireland) 700, designed to increase disclosure about the audit process and how material accounting treatments have been decided.[412] KPMG supported the need for audit firms to provide more information on the audit, but believed that the key was to fully understand what information investors were interested in obtaining from the audit firm.[413]

[401] ibid, paragraph 2.10.2.1.
[402] ibid, paragraph 2.10.2.2.
[403] ibid, paragraph 2.10.2.3.
[404] ibid, paragraph 2.10.2.3.
[405] ibid, paragraph 2.10.2.4.
[406] ibid, paragraph 2.10.3.1.
[407] ibid, paragraph 2.10.3.2.
[408] ibid, paragraph 2.10.3.4.
[409] ibid, paragraph 2.10.3.6.
[410] ibid, paragraphs 2.10.3.9, 10.
[411] ibid, paragraphs 2.10.4.1, 2.
[412] ibid, paragraph 2.10.4.3.
[413] ibid, paragraph 2.10.4.4.

PwC

7.258 PwC acknowledged the scope for further information to be provided to shareholders. It said the restrictions on doing this were principally the result of regulations limiting the scope and form of audit reporting.[414]

Our views regarding unmet demand

7.259 We received evidence from shareholders, the FRC and from the Big 4 firms that there was a demand for further or different information regarding the audit of companies.

7.260 We note that different shareholders may demand different information,[415] but we think that this is to be expected: suppliers in markets often face varying demands from their customer base. While firms provide one audit report that is available to all shareholders, it could be possible to produce a report that satisfied more demanding as well as less demanding shareholders, without disadvantaging the latter. Given that much unmet demand appears to relate to disclosure of information that auditors would have acquired during the course of their investigations, the incremental cost of this would be low.

7.261 This sector is heavily regulated and standardised, which produces benefits by facilitating comparison,[416] but we think such regulation is also likely to dampen incentives to satisfy unmet demand. Some variation in auditors' reports would not necessarily remove the benefits of standardization.

7.262 To the extent that management and the AC are content for the auditor to do the minimum to comply with applicable regulation, this too is likely to contribute to unsatisfied shareholder demand. We accept, as the firms said, that it is not within their power unilaterally to produce more extensive reports.

7.263 We note the recent revisions by the FRC of ISA (UK and Ireland) 700, designed to increase disclosure about the audit process and how material accounting treatments have been decided, and return to this issue in paragraphs 16.291 to 16.298.

7.264 We consider unmet demand further, and in particular the submissions we received from the audit firms themselves under our second theory of harm, Section 11).

Our views regarding market characteristics and outcomes

7.265 We have reviewed the market in terms of price, quality, innovation and output. These observations inform our consideration of competition in the relevant market and so of whether or not there are features that cause an AEC. They are considered in that context in paragraph 9.340, paragraph 11.194 and paragraph 13.8.

7.266 We have identified concerns with several of the issues that we examined, in particular, pricing patterns following tender processes or switching (paragraphs 7.48 to 7.70), the existence of a cohort of profitable engagements (paragraphs 7.100 to 7.109); concerns raised by the AQR team (paragraphs 7.147 to 7.150); and unmet demand (paragraphs 7.259 to 7.264).

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[414] PwC response to provisional findings, Annex 1, paragraph 40.
[415] See EY submission reported in paragraph 7.243 and KPMG submission reported in paragraph 7.253.
[416] AS KPMG pointed out: KPMG response to provisional findings, paragraph 2.10.3.4.

7.267 We appreciate that these issues might be explained either by reference to the existence of features or a combination of features in the FTSE 350 audit market that have an AEC, or by alternative explanations. In the following sections, we set out the competing explanations for these observations, and using our theories of harm as a framework for assessment, in Sections 9, 10 and 11 assess whether or not there is an AEC in the relevant market.

8. 'Features'; theories of harm; alternative explanations

Features

8.1 Under section 134(1) of the Act, it is our statutory task to determine if any feature or a combination of features of the market or markets in the provision of statutory audits to FTSE 350 companies prevent, restrict or distort competition in the UK (see paragraph 1.2). To conclude that there is an AEC in a market, we must identify such features or combination of features (ie the sources of harmful effects in a market). We interpret the phrase 'prevents, restricts or distorts' in the Act broadly to cover any adverse effect, whether actual or potential. We therefore consider features that affect potential competition in a market (for example by preventing entry and expansion) as well as those that affect the existing market situation.[417]

8.2 The Act states that the following may be a feature of the market:[418] *(a)* the structure of the market concerned or any aspect of that structure; *(b)* 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 *(c)* any conduct relating to the market concerned of customers of any person who supplies or acquires goods or services.

8.3 The Act does not require us to state whether particular features of a market are structural features or some aspect of conduct. It may not always be clear in which category the feature fits. Provided the relevant feature falls within at least one of these categories, the categorization has little practical importance.[419]

8.4 The concept of a feature is broad, allowing us the flexibility to investigate a wide range of possible market features, each of which may have effects on different aspects of competition. Moreover, how far any feature identified by us is along the causal chain resulting in harm to competition may vary (ie some may be directly causing harm and others may be doing so indirectly).[420]

8.5 Structural features may include high levels of market concentration, common ownership of competing facilities and buyer power. Structural features may also include other aspects of market structure such as government regulations and information asymmetries.[421] Conduct features may include the conduct of any market participants (whether sellers or buyers). As stated in the Act, conduct includes any failure to act, whether intentional or not and any other unintentional conduct.[422]

8.6 Since the behaviour of customers can sometimes limit competition between firms, such behaviour can be categorized as a conduct feature of a market. Market investigations allow us to look at customer behaviour and customer vulnerability in relation to its implications for competition, instead of just looking at it as a consumer protection issue.[423] In some circumstances, several features may in combination harm competition.[424]

[417] CC3, paragraphs 29 & 30.
[418] Section 131(2) of the Act.
[419] See paragraph 302 of the Explanatory Notes to the Act; and CC3, paragraph 155.
[420] CC3.
[421] CC3, paragraphs 157 & 158.
[422] CC3, paragraph 159.
[423] CC3, paragraph 161.
[424] CC3, paragraph 162.

Theories of harm

8.7 In conducting its assessment of whether or not there is an AEC in a given market, we will seek to establish whether or not any of the possible features, or any combination of them, can be expected to harm competition. Assessing the competitive effects of features means that any AEC finding should be grounded in a clear understanding of why competition in a market may be harmed. As noted in paragraph 7.1, the CC recognizes that the theoretical benchmark against which to measure an AEC cannot be a 'perfectly competitive' market. In past market investigations we have used the term 'a well-functioning market', generally in the limited sense of the market absent the feature or combination of features, as such a benchmark.[425] This has been our approach in this investigation as we do not consider there to be a realistic alternative comparator for the relevant market. We note that certain features may be intrinsic to some extent and so while the relevant market cannot realistically be envisioned without them,[426] we can nevertheless consider what effect these have in shaping competition. In addition, where competition in a market is affected by an intrinsic feature, this is something that may influence the assessment of remedies, for example pointing towards remedies that mitigate the effect of the feature rather than the cause.

8.8 To provide focus and structure to our assessment of the way competition is working in the market, the CC sets out 'theories of harm'. A theory of harm is a hypothesis of how harmful competitive effects might arise in a market and adversely affect customers.[427] The CC typically devises such theories at the outset of its investigations, to focus its consideration and evidence gathering.

8.9 Accordingly, we published an issues statement that included several theories of harm,[428] and we subsequently refined them to two principal theories, described below in paragraphs 8.11 to 8.16.[429] Our issues statement also contained theories of harm relating to coordinated effects, bundling by the Big 4 firms, and regulatory distortions. Our investigation did not identify evidence to support these: see further Section 12, and Appendices 8.1, 8.2 and 8.3.

8.10 As noted, our view is that the term 'customers' for the purposes of our investigation includes the shareholders of large companies as a class and that in considering whether competition is working effectively in the market for statutory audit services we should consider the extent to which it is efficiently and effectively meeting the needs of those customers. Under the Act, the concept of customers includes future customers.[430] This captures the wider investment community.

Audit firms have some unilateral market power

8.11 Our first theory of harm is that audit firms have some unilateral market power with regard to their client FTSE 350 companies. In investigating this theory of harm we considered factors relating to demand and supply, and how they interact.

8.12 On the demand side we assessed whether the periods of tenure, and frequency of tender processes that we have observed in the relevant market (see paragraphs 7.6

[425] CC3, paragraphs 30 & 320.
[426] CC3, paragraphs 30 & 320; KPMG made this point in its Response to provisional findings, Executive summary, paragraph 18.
[427] CC3, paragraphs 163 & 164.
[428] www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/111207_issues_statement_final.pdf.
[429] www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/framework_for_the_ccs_assessment.pdf.
[430] Section 134(5) and 134(8) of the Act.

to 7.30) are caused by search costs, switching costs or other barriers, which make it less likely (than absent any such barriers) that a FTSE 350 company will put its audit out to tender or switch auditor, resulting in limited competition between auditors for these engagements. We also considered whether information asymmetries make it more difficult for management to assess the value for money or the quality of the audit product or service provided by their auditor and the potential gains from switching, which may limit their incentives to go out to tender and to switch.

8.13 On the supply side, we investigated how audit firms compete to win and retain FTSE 350 audit engagements both outside and within tender processes run by FTSE 350 companies. We investigated the relationships which firms cultivate with their clients and the implications these have for competition, in particular the willingness of companies to switch auditor.

8.14 We examined these issues by considering the willingness of a company to put its audit engagement out to tender and to switch auditor and its bargaining power with its auditor bearing in mind the market structure that we have identified, both outside and within a tender process (see Section 9).

8.15 We also investigated the nature and extent of barriers to entry to those firms not currently auditing FTSE 350 companies and barriers to expansion and selection to those firms that currently audit a very small number of FTSE 350 companies: see Section 10.

8.16 We consider that weak competition could have an adverse effect on all aspects of the audit product and its delivery. In particular, weak competition could reduce the incentives of audit firms to reduce audit fees, to ensure that audits are carried out effectively and supplied efficiently, and to invest in their people, expertise and systems. Weak competition could lead to audit firms reducing the range and depth of their investigation. The result could be higher audit fees, a reduced quality of service; and a reduction in the quality of the audit investigation and opinion and lower rates of innovation on the audit product supplied.

Principal-agent issues

8.17 Under our second theory of harm, we considered possible competition problems arising in the supply of audit services to FTSE 350 companies as a result of specific features of this market that have the effect of preventing, restricting or distorting competition between audit firms in respect of some aspects of the audit product or service, broadly under the heading of principal-agent issues.

8.18 We discuss these principal-agent issues in Section 5. In particular we investigated whether audit firms have incentives to direct their competitive efforts to satisfying executive management rather than shareholder interests and whether the interests of executive management may differ from those of shareholders. We consider that this would amount to a prevention, restriction or distortion of competition. We investigated whether the activities of the AC and other supervision mechanisms are sufficient to mitigate this.

8.19 We investigated whether as a result auditors are insufficiently responsive to shareholder demand and so not always sufficiently independent and sceptical (see paragraphs 7.151 to 7.189) and do not supply the information that shareholders demand. For example, whether audit reports provide shareholders with the level of disclosure or judgement that they demand. See paragraphs 7.226 to 7.264.

Links and possible conflicts between our theories of harm

8.20 We noted KPMG's submission that there was a clear inconsistency in our treatment of bargaining power across our theories of harm.[431] It said that in our second theory of harm, we suggested that audit firms may be susceptible to management's bargaining power in relation to independence. It said that it was not clear why we considered that management had bargaining power in relation to independence but not in relation to other aspects of the audit offer.

8.21 We do not think that our two theories of harm are inconsistent but rather that they are connected since:

(a) Any reluctance of companies to go out to tender and/or switch, combined with barriers to entry, expansion and selection in the market, investigated under our first theory of harm, may contribute to lengthy relationships between audit firms and companies. These lengthy relationships that are not subject to the more transparent and thorough review that, for example, tender processes could provide may allow incumbent firms to focus on satisfying executive management demand and so increase the likelihood of the principal-agent problems considered under our second theory of harm occurring.

(b) the prevention, restriction or distortion of competition that we investigate under our second theory of harm may give audit firms incentives to invest in their relationships with FDs, which may raise companies' switching costs since companies are reluctant to disturb these relationships. Further, shareholder demand may not be fully factored into the auditor selection decision, as executive management may prioritize continuity of relationships and service quality and may give insufficient weight to the benefits of fresh scrutiny that may come from tendering and switching. This may contribute towards a weakening of companies' bargaining power and would be consistent with the long tenures and limited tender processes we observed.

8.22 Further, we note that neither issue is binary (in that we are examining degrees of bargaining power under our first theory and degrees of influence with regard to independence and scepticism under our second theory of harm).

Alternative explanations

8.23 The Big 4 firms submitted that the outcomes we observed were the result of a competitive process.[432] In summary:

(a) companies were expert and well-informed purchasers; they could tell if their auditor was underperforming, and could institute a tender process at any time;

(b) companies had sufficient alternatives among the Big 4 firms in particular, though Mid Tier firms might be an option for some;

(c) ACs were highly professional and fully represented the interests of shareholders;

(d) auditors had strong incentives to maintain their reputations for competence and integrity, and so their interests were well-aligned with those of shareholders;

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[431] KPMG response to provisional findings, paragraph 3.10.9.

[432] This is a brief summary of multiple submissions from and hearings with the Big 4 firms, and is not comprehensive. We consider their submissions on specific issues throughout. However, see, for example, KPMG submission prior to provisional findings dated 21 December 2012; and PwC closing submission dated 7 January 2013.

(e) there were some costs when a company switched auditor, but these should not be overstated;

(f) firms invested heavily in individual companies, and they had much to lose if they lost an engagement: this increased companies' bargaining power; and

(g) low switching rates indicated that companies were content and were able to obtain competitive outcomes by bilateral negotiation.

8.24 We kept such alternative explanations of the market outcomes we saw in Section 7 in mind throughout our investigation, and aimed to consider all the evidence we obtained in the round, in order to determine the cause of the outcomes that we observed. In doing this, since the nature of the available evidence base meant that clear-cut distinctions between competing explanations for a number of issues were hard to determine (see paragraph 2.13), we had to weigh the evidence in its totality and apply our judgement accordingly.

9. Assessment of firms' unilateral market power (our first theory of harm)

Introduction

9.1 We described our first theory of harm in paragraphs 8.11 to 8.16. We assessed it from the perspective of the companies comprising our relevant market. Given that each audit is to some extent bespoke, firms tailor their offering for any one company so that prices (and other terms and conditions of supply) are individually negotiated. This means that companies that cannot obtain a competitive offering on an individual basis could not be protected by a prevailing market price set to satisfy those companies that can obtain a competitive offering.[433]

The possibilities for competition

9.2 Under the Companies Act, auditors are appointed for a single year at a time, and typically a company negotiates the terms of the audit engagement with its auditor each year. At this point the company may either decide to reappoint the incumbent auditor or to initiate some competition for the engagement. The evidence was that usually the incumbent auditor was reappointed without a competition for the engagement. When there is such competition, this typically takes the form of a tender, but there are other options available to companies.

9.3 Bargaining power may be exercised by companies both outside and within a tender process: while many of the underlying issues (namely the factors set out in paragraph 9.5) are the same, the balance in considerations often differs significantly between settings. Since the perceived infrequency of tender processes was a reason for this reference, we consider the position outside the tender process first.

Factors that affect a company's bargaining position and the structure of our assessment of this theory of harm

9.4 In general, we think that the strength of a company's bargaining position is underpinned by the strength of its outside option: ie how good (in terms of quality and price) its best alternative auditor is, and how easily a company can switch to that best

[433] Unlike, say, a retail market in which suppliers fix a single price for all shoppers, even though some shoppers may be more active than others in comparing rival offerings.

alternative. If a company is perceived by its incumbent auditor to have poor alternatives or high switching costs, the incumbent firm might exploit this by worsening its offering, judging that the company would be in a poor position to switch.

9.5 We have identified specific factors that we think will determine the extent of a company's bargaining power as it negotiates with its incumbent auditor, which we consider in turn.[434] They are:

(a) the availability of alternative suppliers of its audit services (see paragraphs 9.8 to 9.66);

(b) the company's ability to appraise accurately the offering that it is receiving from its incumbent auditor (see paragraphs 9.67 to 9.115);

(c) the ability to appraise the offering of the available alternative suppliers (see paragraphs 9.116 to 9.168);

(d) the costs to companies associated with search and switching (see paragraphs 9.169 to 9.218);

(e) the balance between the costs and gains from tender processes and switching (see paragraphs 9.219 to 9.240); and

(f) the firms' incentives to retain engagements. These are relevant to understanding the balance of bargaining power, since if firms suffer significant losses with a loss of a particular engagement, they may be expected to strive to retain the engagement, enhancing quality and lowering price (see paragraphs 9.241 to 9.270).

9.6 Following our assessment of those factors, we examine:

(g) bargaining power in the context of a tender process (paragraphs 9.271 to 9.310); and

(h) the price effects of tender processes or switching for companies (see paragraphs 9.311 to 9.317).

9.7 We then:

(i) summarize submissions responding to our provisional findings (see paragraphs 9.318 to 9.325)); and finally

(j) set out our views on the willingness to go out to tender and to switch and bargaining power (paragraphs 9.326 to 9.340).

Availability of alternative suppliers

9.8 To assess whether companies have alternative suppliers of their audit, in this subsection we *(a)* identify the suppliers of audit services to large companies and the capabilities of these suppliers; and *(b)* set out the views of companies on the options available to them. We also consider *(c)* whether firms have incentives to take on new engagements. Alternative suppliers must be both able and willing to substitute for incumbents if they are to act as credible outside options. We then *(d)* summarize

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[434] We received no submissions challenging this framework. GT supported our approach to considering this issue: Appendix: Grant Thornton views on the provisional findings, paragraph 2.5.

submissions received in response to our provisional findings and *(e)* set out our views.

The suppliers of audits to large companies

9.9 As an indicator of firms' capabilities to supply audits to large companies, we considered *(a)* their market and sector shares, and *(b)* their self appraisals of their capabilities.

Market and sector shares

9.10 We consider the evidence provided by the shares that firms have had of FTSE 350 audit engagements overall, and FTSE 350 audit engagements by sector to be indicative of the capabilities of firms and, given the importance of demonstrable expertise and experience in the selection of auditors,[435] of their credibility among FTSE 350 companies as an alternative supplier.

9.11 Details of firms' market shares are set out in Section 7 and Appendix 2.4. These show that the Big 4 firms have consistently had a share of over 95 per cent in the supply of FTSE 350 audits and over 99 per cent of FTSE 350 audit fees. The presence measured by fee of Mid Tier firms has been limited largely to the supply of audit services to real estate companies (see Section 7, Table 7.4). Mid Tier firms have 5 per cent of the financial services engagements and 6 per cent of mining engagements in the FTSE 350 (also see Section 7, Table 7.4).

9.12 These also show that while each of the Big 4 firms has a presence in the supply of FTSE 350 audit services in most sectors, there are many sectors where for one or two of these firms this has been relatively and consistently weak measured by their shares of engagements and fees. For example, over the last ten years EY has consistently had a relatively small share of FTSE 350 audit fees and engagements in the FTSE 350 banking, financial services, industrials, insurance, technology, telecommunications and utilities sectors. There are a few sectors where two firms have high shares, particularly shares of fees, namely basic materials, health care, oil & gas, consumer goods and consumer services (see Section 7, Table 7.3).

- *Firm submissions*

9.13 KPMG commented on the strategic importance of relevant audit experience. In particular, KPMG said that the loss of an audit client of a certain size or complexity or in a certain sector represented a loss in the audit firm's relevant experience base (see paragraph 9.260). PwC indicated that there are sectors where there are recognized to be leading firms and the appointment of lesser specialized firms could lead to a reduction in audit quality.[436]

9.14 KPMG said in response to the provisional findings that audit firms strove to improve their services by building expertise, and investing in a number of areas and that a product of this competitive process was that not all firms were equivalent in their services to customers at any one point in time.[437]

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[435] Appendix 2.4, Annex 1, Tables 1–40.
[436] PwC response to the Remedies Notice, paragraphs 3.42 a) ii) and viii).
[437] KPMG response to provisional findings, paragraph 3.3.3.

9.15 KPMG also said in response to the provisional findings that we should not infer from market shares in certain sectors that any of the largest four audit firms would not be a credible alternative in all sectors. KPMG said that the largest four audit firms use the supply of NASs to potential FTSE 350 audit clients and audit services to companies in the same sector outside of the FTSE 350 to gain sufficient sector expertise. In addition, KPMG said that market share figures in certain sectors can be skewed by the limited number of companies in that sector in the FTSE 350.[438]

- *CC comment*

9.16 We accept that we would not expect (nor would it be necessary for) all firms to have same capabilities at any point in time in a well-functioning market and that evidence of firms investing in their capabilities in response to demand would be evidence of a dynamic competitive process. We observe, however, that in many sectors one or two firms appear to have a markedly weaker presence for much or all of the last ten years for which we have data. This would not seem to be consistent with the dynamic process described by KPMG.

9.17 We also accept that an audit firm's presence in the FTSE 350 may understate its sector capability if it provides audit services to companies in the same sector outside of the FTSE 350. We do not have information on sector shares outside the FTSE 350. We also recognize that the provision of NASs may be used by firms in building relationships with potential audit clients (see paragraph 9.49). However, whether a NAS engagement would give a firm experience relevant to the provision of audit services (for example, experience of the accounting policies, financial controls and systems) would depend on the specific nature of that engagement. Further, Ethical Standards might prohibit the firm from undertaking the audit if they had been involved in the design of a company's IT systems.[439]

9.18 We recognize that in some sectors the pattern of market shares will be a reflection of the small number of engagements. Nevertheless, it remains the case that in these sectors those firms that have not had a presence would not have demonstrable sector experience in the FTSE 350.

Firms' self-appraisals

9.19 In terms of firms' self appraisals of their capability and willingness to audit FTSE 350 companies:

(a) BDO considered that there were only about 35 or so of the largest UK-listed businesses that it would currently not be able to audit, such as the very largest financial services, oil, pharmaceutical and telecom companies. It was confident that it could audit the rest of the FTSE 350.[440]

(b) Deloitte said that there was no industry category in which it did not provide statutory auditor services to FTSE 350 companies. There was no technical or capability limitation which would prevent it from being active in any sector and it considered itself well placed to provide audit services to any FTSE 350 company regardless of size and sector.

[438] ibid, paragraph 3.3.5.
[439] Ethical Standard 5 (Revised)—Non-audit services provided to audited entities.
[440] Summary of hearing with BDO held on 13 February 2012, paragraph 7.

(c) EY said that the firm offered and had the capability to offer statutory audit services in all FTSE 350 industry sectors although there were certain sectors where it did not currently have audit clients.

(d) GT said that 290 out of the FTSE 350 companies were comfortably within its scope and competency and there were approximately 60 companies with fees greater than £3 million, or with 75 per cent of turnover overseas for whose audits it was currently unlikely to bid.[441,442]

(e) KPMG said that it competed with a number of alternative providers to provide statutory audit services to clients in all sectors. In some sectors it had not been successful in winning the audits of any companies which were currently in the FTSE 350.

(f) Mazars said that it would be capable of auditing the large majority of FTSE 350 companies on a sole basis and all others, with the exception of one or two of the very largest companies, on a joint basis.[443]

(g) PKF told us that although its international network was not nearly as large (in staff numbers) as the Big 4 firms', it could provide audit services for FTSE 350 companies.[444]

(h) PwC said that it operated in all industry sectors. It did not believe there were any industry sectors where it was not able to provide a quality audit service. [✂][445]

9.20 As noted (paragraph 4.22), BDO and PKF merged in April 2013.

The views of companies on their options

9.21 We considered the observed behaviour of companies in the selection of auditors to be evidence of which firms the large companies in practice consider to be their possible auditors. We present the evidence provided by *(a)* the survey, *(b)* the case studies and *(c)* the public data set.

Survey results

9.22 The survey we commissioned did not specifically ask respondents how many options they thought they had when selecting an auditor. However, it asked which firms had been invited to tender where the surveyed FTSE 350 companies had gone to tender in the past five years.[446] Of the 44 companies that had gone out to tender in this period, 40 were able to recall which firms had been invited to tender. The responses indicate that: 62 per cent of FTSE 350 companies thought that they had a choice of at least four firms (including Big 4 and Mid Tier firms); 72 per cent of the tender lists included at least three of the Big 4 firms; and 42 per cent all four of the Big 4 firms.[447]

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[441] Summary of hearing with GT held on 30 January 2012, paragraph 11.
[442] Summary of hearing with GT held on 4 October 2012, paragraph 18.
[443] Summary of hearing with Mazars held on 13 February 2012, paragraph 13.
[444] Summary of hearing with PKF held on 25 June 2012, paragraph 10.
[445] PwC submission and response to the issues statement, 12 January 2012.
[446] Forty-four (or 23 per cent) of the 195 FTSE 350 companies surveyed had put the engagement out to tender in the last five years, and 40 of these companies were able to provide information on the tender lists. See Appendix 2.2, Table 16, and paragraphs 50 & 52.
[447] Appendix 2.2, paragraph 52 & Table 18.

Five out of the 40 invited just two Big 4 firms and a further six companies included one or two Big 4 firms as well as Mid Tier firms.[448]

9.23 We also asked questions aimed at understanding the factors that would limit choice. In particular, we asked companies why their tender lists had been limited to the firms they mentioned. About 20 per cent of FTSE 350 companies said that they had short-lists in order not to waste time and that the number of firms invited to tender was sufficient to ensure a competitive process, suggesting that these respondents, at least, had the option of inviting more firms to tender had they thought this necessary to ensure an effective competition. Around 70 per cent identified one or more of the following as limiting factors: the specialist knowledge of the audit firm, the regional and geographic coverage of the audit firm; and the size of the firm.[449]

9.24 We also asked respondents which firms their company would formally consider if their current statutory auditor were to cease trading. These results suggest that 78 per cent of FTSE 350 companies have a choice of at least four firms (including Mid Tier firms and their existing auditor).[450] Over 70 per cent of FTSE 350 companies said that they would formally consider only Big 4 firms if their current auditor ceased trading.[451] The most frequently mentioned reason for this, by both FDs and ACCs, was the size and geographic coverage of the Big 4 firms. Sector knowledge and experience, reputation, better calibre/trained staff and size and complexity of the audit were other frequently mentioned reasons.[452]

9.25 We asked the FDs and ACCs who said that their company would consider only Big 4 firms (if their current auditor ceased trading) whether there were factors that would limit choice between Big 4 firms. For FTSE 350 companies, 60 per cent of FDs and 65 per cent of ACCs said that there were no factors limiting choice between Big 4 firms. For those that did, the most frequently mentioned factor was the provision of NAS (21 per cent of FDs and 15 per cent of ACCs) and some also mentioned conflict of interest/independence issues (4 per cent of FDs and 3 per cent of ACCs).[453]

9.26 Firms said that such issues (ie conflicts of interest and independence) could generally be resolved given some time, and that it would be in the interests of companies to facilitate this if they considered it necessary for a competitive tender.[454] Further, it would not be in a firm's interest to decide not to compete for an audit engagement in order to retain non-audit work that would create a conflict of interest as this would be damaging to its relationship with the company.[455,456] However, evidence provided by case studies suggest that in some cases choice would be limited by such considerations (see paragraph 9.31.) The case studies also provided evidence that choice between the Big 4 firms may be limited by relevant experience (see paragraph 9.30).

9.27 Nevertheless, these results suggest to us that the majority of FTSE 350 companies, if the audit engagement were put out to tender, would invite at least three of the Big 4 firms to bid. Some might also invite Mid Tier firms. There are factors that have the effect of limiting the choice of potential bidders, in particular, the experience and capabilities of the firms. These factors are, however, more likely to be reasons for not

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[448] Appendix 2.2, Table 18.
[449] Appendix 2.2, paragraph 55.
[450] Appendix 2.2, paragraph 82.
[451] Appendix 2.2, paragraphs 80.
[452] Appendix 2.2, paragraphs 85–87.
[453] Appendix 2.2, paragraphs 89–91.
[454] Deloitte response to the CC working paper 'Nature and strength of competition', paragraph 7.19.
[455] ibid, paragraph 7.20 (c).
[456] KPMG response to the CC working paper 'Nature and strength of competition', Annex 1: paragraph 126.

inviting Mid Tier firms than particular Big 4 firms. Nevertheless, the results suggest that for some companies choice between the Big 4 firms may be limited.

Case studies

9.28 Review of the case study companies suggested that their FDs and ACCs saw their options principally among the Big 4 firms. Some companies (eg Companies E, I and J) considered Mid Tier firms as suitable suppliers, for other companies Mid Tier firms might be considered suitable although there were some doubts (Companies D and H). Some companies saw Mid Tier firms as unsuitable (Companies A, B, C, F, G, K, L, M, N, Q, R, S and W).[457] We consider the barriers to entry, expansion and selection for Mid Tier firms in Section 10.

9.29 In terms of possible alternative suppliers we noted that the option of shared audit (by which one firm might audit a geographic area or subsidiary, and report to another firm conducting the Group audit) was not considered attractive. At Company A, such a shared audit had been in place at one point, and was considered in part responsible for control issues.[458] Likewise, at Company G, there was a shared audit, but this was considered to be an added complication, rather than an added assurance.[459]

9.30 The case studies suggested that some FTSE 350 companies saw little difference between the Big 4 firms in terms of technical, 'pure audit' competence. For example, the GFD of Company P[460] and the ACC of Company N[461] said that auditing was almost a commodity product; the ACC of Company R said that, by using a Big 4 firm the company would get the same technical quality;[462] and the GFD of Company T said that 'switching auditor had not affected audit quality because the Big 4 firms provided a high quality audit'.[463] However, we noted (see Appendix 6.1, paragraph 34) that at Company G (a bank) and Company C (an insurance company), interviewees expressed a view that one of the Big 4 firms was weaker than its competitors, although the ACC of Company C still thought that all of the Big 4 firms could compete for its audit.

9.31 Other case studies provided evidence on the importance of relevant sectoral experience and international capability, which might limit the number of potential auditors.[464, 465, 466, 467, 468] The responses also indicated that choice might be limited by other considerations. In particular if a firm was providing substantial NAS then either company or firm or both might decide that the firm should not become auditor.[469]

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457 Appendix 2.1, Company C—the reasons given by the FD and ACC for not using/considering a Mid Tier firm differed.
458 Appendix 2.1, Company A, paragraphs 32 & 59.
459 Appendix 2.1, Company A, paragraph 15.
460 Company P, paragraph 9.
461 Company N, paragraph 33.
462 Company R, paragraph 35.
463 Company T, paragraph 16.
464 Company L said that whilst the Big 4 all had global capacity they were not equally skilled with regard to digital and media developments. Company L, paragraph 19.
465 Company R said that one Big 4 firm declined to participate in a tender as it could not provide the relevant experience and capabilities required in three key geographic markets.
466 Company S said that it was important for the auditor to understand the nuances and specifics of the sector. Certain accounting standards were of particular relevance to the sector. It considered that the only firms with sufficient expertise to compete for its audit were two Big 4 firms.
467 Company U considered that one of the bidders was not considered strong in the geographical areas in which the company had set up new operations. Company U, paragraph 12. See also Company P, paragraph 10.
468 Company V said that it did not consider one Big 4 firm ([✂]) as it felt this firm did not have the relevant sector experience. Company V, paragraph 3; see also Company Q, paragraph 4.
469 Company L said that one Big 4 firm ([✂]) was conflicted from participating in a tender as it was currently working with the company to install a new finance system and earning many millions of fees. Company V did not invite one Big 4 firm ([✂]) to

The public data set

9.32 Observing those firms to which companies actually switched indicated which firms companies considered to be suitable alternative suppliers. From 2001 to 2010, we identified 83 occasions (excluding switches away from Arthur Andersen and instances where a company changed to or from a joint audit) in the public data set when a FTSE 350 company switched auditor: approximately 82 per cent of these switches were from one Big 4 firm to another, and 13 per cent were from a Mid Tier firm to a Big 4 firm. There are three examples of a company switching from a Big 4 firm to a Mid Tier firm, and one of a company switching from one Mid Tier firm to another. For FTSE 350 companies the observed switching has overwhelmingly been either between Big 4 firms or to a Big 4 firm.[470]

Submissions

9.33 SAB Miller[471] said an auditor must have the required expertise, experience, size and international scope. In addition, a company would typically not wish to appoint an external auditor which: already undertakes extensive NAS for the company (because of the need not only to tender and change the provider of audit services, but also to tender the NAS previously provided by the new auditor); has close links with a key member of financial management or the AC; or (in some industries) already acts as auditor to a major competitor. The GC100 (an association for the general counsel and company secretaries of companies in the UK FTSE 100) made similar points.[472]

9.34 AFME (the Association for Financial Markets in Europe)[473] said that for the majority of the largest global firms (at least in the financial sector) choice was in practice very limited. Many of these firms are said already to use a second Big 4 firm to carry out non-audit work, and may have reservations (because of perceived capability, competitive issues etc) about using another. It was therefore quite possible that the AC of such a global company, when considering a possible change of auditors, could find their choice limited to a single alternative. These views were supported by the British Bankers Association (BBA).[474]

CC view

9.35 We consider that overall these results suggest that for the majority of FTSE 350 companies a Mid Tier firm is unlikely to be considered to be a credible alternative supplier of audit services, but at least three Big 4 firms (including their existing auditor) would be credible bidders for the audit engagement. Nevertheless, given the importance of relevant experience to companies in the selection of auditors, in many sectors at least one firm may be a less credible alternative, and there appear to be companies for which the choice of auditor may be restricted to two suppliers.

Incentives of alternative firms to take on new engagements

9.36 In addition to capability, potential suppliers must have incentives to take on a FTSE 350 engagement, if they are to be good outside options for any given company (and

tender as it was involved in tax advisory work for the company at the time. Company W invited all of the Big 4 firms to tender, but one [✂] decided not to participate in the tender because of a preference to maintain its ongoing consulting work for which it had been engaged by the company.

[470] Appendix 2.4, paragraphs 49–51, Table 7.
[471] See response to Remedies Notice.
[472] See GC100 response to Remedies Notice.
[473] AFME response to provisional findings and Remedies Notice.
[474] See BBA response to provisional findings and Remedies Notice.

so increase that company's bargaining power when it negotiates with its incumbent auditor). We consider that a firm's incentives may differ between engagements and by firm since they depend on the expected incremental profit to the firm from gaining the engagement and the opportunity an engagement may give the firm to maintain, build and demonstrate sector and other expertise and experience (and thereby increase its chance of winning other audit engagements).

9.37 We consider that the strength of these incentives to take on an engagement is indicated by the following factors, which we consider in turn:

(a) the financial incentive, in particular the size and profitability of audit engagements and the likelihood that a company following a tender would switch audit firm;

(b) the efforts made by firms to gain new clients (which are also relevant to companies' ability to appraise rival firms, see paragraphs 9.139 to 9.147);

(c) the competitive value of demonstrable experience and expertise which securing a FTSE 350 appointment brings; and

(d) firms' willingness to participate in tender processes when invited to do so.

Profitability of audit engagements

9.38 The greater the fees generated by, and the profitability of an engagement, the more attractive it is to a potential auditor (and so the greater the likely competition for that engagement).

9.39 In 2010, the published audit fees (in March 2005 prices) for FTSE 350 companies were in the range of £0.014 million to £44.5 million. The median fee was £0.58 million. For FTSE 100 companies the median fee was £2.8 million.[475]

9.40 Using data provided by parties on their individual audit engagements, we created a database of the audit fees and the level of staff resources used in each year's audit; by combining this data with information on employment costs we are able to estimate the gross profit margin generated by individual engagements. This gross profit margin is stated after the costs of staff and partners[476] who work directly on engagements and any costs directly incurred in delivering the audit.

9.41 The data indicates that statutory audit in the reference market is profitable at the gross margin level, but that the gross profit achieved by a firm from a given audit engagement may vary considerably, both with respect to other engagements and over time (see paragraphs 7.94 to 7.99 and Appendix 7.3).

9.42 As noted in Section 7, we found some indication that engagements were on average less profitable in their first years, with profits increasing after initial engagement, and with the average level of profitability levelling off after five years (paragraph 7.44). However, even in the early years, revenue from engagements generally covers direct costs (including salary costs for partners).[477] Given the low level of switching we observed, firms on average could expect to retain engagements for relatively long

[475] Appendix 2.4, Table 3, and Annex 1, Table 41.
[476] We included partner time at twice the value of a director's time. We tested the sensitivity of our findings on the relative level of profitability in each of the market segments we considered, ie FTSE 100/FTSE 250 and other engagements, by increasing this ratio to four times director cost and observed similar trends.
[477] We were unable to assess the adequacy of the contribution that engagements made on average to fixed costs in the first years of engagement.

periods, hence the prospect of lower returns in the initial years of an engagement is unlikely to affect their incentives to bid for work. We noted that firms did not undertake internal rate of return (IRR) calculations for their audit engagements or calculate the payback period for recovery of costs incurred in tenders: this suggests that these upfront costs are also unlikely to affect incentives to bid for work.

9.43 For the reasons discussed in paragraphs 7.82 to 7.84 we were not able to assess economic profitability in this market. However, a comparison of the profit margins of the individual service lines indicates that Assurance service lines achieved comparable gross margins to other service lines across the firms. Given the obligation to purchase a statutory audit each year and the low levels of switching, we consider that the provision of audit services provides a stable and predictable revenue stream for firms. Our analysis suggests that net margins, after allocations of costs that are incurred by the Assurance service line, are positive (see Appendix 7.3, Annex 1, Table 6). Additional engagements may therefore be expected to generate a positive contribution to the fixed cost base of the firm and partnership profits.

9.44 For the incumbent firm the chance of retaining the engagement and for rivals the chance of winning the engagement will be a factor in the potential gains from participating in the tender process. We found that in around 23 per cent of tender processes the winner was the incumbent.[478]

9.45 As a result we consider that incumbent and rival firms have good financial incentives to compete for audit engagements if the opportunity arises.

Efforts made by firms to gain new audit engagements

9.46 The extent of efforts made by firms to win FTSE 350 engagements may show how attractive those engagements are to firms. This in turn indicates firms' willingness to take on an engagement: all else equal, the greater the willingness of firms to take on an engagement the more credible the threat to the incumbent auditor that the client may switch auditor.

9.47 All the Big 4 firms had programmes for targeting new clients[479] including FTSE 350 companies.[480] The firms identified particular companies to target and each FTSE 350 company may be allocated an individual partner to lead and coordinate efforts for building a relationship. Partners' individual lists of target clients may be included in their goals and objectives against which their performance is appraised and remuneration decided. The Big 4 firms selected companies for targeting on a number of bases including either establishing or increasing a presence in certain industry sectors, those companies with which they had strong existing non-audit relationships, or where specific circumstances were identified that would make a change in auditor likely. Some firms made reference to their international network identifying target clients or sectors.

9.48 The Mid Tier firms target particular FTSE 350 clients where they believed they had existing sector expertise and Mid Tier firms adopted a similar partner remuneration

[478] Appendix 7.1, paragraph 42.
[479] See Appendix 9.1; KPMG response dated 19 October 2012 to working paper 'Nature and strength of competition', Annex 2.1; PwC response to working paper 'Nature and strength of competition', paragraph 36 e) i) and initial submission, paragraphs 4.29–4.39.
[480] Appendix 7.8.

structure to the Big 4 firms (ie that some partners are incentivized to win new work from specific clients.[481]

9.49 Partners may draw up plans for targeting each client and maintain records tracking their progress. Relationships may be built through introductions and periodic meetings between a partner and senior management at a potential client, or it may involve undertaking a number of non-audit engagements. The benefits of such an approach are twofold: the first is making the firm, and potentially an audit team, known to the target company and the second is that the firm is able to develop its own knowledge of the client's operations and business risks and use this in any subsequent tender.

9.50 BDO said it could do more to target the CFOs, CEOs and ACCs. BDO held activities such as running a non-executive network at which it regularly spoke. BDO's partners also man-marked NEDs. This activity was designed to target a particular tier of non-executives to extend BDO's influence and to understand their priorities, as well as increase BDO's chances of being asked to participate in an activity with them.[482]

9.51 GT considered that an average of [✂] hours a year felt about right for the amount of time for its audit partners to invest in business development with the FTSE 350. If there was a significant increase in switching, GT would significantly increase the numbers of hours spent in marketing activity. GT's current approach to the FTSE 350 audit market was based on its assessment of what was realistic, ie building sustainable relationships with a number of companies.[483]

9.52 Our survey found that among FDs for FTSE 350 companies 88 per cent had been approached in the last five years by a rival firm offering to audit the company. The figure for ACCs was 53 per cent. These approaches were predominantly by Big 4 firms.[484]

9.53 The case studies provided further evidence that building relationships, either informally or through other work, with potential audit clients was an important element of the firms' strategies as they seek to win engagements.[485,486,487,488,489,490]

9.54 We consider that the evidence indicates that the Big 4 audit firms make considerable efforts to gain FTSE 350 audit engagements by targeting the clients of rival audit firms and seeking to build relationships with these companies. The evidence suggests that the Mid Tier firms are somewhat less engaged in such activity.

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481 Appendix 7.8.
482 BDO hearing summary, paragraphs 55 & 56.
483 GT hearing summary, paragraph 11.
484 Appendix 2.2, paragraphs 76–78.
485 The ACC at Company D received regular marketing material from the Big 4 firms. See Appendix 2.1, Company D, paragraph 68.
486 The ACC at Company E had accepted non-executive forum invitations from Big 4 firms. See Appendix 2.1, Company E, paragraph 55.
487 The AEP (from a Mid Tier firm) of Company J had run training courses for companies in the sector which he thought was why his firm was invited to tender. See Appendix 2.1, Company J, paragraph 70.
488 Company P said that it invited the Big 4 firms to tender because each had an existing relationship with the Company. Company P, paragraph 3.
489 Company T invited three Big 4 firms selected on the basis that they had an existing relationship with the Company or had had a relationship with them in the past. Company T, paragraph 5.
490 Company U invited three audit firms with which the Company had pre-existing relationships ([✂]) to tender. Company U, paragraph 4.

Willingness to participate in tender processes when invited to do so

9.55 The more that firms participate in tender processes when given the opportunity, and do so actively, the stronger the potential competition for engagements and so the more credible the threat that a company will put its audit out to tender.

9.56 Our analysis indicated that the Big 4 firms generally accepted invitations to participate in tender processes for audit engagements. In some circumstances firms may decide not to accept an invitation to tender if they believe chances of winning are low or the audit risk is too high.[491,492] In terms of Mid Tier firms, as noted, GT said that it was unlikely to bid for engagements where the fee exceeded £3 million or 75 per cent of a company's turnover was overseas. BDO and Mazars indicated that of the FTSE 350, there were some 35 companies for which they considered themselves unable to provide an audit service on a sole basis (see paragraph 9.19). See further Section 11 and Appendix 7.8 regarding firms' acceptance criteria, by which they establish if they would be willing to audit a company.

9.57 Our survey results and case studies suggested that firms may be prevented from bidding for audit engagements given conflicts of interest or independence issues (see paragraphs 9.25, 9.26 and 9.31). We were told that often such situations were manageable given some notice, for example, where a firm is conflicted by its non-audit work for a prospective audit client.[493] We consider that where this is possible it will also be in the company's interests to assist to ensure competitive tender processes. Firms have also said that it would be damaging to a firm's relationship with a client to decline to tender on whatever grounds including a wish to continue providing NAS (see paragraph 9.26 above).

9.58 Firms also said that they had a strong incentive to participate actively in tender processes as a poor performance would be damaging to the firm's reputation with the client and with individuals who may have positions in other FTSE 350 companies that are existing or potential clients. In addition, even if a firm fails to win the tender process a good performance is an opportunity to develop its relationship with a client with future prospects in mind.

9.59 Overall we consider that if invited to tender, generally the Big 4 firms will accept the invitation to do so and will have strong incentives to perform well in the tender process.

The competitive value of experience and expertise in the appointment process

9.60 The more valuable any given engagement is to a firm (in terms other than direct profits, which we considered above), the greater its incentives to win an engagement (and so the greater the competitive constraint on the incumbent auditor).

9.61 The firms emphasized the importance of sector experience in winning engagements. Companies wish their auditor to have sector expertise, which gives firms with this experience a competitive advantage. For example, we noted that:

(a) In the tender processes we examined, companies always required details of the experience and credentials of the team that will carry out the audit. Particular regard was given to partners and managers, but information on the experience

491 Appendix 9.2, paragraphs 41–48.
492 Company V, paragraph 3.
493 Deloitte response to working paper 'Nature and strength of competition', paragraph 7.18.

and business and industry knowledge of other team members was usually requested. Tender proposals frequently gave details of the firm's relevant experience including lists of well-known clients and clients in the relevant industry.[494]

(b) In feedback given by companies to firms that had participated in a tender process, the most frequently mentioned reason for a firm not being appointed to the engagement was its lack of experience or competition from a firm with more experience.[495]

(c) Our first survey provided evidence of the importance of relevant experience in the selection process. For FTSE 350 FDs and ACCs the factor most frequently identified as important in the appointment or reappointment of an auditor is the experience and knowledge of the AEP followed by good working relationships with the audit team, the experience and knowledge of the team and the reputation of the audit firm with investors etc.[496]

(d) The case studies provided evidence on the importance of relevant experience to companies in deciding which firms to invite to tender (see paragraph 9.31).

9.62 We found that while all Big 4 firms had experience of audits in most sectors, there were many sectors where one or two firms have a relatively small share of FTSE 350 engagements (see paragraph 9.12) although sector experience might be gained with non-FTSE-350 clients. This suggests to us that the strategic value of winning a particular engagement might differ between firms. KPMG said, for example, that audit relationships were likely to be valued differently by different audit firms depending on the benefits that an audit was likely to bring in terms of learning by doing, reputation and other factors.[497,498]

9.63 We therefore consider that the benefits to a firm of winning a new engagement are likely to be greater than the profits earned on the engagement, if winning the engagement by adding to the experience of the firm will increase its chances of winning other clients with similar demand (this assumes, and our evidence indicates, that those further engagements will be profitable). We consider the effect of this 'virtuous circle' as a barrier to expansion and selection further in Section 10.

Our view on the availability of alternatives

9.64 The Big 4 firms considered themselves capable of auditing any company in the FTSE 350 (though they might have reasons not to seek the audit of a particular company, for conflicts, risk or independence reasons). BDO and Mazars considered themselves capable of auditing all but approximately 35 companies in the FTSE 350 on a sole audit basis, and GT all but approximately 60 companies. We note that firms outside the Big 4 have had very limited success in obtaining FTSE 350 audit clients to date.

9.65 The majority of FTSE 350 companies appear to have a choice of at least three Big 4 firms (including the incumbent auditor). In many sectors it appears that one or more firms may be at a competitive disadvantage given the importance to companies of relevant experience, knowledge and expertise in the selection of auditors. We think

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494 Appendix 9.2, paragraphs 33, 73 & 76.
495 Appendix 7.1, paragraph 53.
496 Appendix 2.2, Table 13.
497 KPMG submission in response to issues statement, paragraph 347.
498 Appendix 8.3, Annex 1, paragraph 31.

that the Big 4 firms have strong incentives to compete to win engagements when the opportunities arise demonstrated by the profitability of FTSE 350 engagements and the efforts that firms make to win engagements. We therefore consider that generally a FTSE 350 company and its incumbent auditor can expect strong competition for the audit engagement if the company were to decide to go to tender.

9.66 However, the availability of alternatives is only relevant to the extent of bargaining power if customers can both compare the current supplier with those alternatives, and switch to one of those alternatives if unable to negotiate a competitive offer with its incumbent. We consider one element of comparison, the companies' appraisal of the incumbent auditor in the next subsection.

Companies' appraisal of their incumbent auditor

9.67 We considered whether companies (mainly their FDs and ACCs) can accurately appraise the quality of the audit product and service provided and the fees charged by their incumbent, as a company's ability to negotiate a competitive offer depends on its ability to form a view of the competitiveness of the service that it is receiving. We think such a view cannot be formed in isolation: it must necessarily be a comparison with other options (and we consider companies' ability to appraise potential auditors in the next subsection: see paragraphs 9.115 to 9.168).

9.68 Therefore to understand how and the extent to which FDs and ACCs can appraise incumbent auditors, we consider: *(a)* the qualifications of those principally making the buying decision (namely FDs and ACCs); *(b)* their resources and the information available to them regarding their current auditor when they decide to reappoint; *(c)* firms submissions; and *(d)* our view of companies ability to appraise their incumbent auditor. We consider FD and ACC incentives (and the potential of those incentives to prevent, restrict or distort competition) under our second theory of harm in Section 11.

The qualification of FDs and ACCs

FDs

9.69 While there is no requirement for FDs to be qualified accountants, they often are, and in our survey (ie including FTSE 350, private and other listed company respondents)[499] we found that two-thirds (66 per cent) of the FDs/CFOs surveyed had previously worked for one of the Big 4 firms (20 per cent had worked for Deloitte; 11 per cent for EY; 15 per cent for KPMG; and 28 per cent for PwC). This proportion was similar for FDs/CFOs of FTSE 350 companies.[500]

9.70 We interviewed ten CFO/FD equivalents in our first set of case studies, of whom seven had trained at a Big 4 firm, and a further two who having trained elsewhere then went on to work for a Big 4 firm. Most had practised as an auditor at a Big 4 firm, although one was a tax practitioner and another (who had joined after qualifying) worked on management consultancy. One CFO/FD equivalent had previously been an audit partner at a Big 4 firm.[501] The one FD who had never worked for a Big

[499] Appendix 2.2, paragraph 24.
[500] Appendix 2.2, paragraph 24.
[501] Appendix 9.3, paragraph 58.

4 firm had trained as a management accountant (CIMA) in industry (rather than in public practice).[502]

ACCs

9.71 With regard to ACs, the FRC's Guidance on ACs requires that at least one member of the AC has recent and relevant financial experience.[503] The FRC Guidance does not specify that this person should be the ACC.

9.72 Around 60 per cent of the ACCs we surveyed had previously worked for one of the Big 4 audit firms (15 per cent for Deloitte; 18 per cent for EY; 16 per cent for KPMG; and 20 per cent had worked for PwC). The proportion was similar for ACCs of FTSE 350 companies.[504]

9.73 In our follow-up survey of FTSE 350 ACCs, we found that 39 per cent of the ACCs in that survey were on the AC of multiple[505] FTSE 350 companies, mostly in the role of ACC. 6 per cent were also a member of the board at another FTSE 350 company, but not on the AC. Almost all of the respondents were professionally qualified accountants (89 per cent) and had professional experience directly relevant to their position as ACC for a FTSE 350 company.[506] 82 per cent of respondents had been active in their current role of ACC for three years or longer.[507]

9.74 During our case studies, we interviewed ten ACCs, of whom seven had trained at a Big 4 firm, and three had subsequently become audit partners at a Big 4 firm. Of the three ACCs who had not trained at a Big 4 firm two subsequently went on to work in audit at a Big 4 firm for a time after qualifying. The one ACC who had never worked for a Big 4 firm (either as a trainee or after qualification), had trained as a management accountant (CIMA) in industry (rather than in private practice).[508]

9.75 We consider that this evidence shows that FDs and ACCs for FTSE 350 companies are typically well-qualified and experienced individuals.

Role, resources, and information of FDs and ACs

9.76 In order to assess if these individuals were in a position to form an accurate opinion of the audit product and service provided by the incumbent auditor, we consider the role of *(a)* FDs (paragraphs 9.77 to 9.80) and *(b)* ACs (paragraphs 9.81 to 9.99) and the resources available to them. We then *(c)* consider the information available to both FDs and ACCs through the appraisals that companies carry out on their auditor (see paragraphs 9.101 to 9.109).

Role of FDs

9.77 FDs are responsible for producing the company's accounts. They manage the reporting of the company and are respondents to the auditor in the conduct of the audit. Typically the FD took the lead in the negotiation with the AEP on the terms of

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[502] Appendix 9.3, paragraph 60.
[503] www.frc.org.uk/getattachment/6ec23196-28ee-406e-8f56-89ab9d1dc06d/Guidance-on-Audit-Committees-September-2012.aspx, paragraph 2.3.
[504] Appendix 2.2, paragraph 24.
[505] Generally two or three, but for some up to four FTSE 350 companies.
[506] Of particular note was that of the ACCs surveyed 28 per cent had previously been audit partners and 54 per cent had previously been FD/CFOs of a FTSE 350 company.
[507] See responses to follow-up survey of FTSE 350 ACCs, questions A1–A8.
[508] Appendix 9.3, paragraph 60.

engagement and would be involved in discussion of the audit scope and plan at the beginning of the audit cycle. We found that in general the FD's role was to discuss areas of judgement regarding accounting treatment with the auditors and to discuss any issues that had arisen in the course of the audit, prior to meetings with the AC.

9.78 Audit issues were resolved at the appropriate level of management.[509] Any significant issues were escalated to regional and then Group teams. This would occur where something was not resolved satisfactorily, but more often than not the issues that were flagged to the Group auditors were where there was an uncertainty that needed a considered judgement, which accordingly should be discussed with the AC. The FD and AEP typically attended AC meetings, FDs wanted audit issues to be resolved in advance of these meetings. Depending on the company, there might be far more frequent contact.[510]

9.79 All the FDs we spoke to in our case studies in effect had a 'no surprises' policy with their auditor, so that any audit issues would be escalated up through a hierarchy and discussed with the FD before presentation to the AC.[511]

9.80 Since the auditors are in effect scrutinizing the data produced and judgements reached by the financial function of each company, the FD is accountable for the work that the auditor is scrutinizing. It is his or her staff that answer the questions that the auditor asks, and produce the documents and data requested in the first instance. In this role FDs can draw upon the resources of the financial reporting functions within the company.

Role of ACCs and ACs

9.81 With regard to ACCs and ACs we considered: *(a)* their role in principle and practice; *(b)* the resources (in terms of their own time and external assistance) available to them in completing their task; and *(c)* their own views of their ability to appraise incumbent auditors. We *(d)* set out our views.

- *ACC and AC role in principle and practice*

9.82 The AC was responsible for overseeing the appointment and reappointment of external auditors, monitoring the effectiveness of the external audit process and reviewing independence and objectivity of external auditors (with particular regard to external auditors supplying NAS). See Appendix 3.1, paragraphs 233 and 234.

9.83 The FRC's Guidance on ACs states that while all directors have a duty to act in the interests of the company, the AC has a particular role, acting independently from the executive to ensure that the interests of shareholders are properly protected in relation to financial reporting and internal control.[512] It states that the most important features of the relationships between the AC, board, executive management and internal and external auditors could not be written down: a frank, open working relationship and a high level of mutual respect were essential, particularly between the ACC and board chairman, the chief executive and FD. The AC must be prepared

[509] For example, at Company C, if an issue arose in an overseas business, the first stage would be for the local audit team to discuss it and seek to resolve it with the local management. Appendix 2.1, Company C, paragraph 90.
[510] The FD at Company I, for example, said that he had very frequent contact with the senior AEP during the year, approximately every two weeks. This was most frequent during the interim and final audit processes. Appendix 2.1, Company I, paragraph 5.
[511] The larger and complex the company, the more elaborate the issue resolution hierarchy: see, for example, Company G, paragraph 16.
[512] FRC, Guidance on Audit Committees, paragraph 1.3.

to take a robust stand and all parties must be prepared to make information freely available to the AC, to listen to their views and to talk through the issues openly.[513]

9.84 Many of the core functions of ACs specified in the FRC's Guidance on ACs are expressed in terms of 'oversight', 'assessment' and 'review' of a particular function. It is not the duty of ACs to carry out functions that properly belong to others, such as the company's management in the preparation of the financial statements or the auditors in the planning or conducting of audits.[514] However, the high-level oversight function may lead to detailed work, and the AC must intervene if there are signs that something may be seriously amiss.[515]

9.85 Under the FRC's Guidance on ACs, ACs have wide-ranging, time-consuming and sometimes intensive work to do and companies need to make the necessary resources available.[516] The AC should have access to the services of the company secretariat on all AC matters.[517] The board should make funds available to the AC to enable it to take independent legal, accounting or other advice when the AC reasonably believes it necessary to do so.[518]

9.86 From our case studies, we found that ACCs were involved in discussing and approving the audit plan (although they saw it as the responsibility of the auditor to draw up the plan). There were typically four AC meetings each year (though they were more frequent in larger companies), and the ACC would meet the AEP in advance of each meeting. These meetings would involve discussion of the auditors' work undertaken on material areas of audit judgement and risk. There would be a part of the meeting where only the AEP was present. ACCs received reports of the auditors' work.[519] See also paragraphs 11.38 and 11.39 regarding the case study ACCs' views of their role.

9.87 The results of our follow-up survey indicated that FTSE 350 ACCs consider themselves to have a considerable role in ensuring the quality of external financial reporting and auditing, concerning themselves with the accounting policies applied by the company and auditor, the firm's audit plan and methodology (and how well it is executed), the extent of company disclosures and how audit issues have been resolved, among other things. A sizable minority indicated that they were less involved in the detail of the audit work (such as sample sizes or review within the audit firm).[520]

- *ACC and AC resources*

9.88 We considered the resources that ACCs and ACs could call upon, based on our surveys, case studies, and evidence supplied by audit firms.

  - *Evidence from surveys*

9.89 According to our follow-up survey of FTSE 350 ACCs, 77 per cent of respondents indicated that they spent two days a month or less in their role as ACC, even though

[513] ibid, paragraph 1.6.
[514] ibid, paragraph 1.8.
[515] ibid, paragraph 1.9.
[516] ibid, paragraph 1.10.
[517] ibid, paragraph 2.12.
[518] ibid, paragraph 2.14.
[519] By way of examples, see Appendix 2.1: Company A, paragraphs 50, 51 & 52; Company B, paragraphs 37 & 38; Company C, paragraphs 48, 49 & 51; Company D, paragraphs 48, 50, 53 & 54; Company E, paragraphs 39 & 41; Company F, paragraphs 37 & 38; Company G, paragraphs 52, 53, 54, 56 & 58; Company H, paragraphs 53, 54, 55 & 60; Company I, paragraphs 37, 38 & 39; and Company J, paragraph 34.
[520] See Appendix 2.3, responses to questions B1–B3.

there was substantial variation in this number. With the exception of a single respondent that indicated spending eight days a month in this role, the upper limit of time spent as ACC was five days a month.[521]

9.90 About half of respondents indicated that in the past three to five years the AC had requested supplementary information, beyond that which one would expect to receive as part of a normal AC agenda. Such supplementary information was typically requested on a yearly basis and covered areas such as accounting standards, a deeper review of specific topics or areas, and benchmarking the company's internal procedures to those of its peers. Respondents that indicated they had not requested additional information did not do so mostly as it was not necessary or because they could obtain such information from internal sources.[522]

9.91 About one-quarter of the ACCs surveyed indicated they had engaged resources independent of the company and its external auditors to obtain advice on an external audit or financial reporting issues. In general these respondents indicated they had done so around once a year or less and that they were mainly looking for a second opinion, either to obtain additional assurance, or because there were doubts about the information that had been provided. Another common reason for engaging additional resources was the necessity of additional expertise in areas other than statutory audit, such as valuation or legal matters. The majority of ACCs that indicated they had not engaged additional independent resources had not done so as it had not been necessary.[523]

° *Evidence from case studies*

9.92 We asked our case study ACCs about the conduct of their role. The amount of time spent varied depending on the size of the company and if there were particular issues that required their attention,[524] and the state of the company.[525]

9.93 ACCs were typically on fixed salaries, unrelated to the number of hours they spent on audit issues. In 2010 average NED remuneration for FTSE 100 companies was £59,000, with ACC's receiving on average an extra £15,000.[526]

° *Evidence from firms*

9.94 Deloitte said that third party firms or professionals might be commissioned by a company to advise on issues relating to external audit arising during the normal course of process. Examples could include specialist advice on provisions required in companies' accounts for taxation, litigation or environmental risks or specialist advice on property or other asset valuations. These professionals would be typically hired by the company CFO or finance function and not by an NED such as the ACC, although it is possible that the ACC could have been the catalyst behind the request for this external advice. Further, it was aware that ACCs might commission other firms to perform work from other suppliers on other matters in exceptional circumstances. For example, a separate firm might be commissioned to investigate circumstances around a fraud.

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[521] See Appendix 2.3, paragraphs 20 & 21.
[522] See Appendix 2.3, paragraphs 22 & 23.
[523] See Appendix 2.3, questions C8–C12.
[524] For instance, the Company G ACC reckoned he spent perhaps a day a week on its audit. Appendix 2.1, Company G, paragraph 51.
[525] The Company A ACC spent more time than he had anticipated due to control issues within the company. Appendix 2.1, Company A, paragraph 55.
[526] www.incomesdata.co.uk/news/press-releases/FTSE_100_NEDs_2010.pdf.

9.95 KPMG identified seven examples of ACs calling for external resources, and noted that it would not necessarily have full visibility of all instances where work was commissioned by, or on the instruction of, the AC.

9.96 PwC also identified seven examples of ACCs calling for external resources (where either PwC was the auditor or it had been called on to provide advice with respect to an audit conducted by another firm) and PwC said that this was likely to happen:

> in particularly complex or contentious areas where ACCs may seek the additional comfort of a second opinion from another audit firm on an issue or ask a different firm of specialists, eg, a law firm, to advise on an aspect related to the accounts or audit or where we are sometimes requested to provide advice or assistance by ACCs of companies which are not our audit clients. This is more often commissioned by the company, sometimes after discussion with the ACC, rather than directly by the ACC and we would not necessarily know the extent of ACC influence.

- *ACCs view of their ability to appraise incumbent auditor*

9.97 In the follow-up survey we asked ACCs for their views on the degree of confidence they have in their ability to assess various aspects of the audit.[527] Generally more than 90 per cent of the respondents were either 'very confident' or 'quite confident' in their ability to make an assessment of the listed aspects, such as the appropriateness and sufficiency of the expertise and experience of the audit team or the robustness and perceptiveness of auditors in handling key judgements on accounting policies.

9.98 Their responses suggest that the detailed work of the auditor may be less visible to ACCs and ACs than other aspects of the audit. These detailed areas include sample sizes, internal reviews and tests, and staffing questions such as the quality of more junior staff and the overseas audit teams.[528]

- *Our view regarding role and resources of FDs and ACCs*

9.99 We consider that this evidence (regarding their role and resources) indicates that the role of FDs in the audit process required a detailed knowledge of the work undertaken by the existing auditor. In particular, FDs typically take the lead in the negotiation of the terms of the engagement, are involved in the agreement of work plans, and will discuss issues arising with the auditor prior to meetings with the AC. FDs will be able to draw upon the resources of the finance team.

9.100 In contrast the ACC, while involved in many of the same matters, has an oversight role. ACCs generally considered themselves to have the resources which they considered necessary to carry out their responsibilities.

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[527] Details on these aspects and the ACCs' responses are contained in Appendix 2.3.
[528] See Appendix 2.3, paragraph 25.

Information available to FDs and ACCs

9.101 Having considered their roles individually, we consider the information available to both FDs and ACs regarding the incumbent auditor deriving from reviews that companies carry out with respect to *(a)* quality and *(b)* fees. We *(c)* set out our views.

- *Quality*

9.102 With regard to quality, in our first survey, we found that most companies regularly carry out reviews (internal or with their auditors) of audit quality and service based, in general, on staff opinions drawn from their interaction with auditors. 91 per cent of FTSE 350 companies carry this out annually and 99 per cent at least every five years.[529]

9.103 These results are consistent with the findings of the case studies. All case study companies reviewed the auditors' performance before reappointment in some way. There was a mix of formal review processes (for example, a written questionnaire) and informal processes (for example, oral feedback).[530]

9.104 Firms said that annual reviews were detailed processes involving a significant number of personnel who had interacted with the auditor allowing for a detailed appraisal of the existing auditor's performance.[531]

9.105 For example, KPMG said that 74 per cent of its FTSE 100 audit clients had extensive review procedures in place with the audit partner during which their client reviewed the terms of audit including fees and the scope. Governance and price were found to be the most frequent drivers for these reviews, and service and mergers and acquisitions the next most frequent.[532] KPMG also provided evidence in relation to surveys, reviews and benchmarking exercises carried out by its clients. Whilst the scope of these activities varied, many were wider ranging covering areas such as: fees; the audit team; technical expertise and support; relationships and communication; audit approach, plan and scope; quality of judgements, independence and objectivity; audit firm and internal quality controls; and interaction with Internal Audit.[533]

- *Fees*

9.106 With regard to fee, from our survey, we found that 93 per cent of companies negotiate their audit fee every year, and all companies negotiate their fee at least every five years.[534]

9.107 Our case studies suggest that companies also requested granular fee details to assess the competitiveness of the audit fee.[535,536,537]

9.108 Our assessment of submissions made by firms and case studies suggests that when an auditor is reappointed, the scope of the audit and fees in the previous year is the

529 Appendix 2.2, Table 14.
530 Examples included: Appendix 2.12, Company B, paragraphs 16 & 18; Company C, paragraphs 25 & 26; Company E, paragraphs 18 & 19; Company F, paragraph 49; and Company G, paragraphs 17, 18 & 19.
531 For example, Deloitte response to working paper 'Nature and strength of competition', paragraph 5.2.
532 KPMG response to working paper 'Nature and strength of competition', paragraphs 3.2.2–3.2.5.
533 ibid.
534 Table 14.
535 For example, Company B received a fee per subsidiary. Appendix 2.1, Company B, paragraph 25.
536 Company G negotiated a fee on a business-by-business basis. Appendix 2.1, Company G, paragraph 30.
537 Company I negotiated fee on a subsidiary level and requested the hourly rates charged for each grade and the number of hours taken on the audit. Appendix 2.1, Company I, paragraphs 26 & 27.

starting point for the vast majority of discussions. The survey results suggest that around 60 per cent of FTSE 350 companies would require firms to make formal proposals or presentations before reappointment at least every five years.[538]

9.109 We consider that the evidence indicates that this process of negotiating audit fees will give the FD, in particular, a detailed understanding of the components of the audit fee although based on the fee in the previous year.

- *Our view of information available to FDs and ACCs*

9.110 We think that in carrying out their responsibilities both FDs and ACCs acquire considerable information on the audit product and service provided by the auditor. Based primarily on the results of the case studies it appeared to us that there was significant overlap in the information that the FD and the audit team had regarding the audit process, methodology and fees. The FD is likely to be better informed than the auditor on the fundamentals and facts of a company (an auditor has to be selective in its scrutiny and testing of financial data and does not know what it has not found),[539] and the auditor knows better than the FD the detailed work it has undertaken in carrying out the audit. However, the asymmetry of information (between FD and auditor) may vary with the time available and the effort made by the FD to understand what the audit team did, for example on the extent of substantive testing. We understand that FDs do not have access to the detailed audit files compiled by firms to record their activities. The relative expertise of the individuals will also vary over time, depending on their length in post (AEPs may not serve more than five years, and we understand that the average tenures of FTSE 350 FDs are around five years,[540] and that of their respective teams and advisors).

9.111 These factors also apply to the ACC, although as noted his or her role is more supervisory: see paragraphs 9.81 to 9.100. We return to the role of the AC in considering our second theory of harm in Section 11.

Firms' submissions on companies' ability to appraise their incumbent auditor

9.112 Deloitte agreed that FTSE 350 companies have the expertise, resources and information to appraise their current auditor but could not see why we had qualified this conclusion by stating it only related to some aspects of the audit and to a certain extent. It said that our evidence fully supported the conclusion that FDs and ACs can and do fully appraise their auditors.[541]

9.113 KPMG considered that our provisional findings provided strong evidence that companies were well able to appraise accurately their audit firm. It thought that we had implied that there were material aspects of performance that customers were not in a position to appraise, but we had not provided any explanation of what such aspects may include. Detailed substantive work using sample-based testing, while important, should be viewed in the context that in any sizable multinational organization the audit will inevitably be risk focused and will seek to test and wherever possible rely substantially on the controls implemented by management. It said that we could not

538 Appendix 2.2, paragraph 42.
539 For example, Appendix 2.1: Company E, paragraph 33; Company C, paragraph 39.
540 CC analysis of *Financial Director* magazine salary survey data. Mean is 6 years, median is 4.5 years. *Financial Director* had calculated the average tenure to be 5.6 to 5.8 years in 2010. This is also consistent with the University of Southampton's work on FTSE 350 boards 'FTSE 350 Board Review 2012' on behalf of Thorburn McAlister.
541 Deloitte response to provisional findings, paragraph 3.5.

put weight on the observations that ACs are less involved in certain detailed aspects of audit work (such as selection of sample sizes) to support any AEC finding.[542]

Our view on companies' ability to appraise their incumbent auditor

9.114 Our view in light of each of the above is that in general FDs and ACs can appraise their current auditor, although the information asymmetry between FDs and auditors may vary and the detailed work of the audit team such as sample sizes and internal reviews and tests may be less visible to ACs.

9.115 However, in the context of our assessment of bargaining power, the appraisal of the incumbent can only be comparative, ie exercised in combination with knowledge of available alternatives and ability to switch, and we turn to that issue next.

Companies' ability to appraise non-incumbent suppliers outside the tender process

9.116 In this subsection, we assess how effectively companies can appraise non-incumbent suppliers' offerings. We:

(a) consider the evidence on the frequency with which companies attempt to compare the offering of the incumbent auditor with that of other firms and the extent of these comparisons (paragraphs 9.117 to 9.123);

(b) consider other sources and quality of the information available to FDs and ACCs (paragraphs 9.124 to 9.149);

(c) summarize relevant firm submissions responding to our provisional findings; and

(d) set out our views (paragraphs 9.156 to 9.168).

Frequency and extent of benchmarking

9.117 The term 'benchmarking' has been used by firms to describe comparative exercises by which companies attempt to compare the offering of the incumbent auditor with that of rival firms. Since it is a direct comparison, it is relevant to both companies' appraisals of their incumbent and rival auditors. Benchmarking exercises are said to be based on comparisons with companies in the same sector or with similar characteristics. Those making the comparison can take into account relevant similarities and differences in the characteristics of companies to the extent that these are observable.

Evidence

9.118 Our survey found that about two-thirds of FTSE 350 companies carry out some form of benchmarking or other formal comparisons with auditors at least every five years (and 25 per cent every year), and suggested that about 90 per cent make informal comparisons.[543] About three-quarters of companies that carry out benchmarking

[542] KPMG response to provisional findings, paragraphs 3.4.1–3.4.3.
[543] Appendix 2.2, Table 14.

exercises or other formal comparison compared their audit fees with those paid by other companies in the same sector and/or of a similar size and complexity.[544]

9.119 Nearly half of companies said that they looked at the expertise, experience and reputation of the audit firms and the audit team when making a comparison. Only 5 per cent of respondents did not mention any of these three factors. The next most frequently mentioned factors were: quality of service (21 per cent), geographical coverage of the audit firm (20 per cent), audit techniques, approach and accounting treatments (10 per cent). A number added that they also made comparisons based on informal discussions with other FDs, auditors etc.[545]

9.120 Benchmarking the audit fee against other companies to assess its competitiveness was widely used across the case study companies, although views varied as to its effectiveness.[546] 3i Group plc told us that it had instructed The Buying Team (since renamed Proxima) to assist in negotiating fees at the last review and would typically engage someone outside the direct audit engagement. The Buying Team was an external procurement consultancy that would not be swayed by any relationship issues and which had experience across the largest four auditors to identify best practice, time estimates and differing rates.[547]

Firm submissions

9.121 The Big 4 firms said that companies were able to assess the relative, as well as absolute, performance of the existing auditor on price and quality using a range of tools. They said that companies were well informed on the competitiveness of their incumbent firm's offering.[548] PwC said that the case studies showed the extent and value of the annual reviews of auditor performance. Against a backdrop of the standards expected and experienced by AC members and other senior management in their roles at other companies where they encounter other audit firms, they provide important insights and evidence enabling companies to evaluate and compare auditor performance.[549]

9.122 The firms said that benchmarking on fees is based on a detailed analysis of factors that will inform the audit fee of different companies taking account of industry sector, turnover, market capitalization and the extent of international activities. Those making the analysis are knowledgeable about the characteristics of other major companies in the same sector or with similar characteristics, and will commonly test the reasons why another company might or might not be considered an appropriate comparator. Comparisons are made by reference to hourly rates or proposal prices seen in other contexts. Firms said that our first survey showed that benchmarking was widespread and regular and this strongly suggested that this was seen to be a useful tool for assessing value for money. They said that the case studies provided further evidence on this point.[550]

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[544] Appendix 2.2, Table 15.
[545] Appendix 2.2, Table 13 & paragraphs 4 & 47.
[546] See, for example, Appendix 2.1: Company A, paragraph 70; Company B, paragraph 25; Company C, paragraph 37; Company D, paragraphs 37 & 91; Company E, paragraph 60; Company G, paragraph 30; Company H, paragraph 39; Company J, paragraph 16.
[547] 3i Group plc summary of conference call, paragraph 12.
[548] Deloitte response to working paper 'Nature and strength of competition', paragraphs 5.9–5.15; KPMG response to working paper 'Nature and strength of competition', paragraphs 1.5 and 2.2.1–2.2.14; PwC response to working paper 'Nature and strength of competition', section 2.
[549] PwC response to working paper 'Nature and strength of competition', section 2, paragraph 36 c).
[550] Deloitte response to working paper 'Nature and strength of competition', paragraph 5.12; PwC response to working paper 'Nature and strength of competition', section 2, paragraph 36.

9.123 The firms said that comparative quality was assessed by means of considering the approach of other firms to any non-audit work they undertook for the company, audit and non-audit work they undertook for other companies with which other directors have a relationship and from the directors' own accounting and audit backgrounds.

Sources and quality of information regarding non-incumbent firms outside a tender process

9.124 In our follow-up survey of FTSE 350 ACCs, the respondents were asked to what extent they were able to assess the quality of the audit that could be delivered by audit firms other than their current auditor, outside of a tender process.

9.125 Some of the respondents indicated that this was difficult or only possible to a limited extent, but more than 75 per cent considered that they could assess quality outside of a tender process one way or another. Many of the ACCs surveyed had themselves worked with various audit firms, and therefore felt they had an understanding of the service quality offered. Alternative sources of information regarding quality were feedback from contacts in their professional network, the general reputation the audit firms have in the market, and regulatory reports. ACCs identified useful indicators for the quality of audit firms as their staff (how they presented themselves, whether they understood the sector), and the firms' global coverage.[551, 552]

9.126 We consider in turn the following ways in which FDs and ACCs obtain information on potential auditors, short of a formal tender process:

(a) experience FDs and ACCs obtain of firms' audit service via roles in other companies;

(b) experience of firms' capabilities via provision of NAS;

(c) regulatory reports; and

(d) firms' marketing efforts, including their websites that promote their audit capabilities, along with contacts for those interested.

Experience of non-incumbent firms' audit service via roles in other companies

9.127 Nearly all ACCs we surveyed sat on or chaired another AC (of these 33 per cent on one other, 34 per cent two others, 20 per cent three others, 8 per cent four others, and 5 per cent five or more). The proportions are similar for ACCs of FTSE 350 and other companies.[553]

9.128 This was consistent with our case studies, where ACCs were typically part-time and had other roles on ACs, or had previous experience of other auditors through FD roles. Some were former AEPs or FDs themselves.[554] The broader experience of

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[551] See Appendix 2.3, paragraphs 29 & 30.
[552] In its submission to the CC prior to the provisional findings 21 December 2012, paragraphs 2.13 & 2.14, KPMG points out that the answers given for questions D7 (evaluating audit quality in a tender procedure) and D8 (evaluating audit quality outside of a tender procedure) of the follow-up survey were similar. In particular it pointed out that in a number of instances ACCs provided the same answers, which suggested that they noted no distinction.
[553] Appendix 2.2, paragraph 24.
[554] See Appendix 2.1. The Company A ACC was previously a senior audit partner with a Big 4 firm and a member of the Audit Practices Board (paragraph 49); the Company D ACC could benchmark against another firm that audited the company at which she was the FD (for fee and overall performance) (paragraph 61); the Company E ACC had extensive experience, having held FD roles with a number of companies. He had held a number of ACC roles, the first of which was in 2005. The ACC was also the Chairman of a plc and held a number of NED roles (paragraph 37); the Company F ACC was also an FD at a FTSE 350

individuals at a company was also used to benchmark fees.[555,556,557] However, Company R's GFD said that although he had interactions with other audit firms around the world a tender gave a more granular understanding of firms' capabilities, and the primary benefit of holding a tender was getting a better idea of the actual ability of the Big 4 audit firms rather than their perceived ability.[558]

9.129 All the Big 4 firms considered that large companies were experienced and knowledgeable purchasers of audit services. For instance, PwC said that directors (including FDs and ACCs) who made audit purchasing decisions had a wealth of current and past experience accumulated at different companies and with different audit firms. It provided specific examples of concurrent director appointments.

Experience of firms' capabilities via provision of NAS

9.130 Our case study companies tended to limit the extent of NAS provided by their auditor in order to maintain its independence. However, this provision of NAS was also a source (for some of them) of information regarding potential auditors.[559,560,561,562,563,564,565.]

9.131 Firms also saw provision of NAS as a way of demonstrating their capabilities to potential clients (see Appendix 9.3, paragraphs 34 to 37 on marketing strategy). PwC said that some companies had relationships with a number of firms at one time allowing them to make comparisons and test alternative audit firms, and it gave examples of companies both where PwC was the external audit firm and other Big 4 firms or Mid Tier firms provided internal audit services, and vice versa. It also gave instances of companies making changes to their suppliers of assurance and NAS to give them greater experience of the Big 4 firms and/or to reduce the proportion of non-audit fees paid to their auditor.

9.132 We note that in 2011 the six largest audit firms reported NAS revenue from the FTSE 350 (both audit and non-audit clients) of £1.3 billion of which 99 per cent was

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company, and so had direct experience of another firm (paragraph 35); at Company G, the ACC was also Chairman of two plcs (paragraph 49); the Company H ACC had spent the majority of his career at KPMG as an audit partner. He was also an NED at a private oil company, four investment trusts and a local development agency (paragraphs 51 & 52); the Company J ACC was ACC of two other investment trusts which used a mixture of Big 4 and Mid Tier audit firms. He was also Chairman of one other investment trust and a director of another (paragraph 32).

555 At Company E, the ACC had extensive retail experience and contacts at other companies to whom he could talk about fees. Appendix 2.1, Company E, paragraph 60.

556 At Company F, the AEP said that various FDs [✄] shared information with one another fairly freely in relation to fees and how fee deals had been agreed. Appendix 2.1, Company F, paragraph 89.

557 The CFO at Company C said that benchmarking was never conclusive. Appendix 2.1, Company C, paragraph 37.

558 Company R, paragraph 3.

559 See Appendix 2.1. Company A tendered most non-audit work to two or three firms. The start point was that the auditors should not be used which meant that, for some work, the auditors missed out even when they were well placed (paragraph 48).

560 See Appendix2.1. At Company B all outsourced NAS were put to competitive tender and different firms were selected for each piece of work (paragraph 32); according to the ACC, the company tended to use other firms for non-audit work. This was partly due to company policy and partly as it allowed the company to keep an eye on other firms from time to time. The ACC said that in the past, performing NAS could be an advantage in tenders but this was not the case now (paragraph 57).

561 See Appendix 2.1. Company D's policy was to limit non-audit work performed by the current auditor to less than 100 per cent of the audit fee for two reasons: *(a)* the main one being to avoid any conflict with the auditors' independence; and *(b)* also to keep things competitive by having a relationship with, and sharing work around, a number of firms (paragraph 44).

562 See Appendix 2.1. At Company F the FD was very keen on auditor independence. He preferred to instruct another firm to undertake non-audit work. The other Big 4 firms were all capable of providing the non-audit work to a high standard (paragraph 33).

563 See Appendix 2.1. Company G would not appoint its auditor to work on advisory assignments in operating platform, strategy or IT. Any work for the incumbent that was over £100,000 in value would need to be approved by the AC (paragraphs 47 & 48).

564 See Appendix 2.1. At Company H the FD was very strict about giving the auditor non-audit work in general. For work such as tax advisory, due diligence and other general advisory services the FD preferred to give the work to other firms. There was always a benefit of other firms having an understanding of the business. If the company wanted to change auditor it was beneficial to have people who had that understanding and had established creditability with the company's employees. The company used Mid Tier firms for non-audit work. See paragraphs 45, 47, 48 & 86.

565 See Appendix 2.1. Company I's policy was not to use the auditor for NAS. See paragraph 34.

received by the Big 4 firms. BDO and GT had relationships, in a given year, with around one-third as many companies as each of the Big 4 firms.

Regulatory reports

9.133 We set out our understanding of the AQR team reporting on audit quality in Appendix 3.1, paragraphs 171 to 182. The AQR team produces various different reports, both private and public.

9.134 Private reports on issues arising from the review of specific engagements are sent to the audit firms and the professional accounting bodies. Audit firms are expected to provide copies of these reports to the directors of the audit clients concerned. These reports can therefore be seen by the ACs, whose members may hold positions with other FTSE 350 companies (ie the effect of the information may be felt more widely than just at that one company). The AQR team publishes individual reports on the inspections of major firms (the Big 4 firms plus six others) on the FRC's website. The frequency of AQR team reviews of individual company audit engagements varies across the FTSE 350. The AQR team told us that it based its selection of audits for inspection on a risk model which used market capitalization as a surrogate measure for impact. This resulted in the larger and more risky audits being selected for review more frequently than smaller and less risky audits. Over the five years to 31 March 2013 it said that some 143 FTSE 100 audits had been reviewed which implied that on average a FTSE 100 audit was inspected between every six and seven years. In the same five-year period 112 FTSE 250 audits would have been inspected and this implied that a FTSE 250 audit was inspected on average every 11 years.

9.135 Our case studies showed that the use of AQR team reports on individual audits varied among companies, with some but not all making changes to the audit approach as a result.[566] In general, it appeared to us that such reports were considered carefully by ACCs.

9.136 In our follow-up survey of FTSE 350 ACCs, 64 per cent indicated that the company's external auditor had been the subject of an AQR team report (this could refer either to AQR team reports on firms as a whole, or to AQR team company-specific reports). Of those, 98 per cent saw a copy of the report. In many cases the report indicated there were no concerns or only minor issues raised, and no changes were made as a result of the report.[567]

9.137 Our case studies provided some views on the usefulness of the AQR team reports. With regard to the firm-wide reports which are available publicly, Company G's ACC said he used the AQR team reports as a measure of the quality of the audit firm.[568] The Company H ACC said that the AQR team review regarding the incumbent auditor was more helpful than Financial Reporting Review Panel letters (which were usually to do with accounting treatment or disclosure).[569] The Company J ACC noted that the FRC had sent him the AQR team report into the current auditor. He had been a little disappointed with the results as two out of ten audits reviewed had been flagged as requiring significant improvement. He had raised this with the AEP. These issues did not relate to audits in the relevant sector for Company J but were still of concern. The incumbent auditor had undertaken to improve.[570]

[566] See, for example, Appendix 2.1, Company A, paragraphs 77 & 78; Company I, paragraphs 32 & 33.
[567] See Appendix 2.3, paragraphs 38–40.
[568] Appendix 2.1, Company G, paragraph 76(b).
[569] Appendix 2.1, Company H, paragraph 83.
[570] Appendix 2.1, Company J, paragraph 54.

9.138 The audit firms generally regard the AQR team reviews as providing a public measure of audit quality. BDO and GT said that these reviews indicated that the quality of their audits were comparable with the quality of Big 4 audits.[571,572] Deloitte said: 'A reader of the [AQR team] reports can assess the quality of a firm's audit work in both absolute terms and can compare those results with other firms. The public nature of the reporting acts as a real incentive for audit firms to maintain and improve audit quality.'[573]

Firms' marketing efforts

9.139 Detail on the information that firms provided to us about their competitive strategies is contained in Appendix 7.8. Part of these strategies is to inform potential clients of a firm's capabilities, to increase its chances of being invited to participate in any tender process, and its chances of success in any such tender process.

9.140 The most obvious strategy is for a firm to offer to audit a company in place of an incumbent firm. According to our survey, 71 per cent of FTSE 350 FD/CFOs and 46 per cent of FTSE 350 ACCs had been approached by an audit firm offering to audit their company in the past five years.[574] The majority of these approaches were by the Big 4 firms, though some had been made by BDO and GT, as well as smaller Mid Tier firms.[575] In total, 64 per cent of FTSE 350 companies had been approached in some way.

9.141 However, none of the firms stated that they made unsolicited bids to potential new clients on a frequent basis.[576] Some of the Big 4 firms indicated that they had used them on occasion but had not been successful in winning audit engagements in their own right.[577] However, these may inform companies of what other firms could provide and at what approximate price.

9.142 PwC told us that some prospective clients (as was the case with [✂]) sought indicative proposals before deciding whether or not to proceed to a full tender.[578]

9.143 All the firms told us they sought to win work from new clients, or sought appointments as auditors for clients for which they already provided NAS, and the firms consistently referred to the importance of building relationships with clients before a tender situation occurred. These relationships may be built through introductions and periodic meetings between a partner and senior management at a potential client, or it may involve undertaking a number of non-audit engagements. The benefits of this approach are twofold: the first is making the firm, and potentially an audit team, known to the target company and the second is that the firm is able to develop its own knowledge of the client's operations and business risks and use this in a subsequent tender.

9.144 The most common strategies that we identified firms used to develop a potential client's awareness of a firm and an appreciation for its service offering were:

(a) provision of NAS to develop relationships with key individuals;

[571] BDO response to the issues statement, paragraph 1.6.3.
[572] GT response to the issues statement, paragraph 1.5.
[573] Deloitte response to the issues statement, paragraph 2.6.
[574] Appendix 2.2, paragraphs 76–78.
[575] Appendix 2.2, paragraphs 76–78.
[576] Appendix 7.8, paragraphs 54, 98, 124, 168, 205 & 240.
[577] Appendix 7.8, paragraphs 54 & 168.
[578] PwC response to working paper 'Nature and strength of competition', p11, fn 52.

(b) regular face-to-face contact with key potential client staff, regardless of whether any services are provided; and

(c) developing a strong reputation for quality and experience in the sector through work with companies in the same market as the target client, as well as demonstrating its ability to deliver large, high-quality, audits more generally.

9.145 According to the firms, the need for a prospective auditor to demonstrate sector credentials requires initial entry to a sector either through previous audit or non-audit work. For firms without this audit experience, non-audit work can therefore be used as a way of developing a professional relationship with a company and increasing the likelihood of being invited to tender for audit should the opportunity arise. Such engagements develop personal relationships and the firm's understanding of a company's business, which could then be employed in preparing a formal audit tender at a later date. Further, when undertaking this work for other companies, the firm develops a more holistic appreciation of a sector which may give rise to the opportunity to provide value added insights to a prospective client.[579] Several firms referred to arranging or attempting to arrange meetings with staff at prospective clients to offer information.[580] Our first survey shows that ACCs and FDs are in regular contact formally and informally with rival audit firms and are often approached by rival audit firms.[581] When approaching clients of rival firms, firms may explain their proposed audit approach and fees.[582] However, Mazars noted that it had struggled to gain access to key decision-makers and influencers of companies where it did not have an existing connection.[583]

9.146 In circumstances where approaches are not answered, an enhanced programme of sponsorship or thought leadership publications might be used to improve the receptiveness of target company staff to approaches from the firms (and this was the case for both Big 4 and some Mid Tier firms).

9.147 BDO, Deloitte, EY, KPMG and PwC referred to assembling shadow teams and making their presence and potential to service a prospective client known.[584] Such teams are not full audit teams, but rather designated individuals within the firm given the task of building and developing relationships with a specific company, drawing on available firm resources. They exist outside any announced tender process, and allow the firm to advertise to a target company a team of named individuals with specific experience and skills. Accordingly, they are a way for a firm to demonstrate to a company its capability, and may be a way of destabilizing the current incumbent. It is also a strategic competitive tool, developing knowledge and understanding of a company before any tender opportunity arises. Only BDO of the Mid Tier firms referred to the use of standing shadow teams.[585]

9.148 We found that the Big 4 firms usually knew about tender processes before they were officially launched. It appears that the Big 4 firms monitored potential 'trigger points' in a company. These events might be the breakdown in the relationship between management and the company's auditor, or any change in key staff, including particularly where a new FD or ACC is either an alumnus or has had a previous

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579 Appendix 9.3, paragraph 31.
580 See, for example, Appendix 7.8, paragraphs 14, 47, 55, 98, 123, 165,168, 206, 221 & 238.
581 Appendix 2.2, paragraphs 76–78.
582 Deloitte response to working paper 'Nature and strength of competition', paragraph, 5.13; PwC response to working paper 'Nature and strength of competition', section 2, paragraph 36 e).
583 Appendix 2.2.
584 See, for example, Appendix 7.8, paragraphs 14, 49, 55, 170 & 238.
585 See the respective firm-specific section of Appendix 7.8.

commercial relationship with the firm. Capturing this information depends on a close ongoing relationship with staff across a client company.[586]

9.149 We think that companies have incentives to respond to these firm initiatives, on the basis that the better informed they are about potential alternative suppliers, the stronger their bargaining position with respect to their current auditor.

Firms' submissions on companies' ability to appraise non-incumbent suppliers outside tender processes in response to our provisional findings

Deloitte

9.150 Deloitte said that our provisional finding that companies may encounter 'significant uncertainties' in appraising auditors outsider of a tender, in particular in relation to quality and fee of the audit offering was contrary to the evidence we obtained, which showed that companies actively compare their auditors to alternative providers in terms of fee and quality.[587] In particular: *(a)* the survey showed that two-thirds of companies carry out some form of benchmarking at least every five years and 90 per cent make informal comparisons; *(b)* in the follow-up survey most ACCs felt that could assess quality outside a tender one way or another; *(c)* ACCs make use of private and public AQR team reports; *(d)* FDs and ACCs draw on personal experience, firms' provision of NAS, regulatory reports and firms' marketing efforts; and *(e)* level of public disclosure on fees charged and regulator's review of quality is greater than for other professional services.

KPMG

9.151 KPMG said that: FTSE 350 companies regularly and actively make comparisons of the incumbent audit firms' offer with that of rival firms; our survey found that nearly all ACCs that it surveyed sat on or chaired another AC. This provides them with the ability to directly compare the work of different audit firms. Companies are also able to use experience of other audit firms gained through their provision of NAS to gauge their quality. External regulatory reports provide further information on audit firms' quality, which are considered carefully by ACCs. Audit firms engage in extensive marketing efforts which provide companies with further information on their offers, and companies are incentivized to respond to these audit firm initiatives. It said it also provided us with extensive examples of companies undertaking comparisons. KPMG said these examples demonstrated unequivocally that companies can and regularly do engage in wide-ranging comparisons that enable them to compare overall performance effectively across all dimensions of competition outside tenders.[588]

9.152 With regard to fees, KPMG said that companies had a breadth of options to assess value for money, and noted that the FRC's Guidance on ACs recommends that companies set out or cross refer to fees paid to the auditor for audit services. It said that companies may ask detailed questions of their auditor, compare fees with those charged to other companies of which they are board members. Companies are also approached by other audit firms or can seek quotes from them if they feel this would provide further information to judge their incumbent's fees. This had occurred at [✂].

[586] See the respective firm-specific section of Appendix 7.8.
[587] Deloitte response to provisional findings, paragraph 3.6.
[588] KPMG response to provisional findings, paragraph 3.5.2.1.

Our survey had shown that 88 per cent of companies had been approached by a rival firm in the last five years.[589]

9.153 With regard to our view that audit is an experience good (and so difficult to appraise in advance), KPMG said that many goods and services are experience goods and it was unclear why we had given such weight to this intrinsic feature of the audit product.[590] It said that there exists a broad range of effective ways to gauge audit quality in advance.[591] It said that we were inconsistent in finding that companies could accurately judge the quality of rival auditors during tenders, but that they could not outside tenders.[592]

PwC

9.154 PwC said that it was wrong to suggest that large companies were unable to assess the likely quality of the potential audit firms prospectively. In fact, given the relatively limited number of audit providers to large companies (compared, for example, to legal service advisers or management consultants); the information and data available from regulators and the firms themselves; and the business experience of ACCs and FDs (as well as others at the company), it was easier to make this assessment in respect of audit firms than for many other professional services.[593]

9.155 It said that outside tenders companies have the power to obtain the information required for effective benchmarking exercises if they so desire as no rational audit firm would refuse to provide this information if requested, given the incentives to develop relationships with target audit clients.[594]

Discussion and our view on companies' ability to appraise alternative suppliers outside tender processes

9.156 In the context of an assessment of bargaining power, the credibility of the threat to the incumbent that a client might switch to an alternative auditor depends in part on the accuracy of the information available to that client, both regarding its incumbent auditor, and its alternative auditor(s).

9.157 We found that in tender processes companies typically requested information on the following:

(a) the proposed fee and sometimes further details such as fee rates by grade and a breakdown of hours by grade (see paragraph 9.277);

(b) the qualifications and experience of the audit team that would work on the company's audit and the partner who would conduct the audit (see paragraph 9.282);

(c) the tender process was said to provide the company with the opportunity to test the audit teams' capabilities and likely working relationships;

(d) the relevant audit experience of the firm including sector experience (see paragraph 9.282);

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589 ibid, paragraph 3.5.3.2.
590 ibid, paragraph 3.5.3.4.
591 ibid, paragraph 3.5.3.5.
592 ibid, paragraph 3.5.3.6.
593 PwC response to provisional findings, Annex 2, paragraph 5.
594 ibid, Annex 2, paragraph 4.

(e) the firms' approach to quality assurance and risk assessment (see paragraph 9.282); and

(f) where relevant, details of the international network (see paragraph 9.282).

9.158 These findings are consistent with the factors FDs and ACCs said were most important in the selection of an auditor in response to the survey[595] and case studies.[596]

9.159 We found that the majority of FTSE 350 companies regularly and actively make comparison of the incumbent auditor's offer with that of rival firms. In this respect we agree with many of the firms' submissions. These comparisons can take the form of structured benchmarking exercises in which companies typically attempt to compare the fees they pay with published fees for comparable companies, and the experience of the incumbent auditor with that of rival firms. Such comparisons may also be informed by other less structured activity including discussions with peers and/or rival audit firms which might be more wide ranging in scope than fee and experience.

9.160 We have identified and assessed the quality and type of the information available to companies without them incurring the expense of a tender. Benchmarking exercises conducted by companies are an exercise to obtain and analyse the available information. This information derives from the personal experience of FDs and ACCs, firms' provision of NAS, regulatory reports and firms' marketing efforts. The quality of the information these provide individually and cumulatively will vary between companies as discussed below in paragraphs 9.161 to 9.164.

9.161 With regard to information on fees, the fee paid for each FTSE 350 audit must be published. We note that in practice, it is generally difficult for FTSE 350 companies to compare the audit fees they pay with those paid by others since each FTSE 350 audit is tailored reflecting a range of factors. The published audit fee may also include fees for audit-related services,[597] which need not be published.[598]

9.162 Therefore with regard to fee, we think that benchmarking does provide some information with regard to how fees paid by one company compare with its peers, but given the tailored nature of each audit and that other services might be contained in the published audit fee, the comparison is generally imprecise. Given the structure of the FTSE 350, any insights will be largely restricted to information on fees charged by Big 4 firms (since they conduct almost all FTSE 350 audits). Firms need significant amounts of information to bid accurately, and that information is typically provided only within the context of a tender.

9.163 With regard to other aspects of an audit, we note that FDs and ACCs may have personal experience of non-incumbent firms, and may have access to regulatory reports of other firms. Firms also engage in efforts to alert potential customers of their abilities. However, it appears to us that the quality of the team undertaking an audit is key (see paragraph 9.157), and their identity and the quality of the service that they would deliver cannot be known in advance. Information based on personal experience of firms' performance in the delivery of NAS will be indirect evidence on the offer that might be expected in the provision of audit services. Our survey showed that for FDs and ACCs the most important factor in the selection of auditors is the experience and knowledge of the AEP and this was followed by good working relationships with the

[595] See Appendix 2.2, Table 13 & paragraphs 36–39.
[596] See Appendix 14.1, paragraphs 37–47.
[597] Appendix 6.1, paragraphs 15–17.
[598] Firms said that the proportion of the total fee accounted for by audit-related services (as opposed to the audit itself) varied significantly by client and estimated a range based on hours and/or fees of between 0 and 30 per cent.

audit team and the experience and knowledge of the audit team.[599] We do not consider that this type of information is readily available outside of a tender.

9.164 We also consider that the AQR firm-wide reports are not designed to be used on a comparative basis and so whilst they may provide ACs with some information as to the general quality levels and areas for improvement within a firm they do not provide a basis for comparison with other firms. For the company specific AQR reports whilst these may help an ACC to understand the technical quality of the company's audit these reports do not 're-audit' or 're-assess' judgements taken rather they review the adequacy of the process and the documentation of work undertaken.

9.165 This illustrates the general point that audit is an experience good: it is only possible to determine its quality with precision in retrospect. While the company will be familiar with the quality and performance of its current auditor, there will be significant uncertainties in assessing these factors in advance with regard to potential auditors.

9.166 In this context we note that tenders are highly structured processes. They make provision for rivals to have access to confidential information on the company and for the company to test directly the capabilities of the firm and its prospective audit team. We think this shows the extent and quality of information required to make accurate comparisons of rival firms (see paragraphs 9.309 and 9.310).

9.167 While firms make efforts to target some companies (and may assemble 'shadow teams'), we found that firms' efforts generally were hampered by the lack of access to the detailed information that they would need to provide an accurate assessment of the audit requirements of any given company. Equally, without a tender process, firms could not demonstrate the personal capabilities that appear important to FDs and ACCs when they choose audit firms (see paragraph 9.157).

9.168 Accordingly, our view is that companies may encounter significant uncertainties in appraising potential auditors outside a tender process, in particular in relation to the quality of the team and fee of the potential audit offering. This incomplete picture is unlikely to provide companies with sufficient information to be able to assess accurately whether they may obtain a better service from an alternative audit firm.

Search and switching costs

9.169 In this Section 9, we have so far assessed companies' possible alternative suppliers and their ability to compare their incumbent auditor against those alternative suppliers, and therefore the ability of a company to identify the extent to which there are benefits from switching.

9.170 In this subsection, we consider search and switching costs, which are relevant to companies' willingness to switch and so of their bargaining power, since such costs must be set against any benefit that a company might expect from switching. If such costs were sufficiently high, a company might be constrained to continue to reappoint its incumbent, even if it thought that an alternative firm could provide a better offering. Accordingly, the higher the search and switching costs, the greater the expected benefits from any switch must be in order to prompt a company to switch audit firm. We draw on evidence in relation to both expectations on the costs of switching and experience on the costs of switching. We note that there may be a difference between actual and expected switching costs, and that it is the expected costs of switching

[599] See Appendix 2.2, paragraph 36.

that companies will take into account when thinking about holding a tender of whether to switch auditor.

9.171 Any cost to a company of identifying and assessing rival offers is a search cost. In this case the search costs include the costs to the company of conducting a tender. Evidence on the cost of tendering for companies is considered in paragraphs 9.301 to 9.306. Any loss to a company arising from a switch may be seen as a switching cost.

9.172 We considered evidence on:

(a) the existence and prevalence of switching costs for FTSE 350 companies (paragraphs 9.173to 9.183);

(b) the nature and scale of these costs (paragraphs 9.184 to 9.201); and

(c) firms' investments to mitigate switching costs (paragraph 9.202).

We then:

(d) summarize firms' relevant submissions responsive to our provisional findings (paragraphs 9.203 to 9.209); and

(e) set out our view of search and switching costs (paragraphs 9.210 to 9.218).

Existence and prevalence of switching costs

9.173 The available evidence comprised: *(a)* survey results, *(b)* evidence from case studies, and *(c)* evidence provided by audit firms.

Survey evidence

9.174 In our first survey we asked respondents at companies that had not put their audit engagement out to tender in the last five years, why this was the case. Over 60 per cent of FTSE 350 companies responded that this was because they had been satisfied with the performance of their current auditor. However, some of these 'positive' responses to the survey question indicated that even satisfied companies were concerned about switching costs, in terms of management time and the risk of switching auditor.[600] Accordingly, we think that even if their primary reason for not switching was their satisfaction with the incumbent auditor, these companies expected that there to be costs in switching auditor.

9.175 In particular, we consider that the verbatim responses to this question ('why haven't you switched in the past 5 years?') provide strong evidence that: there are expected costs for companies associated with tender processes and switching their audit engagement; that these costs are greater for some companies than others; and that companies in deciding whether to reappoint their current auditor or go to tender are making an assessment of the balance between the potential gains and costs of these options.[601]

9.176 We asked the surveyed companies that had switched in the last five years what their experience had been. The responses (reported in full in Appendix 2.2, Annex 3)

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[600] See Appendix 2.2, Annex 2, Table 2.
[601] Appendix 2.2, paragraphs 56–62 & Annex 2.

suggest a mix of experiences in terms of costs incurred through switching auditor. The responses of some suggest that there was no significant cost while for others the experience of tender processes and switching was disruptive and costly in terms of the opportunity cost of management time. Where this had been the case, the cost was greatest (and often only) in the first year after a switch.[602]

Case studies

9.177 We conducted the 14 further case studies G (for a second time) and K to W, and interviewed Mr Nick Land (ACC for Vodafone) to improve our understanding of the perception of the costs and benefits to companies of tendering and switching and their experiences of doing so.[603] Many respondents said that there were costs to a company associated with switching auditor (see Company M,[604] N,[605] O,[606] P,[607] Q,[608] R,[609] S,[610] T,[611] U,[612] V,[613] and W[614]) although some said that the costs incurred by the company had not been substantial. The CFO for Company K said that the transition process had been less intensive than he had expected. Mr Nick Land said that from his previous experience as an AEP, companies found that switching auditor was less disruptive than expected and that the transition to a new audit firm could be relatively painless.

9.178 Several respondents said that the costs and risks of switching could be reduced by careful transitions planning.[615] Respondents also said that costs of switching would be short-lived. They said that costs were greatest in the first year of the engagement and generally expected the auditor to be up-to-speed by year two or three.[616]

Firm submissions

9.179 Both the Big 4 and Mid Tier firms warned against the risk of overstating switching costs. Before publication of the provisional findings, only PwC stressed the importance of not underestimating the cost involved for large companies.[617] In particular, PwC said that switching costs could be potentially significant for large companies and that the larger (often more international) and more complex the company, the greater the switching costs were likely to be.

9.180 In response to our Remedies Notice, Deloitte, EY and KPMG appeared to acknowledge that switching auditor may involve substantial costs for companies. Deloitte referred to the statements in the provisional findings on the cost to companies, mainly the opportunity cost of management time of conducting a tender and educating a new audit firm.[618]

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[602] Appendix 2.2, paragraphs 70 & 71.
[603] During the course of these case studies, the CC spoke to 25 CFOs (or equivalent) and ACCs, selected on the basis of their association with 15 FTSE 350 companies.
[604] Company M, paragraph 4.
[605] Company N, paragraph 32.
[606] Company O, paragraph 6.
[607] Company P, paragraphs 12 & 25.
[608] Company Q, paragraphs 6 & 9.
[609] Company R, paragraphs 14 & 31.
[610] Company S, paragraph 33.
[611] Company T, paragraph 31.
[612] Company P, paragraphs 8, 9, 21 & 22.
[613] Company V, paragraph 10.
[614] Company W, paragraphs 9 & 10.
[615] See responses for companies K, N, V & Mr Nick Land.
[616] See responses for companies M, P, Q, R, S, T, U & V.
[617] PwC response to working paper 'Switching costs', paragraph 9.
[618] Deloitte response to Remedies Notice, paragraphs 3.11–3.16.

9.181 EY said that due to the learning curve that audit firms faced with any new audit client, audits could be less efficient at the beginning of an engagement and present a higher level of audit risk. EY said that companies would face repeated distraction and disruption due to the need to educate the new audit firm about their business and operations. EY also said that there would be a significant extra time commitment from senior personnel at the audited company to help explain to the incoming auditor the company's business, internal control environments, processes and corporate structures.[619]

9.182 KPMG estimated the opportunity cost to a FTSE 350 company of the additional support that the incoming auditor would need to be in the range of £157,000 to £558,000 (with an average of £357,500) but that this was likely to be a substantial underestimate for the largest companies.[620] KPMG also said that whilst audit firms and companies may increase the hours devoted to the audit in the initial period of a new engagement in an attempt to minimize the increased risk of audit failure in the early period of a new engagement, it will not be possible to fully eradicate this risk.[621]

9.183 Mid Tier firms said that our first survey evidence highlighted that those FTSE 350 companies that had switched auditors had not found the process particularly burdensome or the costs particularly high. BDO highlighted the contrast in views of those who had switched compared with those who had not and considered the perception that costs were high to be unjustified.[622] KPMG considered that there was no perception gap (and no evidence to suggest that there was a perception gap) between actual and perceived costs.[623] PwC also considered that there was no perception gap and in particular considered that undue weight should not be given to the experience of companies that had switched given that those companies were largely dissatisfied customers (who, according to the first survey results, had switched mainly due to price, previous poor auditor performance, etc).[624] PwC considered that the FDs and ACCs who selected the audit firm could accurately assess the costs involved in switching.[625]

The nature and scale of switching costs

9.184 The survey and case studies provide evidence on the nature and scale of switching costs. We identified two main categories of switching costs: *(a)* the loss of the benefits of continuity in the client-auditor relationship; and *(b)* the opportunity cost of management time involved in the selection and education of a new auditor, and reorganizing the provision of NAS where necessary to comply with independence requirements. We summarize our evidence and appraise each below.

Loss of benefits of continuity

9.185 We received evidence that companies valued long-lasting relationships, particularly as incumbent firms acquired significant company-specific expertise over time, and established relationships with companies. If a company switches auditor it loses the benefits of this relationship, in particular the expertise acquired by its incumbent auditor the consequences of which might be reduced efficiency in the conduct of audit; increased risk in relation to the technical quality of the audit particularly in early

[619] EY response to Remedies Notice, paragraph 3.4.
[620] KPMG response to Remedies Notice, paragraph 4.2.2.4.
[621] ibid, paragraphs 4.2.5.1 & 4.2.5.4.
[622] BDO response to working paper, 'Evidence on switching costs', paragraph 1.2.1.
[623] KPMG response to working paper 'Evidence on switching costs', paragraphs 1.2 & 1.3.
[624] PwC response to working paper 'Evidence on switching costs', paragraph 13.
[625] ibid, paragraph 4.

years of the engagement; and a loss of the commercial insight provided by the incumbent firm.

- *Survey evidence*

9.186 Our survey provided evidence of the presence of these continuity benefits. Responses to this question are provided in full in Appendix 2.2.[626] As noted above, survey respondents also said that audit firms and companies will anticipate the risks associated with the loss of continuity and make considerable effort to mitigate these risks. These risks may therefore be reflected in additional resources allocated by the firms and companies to the audit in the first years of the engagement.[627]

- *Case studies*

9.187 Our case studies supported the presence of continuity benefits and the costs to a company associated with the loss of continuity in the early years of an engagement.[628,629,630,631,632] The first year of a new audit was said to always be the most difficult and carried risks that the auditors could miss an important issue.[633]

- *Firm submissions*

9.188 Generally the Big 4 firms agreed that there are continuity benefits, but did not accept that the loss of such benefits should be considered to be a cost of switching.

9.189 Deloitte said that a long-term relationship with an audit client allowed it to provide more insights of value to the client.[634]

9.190 KPMG said that a key part of audit quality and client demand was for it to have a detailed understanding of the audit client's business, and this entailed learning about the client's business and its complexities; developing relationships with the key personnel at the client, at all levels of seniority; and providing specific staff members with expertise for that client's needs.[635] KPMG said that in order to obtain client-specific knowledge, audit firms needed to learn from the client's management about its commercial arrangements, its reporting practices and requirements, its structure, its transactions-processing arrangements and so on. This required significant management time and effort on the part of the company to ensure that the audit firm

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[626] Appendix 2.2, Annex 2, Table 2.
[627] The GFD for Company P said that both the company and the new audit firm were very conscious of the potential risks involved in switching auditor and as a result the new auditor spent significantly more time on the interim audit review conducted at the half year, in order to reduce the risk of problems at the year end. Company P, paragraph 12.
[628] Appendix 2.1. The company A ACC rated the auditor (a Big 4 firm) at six out of ten and felt that, for a first-year audit, it had done pretty well and he would have been surprised if it had done better: 'having done a number of first-year audits as an auditor, they are scary because you do not know everything, and you just do not know who has got what angle within the management of the company until you get to know them and work with them' (paragraph 61).
[629] Appendix 2.1. At Company B, the AEP said that it was not completely unfair to categorize him as being at the top of his game when he did his fifth audit of the company, although he said that there were benefits to having a fresh look (paragraph 107).
[630] Appendix 2.1. At Company F, the ACC thought that there was a time for fresh eyes but five years was too short a period before switching, as the company lost the benefit of knowledge acquired by the auditors (paragraph 53).
[631] The ACC for Company L said that the biggest risks arise as a result of a new auditor's lack of familiarity with many aspects of the company, such as: a company's systems and controls; the regulatory requirements of different companies and jurisdictions, which varied widely; and the particular interplay of financial systems across multiple countries and companies. Company L, paragraph 27.
[632] The ACC for Company U said that companies valued having an auditor with a deep knowledge of the company concerned, that the knowledge that an incumbent auditor had acquired was inevitably lost when the auditor was switched, and the incoming firm needed to make a heavy investment to acquire a comparable level of knowledge. Company U, paragraph 21.
[633] See also Appendix 2.1, responses from Companies M, N, O, S and W.
[634] See Appendix 7.4, paragraph 49.
[635] KPMG response to the issues statement, paragraphs 210 & 211.

had the required degree of knowledge. In addition, time and effort was required in developing relationships with the audit firms, in particular for more complex organizational structures (for example, global groups with a large number of subsidiaries). These investments on the part of the company's management and ACs impacted on the quality of the audit service that the audit client received. Investing in developing the audit firm's knowledge of the company's business would ensure that the auditor was best placed to identify and address audit risks. In addition, it would minimize management time further down the line, by ensuring that the learning took place early on and the audit was delivered efficiently as soon as possible.[636]

9.191 PwC said that while there were switching costs, these were not the main reason that companies did not tender—rather there were enhanced quality benefits accruing from the knowledge and experience gained over time by the existing auditor, and companies could take advantage of these benefits while the threat of tender ensured competitive pressure was placed on the audit firm.[637] It said that a thorough knowledge of the business allowed the auditor to provide insight and advice on issues such as: the effectiveness of the company's operating and financial management systems; the design and implementation of its internal controls; and recommendations for improvement.

Opportunity cost of management time involved in the selection and education of a new auditor

9.192 We considered the opportunity cost of management time involved in the selection and education of a new auditor and whether this was at a premium at certain times.

- *Opportunity costs*

9.193 Management and staff time was a frequently cited cost: before, during and after a tender or switching process. The larger, more international and complex the company, the greater the costs. We note that companies can generally plan a tender process around their corporate reporting cycle, to mitigate costs of switching to some extent.[638]

9.194 These selection and education costs mainly comprise: the time commitment for management in running a tender process and the opportunity cost of this time; and if a company switches auditor, the time management has to give educating a new auditor.[639] These costs are illustrated by some of the responses to our survey contained in Appendix 2.2. See also paragraph 9.302 to 9.305.

9.195 Just as firms said that they make considerable effort to mitigate the inherent risks associated with switching, we consider that the additional time commitment for management in the earlier years of an audit engagement may reflect efforts made by the company to minimize the risks associated with switching that result from a loss of continuity (see paragraphs 9.185 to 9.191).

9.196 The case studies conducted since publication of the provisional findings provide further evidence on the point.[640] They also indicate that there may be a substantial

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[636] ibid, paragraphs 5.2.1 & 5.2.2. We use the terms 'company' where KPMG used the terms 'audit client', for consistency with these provisional findings.
[637] PwC response to the issues statement, paragraph 1.11(c).
[638] See Company T, paragraph 7, and Company V, paragraph 8.
[639] Appendix 2.2, paragraph 61.
[640] See Appendix 2.1, responses for Companies K, M, P & R.

opportunity cost associated with the time spent reorganizing the provision of NAS.[641] Such costs are like to be greatest in sectors subject to specific independence requirements such as banking.[642]

9.197 We obtained some evidence of external costs for companies going out to tender or switching their audits (since in some cases companies do instruct external consultancies to assist).[643]

- *Timing issues*

9.198 The survey results provide evidence that commercial or operational circumstances (such as recent merger activity, rapid growth, or recent investment programmes) may have the effect of raising the opportunity cost of management time.

9.199 Our case studies supported the view that at certain times, management time was at a premium. We have evidence of instances where, at a particular point in time, switching auditor was not feasible, particularly when management is preoccupied with other concerns (eg significant transactions; financial stresses; or any other reason where the company wishes to portray stability).[644]

9.200 PwC agreed that at certain times (for example, during restructuring, refinancing and acquisitions or disposals) switching auditors would not be practicable or might risk a company's reputation. At such times investors were likely to prefer that company management focused on immediate issues, and these were precisely the times when the incumbent firm's knowledge was valuable. Nevertheless, PwC said that the periods in which a company would not choose to tender were relatively short, meaning that auditors remained keenly aware of the threat of a tender even during these periods.[645]

9.201 Other firms expressed a similar view that timing issues were short-term and that incumbents would not take advantage of this as it was not in their long-term benefit. Deloitte said that it did not believe any audit firm would exploit short-term situations as this would result in a significant increase in the risk of losing the client.[646] KPMG said that timing issues were not a continuous barrier and so would not enable an incumbent to reduce the competitiveness of its offering, since if it did so companies would switch audit firm once the short-term constraint on tendering and switching were relaxed.[647]

Firms' investments to mitigate switching costs

9.202 Firms said that the challenges of a first-year audit were well-known, and incoming firms went to considerable efforts to mitigate these (in particular via transition plans and enhanced hours in the first years of an engagement).[648] Our data analysis[649] suggested that audit firms tend to do more work in the early years (and use more senior resource in the first year) than the previous auditors. Whilst this may mitigate

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[641] The ACC for Company Q (an energy company) said that a major challenge had been the reorganization of the provision of NAS. In all, about two-thirds of NAS had to be re-tendered. Company Q, paragraph 7.
[642] For example, staff may have to change bank accounts.
[643] www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/summary_of_conference_call_25_january_2012.pdf, paragraph 18.
[644] Appendix 2.1, paragraphs 57–65.
[645] PwC response to working paper 'Evidence on switching costs', paragraph 11.
[646] Deloitte response to working paper 'Switching costs', paragraph 3.2.
[647] KPMG response to working paper 'Switching costs', paragraphs 3.3.2–3.3.4.
[648] Appendix 7.4, paragraphs 75–90.
[649] See Appendix 7.4, paragraphs 89 & 90.

the inherent risk of an audit error (as discussed above, see paragraph 9.187), we recognize (as stressed by PwC[650]) that this does not mean that there is no cost to the company in ensuring the new auditor provides an effective audit in the early years (for example, in terms of opportunity cost of management time).

Submissions responding to our provisional findings on switching costs

Deloitte

9.203 Deloitte said that the evidence that we had gathered and set out was inconsistent with our provisional view that there were significant barriers to and costs associated with switching. In particular it said that companies are fully able to compare offers of alternative auditors to their incumbent and there was no concrete evidence of an information-based barrier to switching. While it agreed that the costs of switching will vary by company there was no evidence that costs were high in general. Virtually all market participants agreed that barriers to switching were low. Deloitte said this was absolutely consistent with the evidence of the case studies and our survey which showed that the overwhelming reason why companies had not tendered was not related to switching costs.[651]

KPMG

9.204 KPMG agreed that companies had incentives not to switch away from their incumbent audit providers, but said that while trust is important, as in any business relationship, this was not the key feature of an audit relationship. Rather the key incentives for companies not to switch related to the efficiency that is gained as the audit progresses. At the start of any new engagement, audit firms need to make substantial investments in learning about the company's business, and management needs to make investments to allow them to do that effectively. These investments continue throughout the life of the engagement (though are not as substantial as in the first years).[652] Switching audit firm therefore necessitates duplication of these investments, which is costly for both audit firms and management. It leads to reduced efficiency and also increases the likelihood of errors.[653]

9.205 KPMG also said that we suggested that anticipation by investors of an increased risk of audit failure in the early years of an appointment could lead to adverse market reaction, but this was not supported by our evidence on investors' views.[654]

9.206 KPMG said that incentives not to switch held only so long as companies were also receiving good quality and value for money, and these incentives did not imply that companies achieved less than competitive outcomes. It was precisely because of these relationship-specific investments that, as in many other competitive markets, interactions between market participants were characterized by longer relationships.[655]

9.207 KPMG said that we should not overstate the opportunity costs to a company associated with switching. It said we had overstated any reduction in bargaining power that companies may have during particular commercial or operational circumstances.[656]

[650] PwC response to working paper 'Switching costs', paragraph 10.
[651] Deloitte response to provisional findings, paragraphs 3.7.
[652] KPMG response to provisional findings, paragraphs 3.6.2.1 & 3.6.2.2.
[653] ibid, paragraph 3.6.2.3.
[654] ibid, paragraph 3.6.2.4.
[655] ibid, paragraph 3.6.2.5.
[656] ibid, paragraphs 3.6.3.1 & 3.6.3.2.

PwC

9.208 PwC broadly agreed that company management face significant opportunity costs in the management time involved in the selection and education of a new auditor. However, it said the evidence available to us showed that this would not prevent companies from tendering if they were dissatisfied with the service they were receiving.[657] That there may be certain occasions when management time is at a premium did not mean that such periods last indefinitely. Therefore firms were unlikely to exploit any short-term inability of a company to tender and it said that we had not provided any evidence demonstrating that this has occurred.[658] It said that to the extent that we believed that there may be certain times when companies may be disadvantaged in their dealings with auditors, mandating that tenders must take place at specified times was ill-advised.[659]

Professor Doctor Annette Köhler

9.209 Prof Dr Köhler believed that the barriers to switching suppliers of audit services we identified held for any market for large service providers and were not restricted to the audit market, since they were caused by transaction costs prior to the choice of a transaction partner (both on the demand and supply side) and the nature of the service (eg experience good). She said that given these market characteristics, *ceteris paribus* long audit tenure was an efficient market solution.[660]

Our view on search and switching costs

9.210 We found that the cost to a company of running a tender process is largely the opportunity cost of the management time involved, and that the larger, more complex and more international the company the more expensive its tender process will be.

9.211 We consider that given the costs of tender processes, a FTSE 350 company that is satisfied with the performance of its auditor may be reluctant to initiate a tender process just to test the market. We consider the evidence on the frequency of tender processes over the last ten years may be explained by the presence of such costs: in the last ten years there had been around 85 to 103 tender processes for FTSE 350 audits (or around eight to ten each year) that had not be driven by external events (see paragraph 7.23).

9.212 We consider that the evidence is that there are costs to companies associated with switching auditor, although these are greater for some than others. The costs will be greatest in first year on an engagement and typically would not extend beyond year two. We find they comprise *(a)* loss of relationship; *(b)* costs that a company must incur in educating its new auditor; and *(c)* the inherent uncertainty in the performance of a new auditor, which we consider in turn.

Loss of relationship

9.213 Given the nature of the relationship between auditor and company, by which each invests in and places trust in the other, we think that companies do not lightly walk away from such a relationship (see paragraphs 5.45 to 5.49): the loss of an existing

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[657] PwC response to provisional findings, Annex 2, paragraph 9.
[658] ibid, Annex 2, paragraph 10.
[659] ibid, Annex 2, paragraph 11.
[660] www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/030513_prof_dr_annette_g_kohler.pdf, p1.

relationship is a cost that is considered in companies' deliberations. We think this relationship operates at both corporate and personnel/personal level: if company staff trust and work well with the audit team supplied by the firm, we find that there is a reluctance to disturb those relationships unless necessary.

The costs that a company must incur in educating its new auditor

9.214 Firms and companies alike said that there was a two- to three-year education process as the company invested in educating its auditor and the auditor likewise had to invest significant resources in becoming expert in the specific company. The evidence suggests that companies and firms would expect a new auditor to be largely up-to-speed by year three of the audit engagement.

9.215 This cost means that companies may expect that switching auditor is an onerous process that may in the short term produce a less good audit (at least in terms of service provision efficiency), as the new auditor acquires information that the former one held.

9.216 The scale of these switching costs varies between companies. In particular, we find that the larger and more complex the company is, it is likely that the greater the company investment to educate the auditor will be in the event that the company switches auditor.[661] Once the company has made the investment, it can look to the audit firm to keep itself informed (and educate new audit team members) on a rolling basis, so that its own costs remain low relative to the cost of educating a new auditor. However, we would expect the company to offset this cost against the benefits of switching, if it has decided to switch.

The performance of a new auditor is inherently uncertain

9.217 Since audit is an experience good (paragraph 5.57), a company cannot tell in advance how the new auditor will be to work with, its service levels, and whether it will form disruptive views regarding the company's judgements and financial treatments. Audit as an assurance business is an area in which we think that companies are disinclined to take risks.

9.218 As is to be expected, companies will be minded to go to tender and possibly switch in response to dissatisfaction with the current auditor's offer only if they expect that the benefits to be had from doing so in terms of quality and/or fee will outweigh the costs of searching and possibly switching auditor. We consider next factors relevant to the companies' assessment of such potential gains and costs.

Balancing the costs and gains from tender processes and switching

9.219 In deciding whether to launch a tender process, companies must balance the expected costs and benefits. In this subsection we: *(a)* review the evidence regarding how companies do this and their relevant considerations; *(b)* summarize relevant firm submissions; and *(c)* discuss and set out our view.

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[661] We note the views of the ACC in Appendix 2.1, Company G, who said that for a bank in particular, switching auditor would be a huge exercise and had a huge risk associated with it.

How companies balance the costs and benefits of switching and their relevant considerations

9.220 We set out evidence regarding: *(a)* companies' considerations in going out to tender; *(b)* their triggers for a switch; *(c)* the significance of fees in consideration of switching; and *(d)* companies' perception of a lack of differentiation between firms.

Considerations in going out to tender

9.221 Our survey provided evidence that companies balance the costs and gains of tendering and switching in deciding whether to tender. The costs appeared to figure highly in their consideration. For example, a FTSE 350 company responded when asked why the company had not gone out to tender in the last five years: 'we also took into account the management time and effort involved in the tender process and whether we would get any benefit from the tender process'.[662] Another summarized the issues as follows:

> tendering and changing auditors … is an incredibly expensive and disruptive process. It's expensive in terms of time and the money it incurs and it's disruptive and takes probably two years for new audit team to get really up to speed and familiar with our business … If [the audit process] is working well and you're happy with it, and there's the right level of challenge, efficiency, advice, no significant issues, personalities fit, it's something you do not want to undertake lightly. [663]

Triggers for a switch

9.222 Our survey provided evidence on the circumstances likely to trigger a company to switch. We asked all respondents to consider events that would cause a company seriously to consider switching auditor. The results suggest that generally companies must have reason to be dissatisfied with their existing auditor to consider switching.

9.223 The potential trigger most frequently identified as 'very likely' or 'likely' to prompt a company seriously to consider switching were:

(a) the complacency of the audit firm (86 per cent of FTSE 350 FDs and 94 per cent of FTSE 350 ACCs);

(b) a problematic working relationship between auditor and management (61 per cent of FTSE 350 FDs and 69 per cent of FTSE 350 ACCs);

(c) a substantial increase in the audit fee (particularly among FDs) (71 per cent of FTSE 350 FDs and 55 per cent of FTSE 350 ACCs); and

(d) pressure from shareholders, bankers, lawyers or analysts (particularly among ACCs) (54 per cent of FTSE 350 FDs and 62 per cent of FTSE 350 ACCs).[664]

9.224 We asked whether there were any other triggers (not mentioned by the interviewer). Over 55 per cent of FDs and over 40 per cent of ACCs for the FTSE 350 companies said poor quality audit.[665]

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[662] Appendix 2.2, Annex 2, p41.
[663] Appendix 2.2, Annex 2, p51.
[664] Appendix 2.2, Table 20.

9.225 The evidence produced by our case studies accorded with these survey responses. The Company P ACC had been unhappy with aspects of one partner's style, the audit team's composition and interaction with the Company. These issues were largely resolved with the introduction of a new partner to the team, but when that partner left the audit firm after two years this served as the trigger to launch a tender.[666]

9.226 Company T's GFD said that the rationale for tendering the Company's audit engagement was based on a desire for its auditor to 'add value' to the business by providing useful commercial feedback. The GFD thought that the incumbent had become complacent with respect to the overall level of service provided. When the incumbent failed to respond to the Company's requests to improve the service provided, the GFD decided to test the market.[667]

9.227 Company U's ACC said that there had been several considerations: the incumbent auditors had been in place for a decade and a tender was seen as good corporate practice; the Company was not convinced that the AEP was giving sufficient time to the engagement; the Company was looking for a more challenging audit than was being provided; and the incumbent was not considered to be strong in the [✂] sector in the geographical areas in which the Company had set up new operations. The ACC aid that the decision to go out to tender was not taken lightly and without the concerns about quality the drive to go to tender would have been lower.[668]

Fees are a secondary consideration to quality

9.228 In Section 7 we assessed the effect on fees of switching. We found that switching auditor is on average associated with a transitory fee reduction (paragraph 7.70). The survey results on the reasons for not going out to tender provide evidence that quality was the principal concern and price is a secondary consideration. In particular, many of those who said that they were satisfied with the performance of their auditors focused on audit quality and independence.[669, 670]

9.229 The case studies also indicated that price was a secondary consideration. Company K said price was not the primary driver for going to tender because the cost of the Company's audit fee relative to its turnover was very small.[671] Company O said that a 'very soft' tender was driven by concerns that the audit fees were high, but having spoken to other audit firms the Company decided against proceeding to a full tender as the gain would not have been proportionate to the cost.[672] Company V's CFO had

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[665] Appendix 2.2, paragraph 75.
[666] Appendix 2.1, Company P, paragraph 16.
[667] Appendix 2.1, Company T, paragraph 4.
[668] Appendix 2.1, Company U, paragraphs 12 & 13.
[669] See response:

> Because, when we look at the criteria for appointment of auditor, we are satisfied that [✂] at least meet those criteria, and they're as strong as any of [✂] competitors. It comes back to the criteria and I think the main criteria are independence, quality of service, and that would be in terms of technical audit knowledge, technical accounting knowledge, industry knowledge and global reach, so knowledge of the environment in which we work. Then the last criteria is value for money and efficiency.

(FTSE 100 FD/CFO.) Appendix 2.2, Annex 2, p40.
[670] See response:

> Because quality is of paramount importance and ultimately we have to make a judgement of the cost of a tender and change-out, not just the cost of a tender itself. First there is the erosion of quality it will bring versus the potential benefit in price that can be achieved. Price is not the predominant consideration in the choice of our external auditors, it is quality. An audit service is typically an area where longer tenure brings advantages and we have other means to negotiate the costs of the audit service.

(FTSE 100, FD/CFO.). Appendix 2.2, Annex 2, p42.
[671] Appendix 2.1, Company K, paragraphs 19 & 20.
[672] Appendix 2.1, Company O, paragraph 2.

estimated that the company was paying 25 to 30 per cent more than it should and would benefit from a fresh approach.[673]

Perceived lack of differentiation between firms

9.230 We also consider that whether rival firms might be expected to offer a company a different (and so potentially higher quality) audit service to be relevant to a company's assessment of the potential gains of switching. In our survey we asked companies that had not put the audit out to tender in the last five years why they had not done so. Some respondents said that a perceived lack of choice or differentiation between auditors was a factor. For example:

(a) 'In our experience differences between firms are much less significant than differences between audit partners' (FTSE 250 FD/CFO).[674]

(b) 'There is actually little to choose between big firms' (FTSE 250 ACC).[675]

(c) 'I think over recent years there's been a trend in large companies not to see much differentiation among the Big 4 and what they offer' (FTSE 100 ACC).[676]

(d) 'No particular pressure to change and a limited choice of alternatives' (FD/CFO, FTSE 250).[677]

9.231 Deloitte, in a strategy document based on a summary of client interviews, said 'its clients typically do not see us as materially differentiated from our competitors'. It quoted the following remarks from clients:

(a) 'I do not see Deloitte as being distinctive, but neither are any of the other Big 4'.

(b) 'Personality and relationships are the biggest differentiator, and we don't think that any of the Big 4 have that solved'.

(c) 'The Big 4 are all very similar. When we deal with you, there is very much the feeling that we are getting the same old same old'.

(d) 'There is no distinction at all between the Big 4 ... the real difference between one firm and the next is the teams, not the brand'.

9.232 The case studies provide further evidence on this point (see paragraph 9.30).

Firms' submissions responding to our provisional findings

9.233 Deloitte said that our provisional findings correctly concluded that companies would be minded to go to tender only if they had reasonable expectation that the benefits to be had from doing so in terms of quality and/or fee would outweigh the costs of searching and switching. It said this was a rational economic trade-off that companies made and applied equally to the purchase of any professional service, not just statutory auditing.[678]

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673 Appendix 2.1, Company V, paragraph 1.
674 Appendix 2.2, Annex 2, p51.
675 Appendix 2.2, Annex 2, p53.
676 Appendix 2.2, Annex 2, p43.
677 Appendix 2.2, Annex 2, p51.
678 Deloitte response to provisional findings, paragraph 3.8.

9.234 KPMG said that the gains from switching audit firm depended crucially on the performance of the incumbent. If the incumbent audit firm's performance was high quality and good value, then naturally the gains from switching to an alternative audit firm will not outweigh the costs.[679] It provided examples where it said that we had failed to fully appreciate this point.[680] For instance it thought that incumbent firms responding to company discontent, and a survey finding that generally clients must have reason to be dissatisfied with their existing auditors to consider switching were evidence of a competitive market. It said that the survey results did not show that in the event of dissatisfaction with the incumbent firm companies would not switch provider. Further, we had consistently failed to take into account the efficiencies of long-term relationships.[681]

9.235 KPMG said that the evidence did not support our provisional view that fee increases were unlikely to trigger a tender unless they were significant.[682] There were examples of companies going to tender without firms requesting significant fee increase. It referred to evidence that when companies ask firms to reduce fees, fee reductions have been secured and said there could not be more direct and clear indication of a competitive market.[683]

Our view on balancing the costs and benefits of tender processes and switching

9.236 All the considerations set out in this Section 9 are relevant to a company's decisions on whether or not to initiate a tender process and to switch auditor. It must balance the costs and benefits, taking into account: the availability of potential alternative firms, the company's appraisal of its own firm, the information that a company has regarding those alternative firms' capabilities, and the company's expectation regarding how much it would cost to run a tender process and then (depending on the outcome of that tender) how much it would cost to switch to the best alternative firm. It is to be expected that generally dissatisfaction with the incumbent auditor will not trigger a tender process unless the company expects that the benefits will outweigh the costs.

9.237 We consider that the nature of the assessment that management makes of the balance between the costs and benefits of switching auditor is materially different depending on whether or not the company was content with the quality of the audit product or service provided by the incumbent auditor. In particular, if dissatisfied with the current quality of service, the company may be less concerned that changing auditor would lead to a less efficient audit process and would be more prepared to undertake a tender process with a view to switching.

9.238 We think that from the point of view of some companies there is little perceived differentiation between the Big 4 firms in terms of the audit product supplied. In particular companies perceive that the firms adopt similar methodologies and approaches in conducting audit. Rather the differentiation that there is tends to derive from the composition and expertise of the audit team that a particular firm can offer to a company (see paragraphs 9.230 to 9.232). This means that those companies would see little benefit in switching firm.

9.239 We found that there are costs to companies of putting an audit engagement out to tender and switching auditor and that for some companies these costs can be sub-

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679 KPMG response to provisional findings, paragraph 3.7.2.1.
680 ibid, paragraph 3.7.2.2.
681 ibid, paragraph 3.7.2.3
682 ibid, paragraph 3.7.3.1
683 ibid, paragraph 3.7.3.2.

stantial (see paragraphs 9.210 and 9.214). We also found that companies will not be able to assess accurately the gains to be had from switching (at least, prior to a tender process) (see paragraph 9.168). We consider that this uncertainty makes it more difficult for companies to take a view on whether the gains to be had from putting an engagement out to tender are likely to exceed the costs.

9.240 Overall we consider that dissatisfaction with the audit fees is unlikely to trigger a tender process unless the company expects to achieve a substantial fee reduction given the evidence that price gains may be short-lived (see paragraph 9.228) and the value attached to continuity (see paragraphs 9.185 to 9.191).

Firms' incentives to retain engagements

9.241 So far, we have considered the bargaining process principally from the company's perspective, in terms of its ability to perform a cost-benefit analysis of switching auditor. However, the firms' incentives are also relevant.

9.242 If a firm has much to lose if it loses an engagement then such potential losses will increase the company's bargaining power, as the firm will be eager to avoid those losses and retain the engagement. Accordingly, the greater the losses that the firm may incur should it lose the engagement, the more power a company has to extract a competitive offer from the incumbent firm. The company needs to know of such potential incumbent firm losses in order to bring them to bear in a negotiation.

9.243 Firms have said that they have a strong incentive to compete to retain audit engagements. PwC said that the significance of losing an FTSE 350 audit meant that firms invested considerable efforts in ensuring that they provided the requisite service and quality to their current audit clients in order to avoid a formal tender.[684]

9.244 KPMG said that audit firms had strong incentives to retain their existing clients, and this exerted competitive pressure as the consequences to audit firms of losing a FTSE 350 client's audit were substantial and went beyond the lost profit on that particular engagement. KPMG said that the firm would lose the value of the relationship-specific investments and reduce its ability to win and retain other clients in future.[685]

9.245 In addition to the evidence set out above in paragraphs 9.36 to 9.62 regarding firms' incentives to win engagements, we consider below the evidence of the costs to firms of losing engagements provided by:

(a) the efforts that firms engage in to retain clients;

(b) costs of participating in tenders;

(c) the likelihood of an audit firm retaining a client in the event of a tender process;

(d) the importance of the experience of the audit firm and the audit team to companies when companies select auditors; and

(e) the incremental costs to a firm of gaining new clients.

[684] Submission and response to issues statement, 12 January 2012, paragraph 4.23
[685] KPMG main submission, paragraphs 259–264.

The efforts that firms engage in to retain clients

9.246 The efforts that firms expend to retain an engagement indicates how much they might lose if they are not reappointed. The strategies most commonly referred to are the use of annual surveys and performance reviews with clients when the audit is complete, used to monitor the performance of the audit firm and to understand what clients want from their auditor.

9.247 All the Big 4 firms said that they carried out detailed annual reviews of their own performance with audit clients. These reviews are generally compulsory for large clients. In some of the Big 4 firms, partners not involved in delivering a given audit undertake interviews of key clients. Most firms also carry out surveys of their audit clients asking them to rate their performance on factors such as: industry knowledge; competitive fees; speed of response when accounting guidance is needed; insight into different areas of the business; and frequency and quality of interaction.[686] Where issues are identified on receipt of the survey or review, partners must deal with these in the next year's audit approach. In extreme cases, this may lead to a replacement of members of the audit team. The firms collate these findings and share common trends across their staff and partners.[687]

9.248 PwC said that it was acutely aware that any (actual or perceived) failure in its performance increased the risk of a tender, and it therefore always regarded the possibility that a company would consider switching auditors to be realistic and serious.[688] PwC also said that its Audit Relationship Diagnostic tool had been developed specifically to monitor such threats and allow it to act quickly to mitigate concerns where they arose, and that its client satisfaction process always focused on this point.[689]

9.249 We found that firms have regular opportunities throughout the audit process to assess the satisfaction of the company and to take action to address any concerns. Typically the company will negotiate the terms of the audit engagement with its auditor each year (see paragraph 9.2). These negotiations will generally be informed by the detailed reviews of the previous year's engagement (see paragraphs 9.102 to 9.109). During the audit process the AEP will have regular contact with the FD and, although less frequently, the ACC (see paragraphs 9.77 to 9.87).

9.250 We were also told that a client contemplating putting its audit out to tender will usually discuss this possibility with the incumbent auditor before deciding to do so. The company may ask the incumbent to re-tender, or to renegotiate the scope and fees in a more informal way.[690]

9.251 Firms provided the following examples where companies have asked firms to reduce fees, and fee reductions have been secured:

(a) In renegotiations with PwC in 2012, [✂] received an unsolicited proposal from [✂] offering to audit the company for £[✂] compared with an initial PwC fee proposal of £[✂]. [✂] agreed a fee of £[✂] with PwC.

(b) In 2011, [✂] had a quote from PwC of £[✂], compared with a fee of £[✂] that KPMG was charging. KPMG and [✂] agreed a fee of £[✂].

[686] Appendix 7.8.
[687] Appendix 7.8, paragraph 244.
[688] PwC response to working paper 'Nature and strength of competition', Annex 2, paragraph 3.19.
[689] ibid, Annex 2, paragraph 3.19.
[690] Appendix 9.2, paragraph 15.

(c) [✄] threatened to tender during its 2008 renegotiation with KPMG, which resulted in a base fee fixed for three years at a reduced level.

9.252 We also saw examples of where case study companies had negotiated fees down, or changes in audit scope.[691,692,693,694] There were also instances where companies had the actual or proposed lead partner changed where they were dissatisfied with performance (for instance at case study companies A,[695] G,[696] and I[697]).

9.253 One counter influence to the downward fee pressure exerted by management was the ACC. ACCs stressed that their priority was to obtain quality and would pay the necessary fee. A question asked of auditors by some ACCs was whether the fee was high enough for the auditors to do the job properly.[698]

9.254 Firms provided evidence of pressure to provide high-quality service and competitive fees. PwC gave examples of where it had changed team members in response to client dissatisfaction,[699] including adding more resources and/or more qualified/ specialized individuals, and of how companies applied pressure on fees at various points in the annual audit cycle, and almost always challenged fees in the annual renegotiation.[700] It said that companies could and often did explicitly threaten to tender in order to achieve competitive fees and improved service.[701]

The costs of participating in a tender process

9.255 If an incumbent firm is forced to participate in a tender process to retain an engagement, it will have to incur the associated cost. Such avoidable cost provides the firm with incentives to try to retain the engagement (whether by reducing its fee or increasing its quality) and so avoid the tender costs.

9.256 We sought to quantify the costs to firms of participating in tender processes. Using data on 49 recent tenders we calculated the total staff hours and staff hours by grade allocated to a case. We found that the costs of tendering are proportionate to the size and the complexity of the audit, and differ significantly between engagements. We also found that the mix of staff used was senior as compared with audit teams. Much of the time allocated to tenders was partner and senior manager time. We estimated the cost per additional tender process to be in the range of £[✄] for a FTSE 250 engagement to £[✄] or more for the most complex FTSE 100 engagements (see

[691] Appendix 2.1. At Company B, the audit fee was frozen for the current year and had been frozen for the last couple of years. The FD thought this was a good result as the business had grown by approximately 10 per cent. The FD was open with the auditor about wanting to switch auditor due to the high audit fee (paragraph 26).
[692] Appendix 2.1. At Company F, in agreeing the fee with KPMG, the tender fee was not altered but the company requested more partner hours. The fee was agreed on a fixed basis for three years (subject to inflation and scope changes), paragraph 30.
[693] Appendix 2.1. Company G had undertaken a cost reduction programme across the business. It had asked PwC to find a [✄] per cent saving in one year. The AEP agreed to seek opportunities for a £[✄] ([✄] per cent) reduction over two years: paragraph 108.
[694] Appendix 2.1. At Company J, during the AEP's tenure the requirements for the audit increased, and he proposed fee increases to the four unit trust ACs for which he was responsible. Three of the ACs accepted the increase, acknowledging that more work had to be done. The other ACs refused the increase, resulting in the larger audit being conducted for the original fee: paragraph 77.
[695] Appendix 2.1, Company A, paragraph 102.
[696] Appendix 2.1, Company G AEP, paragraph 122.
[697] Appendix 2.1, Company I, paragraphs 46–48.
[698] Although, we were told by some AEPs that the audit firm could not say 'no' to this question as effectively by that stage it had agreed to do the work. Appendix 2.1, Company B, paragraph 99.
[699] Response to working paper 'Evidence on switching costs (and implications for barriers to entry)', paragraph 10(c).
[700] ibid, paragraph 3(a)(A).
[701] Response to working paper 'Evidence relating to the selection process: tendering, annual renegotiations and switching', paragraph 3(c)(ii).

Appendix 16.2, paragraph 10). Nevertheless, the cost of tendering has not been a barrier to participating in tenders when invited to do so (see paragraph 9.56).

The likelihood of an audit firm retaining a client in the event of a tender process

9.257 The smaller the chances of an incumbent firm winning an audit tender process, the greater its incentives to try to persuade the company not to go to tender at all.

9.258 The firms said that the incumbent will be aware that its chance of winning a tender process is low where triggered by dissatisfaction on the part of the client. Our first survey found that the incumbent retained the audit engagement in around 20 per cent of tender processes.[702] These tender processes may include events triggered by circumstances such as mergers and acquisitions (see paragraph 7.20), or a policy of tendering auditor regularly[703] and so the chances of retaining a client may be lower than 20 per cent absent such circumstances.

The importance of experience and reputation to companies when they select an auditor

9.259 An engagement may have a strategic value beyond its direct profitability. The more important experience and reputation are to companies when they select a new auditor, then the greater the incentives an incumbent firm will have not to lose any given FTSE 350 engagement, as having that engagement allows the incumbent firm to demonstrate relevant experience when it comes to bidding for new engagements.

9.260 Our first survey found that for both FTSE 350 FDs and ACCs the factors most frequently identified as important in the appointment of an auditor included the experience and knowledge of the engagement partner and the experience and knowledge of the team.[704] The reason for a firm losing in a tender process most frequently mentioned by companies has been a lack of experience or competition from a firm with more experience.[705]

9.261 KPMG said that losing an audit client implied a reduction in the ability to win or retain other audit clients in future. In particular, the loss of an audit client of a certain size or complexity or in a certain sector represented a loss in the audit firm's relevant experience base. The experience base was said to be an important aspect of quality and to provide a signal to shareholders on a firm's competence. In this way a loss of a current audit client was said to decrease its probability of winning new clients.[706]

9.262 KPMG also said that the loss of an audit client might damage a firm's reputation for quality. KPMG said that any aspects of poor quality of service were likely to become common knowledge across company management as FDs and ACCs sat on multiple boards whereby issues around audit firms' quality could be communicated.[707]

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[702] For the tender processes of FTSE 350 engagements during the period 2007 to 2011 on which we have information, 23 per cent were won by the incumbent. See Appendix 7.1, paragraph 48.
[703] Appendix 2.1, Company H, paragraph 29 is an example of a company which has adopted a policy.
[704] Appendix 2.2, Table 13.
[705] Appendix 7.1, paragraph 47.
[706] KPMG main submission, paragraph 262.
[707] ibid, paragraph 263.

The incremental cost of gaining new clients

9.263 If winning new audit clients is expensive for a firm, then firms have strong incentives to retain their existing engagements. If winning new engagements were cheap, firms could afford to be less concerned.

9.264 All of the Big 4 firms had programmes for targeting new clients[708] including FTSE 350 companies. We consider the relevant costs to be the incremental costs incurred by a firm to gain a new client. We found that firms identify particular companies they want to target and each FTSE 350 company may be allocated an individual partner to lead and coordinate efforts for building a relationship.[709]

9.265 We also found that when an audit engagement becomes available firms allocate considerable resources including senior partner time to the process of preparing a bid.[710] Finally, analysis of the hours allocated to engagements suggests that firms in the first few years of an engagement typically allocate considerable extra resource which is not reflected in higher audit fees: we estimated that the number of hours increased by 24 per cent compared with the previous auditor in the first year after a switch. We characterized this as an investment made by the firm at the start of an assignment in building their knowledge of the business and in establishing relationships with the FD, ACC and other relevant individuals in the company.[711] This may also reflect the efforts made by firms at the start of an engagement to minimize the costs to companies associated with switching auditor.[712]

9.266 This indicated to us that winning new engagements is expensive, and entails the costs of becoming familiar with the company. The low incidence of tender processes (as set out in paragraphs 7.17 to 7.30) in our view also increases incentives to retain engagements, since the loss of one engagement may not quickly be made good by the acquisition of another.

Our view on the losses firms may incur if they lose an engagement

9.267 Our view is that firms may incur significant costs if they lose a client. They lose the income stream of the engagement; their portfolio of engagements in any given sector is weakened (although the extent to which this matters will depend on the strength of the retained portfolio); and they may suffer reputational damage depending on the circumstances of the loss.

9.268 Given that a new auditor must be selected, the incumbent may have to participate in a tender process and incur the associated costs. Targeting and obtaining replacement engagements may be expensive: tender processes are infrequent, and if successful, the firm must incur the costs in becoming expert regarding that company's business.

9.269 However, these costs will vary by firm, and with respect to each company. The loss of one company may not matter to a given firm if it has a large portfolio. All tender processes are not equally expensive. It may be that an expert audit team can easily acquaint itself with the business of a new client company.

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[708] See Appendix 7.8; KPMG response to working paper 'Nature and strength of competition'; and PwC response to working paper 'Nature and strength of competition', paragraph 36 e) i) and response to issues statement, 12 January 2012, paragraphs 4.29–4.39.
[709] Appendix 7.8.
[710] Appendix 7.1, paragraphs 32 & 33.
[711] Appendix 2.4, paragraph 97.
[712] Appendix 7.4, paragraphs 75–94.

9.270 Our view of relative bargaining position of companies and firms taking into account all the factors discussed so far is set out in paragraphs 9.326 to 9.337, once we have considered the position within a tender process.

Bargaining power in the context of a tender process

9.271 In the section below, we consider companies' bargaining power within the context of a tender process and accordingly how competitive the outcome is likely to be. Our detailed evidence is contained in Appendices 7.1 and 9.2 and is summarized below. As set out above (see paragraph 7.23) we estimate that on average there have been about ten tender processes for FTSE 350 audit engagements a year.

9.272 This subsection describes:

(a) the tender process;

(b) tender lists;

(c) firms' incentives in participating in tender processes;

(d) firms' costs in tendering;

(e) company costs in tender processes;

(f) submissions received responding to our provisional findings; and sets out

(g) our view on competiveness of tender processes.

The tender process

9.273 The tender process for FTSE 350 audit engagements is typically a structured and thorough process which can be expected to provide bidders with the access and information they need to prepare informed proposals; and the selection committee with the information they need to make an informed decision.

9.274 Typically, the tender process might last for a period of six weeks to three months from the issuing of invitations to tender to the appointment of the auditor. Throughout the process there will be interaction between key individuals in the company and the bidding audit firms, and will provide information to the company regarding the bidding firms' potential audit teams.

9.275 Before invitations to tender are issued, there is a period of internal debates within the company and informal discussions between the company and the incumbent audit firm. The company may also have discussions with competitor audit firms.

9.276 Invitation to tender letters are signed by a company's FD and provide an indication of the expected time scale of the tender process and the deadline for receiving the tender proposal, details of the selection committee, the service or services that the company requires, and information on the company. The letters also set out procedures for giving bidders access to further information and people in the company.

9.277 Invitation letters require that firms state the level of fee proposed and sometimes require further details such as charge-out rates by grade of staff and a breakdown of hours by partner, manager and other staff. In some circumstances, companies may also require firms to provide the basis for agreeing fees in future years, and fees that will be charged for additional services.

9.278 The invitation letters typically request that proposals provide details on: the firm's internal processes for ensuring independence and quality assurance; the team that will carry out the audit; the firm's service approach; and how the firm proposes to manage the switching process.

9.279 Invitation letters usually require firms to describe their approach to the audit including: an outline timetable; a risk assessment and proposed audit response to these risks; the proposed balance of work between reliance on internal controls and substantive testing; issue resolution; and adaptability to changes in the company's group. Companies may also require firms to specify in their proposals the audit objectives, the use of IT, the communication methods, value added services, the ability to be proactive and innovations.[713]

9.280 The selection committee usually consists of the FD, the ACC, AC members and the CEO. Depending on the company, others may be involved, such as the Group Financial Controller, the Group Director of Tax, and the Head of Internal Audit.

9.281 Prior to submitting the proposals the firms may have preliminary meetings with management or request further information allowing them to better understand the business and its requirements.

9.282 Our analysis of 145 tender proposals covering the period 2007 to 2011 suggested that the proposal documents submitted typically provide information on the following:[714] the proposed fee; the proposed approach to the audit; the qualifications and experience of the audit team and the partner who will conduct the audit; the relevant audit experience of the firm including sector experience; the firms' approach to quality assurance and risk assessment; and the use of UK offices and, where necessary, the international network.[715]

9.283 In some circumstances the client and the firm can discuss the firm's proposal as to how they will reduce switching disruption for the company. Transition plans include discussion regarding how the firm proposes to familiarize itself with the company's organization.[716]

9.284 Firms may or may not provide a breakdown of staff hours by grade, and international and local offices. In the tender documents we received, a minority provided details on fees by grades, type of work and location.[717] Some set out the number of meetings that will occur along the year, while usually firms only provided a high-level timeline.[718] Some provided details of their IT systems and the software used to conduct the audit, but did not generally give further details on the methodology proposed.[719]

9.285 There are few examples of proposals where firms offered non-audit-related benefits such as the offer of a preferred supplier status, invitations to public events organized by the firms, networking opportunities, and access to publications, such as studies and reviews of sectors and industries. In a minority of cases we found that firms may offer discounts on NAS. Incumbent auditors that participate in tenders usually offered a significant reduction in the fee.[720] There were also some cases of the incumbent

[713] See, for example, [✄].
[714] Appendix 7.1, paragraph 2.
[715] Appendix 9.2, paragraphs 60–99.
[716] Appendix 9.2, paragraph 35.
[717] Appendix 9.2, paragraphs 32 & 69.
[718] Appendix 9.2, paragraphs 34 & 68.
[719] Appendix 9.2, paragraphs 34, 79 & 81.
[720] Appendix 9.2, paragraph 70.

offering retrospective reductions in audit fees or to negotiate on their price if other proposals were cheaper.[721]

9.286 The tender proposals did not appear to vary in their form, content or detail with the number or identity of the firms invited to tender.

9.287 Following the submission of proposal documents, firms give a formal presentation to the selection committee at which the members of the committee will have the opportunity to ask the bidders questions. This is followed by a contract negotiation phase, when the audit engagement contract is completed with the winning auditor, and feedback may be given to losing bidders.

Tender lists

9.288 As explained above (see paragraphs 9.18 to 9.23) survey results suggested that the majority of FTSE 350 companies considered that they had a choice of at least three Big 4 firms. Firms stated that only rarely would they decline an invitation to tender and that potential conflicts of interests were frequently resolvable (see paragraphs 9.46 to 9.53). Nevertheless, the results also suggest that for some companies the availability of credible alternative suppliers of audit services is more limited (see paragraph 9.27).

9.289 The survey results indicate that companies do not invite more firms to tender than is necessary for a competitive tender. In particular, when asked why tender lists had been limited to the firms mentioned, about 20 per cent of FTSE 350 companies mentioned that they had shortlists, the need not to waste time and that the number of firms invited to tender was sufficient to ensure a competitive process.[722]

Firms' incentives in participating in tender processes

9.290 We consider that firms have an incentive if they participate in a tender process to take the process seriously and make best efforts to impress the client. Given that the demand for statutory audits by FTSE 350 companies is fixed in terms of numbers of available engagements, to expand their FTSE 350 client base, firms must displace competitors. Firms said that only rarely had they acquired new FTSE 350 engagements without participating in a competitive tender.[723]

9.291 We could not determine the precise number of tender processes that have taken place over the last ten years. However, the firms provided data on 52 tender processes for FTSE 350 audit engagements between 2007 and 2011.[724] Our analysis of switching data and information provided by firms indicated that over the period 2001 to 2010 (see Appendix 2.4 for further details), on average there have been between eight and ten tender processes a year for FTSE 350 engagements (see paragraphs 7.22 and 7.23).

9.292 We consider that with this low frequency of opportunities to acquire new engagements, firms have a strong incentive to compete intensely for engagements when the opportunities arise (assuming that the firms expect the engagement to be profitable).

[721] Appendix 9.2, paragraph 70.
[722] Appendix 2.2, paragraph 55.
[723] Appendix 9.2, paragraph 11.
[724] Appendix 7.1, paragraph 2.

9.293 There is also evidence that companies recognize that inviting more firms than necessary to tender could be damaging to the efficiency of the process (see paragraph 9.289). We consider that this contributes to the incentives that firms have to compete in tender processes in two ways: each firm will be invited to participate in fewer tender processes; and, all else equal, the probability that a given firm will be successful in winning the engagement is higher once it has been invited to participate.

9.294 Further, firms stated that even if they failed to win an engagement it was important that they performed well in the tender process. A good performance was an opportunity for the firm to demonstrate its capabilities to the company and build its relationship with the company, and the possibility that this might generate work in the future. A poor performance could be damaging to the reputation of the firm with the company and those individuals involved in the process (see paragraph 9.49).

9.295 We consider that the costs incurred by firms in participating in tender processes are further evidence of the incentives they face to compete intensely. We consider the evidence on this point next.

Firms' costs in tendering

9.296 Firms stated that the costs of preparing tenders fell into two categories: direct and indirect costs.

9.297 The direct costs incurred by the firms in preparing for the tender are mainly the costs of the time allocated by the pitching team. Deloitte explained that the factors that could influence the cost of submitting a tender were the mix of pitching team, the specifics of client requests, the extent of overseas visits, the number of meetings during the tender process, the length of the tender process, and any additional costs associated with innovative approaches in the pitch. They varied from company to company and depended largely on the complexity of the assignment and the requests of the clients.[725]

9.298 The indirect costs are said to be not easily quantifiable and include the time spent before the tender process, to increase the probability of being invited if a tender opportunity emerges, such as the costs of building a relationship with the client; and the opportunity cost of staff not working on other projects while preparing for the tender.[726,727]

9.299 All firms agreed that the more complex the tender, the more time firms spent in the preparation, and the higher its cost. It also appeared that the pitching team was generally more senior than the team required for the delivery of the audit service. For example, GT explained that engagement and audit partners, audit senior managers, managers and bid managers were those in the team that spent most time in preparing the tender. EY stated that a typical tender team consisted of a lead engagement partner and reviewing partner or committee, audit senior manager or director and pursuit leader who could be either a specialist or an engagement partner.[728]

9.300 Our findings on the costs to firms of tendering are set out above (see paragraph 9.256).

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[725] Appendix 7.1, paragraph 20.
[726] We report here firms' views on the matter, but recognize that accounting for opportunity costs creates the risks of double counting direct time costs.
[727] Appendix 7.1, paragraph 21.
[728] Appendix 7.1, paragraph 22.

Company costs in tender processes

9.301 We consider that: *(a)* the costs that FTSE 350 companies incur when they have put the audit engagement out to tender are evidence of their commitment to the process; and *(b)* if the costs to a company of putting an engagement out to tender are high we would expect a company that has taken a decision to go to tender to want to ensure that the process delivers a good outcome. These costs largely take the form of the opportunity cost of the time committed by management to the process (see paragraphs 9.192 to 9.197).

9.302 We do not have quantitative data on company tender costs, although our first survey asked about tendering behaviour. Among FTSE 350 companies that had not put their audit engagement out to tender in the last five years, around 20 per cent mentioned the costs involved in tender processes and switching as a reason for this. The responses suggested that the expected costs of running a tender process can be high, in particular the opportunity costs.[729] For example, one respondent said that tenders were very expensive and time-consuming, and another that tendering an audit was hugely disruptive in terms of management time.

9.303 Our case studies and hearings described processes of various size, duration, complexity, and so of costs associated, but accorded with the description given in paragraphs 9.273 to 9.287 above.[730,731,732,733,734,735,736,737,738,739]

9.304 Barclays said that tendering processes involved significant disruption to business activities of multinational companies due to their scale, depth and geographical spread. It estimated that the cost of a single tender process in terms of man hours for a group the size of Barclays would involve in excess of 200 staff with a total time spent in excess of 1,000 man days over an estimated project time of two years.[740]

9.305 Accordingly, while we do not have quantitative data, it appears that running a tender process can be onerous for some companies: the cost, principally in management time, appears related to the size, complexity and geographic spread of the company. Estimates of the time spent on various stages in the tender process ranged from three to four days to three to four weeks, generally over periods ranging from six weeks to several months.[741] We note that very senior management time is required. However, the CFOs and ACCs from at least six case study companies thought that the opportunity cost to companies of going out to tender was manageable, if sometimes onerous, and could be calculated in advance.[742] Several challenged any notion that holding a tender process was unduly disruptive of other executive activities. However, a few of those interviewed said that going out to tender was time-consuming

[729] Appendix 2.2, paragraph 59 & Annex 2.
[730] Appendix 2.1, Company B, paragraph 20.
[731] Appendix 2.1, Company C, paragraphs 29 & 59.
[732] Appendix 2.1, Company H, paragraphs 24 & 25.
[733] www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/summary_of_conference_call_25_january_2012.pdf, paragraphs 15 & 16.
[734] Company L, paragraphs 7 & 26.
[735] Company M, paragraph 17.
[736] Company N, paragraphs 6–9 & 27.
[737] Company P, paragraphs 11 & 19.
[738] Company R, paragraphs 8 & 29.
[739] Company S, paragraph 5. See also Appendix 14.1, paragraphs 26–33.
[740] Barclays response to the Remedies Notice.
[741] See Appendix 14.1, paragraphs 30–32.
[742] The FD of Company T, for example, said that the tender process did not cause significant disruption to the company, and the ACC considered that the financial and opportunity costs in terms of management time were exaggerated and that the costs could be minimized by a well-designed tender process (see Appendix 14.1, paragraph 30).

since running the process involved executive staff in considerable work additional to their normal duties.[743]

9.306 We consider that these costs reflect the effort made by FTSE 350 companies to ensure that tenders have been effective and competitive processes. We have set out above the evidence on how tender processes for FTSE 350 engagements have operated. It appears that companies design the process to ensure that firms have access to company information and employees that they need in preparing a bid. The selection panel comprises senior people in the company. The process will involve frequent interaction between the company and firm when companies will have the opportunity to test the capabilities of the firms bidding.

Submissions responding to our provisional findings regarding tender processes

9.307 KPMG said that our provisional findings contained strong evidence that companies had an effective bargaining position.[744]

9.308 PwC accepted that formal tenders provided the best opportunity for companies to obtain information on auditors, although it did not accept that the evidence showed that large companies were unable to achieve competitive outcomes without frequent tendering.[745]

Our view on competitiveness of tender processes

9.309 Our view is that competition in tender processes for FTSE 350 engagements is strong in relation to the factors on which selection is based, namely the capabilities and experience of the firms and the audit team, the reputation of the firm and the audit fee. In particular:

(a) Given that the demand for statutory audits by FTSE 350 companies is fixed in terms of numbers of available engagements, to expand their FTSE 350 client base, firms must displace competitors, and tender processes are the principal means to do that. Therefore we consider that audit firms have the incentive to compete intensely during tender processes.

(b) If invited to tender, Big 4 firms will generally participate. Tender lists typically include at least three Big 4 firms although the analysis of sector experience suggests that some firms may be better placed that others in competing for the certain engagements. Mid Tier firms appear to be invited to participate in only about one-third of tenders, but the performance of these firms in the tender processes for FTSE 350 engagements suggests that they were not the strongest competitors.

(c) The tender process is designed to ensure that firms have strong incentives to compete intensely for the engagement. To address the advantages the incumbent may have, companies build into the process opportunities for all firms to gather information and to interact with key individuals in the company. Shortlists are used to avoid diluting incentives to compete.

743 The FD of Company S, in particular, had found the process to be very time-consuming for himself, the senior members of his finance team (approximately seven to eight people) and senior business heads. He said that the firms had unfettered access to him and his finance team. The ACC said that the time that would be spent on the tender process had been considerably underestimated at the outset and that the accounting department had borne the brunt of this, having to brief two new firms on the company's systems and activities (see Appendix 2.1, Company S, paragraph 5).
744 KPMG response to provisional findings, paragraph 3.9.2.
745 PwC response to provisional findings, Annex 2, paragraph 2.

(d) The tender instructions are detailed ones in which firms make submissions responding to company specifications. One consequence of this may be intense competition on the parameters specified by limited product differentiation between firms in their offers. Companies are therefore able to obtain specific information about the offering of the firms and can compare them easily. Typically proposal teams are made up of senior individuals with a considerable proportion of the time allocated accounted for by partners. The company is able to become familiar with the key individuals who would make up the audit team were the firm selected, including the AEP. The company can obtain information on their experience.

(e) The tender selection process is led by FDs, CFOs, and ACCs who are usually experienced individuals and many have trained with or worked for one of the Big 4 firms (ie they have relevant experience of the main suppliers). Most ACCs hold more than one AC position.

(f) For the company, there is a (possibly significant) opportunity cost in senior management time of launching and running a tender process (which may vary given other issues that may call for management attention). Accordingly, having taken the decision to put the audit out to tender, we expect that management and the AC take the process seriously. For example, we know that the process allows firms to have access to the individuals and information they need to prepare tenders. This includes contact with the FD and ACC.

(g) For the audit firms, participating in a tender process is a time-consuming and costly process and potentially damaging to their reputation with the potential client if they do not perform well. For this reason, firms are unlikely to participate unless they intend to take the process seriously.

9.310 Accordingly, in our view, formal tender processes provide the best opportunity for a company to obtain the information and weigh the factors necessary to enable them to obtain the most competitive offerings available in the relevant market (as listed in paragraph 9.5), and so to fully exercise their bargaining power.

The price effects of tender processes or switching for companies

9.311 In Section 7 we presented evidence on the price effects of tender processes or switching. We found that historically companies obtained a relative price benefit (of initially 13 per cent) from tender processes or switching,[746] but also that this benefit eroded over the course of the following three years (see paragraph 7.70).[747]

9.312 Firms' submissions (which we considered carefully) are also summarized in Appendix 7.5. In this subsection we set out our view of the implications of those effects.

9.313 One explanation for the erosion of price gains after direct tender processes or switching was that audit firms made unsustainably low bids to obtain a new engagement, and in the following years increased the audit fee to a sustainable level. An alternative explanation was that there was a certain information asymmetry due to the bespoke characteristics of statutory audits, so that companies did not know the com-

[746] PwC's analysis, from which we took this result, did not distinguish between tenders that resulted in a switch and those that did not.
[747] We do not consider this reduction in audit fees to be 'low-balling'. See paragraphs 12.7–12.9.

petitive price of an audit. A direct tender process or switch resolved this information asymmetry, but only for a limited amount of time.[748]

9.314 We do not have engagement level profitability data that is sufficiently reliable to understand whether on average audit fees in the first year after switching were at a sustainable competitive price or not.[749] However, we also have no evidence that companies were incurring the costs involved in tender processes and switching auditors in order to gain short-term reduction in fees, and no evidence that fees quoted in a tender process are presented as including initial discounts.[750]

9.315 We do not think that a company with sufficient bargaining power would accept fee increases in the years following a switch that are not directly related to scope increases.[751] Therefore, we consider the observed relative price pattern is consistent with companies, on average, losing bargaining power in the years after tender processes or switching auditor.

9.316 We acknowledge that it is possible for the observed price pattern to be compatible with a well-functioning market. Even if the auditor can increase and sustain its audit fee later on in the engagement, competition for such an engagement could be so fierce that any expected additional rents are given away through low fees in the first years of an engagement. However, we consider that the imperfect information regarding the lifetime value of an engagement[752] makes the trade-off with an up-front discount complicated and therefore less plausible.

9.317 There may have been cases where a discount was given, or where the scope of an engagement was underestimated during a tender procedure. However, we are not convinced that this is typical. Given the market characteristics, we consider it more plausible that companies lose bargaining power over the course of an engagement. The observed relative price pattern after tender processes or switching is consistent with that. We have not seen any robust evidence suggesting that competition for engagements fully compensates companies for this. We further note that some companies might have bargaining power outside of a tender situation, whereas others do not (see further paragraph 9.340).

Submissions responding to our provisional findings regarding our first Theory of Harm

Deloitte

9.318 Deloitte said that it was clear from the evidence that companies were well-placed to use switching, tendering, the threat of both as well as other mechanisms to ensure that they maximized quality and value in the market at present. The fact that some

[748] Even though it might occur in isolated instances, we consider it unlikely that the observed relative pricing pattern is driven by audit firms systematically underestimating audit scope and subsequently bargaining for increases to fees to cover the incurred additional effort. See Appendix 7.5, paragraphs 122–133.

[749] However, we have no evidence that first-year audits were not profitable despite the additional efforts that firms typically make in the early years of an engagement to understand the company. On the contrary, we think that even in the early years, engagements are generally profitable at the gross margin level (see paragraphs 7.44 & 9.42, and Appendix 7.3).

[750] We have not encountered examples of firms offering short-term discounts to companies to induce switching, even though we have run approximately 25 case studies and spoken to numerous stakeholders, including personnel of both companies and firms who negotiate fees.

[751] PwC's analysis already controlled for scope through a range of variables. Therefore we consider that scope changes were not a likely driver of the relative price development.

[752] For example, due to variation around scope, duration, NAS etc.

companies did not tender was typically because they were happy with the price and quality of service being provided by their auditors.[753]

EY

9.319 EY disagreed with our finding that the bargaining position of companies is weakened outside of the tender process and that this constituted an AEC. Although competitive interaction was more visible and intense during the tender process, significant competitive pressures exist outside of the tender process.[754]

KPMG

9.320 KPMG said that our assessment of bargaining power was fundamentally flawed, since we had failed to consider fully the relevant parameters in any economic assessment of bargaining and to properly take into account the full weight of evidence that showed the effectiveness of bargaining in exerting competitive constraints outside of tender events.[755] It said that audit firms faced considerable uncertainty over the alternatives available to their clients. It was unaware of whether its clients had received alternative offers, how well-grounded and serious those offers were and whether they would subsequently be revised downwards. Instead, audit firms were aware that, in general, their clients have ample alternatives, are likely to be being frequently approached by rivals, are experienced and knowledgeable buyers, conduct detailed assessments of their audit firm's performance, are likely to have experience of at least some competitors from the provision of NASs and could always decide to put the audit out to a highly competitive tender if they are dissatisfied with their audit firm's performance. This meant that audit firms did not, and could not, seek to take advantage of any possibility of a lack of information about their alternatives on the part of FTSE 350 companies. As a result even if it was the case that some companies' reviews and benchmarking activities were less informative than those of others (or than in tender events), this would not imply that a supplier of audit services to that company would be in a stronger bargaining position because of it.[756]

9.321 KPMG said that companies exert competitive pressure on their audit firm constantly, not on occasion as it said we implied in our provisional findings. It had seen no direct evidence to show that some companies could not obtain competitive outcomes.[757] It said we appeared to be reaching a provisional AEC finding based almost solely on speculation that some companies might not get good outcomes all the time. It said that it was the nature of markets where firms bilaterally negotiate terms for bespoke services that different firms will have different terms for their services. Some of these differences would be down to scope and some may be down to the ability of firms to negotiate. This is was entirely consistent with a competitive market.[758] It said we had not explained what these less favourable outcomes may be or in what way and to what extent they may be unfavourable. We had provided no examples of any clients being in a 'captive' relationship with any audit provider.[759]

[753] Deloitte response to provisional findings, paragraph 3.10.
[754] EY response to provisional findings, Annex 1, paragraph 1.2(a).
[755] KPMG response to provisional findings, paragraph 3.10.2.
[756] ibid, paragraph 3.10.7.
[757] ibid, paragraph 3.8.2.
[758] ibid, paragraph 3.8.3.
[759] ibid, paragraph 3.8.4.

PwC

9.322 PwC said that the balance of evidence did not justify a finding that companies face significant hurdles in comparing the offerings of an incumbent audit firm with those of other supplies, other than through a tender process.[760] It said that our provisional findings acknowledged that the overwhelming majority of companies carry out reviews of quality and fees. These reviews could be assessed by companies with the benefit of ACCs and FDs relying on their personal experience of other audit firms from other companies; their experience of other firms capabilities via provision of NAS; regulatory reports into other audit firms; and the benefit of other firms' marketing efforts to draw on in making a comparison with the existing audit firm. It did not follow that because some companies may not conduct benchmarking exercises that that was because they had insufficient information to do so.[761]

9.323 PwC said that we referred to the substantive body of evidence that showed that firms make substantial efforts to retain existing clients, and said that the absence of such evidence would have been a strong indication that incumbent auditors felt comfortable in their position and insulated from the effects of rivalry.[762] It said that we appeared to be using the benchmark of a perfectly competitive market.[763]

9.324 It said that we had not explained our finding, or the evidence supporting it, that firms' efforts to gauge the extent of company discontent and adjust the dimension of the audit to mitigate the risks of tender meant that firms did not need to give away more than necessary to retain a client, because companies were less well placed to determine at what point a firm would be unwilling to act.[764] To the extent that our case was that the audit firm is able to achieve a delicate balance between accommodating the client and preventing a threat of tendering materializing, whilst simultaneously maintaining prices at above a competitive level, we should provide clear evidence.[765]

9.325 With regard to our finding that some companies had not obtained competitive outcomes on fees, PwC said that prices had fallen in real terms over the last six years, and the fact that some companies may pay higher fees than others was entirely consistent with what would be expected in a business to business market characterized by a series of bilateral fee negotiations where companies' needs and circumstances differ.[766]

Our view on unilateral market power and bargaining power

Discussion

9.326 In paragraphs 9.8 to 9.269 we examined the criteria listed in paragraph 9.5 that we think determine the extent of a company's bargaining power. Having regard to the structure of the market, we consider that overall the competitive pressure that a company can exert in negotiations with its existing auditor depends on the firm's assessment of the risk of losing the engagement if it does not provide the audit at a competitive price and to a high quality, and the consequential costs for the firm. This risk in turn depends on the strength of a company's outside option, the information

[760] PwC response to provisional findings, Annex 2, paragraph 3.
[761] ibid, Annex 2, paragraph 4.
[762] ibid, paragraph 2.30.
[763] ibid, paragraph 2.33(a).
[764] ibid, paragraph 2.33(b).
[765] ibid, paragraph 2.30(b).
[766] ibid, paragraph 2.33(c).

available to it on its outside options, and its costs of running a tender process and switching.

9.327 We find that, generally, FTSE 350 companies have a choice of alternative suppliers, although we note the more limited choice that may prevail in certain sectors (such as for large financial institutions) (see paragraph 9.35) and that FTSE 350 companies typically focus on the Big 4 firms.

9.328 FTSE 350 companies (in particular their FDs and ACs) generally can appraise their incumbent auditor's offer on many aspects of the audit. (See paragraph 9.114.)

9.329 Although there are sources of information available to FDs and ACs regarding alternative auditors, the information available to them outside a tender process leaves significant uncertainties in assessing the prospective relative performance of these alternatives in terms of price and quality (and this makes the benefits of switching uncertain). (See paragraphs 9.159 to 9.168.)

9.330 There are significant costs to companies associated with tender processes and switching (see paragraphs 9.210 to 9.217), in particular: the close nature of the company-auditor relationship of trust and confidence means that companies do not tend to walk away from established corporate and personal relationships unless the incumbent auditor significantly underperforms or overcharges; the significant costs companies must incur in educating a new auditor; and the direct costs of running the tender process in terms of management time and (possibly) external consultants.

9.331 A company will contemplate switching auditor if the gains to be had are expected to outweigh the cost of tendering and switching (see paragraphs 9.219 to 9.239). Relevant to this are: the inherent uncertainty regarding the abilities of any new auditor and therefore the gains to be had from switching (however rigorous the tender process undertaken); evidence that on average any reduction in price achieved from switching may be short-lived; a perception that there is a lack of differentiation between the Big 4 firms; and the likely risk aversion of those taking auditor reappointment decisions.

9.332 Formal tenders processes provide the best opportunity for a company to obtain the information and weigh the factors necessary to enable them to obtain the most competitive offerings available in the relevant market (see paragraph 9.310).

9.333 We find that companies that are satisfied with the performance of their auditor will be reluctant to go out to tender just to test the market (see paragraph 9.211). While a company may be satisfied with the performance of its auditor without going to tender, this may not be based on accurate information (see paragraph 9.168). Companies will be less reluctant to instigate a tender process where dissatisfied with some aspect of the quality of the audit product (see paragraph 9.239).

9.334 We consider that companies' reluctance to move to a tender process and switch has to be weighed against the potential cost to an audit firm if a client initiates a tender process and the firm loses the engagement. We consider that firms can gauge the extent of company discontent, and adjust the dimensions of the audit (in terms of personnel and fee) accordingly, and so substantially mitigate the risks of a tender process. We accept that this responsiveness of audit firms to the demands of their clients is behaviour that is consistent with a competitive market. Nevertheless, in this market the behaviour also has the effect of reducing the risk to the audit firms of a tender process.

9.335 We found a tender process provides the best opportunity for companies to secure a competitive outcome because we found companies have increased bargaining power in this situation since they are better able to appraise non-incumbent suppliers (see paragraphs 9.156 to 9.168) and since competition in the tender process is strong (see paragraphs 9.309 to 9.310). Incumbent auditors therefore face less competition for their ongoing engagements than they would were the company more willing to go out to tender and switch, thereby ultimately reducing rivalry between firms.

9.336 We do not accept the view put to us that we have applied a benchmark of a 'perfectly competitive market' as opposed to that of a 'well functioning market', or that we are merely speculating by considering that some companies are unable to obtain competitive outcomes[767] or that some companies might not get good outcomes all the time.[768]

9.337 Rather, based on the available evidence including parties' submissions, we have formed the view on the balance of probabilities that there are features of the market that prevent, restrict or distort competition thereby resulting in an AEC, which we define next.

Features that prevent, restrict or distort competition

9.338 In light of the above factors, we identified particular features of the relevant market, within the meaning of section 131(2) of the Act:

(a) Company management face significant opportunity costs in the management time involved in the selection and education of a new auditor (see paragraphs 9.192 to 9.201, 9.214 to 9.216 and 9.301 to 9.306.

(b) Companies and firms invest in a relationship of mutual trust and confidence from which neither will lightly walk away as this means the loss of the expected benefits of continuity stemming from the relationship. In particular, the loss of the expertise and knowledge of the incumbent arising from a loss of continuity may lead to reduced efficiency in the conduct of the audit and increased risk in the technical quality of the audit in the early years of the incoming firm (paragraphs 9.185 to 9.191 and 9.213).

(c) Companies face difficulties in judging audit quality in advance due to the nature of audit (paragraph 5.57 to 5.59, paragraphs 9.160 to 9.168), which means that companies cannot calculate accurately the benefits that tender processes and switching would bring.

9.339 We found that each of these aspects amounted to a feature of the market which individually and/or in combination prevents, restricts or distorts competition by weakening a company's bargaining power outside the tender process. As such, there is an AEC in the market for the supply of statutory audit services to large companies in the UK.

9.340 We think that these features are pervasive throughout the FTSE 350 statutory audit market but their effect will be uneven across companies. How a feature or combination of features affects an individual company's strength of bargaining power will vary over time and depend on its particular circumstances. While the features that we

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[767] As KPMG said in its response to provisional findings, paragraph 3.8.2.
[768] PwC response to provisional findings, paragraph 2.33(a).

identified may be intrinsic to some extent,[769] we are satisfied that they have anti-competitive effects. We think that in a well-functioning market companies would be able to exercise more effectively the bargaining power that they do have, and obtain lower audit fees, a higher quality of service; and an increase in the quality of the audit investigation and opinion and higher rates of innovation on the audit product supplied (see paragraphs 8.7 and 8.16).

10. Barriers to entry, expansion and selection

10.1 If a supplier increases its prices above competitive levels, its customers may switch to other suppliers. If enough of them do this, the price increase becomes unprofitable. However, if there are barriers to entry or expansion by rival suppliers, the customers may not be able to switch, and so the initial supplier may be able to sustain its price increase. Accordingly, a barrier to entry or expansion may be defined as any characteristic of the market that gives incumbent suppliers a cost or other advantage over efficient potential suppliers.

10.2 The prospect of timely expansion on a sufficiently large scale is important to our assessment of competition, as it can counter adverse effects arising from other sources. If rival firms could expand rapidly and with low risk, incumbent firms would be unable to increase prices or lower service quality without being substituted.

10.3 We note that high concentration in a market does not always indicate weak rivalry, as suppliers with large market shares could be vulnerable to entry and expansion which might constrain market power. Conversely, suppliers with a high market share have less incentive to compete vigorously with rivals where there are significant barriers to entry or expansion.[770]

10.4 In this section, we have considered in particular the position of Mid Tier firms, such as BDO, GT, Mazars and PKF. These are large firms with significant audit practices and extensive international networks: see Appendices 4.1 and 9.1. However, collectively they have only few engagements among the FTSE 350, and just one engagement within the FTSE 100.

10.5 We assess the competitive pressure that Mid Tier firms exert on the Big 4 firms. We consider: *(a)* the frequency with which Mid Tier firms are invited to tender and their success rates; *(b)* companies' awareness of Mid Tier firms; possible barriers to expansion to the Mid Tier firms in the form of *(c)* investments and sunk costs, *(d)* strategic behaviour by the Big 4 firms; and *(e)* regulation.

10.6 We also consider barriers to selection in the form of *(f)* experience and *(g)* reputation. We use the term 'barriers to selection' to refer to these reasons, to distinguish them from potential barriers to entry or expansion such as economies of scale or sunk investment costs. We *(h)* summarize submissions responding to our provisional findings and *(i)* set out our views.

Frequency of invitation to participate in tender processes and success

10.7 We considered how frequently Mid Tier firms were invited to participate in tender processes and their subsequent success. Mid Tier firms were invited to 33 per cent (of 40) tender processes (for which we had tender lists) at surveyed FTSE 350 companies and 51 per cent (of 123) tender processes at surveyed non-FTSE-350

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769 CC3, paragraph 320.
770 CC3, paragraphs 187 & 190.

companies in the past five years (see Appendix 2.2). The success of Mid Tier firms in these tender processes appeared limited. A Mid Tier firm was successful in winning only one of the 40 tender processes (a switch from one Mid Tier firm to another). A Mid Tier firm was the incumbent of five companies and in four out of five the result was a return to a Big 4 firm.[771] We also asked FDs and ACCs which audit firms their company would formally consider if their current statutory auditor were to cease trading. 23 per cent of FTSE 350 FDs and ACCs said that they would formally consider both Big 4 and non-Big-4 firms.[772]

10.8 In this context, we considered a model provided by Oxera on behalf of BDO and GT, looking at the potential profitability of entry by a Mid Tier firm. The model showed that it was not economic for Mid Tier firms to incur the costs of tendering for FTSE 350 audits given the probability of winning.[773]

10.9 GT said that the low levels of switching made it extremely difficult for it and other suppliers of audit services to destabilize the position of the four largest audit firms and grow market share, particularly when FTSE 350 audits were tendered infrequently.[774]

Companies' awareness of Mid Tier firms

10.10 We considered the evidence of companies' awareness of audit firms and their capabilities. Our survey results showed that 77 per cent of the FTSE 350 companies had been approached in relation to the audit of their company by only Big 4 audit firms (and not Mid Tier firms).[775] In our case studies the interviewees (all FDs or ACCs of FTSE 350 companies) generally had much better awareness of the capabilities of the Big 4 firms than they had of the Mid Tier firms.

10.11 Deloitte, KPMG and PwC all submitted that weaker market awareness of Mid Tier firms was driven by Mid Tier firms' less significant efforts to target larger companies. (See Appendix 9.3, paragraphs 9 to 11.)

10.12 However, this is a 'chicken and egg' situation. If Mid Tier firms do not believe they will win FTSE 350 audits they have no commercial rationale to invest more in marketing to FTSE 350 companies. If companies are not aware of Mid Tier firms' capabilities then they are unlikely to invite them to tender.

Investment and sunk costs

10.13 As noted in paragraph 9.19, BDO, GT, Mazars and PKF considered themselves able to audit FTSE 350 companies. They considered that it was not the lack of investment in capability or international network that meant they were not winning FTSE 350 audit engagements.

10.14 We broadly accepted this submission, to the extent that we have not identified any specific large sunk investment that they would need to make in order to expand in the market. The largest Mid Tier firms have substantial international networks and have invested substantial amounts in IT and compliance software, and do currently audit some FTSE 350 companies. However, we note the views of Big 4 firms that there is

[771] Appendix 2.2, paragraphs 53 & 54.
[772] Appendix 2.2, paragraph 80.
[773] www.competition-commission.org.uk/our-work/statutory-audit-services/evidence/initial-submissions.
[774] GT response to working paper 'Descriptive statistics', paragraph 2.6.
[775] Appendix 2.2, paragraph 78.

a real difference in the quality of the networks of Big 4 and Mid Tier firms and that this is a real reason for their lack of expansion in the reference market (see Appendix 9.3, paragraphs 42 and 43). We have not formed a view on this. We found no evidence of significant economies of scale such that the Big 4 firms had lower costs than large Mid Tier firms.[776] Our consideration of investments in international networks and non-staff costs can be found in Appendix 9.1.

Strategic behaviour by Big 4 firms

10.15 We considered whether there was evidence of strategic behaviour by Big 4 firms to exclude smaller firms, ie whether there was evidence of bundling or tying audit with NAS (see Section 12 and Appendix 8.1) and whether there was evidence of aggressive targeting of Mid Tier firms' clients by Big 4 firms (see Appendix 10.3). We found no link between the profitability of engagements and the level of NAS provided and this did not therefore support the view that firms strategically price their audits at a low level to win NAS work. In the four specific cases of aggressive pricing we investigated, we found evidence of price pressure both during and outside of formal tender processes. However, we did not find evidence that the Big 4 firms were specifically targeting BDO's clients with aggressive pricing and in some cases found that the Big 4 firms had proposed price increases to BDO's clients.

Regulatory framework

10.16 We also considered whether there were aspects of the regulatory framework that acted to restrict entry, in particular liability and insurance requirements, independence requirements (including limits on fees from single clients), and ownership requirements, see Appendices 7.7 and 9.2. Although it has not been possible to make a direct comparison of the cost of insurance between firms, we have seen no evidence to suggest that Mid Tier firms cannot obtain adequate levels of insurance cover or pay disproportionately more for cover than do the Big 4 firms. More generally, we found that the regulatory framework applied equally to all firms and we found no evidence that it restricted entry by Mid Tier firms.

Experience

10.17 As noted in paragraph 5.43*(e)*, the provision of audit services (like many services) is an experience good for company management, in that it is hard to know with confidence the quality of an audit in advance. Unlike other services, it is not possible for audit firms to show prospective clients examples of audit work for other companies, since the audit file is confidential, and there is little information in the published audit report to allow firms to demonstrate their ability.

10.18 In paragraphs 9.124 to 9.149 we consider the sources of information available to companies when considering possible alternative suppliers. In practice it appears that the most convincing way for a firm and its audit partners to demonstrate capability to a prospective client is to point to audit engagements that they have delivered for similar companies. FTSE 350 companies look for firms that have experience of auditing large, complex, international audit clients who are listed on the main market, and may also look for specific sectoral expertise (in other words, companies that are

[776] See Appendix 10.1, paragraph 96, and Appendix 10.2. We note that given the limited number of engagements for Mid Tier firms in our data set, we could not expect this analysis to identify economies of scale in staff costs that are realized at levels below which the Big 4 operate. Our assessment of economies of scale in non-staff costs was limited to three specific areas of expenditure (marketing, IT and property costs) which we identified as areas where firms might achieve an economy of scale.

as similar to themselves as possible, with the proviso that some companies eschew firms that audit direct rivals). We think this generates a virtuous circle for firms that have a significant number of FTSE 350 clients. Those engagements generate experience and expertise for a firm and its partners, which in turn helps them to acquire further clients.[777]

10.19 The converse is also true: having only a limited number of (or no) FTSE 350 audit engagements means that the Mid Tier firms are less likely to be able to demonstrate significant audit experience in relevant sectors or with relevant companies. Only the Big 4 firms can cite substantial experience of the largest, most complex listed companies. Such experience may also be considered valuable to smaller, less complex listed companies with ambitions to grow (even if they currently have no need for such expertise). We have received evidence of cases where a larger Mid Tier firm was considered capable in theory but, when the company came to make its final decision, the lack of experience in the FTSE 350 audit market meant that a Big 4 firm was chosen. See further Appendix 9.3, paragraph 29. Another way by which an audit firm can demonstrate its capabilities to a prospective audit client is by establishing a working relationship with the company in a related area, for example the provision of NAS such as tax, due-diligence, internal audit or systems work. We found that some of the larger Mid Tier firms had fewer and lower-value NAS relationships with FTSE 350 companies than Big 4 firms (see Appendix 9.3).

Reputation

10.20 By reputation, we mean 'perceived ability', and it is the perception of those making the appointment decision that is key. In this market, we think that it is the views of the ACCs and FDs that are most influential in selecting auditor (see paragraph 11.17), however, they take into account the perceptions of other parties such as investors. As discussed above, reputation is often based on experience and may to some extent be synonymous with it, because of the difficulty of gauging quality in another way. Reputation can attach to a firm, or to an individual audit partner.

10.21 To the extent that reputation is an accurate reflection of capacity, quality, expertise, and efficiency, it allows companies to distinguish between potential suppliers of audit services and select the most appropriate for their needs. However, if it is not an accurate reflection, then any inaccuracy may distort companies' decisions as to choice of auditor, and so amount to a barrier to selection to the Mid Tier firms.

10.22 Our survey indicated that 'reputation' was an important or very important factor in auditor selection for 84 per cent of FDs/CFOs and 82 per cent of ACCs.[778] However, of the companies that stated they would not formally consider any firms outside of the Big 4, only 23 and 11 per cent of FDs and ACCs respectively indicated 'reputation' as the reason.[779]

10.23 Some case study companies favoured the Big 4 firms. Equally, some of the investors that we spoke to or contacted favoured the Big 4 firms, though most expressed a nuanced view: depending on the company (size, sector etc). While some investors considered the Big 4 firms to be better able to audit large companies (ie FTSE 100), most investors seemed to be comfortable with a larger Mid Tier audit firm auditing FTSE 250 companies. (See Appendix 7.11.)

[777] We also note that other benefits may also be conveyed such as the ability to attract and retain graduates who may be attracted by the opportunity to work on prestigious and/or international listed company audits.
[778] Appendix 2.2, Table 12.
[779] Appendix 2.2, Table 23.

10.24 Given this view, and the view of larger Mid Tier firms that they were capable of auditing all but the very largest FTSE companies, we considered why Mid Tier firms could not retain clients as they grow and join the FTSE 350. We also noted that the Mid Tier firms appear to have a relatively low market share of audit engagements for companies listed on the main market but outside the FTSE 350.[780] In considering these issues, we asked various providers of capital, and corporate advisers, about their influence on auditor selection.

10.25 We found a tendency to prefer Big 4 auditors by private equity houses, institutional investors, and investment banks (see Appendix 2.6). We also found 'Big 4 clauses' in some syndicated leveraged loan agreements that in effect mandate the use of a Big 4 auditor (see Appendix 2.6). We consider that such clauses add to the reputational barriers to Mid Tier firms expanding or entering the FTSE 350 audit market.

10.26 This commonly held 'City' view, in our view, is a factor that companies preparing to list on the main market, or who are already listed, are likely to take into account in their decisions about auditors. It implies that Mid Tier firms face difficulties in retaining audit clients who are planning to raise private equity or list on the main market and is supported by the evidence we received from many institutions that most companies already had Big 4 auditors when they approached them for private equity capital or to underwrite an equity issue. Whilst the preference for Big 4 firms is not universal, companies interact with a large number of institutions during the process of preparing to raise capital. Given a preference for Big 4 firms by many institutions, it appears rational for a company to appoint a Big 4 firm. Further, the tendency for financial market participants to prefer Big 4 auditors indicates some risk for a listed company in switching from a Big 4 firm to a Mid Tier audit firm. An adverse reaction from the City could increase the risks of switching from a Big 4 firm to a Mid Tier firm for a listed company on the main market.

10.27 BDO and GT submitted that the so-called 'IBM effect' prevailed in the sector (the phrase quoted to us was that 'you never got sacked for using IBM'[781]). (See Appendix 9.3, paragraph 93.)

10.28 The evidence we have of companies' views of their options is set out in paragraphs 9.22 to 9.32. The view was succinctly summed up by the ACC at Company E who thought that a Mid Tier firm would be able to perform the company's audit. However, there was pressure for a PLC to use a Big 4 firm and that the larger the company the greater the pressure was. He thought it was very hard to move away from the Big 4 and that 'no one lost their job for appointing a top four'.

10.29 We found that it was the case that some companies felt 'safer' by engaging a Big 4 firm, and that they thought that not to choose such a firm would be to step out of line with peer companies (see further Appendix 9.3, paragraph 70).

Submissions responding to our provisional findings

GT

10.30 GT said that it had faced, and continued to face, real barriers in winning FTSE 350 audits. It said we had accurately summarized them as follows:[782]

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[780] We have not investigated the share of supply of audit outside of the FTSE 350. Oxera (2006) found that the Big 4 had approximately 80 per cent of audits of companies listed on the main market but outside of the FTSE 350.
[781] In case of doubt, we conducted no investigation and have no view of the merits of IBM.
[782] GT response to provisional findings appendix, paragraph 2.8.

- limited tenders and low-levels of switching (and limited incidence of GT being invited to participate in those few tenders that do take place);

- limited awareness by FDs and ACCs of FTSE 350 companies of the capabilities of audit firms outside the largest four firms. This issue was exacerbated by the fact that a large proportion of FDs, CFOs and ACCs were ex employees or alumni of the largest four firms;

- limited ability to point to experience of auditing FTSE 350 companies; and

- a lack of reputation, or perceived ability by those making the appointment for auditors (or on the part of those that influence that appointment). This might also be described as the 'IBM effect'.

KPMG

10.31 KPMG said that we had not demonstrated how barriers to entry or expansion (such that they exist) gave rise to an AEC.[783] It was not sufficient for us to reach an AEC finding to find that there were barriers to entry or expansion, rather we must show that these barriers have a negative impact on competition and on outcomes, which it said we had not done.[784] As a result, we did not have the evidence to conclude that if the Mid Tier were more effective that there would be a direct impact on outcomes of tender processes. It said that we had confused 'choice' and 'competition', and appeared to infer from the sole existence of alleged barriers to entry that these give rise to an AEC.[785] It said that our error may arise from a (lack of) market definition analysis.[786] We needed to consider what constraint the Mid Tier firms would impose should the Big 4 firms all worsen their competitive offer by some small amount. KPMG believed that if they did so, the Mid Tier would be able to exploit this.[787]

10.32 KPMG said that we had overemphasized the importance of reputation and experience as barriers to entry and experience.[788] It said that the lower effort that Mid Tier firms put into winning work compared with the Big 4 firms was likely to be a fundamental reason as to why they were less successful.[789] It said that we speculated that there was a 'chicken and egg' situation where Mid Tier firms were less likely to invest in targeting new clients because they did not believe they would win them. It said that any investment has an element of risk, and that there were certain clients in the FTSE 350 which would provide a useful starting point for Mid Tier firms in expanding their presence in the FTSE 350 audit market.[790]

10.33 KPMG said that we had failed to recognize the real quality differences between the Mid Tier and the Big 4 firms.[791] There were a number of FTSE 350 companies which the Mid Tier firms lack the capability to audit, as they themselves recognized.[792] AQR results were proportionately worse for the Mid Tier than the Big 4 firms.[793] Even in respect of those companies where they do believe they have the capability and do participate in tenders they are often not successful.[794] Overall, a 'virtuous circle' is not

[783] KPMG response to provisional findings, paragraph 4.1.2.
[784] ibid, paragraph 4.2.1.
[785] ibid, paragraph 4.2.2.
[786] ibid, paragraph 4.2.4.
[787] ibid, paragraphs 4.2.5 & 4.2.6.
[788] ibid, paragraph 4.1.2.
[789] ibid, paragraphs 4.3.1–4.3.3.
[790] ibid, paragraph 4.3.4.
[791] ibid, paragraph 4.1.2.
[792] ibid, paragraph 4.4.2.
[793] ibid, paragraph 4.4.3.
[794] ibid, paragraph 4.4.4.

the reason that Mid Tier firms are less successful in winning work. Rather, their market share in the FTSE 350 was a function of the existing fierce competition between the largest four audit firms, the Mid Tier's choice to invest less, resulting in weaker targeting activities; and the real differences in quality between the Big 4 and Mid Tier firms.[795]

PwC

10.34 PwC said that we had failed to acknowledge that the quality of the network may be a critical reason why Mid Tier firms were unable to gain the experience (and hence reputation) that would allow them to win more large company audit clients.[796] It said that we had failed to place sufficient weight on the fact that:[797]

(a) Despite Mid Tier firms being invited to 33 per cent of tenders and having a significant number of NAS engagements with large companies, the survey evidence indicated that Mid Tier firms make less significant efforts to target larger companies than Big 4 firms and often fail to make large companies aware of their capabilities.

(b) Although finding that 'most investors seemed to be comfortable with a larger Mid Tier audit firm auditing FTSE 250 companies', the CC ignores the survey evidence that found that if their current auditor ceased trading, 73 per cent of large companies would only consider Big 4 alternatives.

10.35 PwC supported the removal of Big 4-only clauses, but did not believe that the Mid Tier audit firms faced any other barriers to entry that we should regard as leading to an AEC.[798]

Our view of barriers to entry, expansion and selection

10.36 We found that the threat of expansion by the Mid Tier firms is not a competitive constraint on the auditors of FTSE 350 companies (which, in the large majority of cases, means one of the Big 4 firms). We think that to date Mid Tier firms have been held back by their inability to point to significant experience of auditing equivalent companies and by their lack of reputation.

10.37 We think that experience conveys reputation. The Big 4 firms have a reputation for capability in the large listed audit market which is shared by companies and City institutions alike. The tendency of City institutions to favour Big 4 audit firms for large listed clients is likely to be a factor that companies take into account when appointing auditors.

10.38 We do not think that this 'chicken and egg problem' is insurmountable. Given strategic investments to build reputation and to target appropriate FTSE 350 companies we saw no reason why Mid Tier firms could not enter the market on an incremental basis. We note that to date Mid Tier firms have not have done all that they could in order to target and win FTSE 350 engagements and were somewhat less engaged than Big 4 firms in this respect (see paragraph 9.54).

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[795] ibid, paragraph 4.4.5.
[796] PwC response to provisional findings, Annex 2, paragraph 13.
[797] ibid, Annex 2, paragraph 14.
[798] ibid, Annex 2, paragraph 15.

10.39 We considered that such investments may have not been viable for Mid Tier firms in part because tender opportunities historically have been so infrequent (on average approximately ten tenders a year). In addition, there has been no way to predict when a company is likely to put its audit out to tender, if at all. The low probability of bid opportunities arising and the difficulty of predicting when such an opportunity might arise have contributed to Mid Tier firms having little incentive to make the requisite investments in winning work.

10.40 We find that companies' requirement of relevant experience and reputation adversely affects Mid Tier firms in particular, though may also apply to Big 4 firms with regard to sectors where they are currently not active.

10.41 Taking into account each of the above, we find that Mid Tier firms face experience and reputational hurdles within the relevant market. This, together with the infrequency and unpredictability of opportunities to tender, affects the viability of and firms' incentives to make the necessary investments to overcome such hurdles. We therefore find that there is a barrier to entry, expansion and selection that is a feature of the relevant market within the meaning of section 131(2) of the Act.

10.42 We note in particular the dynamic effects of this feature: it has the effect of reinforcing current market positions, hindering the emergence of new or strengthened rivals and reduces the potential competitive constraints firms can exercise on rivals. It also weakens companies' bargaining power since companies may have a lesser range of outside options available to them. We therefore find that this feature individually or in combination with the other features we identified prevents, restricts or distorts competition within the relevant market, and as such there is an AEC in the market for the supply of statutory audit services to large companies in the UK.

11. Assessment of our second theory of harm: principal–agent issues

11.1 In paragraphs 5.6 to 5.10 we said that the carrying out of an audit aims to address one principal–agent problem (ie shareholders–managers) but introduces another (ie shareholders–auditor—see paragraph 5.40). In particular, we noted that auditors (and managers) are better informed than shareholders on the audit conducted and that managers are influential in the appointment of the auditors. Therefore, auditors may have incentives to be influenced by managers, possibly at the expense of shareholders' interests (see paragraphs 5.40 and 5.45 to 5.49). We also noted certain corporate governance and regulatory provisions, most notably the AC, supplemented by professional standards and regulatory bodies aimed to ensure that this did not happen and that auditors act in the interests of shareholders (see paragraph 5.41).

11.2 Under our second theory of harm, described in paragraphs 8.17 to 8.19, we considered features of the market related to these principal–agent issues that have the effect of restricting, preventing or distorting competition. For principal agent problems to arise, there must be both information asymmetries and misaligned interests between principal (shareholders) and agent (auditor) (see paragraph 5.7).

11.3 Accordingly, we investigated whether audit firms have incentives to direct their competitive efforts to satisfying executive management and whether the interests of executive management may differ from those of shareholders. We considered whether this would amount to a prevention, restriction or distortion of competition. We investigated whether the activity of the AC and other supervision mechanisms are sufficient to mitigate this.

11.4 We investigated whether as a result auditors are insufficiently responsive to shareholder interests and so not always sufficiently independent and sceptical (see paragraphs 7.151 to 7.189) and do not supply the information that shareholders demand. For example, whether audit reports provide shareholders with the level of disclosure or judgement that they demand. See paragraphs 7.226 to 7.264.

11.5 In the following subsections we assess:

(a) whether there are information asymmetries between auditors and shareholders (paragraph 11.7);

(b) who in practice appoints auditors (paragraph 11.8 to 11.18);

(c) whether the interests of executive management differ materially from those of shareholders (paragraphs 11.19 to 11.43);

(d) the incentives of audit firms to compete to satisfy executive management demands (paragraphs 11.44 to 11.66);

(e) whether the activities of the AC and other factors are sufficient to mitigate any misalignment of interests and keep auditors focused on the interests of shareholders (paragraphs 11.67 to 11.142); and

(f) how these principal–agent issues affect the product that shareholders receive, in particular:

(i) the concerns we identified in paragraphs 7.151 to 7.189 that audit firms on occasion were insufficiently sceptical in carrying out audits (see paragraphs 11.143 to 11.148; and

(ii) auditors not supplying the demand of shareholders for better information provided by the audit (see paragraphs 7.226 to 7.264), as discussed in paragraphs 11.149 to 11.184).

11.6 We then *(e)* discuss and set out our views as to whether principal–agent problems occur between shareholders and auditors (paragraphs 11.185 to 11.194).

Information asymmetries between auditors and shareholders

11.7 With regard to information asymmetries, we found that shareholders have only very limited information regarding the processes, conduct and review of the external audit. This appears to us to in part be due to the commercially sensitive nature of the information to which auditors must have access in order to conduct the audit (see paragraphs 5.50 to 5.52. In practice, the only information that shareholders obtain is contained in the auditors report and the AC Report. This means that shareholders cannot assess directly if auditors are performing the audit as they would wish. This compares with the auditors and company management who will have access to detailed information on the audit work undertaken (to the extent set out paragraphs 9.101 to 9.111). One of the conditions (an information asymmetry) necessary for principal–agent issues to arise is therefore present.

Who in practice appoints auditors

Role of shareholders

11.8 As a matter of law, it is the shareholders as a body that appoint or reappoint the auditor by ordinary resolution in an AGM (see paragraph 3.9). However, given their lack of information (see paragraph 11.7) we consider that shareholders are poorly placed to judge the performance of their auditors and, even where they do have a well-informed view on these matters, it may be hard in practice for shareholders to oppose the recommendations of the company's board, due to the coordination problem we identified in paragraph 5.25. We found that, in practice, shareholders almost always follow the recommendations of the board.[799]

Role of board members (in particular FDs and ACs)

Evidence

11.9 We considered the evidence provided by our survey, our case studies and our review of tender documents.

11.10 From our first survey, for FTSE 350 companies it appears that in selecting the auditor, the key individuals are the FD/CFO, the ACC and the other members of the AC. 59 per cent of FTSE 350 ACCs said that the ACC or AC were the most influential, but 16 per cent said that the FD or CFO was most influential. Of FTSE 350 FDs/CFOs, 47 per cent said that the ACC or AC was most influential, but 29 per cent said that it was the FD or CFO that was most influential.[800]

11.11 The case study evidence indicated that the external auditor recommended to shareholders by the board is generally a joint decision between the executive and non-

[799] We have not identified any instance of shareholders (as a body) not following the recommendation by the management of a FTSE 350 company to (re)appoint an auditor.
[800] See Appendix 2.2, paragraph 33.

executive management.[801,802,803,804,805] We found that executive management often had a key role in recommending a particular audit firm for the ACC and AC to approve.[806,807,808,809,810] However, in other case studies the AC position was seen as primary to any decision.[811,812,813] The case study descriptions of tender processes showed that both were involved. Other senior management and members of the finance team may also be involved including as members of the selection panel. This accords with our review of the tender process, see Appendix 9.2.

11.12 The second set of case studies indicated that tender processes were managed by executive management and staff of the companies. The role of the ACC was to ensure that the process was thorough, fair and open. The ACC would therefore typically be involved in the design of the tender process and the establishment of the evaluation criteria, as well in interviewing and helping select the bidding firms.[814]

11.13 We saw evidence that it was generally the executive management that had responsibility for fee negotiation with auditors. A typical audit process cited to us was that fees were negotiated by the CFO and signed off by the AC, and the CFO would be involved in discussions on audit scope and planning. We also found that in general the FD's role was to discuss areas of judgement regarding accounting treatment with the auditors as these arise, and to discuss any issues that had arisen in the course of the audit prior to meetings with the AC. (See paragraph 9.77).

11.14 We also saw from our case studies that the views of executive management are reported to the AC during the annual appraisal process.[815]

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[801] Appendix 2.1, Company B, paragraph 69. The whole board made the assessment (the former ACC noted that the company's board was small and this would not be a suitable approach for all companies).
[802] Appendix 2.1, Company C, paragraph 22. The Big 4 firms submitted a written proposal and presented to a selection committee comprising (approximately nine people) the ACC, CEO, CFO, Corporate Finance Director and the senior management in each of the directly affected teams. The selection committee selected two firms to make a final presentation to the AC.
[803] Appendix 2.1, Company E, paragraphs 85 & 86. Each firm had access to the company via three to four fixed meetings with management. The initial meeting was with the Group Financial Controller discussing the audit approach and issues from previous years. There was also a site visit which the FD and FC attended, where the current auditor could question [✂] managers about processes, systems and controls. The current auditor had a call with the ACC for an hour to discuss governance and there was a final meeting with the FD. The AEP thought he had as much access as he needed. The process culminated in a presentation to four people: the ACC, CEO, FD and Group Financial Controller.
[804] Appendix 2.1, Company F, paragraph 25. Four individuals at the company were involved in the selection process (the FD, CEO, ACC and GFC).
[805] Appendix 2.1, Company H, paragraph 25. EY and KPMG made presentations to the AC, the other board members and some members of the finance team at the second stage of the tender. Each gave a presentation of 2 and a half to 3 hours.
[806] Appendix 2.1, Company B: the FD made a recommendation whether to reappoint or switch auditors. Prospective firms would pitch to the FD, CEO and ACC. The ACC would be guided by the FD and the AC as to who he wanted to include in any process. The AC and ACC had to see that the process had been run on a fair, objective and independent basis. If this was the case then they would tend to allow the CFO, with the endorsement of the CEO, the final say on auditor selection (paragraphs 16, 48; see also paragraph 72).
[807] Appendix 2.1, Company C, paragraph 98. The management team gave a recommendation to the AC which had the final say.
[808] Appendix 2.1, Company D, paragraphs 15 & 91. The FD described his role in auditor selection as involved and influential, but as part of the board. The FD had a lead role in the re-tender but the decision was taken by the AC as a whole.
[809] Appendix 2.1, Company E, paragraph 18. While the ultimate decision rested with the board, via the ACC, consideration of the auditor was within the FD's remit and if there were issues with the auditor he would be the first person to be aware of them.
[810] Appendix 2.1, Company H, paragraph 67. The ACC said that he would have the final say on auditor selection but would be influenced by management's views.
[811] Appendix 2.1, Company A, paragraph 35. The AC, led by the ACC, would make recommendations to the board, for shareholder approval, on any change in auditors. In practice, this would be instigated by a recommendation from the CFO and ACC together.
[812] Appendix 2.1, Company E, paragraph 49. The ACC said that he was fully involved in decisions about the auditor. In previous roles the ACC had been through three tender processes, and in each case he had been fundamentally involved in the decision to tender and the decision to appoint the auditor.
[813] Appendix 2.1, Company F, paragraph 7. The FD was clear that the auditors reported to the AC and not to him—it was the AC that appointed the auditors and directed their work. The auditors were there to check the FD's (and his team's) work.
[814] Appendix 14.1 paragraphs 29 & 33.
[815] At Company A, an auditor effectiveness review was conducted annually, completed by both management and the AC (paragraph 60); Company C: There was a formal process leading up to the decision to recommend reappointment or not. Management took soundings about the audit experience from the business and presented a management view to the AC,

Our view

11.15 We found that the FD is responsible for managing the reporting of the company and is a respondent to the auditor in the conduct of the audit (see paragraph 9.80). Based on our case studies, we found that typically the FD took the lead in the negotiation with the AEP on the terms of engagement and would be involved in discussion of the audit scope and plan at the beginning of the audit cycle, and would be the first point of contact throughout the engagement. The AC was formally responsible for overseeing the appointment and reappointment of external auditors, monitoring the effectiveness of the external audit process and reviewing independence and objectivity of external auditors (see paragraph 9.82).

11.16 Based on our first survey results, it was apparent that many (29 per cent) FDs and CFOs saw themselves as most influential and even 16 per cent of ACCs saw FDs/CFOs as most influential in appointing or reappointing auditors.

11.17 We think therefore think that it is the preferences and perceptions of FDs and ACCs that are central to a company's assessment of its current and potential auditors (and therefore to how external auditors shape their services as they seek to retain and obtain engagements). This will include the perceptions these individuals have in relation to what is important to shareholders and other stakeholders, to the extent that they take into account the views of others as to the appointment of the external auditor.

11.18 The evidence that we have seen suggests that the influence of executive management in the auditor reappointment and selection decision varies between companies but it is generally influential and in some cases may be very influential.

Evidence and discussion regarding differences and similarities between executive management and shareholder interests

11.19 We considered in which respects the interests of executive management (ie FDs) in the conduct of an audit might differ from those of shareholders (paragraphs 11.20 to 11.43). We set out: *(a)* evidence regarding executive management interests; *(b)* evidence regarding shareholder interests; *(c)* firms' submissions; and *(d)* our view.

Executive management interests

11.20 We sought evidence regarding the interests of executive management in the conduct of the auditor. In our first survey we asked FDs how important they considered certain factors to be in the selection of auditors (and so what they looked for in the mandatory product). The findings are set out in detail in Appendix 2.2.[816] We found that for FDs (and ACCs) the factors most frequently identified as important were the experience and knowledge of the AEP, good working relationships with the audit team and the experience and knowledge of the team.

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which also had views on the audit process and how it had been communicated. It also appears that the annual reappraisal questionnaire was completed by members of the AC, the Chief Auditor, General Counsel and regional senior management (paragraphs 25 & 101); Company D: The company reviewed the current auditor's performance on an annual basis. The company issued questionnaires to the finance teams of each individual business and each divisional team. These were relatively detailed, focusing on how the audit was performed and whether it was efficient etc. The FD also conducted an informal assessment based on his observations at the Group head office throughout the year. His reports to the AC included his observations of the audit and its effectiveness (paragraph 92); Company E: There was no formal evaluation of the auditors' performance on an annual basis, but there were informal discussions at all levels of the business. The FD would ask the finance team how the audit team performed and whether they covered all the issues. The ACC would ask the FD how his team had interfaced with the auditors (paragraph 19).

[816] Appendix 2.2, paragraphs 37–39.

11.21 From our case study interviews, it appeared to us that both FDs and ACCs were strongly incentivized to avoid restatements of company accounts (for the reasons given in paragraph 3.22),[817,818] and this would reinforce their interest in a competent audit, since it would reduce the risk of needing to restate.

11.22 FDs are responsible for producing their company's financial statements and are respondents to the auditor in the conduct of the audit (see paragraphs 9.77 to 9.80). As such we consider that FDs are likely to be the individuals who at board level will be accountable for these statements. FDs are therefore likely to have views on matters raised by the auditors and, if their judgement is challenged, to want to defend their position.

11.23 We also note that listed companies are under pressure to meet market expectations of financial performance. It has long been recognized that executive management in general and the FD in particular are likely, from time to time, to have strong incentives to manage reported financial performance to accord with expectations and to portray performance in an unduly favourable light.

11.24 This was a view underpinning the Cadbury Report:[819] 'Companies too are subject to competitive pressures. They will wish to minimize their audit costs and they are likely to have a clear view as to the figures they wish to see published, in order to meet the expectations of their shareholders' (paragraph 5.3*(d)*) and 'the underlying factors were seen as ... competitive pressures both on companies and on auditors which made it difficult for auditors to stand up to demanding boards' (paragraph 2.1).

11.25 The role of audit in light of such pressures was recognized in our case studies. As the Company C FD stated:

> The value in an audit was not in the auditor finding points or arguing with management but that an audit kept people on the straight and narrow and was absolutely indispensible to the integrity of the published accounts, *given the temptations and pressures to produce accounts that presented a company in the most favourable light*.[820] [Our emphasis]

11.26 The AEP for Company A also noted the issue of management incentives to manage financial reporting:

> Auditors needed to understand how a set of numbers were put together and what motivated the team who produced them. The auditor needed to understand this so he knew where the management team might have placed their cards in terms of the range of possible answers ie whether they had taken an aggressive or conservative approach.[821]

11.27 Further, Blackrock expected auditors to provide a strong element of objectivity although it understood that a set of accounts was never wholly objective (as the application of some accounting policies was subjective). The auditors were there as a

[817] Appendix 2.1, Company A, paragraph 69. From the AC's perspective the focus was about quality and getting it (the audit) right, because another restatement in this business would be disastrous.
[818] Appendix 2.1, Company H, paragraphs 42 & 43. Restatements were embarrassing and if they happened regularly would raise issues about auditor quality.
[819] www.icaew.com/~/media/Files/Library/subjects/corporate governance/financial aspects of corporate governance.pdf, paragraph 5.3(b).
[820] Appendix 2.1, Company C, paragraph 40.
[821] Appendix 2.1, Company A, paragraph 88.

'counter-weight' to the subjectivity, and sometimes creativity, that management might seek to apply.[822]

11.28 We note the evidence in paragraphs 11.145 to 11.147 (directly concerned with the effectiveness of AC's and auditor independence from executive management) also indicates a concern that FDs have interests that may diverge from those of shareholders. One investor [✄] suggested this resulted in slightly more aggressive accounting practices, a lack of transparency in accounting assumptions, and a lack of colour regarding how accounts were put together (see further detail in paragraph 11.145).[823]

Shareholder interests

11.29 We set out in paragraphs 5.9 and 5.10 how we perceived shareholders' interests, namely to have reliable financial information about the company, so that they can accurately appraise its performance and that of its managers and so take well-informed decisions. We note that the evidence in Section 7 regarding both scepticism and unmet demand indicates that shareholder interests differ from those of executive management (see paragraphs 7.151 to 7.189 and 7.226 to 7.264).

11.30 In considering what an 'ideal world audit' might provide, BlackRock considered that, as today, a 'true and fair' view was what it would look for. It did not consider that all fraud could be detected through even the very best audit processes. Further information that BlackRock would have liked to see was an explanation of the differences between the Cash Flow and Income Statements. A discussion of the areas that management and the AC had debated most would also be helpful.[824]

Firm submissions on differences in interests

Deloitte

11.31 Deloitte stated that the evidence showed that management and investors highly valued a wide range of facets of audit quality including both technical and service quality, and that there was therefore no misalignment of incentives as between management and investors as to the delivery of audit quality.[825]

11.32 In response to our provisional findings, Deloitte said that its experience was that the incentives of auditors, company directors and shareholders were broadly aligned, and that the UK's well-regarded corporate governance structure operated to ensure that this continues to be the case. There were already a number of significant checks and balances within the UK Corporate Governance Code and Stewardship Code and the FRC has sought to strengthen these even further with the reforms in 2012.[826] It said that our analysis appeared to be based to a large extent on theory rather than practice or evidence. Several key building blocks in the provisional findings analysis were either unevidenced or were not supported by the available evidence.[827]

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[822] www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/case_study_company_blackrock.pdf, paragraph 30.
[823] Appendix 7.11, paragraph 90(b).
[824] www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/case_study_company_blackrock.pdf, paragraph 32.
[825] Deloitte response to working paper 'The framework for the CC's assessment and revised theories of harm', paragraph 2.10.
[826] Deloitte response to provisional findings, paragraphs 4.1.
[827] ibid, paragraphs 4.2.

EY

11.33 EY said that our provisional findings levelled criticism, without any evidential basis against FDs, who were characterized as self-interested individuals who seek to influence auditor appointment and auditor conduct to meet their own requirements and act in such a way as to undermine the independence of auditors.[828] It said that the unsubstantiated criticisms directed at executive management (and others) were unwarranted and unsupported by the evidence, based on an incomplete and prejudicial analysis of the corporate governance regime, and were not constructive additions to important ongoing debate on these issues in other fora.[829]

KPMG

11.34 KPMG stated that there was in general the potential for a misalignment between management and shareholder objectives: indeed this potential provided the underlying rationale for the statutory audit requirement.[830] However, given the requirement for an audit, KPMG said it was not clear from the evidence that any misalignment in the interests of managers and shareholders as regard the provision of that service existed in practice, and in any case the UK corporate governance regime was designed to mitigate the risks of any such misalignment.[831]

11.35 In response to our provisional findings, it said that we had confused or conflated the relationship between the board, executive management, AC/ACCs and shareholders. We had overlooked and in places ignored the fact that auditors are appointed by shareholders on a proposal from the board itself based on a recommendation from the AC.[832] It said that we had also not fully appreciated the role that NEDs play in the governance of FTSE 350 companies. The UK Corporate Governance Code requires FTSE 350 companies to have NEDs constituting at least half of all board members. Under the Code, the main purpose of NEDs is to provide independence and challenge to ensure that boards do represent shareholders' interests.[833]

PwC

11.36 PwC stated that there was potential for principal–agent issues to arise as between management and shareholders but that this was precisely the reason why audits existed, why ACs had been introduced and why their role had developed over time. PwC went on to explain that, for such a misalignment to exist, this would mean that ACs were failing to perform the principal tasks entrusted to them by law and regulation and were acting contrary to their obligations and integrity as professionals, but that no evidence existed to demonstrate this.[834] PwC also stated that ACCs and FDs were engaged with the audit process and acted in accordance with their duties to the company and shareholders, and placed value on the quality, objectivity, and independence of the external audit above other characteristics.[835]

11.37 In response to our provisional findings, PwC said that both management and shareholders had complementary demands in ensuring that the audit was performed

[828] EY response to provisional findings, Annex 1, paragraph 6.4(a).
[829] ibid, Annex 1, paragraph 6.6.
[830] KPMG response to working paper 'The framework of the CC's assessment and revised theories of harm', paragraph 3.5.4.
[831] ibid, paragraph 3.5.4.
[832] KPMG response to provisional findings, paragraph 5.1.2.
[833] ibid, paragraph 5.1.3.
[834] PwC response to working paper 'The framework for the CC's assessment and revised theories of harm', paragraph 7(b)(vi).
[835] ibid, Annex, p11, a ii) and iii).

efficiently and was of sufficient quality; that the company's financial information was a true and fair refection; and that this was recognized by the wider capital markets.[836]

Our view on differences between executive management and shareholder interests

11.38 KPMG and PwC accepted (at least in principle) the potential for a misalignment in the interests of executive management and shareholders in the conduct of an audit. They argued, however, that this concern was addressed by the wider regulatory framework (see paragraphs 11.34 to 11.37). KPMG also said that we had failed to take sufficient account of the role of NEDs (see paragraph 11.35).

11.39 Whilst we accept that formally auditors are appointed by shareholders on the recommendation of the board, we have found that, in practice, the appointment of the auditors is principally the responsibility of the FD and AC (see paragraph 11.8), and that it is for the AC to represent the interests of shareholders in the conduct of the audit (see paragraph 9.83). During our case studies, FDs, ACCs and even the AEPs that we interviewed made frequent reference to the role of the AC with respect to the conduct of the audit, but not of other NEDs.

11.40 In assessing the interests of executive management we focus on those of the FD as the evidence indicates that within the executive management team it is the FD that has responsibility for the management of the audit engagement. The evidence is that other senior management may be involved on occasions (for example as a member of the selection panel in tender process), but that it is the FD that has regular contact with the external auditor (see paragraph 11.13 above).

11.41 We think that in many respects FDs and shareholders' interests align, but that shareholders may have greater interests in the objectivity and independence of the audit, and in greater levels of transparency and reporting than management.

11.42 We consider it uncontroversial that FDs will have views on the accounting practices and treatments adopted in the preparation of a company's audited accounts. We also consider that FDs cannot be expected to be entirely objective in exercising their judgement as they will have a personal perspective on matters raised by the auditor.

11.43 Given our analysis in paragraphs 5.6 to 5.10 and the submissions and evidence in paragraphs 11.20 to 11.28, we also think that executive management may at times have incentives to encourage the external auditor to accept treatments and judgements that portray the company in a favourable light. Accordingly, our view is that executive management interests in relation to the audit delivered may materially differ from those of shareholders.

The incentives of audit firms to compete to satisfy executive management demands

11.44 In this subsection we consider:

(a) the incentives for auditors to accommodate executive management interests (paragraphs 11.45 to 11.56);

(b) submissions responding to our provisional findings (paragraphs 11.57 to 11.61); and

[836] PwC response to provisional findings, Annex 2, paragraph 16(a).

(c) set out our views on the demand that auditors are competing to satisfy in the supply of audit services (paragraphs 11.62 to 11.66).

The incentives of auditors to satisfy executive management demand (ie the FD and his/her staff)

11.45 In this section we consider the incentives of auditors which could encourage them to identify with, or accommodate, the accounting judgements and treatments and disclosures favoured by executive management, possibly at the expense of the interests of shareholders (as expressed by the AC or judged by the auditor). We consider in turn:

(a) the importance of the auditor relationship with the FD and his staff;

(b) the significance of fees on individual audit engagements to the fees of the audit firm; and

(c) AEP incentives.

The importance of the auditor's relationship with the FD and his staff

11.46 We note in paragraphs 7.159 to 7.160 the efforts that firms expend in maintaining good relationships with company management, including executive management. From our case studies, it was apparent that all AEPs saw it as a part of their role to maintain good relationships with FDs. We also note firms' submissions in paragraphs 9.188 to 9.191 (in the context of continuity benefits). At times there may be a tension between maintaining a good relationship and applying appropriate scepticism.

11.47 In our first survey (see paragraph 9.102) we found that most companies regularly carry out reviews of audit performance (internal or with their auditors) based, in general, on staff opinions drawn from their interaction with auditors. In addition we found that firms also carry out detailed annual reviews of their own performance with audit clients, to ensure that the companies are satisfied with the service they receive (see, for example, paragraphs 9.246 and 9.247).

11.48 The FRC stated in a 2010 paper on auditor scepticism:[837]

> Audit firms place considerable importance on retaining their client base. Emphasis on client service planning and relationship management within the firms may act as a disincentive for auditor scepticism if audit teams believe that by demonstrating scepticism they risk having an 'unhappy client'.

Significance of individual engagements

11.49 In Section 7 we considered firms' financial interests in audit engagements (paragraphs 7.94 to 7.99). Firms' incentives to obtain and retain engagements were also discussed in detail in Section 9.[838] In particular, firms have financial incentives to win and retain FTSE 350 audit engagements because they are profitable in themselves, may enhance the prospect of winning audit-related and non-audit work from the

[837] FRC discussion paper, 'Auditor Scepticism: Raising the Bar', August 2010, paragraph 27.
[838] Paragraphs 9.36–9.63 and 9.256–9.270.

same company, and because obtaining and retaining audit engagements will enhance a firm's ability to win further audit engagements.

11.50 We note that the financial significance of any one engagement to a firm varies. While we have encountered some difficulties in establishing engagement-level profitability (see Appendix 7.3), it can at least in principle be calculated. We think that the more important a client is to any firm, the greater the financial incentive on the firm to retain the engagement. As audit engagements are generally lengthy (paragraphs 7.13 to 7.16) and the relationships with FDs are important and in part built around trust, audit firms have incentives not to damage these relationships.

11.51 Regulation provides that total fees for both audit and NAS receivable from a listed company by the audit firm may not regularly exceed 10 per cent of the annual fee income of the audit firm, and must consider appropriate safeguards to eliminate or reduce the threat to the auditor's objectivity and independence where the proportion is 5 and 10 per cent for a listed company (Appendix 3.1, paragraph 126). We have estimated the proportion of revenues accounted for by the five largest engagements of the six largest firms.

TABLE 11.1 **Financial significance of the five largest FTSE 350 UK audit fees for each audit firm (UK element of the group audit fee as a proportion of total firm revenue)**

per cent

BDO		*Deloitte*		*EY*		*GT*		*KPMG*		*PwC*	
Randgold Resources	[✂]	RBS	[✂]	BP	[✂]	Sports Direct	[✂]	HSBC	[✂]	Lloyds Banking Group	[✂]
Bwin.Party Digital Entertainment	[✂]	WPP	[✂]	Aviva	[✂]	Perform Group	[✂]	Prudential	[✂]	Barclays	[✂]
Derwent London (DL)	[✂]	Balfour Beatty	[✂]	Resolution	[✂]	Fidelity China Special Situations	[✂]	BAE Systems	[✂]	Royal Dutch Shell	[✂]
RPS Group	[✂]	BSkyB	[✂]	British Airways	[✂]	Anglo Pacific	[✂]	Standard Chartered	[✂]	GSK	[✂]
London & Stamford Property Plc	[✂]	Anglo American	[✂]	Investec	[✂]	Fidelity Special Values	[✂]	Old Mutual	[✂]	BT Group	[✂]

Source: CC analysis.

11.52 Table 11.2 presents the same information in the context of the firms' Assurance businesses, as opposed to the overall revenues.

TABLE 11.2 **Financial significance of the five largest FTSE 350 UK audit fees for each audit firm (UK element of the group audit fee as a proportion of total assurance revenue)**

BDO		*Deloitte*		*EY*		*GT*		*KPMG*		*PwC*	
Randgold Resources	[✂]	RBS	[✂]	BP	[✂]	Sports Direct	[✂]	HSBC	[✂]	Lloyds Banking Group	[✂]
Bwin.Party Digital Entertainment	[✂]	WPP	[✂]	Aviva	[✂]	Perform Group	[✂]	Prudential	[✂]	Barclays	[✂]
Derwent London (DL)	[✂]	Balfour Beatty	[✂]	Resolution	[✂]	Fidelity China Special Situations	[✂]	BAE Systems	[✂]	Royal Dutch Shell	[✂]
RPS Group	[✂]	BSkyB	[✂]	British Airways	[✂]	Anglo Pacific	[✂]	Standard Chartered	[✂]	GSK	[✂]
London & Stamford Property Plc	[✂]	Anglo American	[✂]	Investec	[✂]	Fidelity Special Values	[✂]	Old Mutual	[✂]	BT Group	[✂]

Source: CC analysis.

11.53 We consider that an assessment based on the audit fees earned will understate the importance of individual audit engagements to an audit firm. The firms concerned are audit firms: conducting audits is their core business. They use their share of audit engagements to measure their performance against their rival audit firms (see Appendix 7.8, paragraphs [✂], 85, 194, 195 and 238). The loss of a FTSE 350 engagement would result in a loss of market share and create an opportunity for a rival firm to grow market share. Given the importance of demonstrable expertise and experience retaining a client (or a rival gaining a client) can have wider strategic value (see paragraphs 9.60 to 9.63). The importance of a client in a particular sector may therefore be a better measure of its value to the firm.

AEP incentives

11.54 We considered the incentives of individual AEPs, and the pressures on them to retain clients. Each firm has a different structure for the remuneration of its partners which may consist of a combination of the level of their equity contribution, role, experience and personal performance.[839] The proportion of distributable profit which is allocated as performance-related pay varies by firm and over time (both as a result of each firm's remuneration policy and the overall level of distributable profit).

11.55 Of the firms which gave us their structure of partner remuneration, the performance-related element ranged from 10 to 100[840] per cent of distributable profits.[841] All of the firms stated that achieving a certain level of fee income was not a universal requirement. However, our review of partner performance frameworks indicated that all included scope for the financial performance of a partner's engagements to be included as an objective. Some firms provided example partner objectives which included a level of target revenue. Some objectives included references to maintaining an audit client during potential trigger points.

11.56 Our review suggests that the firms use a balanced scorecard approach that assesses a partner's performance in a number of categories. The loss of an audit client would

[839] Not all partners within a firm will necessarily receive a performance-related award.
[840] [✂]
[841] We understand from submissions from parties that this is a notional allocation of distributable profits and the base pay element does not necessarily relate to the economic value of a partner's labour.

appear therefore potentially to affect the level of an individual partner's remuneration. However, the effect of this on a partner's remuneration appears to vary significantly by firm. A poor partner performance score could lead to a partner being reallocated to a different role profile which would affect their remuneration.

Submissions responding to our provisional findings

BDO

11.57 BDO said that the issue of auditors' representation of shareholders' interests was more nuanced than some respondents to our provisional findings may suggest. In its view, the key question was whether shareholders could be confident that the current auditors act in the best interests of shareholders, not necessarily whether such auditors had actually acted or would act in pursuit of other interests. If the status quo did not deliver the requisite level of assurance to shareholders, then both companies and auditors needed to be seen to be taking steps to rectify this.[842]

GT

11.58 GT concurred with our finding that the incentives of audit firms are often misaligned with those of shareholders. This had occurred over time as the audit model had evolved to the current situation where auditors spend most of their time communicating with FDs/CFOs, some time with ACCs and no time with shareholders.[843] GT said that the auditor was inevitably motivated by a desire to meet the demands of FDs/CFOs who are instrumental in auditor appointment decisions.[844]

KPMG

11.59 In terms of auditor appointment, KPMG noted that while the FD is influential, auditors are appointed by shareholders on a proposal from the board itself based on a recommendation from the AC.[845] It said our survey evidence showed that the AC and ACCs and not FDs were most frequently cited as the most influential in selecting the audit firm.[846] Our case studies contradicted our assertion that the FD's role was central.[847] Further, a 2011 survey by Beattie found that the CFO had lost power over the auditor and this power had transferred to the ACC. KPMG said that this was consistent with its experience and other evidence before us.[848] It said that we had not presented any evidence to suggest that there were instances where the AC or ACC held a view on auditor reappointment or tender which did not prevail and it suspected that such instances are either non-existent or very rare.[849]

11.60 With regard to audit firms' incentives to maintain good working relationships with executive management, KPMG said that this was part of the service aspect of an audit which constituted the 'third limb' of audit quality. It must be handled efficiently to avoid additional cost and delay and support an effective audit process.[850] Good

[842] BDO response to provisional findings, point 4.
[843] GT response to provisional findings, Appendix, paragraph 2.11.
[844] ibid, Appendix, paragraph 2.11.
[845] KPMG response to provisional findings, paragraphs 5.4.2.1.
[846] ibid, paragraphs 5.4.2.2.
[847] ibid, paragraphs 5.4.2.2.
[848] ibid, paragraphs 5.4.2.3.
[849] ibid, paragraphs 5.4.2.4.
[850] ibid, paragraph 5.4.3.3.

relationships between firms and management also allowed audits to provide management with an insight into the functioning of the company.[851]

PwC

11.61 Responding to our provisional findings, PwC said that our approach was flawed by false certainty.[852] It was wrong to characterize management and shareholder demand as two distinct, easily separable and competing demands; then to analyse the relative incentives for audit firms to respond to each set of demands in a binary way; thereby reaching the conclusion that because executive management is influential in the appointment and retention of auditors, those audit firms must be—and therefore are—incentivized to respond to management rather than shareholder demands, such that competition is distorted as firms are competing on the wrong parameters. PwC said that this flawed underlying assumption had led us to *(a)* mischaracterize how auditors perform their role; and *(b)* fail to acknowledge the paramount duty that auditors owe to the company in the interests of shareholders.[853]

Discussion and our view on the demand that auditors are competing to satisfy

11.62 Audit firms have strong incentives to compete for and win audit engagements, in general and within specific segments. Firms' audit incomes depend on the retention of audit engagements. Fees earned from individual audits as a percentage of firm revenues is an incomplete measure of their significance as it does not reflect the strategic importance of engagements, such as the ability to demonstrate experience and capability and to retain and develop sector expertise (see further paragraphs 9.60 to 9.63). We think that individual AEPs are likely to have even stronger incentives than the audit firm not to lose a client.

11.63 We think that, in practice, executive management and ACs take responsibility for decisions relating to the appointment and reappointment of the auditors (see paragraphs 11.15 to 11.18), and that FDs are influential in such decisions including whether to reappoint an auditor for the following year's engagement. In particular, the evidence indicates that the FD role requires a detailed knowledge of the work undertaken by the existing auditor (see paragraph 9.100), and that FDs will be involved in the regular reviews conducted by companies of the incumbent auditor's performance (also paragraph 9.100). While the evidence indicates that the tender process is managed by the FD and his team (see paragraph 9.272 to 9.287]) we accept that their influence will be reduced by the involvement of other senior management and rigour of the process (see paragraphs 9.274, 9.280).

11.64 We consider that this provides incumbent firms and the in-post AEPs with incentives to respond to the demands of FDs whose interests on occasions may not be fully aligned with those of shareholders. This was recognized by the FRC in 2010 (see paragraph 11.48) for reasons unaffected by developments in regulation since then.

11.65 We agree with PwC that it would be wrong to characterize the interests of executive management and shareholders as distinct and competing and accept that those interests overlap, but we do not think that they are identical and may be materially different (see paragraph 11.61). We also agree that ACs have an important and influential role in the appointment and reappointment of auditors.

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851 ibid, paragraph 5.4.3.4.
852 PwC response to provisional findings, paragraph 2.4.
853 ibid, paragraph 2.5.

11.66 We also accept KPMG's point that auditors need an effective relationship with executive management (its 'third limb'). However, given the incentives for audit firms to be responsive to FDs and that FDs' interests are not always well-aligned with shareholders' interests, we consider a key question for our second theory of harm is whether the activities of the AC and other factors are sufficient to ensure that firms' interests are well aligned with those of shareholders and to give shareholders the confidence that firms act in their interests. We consider this issue in the following sub-section.

Whether the activities of the AC and other factors are sufficient to align the interests of auditors and shareholders

11.67 To set against factors that might provide incentives for firms and AEPs to identify closely with executive management (see paragraphs 11.44 to 11.56), we also considered factors relevant to incentives of firms and individual AEP to maintain their reputation for quality and independence.

11.68 We considered: *(a)* the effectiveness of ACs in representing shareholder interests, *(b)* the importance of reputation to firms; *(c)* firms' engagement acceptance criteria; *(d)* their internal efforts to maintain quality; and *(e)* the effect of regulatory supervision.

AC effectiveness in representing shareholder interests

Introduction

11.69 Article 41.1 of the Audit Directive[854] requires every PIE to have an AC, which has at least four functions: *(a)* to monitor the financial reporting process; *(b)* to monitor the effectiveness of the company's internal control, internal audit where applicable, and risk management systems; *(c)* to monitor the statutory audit of the annual and consolidated accounts; and (*d)* to review and monitor the independence of the statutory auditor or audit firm, and in particular the provision of additional services to the audited entity.

11.70 The AC is made up of independent NEDs, at least one of whom must have recent and relevant financial experience, and is a committee of the board, like other committees to which particular responsibilities are delegated (such as the remuneration committee). The principle of the unitary board is maintained, ie all directors remain equally responsible for the company's affairs as a matter of law. Any disagreement within the board, including disagreement between the AC members and the rest of the board, should be resolved at board level.[855] ACCs are appointed by the board on the recommendation of the nomination committee, as are other members of the AC in consultation with the ACC. Shareholder approval would be required for an appointment of new NEDs.

11.71 ACs have a duty to ensure, on behalf of the board, that the interests of shareholders are properly protected in relation to financial reporting, and in paragraphs 9.82 to 9.87 we identified the role of ACs as being designed to ensure that auditors act in the interests of shareholders. Accordingly we consider:

(a) evidence of AC and ACC effectiveness (paragraphs 11.73 to 11.84);

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[854] Council Directive (2006/43/EC) on statutory audits of annual accounts and consolidated accounts [2006] OJ L157/87, Article 41.
[855] See the FRC's Guidance on Audit Committees, September 2012, paragraph 1.4.

(b) ACCs' incentives (paragraphs 11.85 to 11.87); and

(c) firms' submissions on AC effectiveness and ACCs' incentives (paragraphs 11.88 to 11.105).

11.72 We then *(d)* set out our view (paragraphs 11.106 to 11.113).

Evidence of AC and ACC effectiveness

11.73 ACs and their ACCs are not subject to external supervision, although companies and ACs should carry out effectiveness reviews annually.[856] There are several factors that make it difficult to measure the effectiveness of the AC. Notably the visibility of AC activity to third parties (such as shareholders) is low and much of it takes place behind closed doors in informal interactions with the auditor and executive management.

11.74 We set out evidence regarding ACCs' ability to appraise their incumbent auditor in paragraphs 9.67 to 9.115. In this subsection we consider evidence from *(a)* the FRC; *(b)* our follow up survey; *(c)* case studies; *(d)* investors; and *(e)* academic research regarding the effectiveness of ACs in ensuring that shareholders interests are protected.

- *FRC*

11.75 The FRC told us that in its experience the standard of corporate governance varied significantly from company to company. It considered that the level of resources devoted to corporate governance within companies declined further down the FTSE index.[857]

11.76 We note the findings of the AQR team, and its most recent report, as summarized in paragraphs 7.166 to 7.170. We think that its findings which raise concerns with an audit may be taken to suggest that the respective AC has not been uniformly effective.

- *Survey evidence*

11.77 Results from our follow-up survey of FTSE 350 ACCs indicated that in general ACCs felt confident or very confident that they could assess various aspects related to the audit (such as the robustness and perceptions of auditors in handling key judgements on accounting policies). When we asked ACCs how confident they were that substantive audit work had been carried out to a satisfactory standard, 4 per cent indicated they were not very confident and 1 per cent indicated they were not confident at all. This translates into 4 out of 71 respondents that were less than quite confident. Further, 1 per cent said that they did not know and 1 per cent said that the area was not applicable. ACC responses also suggested that detailed work of the auditor may be less visible to ACs. In particular 18 per cent of ACCs said that they were less than quite confident that the sample sizes were appropriate. Further, 8 per cent indicated that they did not know and 13 per cent said that the area was not applicable.[858]

[856] Corporate Governance Code, section B; FRC's Guidance on Audit Committees, paragraph 3.3.
[857] Summary of hearing with the FRC held on 26 October 2012, paragraph 8.
[858] See responses to the CC follow-up survey of FTSE 350 ACCs, question D1.

11.78 The follow-up survey also suggested that on occasion the ACs act independently of executive management in their review of the external financial reporting and auditing. In particular, the evidence suggests that ACCs requested the provision of supplementary information from time to time (52 per cent of those surveyed had done so in the last three to five years) and have been able to engage additional resources independent of the company when they have considered this to be necessary (24 per cent of those surveyed had done so in the last three to five years).[859] We found that 77 per cent of ACCs spend two days a month or less on their duties.[860] The results are discussed in more detail in paragraph 9.89 to 9.91 and Appendix 2.3.

- *Case studies*

11.79 The ACCs that we spoke to during our case studies saw their role as maintaining financial controls and looking after the interests of shareholders, but there appeared to be differences in how they discharged this role.[861] For example, we were told by some that the ACC would want to understand what issues the auditors had found and should have a very good understanding of the audit process and the key judgements made.

11.80 We were told by others that it was difficult for an AC to examine in detail the work that the auditors had undertaken and that it was not its role to do so. Examples from our case studies illustrate the practical limitations some ACs face in examining their auditor's work:

(a) At Company B the ACC had little visibility of what happened during the actual auditing process. The ACC wanted to understand what issues the auditors had found and what decisions the AEP wanted the AC to take if there were to be any adjustments to the accounts prepared by management (paragraph 54).

(b) At Company C the ACC could not know if the auditor was doing a poor job unless management raised an issue or something came to light after the event (paragraph 73), although other comments suggested that s/he did have good visibility of the audit process (paragraph 50).[862]

- *Investors*

11.81 PwC's interviews with investment professionals in a number of countries, including the UK, indicated that investors thought that ACs were not sufficiently independent of management, with 39 per cent of respondents disagreeing that ACs were sufficiently independent of management.[863]

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[859] ibid, questions C5 & C8.
[860] See Appendix 2.3, Table 4.
[861] For example, the Company B ACC did not view the role of auditors as protecting shareholders from management. She saw the auditors' role as to ensure that the accounts gave a true and fair view of the company's trading position and balance sheet (paragraph 39); the Company C ACC saw his role as to see that the company was well run and controlled. He was there to represent shareholders and other stakeholders (paragraph 56); the Company D ACC saw her role on behalf of the shareholders to make sure that management was managing the business and that the results were credible and reliable. The AC's role was to address any issues that were raised as a result of the audit process and to act as a safeguard between the management and the shareholders to help the shareholders to have some confidence that the numbers were true and fair (paragraph 57); the Company G ACC saw part of his role as to protect the auditor on big judgemental issues. He needed to ensure that the auditor was not being hit too much on fee. It was important to have a relationship with the auditors that was based on trust. He said in any constructive relationship there would be disagreements and the auditors could do a better job if supported by the AC (paragraph 57); the Company H ACC said that the AC needed to ensure that the relevant standards were applied and that the auditors were satisfied with the final decisions (paragraph 64).
[862] As pointed out by KPMG in its response to provisional findings, paragraphs 5.3.6.7.
[863] PwC 'Assurance Today and Tomorrow' Global Investor Survey 2012.

11.82 We noted that despite the presence of the AC, some investors were concerned about auditor independence. There is similar evidence on this point from the Oxera survey on behalf of BDO and GT (see paragraphs 11.145 to 11.147).

- *Academic research*

11.83 AC effectiveness is a subject that has been considered in the academic research, although there are relatively few recent UK studies. Relevant studies include Song & Windram[864] (2004) which noted a significant shift in AC function from one of traditional financial reporting to a greater focus on internal controls and risk management. The study notes lack of time, pressure from executive directors, and an unclear remit as impediments to the effectiveness of the AC. Spira[865] (2003) questions the potency of the AC against a backdrop of ambiguity and complexity surrounding the AC role. Turley & Zaman[866] (2007) note that AC effectiveness is very difficult to measure and that qualitative research approaches are 'nearly impossible' to operationalize due to access and sensitivity concerns. Other studies, such as Spira (2002)[867] and Zaman and Collier (2005)[868] express reservations about the AC's ability to discharge enhanced responsibilities post Cadbury.

11.84 Beattie (2012)[869] in a study of AC and ACC engagement in audit-related matters in UK-listed companies in the 2007 regulatory environment finds less than full engagement. The regulatory environment when the article was published was said to be fundamentally unchanged from that in 2007. The study notes the following key relevant policy findings: relatively low priority of engagement with risk; incomplete engagement by ACs with key audit-related issues; varying patterns of engagement based on company size, audit firm size and AC composition, and a relatively high level of engagement by the CFO with audit fees and NAS.[870] We consider that this more recent study confirms the concerns highlighted in the studies mentioned above have not been remedied by changes in the regulatory environment since publication of some the papers.

ACC incentives

11.85 We also considered the evidence on the incentives of individual ACCs to be effective.

11.86 The key incentive we identified for ACCs to be effective was professional pride and reputation. In three of the case study companies the ACCs expressed a view that the incentive of the ACC to do a thorough job was the effect on their professional reputations.[871] Another ACC thought that individuals did not accept the role of ACC with remuneration in mind (as it was not linked to the amount of time actually needed).[872] ACCs also stated that they saw their role as acting on behalf of shareholders.[873]

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[864] Song, J and Windram, B, 'Benchmarking Audit Committee Effectiveness in Financial Reporting', *International Journal of Auditing*, Vol 8, No 3, pp195–205, November 2004. Available at SSRN: http://ssrn.com/abstract=605160.
[865] Spira, L F, 'Audit Committees: Begging the Question?' *Corporate Governance: An international Review* 11(3), pp180–188.
[866] Turley, S and Zaman, M, 'Audit Committee Effectiveness: Informal Processes and Behavioural Effects', *Accounting, Auditing & Accountability Journal*, 20(5), pp765–788.
[867] Spira L F, *The Audit Committee: Performing Corporate Governance*, Boston, MA: Kluwer Academic Publishers.
[868] Zaman M and Collier P (2005), Convergence in European Corporate Governance: The audit committee concept', *Corporate Governance: An International Review*, 13(6) 753–768.
[869] Beattie, V, Fearnley, S, and Hines, T (2012) 'Do UK audit committees really engage with auditors on audit planning and performance?' *Accounting and Business Research*, 42 (3) pp349–375. ISSN 0001-4788.
[870] The author confirmed that the results for FTSE 350 companies were similar to those for all UK-listed companies.
[871] Appendix 2.1, Company E, paragraph 48; Case Study G, paragraph 51; Case Study I, paragraph 44.
[872] Appendix 2.1, Company C, paragraph 54.
[873] Appendix 2.1, Company D, paragraph 57; Company F, paragraph 48.

11.87 We asked firms for examples of the ACC suffering adverse consequences (whether loss of role or other) where financial statements were restated due to error. We accept that they may have limited visibility of such issues, although generally we found that the Big 4 firms were well-informed regarding the corporate governance of FTSE 350 companies. BDO, Deloitte, EY, GT and PwC were not aware of this happening, although PwC identified three instances of an ACC being changed or resigning. KPMG identified four instances of ACCs leaving the position early, fairly or unfairly, and cited adverse consequences.[874]

Firm submissions on AC and ACC effectiveness and incentives

11.88 We considered the submissions that firms made regarding the effectiveness and incentives of ACs and ACCs.

- *Deloitte*

11.89 Deloitte stated that FDs took seriously their fiduciary duties to act in the best interests of the owners of the company.[875]

- *EY*

11.90 EY considered that criticisms of AC and ACCs that it said were levelled in our provisional findings were unsubstantiated, as it did those that it said we levelled against FDs: see paragraph 11.33.

- *GT*

11.91 GT did not believe that our provisional findings were a criticism of auditors or an understatement of a strong corporate governance regime in the UK, more an observation of how the audit role had evolved and the difficulties shareholders have in understanding how the auditor and the AC have been discharging their responsibilities to them.[876]

- *KPMG*

11.92 KPMG noted that there were a number of other factors which governed audit firms' incentives as well as any role of management in the context in which an audit firm was (re)appointed; for example, the effect on reputation of adverse regulator findings. This ensured that audit firms acted in line with shareholder interests and conducted an audit of high technical quality, regardless of any misalignment of incentives.[877] KPMG also said that ultimate responsibility for the selection of the auditor rested with the AC, not management.[878]

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[874] The examples KPMG gave were: Enron Inc, where the ACC's reputation suffered considerably due to his position as ACC during the well-documented fraud by some of the company's executive directors. This was despite a previous distinguished parliamentary and business career; RBS plc, where the ACC came under significant and widespread criticism at the time of the Government rescue of the bank following the controversial acquisition of ABN Amro. This was part of some more widespread governance issues highlighted at RBS; the ACC at the time of Northern Rock Plc's collapse and Government rescue, despite his previous outstanding reputation in business and Government, never received another appointment before his death in 2012; HBOS plc—the ACC at the time of its forced acquisition by Lloyds had no new appointments since 2009:

[875] Deloitte response to working paper 'The framework for the CC's assessment and revised theories of harm', paragraph 2.31.

[876] GT response to provisional findings, Appendix, paragraph 2.13.

[877] KPMG response to working paper 'The framework of the CC's assessment and revised theories of harm', paragraph 3.5.6.

[878] ibid, paragraph 3.5.7.

11.93 KPMG stated that the AC's interests were aligned with those of shareholders and that ACs could and did exercise proper scrutiny of the audit firm. As independent non-executives, AC members had no incentive to act other than in the interests of shareholders. The obligations placed on ACs and the personal reputational damage that might ensue in the event that the job was not performed adequately provided ACs with a powerful incentive to act in the best interests of the shareholders. These obligations were said to be well codified and to leave no uncertainty as to the time and effort required.[879]

11.94 In response to our provisional findings, KPMG said that the AC was not and was not intended to be a comprehensive regulatory solution to ensuring auditor independence, but rather formed part of a wider framework including the FRC, provisions of the UK Corporate Governance Code and firms' own quality review programs.[880] It said that the concerns raised by the Cadbury Committee in 1992 had been effectively addressed, in particular by amendments to the UK Corporate Governance Code made in 2003 following recommendations made by the Higgs Report in the wake of the scandals of the early 2000s (eg Enron).[881]

11.95 It believed that we had overstated investor concerns about the level of auditor independence with regard to FTSE 350 companies.[882] It said that given our findings that any loss of independence would not be visible to shareholders, then any concerns could only be of a general nature based on their perception and we could only place limited weight on such concerns.[883] It said that we could not use evidence from the PwC survey (see paragraph 11.81) as a reliable indicator of investor concern, since the basis on which views were formed was unclear and the survey covered 11 countries including some in emerging markets. With regard to the investor quoted in paragraph 11.145 ([✂]) we had not substantiated its claims and they were not representative.[884] It said that there was no direct or robust evidence that long tenure may impact auditor independence.[885] We had not taken into account evidence which suggested that investor concerns may not be significant.[886]

11.96 With regard to the academic papers we cited, it said that these were few and far between, and the Beattie study that it said we appeared to rely on was based primarily of research conducted in 2007/08, and so was not up to date and did not take account of recent developments, such as improvement in auditor-AC dialogue, provision of AQR team reports to ACs, and AC reporting to shareholders.[887]

11.97 KPMG said that as NEDs AC members not only had a fiduciary duty to represent the best interests of shareholders, but also to provide challenge to, inter alia, financial controls to ensure that they were robust. It could not envisage circumstances in which ACCs would need to balance the competing demands of the board and shareholders unless the directors as a whole were breaching their duties to shareholders.[888] In its experience, ACCs were not reluctant to voice their honest views and challenge management. It said that this experience was supported by our survey: in the past three to five years 31 per cent of ACCs said their views had caused disagreement with executive management. Of those who replied that disagreements

[879] ibid paragraphs 3.2.1–3.2.5.
[880] KPMG response to provisional findings, paragraph 5.3.1.2.
[881] ibid, paragraph 5.2.2.3.
[882] ibid, paragraph 5.3.3.1.
[883] ibid, paragraph 5.3.3.2.
[884] ibid, paragraph 5.3.3.3.
[885] ibid ,paragraph 5.3.3.6.
[886] ibid, paragraph 5.3.3.8.
[887] ibid, paragraph 5.3.4.1.
[888] ibid, paragraph 5.3.5.1.

had not arisen, 81 per cent said that this was because there was 'an open dialogue/(healthy) debate through which agreement was reached'.[889]

11.98 KPMG disagreed strongly that ACCs may not be able to identify judgements taken to accommodate management aims.[890] In its experience, ACCs actively sought information from executive management, other board committees, external auditors and internal auditors and others, and brought their experience to bear. They focus on big picture, strategic and key issues. This was how they best served shareholders. It was the AQR and other independent quality assurance bodies which reviewed auditors work in detail.[891] When ACs needed further information, they could and did request it.[892] KPMG said that it would be very curious if the very nature of the role of an AC which was codified in 1994 to represent shareholders interest was an impediment to them ensuring shareholder interests were adequately protected.[893]

11.99 KPMG said that we did not have evidence that ACCs' visibility of incumbent firms' work was materially inhibiting their ability to effectively undertake their role, citing our case studies and survey.[894]

11.100 With regard to the time and resources spent by different ACCs, it said that companies had a duty under the UK Corporate Governance Code to provide ACs with sufficient resources to enable them to properly discharge their duties. We had not presented evidence that any were not doing so.[895] It was not surprising that ACCs described their roles in different ways, given that audit is a bespoke product and the wide varieties of company sizes and complexities in the FTSE 350.[896] It said our comparison of the number of hours spent on an audit by the ACC per month to the number of person hours spent on a FTSE 350 audit was meaningless and in no way suggested that ACC were not an effective monitor of auditor independence.[897]

11.101 Finally, KPMG said that while we had asserted that executive management may at times have the incentive to encourage audit firms to accept treatments that were unduly favourable to companies, we had not cited any evidence or examples of this happening.[898] It said the case study examples we cited showed that FDs valued audit firms precisely because they do not cede to management demands.[899] It noted that FDs interviewed as part of our first survey indicated that a high degree of challenge by audit firms and the independence of an audit firm were both important factors when selecting an audit firm.[900] KPMG's experience supported this view.

- *PwC*

11.102 PwC said that there was no misalignment of incentives between shareholders and the AC such as to introduce new principal–agent problems (ie between shareholders and ACs), given that the specific role of the AC was to represent the shareholders'

[889] ibid, paragraph 5.3.5.2.
[890] ibid, paragraph 5.3.6.2.
[891] ibid, paragraph 5.3.6.2.
[892] ibid, paragraph 5.3.6.3.
[893] ibid, paragraph 5.3.6.4.
[894] ibid, paragraphs 5.3.6.6–5.3.6.9.
[895] ibid, paragraph 5.3.6.11.
[896] ibid, paragraph 5.3.6.12.
[897] ibid, paragraph 5.3.6.13.
[898] ibid, paragraphs 5.2.3.1–5.2.3.3.
[899] ibid, paragraph 5.2.3.3.
[900] ibid, paragraph 5.2.3.5.

interests in respect of an audit. In PwC's view the evidence showed that this was a role that the ACs took seriously and performed to a high standard.[901]

11.103 In response to our provisional findings, PwC said that we had grossly underestimated the role of the AC by exercising our discretion to discount evidence from our survey concerning the confidence of ACCs to assess the credentials of an audit team.[902] We should have placed greater weight on survey findings that: over three-quarters of ACCs reported no constraints on their ability to carry out their role; AC engagement was over 93 per cent for 12 areas covered in our first survey (excluding sample sizes, this rose to 98 per cent); over half of ACCs requested supplementary information on external audit matters and the rest did not either because it was not needed (72 per cent) or felt that it was dealt with in prior discussions (28 per cent).[903]

11.104 PwC said that our survey and case studies should have lead us to conclude that ACs are usually effective (notwithstanding that there may be scope for further improvement).[904] PwC's 2011 and 2012 surveys of investment professionals showed that very few professionals had direct contact with AC members and did not regularly read AC reports, which meant that views of investors regarding lack of AC independence may be perception rather than reality.[905]

11.105 PwC said that we had placed inappropriate weight on the views of Beattie (2012) because the underlying data dated from 2007 and nearly one-third of the data related to companies outside the FTSE 350. Our follow-up survey was more reliable and current. Beattie (2012) was also inconsistent in a number of respects with Beattie's 2011 research, which it said concluded that ACCs were fully engaged with financial reporting and the audit process; both the CFO and AEP were accountable to the ACC who manages the AC; the ACC (and AC) had gained power on accounting and auditing matters at the expense of the CFO and AEP; and the enhanced role of the AC made it more difficult for other executive directors to get heavily involved in decisions.[906] PwC concluded that the existence of a few observed limitations on the role of the AC was sufficient to justify the conclusion that ACs were not effective in managing the misalignment between the executive management and shareholders. It did believe that there was scope to enhance and clarify the role of the AC.[907]

Discussion and our views on AC effectiveness

11.106 We discuss our sources of evidence in turn. We consider the results of our follow-up survey on the percentage of ACCs who were less than quite confident that the substantive work had been carried out to a satisfactory standard and the sample sizes are appropriate (summarized in paragraph 11.77) to be sufficient to cause concern in the particular context of the FTSE 350 audit market, given the important economic function of audits (see paragraph 5.3 to 5.17), the limited information available to shareholders to judge for themselves the quality of the audit (see paragraph 11.7), the responsibility that ACs have to represent the interests of shareholders (paragraph 3.26) and the size and therefore importance of FTSE 350 companies.

11.107 We also note that results indicate that the ACCs who were less than quite confident in relation to these aspects of audit quality had greater confidence in their ability to

[901] PwC response to working paper 'The framework for the CC's assessment and revised theories of harm', p12, paragraph b(ii).
[902] PwC response to provisional findings, paragraph 2.36.
[903] ibid, paragraph 2.36(a).
[904] PwC response to provisional findings, paragraph 2.36(b).
[905] ibid, paragraph 2.36(c).
[906] ibid, paragraph 2.37.
[907] ibid, paragraph 2.38.

assess other aspects of audit quality. This suggests to us that their lack of confidence in respect of certain aspects of audit quality is not attributable to cautiousness in responding to the survey or recent appointment to the position. These ACCs were, relative to other considerations, less confident in their ability to assess whether the substantive audit work had been carried out to a satisfactory standard and/or the sample sizes adopted were appropriate.

11.108 The continuing concerns of the AQR team (the external objective body with access to detailed information) indicate to us that ACs have not been uniformly effective in ensuring that auditors act in the interests of shareholders.

11.109 We think that the views of investors are important and note that a significant proportion of investors surveyed by PwC thought that ACs were not sufficiently independent of the board (see paragraph 11.81) and the view of some investors that, despite the presence of ACs, auditors were not sufficiently independent of management (see paragraphs 11.145 to 11.147). We accept KPMG's point regarding our view that investors cannot be well-informed regarding the workings of the audit process. We consider that the effectiveness of ACs therefore relies on the confidence or trust that investors can place in the process (and agree with BDO's point in this regard (see paragraph 11.57)). Any doubts among investors regarding the effectiveness of ACs may have broader market effects (see paragraphs 14.26 and 14.36).

11.110 The ACCs that we spoke to felt confident that they could discharge their responsibilities effectively and thought that they were properly resourced to do so. Only a relatively small number reported a lack of confidence that some aspects the audit of 'their' company had been carried out to a satisfactory standard (paragraph 11.77). However, we think that there is a risk of underreporting (given the difficulties of self-appraisal and the general tendency to give 'virtuous' answers). Further, given the nature of audit as a trust or assurance product, even a small loss of confidence can have significant adverse effects of trust generally (see paragraphs 14.14 and 14.15).

11.111 Our view, based on the evidence above (in particular the AQR's findings, investor views, and the views of external commentators such as Beattie (2012)), is that the activities of ACs have not been sufficient to ensure that auditors' interests are well aligned with those of shareholders.

11.112 We recognize that ACs form part of a wider corporate governance framework. We considered above the role of the board and shareholders in the appointment of the auditor, but found that, in practice, auditors are appointed by executive management and ACs (see paragraph 11.8). We also found that whilst all directors have a duty to act in the interests of the company it is the AC that has a particular role, acting independently from the executive, to ensure that the interests of shareholders are properly protected in relation to financial reporting and internal control (see paragraph 3.26). We also consider that NEDs (who are not AC members) are unlikely to be sufficiently well informed and influential to have an effective role in protecting the interests of shareholders in the conduct of the audit.

11.113 We consider next other factors that might contribute to aligning the interests of auditors and shareholders.

The importance of reputation to firms

11.114 We made a distinction between a reputation for competence, that might be affected by claims or allegations of negligence without compromising the viability of a firm (on the basis that companies and their shareholders accept that some mistakes are occasionally inevitable), and a reputation for honesty and integrity.

11.115 Firms stated that while individual claims for negligence may be managed, the loss of the reputation for integrity was likely to prove catastrophic and the example of Arthur Andersen was frequently cited.

11.116 BDO stated that the risk it faced was one of confidence because 'audit is a product of confidence' and Arthur Andersen failed because people lost confidence in their audit.[908]

11.117 Deloitte stated that the incentives of shareholders and auditors were aligned for three reasons: auditors needed to be responsive to management's requirements whilst maintaining an independence of mind to be reappointed; the risk to the auditor's own reputation which was founded on continued delivery of high quality; and the auditor's own financial risk meant that they were strongly incentivized to pursue high levels of quality.[909]

11.118 KPMG said that reputational damage was most probably caused either by a number of audit failures, pointing to systemic failings, or a deliberate act involving senior personnel at the firm which undermined the firm's reputation for integrity.[910] KPMG said that 'isolated audit failures are financially damaging, reputationally survivable. Losing our reputation for integrity and honesty is deadly'.

11.119 In response to our provisional findings, it said that the risk to an audit firm's and an individual AEP's reputation would be significant if independence were undermined and said this was a fact we had noted and widely recognized by all audit firms and the broader industry.[911]

11.120 PwC said that we had failed to recognize the overriding influence of the auditor's personal incentives not to compromise his/her duties. The risk of substantial loss of reputation and livelihood meant that no rational auditor would knowingly put at risk his or her career by compromising their legal duties of independence and scepticism.[912]

11.121 Our view is included below in paragraphs 11.138 to 11.142.

Firms' engagement acceptance criteria

11.122 Firms told us that they considered the risk to their reputations in taking on or retaining any particular engagement, and had structured processes to assist them do this: audit failure (ie failing to detect or report an issue that might materially affect accounts (see paragraphs 3.21 to 3.22)) could damage a firm's reputation for competence and/or integrity, depending on the circumstances. These processes covered the firms' own ability to conduct the audit, their independence (in accordance with applicable regulations), money laundering regulations, but also the risk the engagement might pose to the firm's reputation. Further detail of firms' criteria is contained in Appendix 7.8.

11.123 Our view is set out below in paragraphs 11.138 to 11.142.

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[908] Summary of hearing with BDO held on 13 February 2012.
[909] Deloitte response to working paper 'The framework for the CC's assessment and revised theories of harm', paragraph 5.6.
[910] KPMG response to CC working paper 'Liability, insurance and settlements', p3.
[911] KPMG response to provisional findings, paragraph 5.4.4.3.
[912] PwC response to provisional findings, Annex 2, paragraph 16(c)(i).

Firms' internal efforts to ensure quality

11.124 Firms told us that they invested heavily to ensure the quality of the audits they provided. Detail is contained in Appendix 7.9, and summarized here. All of the firms undertook some form of internal audit file review and a periodic assessment of their quality control framework. These reviews were intended to comply with International Standard of Quality Control No.1 issued by the International Federation of Accountants.[913]

11.125 All firms operated 'cold' file reviews after an audit report has been issued. These are a detailed review of an audit file to confirm that the firm's methodology has been followed, appropriate documentation has been inspected and the audit opinion was correct. Audit files are graded by the firms depending on the nature of the issues found.

11.126 Cold reviews typically led to at least one audit led by each Responsible Individual (RI) in the firm being reviewed every three years. The proportion of files reviewed varied by firm, but in all cases there was a greater focus on large, high-risk, listed or PIE clients. Typically if an audit file is found to be of poor quality, it will be reviewed the following year and a number of firms made reference to reviewing additional files overseen by the same AEP the next year. If an AEP failed to improve the quality of their audits, their RI status might be removed and some firms stated this had occurred in recent years. Internal quality review scores are not communicated to clients.

11.127 Audits which have been assessed to be of lower quality are subject to a formal response which may relate to the AEP specifically or to the firm's guidance (such as where ambiguity may lead to a divergence from ISAs or best practice). Several firms made specific reference to quality ratings feeding into the AEP's performance appraisal.

11.128 Some firms made reference to 'hot' reviews, which focused on whether the proposed audit opinion was correct before the audit report was issued. One firm made reference to undertaking hot reviews on all audit opinions before an audit report was signed by the AEP. The length of time taken to review a file varied depending on the size and complexity of the audit, and the nature of the review but extended to up to two weeks for a cold review.

11.129 In response to our provisional findings, KPMG rejected our finding that steps taken by firms to address technical quality and integrity issues did not resolve misaligned incentives and said we provided no evidence. It and other firms had implemented a number of procedures and review processes to ensure that audit quality was monitored and assessed on a regular basis. It said that we had underestimated the value and effectiveness of these internal programs which were themselves assessed by the AQR team and the results published in KPMG's transparency report. KPMG submitted that these internal programs focused the audit firms' attention on the interests of its customers, ie shareholders.[914]

11.130 Our view is contained below in paragraphs 11.138 to 11.142.

[913] www.ifac.org/sites/default/files/downloads/a007-2010-iaasb-handbook-isqc-1.pdf.
[914] KPMG response to provisional findings, paragraph 5.4.4.6.

Regulatory supervision

11.131 As noted in Section 3 and detailed in Appendix 3.1, the provision of audit is regulated, both in terms of who may undertake an audit and its substance. That regulation is enforced by the FRC and the Recognised Supervisory Bodies (RSBs) in the UK, and the PCAOB in the USA.

11.132 The inspection regime of the AQR team is described in paragraphs 7.120 to 7.123, and its findings with regard to audit quality, including independence and scepticism is contained in paragraphs 7.124 to 7.132.

Evidence

11.133 We asked firms about complaints that had been made by statutory audit clients to such external bodies in the last ten years including complaints instigated by the regulatory body itself. (In addition to these specific complaints, in Section 7 we considered the investigations of the FRC into specific audits.)

11.134 A summary of the number of complaints and outcomes is shown in Table 11.3.[915] They mainly concerned allegations of negligence. The regulators found against the firms in 13 out of 60 cases (22 per cent). The largest fine imposed was £1.4 million (reduced from £2 million for cooperation) by the Accountancy and Actuarial Discipline Board (AADB) against PwC. When costs are included, EY paid the greatest amount, when it received a fine from the Joint Disciplinary Scheme of £500,000 with costs of £2.4 million.

TABLE 11.3 **Complaints made to regulators 2002 to 2012**

Firm	*Number of complaints**	*Complaints upheld*	*Value of financial awards*
BDO	[✂]	1	£10,000 + costs of £15,799
Deloitte	8	2†	£140,000 + costs of £20,000
EY	11	3‡	£580,000 + costs of £2.4 million
GT§			
KPMG	13	3	£[✂] + costs of £[✂] million
Mazars¶	2	2	£1,000 + costs
PKF	[✂]	[✂]	Nil
PwC	13	1	£1.4 million + costs

Source: The audit firms.

*These include [✂] relating to BDO and three cases relating to PwC which have not been concluded on.
†Neither of these cases related to a FTSE 350 company.
‡In one of the three EY complaints, the finding was against two individuals and not the firm.
§GT does not maintain a record of complaints to regulators in a format which enables the relevant data to be extracted in a practicable manner.
¶ Both of Mazars' cases were referred by the firm itself to the regulator and were not subject to a third party complaint.
Note: Investigations and disciplinary cases handled by the ICAEW, Joint Disciplinary Scheme and AADB respectively have differing standards of public reporting.

Firms' responses to our provisional findings

11.135 KPMG said that it was difficult to see that anything other than a detailed check of every audit could ensure that each and every one was performed perfectly. We had significantly underestimated the impact of the AQR: its sample was not representative but risk-based and so deliberately slanted towards those audits where it believed

[915] The firms submitted data on the number of complaints made against them and we believe these all relate to the audit of UK companies. As not all firms provided client details we are not able to establish how many relate to the audit of subsidiaries of foreign companies or how many of the complaints relate to FTSE 350 companies.

it was most likely to find issues; it performed substantial work on the audit firm's own quality procedures; and firms took account of and respond to the AQR findings and where appropriate extrapolate lessons learned from specific file reviews to other audits.[916]

11.136 PwC said that we had failed to recognize the role of the AQR and FRRP in ensuring that the auditor displays sufficient scepticism and independence. For example, it said we had ignored evidence of improvements made by audit firms to demonstrating scepticism in response to the FRC's annual reports of 2008/09 and 2009/10.[917]

11.137 Our view is set out below in paragraph 11.138 to 11.142.

Our views on the effect of the AC and other factors

11.138 As regards the role of the AC, we think that the AC is an important force in focussing audit firms efforts on the interests of shareholders. However, as noted in paragraphs 11.106 to 11.111, we do not think that the activities of ACs have been sufficient to address the problems we have identified regarding the misalignment in the interests of auditors and shareholders.

11.139 We think that auditors are subject to significant pressures to retain a reputation for integrity. We accept that a case of lack of integrity, if it became public and indicated a systemic problem in the audit firm, might prove fatal to their reputations and so their businesses (as was the case with Arthur Andersen). However, we found that the reputation of the Big 4 has provided resilient to a number of other shortfalls in performance (such as PwC's Japanese firm (see Appendix 9.1, paragraphs 129 to 132 and the case of Mr Scott London[918,919]). Whilst reputational damage has been fatal in one case, it appears that firms have successfully managed the potential adverse consequences of threats to their reputation and litigation claims. In particular these do not seem to have resulted in serious loss of audit business.

11.140 Firms' internal efforts (via their acceptance criteria and internal review mechanisms) to ensure quality indicate that they consider the thoroughness of their investigations is important. Nevertheless, the evidence suggests that when these internal efforts fail to ensure audit quality and complaints brought against firms by companies that these generally do not have serious consequences for the firms concerned (see paragraph 11.134).

11.141 With regard to the role of the AQR team in ensuring audit quality, we found that AQR team reports on individual audit files are the only source of independent information on technical audit quality (see paragraph 7.119). We found that AQR team reports at a engagement and firm level are considered carefully by ACCs, and that firms generally saw AQR team reviews as providing a public measure of audit quality that could act as an incentive for audit firms to maintain and improve quality (see paragraph 9.138). However, we also found that at present individual audit engagements are on average reviewed infrequently, albeit with certain more risky audits reviewed more frequently. In particular, the time the average FTSE 350 company would have to wait for its audit to be reviewed was around ten years (see paragraph 9.134).

11.142 Our discussion of whether, considering all the available evidence, we think principal agent problems continue to occur in practice (and not just theory as some firms

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916 KPMG response to provisional findings, paragraph 5.5.4.
917 PwC response to provisional findings, Annex 2, paragraph 16(c)(iii).
918 www.bbc.co.uk/news/business-22698387.
919 [✂]

said[920, 921, 922]) and cause an AEC is contained in paragraphs 11.186 to 11.194. First we consider if they might cause insufficient independence and scepticism and lead to unmet demand on the part of some shareholders for further information on the audit process.

Insufficient independence and scepticism and unmet shareholder demand for the provision of further information

11.143 Having assessed the factors leading auditors to respond to the interests of executive management and therefore compete to satisfy a demand that is not fully aligned with shareholders' interests (paragraphs 11.44 to 11.65, and vice versa, 11.67 to 11.141, we consider how this might affect the product that shareholders receive, in particular *(a)* if audit firms on occasion were not as independent and sceptical in carrying out audits as shareholders wish (paragraphs 11.144 to 11.149); and *(b)* if satisfying the demands of executive management would prevent auditors from supplying the demand of shareholders for more or better information regarding the audit or financial reports.

Insufficient independence and scepticism

11.144 We considered evidence relating to independence and scepticism in paragraphs 7.151 to 7.189.

11.145 We noted that despite the presence of the AC, some investors were concerned about auditor independence. The Oxera survey on behalf of BDO and GT reported that one investor, [✂], said that auditors were much too close to company management, in particular to finance staff and did not act in the best interests of shareholders, although that was not to say that auditors did not fulfil what was required of them. The investor said that the misalignment of incentives resulted in, for example: *(a)* slightly more aggressive accounting practices than long-term investors would like to see, for example the banking sector, where certain accounting practices were accepted (eg recognition of profit upfront) that were not in the interests of long-term shareholders; *(b)* a lack of transparency in accounting assumptions. It said that long-term investors had a preference for simplicity and transparency, and when an auditor had become embedded to a company, there was a concern that they would include something complicated and potentially misleading; and *(c)* a lack of colour: investors would appreciate more nuance, eg general commentary about how the accounts were put together and the relative aggressiveness of accounting—but was not sure how this could be done given the cosy relationship between the auditor and management.[923]

11.146 The Institutional Investor Committee (IIC) comprising representatives from the ABI, the IMA and the NAPF said in their response to the EU Audit Proposals[924] that 'the long periods auditors hold office can impact their independence and objectivity'.

11.147 In response to the provisional findings a coalition of six investors and a body representing 56 local authority pension funds[925] said that they were concerned about

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[920] Deloitte response to provisional findings, paragraph 4.2.
[921] KPMG response to working paper 'The framework of the CC's assessment and revised theories of harm', paragraph 3.5.4.
[922] PwC response to working paper 'The framework for the CC's assessment and revised theories of harm', paragraph 7(b)(i) and (iv)).
[923] Appendix 7.11, paragraph 90*(b)*.
[924] IIC response to the EU Audit Proposals, Section 3, Proposals for the mandatory rotation of audit.
[925] USS Investment Management, RPMI Railpen, National employment Savings Trust (NEST), Local Authority Pension Fund Forum, London Pensions Fund Authority, Governance for Owners and Environmental Agency Active Pension Fund.

auditor independence and professional scepticism.[926] The trust that investors can place in the audit opinion was said to depend on the independence and objectivity of the auditor, real and perceived. JP Morgan said it agreed with the view that where auditors held office for long periods this could materially impact their independence and objectivity, which were vital in ensuring audit quality. The concerns are not limited to those arising from a perception that over time a relationship might develop between auditor and company in which the auditor does not question or challenge management as much as it might have done in the past. There also appears to be a concern that after a while the current auditor might be less likely to challenge its own judgements, ie the judgements made in conducting the audit in previous years. It is hard for a firm to revise or reverse a judgement that it has applied over a number of years. Investors also said that it was difficult for shareholders to ascertain whether auditors were independent as the boiler-plated audit opinion and report shed little light on the discussions that took place between audit partners, company management, and ACs (see Appendix 17.1, paragraph 40).

11.148 We found that an AEP will discuss matters arising with the FD which means that the auditor's assessment of such matters may be influenced by the views of the FD (see paragraphs 9.77 to 9.80). While we accept that it is efficient for the AEP to seek the views of those who are familiar with such matters, our concern is that the FD's interests in relation to such matters may not be aligned with those of shareholders. In these circumstances, ensuring that shareholder interests are protected relies on the auditor's judgement in probing and challenging the FD's views. We discuss this further in paragraphs and 11.185 to 11.194.

Unmet demand

11.149 In Section 7 we identified that there was unmet demand from some shareholders for better information regarding the audit process. Accordingly, we investigated what stopped auditors and ACs providing more or better information, to see if there were features of the market that prevented this demand being satisfied. We wished to understand why the demand was unmet, and accordingly we assess below:

(a) constraints on auditors supplying further information to shareholders (paragraphs 11.151 to 11.160);

(b) constraints on ACs and ACCs supplying further information to shareholders (paragraphs 11.161 to 11.174; and

(c) whether the barriers to providing further information are a regulatory or a competition issue and responses to our provisional findings (paragraphs 11.175 to 11.176).

11.150 We then *(d)* set out our views (paragraphs 11.177 to 11.184).

Constraints on auditors

11.151 Auditors' engagement contracts are with the company. The company discloses significant information to the auditor to allow it to perform the audit. The auditor is bound by confidentiality requirements and cannot disclose detail of its work (beyond

[926] USS Investment Management, RPMI Railpen, National employment Savings Trust (NEST), Local Authority Pension Fund Forum, London Pensions Fund Authority, Governance for Owners and Environmental Agency Active Pension Fund response to Remedies Notice.

that required by applicable regulation) without the company's consent. We summarize *(a)* firms' submissions and *(b)* information from investors below.

- *Deloitte*

11.152 Deloitte said that in providing additional information to investors it was mindful that: *(a)* price-sensitive information could not legally be given to some investors and not others. In practice this meant that auditors could not give information about specific companies outside of the company's reporting process or the company AGM; and *(b)* the role of the auditor was not, and could never provide watertight guarantees to investors or other stakeholders in relation to future performance of the company.

11.153 Deloitte recognized that there needed to be a debate on audit reporting between all interested parties including regulators, investors and audit firms, and it was actively participating. However, with regards to constraints on auditors it said that concerns around audit liability would most likely result in audit firms maintaining audit reporting around accepted norms.

- *EY*

11.154 EY said that there were practical and legal constraints on how far any desire for more direct engagement with the auditors could be met, including the confidentiality and insider information issues and the additional costs entailed.[927]

11.155 EY noted that principles under the Audit Firm Governance Code (issued January 2010) committed audit firms and shareholders to have a dialogue with each other. EY said that it had followed these principles through regular meetings with a number of institutional investor groups to discuss matters of mutual interest that were consistent with its confidentiality obligations.[928]

- *KPMG*

11.156 In response to our provisional findings, KPMG said that audit firms were seeking to satisfy the unmet demand we identified, notwithstanding the fact that it was ultimately the company and not the audit firm that has the final say (subject to meeting statutory requirements) on what information may be disclosed.[929] That firms did not provide additional information at AGMs was a result of a lack of significant and coherent demand from stakeholders as well as a product of constraints on the ability of audit firms and companies to provide certain types of additional information and the benefits of having some level of standardization.[930]

- *PwC*

11.157 PwC told us that *(a)* the auditor had a duty of confidentiality to the company (under the ICAEW Code of Ethics and at common law), notwithstanding (and independent of) its duty of care to the shareholders which the auditor might breach if it were to disclose, without permission from the company, information which went beyond the audit report and was not in any other published documents; and *(b)* the auditor's duty of care was to the shareholders as a body (not individually) (as established by the

[927] EY response to working paper 'The framework for the CC's assessment and revised theories of harm', paragraph 12.
[928] ibid, paragraph 12.
[929] KPMG response to provisional findings, paragraphs 6.2.2.
[930] ibid, paragraphs 6.2.4.

House of Lords judgment in *Caparo Industries v Dickman*) and the auditor would need to be careful, in opting voluntarily to respond to questions, not to take on an expanded duty of care to individual shareholder(s) who ask a question at the AGM.

11.158 It said that auditors do, however, attend AGMs, and that is a possible forum for them to answer shareholders' questions (free from concerns about insider dealing[931]). In this regard, PwC said that the well-advised auditor would turn to the Chair to ask to be released from his duty of confidentiality to the company; cite the disclaimer in his audit report (the '*Bannerman* disclaimer'[932]) as a preface to his response in order to remind those present that there would be: *(a)* no extension of his 'general audit duty' (under the *Freightliner* judgment[933]); and *(b)* no duty owed to any specific party as a result of answering the question.

11.159 In response to our provisional findings, PwC said that we had referred to but not apparently taken into account a number of important regulatory constraints on the ability of auditors to provide greater information about a company.[934] It and other firms had been active in recent years in engaging with the investor community to understand their views on how the audit might evolve and influence companies' corporate reporting. Its findings were that while some investors wish to see greater disclosure of financial information others were broadly content with the current position.[935] It said that we appeared to have relied on certain minority views to conclude that shareholders were not able to get the full benefit from the audit services.[936] Shareholders already had significant powers that they were able to exercise in respect of audit. To the extent these were not exercised regularly, we should consider that this might in reality indicate that they were content with the audit as provided.[937] To the extent that there remained a demand for the audit to evolve, this was being satisfied by the initiatives of certain companies (where PwC had played a role in leading the market), changes to the UK Corporate Governance Code, and the current FRC and IAASB consultation processes.[938]

- *Investors*

11.160 In practice, we understand that questions at AGMs are rarely, if ever, put to auditors. None of the shareholders we spoke to or contacted cited this as a source of useful information for them regarding the audit. For example, one investor told us that it had raised questions addressed to the auditor in general meetings in the past but the Chairman controlled access and had blocked the questions.[939] Another investor told us that it had approached audit firms to discuss the key accounting risks faced by the companies it invested in but that it had been a 'one way street'.

[931] It is insider dealing, and an offence, if a person who has access to information by virtue of his employment, office or profession discloses that information to another person otherwise than in the proper performance of the functions of his employment, office or profession (section 52(2)(b) Criminal Justice Act 1993) but it is a defence if that person shows he did not expect that any person would deal in securities because of the disclosure, or that the dealing would result in a profit attributable to the fact that the information was price-sensitive information in relation to the securities (section 53(3) CJA 1993).
[932] From the decision in Royal Bank Of Scotland Plc v Bannerman Johnstone Maclay [2005] ScotCS CSIH_39.
[933] Man Nutzfahrzeuge AG & Anor v Freightliner Ltd & Anor [2008] Lloyd's Rep FC 77.
[934] PwC response to provisional findings, Annex 2, paragraph 17.
[935] ibid, Annex 2, paragraph 18.
[936] ibid, Annex 2, paragraph 19.
[937] ibid, Annex 2, paragraph 20.
[938] ibid, Annex 2, paragraph 21.
[939] Summary of hearing with institutional investors held on 16 April 2012.

Constraints on ACs and ACCs

11.161 ACs have a duty to act in the interests of the company by ensuring, on behalf of the board, that the interests of shareholders are properly protected in relation to financial reporting.[940]

11.162 We were told that there were two main reasons why ACs and ACCs (whose responsibility it is to promote the interests of shareholders) are reluctant to disclose information about the audit process unilaterally: *(a)* concerns regarding the disclosure of sensitive information and *(b)* the differing interests and demand of shareholders and the difficulties and risks this creates for ACs and ACCs in the disclosure of information to shareholders. In addition to these reasons, parties *(c)* mentioned several other potential constraints. All of these are discussed below, followed by *(d)* a summary of firms' relevant submissions.

- *Concerns regarding the disclosure of sensitive information*

11.163 The disclosure of information about the audit or about the financial position of the company that is not otherwise in the public domain could damage the interests of the company and its shareholders if it reveals commercially sensitive information to competitors. In addition, disclosure of price-sensitive information to a limited group of shareholders could breach rules on insider trading.

11.164 Given these risks, the ACC as a member of the board will be concerned about damage to the company and its shareholders if the AC discloses confidential or otherwise sensitive information. There could be personal reputational risks for individual members of ACs, and ACCs in particular, of taking a decision to disclose further information if the result is damaging for the company and its shareholders.

11.165 In our follow-up survey of FTSE 350 ACCs, 17 per cent said that there were barriers to the provision of further information. Of these, many said that the commercial sensitivity of the information would be a barrier to further disclosure, and suggested that this was the primary barrier.[941]

11.166 PwC said that companies were generally advised to be cautious about disclosure to the marketplace due to liability issues. This is particularly true for Securities and Exchange Commission registrants given the litigious environment that prevails in the USA. An example of such caution is around risk reporting where the threat of legal challenge frequently leads to extensive disclosure of all possible risks, rather than just key risks, in case a risk is excluded which subsequently has a significant impact on the company.

- *The differing interests and demand of shareholders amongst themselves*

11.167 The evidence we have obtained shows that shareholders differ in their demands for information (see paragraphs 7.226 to 7.263).

11.168 The FRC told us that shareholders generally did not have an agreed view as to what they might like in the way of enhanced reporting. This difficulty extended to obtaining a single view from individual shareholder groups (for instance different fund managers may have different views). In the FRC's experience, there had been very

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[940] www.frc.org.uk/getattachment/6ec23196-28ee-406e-8f56-89ab9d1dc06d/Guidance-on-Audit-Committees-September-2012.aspx, paragraphs 5.2, fourth bullet.
[941] See responses to follow-up survey of FTSE 350 ACCs, questions E1 & E2. See Appendix 2.3, paragraph 32.

few occasions when it had been possible to obtain a consensus from shareholders as to what they wanted on any given issue.[942]

11.169 Deloitte said that it was important to recognize that investors were not a single homogenous group. Some were broadly content with the audit market and the way that audits were conducted and reported whilst others had said that they would like changes in the audit report.

11.170 EY said that there was not necessarily any commonality of interest within shareholders, particularly within the FTSE 350. It said that the conflict in interests between different shareholders was patently apparent at many AGMs. Indeed, as the BlackRock case study indicated, a single shareholder may adopt very different approaches and so have different interests in relation to different investments.[943]

11.171 Oxera's investor survey on behalf of BDO and GT also highlighted differing views of investors in relation to the information that could be provided by an audit. In reviewing Oxera's interview summaries, we noted that one investor specifically said that they would prefer to try and get a view on anything else directly from companies, rather than through the audit. This investor said it was not clear how this colour could be provided within the audit report and some investors might want certain information to remain private and not put into the financial statements. However, another investor said that there was a lack of colour in the accounts and that investors would appreciate more nuance, for example general commentary about how the accounts were put together and the relative aggressiveness of accounting treatment (see Appendix 7.11, paragraph 90).

- *Other potential constraints*

11.172 Deloitte indicated other constraints: *(a)* moving away from a tightly prescribed form of audit report wording introduced the possibility that there was a loss of clarity and consistency of message between audit reports making it harder for investors to interpret audit reports; *(b)* variability in the levels of disclosure between companies could impact capital markets through impacting share prices differently. Finally, it thought it important to note that such constraints were neither caused by a lack of competition between audit firms, nor did it lead to a lack of competition between audit firms.

11.173 PwC said that the FRC consultation document aimed at enhancing corporate reporting and audit, 'Effective Company Stewardship', published early 2011 included recommendations, suggesting that fuller reports by ACs on the approach taken to the discharge of their duties would support the board's declaration that the annual report properly and fairly described the business and its financial performance.

11.174 PwC said that the responses to the FRC's consultations were consistent with those made to PwC by those audit clients who expressed reservations about increasing transparency in this area. In summary, the risks of increased disclosure identified by companies included: *(a)* a possible constraint on free speaking during debates between ACs and auditors; *(b)* disclosure of debate around complex matters could lead to confusion and misinterpretation; *(c)* disclosures could be commercially sensitive; *(d)* providing backward-looking information highlighted past problems that might have since been resolved; and *(e)* likelihood of boilerplate or purely process-related reporting which would add additional volume for little value.

[942] Summary of hearing with the FRC held on 26 October 2012, paragraph 12.
[943] EY response to working paper 'The framework for the CC's assessment and revised theories of harm', paragraphs 8 & 9.

Whether extent of disclosure a regulation or competition issue and responses to provisional findings

11.175 KPMG said that any failure of the audit market to provide shareholders with the information they wanted was a regulatory and not a competition matter. In particular, KPMG said that we had recognized that: the incentives of managers and shareholders to commission audits were likely to be insufficient to ensure that the social demand for independently audited accounts was satisfied; the requirements for audit and their exact scope needed to be mandated by legislation and regulation; and the need for audits to comply with a clearly articulated standard also meant that an extension of assurance services was only likely to happen at an industry level.[944] We consider this point below in paragraphs 11.183 and 11.184.

11.176 KPMG said that whether to disclose certain information was a decision which it was appropriate for companies to exercise taking into account the interests of shareholders as a body rather than individual desires. It would be difficult, if not impossible, for an auditor to exercise this judgement.[945] It said that according to our logic, firms should not engage with regulators to encourage ACC and companies to disclose additional information regarding the audit as this would risk antagonizing management. That firms undertake such initiatives undermined our finding that firms tend to focus on meeting the interests of management rather than shareholders or the AC.[946]

Our view on unmet demand

11.177 We have evidence that there is an unmet demand for further information and that audit firm initiatives to respond to this demand have had limited success (see paragraphs 7.226 to 7.263).

11.178 We note that dialogue between audit firms, the FRC, and investor groups has historically not been extensive. There has been more activity in this area recently. There have been some changes to auditor reporting in the UK as a result of this with the FRC revising ISA 700 in June 2013[947] to require auditors to provide more engagement-specific information in the audit report and the ISAAB is also consulting on this issue at an international level.[948]

11.179 We accept that there are legal constraints on disclosure of information to individual shareholders or disclosure of genuinely commercially sensitive information but we were not persuaded that these constraints extend to providing better information about the audit process to the body of shareholders as a whole. While audit firms have some limited ability to provide information to shareholders as a body, for example in the AGM, in practice this does not happen. That some companies have made voluntary disclosures in addition to the regulatory minimum is evidence that management at board level are able to disclose further information.

11.180 We do not consider the differences between shareholders in their demands for information should be a barrier to further disclosure (see paragraph 7.260).

11.181 We consider that the evidence we have seen indicates a reluctance of executive management and ACs to respond to the shareholder demand we have identified and

[944] KPMG response to working paper 'The framework for the CC's assessment and revised theories of harm', paragraphs 2.1.7 & 2.1.8.
[945] KPMG response to provisional findings, paragraph 6.3.2.
[946] ibid, paragraph 6.3.3.
[947] ISA 700 (Revised) UK and Ireland, The independent auditor's report on financial statements, June 2013.
[948] www.frc.org.uk/Our-Work/Publications/Audit-and-Assurance-Team/FRC-Invitation-to-Comment-on-IAASB-Exposure-Draft-File.pdf.

disclose additional information in a statutory audit beyond statutory requirements.[949] We consider that this reluctance of executive management and ACs to disclose further information may be a consequence of incentives that encourage conservative behaviour. Nevertheless we consider that this both restricts the availability of information on which investors may judge the quality of the audit process and leads to the unmet shareholder demand cited in paragraphs 7.226 to 7.263.

11.182 We think that the unmet demand we have identified is not a failure to provide shareholders with prescribed information (which would be a matter solely for regulation) but rather indicates that auditors are not competing to provide shareholders with the information that they demand.

11.183 We consider that competition and regulatory issues are not separable in the way described by KPMG (paragraph 11.175). Audit firms are not appointed by a regulator, but compete for appointment as a company's auditor. Our guidance[950] describes competition as being a process of rivalry that creates incentives for firms to meet the existing and future needs of customers as effectively and efficiently as possible. It states that where this process is hampered or otherwise hindered, by features of the market, competition may be adversely affected. Our view is that regulation and information asymmetries could give rise to an AEC.[951]

11.184 We consider that the regulation applying to the provision of statutory audits creates a framework within which audit firms compete, for example by mandating an 'independent' audit and specifying the form of the outputs delivered. Regulation may set a minimum standard, while competition provides incentives for suppliers to provide better products.

Our conclusion on our second theory of harm

11.185 The fundamental rationale for audit is an information asymmetry between shareholders and the executive management of companies that they invest in, and that executive management interests may diverge from those of shareholders. We also found that such principal–agent problems, between shareholders and auditor, are present in the conduct of audits.

11.186 We found that there was an information asymmetry between auditors and shareholders and examined whether auditors' and shareholders' interests align well. We considered whether the introduction of ACs, regulatory developments since 1992 and other factors including professional duties effectively aligned auditor interests with those of shareholders. Our concern from a competition perspective is with the extent to which auditors are responsive to the interests of shareholders, rather than the extent to which they have or have not met the requirements of applicable law or regulation. We think not, based on the following.

11.187 First, the FD retains an influential role in the decision to appoint or reappoint the auditor. The FD is also responsible for the company's financial reporting and is the respondent to the auditor in the conduct of the audit. It follows that if an auditor performs well (in the eyes of executive management) then it knows that it is more

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[949] We note that this is not universal, some companies do make voluntary disclosures in addition to the regulatory minimum.
[950] CC3, paragraph 10.
[951] For example, in BAA Airports (2009) the CC decided that the applicable regulatory system for airports was a feature which restricted or distorted competition between airports (paragraph 23). The CC also decided that aspects of the planning system were a feature which restricted and/or distorted competition, by acting as a barrier to entry of new airports and expansion of existing ones (paragraphs 12 & 13).

likely to be reappointed and so has strong incentives to meet executive management demand.

11.188 Second, shareholders remain remote from the auditing process, due to the significant information asymmetry. They cannot judge whether auditors have performed well or badly. This has the potential to breed distrust. In practice shareholders have not exercised their legal powers other than to follow board recommendations regarding auditor appointment.

11.189 Third, despite extensive developments in regulation, there remains a degree of judgement in selecting and applying accounting treatments, and FDs will at times have strong incentives to choose the most favourable application. We think that while ACs provide support for auditors to form an independent judgement from FDs, FDs still have the opportunity to influence the work and judgements of auditors on some issues. We think that the effect may be subtle, since by definition any judgement accepted is within the bounds permitted by regulation. The suspicion that they occur may still damage the trust shareholders can place in audit process (see further paragraphs 14.24 to 14.31).

11.190 Fourth, there are several regulatory bodies designed to incentivize better auditing, but they do not (and are not designed to) ensure the quality of each FTSE 350 audit each year.

11.191 Fifth, firms have economic incentives to act in the interests of shareholders (on whose behalf they are conducting the audit), but we do not think that they are sufficiently strong to neutralize executive management influence. In particular:

(a) while a total loss of reputation for integrity may be catastrophic (see Arthur Andersen), firms have been able to manage the potential adverse effects of several less serious incidents; and

(b) while there is a liability regime in place for audits that fail to meet legal standards, we think it is not designed, nor does it, catch all audits that do not meet the quality that shareholders demand.

11.192 Taking into account the above, we find that the following are features of the relevant market within the meaning of section 131(2) of the Act:

(a) the ability of executive management to influence external auditors in how they conduct and report their audit;

(b) the information asymmetry between shareholders and audit firms, so that shareholders have little information regarding the investigation carried out by the auditor.

11.193 We find that, as a result of these features, firms have incentives and the ability to respond to the interests of executive management and may therefore compete to satisfy a demand that is not fully aligned with shareholders' interests. Firms therefore may not compete on the right parameters. Accordingly, the influence of executive management and the lack of information available to shareholders prevent, restrict or distort competition. As such, there is an AEC in the market for the supply of statutory audit services to large companies in the UK.

11.194 We consider that this finding is consistent with the evidence on market outcomes, in particular: *(a)* the concerns raised by the FRC and AQR team (see paragraphs 7.119 to 7.132) and expressed by investors, that auditors have on occasion failed to be responsive to shareholder interests and so demonstrate appropriate levels of independence, objectivity and professional scepticism, and *(b)* the evidence we have that some shareholders have an unmet demand for further information regarding the audit process.

12. Other theories of harm: coordinated effects, bundling, 'low balling', regulatory distortions

Coordinated effects

12.1 Our issues statement said that some of the conditions that are conducive to tacit coordinated behaviour appeared to exist in the audit market, including: high concentration; significant barriers to entry; limited competitive constraint by Mid Tier firms; price transparency (since audit fees are publicly disclosed in a company's annual report and accounts); existence of switching costs; stable demand due to statutory requirement for an audit; and stable market shares.[952]

12.2 Our view is that certain features in the supply of audit services to FTSE 350 companies may be conducive to tacit coordination based on the identity of clients. However, there appear to be other factors, in particular, the lack of price transparency, the low frequency of switching, uncertainty around which engagements will become available and when, and differences between firms in the value of engagements which would not be conducive to tacit coordination on price or the identify of clients.

12.3 Accordingly, whilst there are some market conditions conducive to tacit coordination, there are also some that are not. Moreover, we did not find evidence that there has in practice been tacit coordination. On this basis, our view is that there has not been tacit coordination in the relevant market. Further detail and consideration of parties' submissions is provided in Appendix 8.3.

Bundling by the Big 4 firms

12.4 Bundling of audit services together with audit-related and/or NAS (within the regulatory rules for audit independence) may create barriers to entry and expansion in these markets. This could take the form of pure bundling (ie refusing to supply any of the individual services separately), mixed bundling (ie audit and NAS are available either separately or bundled at a lower price than the sum of the individual prices) or tying (ie one of the services is available individually, but the other is available only if bought in a bundle).[953]

12.5 We found no evidence that the Big 4 firms undertook pure bundling or tying. See Appendix 8.1. We found a tendency for companies to buy fewer NAS from their auditor over recent years, both in absolute terms and as a percentage of the audit fee. In relation to mixed bundling, we did not find evidence that firms were discounting audit fees to encourage the purchase of NAS. However, we found some evidence that firms would offer NAS at a discount to scale rates if appointed as auditor. The extent to which this represents a discount on market prices is unclear.[954] Overall, we

[952] See issues statement, paragraph 46.
[953] ibid, paragraph 34.
[954] Given the disparate nature of NAS, it is not clear how discounts would be identified. To assess if discounts were offered it would be necessary to assess the profitability of all NAS work performed by the firm and be confident that any variation in profitability was driven by discounts offered to audit clients. Such an approach would need to consider whether discounts on additional pieces of NAS were not offered to existing NAS clients.

have provisionally found no evidence to support the view that the bundling of NAS with the statutory audit acts as a barrier to entry. Companies may request firms to include the price for certain services in their tender but we do not believe that these services exclude any of the largest challenger firms. Further, evidence from our customer survey does not indicate that NAS are a significant consideration when selecting an auditor (see Appendix 2.2).

12.6 Accordingly, our finding is that there has not been bundling in the relevant market that prevents, restricts or distorts competition.

'Low balling'

12.7 Some Mid Tier firms stated that Big 4 firms undertook 'low-balling', ie they offered to undertake audits for certain companies at low rates in order to win the clients of those Mid Tier firms, and that this excluded those Mid Tier firms from the market in a way that was anticompetitive.

12.8 We did not find evidence to support this. When we investigated four specific allegations made by BDO we found little evidence to support the interpretation suggested and we found evidence that other Mid Tier firms were also prepared to offer significant reductions on the incumbent's fee during a tender process and that the Big 4 firms had in two cases submitted a tender proposal with a fee greater than BDO's. We found that in some cases a reduced audit fee coincided with an ongoing deterioration of the financial performance of a company. It appeared that in these specific examples, there was evidence of competition between firms, and that the basis of competition was on the perceived merits of the firms and not merely on price. When considering the profitability of the specific engagements to the Big 4 firms, they did not appear to be below the normal range of profitability (using the firms' internal metrics by which they assess relative client profitability).

12.9 Accordingly, our finding is that there has not been 'low balling' in the relevant market that prevents, restricts or distorts competition.

Regulatory distortions

12.10 In our issues statement, we identified three risks to investigate: *(a)* since the market is highly concentrated, the Big 4 firms may have excessive influence on the regulators; *(b)* the fear that one of the Big 4 firms may fail or exit the market, which could represent a systemic risk to the wider economy, and might induce the regulator to protect the four largest firms, for example through tailored interventions in their favour; *(c)* there could be a suboptimal level of regulation in the market. On the one hand, under-regulation may facilitate entry, but could result in a low-quality service. On the other hand, over-regulation could act as a barrier to entry and expansion for smaller firms.[955]

12.11 We considered whether there was any evidence for regulations being skewed in the larger firms' favour. We looked at various aspects of the regulatory system, including partner rotation requirements, regulations on joint/shared audits and limits on maximum fee income from a single client. We did not find any evidence that these or other aspects of the regulatory framework were unduly favourable to the larger firms or that they restricted Mid Tier firms' ability to compete (see Appendix 8.2).

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[955] See issues statement, paragraphs 43–45.

12.12 In this context, we also looked at the composition of the FRC's committees. We noted that a significant number of members of FRC committees were Big 4 partners, staff or alumni. However, we did not think that the proportion of Big 4 partners, staff and alumni (around 50 per cent) appeared to be inappropriately high but noted that although there were a number of senior representatives from other institutions there was little direct representation of other audit and accounting firms. We consider that while it is possible that influence of the Big 4 firms on standard setting may be a factor tending to favour increased complexity, there appear to be other, more fundamental, factors at work, such as increased complexity and globalization of reporting organizations.

12.13 Accordingly, our view is that there are not regulatory distortions in the relevant market.

13. Our findings regarding an AEC

13.1 As noted in our guidance on market investigations, the CC recognizes that the theoretical benchmark against which to measure an AEC can never be a 'perfectly competitive' market. In past market investigation reports the CC has used the term 'a well-functioning market' in the limited sense, generally, of a market without the features causing the AEC.[956] This has been our approach in this inquiry.

13.2 We investigated outcomes in the relevant market, in terms of price, quality (including auditor independence and scepticism), innovation and the outputs supplied by auditors in order to inform our analysis. We have considered carefully the submissions of the Big 4 firms, and the explanations that they provided for the outcomes we observed.

13.3 For the reasons given in Sections 9, 10 and 11 we identified the following as relevant features of the market:

(a) barriers to switching:

(i) company management face significant opportunity costs in the management time involved in the selection and education of a new auditor;

(ii) companies and firms invest in a relationship of mutual trust and confidence from which neither will lightly walk away as this means the loss of the benefits of continuity stemming from the relationship. In particular, the loss of the expertise and knowledge of the incumbent arising from a loss of continuity may lead to reduced efficiency in the conduct of the audit and increased risk in the technical quality of the audit in the early years of the incoming firm; and

(iii) companies face difficulties in judging audit quality in advance due to the nature of audit which means that companies cannot calculate accurately the benefits that tender processes and switching would bring.

(b) Mid Tier audit firms face barriers to entry, expansion and selection in the FTSE 350 audit market. Mid Tier firms face experience and reputational hurdles which, together with the infrequency and unpredictability of opportunities to tender, affects their incentives to make the necessary investments to overcome such hurdles;

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[956] CC3, paragraph 30.

(c) the ability of executive management to influence external auditors in how they conduct and report their audit; and

(d) the information asymmetry between shareholders and audit firms, so that shareholders have little information regarding the investigation carried out by the auditor.

13.4 We found that the features listed in 13.3*(a)* above gives rise to an AEC either individually or in combination by weakening a company's bargaining power outside the tender process. We think that these features are pervasive throughout the FTSE 350 statutory audit market but their effect will be uneven across companies. How a feature or combination of features impacts on an individual company's strength of bargaining power will vary over time and depend on its particular circumstances.

13.5 We found that the feature listed in 13.3*(b)*, either individually or in combination with the other features, gives rise to an AEC as it has the effect of reinforcing current market positions, and hindering the emergence of new or strengthened rivals and so damages potential competition. It reduces the potential competitive constraints firms can exercise on rivals. It weakens companies' bargaining power since companies may have a lesser range of outside options available to them.

13.6 We found the features listed in 13.3*(c)* and *(d)* give rise to an AEC as they have the effect of giving firms incentives and the ability to respond to the interests of executive management and firms may therefore compete to satisfy a demand that is not fully aligned with shareholders' interests. Firms therefore may not compete on the right parameters.

13.7 We noted the likely effect of the introduction, in September 2012, of the FRC's changes to corporate governance that mean that companies should put their audit engagement out to tender at least every ten years on a comply or explain basis (see further Appendix 3.1, Annex C). Our investigation was necessarily largely based on data before the introduction of those changes. We think that the changes contribute to some extent in addressing the AEC we found, however, we did not think that they addressed the AEC fully. We also took the changes into account both in assessing the extent of the detrimental effect on customers resulting from the AEC, and in ensuring that the remedies package we proposed was proportionate and effective in addressing the AEC that we found. We discuss the likely effect of the changes further in paragraphs 16.22 to 16.29.

13.8 Notwithstanding the FRC's changes, as a result of the AEC, we believe that companies are offered higher prices, lower quality (including less sceptical audits) and less innovation and differentiation in offerings than would be the case in a well-functioning market. Further, shareholders cannot appraise the performance of the companies in which they hold shares or the quality of the audit as we think they would in a well-functioning market.

14. Introduction to remedies

The legal framework for consideration of remedies and relevant customer benefits

14.1 Since we found that there are features of the statutory audit market that give rise to an AEC, we are required to decide the following additional questions:[957]

(a) whether action should be taken by us for the purpose of remedying, mitigating, or preventing the AEC concerned or any detrimental effect on customers so far as it has resulted from, or may be expected to result from, the AEC;

(b) whether we should recommend the taking of action by others for the purpose of remedying, mitigating, or preventing the AEC concerned or any detrimental effect on customers so far as it has resulted from, or may be expected to result from, the AEC; and

(c) in either case, if action should be taken, what actions should be taken and what is to be remedied, mitigated, or prevented.

14.2 A detrimental effect on customers includes such an effect on future customers and is defined as one taking the form of:[958]

(a) higher prices, lower quality, or less choice of goods or services in any market in the UK (whether or not the market to which the feature or features concerned relate); or

(b) less innovation in relation to such goods and services.

14.3 Whether such action should be taken involves consideration both of the action that we can take and action we can recommend others to take. In either case, we state the action that should be taken and what it is designed to address. In practice, we may decide to take several discrete actions ourselves and/or make several discrete recommendations. This combination of measures is referred to as a package of remedies.

14.4 The Act requires us, in considering these questions 'in particular to have regard to the need to achieve as comprehensive a solution as is reasonable and practicable to the adverse effect on competition and any detrimental effects on customers so far as resulting from the adverse effect on competition'.[959]

14.5 In deciding the question of remedies, we may also in particular 'have regard to the effect of any action on any relevant customer benefits of the feature or features of the market concerned'.[960]

14.6 When deciding on an appropriate remedy, we had regard to the effectiveness of different remedies and their associated costs and had regard to the principle of proportionality.[961]

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[957] Section 134(4).
[958] Section 134(5).
[959] Section 134(6).
[960] Section 134(7).
[961] See CC3, paragraph 329.

14.7 Where a remedy falls within the scope of our order making powers, the CC generally prefers to act by Order. The content of any Order is limited by the Act.[962] An Order has binding legal force. We can also decide to accept undertakings or make recommendations. The most common instances where the CC is likely to use recommendations are where we do not have the jurisdiction to implement undertakings or Orders directly.[963] Recommendations will be directed to the person best able to implement the necessary action. Recommendations are not binding on the person to whom they are made.

14.8 The Act requires that our remedies are consistent with the course of action decided on in our final report, unless there has been a material change of circumstances since the preparation of the report, or there is a special reason for deciding otherwise.[964] There is also a statutory mechanism to enable us to vary, supersede or release any undertaking,[965] or vary or revoke any Order made where appropriate, by reason of any change of circumstances.[966]

Remedying the AEC or resulting detrimental effects on customers

14.9 To assist in deciding appropriate remedies, we considered what action we could take which would remedy, mitigate or prevent the AEC arising from the features. We also considered the nature and extent of detrimental effects on customers resulting from the AEC, as set out in our description of the legal framework in paragraph 14.2. The Act requires us to consider detrimental effects on customers (including future customers) resulting from the features whether or not those effects were in the market to which the features relate. We decided that FTSE 350 companies and their shareholders, both current and future were directly affected by the AEC. We also considered the extent to which customers in other markets, and as a result the UK economy at large, may be adversely affected, given the public good aspect of audit (see paragraph 5.32) and its potential, as part of the overall UK corporate governance framework, to influence investment and growth and productivity of UK firms.

14.10 In the following subsection we discuss:

(a) higher prices and lower quality arising from a lack of bargaining power;

(b) effects on customers resulting from lower quality, in particular:

(i) audit as a component of the corporate governance framework;

(ii) the link between corporate governance and the cost of capital;

(iii) perception of audit quality and trust in financial reporting; and

(c) market outcomes and the scale of the detriment resulting from the AEC.

[962] Schedule 8 to the Act sets out the type of provisions that may be included in an Order.
[963] CC3, Annex B, paragraph 94.
[964] The Act, section 138(3).
[965] The Act, section 159.
[966] The Act, sections 161 & 162.

Higher prices and lower quality arising from a lack of bargaining power

14.11 In paragraph 13.8 we noted that as a result of the AEC, companies are likely to be offered higher prices, lower quality, and less innovation and differentiation[967] than would be the case in a well-functioning market, and in paragraph 5.61 we said that in this market the demand for statutory audit is inelastic since every FTSE 350 company must buy an audit. If audit fees are above competitive levels then this may be regarded as a transfer of wealth between companies and audit firms, and shareholders may suffer detriment as a result.

14.12 We consider that companies on average tolerate higher prices and lower quality because they regard the costs of going out to tender and switching auditor to be significant. This means that companies are likely to tolerate higher prices or lower quality to the extent that any expected benefit to be obtained is not greater than the expected cost of going out to tender and switching audit firm. This may be expected to have a detrimental effect on shareholder value, on average across FTSE 350 companies. Evidence we have that going out to tender or switching auditor is typically associated with the relative fee reduction is consistent with this.[968]

14.13 This is also supported by case study evidence. We heard examples of companies which had experienced quality issues but had not immediately gone out to tender. For example, the audit firm had ceased to deliver a 'value-added' service to company management and was not providing the expected insights and advice that could improve the performance of the company (eg on the control environment). Some companies had given their audit firm a chance to improve before going to tender, including by replacing the AEP,[969] or had tolerated shortfalls in quality because other priorities had meant that it had not been a convenient time to go out to tender. Examples from our case studies on this point are described in Appendix 14.1.

Effects on customers resulting from lower quality

14.14 Audit is often referred to by audit firms as synonymous with 'assurance' (ie giving assurance to shareholders that company financial statements are materially accurate).[970] As well as underpinning market confidence in individual companies' financial reporting, audit also plays a role in the trustworthiness of financial reporting more generally and confidence in UK listed companies as an investment opportunity (see paragraphs 5.29 to 5.38).

14.15 As discussed above the implications of a shortfall in audit quality arising from the AEC that we found include that individual shareholders have less reliable financial information on which to ensure effective oversight of corporate decisions, including capital allocation decisions. Company performance and shareholder returns are likely to be lower as a result of less effective capital allocation decisions. The wider consequences of this are ultimately lower productivity and growth in the UK economy.

14.16 We also consider that wider welfare losses are likely to arise since the AECs we identified decrease audit quality. These wider welfare losses extend beyond share-

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967 We regard differentiation as an aspect of choice and as a result within the definition of detrimental effect on customers within the meaning of section 134(5) of the Act.
968 See paragraph 7.70.
969 Paragraph 9.252 cites three instances where companies had the actual or proposed lead partner changed where they were dissatisfied with performance.
970 ISA 200—The overall objectives of the independent auditor and the conduct of an audit in accordance with International Standards on Auditing (UK &I), paragraph 3, states 'The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework.'

holders in individual companies to customers in other markets and as a result the economy as a whole. We explain the mechanism for this effect as follows: *(a)* we explain the importance of audit as a component of the corporate governance framework; *(b)* we explain the link between corporate governance and the cost of capital; and *(c)* we discuss the importance of trust in audit on the part of investors.

Audit as part of the corporate governance framework

14.17 In paragraphs 5.29 to 5.38 we described the broader benefits in terms of the contribution of audit to effective corporate governance and the efficient operation of financial markets, including debt and equity markets. The role of high-quality audit as a pillar of good corporate governance is uncontroversial. The economic benefits of investors' ability to make better informed decisions and exercise effective control include more efficient capital markets, better allocation of capital and high growth and productivity.

14.18 The G8 said:[971]

> Efficient capital markets are critical to achieving and maintaining economic growth. To support growth, economies need sound legal systems, effective regulation and transparent corporate governance practices. These factors underpin effective disclosure that is fundamental to well-functioning markets. Sound social frameworks and attention to the long-term impacts, including on the environment, of investment decisions and business processes are also important for sustainable growth.
>
> Timely and accurate information assists shareholders in exercising control and investors in allocating funds to their most productive uses. In support, governmental authorities should ensure that corporate reporting assists them in monitoring markets and in identifying vulnerabilities.
>
> Trust and confidence are key ingredients of a well-functioning market economy. Restoring investor confidence through sound corporate governance, as well as corporate structures and market intermediaries that are more accountable, is essential to promoting growth in our economies. We encourage the many initiatives underway, in national capitals, international financial institutions and by international standard-setting bodies, to strengthen governance standards and disclosure regimes.
>
> Corporate integrity, strengthened market discipline, increased transparency through improved disclosure, effective regulation and corporate social responsibility are common principles that are the foundations for sound macro-economic growth.

14.19 The OECD said:

> Good corporate governance provides incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders and facilitates effective monitoring. More effective monitoring increases investor confidence in the future

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[971] *The G8, Fostering growth and promoting a responsible market economy: A G8 Declaration*, Evian, 2 June 2003.

performance of those companies, and lowers the cost of capital. It encourages firms to use and allocate resources more efficiently, thereby underpinning growth.[972]

The link between corporate governance and the cost of capital

14.20 There is a well-established literature showing that high corporate governance standards can enhance firms' valuation, both of individual firms within an economy and for firms within an economy as whole. The following examples were cited by the FSA:[973] La Porta et al (2002) find a positive correlation between investor protection and company performance across countries. Deutsche Bank (2005) finds a positive correlation between the corporate governance standard of a firm and its share price performance. Those companies with the highest corporate governance standards outperformed those with the lowest standards by 34 per cent. Bruno and Claessens (2007) find a positive correlation between the level of corporate governance and firm performance. Likewise, there is a well-established literature on the link between good corporate governance and cost of capital. The following examples were cited by KPMG:[974] Chen, Chen and Wei (2009) show that good governance was associated with a lower equity cost of capital, and Bhorjraj and Sengupta (2003) showed that there was a cost of debt effect. Lambert, Leuz and Verrecchia (2007) found that increasing the quality of mandated disclosures should generally reduce the cost of capital for each firm in the economy. We considered that the quality of corporate governance therefore has a pricing effect.

14.21 To the extent that FTSE 350 companies are self-financing[975] the availability and cost of debt and equity in the external capital markets may have a limited direct effect on financing costs. However, the external capital markets dictate the opportunity cost of capital for these firms and hence have a direct impact on firm valuation. In addition, equity markets play an important role in providing oversight of companies' internal capital allocation decisions. Auditors underpin the provision of high-quality information that investors need to undertake this monitoring role and thus support effective corporate governance in these companies.

14.22 Deloitte said that the biggest drivers of a FTSE 350 company's cost of capital were its own financial performance, the nature of its operations, sectors of activity, tax regime and liquidity in its securities. It said it was reasonable to consider that any company that thought poor audit quality was damaging its cost of capital would have resolved this through replacing its auditor.[976]

14.23 We recognize that corporate governance is only one factor influencing the cost of capital, both of individual firms and in the economy as a whole, among many others. Equally, we agree that companies would have incentives to replace auditors if they thought this would improve their cost of capital. However, we note that investors lack visibility of audit quality and are likely to form a view on corporate governance based on a range of factors, both company-specific and market-wide. We discuss the importance of trust in audit next.

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972 Based on OECD Principles of Corporate Governance 2004.
973 See FSA Empirical Research on the UK Listing rules and Firm Valuation, 'A review of the Structure of the Listing Regime', FSA 08/01, Annex 2, January 2008.
974 KPMG response to Remedies Notice, paragraphs 4.2.6.1 & 4.2.6.2.
975 See The Kay Report for a discussion of this issue.
976 Deloitte response to provisional decision on remedies, paragraph 4.3(d).

Perceptions of audit quality and trust in financial reporting

14.24 The 'trust' aspect of audit is fundamental given that it is a credence good for shareholders (see paragraph 5.58). An important implication of this is that, since they cannot judge quality directly, investors form perceptions of audit quality from a variety of sources and these perceptions may not always be accurate.[977] Nevertheless, if investors do not trust the audit product in some respects, its power to instil confidence will diminish.

14.25 We think that doubts among investors regarding the quality of a small number of audits could seriously undermine their trust in the information provided by statutory audits paragraph 5.62. Because of the importance of perception, we think that even relatively infrequent or isolated reported instances of significant quality issues could have a more widespread effect, because they undermine trust in the integrity of audit. Instances where auditors have been found to lack professional scepticism are likely to be damaging in this respect.

14.26 Given the above, we consider that our finding that there are features, that result in firms having incentives and the ability to respond to the interests of executive management, and may therefore compete to satisfy a demand that is not fully aligned with shareholders' interests (paragraph 13.6), has important implications for our assessment of detriment.

14.27 We noted, in particular, the concerns of the FRC in regard to professional scepticism, expressed in AQR reports over recent years. The 2012/13 AQR Annual Report notes an overall improvement in the area of scepticism based on the sample of reviews and other work conducted during the year but continues to raise a number of concerns notably in respect of impairment testing of goodwill and other intangibles; and loan loss provisioning in financial service audits.[978] Relevant comments from the FRC's report[979] include:

> *(a)* While these inspection reports are encouraging, further improvement is still required in a number of key areas. Many of these areas are recurring in nature including the exercise of sufficient professional scepticism and the approach to independence and ethics.
>
> *(b)* Initiatives to reinforce the importance of professional scepticism appear to be working although progress is not uniform.
>
> *(c)* Firms should ensure that further improvements and greater consistency are achieved.
>
> *(d)* We continue to raise a number of concerns notably in respect of the auditor's review of the assumptions used for the impairment testing of goodwill and other intangibles.
>
> *(e)* In relation to Financial Services, further improvements are required. Firms should strengthen their testing, particularly in respect of loan loss provisioning and general IT controls.

[977] See Oxera's Investor Survey: Investors expressed divergent views on whether the audit market was delivering well. One investor said that it did not have sufficient information to judge the issue.
[978] Audit Quality Inspections Annual Report 2012/13: 'Key messages'.
[979] ibid: 'Key messages'.

14.28 Audit firms disputed that there was any lack of professional scepticism, and disagreed with our provisional view that there were significant, persistent and widespread concerns regarding the quality of audits delivered to FTSE 350 companies:

(a) Deloitte said that our conclusion was no more than that 'losses of auditor independence do occur' and gave no indication of the scale of the problem.[980] It said that we had not found and there was not any evidence that audited financial information was not reliable. The links we posited between improvement in corporate governance and reductions in costs of capital were not possible to measure in any way.[981]

(b) KPMG said that we tended to overstate the negative findings of the AQR team[982] and said that individual lapses should be seen in the context of high overall audit quality.[983] KPMG thought that our provisional view that shareholders had less reliable financial information on which to ensure effective oversight of corporate decisions and that we expected there to be a wider detriment to the economy lacked substantiation.[984]

14.29 However, we are satisfied that there is evidence of concerns regarding quality based on the findings of the AQR team, and that while there is some evidence of improvement over time, professional scepticism also continues to be a concern. The relative frequency of shortfalls is difficult to determine precisely, given that the AQR's sampling methodology is not designed to be representative of the FTSE 350 as a whole, but, for the reasons discussed in paragraph 14.25 even relatively infrequent high-profile instances are likely to have a significant detrimental effect on confidence. This is particularly the case given that the AQR team inspects a sample of audits biased towards more complex listed entities in which the importance of high quality audit may be regarded as paramount.

14.30 We place significant weight on the views of investors in this regard. We noted comments from investors suggesting that concerns regarding professional scepticism continued to be an issue.[985] A coalition of investors said that audit quality (and ultimately trust in capital markets) depended on real and perceived auditor independence. Auditor independence provided a basis for ensuring professional scepticism and prudence in analysis and willingness to challenge management vigorously. Currently it was very difficult for shareholders to ascertain whether auditors were independent of the executive.[986]

14.31 We consider that the AEC that we have found contributes to a lack of confidence in the auditing profession. In a recent article,[987] Mr Nick Land, NED of the FRC and ACC of Vodafone, said 'Fair or unfair, the perception of the auditing profession in the UK and many parts of the world is very low. I think there is a lack of confidence and trust in the role of auditors'. Not all investors share this lack of confidence: BDO's investor survey noted that a significant number of investors are content or broadly content with the way the market is delivering. On the other hand, around half of the

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[980] Deloitte response to provisional findings, paragraph 5.11(e).
[981] Deloitte response to provisional decision on remedies, paragraph 4.3(c).
[982] KPMG response to provisional findings, paragraph 2.6.3.2.
[983] ibid, paragraph 2.6.3.4.
[984] KPMG response to provisional decision on remedies, paragraphs 2.2.6 & 2.2.7.
[985] Paragraph 7.167
[986] USS Investment Management, RPMI Railpen, National Employment Savings Trust, Local Authority Pension Fund Forum (representing 56 pension funds), Governance for Owners, Environment Agency Active Pension Fund and Sarasin and Partners LLP, 10 April 2013.
[987] Economia, 11 February 2013: economia.icaew.com/opinion/february2013/tales-from-the-front-line.

investors surveyed expressed serious concerns.[988] USS said that ‘Circumstantial evidence and audit quality inspections reveal grave concerns with audit quality’.[989]

Market outcomes and scale of the detriment resulting from the AEC

14.32 We now turn to the extent to which market outcomes (including prices and quality) differ from those we would expect in the theoretical benchmark of a well-functioning market (see paragraph 8.7). It is difficult for us (or any competition authority) to be able to determine directly what the outcomes (eg price and product specification and quality) would be in such a market, and so it is hard for us to calculate with precision the extent of the detriment that results from the AEC we found.

14.33 In the audit market, the calculation of detriment is further obscured by the difficulty of assessing audit quality (see paragraphs 5.57 to 5.59); the difficulty of assessing pricing levels given the bespoke nature of each audit (see paragraphs 5.55); and the difficulty of assessing the profitability of the audit service (paragraph 7.94 to 7.99).

14.34 If competition were directed more fully towards the demands of the shareholder, we consider that the audit product, and the competitive process itself, would be different in certain respects. We consider that the quality demanded is likely to be different: shareholders are likely to place greater emphasis on professional scepticism and thoroughness, and ensuring sufficiency of work performed. A further implication of a reduction in the influence of the FD in the external audit relationship is that firms’ competitive activity is likely to be different in nature. Firms currently invest significant time developing and maintaining relationships with executives at non-audit clients, in order to position themselves favourably in the event of a tender process (and also to attempt to encourage a tender process).[990] We consider that such activity will be less if the influence of the executive over the decision to go out to tender and appoint auditors were lower and competition is more focused on more frequent, well-structured tender processes.

14.35 There are considerable difficulties involved in specifying precisely the dimensions of the competitive product in this market and it may differ in significant respects between companies and over time. If competition functions effectively and towards the right demand, it will be for the market to specify the quality and price of the competitive product (subject to compliance with regulatory standards). We consider that this will best be discovered over time through the process of competition, with appropriate remedies in place to ensure that competition is effective and accurately focused on the demands of shareholders.

14.36 However, we consider that the detriments that we have identified in paragraphs 14.11 to 14.40 are likely to be significant. The importance of trust in this market means that even small imperfections or relatively isolated instances of shortfalls in quality applying to some companies but not all, or only at certain times, may be damaging as they undermine credibility and confidence in the quality of the corporate governance framework as a whole. Given the information asymmetries we have identified, it is difficult for investors to distinguish between companies that have more effective and those that have less effective audits (other than in extreme cases).

14.37 Accordingly shareholders cannot assess accurately the extent to which reports of shortfalls in audit quality are isolated or indicative of more pervasive problems. This

[988] See Oxera: Investor views on market outcomes and on potential remedies in the provision of audit services, August 2012, Figure 2.1.
[989] USS submission to the CC, May 2012.
[990] Paragraphs 9.46–9. 54.

means that even rare instances may be expected to undermine trust in the integrity of the audit product more generally.

14.38 We note that the corporate governance framework in the UK scores well in international comparisons (such as GMI Rating's international rankings[991]), although BIS and HMT noted that the financial crisis showed that there are areas needing improvement.[992] We accept that audit quality is only one part of the overall corporate governance framework.

14.39 Even small improvements in investor confidence as a result of improved trust in audit could have very large financial benefits. As noted in paragraphs 13.7 and 13.8, we think that the changes introduced by the FRC in December 2012 contributed to some extent in addressing the AEC we found. While there are difficulties in quantifying the detriment that we think the AEC causes (notwithstanding the FRC's tender processes regime), we consider that it is likely to be significant. As at the end of February 2013, the market capitalization of the FTSE 350 stood at £1,876.5 billion. Every basis point (0.01 per cent) increase in the market capitalization of the FTSE 350 would represent a benefit to shareholders of around £200 million. As an illustration, every basis point decrease in the cost of capital could represent an increase in overall market capitalization of around £3.8 billion.[993] We cannot be precise as to the quantum of any increase in company value arising from an improvement in the corporate governance framework, however, the above illustrates that even very small effects could have large financial benefits.

14.40 We will take these effects into account in evaluating the proportionality of our remedy package (Section 18).

Structure of our decision on remedies

14.41 We structure our decision on remedies as follows:

(a) by way of background, we set out recent developments in the regulatory landscape (Section 15);

(b) we discuss in turn each of the remedy options that we have decided should form part of our remedy package (Section 16);

(c) discuss the other remedy options that we have considered, which do not form part of our remedy package (Section 17);

(d) consider whether there are relevant customer benefits (RCBs) arising from the features giving rise to the AEC which would be lost if we imposed our remedy package and if so whether we should seek to ensure that we retain any such benefits by modifying our remedy package (paragraphs 18.37 to 18.45); and

(e) assess the overall effectiveness and proportionality of the remedy package (paragraphs 18.46 to 18.93).

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[991] www.gmiratings.com/Images/GMI_Country_Rankings_as_of_10_27_2010.pdf, which have been acknowledged by the FRC, in its document 'Approach to Corporate Governance'.
[992] HM Treasury and BIS, The Plan for Growth, March 2011, paragraph 1.28.
[993] Based on an initial discount rate of 5 per cent and assuming constant cash flows in perpetuity.

15. Recent developments in the regulatory landscape

15.1 We summarize here: *(a)* changes to the UK Corporate Governance Code; *(b)* changes to the FRC's Guidance on Audit Committees; *(c)* changes to auditing standards; and *(d)* European Union developments.

Changes to the UK Corporate Governance Code

15.2 In September 2012 the UK Corporate Governance Code was changed in certain respects. Two changes were particularly relevant to our consideration of remedies:

(a) Expanded guidance on the matters that should be covered in the AC Report:

> The report should include: the significant issues it considered in relation to the financial statements, and how these issues were addressed; an explanation of how it has assessed the effectiveness of the external audit process and the approach taken to the appointment and reappointment of the external auditor, including the length of tenure of the current audit firm and when a tender process was last conducted; and, if the external auditor provides non-audit services an explanation of how auditor objectivity and independence is safeguarded.[994]

(b) FTSE 350 companies should put the external audit contract out to tender at least every ten years on a 'comply or explain' basis.[995] We consider the implication of this change further in our tender processes remedy, Remedy 1 (paragraphs 16.3 to 16.89).

15.3 In addition, the revised UK Corporate Governance Code contains a provision that: 'Where requested by the board, the audit committee should provide advice on whether the annual report and accounts, taken as a whole, is fair, balanced and understandable and provides the information necessary for shareholders to assess the company's performance, business model and strategy.'[996]

15.4 The changes apply to reporting periods beginning on or after 1 October 2012. Since many FTSE 350 companies have December year ends, the first reporting annual reports prepared under the revised Code will be published around late March 2014. We consider the effects of these changes to the UK Corporate Governance Code and the extent to which they may be expected to address the AEC that we found in paragraphs 13.7 and 13.8.[997]

Changes to the FRC's Guidance on Audit Committees

15.5 In addition to the UK Corporate Governance Code, the FRC publishes a series of guidance notes intended to assist companies address specific aspects of the Code. The FRC's Guidance on ACs is most relevant to our consideration of remedies.[998] The Guidance on ACs is designed to assist company boards in making suitable

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[994] FRC, The UK Corporate Governance Code, September 2012, C3.8. This paragraph replaces Provision C3.7 which read as follows: 'The annual report should explain to shareholders how, if the auditor provides non-audit services, auditor objectivity and independence is safeguarded.'
[995] ibid, C3.7.
[996] ibid, C3.3.
[997] Changes in relation to AC reporting are discussed under the AC and auditor reporting remedy; changes in relation to tendering every ten years on a comply or explain basis are discussed under the tender processes remedy.
[998] FRC, The UK Corporate Governance Code, September 2012.

arrangements for their ACs, and to assist directors serving on ACs in carrying out their role. While boards are not required to follow this guidance, it is intended to assist them when implementing the relevant provisions of the UK Corporate Governance Code.

15.6 In September 2012, the Guidance on ACs was expanded to reflect the changes made to the UK Corporate Governance Code. Further detail about these changes and the likely effect is discussed in further detail in paragraphs 16.21 to 16.31.

Changes to auditing standards

15.7 On 4 June 2013, the FRC issued a revised ISA 700 ISA (UK & Ireland) 700—The independent auditor's report on financial statements, which increases the level of disclosure to be made by auditors on the planning and execution of the audit of the audited entity. The revised standard applies to audits of entities which adopt the UK Corporate Governance Code for reporting periods beginning on 1 October 2012. We consider the effects of these developments in further detail in paragraphs 16.313 to 16.319.

15.8 The International Auditing and Assurance Standards Board (IAASB) is also consulting on revising the ISAs on auditor reporting and exposure drafts were published in July 2013,[999] on which the FRC is consulting UK stakeholders,[1000] and final approval of a revised standard is expected in June 2014.

European Union developments

15.9 European Union proposals on the reform of the audit market are currently in draft form. Our understanding (as of 9 October 2013) of the status of the negotiations with member states is as follows (however, discussions are ongoing, so these are subject to change). There has been agreement on the scope of the draft Regulation, namely that it should apply to PIEs, ie listed companies and financial institutions. There is likely to be a provision to the effect that member states can add additional entities to the category of PIEs.

15.10 On the issue of mandatory switching, there is currently support for the principle both in the European Parliament and in the Council. Discussions are still ongoing on the scope and duration of the principle of rotation. The period after which mandatory switching shall apply may be increased if the audit engagement has been tendered. The Council of the European Union has agreed a negotiating mandate on the proposed reforms to enter into trialogue with the European Parliament and the European Commission. [✂]

15.11 On the issue of NAS, the proposals are almost finalized. There is likely to be a 'black list' of certain prohibited NAS. A company's auditor would not be permitted to provide these NAS during its tenure as auditor nor during a period before and after appointment. [✂][1001]

15.12 [✂][1002]

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[999] www.ifac.org/publications-resources/reporting-audited-financial-statements-proposed-new-and-revised-international.
[1000] www.frc.org.uk/Our-Work/Publications/Audit-and-Assurance-Team/FRC-Invitation-to-Comment-on-IAASB-Exposure-Draft-File.pdf.
[1001] [✂]
[1002] [✂]

15.13 Given the lack of certainty surrounding the EU audit market reform proposals, we have not sought to design our remedies around the draft EU proposals. The Act provides us with the ability to take into account the EU reforms once these are of a sufficiently certain nature (see paragraph 14.8).

16. Remedy options that we have decided to take forward

16.1 In this section we discuss the remedy options that we have decided to take forward as our preferred remedy package, as follows:

- Remedy 1: Mandatory tender processes for audit services—paragraphs 16.3 to 16.89.
- Remedy 2: AQR—paragraphs 16.90 16.141.
- Remedy 3: Auditor clauses in loan documentation—paragraphs 16.142 to 16.191.
- Remedy 4: Enhanced shareholder engagement—paragraphs 16.192 to 16.236.
- Remedy 5: Strengthened accountability of the external auditor to the AC—paragraphs 16.237 to 16.287.
- Remedy 6: Extended AC reporting—paragraphs 16.288 to 16.334.
- Remedy 7: Competition object for the FRC—paragraphs 16.335 to 16.367.

16.2 For each of these remedy options we discuss the aims and objectives of the remedy option; consider specific design issues; and evaluate effectiveness and costs. We also consider implementation and enforcement issues on a remedy-specific basis.

Assessment of Remedy 1: Mandatory tender processes

Summary and introduction

16.3 We intend to issue an Order to the effect that:

(a) FTSE 350 companies must put their statutory audit engagement out to tender not less frequently than every ten years.

(b) Companies have the right to require that the incumbent audit firm give them access to specified elements of the audit file for disclosure to rival bidders in a tender process.

(c) Where a company has not tendered in the last five years, the AC Report shall state in which financial year it intends to go out to tender for statutory audit services and why it thinks that going out to tender in this year to be in the best interests of shareholders.

(d) Companies must monitor and certify compliance with the provisions of the Order in the AC Report.

16.4 We also intend to recommend that the FRC amend the UK Corporate Governance Code to align with the Order.

16.5 This remedy will operate as part of a package. Remedy 5 (strengthened accountability of the auditor to the AC) will enhance the role and influence of the ACC and AC, and more frequent tender processes as a result of the mandatory limit provides a channel for them to exert that influence. Aspects of our remedy package designed to improve shareholder engagement (Remedy 4), and extended AC reporting (Remedy 6) will contribute to ensuring that competition in tender processes takes place on the variables that matter to shareholders, and that the interests of shareholders are taken into account in auditor appointment decisions.

16.6 The structure of this subsection is as follows:

(a) aim of the remedy (paragraphs 16.7 to 16.12);

(b) views of parties (paragraphs 16.13 to 16.20);

(c) assessment of the effectiveness of the proposed remedy (paragraphs 16.21 to 16.57);

(d) our view of the appropriate frequency of mandatory tender processes (paragraphs 16.58 to 16.72); and

(e) implementation and enforcement (including phasing in) (paragraphs 16.73 to 16.89).

Aim of the remedy

16.7 We found that there were features of the market which gave incumbent audit firms some market power and incentives and the ability to respond to the interests of executive management so that they may therefore compete to satisfy a demand that is not fully aligned with shareholders' interests (see Section 13). We consider that a mandatory limit on periods between tender processes, combined with further disclosure in the AC report on the company's policy on tendering the audit, addresses the AEC by: *(a)* increasing companies' bargaining power; *(b)* addressing barriers to entry, expansion and selection; and *(c)* better aligning auditor and shareholder interests.

16.8 We note the changes made by the FRC in September 2012 to the UK Corporate Governance Code to encourage tender processes every ten years on a 'comply or explain' basis. We discuss the effectiveness of this recent change in addressing the AEC in paragraphs 16.22 to 16.31, and why we have decided to strengthen these provisions to make tender processes mandatory by year ten in paragraphs (see paragraphs 16.58 to 16.68). For many companies we consider that going out to tender at shorter intervals of between five and nine years will be appropriate. However, we consider that the AC should have discretion to determine the interval that is in the best interests of the company's shareholders, (subject to the oversight of shareholders through an advisory vote, see Remedy 4, paragraphs 16.192 to 16.236).

How the remedy increases companies' bargaining power

16.9 We consider that our remedy will increase the frequency of tender processes above that required by the current FRC provisions. In particular, it will: *(a)* prevent companies from deferring tender processes by 'explaining' in year ten and subsequent years, and *(b)* encourage companies to consider going out to tender at more frequent intervals where appropriate. We consider that more frequent tender would increase the bargaining power of FTSE 350 companies in the following ways:

(a) Tender processes to date have been structured processes which provide firms with the information they need to submit informed proposals and consequently companies are provided with better information on which to base decisions on the auditor appointment. We found that when companies go out to tender they fully exercise their bargaining power (paragraph 9.310), so more frequent tendering than historical levels ensures they fully and regularly exercise that power.

(b) It would increase the bargaining power of companies in reappointment negotiations with the incumbent auditor. A tender process provides the best information on available options, so in the years shortly following a tender process, companies will be better informed on their outside options and so better able to assess the performance of the incumbent auditor.

(c) It would strengthen the incentives of an audit firm to offer a competitive product (particularly as the threat of a tender process gets closer) as it will be aware that any failure to do so is more likely to be revealed in the approaching tender process.

(d) The information gained from going out to tender on the offers of rival audit firms may be shared across FTSE 350 companies since most ACCs (and other non-executives involved in the tender process) hold more than one FTSE 350 position.

(e) As a result of information being shared on how to conduct tender processes efficiently, companies will be able to streamline their processes and tender requirements.

How the remedy addresses barriers to entry, expansion and selection

16.10 Our remedy combines a mandatory limit on periods between tender processes with disclosure of when the company next expects to go out to tender for statutory audit services where it has not gone out to tender in the last five years. More frequent and predictable opportunities to compete for engagements may provide firms with greater incentives to invest in expanding their capabilities (see paragraph 10.39). We consider this relevant in particular to non-Big-4 firms that currently have very few FTSE 350 engagements, and to Big 4 firms with weaker positions in some sectors (see paragraph 9.65). We consider that over time mandatory tender processes may therefore strengthen the bargaining position of companies by increasing the range of alternative providers of audit services.

How the remedy better aligns auditor and shareholder interests

16.11 We consider that a mandatory limit on periods between tender processes could reduce the incentives of auditors to compete to satisfy a demand that is not fully aligned with shareholder interests (see paragraph 13.6). In particular:

(a) Mandatory tender processes and a requirement to disclose the policy on going out to tender significantly reduces the influence of executive management on the decision of whether or not to go out to tender (see paragraph 11.63).

(b) Having decided to go out to tender, while FDs have typically taken the lead in the management of a tender process, ACCs are highly influential in the assessment of the rival bids and the decision on the auditor to be appointed. As the representative of the interests of the shareholders, we expect ACCs to regard professional scepticism and technical quality as important factors in the selection of an auditor.[1003]

(c) Tender processes have been detailed and transparent processes (see paragraph 9.309) which have provided senior management and the AC with the opportunity to reflect on and scrutinize the audit offering and the relationship with the auditor.

16.12 Further, our requirement that the AC report discloses in which financial year the company next intends to go out to tender in relation to its audit engagement and why selecting this year is in the interests of shareholders will work with Remedy 5 in further enhancing the influence of the AC in the decision when to go out to tender. It also complements aspects of our remedy package designed to encourage shareholder engagement. Additional disclosure will encourage AC's to formulate a reasoned policy on when the company will next go out to tender in relation to the audit engagement taking into account the interests of shareholders.

Views of parties regarding mandatory tender processes

16.13 Details of the views of the investor community, FTSE 350 companies, the FRC, Big 4 firms, Mid Tier firms, and UK industry bodies are set out in Appendices 14.1 and 16.1. Many investors supported the FRC's guidance that companies should go out to tender in relation to their audit every ten years on a 'comply-or-explain' basis. A significant proportion of investors supported tender processes on a more frequent basis.

16.14 We received responses from individual investors in support of tendering every ten years. Views were mixed on whether a requirement to tender should be mandatory or on a comply-or-explain basis. The IMA, which represents the asset management industry in the UK, said that whilst a minority of investors supports tendering every five or seven years, the majority support the FRC provisions.[1004] The ABI, which represents the UK's insurance, investment and long-term savings industry, supported the new FRC provisions.[1005] Both the ABI and IMA supported the FRC's comply or explain basis for the remedy.

16.15 Others investors favoured a shorter period. In particular: BlackRock[1006] and JP Morgan supported seven years; Brewin Dolphin supported six to eight years; Newton Investment Management supported five to seven years; and Baillie Gifford supported five years. Brewin Dolphin, Newton Investment Management and Baillie Gifford supported a comply-and-explain basis for the remedy. Royal London Asset Management supported mandatory tender processes at ten years and tender processes on a comply-or-explain basis from five to seven years.

16.16 National Association of Pension Funds (NAPF) supported a seven-year period. NAPF said that priority should be to ensure auditor independence but had apprehensions about a requirement to go out to tender every five years.[1007] A coalition of six investors and a body representing 56 local authority pension funds[1008] supported a five- to seven-year period.

[1003] The CC's first survey found that 97 per cent of ACCs said that high degree of auditor challenge was important in the assessment of audit quality. See Appendix 2.2, Table 10.
[1004] IMA response to provisional decision on remedies.
[1005] ABI response to Remedies Notice, 27 March 2013.
[1006] BlackRock response to provisional decision on remedies, 13 August 2013.
[1007] Hermes response to provisional decision on remedies.
[1008] USS Investment Management, RPMI Railpen, National employment Savings Trust (NEST), Local Authority Pension Fund Forum, London Pensions Fund Authority, Governance for Owners and Environmental Agency Active Pension Fund.

16.17 ShareSoc which represents and supports individual UK investors supported a five-year period.[1009] ShareSoc said that a five-year period would stimulate competition in the market for audit services and encourage more frequent changes of auditors, which will tend to increase their independence from the influence of company management. PIRC, which provides consultancy services to institutional investors on corporate governance and corporate social responsibility, supported mandatory tender processes at five years.[1010] PIRC suggested that the market currently was not working, and to initiate change the remedy should be sufficiently different from current practices. Local Authority Pension Fund Forum supported mandatory tender processes at five years and suggested that longer periods between tender processes would not address the problem of market concentration.[1011]

16.18 We received responses to our provisional decision on remedies from 19 FTSE 350 companies and 12 individuals with relevant FTSE 350 experience (many had been ACs and/or FDs). With one exception, these respondents did not favour a remedy that would require more frequent tender processes than that required by the new FRC provisions (ie every ten years). Most said that the new FRC provisions should be allowed time to take effect before any further changes were made. Some said that tender processes could be expensive and disruptive for companies.

16.19 Big 4 firms did not support a departure from the FRC's ten-year comply or explain provisions. They said that more frequent tender processes would be costly; would result in less effective tender processes and would threaten audit quality.

16.20 Mid Tier firms generally supported tendering on a seven- to ten-year basis.

Assessment of effectiveness

16.21 We first consider:

- *(a)* the likely effect of the new FRC provisions to go out to tender at least every ten years on a comply-or-explain basis as these form part of the background against which we assess the effectiveness and proportionality of the proposed remedies. See paragraphs 16.22 to 16.31;
- *(b)* the incremental costs to firms and companies of going out to tender on a mandatory basis at least every ten years. See paragraphs 16.32 to 16.43;
- *(c)* the incentives on firms and companies as a result of mandatory tender processes at least every ten years. See paragraphs 16.45 to 16.49 the effectiveness of a remedy that would give ACs the power to request that the incumbent auditor gives them access to specified parts of audit file for disclosure to rival bidders, in paragraphs 16.50 to 16.57.

The likely effect of the new FRC provisions with regard to the AEC we found

16.22 Our investigation principally gathered evidence on the period prior to the introduction of the FRC provisions (effective September 2012) during which there was no guidance in the UK Corporate Governance Code on the appropriate interval between tender processes. We found that 40 per cent of FTSE 350 companies had either last gone out to tender more than ten years ago or had never put the audit engagement

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1009 ShareSoc response to provisional decision on remedies.
1010 PIRC response to provisional decision on remedies.
1011 LAPFF response to provisional decision on remedies.

out to tender (see Appendix 2.2, Table 16). We also estimated that for the period 2001 to 2010, there were on average around ten tender processes a year for FTSE 350 audit engagements.[1012] Were all FTSE 350 companies to 'comply' with the new provisions of the UK Corporate Governance Code we could expect an average of at least 35 tender processes a year.

16.23 The rate of companies going out to tender would depend on how companies interpret the possibility not to 'comply' and rather to 'explain' and in particular, the circumstances in which companies consider it acceptable to 'explain' rather than 'comply' and the number of years for which it would be acceptable to take advantage of this possibility. Since these provisions have only been in place since September 2012 the available information on this point is limited. We summarize such evidence from *(a)* the FRC; *(b)* FTSE 350 companies; and *(c)* audit firms.

- *The FRC's expectations*

16.24 The FRC referred[1013] to the findings of a GT survey:[1014] overall FTSE 350 companies complied with 96 per cent of the aggregate UK Corporate Governance Code provisions that applied to them. With regard to the new provisions, the FRC considered that it would be acceptable for a company to explain rather than comply in certain commercial circumstances such as: a change in the FD; a level of risk in the year concerned that made it particularly relevant for the auditor to understand the history; and on the company being engaged in a takeover.[1015]

- *Companies' expectations*

16.25 In our second set of case studies (see paragraph 16.13 above), many FDs and ACCs expected that some companies would explain for a year or so but would then comply.[1016,1017] However, there was also a view that in practice there was likely to be a range of responses from companies and at least one ACC, who was organizing a tender process, suggested that the company might wish to explain for a while for subsequent tenders depending on the disruption caused by a switch in auditor.[1018]

16.26 Generally, the interviewees agreed that, regardless of the interval between tender processes, flexibility on the precise timing of a tender process was necessary to avoid going out to tender at times that were not convenient for the company.[1019,1020] Several interviewees suggested that a tender process could be linked to the rotation of the AEP (see Appendix 14.1, paragraph 53). SABMiller said that it would be inadvisable to tender the audit when there was a new CFO or ACC or if a company had recently been involved in any major corporate activity.[1021]

1012 See paragraph 7.23.
1013 See the FRC's What constitutes an explanation under 'comply or explain', Report of discussions between companies and investors, February 2012.
1014 GT 2011 Corporate Governance Review.
1015 Summary of response hearing with the FRC, paragraph 29.
1016 The CFO of Company V said that 'comply or explain' led to compliance in the vast majority of cases (Appendix 2.1, Company V, paragraph 17). See also Company N, paragraph 17; Company S, paragraph 36; Company W, paragraph 36 (arguing for allowing more time for the FRC's requirements to take effect to see if they had any impact).
1017 The ACC of Company Q said that 'comply or explain' was the basis of good governance (Company Q, paragraph 12).
1018 Company R, paragraph 36.
1019 See, for example, Company K, paragraph 25.
1020 The ACC of Company L gave as examples acquisitions or changes in functional and reporting systems. Company L, paragraph 28.
1021 SABMiller response to Remedies Notice.

- *Auditors' expectations*

16.27 The Big 4 firms said that they would expect a high rate of compliance and that the new FRC provisions were already having an impact on tender processes and switching activity.[1022,1023,1024,1025] The Big 4 firms considered that the circumstances in which it would be acceptable to 'explain' would be limited and short-lived.[1026,1027,1028,1029]

16.28 KPMG said that mandatory tender processes (as compared with a comply-or-explain regime) assumed that all FTSE 350 companies could be treated the same, regardless of their size or complexity, when in fact the size and complexity of a company had an important bearing on the appropriate timescale for a tender process. It also said that, under mandatory tender processes, the lack of a comply-or-explain provision implied that individual company circumstances, such as a change in company leadership or a critical financial situation, could be overlooked in order to comply with a rigid timetable.[1030]

16.29 In summary, the evidence available on how companies will respond to the FRC provisions is limited. Whilst recent announcements by FTSE 350 companies on their intentions to tender indicate compliance, we would expect a higher rate of tender processes in the early years given the number of FTSE 350 companies that have not tendered for many years. There is a general expectation that the level of compliance with the new FRC provisions will be high (see paragraphs 16.22 to 16.28). If this turns out to be the case, the new FRC provision would be expected to result, in a steady state, in a rate of around 35 tender processes being held a year.[1031]

16.30 However, we had some concerns that companies might decide to defer a tender process in year ten and opt to explain for a year or more. We envisaged the following circumstances:

[1022] Deloitte gave BG Group, British Land, Cairn Energy, DS Smith, E2V, Land Securities, Henderson, Hargreaves Lansdown, HSBC, Ladbrokes, Marks & Spencer, Marston's, Perform, RSA, Schroders, Standard Chartered, Tate & Lyle, Travis Perkins and Unilever and as examples of recent more frequent tender activity. These are said to have all gone out to tender following long periods of tenure. Deloitte response to provisional decision on remedies, paragraph 3.13.
[1023] Deloitte also said that a number of its clients had already told it that they would be going out to tender as a result of the new requirement. See Summary of response hearing with Deloitte, paragraph 6.
[1024] KPMG said that it was aware of five completed audit tender processes by companies in the FTSE 350 since September 2012, three of which had taken place within the FTSE 100. These included RSA, Schroders Plc and ITV Plc. In addition, a number of companies were said to have signalled their intention to initiate a tender process. HSBC Plc, Compass Group Plc, Domino Printing Sciences Plc, Foreign Colonial Investment Trust Plc and Ladbrokes Plc had all recently stated they would tender their audits within the next three years. See KPMG response to Remedies Notice, paragraph 3.1.4.
[1025] PwC said that, in its experience, the implications of the new tendering regime were on the agenda of most ACs (over 20 FTSE 350 companies have said as much in the annual reports for 2012) and that HSBC had announced a tender process and BG, RSA and Cairn Energy had decided to switch auditor following a tender process. See PwC response to the remedies notice, paragraph 3.13.
[1026] Deloitte said it expected that it would be acceptable for a company to explain for one year, possibly two years, and only rarely longer. Acceptable circumstances might be a major transaction, a big change of management, or if something disruptive was happening to the organization. See Summary of response hearing with Deloitte, paragraph 6.
[1027] EY said that the circumstances in which it would be acceptable to explain would be a major event such as a merger, a disposal or a major acquisition. EY said that it was difficult to envisage a circumstance where that event would not have moved on a year or two down the road.
[1028] When asked, for example, of when it would be appropriate to 'explain' rather than 'comply', KPMG mentioned a major transformational acquisition or disposal, initial public offering, some form of new build, a major change in the finance function, or the departure of the FD. KPMG said that in these circumstances changing auditors at the same time would involve some risk around the assurance processes. See Summary of response hearing with KPMG, paragraph 44. It would also be hugely inefficient to divert management time towards an audit tender process at such a time. See KPMG response to Remedies Notice, paragraph 3.2.1.2.
[1029] PwC suggested, based on its experience of companies 'explaining' a delay in AEP rotation, that the opportunity to explain provided flexibility to deal with unforeseen circumstances and that the circumstances in which companies might decide to 'explain' would be very limited (examples given were major M&A activity, a recent change in Chief Executive or CFO, or major system changes) and that such circumstances would be limited in duration to a year, on rare occasions, or two. See Summary of response hearing with PwC, paragraphs 36 & 37.
[1030] Summary of response hearing with KPMG, paragraph 26.
[1031] However, KPMG expressed a view that some companies might seek to 'explain' more often and for longer. See Summary of response hearing with KPMG, paragraph 27.

(a) a company plans to go out to tender in year ten but an unforeseeable event occurs, such as M&A or change of personnel; and

(b) a company considers that ten years is too short a period; for example it considers that having gone out to tender shortly after the introduction of the new FRC provisions (ie around now), ten years is too short a period to begin the process again (see paragraph 16.28).

16.31 We do not think that these circumstances would be relevant for the majority of companies, and agree with the general expectation that compliance will be high. However, we think that there is a risk that certain companies, for example larger, more complex groups, companies undergoing corporate upheaval, or those with less well developed standards of corporate governance, may choose to 'explain' rather than comply for one or more years once ten years have elapsed.

The incremental costs associated with going out to tender for audit services at least every ten years on a mandatory basis

16.32 In view of the above, we assessed the incremental costs of a remedy that results in a relatively small number of companies going out to tender at a shorter interval than might otherwise be the case under the FRC's 'comply or explain' regime.

16.33 We do not factor into the assessment of our remedy the incremental costs and benefits that would be associated with more switching. This is because we assume that a company would not switch unless it expected that the benefits of switching would exceed its costs. The likelihood of a company switching auditor following a tender is a factor that affects firms' incentives to participate and companies incentives to run an effective process. We consider this further in paragraphs 9.219 to 9.240.

16.34 We consider the evidence on *(a)* companies' costs and *(b)* firms' costs and *(c)* set out our view of likely future costs.

- *Evidence on the costs of tender processes for companies*

16.35 We found that the main cost to a company of conducting a tender process is the opportunity cost of the time spent by senior management in designing the process and participating in the process, and our evidence is summarized in paragraphs 9.301 to 9.306. Neither we nor companies could not put a reliable monetary value on the time needed to run a tender.[1032]

- *Firms' costs of tendering*

16.36 We set out the evidence and submissions relevant to the costs of tendering in Appendix 16.2. These suggest that the costs to a firm of participating in a FTSE 350 tender vary considerably. Information provided by the parties suggests a range of around £[✂] to over £[✂]. These costs are largely the opportunity cost of staff time involved in the tender process. Key factors in determining these costs seem to be the size of the company, the sector in which it operates and the geographic coverage of its operations. Costs are highest for the large financial institutions.

[1032] KPMG estimated the opportunity cost to a FTSE 350 company of running a tender process to be on average approximately £440,000 per process, and as high as £980,000 (see KPMG response to Remedies Notice, paragraph 3.2.4.4).

- *Discussion and our view on likely future costs of increased tender processes.*

16.37 We consider that estimates based on the costs firms incurred in past tender processes may overstate the incremental unit costs to firms of more frequent tendering in the future.

16.38 First, given the historical frequency of tender processes (ie on average only eight to ten tender processes per year[1033]), only few ACCs have experience of running a tender process, and we think that both company and firm efficiencies may be realized with greater expertise. We received submissions from some firms suggesting that such efficiencies would be possible,[1034] although this was contested.[1035]

16.39 Second, we think there may be some diversion to tender activities of firms' marketing activities (described in Appendix 16.2). The Big 4 firms said that marketing activities, the main objectives of which we found to be identifying and building relationships with potential clients, would continue to be necessary with more frequent tendering.[1036] We do not think that firms would have no further need to engage in such activity, but rather that some of this activity would take place in the more formal context of preparation for and participation in tenders. The dates of such tender processes will become more predictable under this remedy (see paragraph 16.3*(c)*).

16.40 Third, companies often held tender processes at quiet periods in the audit cycle, such as when an audit has just been completed, and hence the opportunity cost at these times may be somewhat lower. We noted the submissions disputing this on the basis that the senior staff typically heavily involved in tenders did not have quieter periods,[1037] and that firms use times when audit itself is less demanding for essential training and compliance activities.[1038]

16.41 In assessing the costs of mandatory tender processes at least every ten years we took the following into account:

(a) the great majority of FTSE 350 companies and audit firms supported the FRC's ten-year provision;

(b) some companies valued the flexibility that the comply-or-explain regime afforded, although we noted that there was some tension between these statements and the expectation that compliance would be high;

(c) we considered the costs of removing this flexibility. It is our view that the circumstances in which a company might explain rather than comply would be limited to those set out in paragraph 16.30 and we think that the period over which a company might wish to delay a tender process beyond ten years would be short.

(d) We note that our remedy might affect a limited number of large, complex entities and that the costs of such tender processes are high; and

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1033 See paragraphs 7.17–7.23.

1034 [✂] BDO considered that aspects of the tender process (such as documentation inviting expressions of interest and invitations to tender) could be relatively standardized, particularly if companies used specialized procurement consultants to help them run the process.

1035 KPMG said that audits were bespoke and so there were very few, if any, economies of scale associated with the participation in audit tender processes and so the cost per process was likely to remain unchanged regardless of the number in which an audit firm participated. KPMG response to Remedies Notice, paragraph 3.2.2.13.

1036 KPMG said, for example, that the time audit partners spend with a company provides them with an understanding of its business and the sector. KPMG response to provisional decision on remedies, paragraph 3.3.1.8.

1037 For example, see Deloitte response to provisional decision on remedies, paragraph 3.14c, and KPMG response, paragraph 3.3.1.7.

1038 PwC response to provisional decision on remedies, paragraph 8b.

(e) in addition our remedy may affect some other less complex entities whose tender process costs would be significantly lower.

16.42 In order to estimate the costs of removing the flexibility to 'explain' after ten years it is necessary to make an assumption about the cost of tender processes for such companies and the number of companies affected. We considered what the likely proportion of companies that would comply (the compliance rate) with the FRC's changes to the Code with respect to going out to tender every ten years would be and how this might vary across the FTSE 350.

16.43 Based on our assumptions of compliance and the estimates of the cost of tender processes identified in Appendix 16.2, we estimated the combined incremental cost of the remedy for firms and companies to be in the order of £1.5 million to £3 million, £[✂] to £[✂] of which relates to the 25 largest companies.[1039]

16.44 We considered whether the removal of flexibility would cause companies which would have preferred to go out to tender in year ten to go out to tender earlier to avoid, for example, the higher opportunity costs associated with certain disruptive corporate events (see paragraphs 9.198 to 9.201). We think that it is large, complex companies that might to want to go out to tender at the maximum interval of ten years and that these companies have considerable resources at their disposal to deal with such events. Further, we were told that such events would be rare and short-lived and we therefore considered that they were unlikely to have a significant effect on the overall cost of our remedy.

Incentives on firms and companies as a result of mandatory tender processes at least every ten years

16.45 As noted, the FRC's comply-or-explain regime specifies tender processes at ten yearly intervals.

16.46 With regard to firms, Crowe Clark, Deloitte, EY, GT, Kingston Smith, KPMG, and PwC supported this ten-year period. BDO and Mazars favoured a shorter period. None indicated that they would not have incentives to compete vigorously in tender processes that occurred every ten years.

16.47 With one exception, companies responding to our provisional decision on remedies did not favour a remedy that would require more frequent tender processes than that required by the new FRC provisions (ie every ten years). None indicated that they would not hold rigorous tender processes that occurred every ten years.

16.48 We accept that there may be some companies which might have 'explained' beyond ten years under the FRC's regime which must now go out to tender within that period, and that there is a risk that they might attempt to run a less rigorous process in order to comply with our Order. As noted, we think that firms should have good incentives to compete vigorously in any tender processes that a company runs, even if it runs it reluctantly. No company told us that it would not be able to go out to tender at least every ten years. As custodians of shareholders' interests, we expect ACs to ensure that any tender process provides a robust basis for auditor selection.[1040] If

[1039] In the absence of reliable cost data for companies' costs, we assumed that the company's costs would be equal to a tendering firm. We further assumed that three firms would compete in each tender.
[1040] The FRC's Guidance on Audit Committees, September 2012, recommends that the AC oversees the selection process and ensures that all tendering firms have access as is necessary to information and individuals during the duration of the tendering process (see its paragraph 4.21).

not, shareholders have the ability, with our remedy package in place, to hold the AC to account.

16.49 Accordingly, we are satisfied that mandating tender processes at least every ten years will not significantly affect the competitiveness of the tender processes that we observed historically. If companies choose to go out to tender the audit engagement more frequently than every ten years (and we think that many would benefit from doing so), then we think that this will be on the basis that the AC is satisfied that a competitive tender process can be run.

Effectiveness of open-book tender processes

16.50 We consider that companies should have the powers to require that incumbent firms give them access to specified parts of the audit file for disclosure to the rival bidders.

16.51 We generally found that companies made considerable efforts to ensure that rival firms have access to the information needed to submit bids (and have strong incentives to do so). This was necessary, given the advantage the incumbent would otherwise enjoy as a result of its knowledge of the company. However, the processes that companies have followed to disseminate the information required can be time-consuming, as they involve substantial management time in bilateral meetings with rival firms.

16.52 We also found evidence that potential rivals for an engagement seek to develop a relationship with the company through the provision of other services. We consider that, whilst this would provide the firm with some familiarity of the company, the incumbent auditor continues to have an advantage. A rival firm could not expect to acquire a detailed knowledge of, for example, a company's financial control systems or accounting treatments, in the provision of, say, tax advice.

16.53 We consider that the ability of an AC to disclose specified parts of the audit file to firms competing in a tender process could *(a)* provide a mechanism for the dissemination of information that reduces the amount of time that management spend in educating rival audit firms, and *(b)* reduce incumbency advantage by facilitating the dissemination of sufficient information.

16.54 In responding to our provisional decision on remedies, parties expressed concerns that this remedy carried a risk of disclosing firms' intellectual property to rival firms, thus discouraging investment and innovation. Parties' views are summarized in Appendix 16.1. We agree that there would be risks if rival firms were provided with unrestricted access to the audit file.

16.55 We consider that companies should have the power to require that the incumbent firm disclose specified parts of the file which would provide rival firms with information specific to the audit and which would not compromise the intellectual property of the incumbent firm. We might expect the disclosure process to operate in much the same way as the data room used by Companies N and W in the case studies (see Appendix 14.1, paragraph 32). We would expect firms' accessing any data room to sign confidentiality agreements at the request of the company.

16.56 We consider that the information to be provided by the company to firms engaged in a tender process should include the following:[1041]

[1041] EY response to Remedies Notice, Annex 2, paragraphs 2.7a), 2.10 & 2.12.

(a) information prepared for the AC on the planning, execution, and findings relating to the statutory audit of the group, parent, and its principal subsidiaries;

(b) the principal audit risks and an accompanying commentary on whether these reflect risks within the business or in the control environment, or both;

(c) the incumbents' evaluation of the design, implementation and effectiveness of the control environment; and

(d) the breakdown of the current audit fee and the number of hours by staff grade and by audit task.

16.57 To the extent that any of the above information is not reproducible from documents provided to the AC, the company may require disclosure of this information from the incumbent firm's audit files.

Our assessment of the appropriate frequency of tender processes

16.58 Following consideration of the various relevant factors in the above sections that are relevant to the appropriate frequency and form of tender processes, this section seeks to summarize why we decided that companies should put their audit engagement out to tender at least once every ten years, and where the company has not put its audit engagement out to tender in the last five years, the AC Report should state in which financial year it intends to put the audit engagement out to tender and why the AC considers that going out to tender in this year to be in the best interests of shareholders.

16.59 We consider that more frequent tender processes as a result of a mandatory limit is likely to generate the following significant benefits:

(a) it allows companies to exercise their bargaining power more effectively both during tender processes and in between tender processes;

(b) it would ensure that there is a formal competition via a tender process for each audit engagement at least every ten years in which the AC has an influential role in the specification of the process and the auditor selection and contribute to ensuring that shareholder interests are given appropriate weight;

(c) it is likely to stimulate increased choice both within the Big 4 and Mid Tier firms for the provision of audit services;

(d) it may reduce the perception of a familiarity threat and may lead to improvements in audit quality and innovation through deployment of new personnel and techniques; and

(e) we expect that the benefits of more regular tendering will also combine with the effects of other proposed remedies to address the AEC, in particular those designed to strengthen further the influence of the AC in the external audit relationship, and encourage shareholder engagement.

16.60 We note that in determining the period of ten years between tender processes, the FRC had regard to the desirability of tender processes coinciding with the end of a normal AEP engagement period in order to minimize disruption to companies (ie the tender period should comprise two AEP engagement periods of five years). Other respondents to our remedies notice also supported continuing the ten-year period between tender processes on the basis that this would coincide with the AEP rotation cycle.

16.61 We consider it to be a matter of judgement as to the appropriate interval between tender processes. We note the FRC's judgement that five years was the appropriate interval for rotation of an AEP to ensure their objectivity and independence.

16.62 We think ten years is in general a long a time for an audit engagement not to be subject to the high level of scrutiny and competition that we found takes place within a rigorous tender process. In our considered view, for many (and perhaps most) companies a period of five years would best ensure the sustained alignment of auditor incentives with shareholder interests. We do not consider from a competition perspective that an intra-firm partner rotation adequately secures this position. While partner rotation plays a legitimate role in ensuring that individual audit partners are objective and independent, it does not disturb the economic incentives of the audit firm and it is those firm-level incentives with which our analysis is primarily concerned.

16.63 Our view is that for many companies five years is an appropriate interval at which to subject the audit relationship to scrutiny and challenge, and that going out to tender at this interval will increase company bargaining power and ensure a competitive service between tender processes. A significant proportion of investors supported this view (see Appendix 16.1, paragraphs 2 to 42). However, we also note that significant numbers of companies, audit firms, investors and the FRC were opposed to it, largely on the basis of the costs this would impose on firms and companies, the risk that such frequency may undermine the intensity of competition that a tender process provokes and the quality of audit that a firm could deliver.

16.64 We note that the FTSE 350 includes a diverse set of companies spanning the most complex global groups as well as more straightforward UK-based companies, with a large range in market capitalization, from less than £10 billion to over £100 billion. The top ten constituents of the FTSE 100 comprise approximately half the value of the FTSE 100 index. We consider that for many FTSE 350 companies, holding a tender process every five years would be manageable and would bring benefits. After five years, we think that an increasing proportion of companies would realize benefits from holding a tender process. We acknowledge, however, that for larger, more complex organizations, the costs of tender processes will be higher (for companies and firms) and the length of time required to conduct a tender process longer. For some organizations, the costs of switching will be significantly higher than average. In particular, there are onerous independence requirements for some financial services organizations, for example necessitating changes to personal and corporate banking relationships, and this may increase the costs of switching auditor. Very high switching costs may adversely affect a company's propensity to switch after five years and so reduce the intensity of competition at a tender process in year five. For these reasons we have decided not to mandate a period between tender processes of less than ten years.

16.65 Having decided on ten years as an appropriate limit on tender process frequency, we considered whether the FRC's recent 'comply or explain' provisions were sufficient. We agree with the general expectation that compliance will be high. However, we do not think compliance will be universal. We think that there is a risk that certain companies, for example larger, more complex groups, companies undergoing corporate upheaval, or those with different views on what represents good corporate governance, will choose to 'explain' rather than comply for one or more years once ten years have elapsed.

16.66 We consider that the benefits of tender processes, in particular in ensuring that shareholder interests are fully represented, may be particularly important for companies in these categories. We therefore consider that in order for our remedy to be fully effective it is necessary to mandate that all companies must put their audit engagement out to tender by year ten, with no exception.

16.67 The incremental costs of our remedy are those of a relatively small number of *(a)* large complex entities and *(b)* other entities going out to tender at a shorter interval than would otherwise be the case.

16.68 We therefore propose make an order to the effect that companies should put their audit engagement out to tender no less frequently than every ten years.

The effectiveness of the disclosure of tender process policy in the AC Report

16.69 We consider that the AC should determine the appropriate period at which an audit tender process should be held, subject to the requirement that this should be at least every ten years. This is because the AC is best placed to understand the specific circumstances of the company, its relationship with its incumbent auditors, and the views of its shareholders.

16.70 Other elements of our remedies package designed to empower the AC and improve shareholder engagement will enable the AC to take a decision on the appropriate interval at which to put the audit engagement out to tender in the interests of shareholders. Additional disclosure about how this decision has been taken will encourage AC's to formulate a well-reasoned policy on when it will next put the audit engagement out to tender that takes into account the views of shareholders.

16.71 An additional benefit to disclosure is that audit firms will have increased visibility of when companies intend to go out to tender and will therefore be better able to prepare themselves to bid. We expect this to lower barriers to entry, expansion and selection and improve rivalry.

16.72 We decided that companies that have not gone out to tender in the last five years should state in the AC report in which financial year they intend to put their audit engagement out to tender, and why the AC thinks that going out to tender in that year will be in the best interests of shareholders. If the company subsequently departs from that, we would expect an explanation as to why in the next AC report. Our package of remedies, in which ACs have significant influence in the decision of when to go out to tender, and shareholders have greater ability to engage with companies, will allow the AC to decide the right period in the interests of shareholders.

Implementation, enforcement and transitional provisions

Implementation, enforcement

16.73 In general, the CC prefers to act by Order where appropriate, as an Order is binding and we can make it directly, so it is more likely to be effective in addressing the identified AEC. Further as discussed above (paragraphs 16.31 and 16.65), the application of the principle of 'comply or explain' does not fully address our AEC finding. In accordance with these considerations, we envisage that our requirement for FTSE 350 companies to put out to tender their external audit engagement at least every ten years will be implemented by CC Order, rather than a recommendation to the FRC to amend the UK Corporate Governance Code.

16.74 Our aim is to ensure that companies put their audit engagement out to tender at least every ten years. This means that no audit firm may conduct more than ten consecutive audits of a company without a competitive tender process having taken place. The Order would in effect require that FTSE 350 companies should put their statutory audit engagement out to tender not less frequently than every ten years. Where a company has not put its audit engagement out to tender in the last five years, the AC Report shall include a statement of in which financial year it intends to put the audit engagement out to tender and why it considers this year to be in the best interests of shareholders. This process should be repeated for each subsequent AC Report until the company puts its audit engagement out to tender. If a company subsequently decides that the proposed financial year is no longer appropriate, it should set out its reasoning in the next AC Report.

16.75 We think that the Order should prohibit auditors and FTSE 350 companies from entering into a statutory audit engagement agreement where the engagement has not been put out to tender in accordance with the provisions of the Order.

16.76 The company may require that the incumbent audit firm provides access to certain elements of its audit file to bidders in the tender process (see paragraphs 16.50 to 16.57).

16.77 We are not mandating a particular form of tender process which companies must follow, and welcome the FRC Notes on Best Practice.[1042] This is because we think that there are sufficient incentives on companies to conduct a thorough tender process (see paragraphs 9.301 to 9.306) and that companies are best placed to specify the form of the process to ensure that it is effective and efficient.

16.78 We will require a compliance statement to be included as part of the AC Report to the effect that the company has complied with the provisions of the proposed Order.

16.79 We have taken into account that the FTSE 350 is a shifting class with companies periodically moving in or out of the listing. We think that new entrants to the FTSE 350 listing should be subject to the provisions of the proposed Order immediately upon entry into the listing. This means that calculation of the ten-year period for the purposes of the proposed Order would take into account periods prior to entry into the FTSE 350. We think that the proposed Order reflects good corporate governance which companies that aspire to join the FTSE 350 are likely to follow, and in any event the requirements of the proposed Order can be taken into account and planned for by companies outside the FTSE 350 listing. We would not therefore expect the provisions to be unduly onerous on companies outside of the FTSE 350 which subsequently enter the FTSE 350 listing.

16.80 We recommend that the FRC amends the UK Corporate Governance Code in line with the provisions of the proposed Order.

Transitional provisions

16.81 The FRC recognized that its provision requiring tender processes at least every ten years on a 'comply or explain' basis could be disruptive if a large number of companies were to go out to tender in the first year in which the revised UK Corporate

[1042] www.frc.org.uk/News-and-Events/FRC-Press/Press/2013/July/FRC-offers-advice-on-conducting-effective-audit-te.aspx

Governance Code applied and issued guidance on transitional arrangements.[1043] These arrangements are not binding.

16.82 The FRC said that companies should put the audit out to tender earlier than they would be expected to under these arrangements if they felt it was appropriate to do so, and shareholders should feel free to request them to do so. Equally, as with all other provisions of the UK Corporate Governance Code, companies could choose not to comply and explain why they had not done so. Whatever their decision, companies are encouraged to state when they first report against the 2012 UK Corporate Governance Code whether or not they anticipate putting the audit contract out to tender in due course.

16.83 The FRC suggested that the timing of tender processes might be aligned with both the cycle for rotating the AEP and the length of time since the audit contract was previously put out to tender. The FRC suggested that where a company had put the audit contract out to tender or changed audit firm in or after 2000, the tender process might be deferred until the latter stages of the incoming AEP's term (in other words, for a further five years).

16.84 In determining the appropriate transitional arrangements for implementing our proposals for mandatory tender processes no less frequently than every ten years, we agree with the FRC's principles that the timing of tender processes should take into account the five-year cycle for rotating the AEP and should be influenced by the length of time since the audit contract was last put out to tender. We have designed our transitional arrangements to ensure that those companies which have not gone out to tender for the longest time do so as early as possible, but we have retained some elements of the FRC's phased transition to take account of the backlog of companies who have not gone out to tender for more than ten years.

16.85 We have also taken into account the need to ensure that companies and firms have adequate notice in advance of the requirement to go out to tender in order that they have the opportunity to plan an effective tender process.

16.86 Our decision on transitional arrangements is as follows:

(a) FTSE 350 companies that last put the audit engagement out to tender before 1 January 2005 (or have never done so), must go out to tender within two years of the end of the current AEP rotation period. Companies should explain when they intend to put the audit out to tender in the AC Report;

(b) FTSE 350 companies that have tendered since 1 January 2005 may choose not to hold a tender process at the end of the current AEP rotation period, but must do so by the end of the final year of the following five-year period.[1044]

16.87 Our transitional arrangements require that companies which last went out to tender between 2000 and 2005 must do so earlier than under the FRC's provisions. We estimate that the number of FTSE 350 companies in this category to be less than 85.[1045] Our transitional arrangements require these companies to go out to tender within two years of the end of the current AEP's tenure, that is, normally within two to

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[1043] www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Corporate-Governance-Code.aspx.
[1044] This period may exceed the tenure of the next AEP in some circumstances.
[1045] The CC first survey results indicate that 23 per cent of current FTSE 350 companies had tendered in the last five years and a further 24 per cent in the last six to ten years (see Appendix 2.2, Table 16).

seven years from the Order coming into effect.[1046] Under the FRC's arrangements, these companies would be required to go out to tender in five to ten years time.[1047] Our arrangements therefore potentially increase the number of companies going out to tender in the first two to five years from the Order coming into effect compared to the FRC's arrangements. At a maximum, this could result in an additional 15 to 17 companies going out to tender each year between 2016 and 2018.[1048]

16.88 However, this is likely to overstate the effect of our transitional arrangements, because it assumes that companies would have otherwise chosen to delay the next tender process for a period substantially longer than ten years (that is, up to maximum of approximately 19 years subject to the relative timing of AEP rotation). We do not consider this is likely in the current corporate governance environment. Further the effect of the transitional arrangements is to bring forward the timing of tender processes rather than require additional tender processes. For these reasons, we do not consider that our transitional proposals are likely to lead to significant incremental costs in aggregate.

16.89 In paragraph 18.24 we discuss the making of the Order further.

Assessment of Remedy 2: Audit Quality Review

Summary and introduction

16.90 We have decided to recommend to the FRC that:

(a) The AQR team should aim to review and report on the controls, systems and processes of each of the 'major firms'[1049] annually, subject to the firm having sufficient PIE audit clients to make this assessment practicable.

(b) The AQR team should review every audit engagement in the FTSE 350 on average every five years, with each individual audit engagement in the FTSE 350 reviewed at least every seven years.

16.91 In this subsection, we set out:

(a) the background and aim of the remedy;

(b) views of parties;

(c) our assessment of effectiveness; and

(d) implementation considerations.

Aim of the remedy

16.92 The function and output of the AQR team is described in Appendix 3.1, paragraphs 171 to 183.

[1046] Depending on when the incumbent AEP is due to rotate off and whether the two year period is used or not. Where an AEP's tenure is extended to the maximum of seven years, the period before a tender could extend to nine years, although we would expect this to be rare in practice.
[1047] Assuming the AEP tenure is five years rather than the maximum permitted period of seven years.
[1048] The annual impact depends on when individual companies choose to tender and whether they utilize the available additional two-year period. This figure assumes all companies use the two-year deferral.
[1049] Those identified by the FRC as having ten or more PIE clients in the AQR's scope.

16.93 We found that the AQR team was the only external source of information on individual audit engagements that had access to the audit files of PIEs.[1050] We found that the use of AQR team reports on specific engagements varied, but it appeared that reports were considered carefully by ACCs.[1051] A number of companies in our case studies had read AQR findings at both an engagement and firm level with one of the AEPs referring to having raised his auditor's firm level report with the AEP.[1052] We found that firms generally saw AQR team reviews as providing a public measure of audit quality and could act as an incentive for audit firms to maintain and improve quality.[1053]

16.94 We found that in the five years to March 2013 the AQR team on average reviewed FTSE 100 company audits between every six and seven years and FTSE 250 company audits every 11 years (excluding follow-up reviews).[1054]

16.95 We consider that more frequent AQR team reviews would address companies' lack of bargaining power with regard to their incumbent auditor (our first theory of harm), barriers to entry, expansion and selection for non-Big-4 firms, and auditors' incentives to compete to satisfy executive management rather than shareholder demand (our second theory of harm).

Companies' bargaining power

16.96 We consider that giving companies more and better information with which to assess the quality of their own auditor and other audit firms will contribute towards companies being able to make a more informed assessment of whether the offering of their incumbent auditor is competitive.

Barriers to entry, expansion and selection

16.97 At present the AQR team issues firm-level reports on nine firms.[1055] As the frequency of reporting for the firms differs (between annual and triennial), there is a disparity in the frequency, and by extension, volume, of information on the quality of audits and the systems and controls to ensure audit quality for different firms. We found that reputation[1056] was an important factor to companies in selecting an auditor and acted as a barrier to entry which is difficult for Mid Tier firms to overcome without being able to demonstrate relevant experience.

16.98 As such we consider that additional independent information about the quality of these firms' large listed company audit engagements may help them to demonstrate relevant experience to the market.[1057]

[1050] Paragraph 7.119.
[1051] Paragraph 9.135.
[1052] Paragraph 9.137.
[1053] Paragraph 9.138.
[1054] However, because of the focus on priority sectors and systemically more risky companies, certain companies are reviewed more frequently than average, while companies considered to have less systemic risk such as investment trusts, are reviewed less frequently than average. See paragraph 9.134.
[1055] The number is determined by the number of PIE audits that each firm conducts (and the recent merger of BDO and PKF).
[1056] That is, perceived ability; see paragraph 10.20.
[1057] We noted that reputation is often based on experience and may to some extent be synonymous with it, because of the difficulty of gauging quality in another way (see paragraph 10.20). We further identified institutional preferences for the largest auditors which might be as a result of the 'IBM effect'; see paragraphs 10.21–10.29.

Auditors' representation of shareholders' interests

16.99 The AC's role is to review and monitor the external auditor's independence and objectivity and the effectiveness of the audit process, taking into consideration relevant UK professional and regulatory requirements[1058] on the behalf of shareholders. A greater frequency of individual audit file review by the AQR team will give ACs more information and insight into the technical quality of their statutory audit.

16.100 Additionally, a greater frequency of audit file review will increase the likelihood that in any given year an audit file will be reviewed, incentivizing auditors to focus on technical audit quality, which is the principal demand of shareholders.

Views of parties

16.101 The views of parties are summarized here and are set out at greater length in Appendix 16.3.

Frequency of engagement and firm inspections

16.102 The FRC stated that it agreed that there was scope to consider more frequent AQR inspections but stated this was in 'some cases of higher risk'. The FRC also noted the potential for more detailed reporting.[1059]

16.103 Case study interviewees generally found AQR reports to be useful and the majority who commented on this area supported increased frequency of company-level reviews, though there were differences in views as to which companies might be reviewed more frequently. Submissions by investors and investor groups were generally favourable to increased AQR frequency, though investors differed on the optimum frequency. Some investors thought a prioritization of certain entities was beneficial. Firms submitted a range of views.

16.104 One investor referred to the different frequency of individual firm-level reports and believed this might inappropriately indicate a hierarchy in the audit market. One Mid Tier firm supported all firms being reported on with the same frequency and at the same time. Two companies referred to the different review cycles of firms and that the remedy should address this.

Scope and content of inspections

16.105 Two investors noted that AQR was the only independent assessment of audit quality available to them, and another investor said that AQR was but one source of information. Several investors and one Mid Tier firm felt a greater focus on audit judgements rather than documentation would make the AQR more useful. Two companies did not see the need to increase the scope of AQR reporting.

16.106 Again, firms submitted a range of views. Deloitte noted that the AQR was not a balanced scorecard of audit quality as it did not consider the relative complexity of an engagement, and further that the findings were not representative of the market as a whole because AQR focused on certain sectors. One Mid Tier firm noted the benefit of the AQR concluding on relative audit quality for comparable audits.

[1058] FRC Guidance on Audit Committees, September 2012, paragraph 2.2.
[1059] FRC response to Remedies Notice, 18 March 2013.

Shareholder access to engagement-specific findings

16.107 Investors held mixed views on whether there should be company-specific reporting, with some stating they would not have time to review company-specific findings and others warning that there might be an undesirable signalling effect to the market if the review found poor audit quality. Some respondents identified the risk of firms becoming more adversarial in agreeing AQR findings.

16.108 The comments we received from parties in response to our provisional decision on Remedies were similar to those summarized above and in general commented on the additional resources that would be required by the FRC and how this would be funded. The FRC identified a number of specific issues, such as the need to review a sufficient number of audit files to support an assessment of a firm's controls and the need for flexibility in choosing which engagements to review.[1060]

16.109 A coalition of ten investors and investor bodies did not consider the remedy to be sufficient and stated that accountability to shareholders depends above all on a robust system for checking the incumbent auditor's work, and the provision of this information to shareholders.

Assessment of effectiveness

16.110 The aspects of this remedy which we consider are:

(a) the frequency of review of company audit files;

(b) the frequency of reporting on audit firms;

(c) scope and content in terms of gradings and company engagement falling within this remedy;

(d) shareholder access to company-specific findings; and

(e) the current funding mechanism for the AQR team.

Frequency of audit file review

- *Discussion of frequency of engagement review and likely cost implications*

16.111 At present individual audit engagements are on average reviewed infrequently, albeit with certain more risky audits reviewed more frequently. As discussed above, AQR team reports on individual audit files are the only source of independent information on technical audit quality. We found that the time the average FTSE 350 company would have to wait for its audit to be reviewed was around ten years.

16.112 Because of the way that the AQR team selects which audit files to review, there is no theoretical maximum length of time between two successive AQRs. Based on the number of FTSE 350 audit files reviewed each year, we can calculate the average frequency, but as the selection of files is based on a risk profile, some companies will necessarily not be reviewed.

16.113 We think that increasing the frequency of audit file review would be beneficial, as:

[1060] The views of the FRC and parties are noted in greater detail in Appendix 16.3, paragraphs 49–53.

(a) the information contained in AQR reports has an important role to play in increasing visibility of audit quality and thereby improving company bargaining power;

(b) more frequent audit file reviews would improve the robustness of firm-level reports because they would be based on a more representative sample of audit engagements. Companies would be better able to make inferences on the relative quality of different firms as a result; and

(c) more frequent reviews would increase the likelihood that all AEPs would have each of their audit engagements subjected to scrutiny during their tenure.[1061] Similarly AC members are more likely to receive the results of an AQR during their time on the AC.[1062]

16.114 We considered how best to increase frequency of audit file reviews, whilst preventing unintended consequences, such as making the timing of AQR file reviews predictable for firms, or constraining the AQR team's primary duty to ensure audit quality of PIEs across the economy in general. We accept that certain companies are of greater interest than others because of issues such as systemic financial risk consequently the need to ensure some flexibility for the AQR team to focus more effort on such companies. However, we aimed to ensure that all companies in the FTSE 350 would benefit from the remedy.

16.115 We identified other possible additional benefits arising from the resultant likely improvement in information on audit quality, such as increased confidence in capital markets, but we have not been able to quantify these benefits (see paragraph 14.39).

16.116 We considered the cost implications of increasing individual audit file reviews to every five years on average. The FRC informed us that, based on the current AQR reporting arrangements, the marginal cost of undertaking an inspection of a PIE would be in the range of £15,000 to £40,000,[1063] but was unable to provide an indicative figure for the average company in the FTSE 350.[1064] Using the maximum and minimum cost of conducting a file review for 70 audits a year (ie 350 over five years) gives a range of £1 million to £2.8 million a year. As this would be broadly a doubling of work, we can assume that at least half of these costs are incurred at present. The marginal cost of the remedy is therefore in the order of £0.5 million to £1.4 million a year.

16.117 Given the current emphasis on larger, more complex audits, even if the overall frequency of review is doubled, this may not give rise to a doubling of cost. It is therefore reasonable to assume the marginal cost of the remedy would be towards the lower end of the above range, and would be unlikely to exceed £1 million a year.[1065]

16.118 In addition, there will be some additional opportunity costs to firms of responding to AQR queries. As the primary focus of the review is on the file itself we do not believe that these costs will be significant.

[1061] Given that AEP tenure is typically at most five years, under the current AQR regime, the average frequency of review is every ten years, companies would only gain insight into the audit delivered by every other AEP on the engagement, on average.
[1062] At present there is no certainty that an AC member would receive the results of an AQR during their tenure (of up to nine years, assuming they joined the AC on appointment as an NED, but typically considerably less than this).
[1063] The FRC told us that were it to be required to increase the number of reviews undertaken these costs might change.
[1064] FRC, 25 June 2013.
[1065] For example, assuming the 50 largest companies cost £40,000, the next 50 cost £30,000, the next 200 £20,000 and the final 50 £15,000, gives a marginal cost estimate of £825,000. There are around 35 FTSE 350 audits where the UK element of the audit fee is £40,000 or less, indicating that a file review would potentially be relatively simple.

- *Our view*

16.119 We concluded that AQR reviews should be more frequent than at present and that, on average, a FTSE 350 company's audit file should be reviewed every five years, with a maximum interval for an individual company's audit to be reviewed every seven years. The FRC should retain flexibility in deciding the frequency and scope of its reviews.

16.120 We chose a period of five years because it aligns with the rotation requirement of AEPs, increasing the likelihood that every AEP will be subject to review at least once for every FTSE 350 audit engagement. Further, in our view many companies will realize benefits if they go to tender every five years, and if they do, this remedy means that they are likely to receive an AQR report on their incumbent auditor between tender processes.

16.121 We recognize the need for the AQR team to have the necessary flexibility to target risky audit engagements more frequently, and to facilitate this we have introduced a maximum interval between the reviews of a company's audit of seven years.

Frequency of reporting on audit firms

- *Discussion of frequency of firm review and likely cost implications*

16.122 At present the frequency of AQR reporting at audit firm level varies between one and three years.[1066] This in part is a function of the number of companies within the AQR team's scope that each firm audits. At present the AQR team currently reviews audit quality of around ten firms.

16.123 We understood that the frequency of firm-level reports is currently a function of the underlying number of PIE audits that each firm undertakes. The audit file reviews undertaken by the AQR team inform the assessment of the effectiveness of the controls, processes, systems and methodology of the firms.

16.124 We received no comments that were opposed in principle to the AQR team reporting on all firms within its scope annually. Some parties identified issues around the dangers of individual clients being identifiable if reporting was too granular within those firm-level reports. Two companies and one investor noted that having different frequencies of review suggested a hierarchy or inherent differences between the different firms. However, the FRC stated that it did not believe that the firm level report could be undertaken without a suitably sized sample of audit files and that outside the six largest firms this would be difficult.

16.125 The FRC informed us that the cost of inspecting a firm's quality control systems and reporting publicly on the results of that work was estimated at between £100,000 and £150,000. We calculated that the marginal cost of annual firm reviews would be around £325,000 a year if all major firms in the FRC's scope were reviewed annually. However, the FRC stated that it would only be able to undertake annual inspections for BDO and GT.[1067] If this is how the remedy is implemented, the cost of the remedy would be in the order of £150,000 a year.

[1066] The four largest annually, BDO and GT biennially and the other firms triennially. Since 2012 the AQR has delegated responsibility for the review of firms with fewer than ten PIE clients in the AQR's scope to the relevant RSB.
[1067] Since both firms have FTSE 350 clients and audit a large enough number of public interest entities to allow it to obtain a reasonable sample to inspect annually. FRC response to provisional decision on remedies, p7.

16.126 We believe that the principal cost will be the AQR staff time required to perform the reviews as discussed above. However, it is likely that firms will incur some staff costs in preparing information for the AQR and responding to queries.

16.127 Some parties expressed concern that this increased frequency would act as a barrier to entry. However, whilst BDO for example estimated the potential cost at £250,000 a year (partially as a result of the increased number of file reviews necessary),[1068] it supported the remedy, as did GT.[1069]

- *Our view*

16.128 By reporting on a larger set of audit firms annually, we consider that the larger Mid Tier firms will be better able to demonstrate their experience and capability in PIE audits and companies will have more timely information on the quality of these firms. We recognize that the extent to which Mid Tier firms are able to use such reports to demonstrate quality is dependent on the findings of the reviews. Further, the remedy would contribute to dispelling presumptions of differences in quality between firms that may arise on the basis they are not subject to the same regulatory regime.

16.129 We believe that the FRC should aim to report on major firms auditing PIE companies with equal frequency and at the same time. We accept that where a firm audits a limited number of PIE companies it may be impractical to report on that firm annually. We conclude therefore that where an audit firm has a sufficient number of PIE audit clients to make the assessment practicable, it should be subject to annual review.

Scope and content of reviews

- *Comparability of gradings*

16.130 We considered whether there was merit in changing the scope of the work of the AQR team, including the contents of reports, to increase their utility for ACs and shareholders in assessing audit effectiveness and comparing quality between firms. We note that by increasing the frequency of individual file reviews, the firm-level reports will be based on a more representative sample of audit files, and will therefore be more suitable for the purpose of comparing audit firm quality.

16.131 A small number of parties[1070] noted that the utility of AQR was diminished by being process driven, focusing on how firms have documented compliance with ISAs rather than how they had reached decisions. However, the AQR team clearly states that its objectives are to focus on audit judgements, and the FRC confirmed that this was the case. We concluded that these comments reflected a misunderstanding of the current scope rather than indicating a need for change.

16.132 The evidence that we have seen suggests that companies and investors generally value the information from AQR file reviews and firm-level reports and were supportive of the work of the AQR team. We considered that the AQR team's emphasis on how judgements were reached and whether those judgements were appropriate was important and provided helpful information to investors and companies about such aspects of audit quality where visibility might otherwise be low.

[1068] BDO response to provisional decision on remedies.
[1069] GT response to provisional decision on remedies.
[1070] Appendix 16.3, paragraphs 1, 5, 8 & 32.

16.133 We therefore make no recommendations in relation to the scope and content of the reviews themselves.

- *Companies in scope*

16.134 The terms of reference of this investigation defined large companies as the FTSE 350, which is a fluid group of companies. Framing the remedy on a changing group of companies means that the remedy needs to be designed so that companies that move in and out of the FTSE 350 are not reviewed with an inappropriate frequency. However, given that companies moving out of the FTSE 350 will still be subject to the scope of the AQR, we believe that this issue should be managed by the FRC in determining its programme of file reviews in pursuance of its objectives.

Shareholder access to company-specific findings

16.135 We received submissions on the potential for AQR reports on audit engagements to be made public and we investigated this further during case study interviews and our investor questionnaire. We discuss this further in Remedy 6 (extended AC reporting) (see paragraphs 16.288 to 16.334).

Funding the increase in the AQR's activities

16.136 We acknowledge that our remedies to increase the frequency of AQR will have a resource cost for the AQR team. At present the costs of AQR are levied by the FRC on the Recognised Supervisory Bodies (RSBs) (the accounting institutes and principally the ICAEW) which recover the costs through fees levied on the firms.

16.137 Under the present funding regime, the burden of this remedy would be directly incurred by firms. The costs of any change include the additional net cost of the FRC's resourcing for AQR and the additional net cost of hosting and responding to AQR queries.

16.138 We expect firms to recover these costs from companies and thus shareholders through fees. However, this pass-through of costs may affect companies outside of the FTSE 350 if the fees paid to the relevant RSB are recovered through a general increase in rates charged to clients. A more equitable solution might be for the FRC to levy these costs on the FTSE 350 as an additional fee to preparers of accounts as this cost would be offset directly against the benefits received by shareholders of FTSE 350 companies.

16.139 We consider that the FRC is best placed to determine the appropriate mechanism by which to recover the additional costs associated with this remedy and make no recommendation in this regard.

Implementation

16.140 This remedy is to be implemented as a recommendation to the FRC to increase the number of FTSE 350 audit files that the AQR reviews each year, set the maximum duration between reviews, and align the frequency of firm-level reviews for all firms auditing FTSE 350 companies.

16.141 We acknowledge that the implementation of this remedy will rely on the ability of the AQR team to expand its resources to undertake additional and more frequent AQR reviews. In light of this, we recommend that the remedy be implemented by the FRC as soon as is reasonably practicable.

Assessment of Remedy 3: Auditor clauses in loan agreements

Summary and introduction

16.142 We decided on the following remedies in relation to auditor clauses in loan agreements:

(a) an Order prohibiting provisions in loan agreements which restrict or have the effect of restricting a company's choice of statutory auditor to lists or categories, but the prohibition will not extend to any objectively justified auditor selection criteria:

(i) by 'company', we mean any company whose annual accounts for a financial year must be audited in accordance with Part 16 of the Companies Act;

(ii) by 'loan agreements' we mean any arrangement with such a company for the purposes of providing borrowing facilities to that company. This includes bilateral and syndicated agreements but would not extend to public prospectuses in relation to bond issues;

(iii) the prohibition will apply to the relevant provision(s) but does not affect the validity of the rest of the loan agreement;

(iv) the prohibition will not apply to loan agreements currently in force but rather to loan agreements entered into on or after the date on which the Order comes into effect;

(v) companies must monitor and certify compliance with the Order in their Annual Report; and

(b) a recommendation to the Loan Market Association that it amend the auditor clause in its template leveraged loan documentation in line with the provisions of the Order.

16.143 In this section we set out:

(a) the effect of auditor clauses in loan agreements and the aim of the remedy;

(b) views of parties;

(c) design issues;

(d) assessment of effects; and

(e) implementation.

The effect of auditor clauses in loan agreements and the aim of the remedy

16.144 We found that lack of experience and reputation[1071] contributed to barriers to entry, expansion and selection in particular for Mid Tier firms in the FTSE 350 statutory audit market. We also identified a tendency of private equity houses, institutional investors and investment banks to prefer the Big 4 firms.[1072] This commonly held

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[1071] See paragraph 10.40.
[1072] See paragraph 10.26 & Appendix 2.6.

'City' view is likely to be a factor companies that are preparing to list on the main market, or which are already listed, take into account in their decisions regarding auditor appointment. It indicates that Mid Tier firms face barriers to retaining audit clients who are planning to raise private equity or list on the main market. Given a preference for Big 4 firms by many institutions, it appears rational for a company to appoint a Big 4 firm. Further, the tendency to prefer a Big 4 auditor indicates some risk for a listed company in switching from a Big 4 firm to a Mid Tier firm.[1073]

16.145 We found that 'Big 4 only' clauses in some syndicated leveraged loan agreements encouraged the use of a Big 4 firm.[1074] We considered that such Big 4-only clauses added to the reputational barriers Mid Tier firms face in expanding within or entering the FTSE 350 statutory audit market.[1075]

16.146 The Loan Market Association's (LMA) template leveraged loan documentation provides that: 'Auditor means one of [Pricewaterhouse Coopers, Ernst and Young, KPMG, Deloitte and Touche] or any other firm approved in advance by the Majority Lenders (such approval not to be unreasonably withheld or delayed).'

16.147 The square brackets in the clause are significant because the LMA states that its documents are designed to promote efficiency by creating a starting point for documentation based on market practice[1076] and is subject to negotiation.[1077] However, although there were examples of non-Big-4 firms being added to the clause, the clause was often left un-amended.[1078] Thus, in practice the clause appears to be used mechanically.[1079]

16.148 In a syndicated loan requiring 'Majority Lender' approval of the appointment of an auditor other than one of the Big 4 firms (see paragraph 16.145), consent of lenders whose aggregate commitments are over 66 per cent of the total loan commitment would typically be needed to approve use of a non-Big-4 firm.[1080] We were told that in a large multinational and multi-party transaction, such approval might be hard to achieve and the company might consider it too onerous to pursue it. This suggests that in practice such clauses may operate to require appointment of a Big 4 firm. We also found that the practice for bilateral loans appeared to be similar to that for syndicated loans and it was likely that Big 4-only clauses may appear in non-investment-grade bilateral agreements.[1081]

16.149 Most FTSE 350 companies would be considered investment grade and we found that the LMA investment grade template did not contain such a clause. We found that it was difficult to define precisely which companies are affected by the LMA's leveraged loan documentation but this could be a non-trivial proportion (at least 17) of the FTSE 350.[1082]

16.150 We think that prohibiting such clauses addresses the AEC by:[1083]

[1073] See paragraph 10.28.
[1074] See paragraph 10.25.
[1075] See paragraph 10.25.
[1076] Appendix 2.6, Annex A, CBS report, paragraphs 19 & 21.
[1077] LMA remedies response, 9 May 2013.
[1078] Appendix 2.6, Annex A, CBS report, paragraph 21.
[1079] We note that the clause refers to 'Deloitte and Touche' (no longer the correct name of a Big 4 firm) which suggests to us that the clause is not reviewed regularly and is not based on any current appraisal of the quality of firms.
[1080] Appendix 2.6, Annex 1, paragraph 5.
[1081] Appendix 2.6, Annex A, CBS report, paragraph 45.
[1082] Appendix 2.6, paragraph 4.
[1083] Remedies Notice, 22 February 2013.

(a) increasing companies' willingness to switch by providing particular companies with an increased pool of possible auditors;

(b) reducing barriers to entry, expansion and selection by reducing restrictions on non-Big-4 firms being retained or selected as auditors;

(c) reducing the role of reputation as a barrier to entry, expansion and selection for non-Big-4 firms; and

(d) enhancing the effectiveness of other remedies designed to facilitate switching (for example, by removing restrictions on auditor choice, it may remove limitations on firms that may be invited to participate in tenders).

Views of parties

16.151 Respondents to our remedies notice and provisional decision on remedies were generally in favour of a prohibition on Big 4-only clauses, in some form, though concern was also expressed for the need to protect lenders' legitimate commercial interests. Greater details of the views of parties are set out in Appendix 16.4.

LMA and lenders

16.152 The LMA said that it was reasonable for a lender to be able to specify a borrower's auditor. Lenders had to rely on financial reports produced by the borrower, and needed to have confidence that they were accurate. The auditor was important in allowing lenders to have such confidence.[1084] If the lender could not specify the selection criteria in the loan agreement, each time the borrower wished to change auditor, it would have to seek consent from the lender(s). This could be onerous, particularly for transactions involving a large number of lenders, and make switching less attractive.[1085]

16.153 The British Bankers Association stated that its member banks did not as a matter of policy stipulate a Big 4 firm. The LMA documentation indicates that lenders and investors should in the first instance consider whether an auditor with a global reach is needed. This, however, is not mandated even in this limited circumstance.[1086]

16.154 Barclays Bank stated that it did not have a 'systematic policy' as a condition of providing financing that borrowers used a Big 4 firm. However, it did not think it would be 'proportionate or appropriate' to prohibit lenders from ever requiring borrowers to appoint a Big 4 firm if this were appropriate in the particular circumstances.[1087]

16.155 HSBC stated the appointment of a particular auditor is primarily a matter for the borrower but lenders have a legitimate commercial interest in ensuring the borrower's auditors are of sufficient skill and reputation/good standing to do a robust job. Where a borrower changes auditor during the lifetime of a loan, lenders need assurance that they can continue to protect their interest.[1088]

[1084] Note of a meeting with the LMA, paragraph 3.
[1085] ibid, paragraph 5.
[1086] Response to Remedies Notice.
[1087] Barclays response to Remedies Notice.
[1088] Response to provisional decision on remedies.

16.156 Standard Chartered PLC stated that it was in general supportive of the remedy and that in certain circumstances it may be appropriate for a lender to require a specific auditor.[1089]

16.157 An international bank ([✂]) was concerned that any Order did not result in a lender being unable to take action if a borrower attempted to change its auditor during the term of a loan and the new auditor was not acceptable to lenders. It noted that applying any prohibition to documentation relating to debt capital market issues may cause difficulties for UK companies wishing to issue into the USA and other foreign markets where investors could require the issuer to be audited by a Big Four firm.[1090]

Investors and companies

16.158 Among responses from investors, those from BlackRock, Hermes Equity Ownership Service, Legal and General Investment Management, the UK Shareholders' Association, and a coalition of eight institutional investors[1091] supported the prohibition proposed in our remedies notice. Respondents to our investor questionnaire broadly favoured the proposed remedy, although one investor did not believe it would be a good idea.

16.159 Where FDs and ACCs in our remedies case studies expressed a view they too broadly favoured prohibiting Big 4-only clauses.

16.160 The Association of British Insurers supported the remedy. It stated that whilst provisions are often explicit, there is also often an implied requirement to use a Big Four firm. It therefore supported inclusion of a statement of positive affirmation that no audit firms are precluded from being appointed.[1092]

16.161 Land Securities Group PLC did not support this remedy. In its experience, such clauses are not common though banks which insist on it do so to provide more confidence in monitoring financial covenants. In its view, a restriction might weaken their confidence to lend.[1093]

16.162 The Chartered Financial Analyst Society of the UK supported the prohibition in all documentation. The main benefit would be to open up tender processes to more firms and would not add to costs.

16.163 The Investment Management Association thought that there should not be 'any' documentation that limits choice to the Big 4 firms as this may be anti-competitive. Further, as it can sometimes be implied that a Big 4 firm should be appointed, a statement to the effect that appointments should be open to all audit firms would be helpful in addressing this.[1094]

The FRC

16.164 The FRC supported a ban on such clauses in loan and 'other banking agreements'.[1095] However, it would not seek to impede the ability of investors to specify that they

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[1089] Response to provisional decision on remedies.
[1090] Response to provisional decision on remedies.
[1091] USS; RPMI Railpen; NEST; LAPFF; LPFA; Governance for Owners; Environment Agency Active Pension Fund; Sarasin & Partners LLP.
[1092] ABI response to provisional decision on remedies.
[1093] Provisional decision on remedies response 13 August 2013.
[1094] Provisional decision on remedies response, 23 August 2013.
[1095] FRC remedies response, 18 March 2013.

would accept certain auditors as long as this was a considered decision as opposed to a default position contained in advisers' standard documentation.

Audit firms

16.165 Audit firms, including the Big 4 firms, broadly supported a prohibition on Big 4-only clauses. KPMG stated that such clauses were not an issue for investment grade loans, which predominated in the FTSE 350, but documentation for leveraged loans could provide the impression of narrowing the choice of audit firms.[1096]

16.166 BDO, in response to the Cardiff Business School (CBS) Report,[1097] said that the effect of Big 4-only clauses was on companies outside the FTSE 350, whose debt was not then investment grade. It said that:

> A change or choice of auditor away from a mid-tier firm to a Big Four firm is imposed on a growing company before it joins the FTSE 350, once it is in the FTSE 350, the company is highly unlikely to reverse that change. Therefore the effect of such requirements is to cut off custom for mid-tier firms and act as a barrier to them auditing present and prospective members of the FTSE 350. The high market share of the Big Four in the FTSE 350 therefore seems partly responsible for the absence of these clauses within the FTSE 350: those clauses apply most effectively outside the FTSE 350, particularly for companies with the potential to join the FTSE 350.

16.167 GT supported the remedy and recommended that the prohibition extends to all forms of third party anti-competitive restrictions on auditor appointment unless those restrictions can be objectively justified.[1098]

Design issues

16.168 As noted in Appendix 16.4, there was support from some respondents to the Remedies Notice and the provisional decision on remedies for the prohibition applying more widely than the LMA template leveraged loan documents, for example, banks' own templates, and non-lending agreements. There was also concern that prohibiting such clauses may not remedy oral arrangements or informal pressure which has the same effect as a Big 4-only clause. Some respondents noted lenders have a legitimate commercial interest in the suitability of the borrower's auditor and that there might be occasions when a lender or lenders justifiably required that a particular auditor be appointed.

16.169 We identified Big 4-only clauses in leveraged loan documentation as adding to barriers to entry, expansion and selection for Mid Tier firms (see paragraphs 16.144 and 16.145). We note that leveraged loans appeared more likely to be prevalent among non-FTSE-350 companies (whilst affecting approximately 17 companies in the FTSE 350) (see paragraphs 16.149 and 16.165).

16.170 We noted that, as a matter of law, it is the shareholders as a body that appoint or reappoint the auditor by ordinary resolution at the AGM. Lenders may wish to restrict this ability to protect their legitimate commercial interests. We were mindful that

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[1096] Appendix 2.6, paragraph 4.
[1097] www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/cbs_clauses_in_auditor_loan_agreements_bdo.pdf.
[1098] Response to provisional decision on remedies.

lenders' interests should not impinge on the freedom of shareholders to appoint or reappoint the auditor unless based on objective criteria relating to ability and/or capacity. In principle, we think that both shareholders and any lender to the company share an interest in a high quality audit.

16.171 Notwithstanding the relatively small number of FTSE 350 companies party to leveraged loan agreements, we think that the effect of the use of Big 4-only clauses (whether occurring in loan agreements within or outside of the FTSE 350 market) is felt within the reference market more widely for two reasons. First, these clauses reinforce perceptions of differences in quality which affect auditor choice for FTSE 350 companies. Second, the FTSE 350 is a fluid group and many of its current members are likely to have been exposed to leveraged loan documentation in the past before entering the index. These agreements may therefore have been a contributory factor in the high proportion of FTSE 350 companies using Big 4 audit firms.

16.172 In light of the findings discussed in paragraphs 16.169 and 16.171, and after careful consideration of the submissions we received, our view is that we should issue an Order to prohibit provisions in loan agreements which restrict or have the effect of restricting a company's choice of statutory auditor to lists or categories.

16.173 We were mindful of avoiding unnecessary complexity in the lending process and accept that lenders have some legitimate commercial interest in the identity of the borrower's external auditor. The prohibition does not therefore extend to objectively justified auditor selection criteria. For example, we do not think that criteria based on reputation or a requirement that the firm be 'internationally recognized' are objectively justified and could have the effect of encouraging the use only of a Big 4 firm. Examples of criteria that we would regard as objectively justified would include: sufficient skill, expertise in a particular sector and relevant or appropriate geographical reach.

16.174 Our remedy does not prohibit companies and lenders agreeing the appointment of a specified auditor. Nor do we seek to prohibit clauses requiring lender consent to a change of auditor during the life time of a loan.

16.175 For the purposes of the Order, 'company' refers to any company whose annual accounts for a financial year must be audited in accordance with Part 16 of the Companies Act and therefore goes beyond FTSE 350 companies. Big 4-only clauses add to reputational hurdles faced by Mid Tier firms and as such contribute to the barriers to entry, expansion and selection in the reference market. We noted that Big 4-only clauses are likely to be more prevalent among non-FTSE-350 companies but their effect is likely to reinforce barriers to entry, expansion and selection within the reference market (see paragraph 16.171). As such, these barriers to entry, expansion and selection hinder the emergence of new or strengthened rivals and reduce competitive restraints firms can exercise on each other within the reference market. The effectiveness of this remedy is therefore underpinned by its application wider than the FTSE 350 statutory audit market. In view of this, and our duty to have regard to the need to achieve as comprehensive a solution to the AEC and resulting detrimental effect on customers, as is reasonable and practicable, we think it is proportionate to extend the application of this remedy beyond FTSE 350 companies.[1099,1100]

[1099] CC3, paragraph 330; the Act, section 138.
[1100] In this respect we note that draft EU proposals regarding the prohibition of Big 4-only clauses extend to PIE and non-PIE audited entities.

16.176 By ‘loan agreements’ we mean any arrangement with such a company for the purposes of providing borrowing facilities to that company. In our view this should include bilateral and syndicated agreements. We do not believe we have sufficient evidence to extend the remedy to public prospectuses in relation to bond issues nor to non-lending agreements.

16.177 We intend the prohibition to apply to relevant provisions rather than affecting the validity of the entire loan agreement. We consider this is reasonable and proportionate, avoiding unnecessary disruption in the market.

16.178 We also intend that the prohibition should not apply to loan agreements already in existence on the date on which the Order comes into effect, again to avoid unnecessary disruption in the market, but rather to loan agreements entered into on or after the date on which the Order comes into effect.

16.179 We consider that relying on private enforcement by parties who may have suffered loss or damage due to a breach of the Order is unlikely to be an effective means of securing compliance with the Order. In view of this, we will include a reporting requirement in the Order. We would require a statement to be included as part of a company’s Annual Report certifying compliance with the Order. In this regard, we note that the FRC’s Guidance on ACs[1101] already provides that the AC Report should include details of any contractual obligations that acted to restrict the AC’s choice of external auditors. We also note that this is appropriate given that it is the shareholders who formally appoint the auditor and therefore shareholders should be aware of any limitations on the range of auditors available for appointment.

16.180 In relation to the LMA template leveraged loan documentation, we recommend to the LMA that it amend its auditor clause to be consistent with the Order. The LMA may wish to incorporate general provisions regarding, or give guidance on, objectively justified criteria in its template leveraged loan documentation. We also welcome the LMA’s suggestion that it emphasize in template documentation that the appointment of a Big 4 firm is not compulsory.[1102]

Assessment of effects

16.181 We considered this remedy’s effect on: *(a)* companies’ bargaining power; *(b)* costs; *(c)* lenders’ willingness to lend and their costs; and *(d)* other remedies.

Effect on companies’ bargaining power

16.182 The proposed remedy would contribute to addressing the AEC we found under our first theory of harm by:

(a) reducing barriers to entry, expansion and selection by removing restrictions on choice; and

(b) reducing reputational barriers faced by non Big 4 firms and reinforced by Big 4-only clauses. Respondents have commented that such a remedy would send a

[1101] September 2012, paragraph 4.26.
[1102] Response to Remedies Notice, 9 May 2013.

strong message that such clauses are not acceptable and would have a significant symbolic effect within the reference market.[1103]

16.183 The remedy would therefore assist companies to make a more independent choice of auditor with less external pressure. It may also incentivize Mid Tier firms to compete more vigorously by reducing barriers to entry, expansion and selection.

Effect on costs

16.184 We sought parties' views on costs:

(a) BDO thought that implementation costs would be low and outweighed by the benefits such as reducing barriers to entry, expansion and selection, thereby increasing competition, enabling companies to make independent choices.[1104]

(b) Deloitte believed that the costs were likely to be limited—principally procedural or administrative costs in the context of the LMA.[1105]

(c) GT envisaged that there would not be any material cost to any parties arising from implementation.[1106]

(d) Kingston Smith believed the costs should be minimal and the benefits self-evident, ie removal of an artificial restriction on choice.[1107]

(e) The LMA believed, that having to engage in a process of agreeing an acceptable auditor each time introduces complexity and costs into the lending process.[1108]

(f) PwC did not think that this remedy would be onerous to implement and envisaged a recommendation to the LMA to amend its precedents.[1109]

16.185 In our view, the remedy is not likely to have any significant cost implications for companies or firms since such clauses are unlikely to have been instigated by the borrower or the audit firm.[1110] We note that any reporting requirement may impose some costs on companies. The FRC's Guidance on ACs requires that contractual obligations restricting the AC's choice of auditor be noted in the AC Report and we do not therefore see a material increment in costs as a result of any reporting requirement for companies that are subject to the UK Corporate Governance Code.

16.186 In relation to changes to the LMA template documentation, we believe the costs on the LMA to be minimal and administrative in nature. We do not expect incremental costs on borrowers or lenders as a result of any changes to the template documentation.

[1103] For example, PwC remedies response hearing summary, paragraph 76: prohibition would 'send a strong message to the market that those clauses are not acceptable'. BDO hearing summary, 10 April 2013, paragraph 34: prohibition would 'send the right message'. BDO response to Remedies Notice, paragraph 4.4.2.
[1104] BDO response to Remedies Notice, paragraph 4.4.2.
[1105] Deloitte response to Remedies Notice, 18 March 2013.
[1106] GT response to Remedies Notice, 18 March 2013, Appendix, paragraph 3.11.
[1107] Kingston Smith response to Remedies Notice, 1 March, section 4.
[1108] LMA response to Remedies Notice, 9 May 2013.
[1109] PwC response to Remedies Notice, paragraph 3.49.
[1110] In the context of the LMA leveraged loan documentation, CBS found that it is the banks which rely heavily on the LMA documents, rather than use being instigated by borrowers or firms. (Appendix 2.6, Annex A CBS report, paragraph 35.)

Effect on willingness to lend and lenders' costs

16.187 Lenders take into account multiple factors in their decision to lend. The effect of the proposed prohibition on any decision to lend is difficult to isolate. We note the LMA suggests that the purpose of the auditor clause is to reflect market practice, whilst lenders appear to import it into their agreements automatically because it is in the LMA template.[1111] This degree of circularity suggests to us that the removal of such clauses is unlikely to affect lenders' decision to lend. Our remedy sets out to prevent such clauses being thoughtlessly applied and does not preclude lenders from agreeing a specified auditor or an objectively justified selection criteria. On balance, we do not think that the remedy will affect lenders' willingness to lend to any material degree.

16.188 We do not expect the remedy to impose significant incremental costs on lenders. We would expect that in the majority of cases, a company's choice of auditor would not present concerns for lenders and individual negotiations would be required in isolated instances only.

Effect on other proposed remedies

16.189 Such a remedy may facilitate the operation of mandatory tender processes by providing a greater range of potential auditors to companies.

Implementation

16.190 We intend to make an Order prohibiting provisions in loan agreements which restrict, or have the effect of restricting, a company's choice of statutory auditor to lists or categories, as detailed above. An Order is not only binding on relevant market participants but is also likely to send a signal to the market. It is thus likely to be effective over time in mitigating perceptions that Mid Tier firms cannot compete in the market.

16.191 We also intend to make a recommendation to the LMA to amend the auditor clause in its template leverage loan documentation in line with the requirements of the proposed Order.

Assessment of Remedy 4: Enhanced shareholder engagement

Summary and introduction

16.192 We decided to recommend that:

(a) The FRC amend the UK Corporate Governance Code by introducing a specific obligation on FTSE 350 companies:[1112] (i) to engage with shareholders through seeking shareholder views on audit issues and stating how any shareholder concerns identified as a result may have been addressed; and (ii) to introduce an advisory vote for shareholders to indicate their satisfaction with the AC Report.

[1111] See paragraph 16.146 and Appendix 2.6, paragraph 3 (there is an expectation of lenders and borrowers that LMA documentation will be used).

[1112] All companies with a Premium Listing of equity shares in the UK are required under the Listing Rules to report on how they have applied the UK Corporate Governance Code in their annual report and accounts. The relevant section of the Listing Rules can be found at: http://fsahandbook.info/FSA/html/handbook/LR/9/8. We have limited our recommendation to FTSE 350 companies in line with the scope of our inquiry. It is at the discretion of the FRC as to whether the obligation should extend to all companies with a Premium Listing.

(b) The FRC update the Stewardship Code to encourage institutional investors to engage with investee companies on audit issues, through monitoring investee companies and escalating stewardship activities.

16.193 This remedy seeks to encourage shareholder engagement on audit issues, increase shareholder influence on the auditor appointment decision, and so give auditors increased incentives to focus their competitive efforts to satisfying shareholder demand. We consider that information provision is important to facilitate shareholder engagement, and our remedies in this area should be considered alongside measures to improve information provision to shareholders, as discussed under Remedy 6, extended AC reporting, (paragraphs 16.288 to 16.334).

16.194 We considered several remedy options for enhancing shareholder engagement. Details of all the options we considered, the views of parties in response to our Remedies Notice, and the reasons we decided not to pursue certain of those remedy options are set out in Appendix 16.5. In this section we discuss the remedy options that we have decided to implement.

16.195 In this subsection we set out:

(a) remedy options and parties' views;

(b) how this remedy addresses the AEC;

(c) design of the remedy;

(d) assessment of effects and costs; and

(e) implementation of the remedy.

Remedy options and parties' views

16.196 In our provisional decision on remedies we set out the following options to encourage shareholder engagement on audit issues:

(a) amendments to the UK Corporate Governance Code;

(b) amendments to the Stewardship Code; and

(c) the introduction of an advisory shareholder vote to indicate their satisfaction with the AC Report.

16.197 We received only a few responses to our proposals. While the majority of respondents were supportive of the general principle of increasing shareholder engagement, some parties thought that shareholders already had sufficient powers in respect of auditor oversight (specifically, the powers to vote against re-appointment of members of the AC, approve the annual report (which includes the AC report), approve the external auditor's fees and approve the appointment of the external auditor).[1113]

16.198 The Association of British Insurers expressed this view and told us that it believed these existing powers would become more important as the UK Corporate

[1113] Responses to provisional decision on remedies from ABI, CBI, GSK, ICAS.

Governance and ISA 700 reporting obligations come into effect (see paragraphs 16.291 to 16.298 under Remedy 6: Extended Reporting).[1114]

16.199 BHP Billiton told us that we should be guided by input from investors and should not assume that all investors want more items on which to vote because some may consider that existing powers are sufficient.[1115]

16.200 KPMG supported this remedy. It noted that we might give consideration to requiring details of the company's policy on tenders to be included in the AC report which would make it subject to the advisory vote.[1116]

16.201 There was some scepticism as to the need for and effectiveness of an advisory vote in increasing competition in the audit market.[1117] GT reiterated its support for proposing two audit firms to shareholders following a tender event, with a duly justified preference for one, and for there being a Q&A session with ACCs at AGMs (for further details of this remedy see Appendix 16.5).[1118]

16.202 The FRC told us that it was willing to consider the amendments to the UK Corporate Governance Code and the Stewardship Code. The FRC also encouraged us to consider adding, as an alternative or additional element, the desirability of discussion between ACCs and major investors on a regular basis and, in any event, before any significant development affecting the company's financial reporting (such as an upcoming tender).[1119]

16.203 We have taken into account these views and decided on the remedy set out in paragraph 16.192 for the reasons set out in the subsections below.

How this remedy addresses the AEC

16.204 In conjunction with Remedy 1 (our mandatory tender process remedy), this remedy will address the lack of bargaining power that we found that companies have outside tender processes (under our first theory of harm). If a company decides not to put its audit engagement out to tender five or more years after appointing an auditor, the AC report must include a statement setting out in which financial year the company intends to put the audit engagement out to tender and why it considers this period to be in the best interests of shareholders. This remedy will give shareholders the opportunity to express their dissatisfaction with any such explanation through the advisory vote, and so indicate to the company that they think the audit engagement should be put out to tender.

16.205 In conjunction with other remedies, this remedy will also address the ability of executive management to influence external auditors in how they conduct and report their audit, and the information asymmetry between shareholders and audit firms, so that shareholders have little information regarding the investigation carried out by the firm (under our second theory of harm). Firms therefore have the incentives and ability to respond to the interests of executive management. This can result in shareholder detriment as auditors may be insufficiently sceptical in carrying out audits and leave

[1114] ABI response to provisional decision on remedies.
[1115] BHP Billiton response to provisional decision on remedies.
[1116] KPMG response to provisional decision on remedies.
[1117] Responses to provisional decision on remedies from CBI, ICAS, GC100, GSK, ICAP plc, Standard Life Investments and the FRC.
[1118] GT response to provisional decision on remedies.
[1119] FRC response to provisional decision on remedies.

shareholder demand unmet. Specifically, this remedy will address the AEC or resulting detrimental effect on customers by:

(a) providing shareholders with the opportunity to obtain better information on the audit process through expressing dissatisfaction on the AC report in an advisory vote; and

(b) by encouraging shareholders and companies to engage on audit issues, as part of good corporate governance, shareholders will have more information on the audit process and judgements made enabling them to better assess audit quality and, therefore, vote on auditor reappointment decisions in a more informed manner.

16.206 As a consequence of increasing the influence of shareholders through the advisory vote and improved information flow on audit issues, we consider this would decrease the influence of management in the auditor selection decision. The effect of this remedy is discussed further in paragraphs 16.224 to 16.227.

Design of the remedy

Amendments to the UK Corporate Governance Code

16.207 Section E of the UK Corporate Governance Code deals with 'Relations with Shareholders'. The main principle of the section states: 'There should be a dialogue with shareholders based on the mutual understanding of objectives. The board as a whole has responsibility for ensuring that a satisfactory dialogue with shareholders takes place.'

16.208 We think that audit-specific obligations, requiring the board explicitly to seek shareholder views on audit matters and explain how shareholder concerns have been addressed would enhance shareholder engagement. We decided to recommend the insertion of the text in bold below into paragraphs E.1.1 and E.1.2:

> E.1.1. The chairman should ensure that the views of shareholders are communicated to the board as a whole. The chairman should discuss **audit,** governance and strategy with major shareholders. Non-executive directors**, notably audit committee chairs and members,** should be offered the opportunity to attend scheduled meetings with major shareholders and should expect to attend meetings if requested by major shareholders. The senior independent director should attend sufficient meetings with a range of major shareholders to listen to their views in order to help develop a balanced understanding of the issues and concerns of major shareholders.
>
> E.1.2. The board should state in the annual report the steps they have taken to ensure that the members of the board, and in particular the non-executive directors, develop an understanding of the views of major shareholders about the company, for example through direct face-to-face contact, analysts' or brokers' briefings and surveys of shareholder opinion **and how any concerns of major shareholders may have been addressed.**

Amendments to the Stewardship Code

16.209 The Stewardship Code was published in July 2010 and is maintained by the FRC. It sets out best practice for institutional investors when investing in UK listed companies and applies on a 'comply or explain' basis. The Stewardship Code aims to enhance the quality of engagement between institutional investors and companies, thereby improving long-term returns to shareholders, and ensuring appropriate exercise of governance responsibilities by investors.

16.210 The Stewardship Code is a set of seven key principles and guidance on how those principles may be implemented. Principle 3 provides that institutional investors should monitor their investee companies. Guidance in the Stewardship Code supporting this principle states that when monitoring companies, institutional investors should, among other things, keep abreast of the company's performance, satisfy themselves that the board adheres to the spirit of the UK Corporate Governance Code, and consider the quality of the company's reporting. Principle 4 provides that institutional investors should establish clear guidelines on when and how they will escalate their stewardship activities. Guidance in the Stewardship Code supporting this principle provides that intervention should be considered regardless of whether an active or a passive investment policy is followed. Examples of when institutional investors may wish to intervene include where they have concerns about a company's strategy, performance, governance or approach to risks.

16.211 We think that these principles already have the potential to encourage institutional shareholders to engage on audit issues. However, we think that audit specific requirements added to these principles and related guidance, thereby expressly drawing the attention of institutional investors to the need to engage on audit issues, would contribute to enhancing shareholder engagement further.

16.212 We recommend that the following text in bold be added to the Stewardship Code:

Principle 3

Institutional investors should monitor their investee companies.

Guidance

Effective monitoring is an essential component of stewardship. It should take place regularly and be checked periodically for effectiveness. When monitoring companies, institutional investors should seek to:

- keep abreast of the company's performance;
- keep abreast of developments, both internal and external to the company, that drive the company's value and risks;
- satisfy themselves that the company's leadership is effective;
- satisfy themselves that the company's board and committees adhere to the spirit of the UK Corporate Governance Code, including through meetings with the chairman and other board members **including the Audit Committee chair and members;**
- consider the quality of the company's reporting **including its reporting on the external audit process**; and

- attend the General Meetings of companies in which they have a major holding, where appropriate and practicable.

....

Principle 4

Institutional investors should establish clear guidelines on when and how they will escalate their stewardship activities.

Guidance

Institutional investors should set out the circumstances in which they will actively intervene and regularly assess the outcomes of doing so. Intervention should be considered regardless of whether an active or passive investment policy is followed. In addition, being underweight is not, of itself, a reason for not intervening. Instances when institutional investors may want to intervene include, but are not limited to, when they have concerns about the company's strategy, performance, governance, **external audit process,** remuneration or approach to risks, including those that may arise from social and environmental matters.

Initial discussions should take place on a confidential basis. However, if companies do not respond constructively when institutional investors intervene, then institutional investors should consider whether to escalate their action, for example, by:

- holding additional meetings with management specifically to discuss concerns;
- **holding additional meetings with the Audit Committee specifically to discuss concerns**;
- expressing concerns through the company's advisers;
- meeting with the chairman or other board members;
- intervening jointly with other institutions on particular issues;
- making a public statement in advance of General Meetings;
- submitting resolutions and speaking at General Meetings; and
- requisitioning a General Meeting, in some cases proposing to change board membership.

Introduction of Advisory vote on AC's Report

16.213 We consider that changes to the UK Corporate Governance Code and Guidance on ACs introduced in September 2012 have the potential to provide greater information on the audit process and how the AC has discharged its duty to assess the effectiveness of the external audit. However, this depends both on ACs complying with the relevant Code provisions and also on the adequacy of the information provided.

16.214 In assessing the effectiveness of the changes in AC reporting we considered the existing level of compliance with the provisions of the UK Corporate Governance Code (see paragraph 16.310 below). We noted that a minority of companies, 25 per cent, were fully compliant in 2012. Although compliance with audit-related disclosures in the UK Corporate Governance Code has improved over time, compliance is not universal and the standard of disclosure is variable.

16.215 For this reason we think that an advisory vote on the AC Report should be introduced. The vote would be by definition advisory and therefore not binding, but the results will signal whether shareholders are satisfied that the AC has discharged its duties to shareholders appropriately.

16.216 We see such votes as an efficient way of giving shareholders the ability to approve or not approve the report of the AC, without taking the more extreme steps of voting down the re-election of directors or voting against auditor reappointment. Currently advisory votes are required under the Companies Act[1120] on the report of the Remuneration Committee and are framed in terms of whether or not shareholders approve the Remuneration Report. While the shareholders vote is not binding, the negative publicity associated with a vote down should prompt the company concerned to address the specific shareholder issues raised. We note that the introduction of an advisory vote on the Remuneration Committee report has been powerful in enhancing shareholder influence over executive pay.

16.217 At present, shareholder engagement on audit is limited. Shareholders currently have powers in relation to accepting the annual report, appointing or reappointing an auditor and the re-election of directors (including members of the AC). The FRC in its response to the Remedies Notice (see Appendix 16.5), and a number of other respondents to the provisional decision on remedies, submitted that these existing shareholder powers were sufficient and was sceptical as to what the addition of an additional advisory vote would achieve.

16.218 However, we have seen little evidence of shareholders using these powers. Responses to our investor questionnaire highlighted that only rarely, and in exceptional circumstances, do shareholders vote against the re-appointment of the auditor and/or directors. We believe this is due to the perception that using these powers is a ‘nuclear option’, alongside the lack of information allowing shareholders to use their powers appropriately.

16.219 In light of this, we consider that an advisory vote would provide shareholders with a mechanism for expressing their dissatisfaction with the audit information provided to them without requiring shareholders to exercise these existing ‘nuclear options’.

16.220 We think that the introduction of the advisory vote will emphasize AC duties in this area and increase AC incentives to discharge their responsibilities in the interests of shareholders, in particular to assess the effectiveness of the external audit process and the approach taken to the appointment and reappointment of auditors. As a consequence, it will reinforce the role of the AC in the external audit relationship thus contributing to ensuring that competition is directed towards shareholder demand. We therefore think that an advisory vote will be effective in contributing to remedying the distortion of demand we found.

[1120] See Companies Act 2006, section 439.

16.221 In circumstances where a company has decided not to hold an advisory vote, we expect the company to provide a full explanation as to its reasons. We consider that decisions not to hold an advisory vote would be rare in practice.

Assessment of effects and costs

16.222 We assessed: *(a)* the effects and *(b)* the costs of these remedies.

Effects

16.223 We think that the Corporate Governance Code and Stewardship Code principles already have the potential to encourage companies and shareholders to engage on audit issues. However, we think that audit-specific requirements added to these principles and related guidance, thereby expressly drawing the attention of companies and investors to the need to engage on audit issues, would contribute to enhancing shareholder engagement further.

16.224 We expect that an advisory vote will incentivize ACs to consider carefully if the audit engagement should be put out to tender after five and subsequent years, and to prepare AC Reports which are fully compliant with the FRC requirements. As a consequence, this will improve the overall level of information on AC activity and effectiveness for a given company. By increasing the visibility of AC activity and effectiveness, ACs will have heightened incentives to deliver on behalf of shareholders. It will therefore have an effect in addressing the distortion in competition we have identified.

16.225 We think that by supplying more information on how the AC has assessed the effectiveness of the external auditor, there will be some reinforcement of the importance of audit quality as an element of shareholder demand. As a result confidence in audit may be improved. We believe that there is a benefit to the UK as a result of increased confidence in audit quality and corporate governance.

16.226 We think that these additional measures will complement other measures to increase the availability of information on the external audit. These measures include recent changes to the UK Corporate Governance Code (see paragraphs 16.292 and 16.293) and ISA 700 (see paragraphs 16.294 to 16.296).

16.227 We believe that by implementing changes to both the Stewardship Code, addressed to institutional investors, and the UK Corporate Governance Code, addressed to companies, the effectiveness of the remedy will be greater than if either Code was amended without regard to the other.

Costs

16.228 Respondents to the Remedies Notice did not consider that costs for this proposed remedy would be extensive or disproportionate.

16.229 We believe that any amendment to the UK Corporate Governance Code will have a minimal additional cost to companies in either preparing the AC Report or holding an advisory vote. Our remedies in this area are an emphasis and reinforcement of current best practice and, therefore, many companies will incur limited additional costs as a result. We accept that some companies and ACs may be encouraged to adopt best practice as a result of these remedies but consider that any costs would be limited to the extra availability and work required of the ACC and AC members.

16.230 We do not think that there will be any direct costs for firms or investors as a result of our remedies in this area. We have not identified any significant costs to the FRC beyond incorporating the changes proposed into the UK Corporate Governance Code and Stewardship Code.

Implementation of the remedy

16.231 We recommend to the FRC that the FRC amend section E of the UK Corporate Governance Code to require that the Board, and in particular the AC, seek shareholder views on audit issues and explain how any shareholder concern may have been addressed.

16.232 We recommend to the FRC that the FRC updates principles 3 and 4 of the Stewardship Code and related guidance to draw the attention of institutional investors to the need to engage on audit matters.

16.233 We recommend that the FRC amend the UK Corporate Governance Code requiring an advisory vote for shareholders to indicate their satisfaction with the AC Report.

16.234 The UK Corporate Governance Code applies to all companies with a Premium Listing.[1121] In line with the scope of our inquiry, we have limited our recommendation to apply only to FTSE 350 companies. It remains at the discretion of the FRC to determine whether the recommendation should apply to all companies with a Premium Listing.

16.235 We recommend that the elements of the remedies package relating to amendments to the UK Corporate Governance Code and the Stewardship Code have an implementation date of October 2014.[1122]

16.236 With respect to the advisory vote, we anticipate that FTSE 350 companies would hold their advisory vote on shareholder satisfaction with the AC Report at the first AGM following the implementation of the recommended amendments into the UK Corporate Governance Code.

Assessment of Remedy 5: Strengthening the accountability of the external auditor to the AC

Summary and introduction

16.237 In order to strengthen the accountability of the external auditor to the AC, we decided to make an Order to the effect that:

(a) For a FTSE 350 company, only the AC acting collectively or through the ACC, and acting on delegated authority from the board, is permitted to:

(i) negotiate and agree audit fees and influence the scope of audit work;[1123]

[1121] The relevant section of the Listing Rules can be found at: http://fsahandbook.info/FSA/html/handbook/LR/9/8.
[1122] We note that the Government has indicated that it will aim to have two common commencement dates each year for new legislation and regulations with a view to minimizing burdens on business. The commencement dates are 6 April and 1 October. While the UK Corporate Governance Code and Stewardship Code are not regulations, but rather both set out standards of good practice, their terms are applied by companies and investors alike on a comply or explain basis. We therefore think use of these dates is reasonable.

(ii) initiate and supervise a tender process for external audit work and make recommendations for appointment of auditors following a tender process;

(iii) influence the identity of an AEP; and

(iv) authorize the external audit firm to carry out any NAS, although the AC may set a threshold of materiality below which executive management may authorize the firm to conduct NAS.

(b) Auditors are only permitted to enter into an agreement with a FTSE 350 company to carry out statutory audit services in the circumstances that the terms of such an agreement have been negotiated with and agreed by the AC.

(c) Companies must monitor and certify compliance with the Order in the AC Report.

16.238 We recommend that the FRC amend the UK Corporate Governance Code in line with the provisions of the Order.

16.239 All UK listed companies are required to appoint a group of NEDs to serve as an AC with a particular responsibility to protect the interests of shareholders in relation to financial reporting and internal control.[1124] To fulfil this responsibility, corporate governance rules grant considerable authority to the AC in relation to external and internal audit. However, in the course of our investigation it became apparent that, notwithstanding the formal authority of the AC, the FD and his or her staff have substantial influence and de facto responsibility for the negotiation of audit fees, appointment and replacement of auditors, and conduct of a company's relationship with its auditors in general (see paragraphs 11.10 to 11.18).

16.240 The Order will specify that the responsibility for making the final decision on appointment of the auditor, and the terms of that appointment, should be delegated to the AC. However, nothing in the Order should be interpreted as a departure from the principle of the unitary board. All directors remain equally responsible for the company's affairs as a matter of law. The AC, like other committees to which particular responsibilities are delegated (such as the Remuneration Committee), remains a committee of the board and the AC acts on its behalf. A disagreement within the board, including disagreement between the AC members and the rest of the board, should be resolved at board level. The Order also does not preclude the AC from utilizing the expertise of the FD and the finance team.

16.241 In this section, we set out:

(a) how this remedy addresses the AEC;

(b) views of parties;

(c) design issues;

(d) assessment of effects;

(e) costs of the remedy; and

[1123] Although the scope of the audit cannot be reduced below the minimum required by the FRC's Scope of an audit of financial statements of a private sector entities arising from the requirements of ISAs (UK & Ireland) and International Standards on Auditing.
[1124] See paragraphs 3.25–3.27.

(f) implementation.

How this remedy addresses the AEC

16.242 We found (in Sections 11 and 13) that the ability of executive management to influence external auditors in how they conduct and report their audit and the information asymmetry between shareholders and audit firms, so that shareholders have little information regarding the investigation carried out by the auditor are features of the market. They result in an AEC, namely that auditors have incentives and the ability to respond to the interests of executive management, possibly at the expense of shareholders' interests. This can result in shareholder detriment as auditors may not be sufficiently sceptical and independent and leaves some shareholder demands unmet.

16.243 The remedy addresses the AEC by reducing the incentives for audit firms to compete to satisfy executive management at the expense of shareholders. It seeks to do this by *(a)* clarifying the responsibility of the AC/ACC for external audit, whose role it is to act in the interests of shareholders (see paragraph 3.26) and *(b)* substantially reducing the involvement and influence of the FD and staff on all key aspects of the external auditor's engagement (tender processes, appointment, scope of audit, fees etc (see paragraphs 9.77 to 9.80). The remedy therefore seeks to address the AEC rather than mitigating its effects.

16.244 This remedy does not address the AEC arising from our first theory of harm in our findings, namely that companies lack bargaining power outside a tender process (although by strengthening the role of the AC, who will have a greater role in relation to decisions to tender the audit engagement, this remedy complements our remedy on mandatory tender processes). This is addressed by other remedies in the proposed remedies package. It should be noted that with an increase in competitive pressure through the effect of these other remedies on our first theory of harm, it becomes even more important that competition is directed towards shareholder demand. Hence strengthening the accountability of the external auditor to the AC is likely to have increased importance where the AEC arising from our first theory of harm is also effectively addressed.

Views of parties

16.245 Details of the views of parties on strengthening the auditor's accountability to the AC are set out in Appendix 16.6.

Responses to the provisional findings and remedies notice

16.246 Most of the 56 submissions received in response to the provisional findings and remedies notice gave a view on this proposed remedy. Some of the main parties elaborated on these views in the response hearings with the Inquiry Group. In addition, the FDs and ACCs of 14 listed UK companies, to whom we spoke in our second set of case studies, had the opportunity to respond to the proposed remedy.

16.247 Investor groups[1125] strongly supported the proposed remedy. The Chartered Financial Analyst Society of the UK, for example, wrote that 'currently the direct line of communication between the auditor and the financial director is too strong'.[1126]

[1125] The Universities Superannuation Scheme Limited, Hermes Equity Ownership Services, Kames Capital, UK Shareholders' Association, Legal & General Investment Management, BlackRock, National Association of Pension Funds: see

16.248 In their submissions, eight companies argued that the current arrangements, following the recent changes to the UK Corporate Governance Code worked well and that no additional powers or enhanced accountability were needed.[1127] The GC100, representing general counsel and company secretaries in the FTSE 100, said that the revisions to the Code 'should be allowed time to take effect before introducing any further remedies'.[1128] The 14 other companies we interviewed at FD or ACC level (published as our second set of case studies) uniformly took the same view.[1129]

16.249 Most of the other respondents to the remedies notice, however, including the Big 4 firms, accepted the principle of strengthening the role of the AC. GT, for example considered that, in making the audit firm more independent of management, the remedy would help to facilitate greater competition in the market (by providing a platform for greater independent review of the performance of audit firms).[1130]

16.250 Respondents generally considered that any changes could be achieved by building on the FRC's current Guidance on ACs.

16.251 In general, despite accepting the principle of strengthening the AC, many respondents to our remedies notice argued that the remedy specified in the remedies notice was in some respects impractical.[1131] It could also undermine the tripartite system (between AEP, FD and AC) and blur the distinction between executive and non-executive functions in a company.

16.252 Some aspects of the proposed remedy attracted more widespread support. Some respondents also put forward variants of those aspects with which they had not agreed in a form they considered more acceptable. Elements of a remedies package that many respondents would accept as proportionate and effective included:

(a) The AC to be formally responsible for approving all decisions made in relation to auditor engagement management. This would enable the three-way dialogue between management, auditors and the AC to be maintained. It would also ensure that management and shareholders understand that the AC is primarily responsible for the appointment and oversight of the auditor.[1132]

(b) The ACC could directly negotiate the scope of the audit and fee for the auditor (EY would, for example, support the AC taking responsibility for negotiating audit fees from the FD[1133]). However, this proposal was not generally well received by the FDs and ACCs we interviewed as part of our case studies on the grounds that ACCs could not be expected to have adequate in-depth knowledge of a company.

(c) The AC could also be given responsibility for when to go out to tender and rotate, the tender process and auditor appointment (as supported by, for example, GT[1134]).

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www.competition-commission.org.uk/our-work/statutory-audit-services/evidence/responses-to-provisional-findings-report-and-notice-of-possible-remedies.
1126 CFA response to Remedies Notice.
1127 Aggreko, Berkeley Group, Billiton, SABMiller, Glaxo, Segro, Smith & Nephew, BT (see www.competition-commission.org.uk/our-work/statutory-audit-services/evidence/responses-to-provisional-findings-report-and-notice-of-possible-remedies).
1128 GC100 response to provisional findings and Remedies Notice.
1129 See Appendix 14.1.
1130 GT response to Remedies Notice, Appendix, paragraphs 4.1–4.3.
1131 Remedies Notice, paragraphs 46–52.
1132 Deloitte response to Remedies Notice, paragraph 7.5*(a)*.
1133 EY response to provisional findings and Remedies Notice, Annex 2, paragraph 6.9.
1134 GR response to Remedies Notice, Appendix, paragraphs 4.4 & 4.5.

(d) All material audit issues to be reported to the AC, including details of how they were resolved. More radically, as proposed by PwC, all material issues to be escalated to the AC for a final decision, when the auditor is fully informed of the facts necessary to form a judgement.[1135]

Responses to our provisional decision on remedies

16.253 A number of respondents to our provisional decision on remedies raised concerns that the terms of the proposed Order would breach the principle of the unitary board under which all directors are equally responsible for the affairs of the company.[1136] HSBC told us that 'management plays an equally important role [as compared with ACs]; to not involve management in a tender process or fee negotiation may deprive the selection and negotiation processes of important skills and insight and would, we believe, be a detriment to ensuring audit quality'.[1137] ICAP told us that by assuming responsibility for negotiation and agreement of audit fees the AC would implicitly assume an executive role and this might also compromise the AC's objective of making sure a full scope audit was performed.[1138]

16.254 The FRC was broadly supportive of this remedy but raised the following three concerns: (1) it is contrary to good corporate governance and the unitary board principle to impose responsibilities on a committee of a board and then preclude that board from overseeing the discharge of those obligations; (2) the AC should not be able to limit the scope below what the auditor thinks is appropriate; and (3) the AC should not have the final say on the AEP—this should be a matter for the audit firm.[1139]

16.255 Other respondents considered that clarifying the role and duties of the AC did not preclude the whole board from overseeing the final discharge of these obligations and therefore the remedy was consistent with the principle of the unitary board. A view was also expressed that we should specify that the AC is acting on behalf of the board.[1140]

16.256 Some respondents told us that the changes would be better implemented by recommending that the FRC made changes to the UK Corporate Governance Code to avoid issuing a prescriptive set of rules and in order to give companies flexibility to apply the rules on a comply or explain basis.[1141] The FRC told us it believed that the remedy should be implemented through changes to FRC guidance and Auditing Standards.[1142]

16.257 Standard Chartered PLC told us that it did not think the AC possessed the knowledge necessary to negotiate for the maximum benefit of shareholders and in its opinion considered that executive management was better placed. It is also submitted that a threshold should be introduced under which it would be possible for executive management to negotiate with auditors for NAS.[1143] ICAEW also expressed concern that the requirement for ACs to authorize any NAS was impractical.[1144]

[1135] PwC response to provisional findings and Remedies Notice, paragraph 3.56.
[1136] See the responses to provisional decision on remedies from BIS, ICAS, GC100 and the FRC.
[1137] HSBC response to provisional decision on remedies.
[1138] ICAP response to provisional decision on remedies.
[1139] FRC response to provisional decision on remedies.
[1140] Responses to provisional decision on remedies from ABI, Grant Thornton and The Weir Group plc.
[1141] Responses to provisional decision on remedies from ABI, ICAS and The Weir Group plc.
[1142] FRC response to provisional decision on remedies.
[1143] Standard Chartered PLC response to provisional decision on remedies.
[1144] ICAEW response to provisional decision on remedies.

16.258 PwC told us that it did not consider that it was necessary for an order to be made requiring an auditor to report any material audit issue to the AC/ACC as soon as practicable. It considered that recent changes to ISA (UK&I) 260,[1145] which is effective for financial reporting periods beginning on or after 1 October 2012, require the auditor to communicate to the AC relevant information to enable them to understand the rationale and the supporting evidence the auditor has relied on when making significant professional judgements. The standard includes a prescriptive list of matters that the auditor must communicate.[1146] With respect to this aspect of the proposed order, BDO responded that it was not clear how we intend to implement and enforce the requirement that the auditor should report any material audit issue to the AC as soon as possible.

16.259 KPMG told us that we should make it clear that the AC can only agree changes to the scope of the audit if it is over and above what the audit firm deems necessary. It told us the AC should not have power to require replacement of the AEP. In its view, it is better to let the FRC implement these changes to avoid any unforeseen consequences associated with an order. It also raised concerns about the requirement that ACs sign-off on NAS.

Design issues

16.260 The main design issues that arise in relation to this remedy are as follows:

(a) the first point of contact issue;

(b) AC/ACC being in sole charge of major audit engagement features;

(c) the issue of 'executive responsibility' and the unitary board principle;

(d) whether time should be allowed to assess FRC changes to AC guidance; and

(e) whether 'comply or explain' is sufficient for this proposed remedy.

16.261 We discuss each of these issues in turn.

First point of contact

16.262 In our Remedies Notice we proposed that 'the ACC would be the first point of contact if a material audit issue arose rather than only being consulted after the Finance Director'.[1147] This was a response to the policy of 'no surprises' apparently pursued by some FDs which may have the potential to delay visibility of audit issues or ensure that AC discussion effectively deals with a fait accompli. This might undermine the independence of auditors.

16.263 This proposal prompted significant concerns as to its practicability (see Appendix 16.6). It was felt that the AEP should establish the facts of an issue in discussion with the FD and his team before raising this with the AC/ACC. It was also felt that such rapid reporting would also require an unrealistic day-to-day involvement of the ACC. The comments of the FRC are also pertinent (see paragraph 16.254) and PwC (see paragraph 16.258) in noting that the revised Guidance on ACs has recently intro-

[1145] ISA (UK & I) 260.
[1146] PwC response to provisional decision on remedies.
[1147] Remedies Notice, paragraph 48.

duced extended reporting requirements to reduce the risk that issues are resolved between the finance director and auditor without reference to the AC.

16.264 We note the revised wording in ISA 260. We note the ISA requires auditors to communicate with the AC, once the facts are established, on a 'timely' basis. We considered whether 'on a timely basis' was equivalent to the wording in our proposed Order of 'as soon as practicable'. Whilst 'as soon as practicable' may convey slightly more urgency than 'on a timely basis' we think the difference is likely to be marginal in practice. We therefore consider that the revised ISA is sufficient in this respect, and accordingly do not propose to include a provision in this regard in our Order.

Sole responsibility for major audit engagement features

16.265 In our Remedies Notice, we proposed that only the AC and the ACC would be able to negotiate audit fees, initiate tender processes for audit work, require a replacement of an AEP, authorize the external audit firm to carry out any NAS or conduct any other aspect of the external audit relationship.[1148] This proposal sought to remove the influence of the FD and his staff on the conduct of the audit relationship and therefore reduce incentives for auditors to compete for management approval.

16.266 There appeared to be general support from respondents to this proposal in principle. However, there were some concerns about how unwieldy this responsibility might be for the ACC and there was some concern from ACCs and FDs that ACCs did not have access to sufficient detail to negotiate audit fees. Standard Chartered PLC told us that it had practical concerns about the requirement for ACs to sign-off on the engagement of the audit firm for NAS (see paragraph 16.257) and submitted that there should be a threshold under which AC sign-off is not required.

16.267 With regard to the suitability of AC/ACCs negotiating audit fees, we note that ACCs are, in general, well qualified and experienced for their roles (see paragraph 9.75). This proposal does not preclude ACCs from consulting others either within or outside the company to obtain information to support negotiations (including the FD). In addition, more frequent tender processes will provide the AC with regular information about the competitive level of fees. Current guidance (paragraph 4.29 of the FRC's Guidance on ACs)[1149] also requires ACs to satisfy themselves that the level of fee payable in respect of audit services is appropriate. We think that to discharge this current requirement adequately the AC needs a good understanding of the basis of audit fees.

16.268 For the above reasons we consider that ACC/ACs will be competent and effective in negotiating and agreeing audit fees. It is possible that in certain circumstances that the ACC may not be as concerned as the FD to obtain low audit fees, in order to preserve audit quality. If so, this should not be regarded as a cost to the company but rather as a choice of quality and pricing that is likely to be more closely aligned with the preferences of shareholders. The ACC/AC negotiating audit fees shows clearly that the ACC/AC is in charge of managing the audit relationship, not the FD.

16.269 With regard to the practicalities of ACs approving NAS engagements, we accept that this may place an unnecessary burden on the AC for low value NAS engagements. Accordingly, we consider that it would be appropriate to allow ACs to set a threshold

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[1148] Remedies Notice.
[1149] www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Corporate-Governance-Code/Guidance-for-boards-and-board-committees.aspx.

of materiality below which executive management may authorize the audit firm to conduct NAS without having to obtain AC approval.

16.270 In view of the above considerations, we considered that the 'major audit engagement feature' of the remedy be broadly maintained as proposed in the Remedies Notice and is formulated as follows:

(a) For a FTSE 350 company, only the AC acting collectively or through the ACC is permitted, acting on the delegated authority of the board, to:

(i) negotiate and agree audit fees and influence the scope of audit work (though we recognize that the scope of the audit cannot be reduced below the minimum required by the auditor to review effectively a company's financial statements in line with Auditing Standards);[1150]

(ii) initiate and supervise tender processes for external audit work and make recommendations for appointment of auditors following a tender process;

(iii) influence the identity of an AEP; and

(iv) authorize the external audit firm to carry out any NAS, although the AC may set a threshold of materiality below which executive management may authorize the audit firm to conduct NAS.

(b) Auditors are only permitted to enter into an agreement with a FTSE 350 company to carry out audit services in the circumstances that the terms of such an agreement have been negotiated with and agreed by the AC.

The issue of executive responsibility and the unitary board principle

16.271 Some respondents raised concerns (see paragraphs 16.251 and Appendix 16.6 that adding responsibilities to the role of the AC or ACC for external audit would transform these into an executive function and so reduce their independence. Some respondents to our provisional decision on remedies also raised a concern that the proposed Order would breach the principle of the unitary board (see paragraph 16.253).

16.272 Under the UK Corporate Governance Code (section A4) NEDs 'should constructively challenge and help develop proposals on strategy' and 'Non-executive directors should scrutinise the performance of management in meeting agreed goals and objectives and monitor the reporting of performance'. Increasing the responsibility of the AC/ACC for external audit does not imply that their role aligns their function with executive directors and becomes less independent. On the contrary, having greater responsibility for external audit should enable the NEDs sitting on the AC to fulfil their responsibilities more effectively for holding the executive to account and monitor the reporting of performance.

16.273 This remedy may increase the involvement of the AC/ACC although this should not be so significant as to change fundamentally the basis of their role. However, the requirement for increased involvement will need to be recognized in an appropriate transitional period to allow companies/NEDs to resource the proposed changes adequately. This will be considered further under the implementation section below.

[1150] The scope of the audit cannot be reduced below the minimum required by the FRC's Scope of an audit of financial statements of a private sector entities arising from the requirements of ISAs (UK & Ireland) and International Standards on Auditing.

16.274 As set out in paragraph 16.240, nothing in the Order should be interpreted as a departure from the principle of the unitary board.

Allowing time to assess FRC changes to its Guidance on ACs

16.275 Some respondents argued that the recent revisions to the UK Corporate Governance Code should be allowed to take effect before introducing further changes (paragraph 16.248). The FRC's main recent changes are summarized in paragraphs 15.7 and 15.8. Our remedy takes account of the changes. However, the FRC's changes do not address the particular purpose of this remedy and in order to address comprehensively the AEC that we have identified, it is necessary to go beyond the FRC's recent changes (see paragraph 16.277).

Sufficiency of 'comply or explain'

16.276 Generally respondents in commenting on implementation of this remedy (see paragraphs 16.250 and 16.256) consider that implementation should be achieved through some form of change in the UK Corporate Governance Code. This in turn would imply that the provisions would be subject to comply or explain principles only.

16.277 'Comply or explain' principles are well suited to situations which need to accommodate a variety of practice. However, it is less clear that this is desirable where compliance is needed with specific requirements. The FRC told us that the standard of corporate governance varies significantly from company to company.[1151] To ensure effective implementation we consider it necessary to incorporate the measures in an Order rather than being subject to the lighter standard of 'comply or explain'.

Assessment of effects

16.278 We expect that this remedy will reduce the influence of the FD in the conduct of the relationship with auditors. It may therefore significantly reduce the risk that competition between audit firms is distorted to satisfy management at the expense of shareholders. This would reduce the risk of shortfalls in auditor scepticism and independence and increase the confidence that investors have in reported results and company governance. This assessment is supported by the strong approval of investor groups for this remedy noted in paragraph 16.247 above.

Costs of the remedy

16.279 Respondents to our provisional decision on remedies generally agreed with our assessment that the remedy would involve direct costs in terms of the additional time commitment required of AC members but that these were sustainable.

16.280 A few respondents (including Deloitte[1152] and Kingston Smith[1153]) suggested that the role of the ACC might also become less attractive as a result of the increased time commitment involved, and the pool of suitably qualified persons willing to take on the role might be diminished. Some ACCs of the case study companies[1154] we interviewed took this view (eg the ACC of Company L).[1155] GT told us that the most significant cost of implementation for this remedy will be any additional resource or

[1151] See paragraphs 11.75 & 11.76.
[1152] Deloitte response to Remedies Notice, paragraph 7.6*(b)*.
[1153] Kingston Smith response to provisional findings and Remedies Notice.
[1154] See www.competition-commission.org.uk/our-work/statutory-audit-services/evidence/case-studies.
[1155] Appendix 2.1, Company L, paragraph 28.

procurement assistance which would be required for ACs, although GT doubted that this resource requirement would be significant given the fact that many ACCs are former auditors/accountants who have sufficient familiarity with the processes they would be undertaking. GT told us that the occurrence of tendering and rotation requirements is unlikely to be frequent enough to require a significant uplift in ACC resource.[1156]

16.281 We think that the remedy is unlikely to result in a significant change in the costs of audit firms. The proposed remedy has been tailored to ensure that it does not require a substantial increase in day-to-day involvement from the ACC. However, the increased overall involvement of ACs in general and ACCs in particular is likely to increase company costs for the time expended by ACs/ACCs. We think that any increase in costs of ACs may be offset to a significant degree by the FD and staff spending less time on negotiating audit fees and the terms and scope of audit engagements. The aggregate incremental cost for each company is therefore unlikely to be significant.

16.282 We estimate that based on median FTSE 100 NED remuneration that if the audit related workload of AC members increased by 5 per cent there would be a £1.6 million cost to companies across the FTSE 350.[1157] As an upper bound we do not think that the remedy would increase workload of the AC by more than 10 per cent and thus the cost of the remedy will not exceed £3.1 million. This estimate does not, however, factor in any savings resulting from the displacement of activities from the FD and the finance team to the AC nor the number of ACs which are already actively undertaking these roles. As such this is an illustrative example only.

16.283 This is considered further in the proportionality section of our report.

Implementation

16.284 In general, the CC prefers to act by Order where possible and appropriate, as an Order is binding and we have the power to make it directly. An Order is therefore more likely to be effective in addressing the identified AEC. We do not think that a recommendation to the FRC will fully achieve the aims of this remedy since the comply or explain duty may not produce full compliance (see paragraphs 16.275 and 16.277). We have therefore decided to issue an Order addressed to FTSE 350 companies and to audit firms as stated in paragraph 16.237.

16.285 We will require a compliance statement to be included as part of the AC Report to the effect that the company has complied with the provisions of the Order.

16.286 We have taken into account that the FTSE 350 is a ‘shifting class’ with companies’ periodically moving in or out of the listing. We will provide that new entrants to the FTSE 350 listing are to be subject to the provisions of the Order immediately upon entry into the listing. We think that the Order reflects good corporate governance which companies with aspirations to join the FTSE 350 are likely to follow, and in any event the requirements of the proposed Order can be taken into account by companies just outside the FTSE 350 listing. We do not therefore think that the provisions will be unduly onerous on companies entering the FTSE 350 listing.

[1156] GT response to provisional decision on remedies.

[1157] Based on four AC members attending ten board meetings and four AC meetings annually. NED remuneration based on www.incomesdata.co.uk/news/press-releases/IDS-FTSE-100-NEDs-release-2013.pdf, additional remuneration for the ACC based on www.incomesdata.co.uk/news/press-releases/FTSE_100_NEDs_2010.pdf uplifted by the rate of inflation for NED pay. As these are median figures for the FTSE 100, we believe that this is an overestimate of cost. If ACs were not remunerated for this additional effort, they might incur an opportunity cost.

16.287 Finally, we also think it appropriate to recommend that the FRC update the UK Corporate Governance Code to bring it into line with the provisions of the Order.

Assessment of Remedy 6: Extended reporting requirements in both the AC's and auditor's report

Summary and introduction

16.288 We recommend to the FRC that it amend the UK Corporate Governance Code to include the following additional provision in relation to the AC Report:[1158]

> In reporting how the AC has assessed the effectiveness of the auditor, the AC of a FTSE 350 company should report on (i) whether the AQR team has concluded a review on the audit of the company's financial statements in the reporting period, (ii) what the principal findings were, including grade, and (iii) how both the AC and auditor are responding to these findings.

16.289 We found that shareholders had little information about the quality of the audit or the audit process with which to engage with companies on matters concerning the external audit and that shareholder demand for more information was not being met.[1159] We also found that the information available to companies outside a tender process leaves significant uncertainties in assessing the quality of other audit firms.[1160] We considered that a remedy which encouraged the AC or the auditor to disclose information about the audit would address this lack of information.

16.290 In this subsection we:

- *(a)* outline recent changes concerning disclosures in the AC Report and the Audit Report;
- *(b)* summarize parties' views;
- *(c)* assess the effectiveness of the recent changes made to the AC Report and Audit Report at addressing the AEC that we have provisionally found;
- *(d)* consider whether further remedies are required, and if so:
  - (i) how these might be designed;
  - (ii) what their effect would be; and
  - (iii) implementation.

[1158] The UK Corporate Governance Code is applied by all companies with a Premium Listing (for a definition of 'Premium Listing', see http://fsahandbook.info/FSA/html/handbook/LR/9/8). We have limited our recommendation to FTSE 350 companies in line with the scope of our inquiry. It is at the discretion of the FRC as to whether the obligation should extend to all companies with a Premium Listing.

[1159] See paragraphs 7.226–7.264.

[1160] See paragraph 9.329.

Recent changes to AC Reports and Audit Reports

AC Reports

16.291 In the December 2010[1161] Guidance on Audit Committees, ACs were required to report annually, as part of the Directors' Report, the following:[1162]

(a) a summary of the role of the AC;

(b) the names and qualifications of all members of the AC during the period;

(c) the number of AC meetings;

(d) a report on the way the AC has discharged its responsibilities;

(e) how it reached its recommendation to the board on the appointment, reappointment or removal of the external auditors;[1163] and

(f) how, if the auditor provides NAS, auditor objectivity and independence is safeguarded.[1164, 1165]

16.292 In April 2012, the FRC issued the consultation document 'Revisions to the UK Corporate Governance Code and Guidance on Audit Committees'[1166] on proposed changes to policies.[1167] One of the expected changes was that 'more informative reporting by ACs, including on the process for appointing the external auditor, will be encouraged'.[1168] The outcome of this consultation was the September 2012 revision to the FRC's Guidance on ACs (applicable to companies whose reporting period began on 1 October 2012) to require the AC Report to include:

(a) the significant issues that the AC considered in relation to the financial statements and how these issues were addressed, having regard to matters communicated to it by the auditors; and

(b) an explanation of how the AC had assessed the effectiveness of the external audit process and the approach taken to the appointment or reappointment of the external auditor,[1169] and information on the length of tenure of the current audit firm, when a tender process was last conducted, and any contractual obligations that acted to restrict the AC's choice of external auditors.[1170]

16.293 The first of these provisions was a new addition to the guidance and the second was a revision to previous requirements. Most significantly, these paragraphs were also included in the UK Corporate Governance Code.[1171] While companies do not need to

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[1161] This was the last version issued before the September 2012 revision.
[1162] Some requirements were introduced prior to December 2010.
[1163] FRC, Guidance on Audit Committees, December 2010, paragraph 4.23. This explanation should normally include supporting information on tendering frequency, the tenure of the incumbent auditor, and any contractual obligations that acted to restrict the AC's choice of external auditors.
[1164] ibid, paragraph 4.37. This includes the policy on appointing the auditor to provide NAS.
[1165] ibid, paragraph 5.2.
[1166] FRC, Revisions to the UK Corporate Governance Code and Guidance on Audit Committees, April 2012.
[1167] This had followed the publication by the FRC of Effective Company Stewardship: Next Steps, September 2011.
[1168] FRC, 'Revisions to the UK Corporate Governance Code and Guidance on Audit Committees', April 2012, paragraph 3.
[1169] Specifically in order that shareholders can understand why the AC recommended either to reappoint or change the auditors. FRC, Guidance on Audit Committees, December 2010, paragraph 4.26.
[1170] FRC, Guidance on Audit Committees, September 2012, paragraph 5.2. Subparagraph B was a redrafting of existing guidance in the December 2010 version.
[1171] This wording is supplicated in the UK Corporate Governance Code, September 2012, paragraph C.3.8.

comply with provisions in the UK Corporate Governance Code, they should explain why divergence is justified and how governance has been achieved.[1172]

The Auditor's Report

16.294 The FRC is responsible for issuing ISAs in the UK and Republic of Ireland, having regard to the pronouncements of the IAASB. The UK and Republic of Ireland version of ISA 700 'The Auditor's Report on Financial Statements' was revised in October 2012 and in June 2013.[1173]

16.295 The October 2012 revision to ISA 700 introduced a requirement for the auditor to report by exception 'if the board's statement that the annual report is fair, balanced and understandable is inconsistent with the knowledge acquired by the auditor in the course of performing the audit, or if the matters disclosed in the report from the audit committee do not appropriately address matters communicated by the auditor to the committee'.[1174] These changes were aimed at supporting changes to the UK Corporate Governance Code to enhance effective stewardship.[1175]

16.296 Following consultation, a revised ISA 700 was issued in June 2013. It requires auditors to:

(a) describe those assessed risks of material misstatement that were identified by the auditor and which had the greatest effect on: the overall audit strategy; the allocation of resources in the audit; and directing the efforts of the engagement team;

(b) provide an explanation of how the auditor applied the concept of materiality in planning and performing the audit; such explanation shall specify the threshold used by the auditor as being materiality for the financial statements as a whole; and

(c) provide an overview of the scope of the audit, including an explanation of how such scope addressed the assessed risks of material misstatement disclosed in accordance with *(a)* and was influenced by the auditor's application of materiality disclosed in accordance with *(b)*.[1176]

16.297 The IAASB describes auditor reporting as its number one priority[1177] and has been undertaking a series of consultations on developing the auditors' report through amending the ISAs since 2011. In a meeting of the IAASB in February 2013, support was given to a new objective of the auditor: 'The objective of the auditor, having formed an opinion on the financial statements, is to communicate in the auditor's report those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements.'[1178]

16.298 This new objective is tentatively expected to result in the creation of a new ISA, ISA 701. The IAASB produced an exposure draft of the new ISAs in July 2013[1179] with

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[1172] FRC, UK Corporate Governance Code, September 2012, paragraph 3.
[1173] The standard is now ISA (UK & I) 700—The independent auditor's report on financial statements, June 2013.
[1174] http://www.frc.org.uk/News-and-Events/FRC-Press/Press/2012/September/FRC-issues-revised-auditing-standards-to-enhance-c.aspx
[1175] Paragraphs 5 & 6. FRC, Revision to ISA (UK & I) 700 Requiring the auditor's report to address risks of material misstatement, materiality and a summary of the audit scope, February 2013.
[1176] ISA (UK & I) 700, paragraph 19A.
[1177] www.ifac.org/auditing-assurance/auditor-reporting-iaasbs-1-priority.
[1178] www.ifac.org/sites/default/files/meetings/files/20120214-IAASB-February-2013_Meeting_Highlights-final.pdf
[1179] The exposure drafts are available on the IAASB's website.

the final revised ISAs approved in June 2014. In August 2013, the FRC began a consultation in the UK on the proposed changes, and noted that similar benefits should be achieved as a result of the changes the FRC made to ISAs (UK and Ireland) 260 and 700 and to the UK Corporate Governance Code in October 2012 and June 2013.[1180]

Parties' views

16.299 We reviewed the responses to the Remedies Notice and other evidence relating to this remedy from the remedies hearings, the case studies with companies, questionnaire responses from investors and responses to the provisional decision on remedies.

16.300 We found widespread support for enhanced reporting by ACs and auditors. We found, however, less of a consensus on the specific scope of this extended reporting and on the issue of whether it should be by both the AC and the auditor. However, the view that the FRC was the appropriate body to advance this remedy was almost unanimous.

16.301 Companies did not generally favour additional disclosure in the AC or auditor report, with some noting the need to consider the burden on the lay reader. The Big 4 and Mid Tier firms were supportive of improved reporting and supported the work of the FRC and IAASB. Some firms favoured additional reporting in the annual report rather than the audit report. Regulators and professional bodies in the UK and internationally supported the work of the FRC and the IAASB.

16.302 Further details on the views of parties about this proposed remedy are given in Appendix 16.7. Design issues are discussed further in paragraphs 16.320 to 16.325.

Assessment of effectiveness of recent FRC reporting initiatives

16.303 The recent changes made by the FRC to AC and auditor reporting[1181] had either not taken effect or had not been finalized at the point at which our provisional findings were published. We now consider the extent to which these reporting changes address the AEC that we found.

16.304 The FRC's recent changes to AC reporting introduced in the UK Corporate Governance Code apply to reporting periods beginning on or after 1 October 2012.[1182] The majority of FTSE 350 companies will publish reports prepared under the new guidance in the first half of 2014, hence it was difficult to assess their effectiveness in practice.

16.305 In relation to the audit report, the FRC had not concluded its consultation on ISA 700 at the point of publishing the Remedies Notice or the provisional findings. Since their publication, the FRC has finished work on ISA 700. The IAASB's consultation on auditor reporting continues at an international level and the FRC is consulting on this within the UK.

AC reporting

16.306 The 2012 revisions to the FRC's Guidance on ACs and UK Corporate Governance Code (see paragraph 16.292) saw the introduction of the requirement for ACs to

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[1180] FRC Consultation, August 2013.
[1181] See paragraphs 15.2–15.6.
[1182] This applies to all companies subject to the Corporate Governance Code.

include an assessment of auditor effectiveness and to explain how the decision to appoint or reappoint was made. This had previously been included in guidance to ACs, and its promotion to the UK Corporate Governance Code places an increased emphasis on AC reporting. In addition (see paragraph 16.292), ACs are now required to communicate the significant issues that they considered in relation to the financial statements and how these issues were addressed, having regard to matters communicated to it by the auditors.

16.307 We believe that the expanded reporting requirements in the 2012 UK Corporate Governance Code have the potential to contribute towards remedying unmet shareholder demand for information on the audit and towards remedying the prevention restriction or distortion in competition that we found. We consider this is partly dependent on the extent to which companies comply with the new requirements and the quality of the disclosures that they make.

16.308 Any requirement for the AC to report under the UK Corporate Governance Code is on a 'comply or explain' basis. Under 'comply or explain' any disclosure will necessarily be voluntary and cannot be enforced. The effectiveness of any remedy is therefore dependent on the willingness of companies to comply.

16.309 On the basis of the level of overall compliance with the UK Corporate Governance Code, we believe that ACs will comply with aspects of these requirements, as total non-compliance is rare. However, GT's review of corporate governance disclosures indicates that disclosures on matters relating to external audit have not consistently been of a high quality.

16.310 Analysis conducted by GT for its annual review of corporate governance[1183] for the FTSE 350 found that disclosures on the appointment of auditors[1184] had improved over the period 2009 to 2012 but that 14.5 per cent of the FTSE 350 fail to make any disclosure[1185] and only 25 per cent of companies are categorized in the most compliant category.[1186,1187] If other requirements of AC reporting also achieve similar levels of compliance, it would indicate that enhanced AC reporting will not be a fully effective remedy, as it will not be implemented by all companies and not all shareholders will benefit, and the trend of compliance with previously introduced measures suggests that compliance with the new measures may take some time to be adopted widely.[1188]

16.311 Since the introduction of the FRC's ISA 700 (October 2012) (subsequently revised in June 2013), auditors are required to report 'if when reading the other financial and non-financial information included in the annual report, the auditor has identified information that is materially inconsistent with the information in the audited financial statements or is apparently materially incorrect based on, or materially inconsistent with, the knowledge acquired by the auditor in the course of performing the audit or that is otherwise misleading'.[1189] We think this provides a safeguard against ACs

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[1183] GT, Corporate Governance Review 2012—'The chemistry of governance: a catalyst for change'.
[1184] This section of the AC report should include an explanation of how the AC has assessed the effectiveness of the external audit process (UK CGC C.3.8).
[1185] This is companies which fail to comply or to explain their lack of compliance.
[1186] GT, Corporate Governance Review 2012—'The chemistry of governance: a catalyst for change', p51, Figure 48.
[1187] GT's highest category is 'More', which is achieved where a company provides a detailed explanation to support each area of the Code with which they choose not to comply. This includes the reasons for their non-compliance, an explanation as to why they feel that this non-compliance is in the best interests of the company and the shareholders, a description of mitigating actions taken and, where appropriate, when the company intends to comply with the provision. GT Corporate Governance Review 2012, p41.
[1188] The annual reports reviewed were not required to adopt the most recent changes to the Corporate Governance Code, and it seems like that compliance with any new requirement would be even lower in the first years after introduction.
[1189] ISA 700 (UK & I) June 2013, paragraph 22A, which replaces ISA 700 (UK & I) October 2012 which introduced the requirement.

disclosing incorrect or misleading information but is unlikely to prevent examples of limited or partial disclosure.

16.312 Based on the above assessment, we did not think that the changes would be effective in all cases and were concerned that the extent of disclosure and quality of disclosures might be limited in some cases. We recommend two additional measures to improve the quality of AC reporting:

(a) As set out above, an advisory vote be introduced on the AC Report, whereby shareholders are asked to indicate their satisfaction with the AC Report. This is discussed in detail in Remedy 4, Enhanced Shareholder Engagement (see paragraphs 16.192 to 16.236).

(b) The AC should disclose the outcome of any AQR team findings on the company's audit to its shareholders. We consider that an AQR review is the only available independent assessment of technical audit quality that has access to detailed information (paragraph 7.119). For this reason, in conjunction with our remedy on increasing the frequency of AQRs, we believe that ACs should report explicitly on any findings arising from an AQR of the company's audit and how the AC has used that AQR in assessing the effectiveness of the auditor. This gives shareholders more meaningful information on how the AC has ensured that shareholder interests in a high quality audit are taken into account. It would also increase visibility of technical audit quality.

Audit reports

16.313 We consider that the changes to ISA 700 will increase the availability of information on the audit approach applied to specific audit engagements. We consider that this information will assist companies to compare the quality of their own audit with that of other firms, and will contribute to addressing the lack of company bargaining power that we found.

16.314 The increased disclosures in the audit report will also provide shareholders with more information with which to judge the quality of the audit, and potentially to form the basis of engagement with companies, and the AC in particular, on the audit approach. As a result, ACs may better understand shareholder demands and reflect these demands in managing the audit relationship and in auditor appointment decisions. This will better align auditor and shareholder interests.

16.315 For example, as the materiality threshold used by the auditor will now be disclosed, firms could choose to compete by offering an enhanced audit service with a lower materiality threshold, which could potentially provide greater assurance to shareholders.[1190]

16.316 In assessing the effectiveness of the revised ISA 700, we considered the likely extent of compliance. As International Standards on Auditing are mandatory for FTSE 350 company audits we consider that compliance will be universal in terms of making the minimum required disclosures.[1191]

16.317 We note that much of the information required to be disclosed under the revised ISA 700 is prepared annually as part of the audit approach and tailored to the specific

[1190] Decreasing the materiality threshold would reduce the tolerable range of accounting estimates and reduce the likelihood of aggressive accounting treatments.
[1191] This is a requirement of the EC Statutory Audit Directive (2006/43/EC).

circumstances of the company, and thus the likelihood of 'boiler plate' (ie standardized reports that are recycled without much change) is reduced.

16.318 In addition, as the new requirements of ISA 700 are framed in relatively high level terms, there is opportunity for firms to differentiate themselves based on the quality of reporting to shareholders, and to demonstrate quality and innovation. Further, we understand that when the AQR team reviews an engagement audit file it will consider if the audit report is correctly prepared based on information on the audit file (as required by ISA 700). Therefore when ISA 700 is amended, we believe that the AQR team will have a role to consider the quality of the resultant disclosures. Our remedy to require more frequent AQR will ensure that audit reports across the FTSE 350 are reviewed and that issues will be reported both at company, firm and audit industry level (via FRC consolidated annual reporting for the major UK firms).

16.319 Based on the above points, we consider that the new disclosures required by ISA 700 will be effective in increasing information to companies and shareholders on audit quality, and will thus contribute to increasing company bargaining power and increasing the influence of shareholders in auditor appointment decisions. We are therefore not recommending any measures in respect of the audit report.

Design issues in requiring AC reporting on AQR team findings

16.320 As discussed above, we expect the AC to have regard to the AQR team's findings in assessing auditor effectiveness and consider that the utility of AC Reports could be improved by requiring the AC to disclose information about this. Specifically, we propose that ACs be required to report on any AQR undertaken on the audit and completed during the reporting period, the grade achieved and how the AC has used this to assess the effectiveness of the auditor.

16.321 Parties were concerned that AQR scores would be seen as a reflection on the quality of the financial statements and not a specific aspect of the audit. In reaching our decision on this remedy we considered that the AC was better placed to make such disclosures than the FRC or AQR team. By requiring the AC to make this disclosure, it would be in a position to provide appropriate context and disclosure if it believed the findings could affect the company's share price (for example, where an AQR grade is poor thus casting doubt on the audit opinion). We consider that there are merits in allowing the AC an opportunity to explain to shareholders what steps it has taken to respond to a poor AQR grade to ensure the effectiveness of external audit.

16.322 Different companies may find that the length of time between their respective ACs receiving the AQR's findings on their audit engagements and the date that the annual report is published vary. If the timing varies significantly across companies, some ACs and firms may feel disadvantaged if they have not had opportunity to respond fully to the AQR findings before the annual report is published. However, we believe this should lead to improved ongoing disclosure on how those issues are being dealt with on an ongoing basis. Given the specific nature of some findings, we believe that ACs and firms should be able to respond to findings before the audit report and annual report are issued.

16.323 We noted that under the 'comply or explain' regime the AC may choose not to disclose the grade if it was perceived to harm the commercial interests of the company.[1192] However, we consider that any failure to disclose on these grounds would

[1192] However, if sufficient other companies were to disclose their grades, a third party may be able to identify the grade of the AQR on a company's audit.

be likely to attract considerable attention and investors would infer that that grade was poor.

16.324 Parties identified the risk that auditors would find themselves conflicted if they are required to review the disclosure made by the AC. We acknowledge the potential for this, but believe the FRC is best placed to address this issue.

16.325 Some parties raised the issue of the AQR process becoming legalistic, as a result of firm or auditor concerns over the impact of a low scoring engagement and we have considered this risk in our assessment of the costs of this remedy (see paragraph 16.331). However, we believe that firms already have incentives to challenge scoring, given the potential reputational effect of the existing firm level AQR reports and given that ACs receive copies of the AQR's findings.

Effect of our proposed remedy

16.326 Our remedy to require ACs to report the outcome of AQR is directed to supplying further relevant information to shareholders on the quality of the external audit and on the effectiveness of the AC in discharging its duties to procure a high quality audit in behalf of shareholders. We consider below the effect of requiring ACs to report on the outcome of the most recent AQR.

16.327 The requirement to disclose AQR grades will lead to greater availability of information on audit quality, both on audit firms in general, as well as on individual engagements, and by inference on individual audit teams and partners. This information will assist companies to compare the quality of their own audit with that of other firms, and thereby contribute to addressing the lack of bargaining power that we have found.

16.328 Disclosure of AQR findings and actions taken by ACs as a result will provide investors with better information with which to assess how effectively the AC has discharged its responsibilities to protect shareholder interests in matters concerning external audit. We expect this to contribute towards ensuring that ACs take account of shareholder interests in managing the relationship with the external auditor and in auditor appointment decisions, and so better align auditor and shareholder interests.

Costs

16.329 We do not believe there will be any direct costs for firms or investors as a result of this remedy.

16.330 We believe that any amendment to the UK Corporate Governance Code will have minimal additional cost to companies in preparing the AC Report. The AC has an existing requirement to consider the effectiveness of the auditor in reaching a conclusion on reappointment. For those ACs discharging their responsibilities appropriately, we do not perceive there to be a significant cost attached to describing the actions that they have taken in this respect.

16.331 We considered whether or not the requirement for ACs to disclose the grade would affect the costs incurred by the AQR team in determining the grading to apply to a file review. We were concerned that firms might perceive there to be an increase in their litigation risk or damage to their reputation should an audit be graded as unsatisfactory and as a result challenge the FRC more aggressively. This might cause the FRC to incur more staffing or legal costs in handling firms' challenges. Whilst firms are conscious of the reputational effect of having any audit graded as unsatisfactory (and included in the firm's performance by the AQR team in the respective firm-level reports), and thus already have incentives to challenge the AQR team, we consider that disclosure by the AC could enhance those incentives.

16.332 On balance we consider that the AQR team may need to increase its resources as a result of the additional transparency and scrutiny that this remedy will place on its findings. We have been unable to quantify this additional resource requirement with precision but do consider that it is unlikely to be substantial as audit firms have an opportunity to comment on the proposed letter to the AC which includes the grade awarded to the audit. The requirement for ACs to report on the findings of AQR team reviews will provide more information on the conduct of the audit and will help reinforce the importance of audit quality as an element of shareholder demand. We believe there is a wider public benefit to the UK as a result of increased confidence in audit quality and corporate governance. We do not perceive there to be any wider costs.

Implementation

16.333 We note the scope of our Order making powers in paragraphs (see paragraphs 18.19 and 18.20) and therefore recommend that the FRC should require through the UK Corporate Governance Code that for FTSE 350 companies: 'In reporting how the AC has assessed the effectiveness of the auditor, the AC should report on whether the AQR team has concluded a review on the audit of the company's financial statements in the reporting period, what the principal findings were, including grade and how both the AC and auditor are responding to these findings.'

16.334 We recommend that amendments to the UK Corporate Governance Code be made by October 2014.[1193] The UK Corporate Governance Code is applied to companies with a Premium Listing. We have limited our recommendation to FTSE 350 companies in line with the scope of our inquiry. It is within the discretion of the FRC as to whether the obligation should extend to all companies with a Premium Listing.

Assessment of Remedy 7: Competition object for the FRC

Summary and introduction

16.335 We recommend that the FRC amends the objects clause in its articles of association so that, without prejudice to its other objects, in performing its functions it will have due regard to the need for competition in the statutory audit market for FTSE 350 companies.

16.336 The proposed amendment would not confer any concurrent powers on the FRC. It would continue to have no power to investigate or enforce the competition rules under the Competition Act 1998 or the Treaty on the Functioning of the European Union.

16.337 In this section, we set out:

(a) background and the aims of the remedy;

[1193] We note that the Government has indicated that it will aim to have two common commencement dates each year for new legislation and regulations with a view to minimizing burdens on business. The commencement dates are 6 April and 1 October. While the UK Corporate Governance Code is not a regulation, but rather both set out standards of good practice, its terms are applied by companies and investors alike on a comply-or-explain basis. We therefore think use of these dates is reasonable.

(b) parties' views;

(c) our assessment of effectiveness and costs; and

(d) conclusion.

Background and the aims of the remedy

16.338 Having carefully considered the responses to the Notice of a further possible remedy[1194] and responses to our provisional decision on remedies,[1195] we decided to recommend that the FRC amends its company objects, such that, when exercising its existing functions in relation to audit, and without prejudice to its other objects, it does so in a way which has due regard to the need for competition between the statutory auditors of FTSE 350 companies. The reasons for this are given below (see paragraph 16.361).

16.339 We think that there is currently scope for the FRC, as the regulator most closely concerned with audit and corporate governance, when exercising its primary functions as regards audit, to have due regard to the need for competition between firms which provide statutory audit services to FTSE 350 companies.

16.340 Our aim in giving the FRC a competition object would be to give the FRC a firm base on which to take appropriate action to support the other remedies we have decided which address the AEC we found to exist in the market for supply of statutory audits services to FTSE 350 companies. We think this (as part of the package of remedies we propose) contributes to addressing the AEC we found since:

(a) it can increase companies' bargaining power outside the tender process by providing greater information about the various audit firms that might be alternatives to the incumbent. We see the increased number of AQR inspections (Remedy 2) as part of this.

(b) it can contribute to ensuring that firms' reputations are an accurate reflection of their abilities, through its firm-level reports. Further, in ensuring that firms auditing PIE companies are inspected and reported on in a similar manner, it might reduce any unjustified perceptions that certain firms are better than others (for example, by avoiding distinguishing between 'the Big 4' and others where there is no objective justification for doing so). This will contribute to addressing the barriers to entry, expansion and selection that we identified.

(c) it may assist the better alignment of auditor with shareholder interests through its information and reporting activities. These enable ACs and shareholders better to hold auditors to account, and so assist in remedying the principal-agent problems we found.

16.341 As the regulator with ongoing responsibilities it may identify other ways in which it could enhance competition and so quality in the market for audit for large companies.

1194 www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/notice_of_further_possible_remedy.pdf.

1195 www.competition-commission.org.uk/our-work/directory-of-all-inquiries/statutory-audit-services/evidence/responses-to-provisional-decision-on-remedies.

Views of parties

16.342 In our provisional decision on remedies we modified this remedy to take into account the views we received in response to our Notice on a further remedy (which had sought views on whether to recommend that the FRC had a secondary duty, to carry out its primary duties in a way which, so far as possible, promoted competition between firms providing audit services to FTSE 350 companies). Details of the views we received are set out in Appendix 16.8.

Regulatory Bodies

- *The FRC*

16.343 The FRC accepted that competition clearly pays an important part in its mission to help investors assess and choose between investment opportunities but had doubts as to how useful it would be for the FRC to have a secondary object to promote competition.

16.344 On the specific question of whether AQR team reports could be adapted to make them a basis for comparing statutory auditors, the FRC said that it was willing to review ways in which it could enhance its reporting in order to increase its usefulness to ACs and investors in relation to changing auditors in addition to improving quality. However, it had concerns about the cost implications, as the FRC considered that it would need to carry out about six times the number of inspections it carries out at present, and estimated that the bill for inspections would rise from nearly £3.5 million to £9 million. It also had concerns that if the reports were to be used as the basis of comparison between firms, they would have an incentive to challenge the grading made by the AQR team of individual audits.[1196]

- *The OFT*

16.345 The Office of Fair Trading (OFT) considered that on its own the remedy would probably not be very effective but, with the package of other proposed remedies, would seem to be worth considering, albeit with some caution. The caution derived from a risk of 'the remedy contributing towards a possible proliferation of bodies with a competition remit, which might suggest that every sector with competition problems ought to have its own 'competition regulator''. The OFT also considered that there was a risk of the purpose and quality of AQRs being jeopardized if the FRC felt that they would have to be written in a way that actively promoted competition.

- *ICAEW*

16.346 The ICAEW in principle endorsed the proposal as set out in the Notice. However, the ICAEW did not wish to see the AQR team instructed to consider the promotion of competition as part of their remit. Their focus should be solely on audit quality.

- *The audit firms*

16.347 BDO supported the FRC having a secondary object of promoting competition, but did not consider it to be an appropriate substitute for any of the other remedies which the CC was considering.

[1196] FRC response to Notice of further possible remedy.

16.348 Deloitte considered that the FRC was already well-placed to take appropriate account of competition issues, but that if we considered that we required additional comfort the measure should be effective.

16.349 GT considered that a secondary duty to promote competition between firms providing audits to FTSE 350 companies would be a useful addition to our package of proposed remedies. Giving the FRC a duty to consider promoting competition would be a useful incentive to improve the way in which AQR reports are performed and reported. It considered that one way of improving the ability for companies and investors to compare audit firms was to increase the regularity of AQR team reviews on audit firms which were not among the four largest firms and there should be an identical frequency of publishing reports for all nine major firms.

16.350 Kingston Smith considered that the proposed remedy of giving the FRC a secondary object of promoting competition was one which would be challenging to make effective in practice and had a potential concern as to the composition of the FRC, as it understood the majority of the serving members of the FRC and its various subsidiary bodies—including the AQR team were drawn from Big 4 backgrounds. Kingston Smith recommended that the serving members of the FRC and its various bodies needed to be drawn not just from the largest firms.

16.351 KPMG said that it was not clear what change or benefit this remedy option would bring and considered that it might distort outcomes in the market. KPMG considered that providing the FRC with a secondary duty to promote competition cannot increase shareholder engagement in any helpful way. The audit appointment needs to be based on an assessment tailored to the needs of the particular company and this is best done by ACs.

16.352 Mazars too considered that giving the FRC a secondary object to promote competition in the FTSE 350 audit market would not be effective unless there were significant changes in its composition, including at board level and that it would also be important for the FRC to establish a new body, with balanced membership, within its structure to deal with promoting competition.

16.353 PwC supported the FRC having a secondary duty to promote competition, provided it retained its primary focus on audit quality and did not have powers concurrent with the Office of Fair Trading to enforce competition.

Other bodies

16.354 The National Association of Pension Funds Limited supported giving the FRC a secondary power to promote competition, so long as this formed part of a package of remedies not a remedy on its own.

16.355 Governance for Owners LLP sent a letter, signed also by Fund and Asset Management firms, which did not oppose the proposed remedy, so long as it was not used as the sole remedy. However, it did not understand how the remedy might lead to further switching.

16.356 The GC 100 Group did not consider it appropriate to give the FRC a secondary duty to promote competition between firms providing audits to FTSE 350 companies.

Responses to our provisional decision on remedies

16.357 We received only a limited number of further responses on this remedy following the publication of our provisional decision on remedies. A number of respondents were, in principle, supportive of our recommendation that the FRC alter its articles of association to include a secondary objective to have due regard to competition.[1197] Deloitte expressed no objection to the remedy but noted that in its view the FRC already takes competition effects into account.

16.358 BDO welcomed the proposed recommendation but requested that we express a view as to whether it considers 'four audit firms is enough to provide sufficient competition'.[1198] In its view, this was relevant in considering whether the 'need for competition' is met at present or at a future point.

16.359 Other respondents to our provisional decision on remedies considered that the FRC should remain focused on its main objective of promoting audit quality.[1199] Kingston Smith had reservations about how the remedy would work in practice.[1200] Similarly, Land Securities expressed a view that it was unsure the FC held sufficient expertise to discharge such a responsibility effectively.[1201]

16.360 The FRC told us that it is was not a competition regulator and it did not have the powers to function as one. However, it said that it had, and will continue to have, due regard for competition issues but its focus must remain on the quality of corporate and financial reporting.[1202]

Assessment of effectiveness

16.361 The responses from interested parties suggest that most considered that this proposed additional remedy had some merit, although they treated specific applications of such an additional secondary power with some caution.

16.362 However, some parties—in particular, the FRC—had concerns about the resource implications of the FRC having a separate, albeit secondary, duty to promote competition. They considered that it might be necessary for the FRC to strengthen its resources by recruiting additional staff with competition experience and expertise, in order to perform such a secondary duty effectively. There was also a degree of scepticism as to whether the FRC has sufficient expertise to successfully exercise a secondary competition duty.

16.363 Having considered carefully the responses that we received, we have decided that it is sufficient for the FRC to have a corporate object, when carrying out its primary functions as to statutory audits, to have due regard to the needs of competition between audit firms offering statutory audit services to FTSE 350 companies.

16.364 We see this remedy as forming part of a package of remedies, rather than forming a 'stand-alone' remedy. However, as an addition to the FRC's other aims and powers, it would underpin and reinforce the steps the FRC is already taking (eg its revision to the Code) to make the statutory audit market for large companies work better.

[1197] Responses to provisional decision on remedies from Deloitte, BDO, GT.
[1198] BDO response to provisional decision on remedies, paragraph 8.1.1.
[1199] Responses to provisional decision on remedies from the ABI, ICAA, ICAS.
[1200] Kingston Smith response to provisional decision on remedies.
[1201] Land Securities response to provisional decision on remedies.
[1202] FRC response to provisional decision on remedies.

16.365 We do not envisage that this remedy would cause the FRC to incur significant additional costs.

Conclusion

16.366 We consider that this proposed remedy to give the FRC a competition object is not a self-standing remedy, but one which forms part of the package of remedies intended to address the AEC we identified.

16.367 It will lead the FRC to have due regard to competition and so encourage it to consider possible measures that would assist in remedying the AEC we found. We think that it is a cost-effective and worthwhile addition to the FRC's primary objects.

17. Remedies we decided not to pursue

Introduction

17.1 We identified a number of possible remedies which we considered to be ineffective or disproportionate in addressing the AEC. These remedies were:

(a) Switching auditors after a specified period of time (see paragraphs 17.3 to 17.63);

(b) constraining NAS provision by the auditor (see paragraphs 17.64 to 17.79);

(c) joint or major component audit (see paragraphs 17.80 to 17.101);

(d) shareholder group responsibility for auditor reappointment (see paragraphs 17.102 to 17.108);

(e) FRC responsibility for auditor appointment (see paragraphs 17.109 to 17.112); and

(f) independently resourced Risk and Audit Committee (see paragraphs 17.113 to 17.117).

17.2 We set out below our consideration of the submissions that we received from parties on these remedy options and our reasoning for not pursuing them.

Mandatory switching

17.3 During the course of our investigation we consulted on the merits of mandatory switching of auditor and specifically asked for views on switching periods of seven, ten and 14 years.

17.4 We decided not to pursue such a remedy since we consider that our remedies package would more effectively address the AEC in a less onerous manner and we discuss this further at paragraphs 18.50 to 18.55.

17.5 In this section, we first set out the views of parties and then our assessment of the effectiveness of this remedy option.

Views of parties

17.6 In this section we summarize the views of: the investor community; FTSE 350 companies; Big 4 and Mid Tier audit firms; the FRC; and academic literature. Views are set out in detail in Appendix 17.1.

Investor community

17.7 The views of the investors were mixed: some were strongly opposed to mandatory switching and others supported switching every 10 to 15 years.

17.8 Those opposed to mandatory switching were concerned that this would undermine the accountability of the auditor to the AC. There was also thought to be a risk of significant disruption to the audit process and a reduction of overall audit quality given the loss of institutional knowledge. Audit risk was said to be highest during the first few years of an engagement. They also said that choice of auditor would be for some companies limited possibly to one alternative.

17.9 Those in favour of mandatory switching emphasized the benefits of ensuring auditor independence and the benefits of a 'fresh pair of eyes'. One investor supported mandatory switching every ten years and several supported switching every 15 years. This was said to be an effective and proportionate response to the misaligned incentives facing auditors. Mandatory tendering was also said to remove negative market signals associated with changing auditor. One investor said that the higher costs would be worth paying for greater market confidence in the degree of scrutiny applied to audits. Finally a party from the investor community said that that mandatory switching would be the most effective market solution to the dominance of a limited number of accounting firms.

17.10 In response to our provisional decision on remedies a coalition of ten investors and investor bodies[1203] stated that having a cap on the length of tenure for an audit firm with the same client is vital to ensuring independence and shifting accountability to shareholders. The coalition proposed mandatory switching after 15 years, with an interim tender including the incumbent permitted, to allow sufficient flexibility to the AC to select the appropriate length for the firm in question.

FRC

17.11 The FRC opposed mandatory switching because it would reduce choice and might have an adverse impact on quality. The FRC said that companies needed to be able to secure the best auditor for their business and should not have their choice of auditor artificially constrained. This was said to be particularly necessary when not all audit firms had the required expertise in sectors such as insurance and banking.

17.12 The FRC said that there was also a risk that mandatory switching would effectively undermine the authority of the AC operating in the best interests of investors by taking the question of reappointment out of its hands. The FRC said that would be inconsistent with the CC's views on the role and accountability of the AC.

17.13 The FRC said the prospects of switching did not guarantee that new firms would emerge. The FRC had heard that Mid Tier firms were not contemplating investing to enter the market for major and complex audit clients in the very top of the FTSE. In some sectors only two or three firms currently competed for work, switching could therefore lead to a danger of a company having no effective choice.

FTSE 350 companies

- *Case studies*

17.14 There was little support for mandatory switching of audit firms among case study companies. It was said that the result would be less choice as the incumbent would have to be excluded. The FD of Company S said that mandatory switching would have left Company S with the choice of only one firm. However, two interviewees considered that mandatory switching would be acceptable if the period of time was reasonable and one thought that ten years would be acceptable.

17.15 Switching was said to have the benefit of a fresh and independent perspective and assessment. The GFD of Company T said that he had gained additional insights as a result of switching auditor. There was said to be a degree of risk associated with a

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[1203] Royal London Asset Management; RPMI Railpen; Local Authority Pension Fund Forum; London Pensions Fund Authority; Legal and General Investment Management; USS Investment Management; Sarasin & Partners LLP; Governance for Owners; Environment Agency Active Pension Fund; UK Shareholders Association.

'fresh pair of eyes' that the new auditor might disagree with its predecessor's assessments, but that this risk could be seen as a benefit.

17.16 Some companies said that these benefits had to be weighed against the risk that the incoming firm would not know as much about a company as its predecessor, would be less able to ask probing questioning and could fail to spot an important auditing issue. Sector experience was said to help to some extent with this but the first year of a new audit team's incumbency was difficult. Estimates of the costs to the company of getting the new auditor up to speed varied. The ACC of Company T said he had to spend twice as much time on Company T's business when the new auditor was first appointed than he spent during a normal year (although he regarded this as time well spent) whereas the ACC of Company W said he spent only a few additional hours on top of the 50 to 60 days he normally devoted to his ACC work.

- *FTSE 350 submissions*

17.17 All the FTSE 350 companies that responded to the Remedies Notice opposed mandatory switching. They said that this would be highly disruptive and could compromise audit quality. Some said that the risks associated with mandatory switching would be likely to outweigh the benefits. The reasons given for these responses included: it would take time for a new auditor team to fully understand the business; a new auditor that was less familiar with the business would be less able to provide a robust challenge to management; the balance between the benefits of continuity and renewed challenge were appropriately met by the requirement for AEP switching; educating the new auditor would be a significant burden on management; the options for switching were limited by the impact of other NAS received by the company from other providers; and the switching of auditors would have a knock-on effect of requiring switching of these other services.

17.18 They said that mandatory switching could force companies to change auditor at a time when the existing auditor's understanding of the business would benefit the audit process. The AC was said to be best placed to decide whether the company should switch auditor. If the outcome of a tender process confirmed that the incumbent auditor was best qualified for the role, it made no sense to appoint a second best alternative. One company said that auditor appointment should be maintained at the discretion of shareholders. The perceived benefits of 'continuity' were said not to undermine the company's ability to go out to tender and/or switch if appropriate to protect shareholders' interests.

17.19 HSBC supported our provisional decision not to pursue mandatory switching on the grounds that it would reduce choice.[1204] Mr Michael Wareing supported the provisional decision on mandatory switching on the grounds of reduction of choice and quality.[1205,1206]

Big 4 firms

17.20 The Big 4 firms said that mandatory switching:

(a) would not address the AEC and would be less effective than mandatory tender processes. They said that we had not provided evidence that length of tenure had

[1204] HSBC response to provisional decision on remedies.
[1205] Michael Wareing is the ACC for Wolsely Plc, Intertek Plc and Cobham Plc.
[1206] Michael Wareing response to provisional decision on remedies.

an effect on independence, or that the current system of AEP switching every five years was insufficient;

(b) would restrict or distort competition by restricting choice;

(c) could undermine good corporate governance as companies and their shareholders should be able to appoint the audit firm and partner best placed to meet their needs;

(d) would force companies to incur substantial switching costs associated with appointing a new audit firm and result in the loss of knowledge and understanding of a company that could enhance professional scepticism and audit quality;

(e) could interrupt the provision of NAS and reduce the likelihood of companies buying NAS from firms that also provided audit services and/or audit firms in bidding for non-audit work, resulting in a reduction in competition in the provision of NAS; and

(f) would dampen competitive pressure outside of the prescribed windows for switching.

17.21 KPMG estimated the costs to audit firms of gaining an understanding of a business in the first year of an audit to be on average £429,000 for every change in audit firm. KPMG expected this to be a substantial underestimate for the largest and most complex FTSE 350 companies.

17.22 KPMG also estimated part of the costs associated with mandatory switching at £54 million or £46 million respectively if the remedy was implemented on a 10- or 14-year basis, and the cost associated with increasing FTSE 350 companies' cost of capital to be in the region of £1 billion. The substantial burden associated with resolving NAS independence issues and international coordination would be additional to these costs.

Mid Tier firms

17.23 BDO said that academic studies had concluded that mandatory switching was detrimental to audit quality and increased concentration in the audit market (as clients of Mid Tier firms rotated away from them to the Big 4). BDO recognized that there was pressure for switching from some investors, but said that mandatory tendering was preferable. BDO said that mandatory switching denied companies the right to make an informed choice to retain their present auditor, and could force a company to change auditor despite having little choice.

17.24 Crowe Clark Whitehall supported mandatory switching at 20 years.

17.25 GT supported mandatory switching after 15 years as a measure to prevent complacency. GT said that while the current requirement for AEP rotation was an important safeguard, it did not address the perceived loss of independence when the audit firm was in place too long. It said that the new auditor might unearth issues previously unnoticed by the incumbent auditor, as new audit techniques brought a fresh approach, and a new firm was likely to be more sceptical because it started from a position where it had no preconceptions. GT said that 15-year switching would limit disruption to the audit market and allow sufficient time for the benefits of an auditor's accumulated knowledge to be built up during the firm's tenure, before the perception of objectivity concerns arose. GT considered that the costs of the remedy would be minimal and likely to be overstated by those who opposed their introduction.

17.26 GT considered that limited choice was to a degree self-inflicted, in that the company chose to award NAS to a potential alternative auditor when other firms would almost certainly have the capabilities to provide those NAS.

17.27 GT in its response to our provisional decision on remedies stated that our evidence showed that it was switching auditors that led to price benefits to customers and not tendering per se. GT did not believe that increased tendering would lead to behavioural changes in companies unless there was a mandatory backstop which would force companies to develop relationships with new firms. GT said that for the vast majority of the FTSE 350 there were more than four firms that could provide audit services and the removal of one of the four would be plugged by other firms. Over time, GT believed mandatory switching would ultimately lead to increased choice.

17.28 GT said the introduction of mandatory switching arrangements would incentivize companies to build relationships with alternative suppliers and firms. The audit firms would be further incentivized to enhance their capabilities where they believed there to be a realistic chance of success. GT said that in a tender the incumbent will always be in an advantageous position, and that therefore excluding the incumbent from a competitive tender likely leads to healthier competition between the remaining firms. GT believed that it was unlikely that the costs of rotation to companies were significantly different from those of tendering, as the greatest cost of switching fell on firms.

17.29 Kingston Smith did not agree that mandatory switching would reduce barriers to involvement of non-Big-4 firms in the market, and said that Mid Tier firms would be unlikely to wish to compete for audits in the reference market if they believed that they would not have a realistic chance of winning.

17.30 Mazars supported a mandatory switching period of 15 years, subject to derogation or significant extension in the event a company appointed joint or major component auditors. Mazars believed that the benefits would outweigh the costs of 'educating' a new firm and the additional costs to the firm in the first year of a new audit if tendering were linked to joint and major component audit.

17.31 In response to our provisional decision on remedies, Mazars disagreed that the remedies package we proposed would address the AEC more effectively, with similar benefits compared to mandatory switching. In particular it was concerned that mandatory tendering alone would not lead to long tenures ceasing. Further, Mazars believed that once the spotlight (arising from the investigation) was reduced, there was a risk that any change in the market would reduce.

Academic literature

17.32 Prof Dr Köhler said that the barriers to switching suppliers of audit services were caused by transaction costs on the demand and supply side and the nature of the service (ie experience good). Given these market characteristics, all other things equal, long audit tenure was therefore an efficient market solution. Prof Dr Köhler said that empirical evidence was mixed on the relationship between tenure and audit quality, and therefore did not provide adequate evidence as to whether the costs related to auditor change would be outweighed by the benefits of a potential increase in audit quality. She added that there might even be a potential decline in audit quality.

17.33 Prof Dr Köhler also said that even if one assumed that auditors had misaligned incentives and competed to satisfy management rather than shareholders, there was no evidence that the imposition of restrictions on tenure would change these incentives. She said that in Germany there was clear empirical evidence that (voluntary) auditor change resulted in increased concentration with a shift of market share from non-Big-4 to Big 4 audit firms.

17.34 EY said that research suggested that mandatory firm switching in South Korea and Italy had not resulted in a significant increase in audit quality and experience in these countries demonstrated that enforced limitations on audit tenure could result in greater concentration and increased overall costs.

17.35 KPMG said that Arruñada and Paz-Ares (1997) found that mandatory firm switching led to an increase in audit fees of between 4 and 15 per cent just because of increased in costs, and that these could be higher if there was also a reduction in competition.

Assessment of effects

17.36 We considered the incremental benefits of mandating switching in comparison with a package of remedies that includes mandating tender processes at least every ten years. We then considered the costs and risks associated with requiring companies to switch auditor after a specified period. We drew on the evidence provided to us in responses to provisional findings, submissions made in response to the Remedies Notice and provisional decision on remedies, the remedies hearings, and further case studies conducted with ACCs and FDs.

Incremental benefits of mandatory switching

17.37 We consider that the potential benefits associated with mandatory switching could be: that investors could place more trust in the assurance provided by the audit report to the extent that any mistrust is based on the long tenure of engagements; a reduction in the costs of switching auditor (actual and/or perceived) resulting in a greater willingness to consider switching auditor outside the prescribed window; and increased incentives for Big 4 and Mid Tier firms to invest in expanding their capabilities in order to compete for engagements that they can confidently predict will become vacant on a certain date.

17.38 We consider that our remedies package, including mandatory tender processes at least every ten years, could be expected to promote the trust that investors can place in audit outputs. In particular we would expect the proposed package of remedies to deliver the following benefits:

(a) To result in more switching in circumstances where this is judged by those involved in the selection process to be in the best interests of the company and its shareholders (see paragraph 16.33).

(b) To give shareholders greater confidence in the audit outputs by giving ACs, as representatives of the interests of shareholders, greater responsibility in the selection of the auditor, making it clear that auditors are accountable to the AC, and ensuring that ACs are actively involved in the management of the audit engagement (see Remedy 1 (Mandatory Tender Processes) and Remedy 5 (strengthening the accountability of the external auditor to the AC).

(c) To provide investors with more information than is currently available to them, and would be provided by the FRC's enhanced reporting requirements, putting them in a better position to judge for themselves whether the auditor is acting in their interests (see Remedy 6 (Extended reporting requirements)).

17.39 We consider below in more detail the extent to which mandatory switching could be expected to deliver benefits over and above those that would be expected with effective implementation of a remedies package that includes mandatory tender processes at least every ten years, enhanced responsibility and accountability for the AC, and more engagement with shareholders over audit issues.

- *Investor trust in the audit opinion*

17.40 In response to the Remedies Notice, a number of investors expressed concerns about trust they can have in an audit when the same auditor has audited a company's financial statements for many years. The trust that investors can place in the audit opinion was said to depend on the independence and objectivity of the auditor, real and perceived.

17.41 We note that the concerns expressed by investors are not limited to those arising from a perception that over time a relationship might develop between auditor and client in which the auditor does not question or challenge management as much as it might have done in the past. There also appears to be a concern that after a while the current auditor might be less likely to challenge its own judgements, ie the judgements made in conducting the audit in previous years. It is hard for a firm to revise or reverse a judgement that it has applied over a number of years.

17.42 Investors also said that it was difficult for shareholders to ascertain whether auditors were independent as the boiler-plated audit opinion and report shed little light on the discussions that took place between audit partners, company management, and ACs.

17.43 Under our package of remedies, ACs will be accountable to shareholders on the appointment and work of the auditor, the auditor will be directly accountable to the AC, and shareholders will have more information to judge for themselves the quality of the work undertaken by the auditor and therefore have a greater ability to influence the auditor selection decision. For example, we would expect our remedy package to provide more information and dialogue between ACs and shareholders on matters concerning the appointment of external auditors, and on how the AC has discharged its responsibilities in the interests of shareholders. We therefore consider that our remedies package would allow investors to place greater confidence in the quality of the audit opinion.

- *A 'fresh pair of eyes'*

17.44 In our second set of case studies, FDs and ACCs said that the benefits of switching were a fresh and independent perspective and assessment (see paragraph 17.15). We agree that the benefits of requiring a company to switch auditor after a specified period would be to restart the relationship. The expectation would be that to conduct the audit a new auditor would have to ask probing questions in order to become sufficiently informed to form an opinion and in so doing challenge management. The new auditor would also have no attachment to the audit opinions of the previous audit firm. We were told that a new auditor could not place any reliance on previous audit approaches or judgements.[1207]

[1207] We note that ISA 510 'Initial Audit engagements—Opening Balances', paragraph 6(c) requires an incoming auditor to establish if the opening balances are materially correct. This can be achieved either through reviewing the previous auditor's work papers or undertaking additional procedures to assess if they are correct, if the auditor's audit approach for the reporting period is not sufficient to obtain this assurance. If issues were found in the current reporting period, the auditor would need to consider if this impacted on the previous period's closing balances.

17.45 Under our remedies package, we expect companies to switch auditors in circumstances where the AC determined that this would be in the best interests of the shareholders, and having gone through a detailed tender process.

- *Reduction in switching costs*

17.46 We found that the costs to FTSE 350 companies of switching auditor were material in the context of the bargaining position of these companies in their annual negotiations with their incumbent auditor (see paragraphs 9.301 to 9.306, 9.330). We recognized that these costs would be higher for some companies than others (in particular those with the more complex audits). Compliance with independence rules was a particular issue for banks.

17.47 Our second set of case studies showed that the (eight) companies that had switched had generally found the switching process was manageable. At Company K the transition process was less intensive than the CFO had expected and the Group Financial Officer of Company T considered that the process had not added greatly to the usual process of interfacing with the auditors. Other interviewees said that switching costs could be reduced by careful planning. Mr Nick Land[1208] said that companies found that switching auditor was less disruptive than expected and that the transition to a new audit firm could be relatively painless.

17.48 Mid Tier firms said that our first survey evidence highlighted that those FTSE 350 companies that had switched auditors had not found the process particularly burdensome or the costs particularly high. KPMG and PwC considered that there was no perception gap between actual costs and perceived costs (see paragraph 9.183). PwC considered that the FDs and ACCs who selected the audit firm could accurately assess the costs involved in switching.

17.49 Historical levels of switching suggest that many ACCs and FDs of FTSE 350 companies do not have recent experience of switching auditors. Under a mandatory regime companies would have to switch auditor more frequently. As a result of ACCs holding other positions on ACs and boards of other FTSE 350 companies, any experience and knowledge gained could be shared with others. Over time we might therefore expect this sharing of experience to result in companies and firms managing the transition process more efficiently.

17.50 However, as a result of the FRC's recent changes to the UK Corporate Governance Code and our chosen remedy package, we expect there to be more switching than has historically been the case (in circumstances where the AC considers such switch to be beneficial) (see paragraph 16.33), and as a result, similar efficiency benefits.[1209]

- *Incentives for firms to invest in expanding capabilities*

17.51 We consider that excluding the incumbent from the competition for engagements under a mandatory switching regime would increase the probabilities of rival firms gaining an engagement. Mid Tier firms have said that companies might actively encourage rival firms to position themselves to be able to compete for the audit

[1208] Mr Land is a former Chairman of EY and is now ACC for a FTSE 100 company, a FTSE 250 company, and two other companies.
[1209] We believe that the rate of going out to tender and switching has increased as a result of the FRC's requirement to go out to tender every ten years, but it is not apparent how this will affect long-term rates of going out to tender and switching.

engagement, if companies knew that they would not be able to reappoint the incumbent.

17.52 We think that mandatory switching would be likely to result in FTSE 350 companies switching auditors more often than would be the case under our remedies package. How much more is unclear. However, compared with our remedies package, those additional switches in auditor would not have made because the AC judged them to be in the best interests of shareholders.

Costs associated with mandatory switching

17.53 We consider that to require companies to switch auditors after a specified period could impose costs on companies and investors. In particular:

(a) the reduction in choice and competition as a result of the exclusion of the incumbent from the competition for the audit;

(b) the costs to the company and firm associated with switching; and

(c) the adverse effect on the incentives of the incumbent to perform well as the limit on its tenure approaches.

17.54 We consider each in turn.

- *Effect of excluding the incumbent from competition*

17.55 We consider that excluding the incumbent from the tender process could have two adverse effects on the competition for an audit engagement. First, the company may be prevented from reappointing the auditor it considered best placed to be its auditor; and second, even if not the preferred provider, excluding the incumbent could reduce the strength of the competition for the engagement. The evidence on the availability of alternative auditors is relevant to both effects.

17.56 We consider that to exclude the incumbent from competition for an engagement, regardless of whether it would have won, has the potential to weaken the competition for the engagement. In any competition, the winner must do enough to beat the second best candidate. Accordingly, if the incumbent is either the best candidate or the second best candidate, its exclusion from a tender process would adversely affect competition.

17.57 We found that in many sectors one or more firms may be at a competitive disadvantage given the importance to companies of relevant experience, knowledge and expertise in the selection of auditors (see paragraph 9.65). We consider that excluding the incumbent from the competition for the engagement could in many sectors have a substantial effect on the strength of competition and result in the appointment of an auditor that was less well placed to carry out the audit than the incumbent.

17.58 We also considered whether choice might be limited by regulations to prevent loss of independence rules and potential conflicts of interests.[1210] We accepted that often such situations would be manageable given some notice (see paragraph 9.57). The recent case studies suggested that choice had been limited by independence requirements in recent tender processes—for example, where a firm was providing a company with NAS (possibly a long-term project) and it would not be in the com-

[1210] Specifically Ethical Standards issued by the FRC in the UK, and SEC regulations as a result of Sarbanes-Oxley in the USA.

pany's interest to disrupt these arrangements. However, we consider that if required to switch auditors after a specified period, companies would have the time and the incentive to manage the procurement of such services so as to minimize the effect on the procurement of audit and other services.

- *Switching costs*

17.59 We set out our findings in relation to the costs associated with switching auditor in paragraph 9.330. All the Big 4 firms agree that switching costs may be substantial (see Appendix 17.1). GT suggested that those opposed to mandatory switching might have overstated the costs of switching (see Appendix 17.1).

17.60 Those investors opposed to mandatory switching were concerned that this would undermine the accountability of the auditor to the AC and could prove disruptive with audit risk said to be highest during the first few years of an engagement (see paragraph 17.8).

17.61 We think that there are significant costs for companies and firms associated with switching and that for some companies these costs may be substantial (for example, where the audit is more complex).

- *Effect on incumbent incentives*

17.62 We considered the evidence on the incentives faced by firms to retain engagements. We found that firms may incur significant financial and reputational costs if they lose a client and targeting, obtaining and becoming expert on replacement engagements may be costly (see paragraphs 9.267 and 9.270). We consider that there is a risk that as a firms' tenure approaches the maximum allowed, these incentives would be weakened.

Conclusion

17.63 We concluded that, while mandatory switching would address concerns expressed by investors where a company has had the same auditor for many years, our remedies package would more effectively address the AEC in a less onerous manner. Compared with our package of remedies, the benefits gained from requiring companies to switch auditor after a specified period would be associated with switches in auditor that would not have been judged by the AC to be in the best interests of shareholders.

Constraints on provision of NAS

17.64 We considered two options for restricting NAS provision. These were *(a)* prohibiting the external auditor from supplying all but audit-related work; or *(b)* recognizing existing restrictions on the supply of NAS by external auditors and seeking to tighten these existing regulations by, for example, introducing a limitation on non-audit fee income that may be earned by the auditor as a percentage of the audit fee.

17.65 We set out the views of parties on these options in the next section, and then set out our assessment of effectiveness.

Views of parties

17.66 Several parties wanted further restrictions on the provision of NAS by the auditor; including Mid Tier firms, investors and investor groups and some representatives of companies. Details of the parties' views on the restriction on NAS are set out in Appendix 17.2.

17.67 There were four main themes supporting further regulation of NAS: *(a)* encouragement of greater focus on the audit, *(b)* independence and reputational issues, *(c)* increased exposure of companies to the Mid Tier, and *(d)* an effective restriction on switching auditors. We summarize these in turn.

17.68 With regard to encouragement of greater focus on the audit, some parties believed that NAS was a distraction to auditors with some perceiving NAS to be more financially lucrative than audit (either more profitable, or the relative scale of the potential revenues) leading to auditors focusing efforts on winning additional work.

17.69 With regard to independence and reputational issues, some parties believed that the scale of NAS provision threatened auditor independence and the increased level of contact increased the risk of over familiarity with client management. Some parties identified the issue to be a perceived loss of independence.

17.70 With regard to increased exposure of companies to the Mid Tier, some parties believed that prohibiting auditors from performing NAS would increase the value of work available to other firms and would necessarily increase the number of firms that companies had knowledge and experience of which might be a factor in deciding which firms to invite to tender for the audit engagement in future.

17.71 With regard to effective restriction on switching auditors, some parties noted that the issue of independence around NAS could be a wider issue as any firm undertaking NAS might be prevented from acting as a company's auditor. Some parties thought that the sharing of NAS across Big 4 firms would therefore effectively restrict a company's choice if ACs were not encouraged to consider a wider range of firms.

17.72 The Big 4 firms did not support any additional restrictions on NAS.

17.73 In response to the provisional decision on remedies, GT said that greater constraint should be placed on the ability of the auditor to provide NAS[1211] either by nature or value[1212] and whilst acknowledging the requirement that the AC should approve NAS, did not believe it likely to lead to a shift in the market.[1213] GT did not think that restrictions on NAS would lead to firms to decline to participate in tenders, as the combined audit fee and authorized NAS would likely be greater than the value of prohibited NAS.[1214]

Assessment of effectiveness

17.74 We note that the supply of NAS to audit clients is subject to the requirement for auditors to comply with Ethical Standards issued by the FRC.[1215] In the course of our review, we found that the levels of NAS supplied by the incumbent audit firms to

[1211] GT response to provisional decision on remedies, paragraph 9.1.
[1212] ibid, paragraph 9.5.
[1213] ibid, paragraph 9.4.
[1214] ibid, paragraph 9.6.
[1215] Ethical Standard 5 (ES5) identifies types of NAS which may create threats to an auditor's objectivity.

FTSE 350 companies had reduced by 17 per cent[1216] and we did not find a relationship between the value of NAS provided to audit clients and the profitability of those audit engagements.[1217] We were not able to investigate directly whether auditor independence was affected by NAS provision, but, to the extent that independence may be related to audit fee[1218] (ie whether the audit fee was linked to the level of NAS provided), our evidence did not indicate that this was the case.

17.75 One aspect of our AEC was that auditors have incentives and the ability to respond to the interests of executive management, and may therefore compete to satisfy a demand that is not fully aligned with shareholders' interests.[1219] We consider that if the award of NAS is influenced by executive management, it may be a factor contributing to the distortion of competition. However, we regard it as a secondary factor that acts in combination with the FD's de facto responsibility for the negotiation of audit fees, appointment and replacement of auditors, and conduct of a company's relationship with its auditors in general.

17.76 We consider that the prevention, restriction or distortion of competition that we found under our second theory of harm is addressed by other elements of our remedy package, in particular the stipulation that, acting on behalf of the Board, only the AC shall negotiate audit fees and authorize the external audit firm to carry out any NAS, where the value of which exceeds a threshold of materiality as set by the AC, and other remedies to promote communication with shareholders. We consider that these remedies will increase the influence of the AC in the decision to award NAS to auditors and we expect this to promote the interests of shareholders in such decisions.

17.77 We received opinions from companies such as the ACC of Company G that further restrictions on the provision of NAS by the auditor would enable firms other than the auditor to establish relationships with companies and to give the other firms the opportunities to develop the right skills for working with the sector concerned.[1220] We agree that developing business relationships with a wider range of firms would lead to greater awareness of other audit market participants.

17.78 We considered the effects of NAS on firms' incentives to compete in tenders for audit work. In reaching our findings we were given evidence that firms would not decline to participate in a tender process even if winning the engagement would mean the loss of NAS work.[1221] However, in consulting on our possible remedies we identified a number of examples of firms declining to participate or agreeing with companies not to participate in tender processes because they were undertaking NAS.[1222] There is a risk that if greater restrictions were placed on NAS provision by the external auditor, other firms would necessarily undertake more NAS and might be disinclined to participate in tender processes thus reducing the level of competition.[1223]

17.79 Our remedy package addresses the AEC that we have found and we think that further restrictions in this area would not add to its effectiveness but may add to the costs, particularly in placing further limitations on company choice in respect of NAS

1216 See Appendix 8.1, Table 2.
1217 Appendix 8.1, paragraphs 34–44.
1218 If reduced audit fees were offered to win NAS work, there might be an indication of the risk that firms' incentives would be more strongly aligned with satisfying management demand through NAS than shareholder demand for a high-quality challenging audit.
1219 Paragraph 11.193.
1220 Appendix 2.1, Company G, paragraph 14.
1221 Provisional findings, paragraph 9.22.
1222 Appendix 2.1, Company W and Company V.
1223 That is not to say that NAS are necessarily more or less lucrative than statutory audit, but delivering certain pieces of work may have specific financial or strategic benefits for a firm.

provision.[1224] Hence we are not imposing additional restrictions in this area, although, as explained in paragraph 16.269, only ACs will be able to approve NAS provided by the incumbent auditor, although they may establish a threshold of materiality below which executive management can commission NAS from incumbent auditors without AC approval.

Joint or component audit

17.80 In this subsection we:

(a) note the remedy option as detailed in the Remedies Notice;

(b) set out parties' views; and

(c) make an overall assessment of the remedy and set out our decision.

17.81 We considered a remedy whereby companies would be encouraged to use joint or major component auditors, with the aim of increasing companies' visibility of audit firms' offerings, such that bargaining power was increased. We also considered whether joint or major component audit would address the AEC we found in regard to distortion of competition, and whether it would be likely to reduce barriers to entry, expansion and selection to the reference market.

17.82 We considered that encouragement of joint or component audit might be achieved either via a requirement or recommendation for firms to have joint (or major component) audits or in combination with other possible remedy options such as mandatory tender processes (or switching). For example, the requirement to go out to tender every X years could be extended to a requirement to go out to tender every X+Y years for those companies with joint or major component auditors.

17.83 We discuss parties' views then set out our assessment.

Views of parties

17.84 The non-Big-4 audit firms strongly promoted shared or joint audits. Their grounds for doing so were equally strongly contested by the Big 4 firms. Investor groups did not challenge our provisional decision not to pursue a remedy in this area.

17.85 Several parties prefaced their views by stating the difference between shared and joint audit. As the European Group of International Accounting Networks and Associations (EGIAN)[1225] explained:

> In the case of joint audits, two or more auditors, usually two, jointly express their opinion on the consolidated financial statements of the group. In the case of consortia [or shared or component] audits, one firm is responsible for the opinion on the group's consolidated financial statements with one or more other firms participating in the audit of certain subsidiaries.

[1224] In addition, European proposals may place restrictions on firms of providing NAS to potential audit clients. See paragraph 15.11.

[1225] See: www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/groupa_egian_paper.pdf.

17.86 The non-Big-4 audit firms advocated a scheme to promote joint and shared audits, either by regulation or by providing incentives. It could, for example, be made mandatory for a company to include at least one non-Big-4 firm in a joint/share audit engagement.[1226] GT and others suggested that companies might be incentivized to use joint or shared audit via an increased mandatory firm switching period or the ability to use the incumbent audit firms for an increased range of NAS.[1227]

17.87 Supporters maintained that joint audit would enhance audit quality. Mazars wrote that it would do so through the 'four eyes' principle as each firm would be checking the other's work carefully and coming to a common view on subjective and complex issues arising on the audit since that would be forming a joint audit opinion and be jointly responsible for it.[1228] Group A also stressed that 'there would be more challenge to judgements' and joint audit would be likely to bring innovations and 'would also increase the perception of auditor independence'.[1229]

17.88 GT said that consortia audits would not increase costs for the company and, in some cases, would result in a reduced audit fee for the entire group. The firm's experience was that groups that had engaged consortia audits had been very satisfied in terms of both cost and quality.[1230] Mazars said that joint or shared audits would be a less expensive alternative to a remedy of audit firm switching.[1231]

17.89 It its response to our provisional decision on remedies GT stated there should be an incentive for companies to utilize consortia audit arrangements and that such arrangements could be used to allow other requirements proposed by GT (on switching or NAS) to be relaxed.[1232] GT disagreed that a consortia audit (a shared audit with each party undertaking at least 25 per cent of the total audit work) would increase costs[1233] or lead to a reduction in audit quality and noted that such an arrangement was no different to the use of different member firms in the group auditor's network.[1234]

17.90 Mazars challenged the view that joint or shared audit would involve extra cost and stated there were no reasons to believe this was the case. Mazars stated that joint audit would increase audit quality, as two firms were joint and severally liable for the audit opinion and that it was the only realistic way of involving non Big 4 firms in the audit of large FTSE 100 companies. Mazars said that our assessment of joint audit was on the basis of making it mandatory, rather than being encouraged through relaxing other remedies. Mazars stated that the use of examples of shared audits associated with corporate scandals was not valid as a significant number of other corporate scandals had involved a single auditor.

17.91 Opponents of the concept, conversely, considered that joint or shared audits would be inefficient and damaging to audit quality. Deloitte said that joint or component audits were ineffective and disproportionate, adding that the historical evidence of undetected fraud under joint or component audits is most significant. Examples include BCCI, Parmalat and Polly Peck.[1235] PwC said that such audits were widely regarded as sub-optimal and inefficient and would increase the likelihood of things

[1226] See, for example, Mazars response to Remedies Notice.
[1227] GT response to Remedies Notice.
[1228] Mazars response to Remedies Notice.
[1229] Summary of Group A response hearing, paragraph 15.
[1230] GT response to Remedies Notice.
[1231] Mazars response to Remedies Notice.
[1232] GT response to provisional decision on remedies, paragraph 10.1.
[1233] ibid, paragraph 10.5.
[1234] ibid, paragraph 10.6.
[1235] Deloitte response to Remedies Notice.

falling between the two (or more) appointed audit firms. They added to cost and reduced clarity of accountability and hence threatened quality.[1236]

17.92 The FD of Company S said:

> It was sensible for the CC not to pursue joint audit. Having experienced joint audit, the lines of demarcation for the audit tended to cause difficulties and it was tough when one firm had to take responsibility for another's work. The Audit Committee was unlikely to be happy if the group audit simply took a joint auditor's work on trust.[1237]

17.93 The Group FD of Company R considered that joint audits did not work—the second auditor often lacked experience and did not add to the work of the primary auditor and, from experience, resulted in less efficient and effective audit.[1238]

17.94 The introduction of a scheme to promote shared or joint audits would, according to its advocates, benefit the audit market, mainly by breaking down barriers to market entry. GT, for example, said that over a period of time, the introduction of consortia audits would facilitate the recognition that additional firms are capable of auditing the largest companies, and thus facilitate the involvement of more audit firms in the audit of large listed groups.[1239] It was also said (eg by the Group A firms[1240]) that a scheme to promote joint audits would provide continuity when one of the auditors changed. It should also reduce the risk of the failure or withdrawal from the audit market of one of the dominant auditors or audit firms.[1241]

17.95 Parties differed markedly on their views of market perceptions. Mazars wrote that joint or shared auditing has a proven track record of delivering benefits. GT believed that the evidence showed that consortia audit was very effective. It provided the example of one FTSE 100 company which it said had seen evidence that consortia audit could drive better audit quality, service quality, and price. As a result of this, GT said it was receiving enquiries from boards and investors as to how consortia audit might work.[1242] However, several non-Big-4 firms acknowledged that market perceptions were unfavourable, if only as a result of resistance from the dominant players and institutional bias.[1243] However, GT said that there was much more of an open mind to consortia audit.[1244] PwC said that the almost complete absence of joint audits from the current UK market reflected their unattractiveness to companies, and gave examples of companies that it claimed had moved away from joint audits.[1245]

17.96 Similarly, the non-Big-4 firms and the Big 4 firms had different viewpoints on the international experiences of shared/joint auditing. Mazars noted that the requirement to have joint audits in France had made the French audit market the least concentrated in the EU.[1246] PwC and KPMG pointed out that other countries had tried and abandoned joint audits on the grounds that they added to cost without benefiting audit quality.[1247]

[1236] PwC response to Remedies Notice, Annex 3.
[1237] Appendix 2.1, Company S.
[1238] Appendix 2.1, Company R.
[1239] GT response to Remedies Notice. See also Kingston Smith response to Remedies Notice.
[1240] Group A firms' response to Remedies Notice.
[1241] GT response to Remedies Notice.
[1242] Summary of response hearing with GT, paragraph 43.
[1243] See Group A firms' response to Remedies Notice. See also BDO response to Remedies Notice.
[1244] Summary of response hearing with GT, paragraph 43.
[1245] PwC response to Remedies Notice, Annex 3.
[1246] Mazars response to Remedies Notice.
[1247] PwC response to Remedies Notice, Annex 3 and KPMG response to Remedies Notice.

Assessment of effectiveness and decision

17.97 We found that although there are sources of information available to FDs and ACs regarding alternative auditors, the information available to them outside a tender process left significant uncertainties in assessing the prospective relative performance of these alternatives in terms of price and quality (and this makes uncertain the benefits of switching) (see paragraph 9.168). Joint or shared audit could lead to greater visibility of audit quality of a greater number of suppliers because companies would obtain direct experience of being audited by more than one firm, although we note that depending on the arrangements of the joint or shared audit, the firms would be undertaking different work and the exposure of the AC to both auditors would vary.[1248]

17.98 We considered whether joint or shared audit would lower barriers to entry, expansion and selection. We consider that shared audit might encourage companies to use firms for parts of the audit that they may not have considered for the Group audit. However, we did not consider that this effect would be significant, as companies would retain incentives to engage auditors with the necessary global coverage and experience for the substantial part of the audit.

17.99 In relation to joint audit, we considered that companies would continue to have incentives to engage audit firms who could demonstrate experience and global coverage and that such a remedy would have little effect on barriers to entry, expansion and selection.

17.100 We have not been able to quantify the potential cost of imposing shared or joint audit on the market. However, we believe that across the market these costs would be potentially significant, particularly if the risk of a reduction in audit quality was to be avoided.

17.101 In relation to increasing visibility of audit quality and addressing the AEC, in that auditors have the incentives and ability to respond to executive management interests, and may therefore compete to satisfy a demand that is not fully aligned with shareholders' interests, we consider that other elements of our proposed remedy package are effective in these respects (see paragraphs 18.7 and 18.8) and do not introduce the potential costs and risks associated with joint or shared audit. While we accept that joint/shared audit has some benefits in relation to lowering barriers to entry, expansion and selection, we were not convinced these benefits were significant, or certain, and did not justify the potential costs of such a remedy. We placed considerable weight on the views of investors who were almost universally opposed to such a remedy on the grounds of additional costs and risks to audit quality. In light of the above we have not adopted this remedy on the basis of its lack of effectiveness in remedying the AEC and its potential costs.

Shareholder group responsible for auditor reappointment

17.102 We considered a remedy whereby a group of shareholders would be appointed to represent all shareholders in selecting an auditor (either annually or when there is a tender process), with the aim of ensuring that shareholder interests were appropriately represented.

[1248] If the second audit firm was auditing overseas or less significant components the group CFO or AC would have less visibility of the quality of their work.

Views of parties

17.103 All parties which commented on the remedy agreed with the decision not to pursue the remedy.[1249] Two Swedish bodies (The Confederation of Swedish Enterprise (Svenskt Näringsliv), Sweden's largest business federation and FAR, the Institute for the Accountancy Profession in Sweden) did not directly support this remedy, but identified the nomination committee, present in Swedish Corporate Governance as an alternative.[1250]

Assessment of effectiveness

17.104 In response to a submission on the Swedish Nomination Committee we undertook some further research on the Swedish model. In Sweden, the members of the committees often directly represent individual or specific shareholders. In contrast members of UK ACs are required to be independent and thus represent the interests of the shareholders as a whole. It is not clear in the British case how individuals would be identified in a way to make their relationship with the company and their shareholders different to that of AC members whilst at the same time ensuring that the interests of any group, or individual investor were not marginalized.

17.105 We noted Deloitte's Center for Corporate Governance which stated that the nomination committee's views are not binding on the board and that shareholding of individual companies in Sweden is often very concentrated.[1251] In the UK, ownership of FTSE 350 shares is heavily diluted and the interests of each shareholder are unlikely to be able to be represented in this Swedish model and shareholder demands and interests cannot be effectively represented. We do not believe that the nomination committee as operating in Sweden would be effective in addressing the AECs we identified.[1252]

17.106 We received no responses supporting the remedy as suggested in the Remedies Notice.

17.107 We considered the costs of this remedy in the UK context to be significant. We believe that the establishment of such committees would require a fundamental shift in UK company law and corporate governance, and it is not clear how they would adequately reflect the interests of shareholders as a whole.

17.108 In view of the limited additional benefits and potentially large costs, we decided not to pursue this remedy. We consider that our remedy package is sufficient to ensure that shareholder interests are represented in auditor appointment decisions; in particular, our remedies to promote shareholder engagement (Remedy 4) and strengthen the AC (Remedy 5).

FRC responsible for auditor appointment

17.109 We considered a remedy whereby the FRC would be required to appoint auditors for FTSE 350 companies to ensure that shareholder interests were appropriately represented. Such a remedy could address the AEC we found, in that auditors have the

[1249] Deloitte response to Remedies Notice; GT response to Remedies Notice; Hermes response to Remedies Notice; ICAS response to Remedies Notice; KPMG response to Remedies Notice.
[1250] Confederation of Swedish Enterprise and FAR response to Remedies Notice.
[1251] www.corpgov.deloitte.com/site/sweeng/nomination-committee-sweng/.
[1252] When we sought to identify the largest investors in the FTSE 350 for our investor questionnaire we found that the largest institutional investors owned only a small percentage of the total number of shares in most companies.

incentives and ability to respond to executive management interests, and may therefore compete to satisfy a demand that is not fully aligned with shareholders' interests.

17.110 All parties which responded agreed with the decision not to pursue this remedy.[1253]

Assessment of effectiveness

17.111 As stated in the Remedies Notice, the FRC would be able to be independent in the decision as to which auditor to appoint. However, whilst the FRC might be able to act as an expert purchaser on the basis of technical audit aspects, it may not have sufficient understanding of the nature of individual companies to choose the auditor best able to protect shareholders interests.

17.112 We believe that this remedy would have high costs associated with it, as it would disenfranchise management, the AC and shareholders. Whilst it would reduce or even remove incentives to satisfy management demand over shareholder demand, it is not clear how shareholders would be able to indicate if the auditor was failing to satisfy shareholder demand. Further, it is not clear that optimal decisions with respect of auditor appointment would be achieved by this remedy. We have received no further evidence to contradict this position. We do not therefore consider this to be effective at remedying the AEC and we decided not to pursue this remedy further.

Independently resourced Risk and Audit Committee

17.113 We considered a remedy whereby Risk and Audit Committees were mandated to procure independent advice on the conduct of the audit. This might be considered analogous to pension fund trustees receiving independent advice on how pension fund investment managers have performed. This could address the AEC as ACs would be better able to assess the judgement and quality of detailed work of the auditors and would increase the independence of the auditors from executive management influence.

17.114 Those parties that commented supported the decision not to pursue the remedy.[1254] Comments received were that other remedies (particularly Remedy 5, strengthening the AC) were more effective and more proportionate[1255] or would lead to additional costs being incurred,[1256] or that ACs had the ability to procure external advice.[1257]

Assessment of effectiveness

17.115 We did not identify any barrier that acted to prevent ACs from obtaining advice or support from a third party and our AQR remedy will provide greater visibility of audit quality to ACs.

17.116 Under the UK Corporate Governance Code, ACs must disclose how they have discharged their duties and we believe our recommendation to introduce an advisory vote, combined with recent changes to the AC report are effective in promoting shareholder interests.

[1253] Deloitte response to Remedies Notice; GT response to Remedies Notice; Hermes response to Remedies Notice; ICAS response to Remedies Notice; KPMG response to Remedies Notice; PwC response to Remedies Notice, Annex 3.
[1254] Six parties commented: Deloitte response to Remedies Notice; GT response to Remedies Notice; Hermes response to Remedies Notice; ICAS response to Remedies Notice; KPMG response to Remedies Notice; and PwC response to Remedies Notice, Annex 3.
[1255] Deloitte response to Remedies Notice, paragraph 14.1.
[1256] GT response to Remedies Notice, paragraph 11.1.
[1257] PwC response to Remedies Notice, Annex 3, paragraph 62.

17.117 We have received no further evidence supporting this remedy. We do not therefore believe that this remedy would effectively deal with the AEC and have therefore decided not to pursue this remedy.

18. The package of remedies: effectiveness and proportionality

Introduction

18.1 Our analysis of the options and the decisions set out in Section 16 leads us to propose the following package of remedies:

- Remedy 1: An Order in effect requiring statutory audit services to be put out to tender periodically and disclosures in the AC report on the timing of future tenders and a recommendation to the FRC to amend the UK Corporate Governance Code in line with the Order (see paragraphs 16.3 to 16.88).

- Remedy 2: Recommendations to the FRC to take action in relation to AQR and reporting (see paragraphs 16.90 to 16.141).

- Remedy 3: An Order prohibiting provisions in loan agreements that restrict choice of auditor to lists or categories, but allowing for objectively justified auditor selection criteria, together with a recommendation to the LMA (see paragraphs 16.142 to 16.191).

- Remedy 4: A recommendation to the FRC to amend the UK Corporate Governance Code and the Stewardship Code in relation to shareholder engagement (see paragraphs 16.192 to 16.236).

- Remedy 5: An Order strengthening the accountability of the external auditor to the AC (see paragraphs 16.237 to 16.287).

- Remedy 6: A recommendation to the FRC to take action in relation to AC reporting requirements (see paragraphs 16.288 to 16.334).

- Remedy 7: A recommendation to the FRC to amend the objects clause in its articles of association so that, without prejudice to its other objects, in performing its functions it will have due regard to the need for competition in the statutory audit market for FTSE 350 companies (see paragraphs 16.335 to 16.367).

18.2 In the remainder of this final report, we:

(a) describe how the package of remedies addresses the AEC and resulting detrimental effect on customers (paragraphs 18.3 to 18.13);

(b) consider the effectiveness of the package, which covers the extent to which the remedies are capable of effective implementation, monitoring and enforcement, the timescale over which the remedies will take effect, the consistency with other rules applicable to the statutory audit market, and the coherence of the package of remedies (paragraphs 18.14 to 18.36);

(c) consider the effect of any action on any RCBs (paragraphs 18.37 to 18.45); and

(d) assess the proportionality of the package (paragraphs 18.46 to 18.93).

How the package of remedies addresses the AEC and resulting detrimental effect on customers

18.3 We discussed the rationale for each element of the remedy package in Section 16. In this section, we set out how the remedy package works as a whole to remedy the AEC and the resulting detrimental effect on customers that we found. We look first at the contribution of each element of the remedy package to addressing the AEC. We then discuss the synergies between the elements of the remedy package and some important common themes.

Contribution of each element of the remedy package

18.4 We discuss in detail in Section 16 how we expect each element of the remedy package to contribute to addressing the AEC, both individually and in combination with certain other remedies. Principally, we consider the contribution of each remedy to be as follows:

- Remedy 1: More frequent tender processes for audit services will strengthen the bargaining position of companies. More frequent tender processes and disclosure of company policy on when it will put the audit out to tender will reinforce the influence of the AC on the timing of the tender process and the selection of auditor, thus ensuring that competition is directed towards fulfilling shareholder interests. In addition, it will reduce barriers to entry, expansion and selection.

- Remedy 2: More frequent reporting by the AQR team will strengthen the bargaining position of companies by providing them with more information on the audit quality of their incumbent audit firm and facilitating comparison of audit firm quality. It will also contribute towards reducing barriers to entry, expansion and selection.

- Remedy 3: Prohibition on undue restrictions on auditor choice in loan agreements will reduce barriers to entry, expansion and selection for Mid Tier firms.

- Remedy 4:

  — The recommendation for the AC to seek shareholder views on audit matters, and explain how shareholder concerns have been addressed, will address information asymmetries and enable shareholders to exercise their powers more effectively. It will encourage ACs to take the views of shareholders into account when appointing or reappointing auditors.

  — The recommendation to update the Stewardship Code to emphasize that investors should engage on audit issues will encourage institutional investors to engage with companies on matters concerning external audit, and to exercise their powers more effectively with regard to auditor appointment.

  — The requirement for companies to hold an advisory vote on the AC Report (in which a company that has not put its audit engagement out to tender for the previous five years will have to set out when it next intends to go out to tender and why it considers this to be the appropriate interval) will give ACs incentives to discharge their responsibilities in relation to the external audit in the interests of shareholders and to take account of shareholder views.

In combination, the measures we are proposing under Remedy 4 will promote more effective shareholder engagement and contribute to ensuring that competition is focused on their interests.

- Remedy 5: The enhanced accountability of the auditor to the AC will increase AC influence in the external audit relationship, thus directing firms' competition towards satisfying the requirements of the AC whose interests are more closely aligned with those of shareholders.

- Remedy 6: Extended AC reporting on AQR team reports will provide companies with more information regarding the audit quality of non-incumbent firms, thus increasing their bargaining power, and give shareholders more information regarding audit quality and AC effectiveness, thereby promoting shareholder engagement and directing firms' competition towards meeting their needs.

- Remedy 7: The competition object of the FRC will encourage it to take appropriate account of the role of competition in facilitating high-quality audits when formulating policy. This may result in better information being provided to companies and shareholders regarding possible audit firms (and so increase their bargaining power, and better align auditor and shareholder interests), and reduce reputational barriers to entry, expansion or selection that to date have applied to non-Big-4 firms.

Synergies and common themes

18.5 Broadly, we consider that the remedies we are proposing individually contribute to remedying the AEC in three ways: first, to improve the bargaining position of companies with regard to external audit (principally Remedies 1, 2, 3, 6); second, to enhance the influence of the AC in the relationship with the external auditors (principally remedies 1, 4, 5) and third, to promote shareholder engagement in the audit process (principally remedies 1, 4, 6). Remedy 7 has a general role in contributing to company bargaining power, shareholder influence, and reducing barriers to entry, expansion and selection. However, there are also important interactions between the proposed remedies, which we discuss below.

18.6 We consider that increased frequency of tender processes will both enable companies to assess more frequently whether their audit service is competitive, and the information produced by going out to tender will increase their bargaining position between tender processes. However, we are aware that enhanced competition, if directed towards the demands of executive management, might result in an audit service that does not fully meet shareholder demands. Thus, we consider that any increase in competitive pressure should be accompanied by measures to ensure that competition is directed towards meeting shareholder interests.

18.7 We consider that our remedies designed to enhance the influence of the AC in the relationship with the external auditors will work in combination with more frequent tender processes to ensure that competition is better focused on shareholder interests, because the AC has a particular role to ensure, on behalf of the board, that the interests of shareholders are properly protected. The influence of the AC, in combination with more frequent tender processes, and additional disclosures on when the company next intends to go out to tender, should help to ensure that competitive outcomes for shareholders are achieved and that shareholders can be more confident that their interests have been at the forefront of any tender process and subsequent appointment decision.

18.8 Further, we consider that our remedies designed to promote shareholder engagement will work in combination with remedies to require more frequent tender processes and enhance AC influence to enable shareholder interests to be better reflected in auditor appointment decisions. We consider that our remedies will encourage more information flow between companies and investors in relation to external audit and thus allow ACs to understand more fully any shareholder concerns on the subject, and so better take them into account. In conjunction with the recent FRC initiatives to improve AC and auditor disclosures in annual reports, our remedies ensure that an appropriate framework is in place to allow shareholders to engage with and influence audit-related matters. It is necessarily up to shareholders and their representatives to make use of it, and thus play their part in promoting competition in the market.

18.9 We consider that more frequent tender processes and visibility of the timing of tender processes may have the dynamic effect of increasing choice, as firms will have increased incentives to invest in developing their capabilities in order to win engagements, since they will be able to predict with confidence when opportunities to tender will arise. We consider that this will apply to both Mid Tier firms in general, and to Big 4 firms in relation to sectors where they are currently less strong. We consider that this will work in combination with our remedy prohibiting restrictions on auditor selection in loan agreements and our remedy to increase reporting by the AQR team, and thus give audit firms other than the Big 4 firms incentives to invest in the capabilities necessary to win FTSE 350 engagements, particularly those engagements lower down the scale of complexity and international breadth.

18.10 We have considered the role of the FRC carefully in formulating our remedy proposals, and we note that it has evolved over time into an agency that is increasingly well equipped to provide high-quality independent regulation to the audit market. We found that the work of the FRC's AQR team was well regarded, considered carefully by audit firms and companies, and so we found that it had an important role to play in promoting competition between audit firms whilst safeguarding audit quality. We welcomed the recent changes to the UK Corporate Governance Code to increase frequency of tender processes and expand AC reporting and we saw these as beneficial steps promoting competition.

18.11 However, we considered that further steps were required to increase the resources of the AQR team, to strengthen the role of the AC, and to encourage transparency of AQR grades. These measures will complement other measures in our overall package of remedies designed to improve visibility of audit quality and enhance AC effectiveness. We also considered that a change to the FRC's objects to have due regard to competition would ensure that it places appropriate weight on the role of competition in facilitating high-quality audit. We are necessarily reliant on the FRC to take our recommendations forward, and to ensure that it secures the appropriate funding to do so. In doing so, we consider that the FRC will further strengthen its role as an accountable, transparent, and independent regulator of the audit industry.

Conclusion on how the proposed remedy package addresses the AEC

18.12 In summary, we consider that our remedies will work in combination to ensure that through an increase in company bargaining power, competitive rivalry and choice in the audit market should increase, and that this rivalry will be better directed towards satisfying the requirements of shareholders for high-quality audit.

18.13 We consider that the package will address both aspects of the AEC that we found: namely that companies lack bargaining power with regard to their incumbent auditor outside of tender processes and that competition may be directed towards satisfying the interests of executive management rather than those of shareholders.

18.14 We now turn to assessing the effectiveness of the package we propose.

The effectiveness of the remedy package

18.15 In evaluating the effectiveness of the proposed remedy package we considered the following factors:

(a) the means by which the remedies are capable of effective implementation, monitoring and enforcement;

(b) the timescale over which the remedies will take effect;

(c) consistency with other rules and codes; and

(d) the coherence as a package of remedies.

Implementation, monitoring, and enforcement

18.16 In developing each of the remedy options, we considered how each measure could best be implemented, monitored and enforced. Our decisions setting out how each measure should be implemented and the reasons for this are summarized in Section 16.

18.17 In deciding whether we should take action to remedy the AEC we found or should recommend the taking of action by others, we had regard to the following considerations.

18.18 Where the CC takes action itself, it has the choice of implementing remedies by accepting undertakings from the relevant parties and/or by making an order. In making this decision, we took into account the extent to which our proposed remedies fell within our order-making powers[1258] and relevant practical issues, such as the number of parties which would have to give undertakings, and the likely delay and complexity of negotiating undertakings with so many parties.

18.19 Where it appeared that a proposed remedy came within our order-making powers, we took into account the likely costs of compliance with our orders, and that the effectiveness of any remedy may be reduced if elaborate monitoring and compliance programmes are required. The Act gives the OFT the formal duty of keeping under review the carrying out of and the effectiveness of enforcement orders.[1259] However, we also took into account that the likelihood of compliance is increased when the operation and implications of remedies are clear to the persons to whom they are directed, and where the arrangements for monitoring compliance are simple to carry out.

18.20 Where we considered that we did not have jurisdiction to make orders in respect of a remedy, as in the case of the shareholder engagement remedy which involves amendment of the UK Corporate Governance Code and the Stewardship Code, we decided to make recommendations to the FRC to take relevant action.

[1258] These are set out in section 161(3) of and Schedule 8 to the Act.
[1259] Section 162(1) and (5) of the Act.

18.21 Based on the above considerations, and our detailed assessment of each remedy option in Section 16, we conclude that our remedies package is capable of effective implementation, monitoring, and enforcement.

Timescale over which the remedies will take effect

18.22 In considering the timescale over which these remedies are likely to take effect, we considered both the time that it is likely to take to implement the remedies and the time that it is likely to take for the remedies, once implemented, to remedy the AEC and the resulting detrimental effect on customers.

- *Orders*

18.23 The CC normally expects to make an order in relation to those matters that we are implementing ourselves within a period of around six to nine months following publication of our final report. In this case we would expect the order on firms in relation to engagement with ACs (Remedy 5); and the order in relation to auditor clauses in loan agreements (Remedy 3) to take effect by 1 October 2014.[1260]

18.24 We expect the Order in relation to mandatory tender processes to have effect from 1 October 2014 with a transitional period that will phase in the new arrangements over the course of five years (ie one AEP cycle) for those companies which have not gone out to tender for the longest period and over an additional five years for other companies. It will likely result in a relatively small increase in the number of tender processes held in the short to medium term (one to five years) in comparison with the number that we expect would be held under the current FRC guidance, but will not lead to an increase in financial or opportunity costs of tender processes. We consider that these transitional arrangements give companies time to make the necessary arrangements to comply with the requirement to go out to tender at least once every ten years and firms to develop the capacity to participate in these tenders. In conjunction with the requirement for companies that have not gone out to tender in the last five years to disclose when they intend to go to tender, we believe that shareholders have the opportunity to engage with companies if they believe a tender process should be held sooner than the transitional arrangements require.

18.25 We consider that as the practice of going out to tender becomes more familiar to company management, the process will become more efficient, and companies will become more familiar with evaluating alternative bids. In addition, any perception that the costs of going out to tender are higher than they are in reality will diminish as companies gain more experience in these areas (although we accept that the costs will nevertheless remain significant for some companies). We also consider that any stigma associated with going out to tender the audit engagement, for example the potential suspicion on the part of shareholders that such a move is a result of a ‘falling out’ over a financial reporting matter, will be reduced in an environment where use of tender processes becomes significantly more common.

- *Recommendations*

18.26 For the periodic tendering and associated disclosure remedy (Remedy 1), the shareholder–auditor engagement remedy (Remedy 4), the strengthened accountability of auditors to ACs (Remedy 5), and extended reporting requirements in both the

[1260] This takes into account consultation on the draft Orders and the Government’s suggested common commencement dates of 6 April or 1 October for new legislation and regulations, aimed at minimizing burdens on business.

AC Report and auditor's report (Remedy 6) we recommend that the FRC makes amendments to the UK Corporate Governance Code and, for Remedy 4, the Stewardship Code by October 2014. The recommendations in relation to these governance codes are largely a change or addition to existing practices or guidance, rather than creating new areas guidance. We therefore expect such recommendations to take less time to develop and implement than measures requiring the introduction of a new regulatory framework. We consider that it is possible to implement these recommendations within the specified time frame.

18.27 We acknowledge that the AQR remedy (Remedy 2) will take some time to come into effect, as it may take some time for the AQR team to expand its resources to undertake more frequent reviews, the total number of reviews being undertaken, and the results of those reviews being reported to shareholders through the AC report. Therefore, we recommend that the FRC implement the changes as soon as reasonably practicable.

- *Other factors*

18.28 A number of other factors will affect the timescale over which our remedies will have an effect on market outcomes.

18.29 We expect some of the measures that we propose to have dynamic effects that may be felt in the longer term, alongside other recent changes to the UK Corporate Governance Code. Such effects include the effects on firms' incentives to invest in the expertise and experience required to win FTSE 350 audit engagements through tenders in specific sectors. We expect the firms to take some actions in the short term in anticipation of the expected increase in companies going out to tender. On the other hand, we recognize that development and execution of competitive strategies in response to increased tendering, for example investments in additional capability, may evolve over a period of time as the market develops.

18.30 Even so, once our remedies have been implemented we expect them to have an immediate effect on the incentives of firms, both within and outside the relevant market. In particular we expect that an increased threat of competition from potential rival audit firms for any given engagement would have an immediate effect on incentives. We expect the certainty that companies will go out to tender on a regular and more frequent basis to increase incumbent firms' incentives to ensure that they provide a competitive product thereby reducing the risk of losing in a forthcoming tender process.

18.31 In relation to the promotion of shareholder interests in the competitive process, we consider that the recent changes to the Guidance on ACs to encourage ACs to disclose more information about how they have discharged their responsibilities to shareholders in relation to the external audit already affect AC incentives, as they apply for reporting periods beginning 1 October 2012. While the first reports under the FRC's revised Guidance on ACs will not be published until late 2013/early 2014, we consider that the process of preparing to report should be underway. We consider that the recent changes should therefore contribute to ensuring that the AC has appropriate influence in relation to external audit with immediate effect. Equally the changes to the Audit Report in ISA 700 apply to reporting periods beginning on 1 October 2012 and audit reports on these periods will start to be published in early January 2014. Audit firms should already be planning to make the additional disclosures required by ISA 700 and, in some cases, are doing so.[1261] We expect that our remedy package will improve market outcomes, including a more competitive product which better meets the demands of shareholders, within one to two years of implementation. We expect that remedies to enhance the influence of ACs and to ensure that shareholder interests are better represented may take between three to five years to be fully reflected in the competitive environment, and remedies to increase tender activity may take up to seven years to be fully effective for all companies. Similarly, the AQR remedy may take seven to ten years to be implemented and for a full cycle of FTSE 350 reviews to be conducted. Improvements in market outcomes in relation to increased choice may take a similar period of time to materialize as firms develop and execute strategies in response to heightened competition.

Consistency with other regulations

18.32 Where possible, we sought to build on the existing regulatory framework that applies in the statutory audit market. Where we have the power to do so, we will make Orders to implement our measures, for example to prohibit firms and companies from entering into agreements for audit engagements where the company has not gone out to tender for a period of more than ten years; to require firms to provide information to other firms participating in a tender process if requested by the company; and to require firms to ensure that fee negotiations are conducted with the ACC. We recommend that such orders should be reflected in the UK Corporate Governance Code and associated guidance, as we expect the FRC to have an interest in providing companies with a comprehensive view of the relevant body of regulation.

18.33 In relation to the prohibition of clauses that unduly restrict choice of auditor in loan agreements, we note that the FRC's guidance on ACs[1262] contains a requirement on ACs to report any such clauses as discussed above in paragraph 16.179. We expect the FRC to revise its guidance to make it clear to companies that these clauses are prohibited in loan agreements going forward.

18.34 We considered the interaction of our remedy package with the proposals currently under discussion by the EU, which we describe in paragraphs 15.9 to 15.13. At the time of writing there remains uncertainty over the nature and timing of any EU action in this area. It is possible that future EU action may obviate the need for some of our remedies, for example if wider in effect, or otherwise necessitate changes to them, for example if they are contradictory. The Act provides us with the ability to take into account the EU reforms once these are of a sufficiently certain nature (see paragraph 14.8).

Coherence as a package

18.35 As discussed in paragraph 18.12, the proposed remedies will work coherently in combination to address both aspects of the AEC we have found.

Conclusion on effectiveness of remedy package

18.36 Based on the assessment in paragraphs 18.15 to 18.35 we concluded that this package of measures would be effective in addressing the AECs that we identified and, as a result, would also substantially reduce the detrimental effect on customers

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[1261] See, for example, Vodafone Group Plc annual report 2013, Independent Auditor's report to the members of Vodafone Group plc.
[1262] FRC, Guidance on Audit Committees, September 2012, paragraph 5.2.

that flows from the AEC. We expect the remedy package to have a substantial effect on the AEC and resulting customer detriment within two to three years of publication of our final report. We accept that the full effect of our remedy package may not be felt for seven to ten years, to allow time for a complete cycle of audit tender processes, and of AQR reviews, and for the dynamic effects of increased competition to take effect.

Relevant customer benefits

18.37 In deciding the question of remedies, we may also have regard to the effect of any action on any RCBs of the feature or features of the market concerned.[1263]

18.38 RCBs are limited to benefits to customers in the form of:

(a) lower prices, higher quality or greater choice of goods or services in any market in the UK (whether or not the market to which the feature or features concerned relate); or

(b) greater innovation in relation to such goods or services.

18.39 The Act provides that a benefit is only an RCB if we believe that:

(a) the benefit has accrued as result (whether wholly or partly) of the feature or features concerned or may be expected to accrue within a reasonable period of time as a result (whether wholly or partly) of that feature or those features; and

(b) the benefit was, or is, unlikely to accrue without the feature or features concerned.

18.40 We considered whether there were any RCBs which we should take account of in formulating our remedies. In doing so, our principal consideration was benefits accruing to shareholders.

18.41 We considered parties' submissions on RCBs. PwC and Deloitte submitted that the feature that companies and audit firms invest in a relationship of mutual trust and confidence from which neither will lightly walk away, gives rise to continuity benefits that are beneficial for shareholders and which we must take into account when deciding on the appropriate package of remedies.[1264]

18.42 To the extent that continuity benefits could be said to be a RCB (for example if it were an aspect of quality), given that we are not proposing to compel companies to switch audit firms, because we found that other remedies were more effective in addressing the AEC that we found (see paragraph 17.63), we do not consider that our remedy package disturbs any continuity benefits that may result from long-term company-auditor relationships. If a company chooses to switch auditor following a tender process, it will be doing so in the expectation that the benefits of switching outweigh the loss of continuity benefits.

18.43 We considered the scope for audit fees to be lower as a result of the features we identified under our second theory of harm, namely the ability of executive management to influence audit firms in how they conduct and report their audit and the information asymmetry between shareholders and audit firms.

[1263] The Act, section 134(7).
[1264] Deloitte response to Remedies Notice; PwC response to Remedies Notice, Annex 3.

18.44 We note that the ACC may have less interest in keeping fees low than the FD, who has traditionally conducted fee negotiations. We considered whether any potential RCB would be lost as a result of our remedy increasing the influence of the AC in the external auditor relationship and that audit fees might rise. We considered that ACCs were capable and financially literate individuals who could be expected to strike an appropriate balance between obtaining an audit fee that was not unduly generous and ensuring that audit scope was sufficient to give the assurance that shareholders demand. We also considered that the ACC would be able to seek advice from members of the executive team, including the FD, and external contractors regarding the scope of the audit and the appropriate fee. We acknowledge that some fee increases might occur in circumstances where the ACC considered that the audit fee would otherwise be too low to provide an effective audit. However, we did not consider that any consequential upwards pressure on fees in these circumstances could be considered to be removing any potential RCB—rather we saw this as a natural consequence of aligning competition with shareholder interests.

18.45 We have not identified any other potential RCBs deriving from the features that we identified. We were satisfied that there are no RCBs that would justify us in changing our remedies package set out in Section 19.

Assessment of proportionality

18.46 We evaluated whether this package would be a proportionate response to the AEC that we have identified by considering whether the remedy package:[1265]

(a) is effective in achieving its aim;

(b) is no more onerous than necessary to achieve its aim;

(c) is the least onerous if there is a choice; and

(d) produces adverse effects which are disproportionate to the aim.

18.47 KPMG said that in considering proportionality it was incumbent on us to conduct a thorough assessment of the expected costs and benefits of each of the remedy options.[1266] We conducted such an assessment and the factors that we have taken account of in relation to individual remedies are set out in detail in Section 16.

18.48 However, given the interconnections between the various remedies set out above we consider it important to assess the proportionality of the remedies package as a whole. This approach is supported by other respondents. PwC said that it was essential to assess such a package of remedies holistically rather than assessing each individual component in isolation.[1267] GT believed the proposed interventions needed to be taken together and considered in aggregate.[1268]

Effective in achieving its legitimate aim

18.49 We concluded in paragraph 18.36 that this package of remedies would be effective in addressing the AEC that we found.

[1265] These four aspects overlap to some extent. We have combined discussion of *(b)* and *(c)* in the text that follows.
[1266] KPMG response to Remedies Notice, paragraph 1.5.
[1267] PwC response to Remedies Notice, paragraph 3.3.
[1268] GT response to Remedies Notice, covering letter, paragraph 7.

No more onerous than necessary and less onerous if there is a choice

18.50 We tried where possible to encourage competition by providing correct incentives, rather than through more intrusive regulation. For example, we sought to encourage ACs and investors to communicate over audit issues and we expect this to be effective, although we acknowledge that this depends to some extent on whether investors make use of the opportunities afforded to them. Similarly we consider that our audit tendering remedy and strengthening AC accountability remedy will establish a framework in which the AC is empowered to act in shareholders' interests and thereby avoid more intrusive regulation such as requiring periodic switching of audit firms.

18.51 Each element of the remedy package is necessary to achieve as comprehensive a solution as is reasonable and practicable to the AEC. As set out in paragraphs 18.5 to 18.13 the remedy package comprises a set of complementary measures, each of which contributes to remedying the AEC by addressing one or more aspects of the AEC. We have not pursued options, such as joint audit, or restrictions on NAS, where we did not consider that they would contribute materially to the effectiveness of the remedy package.

18.52 We have been careful to ensure that the individual elements of the remedy package are not more onerous than necessary to remedy the AEC (see Section 16). We have decided not to impose a mandatory period between tender processes of less than ten years, since we consider that the AC is best placed to determine if a shorter interval between tender processes would be in the best interests of shareholders (see paragraphs 18.74 and 18.78). However, we have decided that it is necessary for the effectiveness of our remedy to remove the ability for companies to explain rather than comply at ten years. Without this provision, we think there is a risk that some companies would defer a tender process beyond ten years, and we consider that this is too long to ensure that competition functions effectively. We have not mandated the form of the tendering process companies should follow, preferring to leave companies with the flexibility to determine the approach that is most suitable for their circumstances.[1269]

18.53 We are therefore satisfied that the remedy package is no more intrusive than necessary to remedy the AEC.

18.54 In developing our package of remedies we considered a wide range of options. We have consulted parties on alternative specifications of remedy options and on different approaches to addressing the AEC. We have not been able to identify any less onerous remedy options that would be as effective as the measures that we propose to take forward.

18.55 We were therefore satisfied that we had chosen the least onerous remedy package from the effective options available to us.

Does not produce adverse effects that are disproportionate to the aim

18.56 In reaching our judgement about whether to proceed with the remedy package we considered its potential effects, both positive and negative, on those parties most likely to be affected by it. We have paid particular regard to the potential effect of these remedies on FTSE 350 companies and have also had regard to the impact on audit firms and other affected parties, including the FRC.

[1269] Although we note the FRC's notes on best practice.

18.57 Our detailed assessment of the potential adverse effects of each of the individual remedy options is set out in Section 16. We now set out what we judged to be the most important considerations that were relevant to our assessment of whether the adverse effects that we identified were disproportionate when compared with the benefits that our remedy package aims to achieve.

Benefits of the remedy package

18.58 In accordance with our guidance, in considering how markets may develop with remedies in place, we considered both benefits that can be quantified and have a high probability of materializing (such as lower prices) and benefits that are harder to quantify and are more uncertain (for example, the dynamic benefits of increased rivalry on productivity and innovation). Both types of benefit are important.[1270]

18.59 As described above, we consider that the various elements of the remedy package will work in combination to address the AEC that we have found by increasing company bargaining power and focussing competition more towards the interests of shareholders.

18.60 We now consider the extent to which our package of remedies would reduce the detrimental effect on customers that we have identified. We discuss the nature of the detriment arising from the AEC in Section 14.

18.61 The most important effect of our proposed remedy package will be to increase confidence in the quality of the audit product. In our discussion of detriment in Section 14, we explain how improving trust and confidence in audit could have economic benefits in terms of improved corporate governance and lower cost of capital. We discuss above that shareholders currently perceive audit quality only indirectly and the lack of visibility that currently exists means that these perceptions may at times depart from reality. In the absence of direct information about audit quality, shareholders place considerable weight on the AC to uphold their interests in this respect.

18.62 We expect our remedies to increase confidence in external audit and in the effectiveness of the AC as follows:

(a) Remedies to increase the frequency of tender processes will:

(i) demonstrate that the AC has subjected the audit relationship to open market review on a periodic basis, and will thus reduce the perception of a 'familiarity threat'; and

(ii) reassure investors that audit firms have better incentives to deliver a service that is aligned with AC and so shareholder interests.

(b) Remedies to enhance the influence of the AC will:

(i) improve shareholder confidence in the effectiveness of the AC in ensuring that auditors are not unduly influenced by executive management when determining audit scope, approach and fees, and when resolving audit issues. As a result shareholders can expect a greater emphasis on professional scepticism and thoroughness; and

[1270] CC3, paragraph 351.

(ii) in combination with more frequent tendering, give shareholders confidence that competition is better aligned with shareholder interests.

(c) Remedies to enhance AC reporting will improve transparency of the performance of the AC and will increase transparency of audit quality through publication of AQR grades. This will:

(i) ensure that ACs are aware of their responsibilities and take them seriously;

(ii) improve shareholder awareness and confidence in the role of the AC and in how it has discharged its responsibilities (and so that AC incentives are well-aligned with shareholders' interests);

(iii) provide shareholders with more information on which to base their views about audit quality, and about the extent to which any quality problems are widespread or otherwise;

(iv) provide shareholders with increased confidence that quality issues will be discovered and dealt with effectively by the AC; and

(v) provide shareholders with information on which to engage with companies on matters concerning external audit, thus fostering dialogue and trust.

18.63 In relation to the lack of company bargaining power outside tender processes that we found, we consider that tendering at least every ten years, in combination with other remedies, will ensure that companies make regular assessments of the benefits of changing audit firm and that these are based on accurate information. If a company finds that there would be benefits to changing audit firm, it will need to consider whether the costs of switching outweigh these benefits. Information on the costs and benefits of switching auditor will be better specified because companies and auditors will over time become more familiar with the process of tendering and switching auditor, and uncertainty and misconceptions will thus be reduced.

18.64 Additionally our remedies to increase the influence of the AC, and promote shareholder engagement, will ensure that appropriate weight is put on the benefits that may accrue to shareholders as a result of putting the audit out to tender or making a change in auditor, and thus ensure that customer bargaining power is exercised in the interests of shareholders.

18.65 Increased opportunities to tender, and visibility of the timing of tenders, will reduce barriers to entry, expansion and selection and give both Big 4 and Mid Tier firms incentives to invest in the necessary capability to win selected engagements. Our remedy to prohibit certain restrictions regarding choice of auditors in loan agreements will reduce reputational barriers to entry, expansion and selection facing the Mid Tier firms. We consider that in combination the effect of these remedies will be to expand choice and hence contribute towards effective competition.

18.66 We consider that in combination our remedy package will result in enhanced competitive rivalry among audit firms, which we expect to benefit companies and their shareholders in the form of a product that better meets their needs.

18.67 The precise configuration of the competitive product that we expect to emerge as a result of our remedy package is difficult to specify and is likely to vary between companies (see paragraph 14.35). Nevertheless we consider that the benefits of improving competition, both in terms of increasing rivalry and by ensuring that rivalry is better focused on the interests of shareholders, are considerable. We attach significant weight to the public benefits[1271] of improving confidence in the audit market taking into account the important role of audit in the corporate governance framework.

18.68 In paragraph 14.39 we note that very small increases in shareholder value or downwards movements in the cost of capital as a result of improvements in audit quality and confidence in financial reporting could have large financial benefits for the economy in the order of billions of pounds.

18.69 In the light of the comprehensive nature of the remedy package and its effectiveness in achieving its aims in respect of improving competition, we expect the customer benefits to be significant.

Adverse effects of remedies

18.70 We have considered the negative effects of our remedies including the costs to business. Such negative effects may arise in various forms, such as:

(a) A remedy may result in implementation costs and ongoing monitoring and compliance costs.

(b) A remedy may result in unintended distortions to market outcomes. Such distortions may adversely affect the interests of customers and reduce economic efficiency.

(c) A remedy may remove an RCB.

18.71 We consider the costs, including monetary and non-monetary costs, of each of our remedies in detail in Section 16.

18.72 The costs of the audit tender process remedy fall largely on companies in running tender processes and audit firms in participating in them.

18.73 We found that the costs incurred by companies were hard to quantify because there were few incremental monetary costs and tender processes largely involved the opportunity cost of management time. Costs appeared to vary according to the size and complexity of the company, as would be expected. We considered that the costs of running the tender process could be controlled by companies and were capable of reduction in the event that tender processes were held more frequently. This could be achieved through efficient tender process design and the timing of the tender process to avoid periods of high workload. We also considered that our remedy requiring audit firms to make available information to bidding firms if requested by the company could improve efficiency of the tender process. In the normal course of events, we would expect the individuals concerned to manage their time and responsibilities effectively as part of their portfolio of responsibilities.

18.74 We note that the FTSE 350 includes a diverse set of companies spanning the most complex global groups as well as more straightforward UK-based enterprises, with a large range in market capitalization from less than £0.2 billion to over £100 billion. The top ten companies in the FTSE 100 account for around 40 to 50 per cent of the value of the index. We think that for many and perhaps most FTSE 350 companies, holding tender processes every five years would be beneficial. After five years, we think that the proportion of companies that would benefit from holding a tender pro-

[1271] As set out in paragraph 14.9, the Act (section 134(5)) enables us to consider the effect on customers in a wider sense.

cess increases. We acknowledge, however, that for some complex organizations, the costs of tender processes might be higher (for companies and firms) and the length of time required to conduct a tender process might be longer. As a result we have stipulated a maximum period of ten years which we consider is sufficient to accommodate the needs of all companies. We consider that this provides significant flexibility for ACs to select an appropriate time to go to tender according to the specific circumstances of the company, subject to the obligation to put the audit out to tender at least every ten years. Companies which have not gone out to tender for five years will have to disclose in which financial year they intend to go out to tender in the company's annual report and why a tender process in that year is in the interests of shareholders. The AC report will be subject to the advisory vote of shareholders, who can therefore indicate their satisfaction, or dissatisfaction, with the stated policy.

18.75 The effect of our remedy will be to bring forward tender processes for those companies which would otherwise have deferred a tender process beyond ten years under the FRC's comply or explain principles. We expect this to apply to a small number of companies. However, we acknowledge that some of these companies could be very large, complex entities and thus the cost of going out to tender earlier than they might otherwise have done could be non-trivial. We faced considerable difficulties in quantifying such costs as these involve the opportunity cost of individuals' time (at firms and companies) and since tender processes have been very infrequent in the past, we did not think that the past was necessarily a good guide to the future since the nature of tender processes would be likely to change and to become more efficient.

18.76 We considered the possible additional costs of our tender process remedy under a number of assumptions about the rate of non-compliance under the FRC's provisions and the likely costs of tender processes. We made different assumptions for very large complex FTSE 100 companies, other FTSE 100 companies, and FTSE 250 companies. Our calculations are set out in Appendix 16.2. If the remedy results in an extra 1.25 tender processes a year with an average cost of £1.5 million a year, then sensitivity analysis suggests an upper bound of an extra four tender processes a year with incremental costs of £3 million a year.[1272] We also considered the cost to companies which would prefer to go out to tender in year ten of removing the flexibility to defer a tender process to avoid the higher opportunity costs associated with certain disruptive corporate events. We considered that this would be unlikely to have a significant effect on the overall cost of our remedy (see paragraph 16.44).

18.77 We also considered the potential adverse effects of bringing forward tender processes for these few companies on their incentives to run an effective tender process (see paragraphs 16.45 to 16.49. However, we do not consider that there will be a reduction in the effectiveness of tender processes by mandating that they be held at least every ten years since:

(a) we believe that firms have good incentives to compete vigorously in tender processes held every ten years;

(b) no company told us that it would not be able go out to tender at least every ten years;[1273]

(c) the recently introduced requirement for the AC to explain the approach taken to the appointment or reappointment of the external auditor in its report to shareholders, and the additional requirements proposed in our remedies package to

[1272] See Appendix 16.2, paragraphs 12–17.
[1273] See paragraph 16.48.

increase the influence and accountability of ACs, lead us to consider that companies will ensure that the tender process is thorough, although companies may find ways to run these processes more efficiently;

(d) firms are unlikely to participate in a tender process that is not designed to give them the necessary information that they need to compete effectively, and this would act as a discipline to ensure that companies run effective tender processes; and

(e) the FRC has published *Notes on Best Practice* on the conduct of effective tender processes, which we expect ACs will wish to follow.[1274]

18.78 We considered the effect of our remedy that requires the AC, for companies which have not gone out to tender for five years, to disclose in the AC report in which financial year the company next intends to go out to tender and why it considers this year to be in the best interests of shareholders. Subject to the interval between tender processes being at least once every ten years, this gives the AC a margin of appreciation to select an appropriate point at which to put the audit out to tender, based on the specific circumstances of the company and the interests of shareholders. We think that this necessarily allows ACs to select a period between tender processes that balances the costs and benefits of going out to tender. While we think this will encourage companies to go out to tender before ten years, we have not factored into the costs of our remedy package any additional costs of earlier tender processes as we think that they were unlikely to have a significant effect on the overall cost of our remedy (see paragraph 16.44).

18.79 We considered the cost of our remedy addressing the role of the AC. We considered that many ACs would undertake these duties already and so would not incur significant additional cost. However, we accept that there may be a cost associated with developing the role of the AC for some companies. We considered that this would be partly offset by the opportunity cost of time saved by the FD and his team (for example, on the fee negotiation) and was unlikely to be significant. On a conservative basis, we assess the cost of ACs spending the equivalent of an additional 10 per cent of their time on audit to be in the order of £3 million assuming that there are no benefits arising from removing duties from the FD.[1275]

18.80 Some additional time on the part of institutional investors may be required to engage on matters concerning the external audit, and to decide how to vote on the AC report. In addition, the FRC would incur some costs in amending guidance and monitoring compliance with additional provisions in the UK Corporate Governance Code and the Stewardship Code. As a result of this additional engagement, there might be further demands on the AC or ACC's time. We believed that the incremental costs of greater engagement were likely to be low and offset by the benefits of greater suitability of the audit product for the needs of investors.

18.81 The AQR remedy would fall mainly on the FRC. Using the FRC's estimates of the AQR team's costs under the current inspection regime, we estimate the costs of both elements of the remedy to be in the order of £1.5 million to £1.7 million a year.[1276]

[1274] FRC, Audit tenders: Notes on best practice, July 2013.
[1275] See paragraph 16.268.
[1276] The costs of reviewing firms more frequently is estimated at £150,000 to £325,000 (paragraph 16.125) and the cost of more frequent file review is estimated at £1.4 million (paragraph 16.116). The FRC is funded by levy and thus these costs would need to be recovered from firms and/or companies.

There will also be additional opportunity costs borne by the firms which we have been unable to quantify.[1277]

18.82 We sought to avoid creating distortions through remedy design. In particular, we had regard to the need to ensure that enhanced competition was not directed towards satisfying the requirements of executive management. We consider that our package of remedies, which includes remedies to promote the influence of the AC and to promote shareholder engagement, will ensure that competition is not distorted in this respect.

18.83 We did not consider the other elements of our remedy package to present risks to distortion of competition. We concluded that in the light of the design of our remedies the potential for distortion was relatively low.

18.84 As set out in paragraphs 18.38 to 18.45 we do not consider that our remedy package will result in the removal of any RCBs.

Comparison of the beneficial and adverse effects of the remedy package

18.85 In weighing up the beneficial and adverse effects of the remedy package, our starting point is that we have assessed the adverse effects, including additional costs, of our remedy package to be relatively low for all remedies.

18.86 Our remedy to require companies to go out to tender at least every ten years will result in relatively few additional tender processes per year on average over and above the additional tender processes that will occur as a result of the FRC provisions. Illustrative calculations suggested the cost, in steady state, to be £1.5 million to £3 million, across the FTSE 350.[1278]

18.87 As a result of our transitional arrangements, we expect more companies to go out to tender over the next five years than would be the case under the FRC's transitional arrangements (see paragraphs 16.81 to 16.89). We do not therefore expect the costs associated with this to be significant.

18.88 We accept that there are some additional costs associated with more frequent AQR reviews and reporting, which we assess at no more than £1.7 million a year.[1279] The combined cost of our tendering and AQR remedies is therefore no more than £5 million a year. We assess the cost of our AC remedy at no more than £3.1 million.[1280]

18.89 We consider that the costs of other remedies are likely to be insignificant in total, but are difficult to estimate accurately. We assess the total cost of our remedy package to be less than £10 million a year across the FTSE 350.

18.90 On the other hand, we consider the benefits of our proposed remedy package to be considerable. In our judgement, we expect that an increase in competition and a focusing of competition more towards shareholder interests will increase audit quality and thus have important beneficial effects on shareholder value, both in terms of stewardship of individual companies and the broader effects of increased confidence in audit. We place considerable weight on the public benefits for the UK economy.

[1277] BDO estimated the cost of increasing its firm level review frequency to be £250,000 and KPMG stated that there would be a not inconsiderable demand on senior members of the audit teams of FTSE 350 companies.
[1278] Paragraph 16.43.
[1279] The costs of reviewing firms more frequently is estimated at £150,000–£325,000 (paragraph 16.125) and the cost of more frequent file review is estimated at £1.4 million (paragraph 16.116). This excludes firms' opportunity costs of responding to AQR queries.
[1280] Paragraph 16.282.

We consider that an audit market in which shareholders have increased confidence will assist in promoting the UK's corporate governance regime as a centre of excellence and will encourage investment in UK companies.

18.91 We have assessed the incremental costs of our remedy package, to be relatively small in the context of the benefits that we expect to achieve. We acknowledge that we are unable to say with certainty by how much our remedy package will improve shareholder value or decrease the cost of capital for UK companies, but the movement need only be very small to have a significant monetary effect, given the sums involved. For illustrative purposes we note that a 1 basis point (0.01 per cent) increase in the market capitalization of the FTSE 350 would represent a benefit to shareholders of approximately £200 million. The annual increase in value that would be required to offset an annual cost of £10 million would be 0.0006 per cent. Further, the benefit to the economy from very small downwards movements in the cost of capital could be considerable. On an illustrative basis, every basis point decrease in the cost of capital could represent an increase in overall market capitalization of around £3.8 billion.[1281] We cannot be precise about the extent of the movement that we would expect to see as a result of our remedy package but we are confident that it is likely to significantly outweigh the costs.

18.92 Based on the above assessment we conclude that the beneficial effects of this package are likely to substantially outweigh the negative effects.

Conclusion on proportionality of the remedy package

18.93 We concluded that our remedy package was a reasonable and proportionate response to the AEC that we have found.

19. Decision on remedies

19.1 For the reasons given above in Section 16, we have decided on the package of remedies as follows.

Remedy 1

19.2 We intend to issue an Order to the effect that:

(a) FTSE 350 companies must put their statutory audit engagement out to tender not less frequently than every ten years.

(b) Companies have the right to require the incumbent audit firm give them access to specified elements of the audit file for disclosure to rival bidders in a tender process.

(c) Where a company has not tendered in the last five years, the AC Report shall state in which financial year it intends to go out to tender for statutory audit services and why it thinks that going out to tender in this year to be in the best interests of shareholders.

(d) Companies must monitor and certify compliance with the provisions of the Order in the AC Report.

[1281] Based on an initial discount rate of 5 per cent and assuming constant cash flows in perpetuity.

19.3 We also intend to recommend that the FRC amend the UK Corporate Governance Code to align with the Order.

Remedy 2

19.4 We have decided to recommend to the FRC that:

(a) The AQR team should aim to review and report on the controls, systems and processes of each of the 'major firms'[1282] annually, subject to the firm having sufficient PIE audit clients to make this assessment practicable.

(b) The AQR team should review every audit engagement in the FTSE 350 on average every five years, with each individual audit engagement in the FTSE 350 reviewed at least every seven years.

Remedy 3

19.5 We decided on the following remedies in relation to auditor clauses in loan agreements:

(a) an Order prohibiting provisions in loan agreements which restrict or have the effect of restricting a company's choice of statutory auditor to lists or categories, but the prohibition will not extend to any objectively justified auditor selection criteria:

(i) by 'company', we mean any company whose annual accounts for a financial year must be audited in accordance with Part 16 of the Companies Act;

(ii) by 'loan agreements' we mean any arrangement with such a company for the purposes of providing borrowing facilities to that company. This includes bilateral and syndicated agreements but would not extend to public prospectuses in relation to bond issues;

(iii) the prohibition will apply to the relevant provision(s) but does not affect the validity of the rest of the loan agreement;

(iv) the prohibition will not apply to loan agreements currently in force but rather to loan agreements entered into on or after the date on which the Order comes into effect;

(v) companies must monitor and certify compliance with the Order in their Annual Report; and

(b) a recommendation to the Loan Market Association that it amend the auditor clause in its template leveraged loan documentation in line with the provisions of the Order.

Remedy 4

19.6 With regard to shareholder engagement, we decided to recommend that:

[1282] Those identified by the FRC as having ten or more PIE clients in the AQR's scope.

(a) The FRC amend the UK Corporate Governance Code by introducing a specific obligation on FTSE 350 companies:[1283] (i) to engage with shareholders through seeking shareholder views on audit issues and stating how any shareholder concerns identified as a result may have been addressed; and (ii) to introduce an advisory vote for shareholders to indicate their satisfaction with the AC Report.

(b) The FRC update the Stewardship Code to encourage institutional investors to engage with investee companies on audit issues, through monitoring investee companies and escalating stewardship activities.

Remedy 5

19.7 In order to strengthen the accountability of the external auditor to the AC, we decided to make an Order to the effect that:

(a) For a FTSE 350 company, only the AC acting collectively or through the ACC, and acting on delegated authority from the board, is permitted to:

(i) negotiate and agree audit fees and influence the scope of audit work;[1284]

(ii) initiate and supervise a tender process for external audit work and make recommendations for appointment of auditors following a tender process;

(iii) influence the identity of an AEP; and

(iv) authorize the external audit firm to carry out any NAS, although the AC may set a threshold of materiality below which executive management may authorize the audit firm to conduct NAS.

(b) Auditors are only permitted to enter into an agreement with a FTSE 350 company to carry out statutory audit services in the circumstances that the terms of such an agreement have been negotiated with and agreed by the AC.

(c) Companies must monitor and certify compliance with the Order in the AC Report.

19.8 We recommend that the FRC amend the UK Corporate Governance Code in line with the provisions of the Order.

Remedy 6

19.9 We recommend to the FRC that it amend the UK Corporate Governance Code to include the following additional provision in relation to the AC Report:[1285]

> In reporting how the AC has assessed the effectiveness of the auditor, the AC of a FTSE 350 company should report on (i) whether the AQR

[1283] All companies with a Premium Listing of equity shares in the UK are required under the Listing Rules to report on how they have applied the UK Corporate Governance Code in their annual report and accounts. The relevant section of the Listing Rules can be found at: http://fsahandbook.info/FSA/html/handbook/LR/9/8. We have limited our recommendation to FTSE 350 companies in line with the scope of our inquiry. It is at the discretion of the FRC as to whether the obligation should extend to all companies with a Premium Listing.

[1284] Although the scope of the audit cannot be reduced below the minimum required by the FRC's Scope of an audit of financial statements of a private sector entities arising from the requirements of ISAs (UK & Ireland) and International Standards on Auditing.

[1285] The UK Corporate Governance Code is applied by all companies with a Premium Listing (for a definition of 'Premium Listing'—see http://fsahandbook.info/FSA/html/handbook/LR/9/8). We have limited our recommendation to FTSE 350 companies in line with the scope of our inquiry. It is at the discretion of the FRC as to whether the obligation should extend to all companies with a Premium Listing.

team has concluded a review on the audit of the company's financial statements in the reporting period, (ii) what the principal findings were, including grade, and (iii) how both the AC and auditor are responding to these findings.

Remedy 7

19.10 We recommend that the FRC amends the objects clause in its articles of association so that, without prejudice to its other objects, in performing its functions it will have due regard to the need for competition in the statutory audit market for FTSE 350 companies.

19.11 In our judgement this package represents as comprehensive solution as is reasonable and practicable to the AEC in the market for the provision of statutory audit services to large companies in the UK and resulting detrimental effect on customers that we found.