STATUTORY AUDIT SERVICES MARKET INVESTIGATION

DELOITTE LLP INITIAL SUBMISSION TO THE COMPETITION COMMISSION

INTRODUCTION

In its reference decision, the Office of Fair Trading (OFT) stated that it believed it is important that the market for the provision of statutory audit to large companies in the UK is "*competitive and delivers efficient outcomes in terms of price, quality and innovation*". We agree with this statement. However, unlike the OFT, we believe that this market is operating in a very competitive way, and is delivering these outcomes for the benefit of the customers.

The investors and audit committees of these companies require their auditors to be able to provide a consistent level of support in all of the territories across the globe in which they (the companies) operate and delivered at a consistent high quality. They expect their auditors to be innovative and to add real value to their businesses as part of the audit deliverable. They expect their auditors to understand the complexities of the industries in which they (the companies) operate. They assume that the auditors will have expert knowledge and understanding of the business and accounting issues which they face. They expect their auditors to field highly skilled and trained engagement teams. They demand value for money. Audit committees are also expert and challenging buyers of professional services, including audits, and are readily able to discern quality and to evaluate the merits of an audit offering. Investors are able to exercise their views of the auditor's service through attendance at Annual General Meetings ('AGM') and their decision to re-appoint the audit firm each year.

These requirements and expectations are not easy to meet. Audits are complex and highly technical professional services. They are also risky, not least because of the current auditor liability regime in the UK, which is effectively unlimited liability. A number of firms have recognised these requirements and expectations and, over many years have made, and continue to make, the necessary investments to enable them to build-up and maintain the capabilities needed to meet these requirements and expectations. Deloitte is one of those firms. Without these capabilities an audit firm could not provide the level of service large companies demand nor could they effectively mitigate the risk to which the audit would expose them.

Through our sustained and determined investment strategies, Deloitte has seen a substantial increase in our presence in this audit market. In 1995 we held only 5 FTSE 100 audits, a far smaller share than any of the current members of the Big 4. As a result of the success of our strategy we now audit 22 of the FTSE 100 (of which only two were FTSE 100 clients in 1995). We gained 6 FTSE 100 audits as a result of the Andersen transaction in 2002 (of which 5 are current members of the FTSE 100), but the majority of our FTSE 100 audit market share growth has been organic.

In our experience, this audit market is very competitive. Companies are able to apply competitive pressures whether the audit appointment is subject to a tender process or the annual renewal negotiation, in either case leading to competitive pricing of statutory audits in this market. We believe that the customers themselves, that is the FTSE 350 investors and audit committees, consider that their demands for a quality service at a price which represents value for money are being met.

We recognise that events in the financial markets over the past few years have raised the question as to whether the current audit model, and the contents of audited financial statements, meets the expectations and requirements of the broader market and, indeed, whether across the profession the quality of auditing that companies require has been delivered. We welcome measures that strengthen audit quality across the profession and we believe that it is right that governance and regulatory requirements, professional standards and best practice that influence audit quality are subject to ongoing scrutiny. A culture of challenging current governance and regulatory arrangements to ensure that they are working well and delivering good outcomes helps to ensure that quality can be maintained and increased. We continue actively to engage in projects to encourage such scrutiny across the industry and develop better methods of working. However, these issues are quite different from the extent of competition in the market for the audit of large companies in the UK where it does not seem evident to us that intervention is merited. We would have concerns with respect to any measures purporting to increase competition where these threatened audit quality.

Parameters of the Commission's Investigation

The market, which is the subject of the Competition Commission's ('the Commission') investigation, is the audit of large companies in the UK, which the OFT has approximated to the FTSE 350. To assist the Commission, we have set out in Section 1 below some background information on this audit market and Deloitte's position within that market as well as on our firm more generally.

The professional service which is the subject of the Commission's investigation is the statutory audit. A statutory audit is not a commodity: it is a complex professional service requiring considerable investment in order to deliver a quality product, tailored to each company's business model and industry. We believe that it is important for the Commission to understand the scale and complexity involved in auditing a FTSE 350 company, an overview of which is set out in Section 2 below.

The OFT's reference decision identifies a number of features of the market which it considers may be preventing, restricting or distorting competition. Deloitte's experience in the auditing market for the largest companies leads to the conclusion that the OFT's concerns about such features are unwarranted. In Section 3 below we explain the capabilities demanded by clients of a FTSE 350 audit firm today, and in Section 4 we go on to show that the features identified by the OFT are direct functions of client demands for the delivery of quality audit services, which is the fundamental driver of competition in the audit market. Rather than being detrimental to customers, such features provide directly for customer benefits and arise specifically in response to client needs and demands.

The OFT has stated that there are low levels of switching which are indicative of an uncompetitive market, and that the lack of competition is reflected in customers not benefitting from competitive pricing. We are confident that the evidence will show that the current market structure is delivering high quality audit in a way that is efficient, effective and competitive, as explained further in Section 4 below.

As requested by the Commission, at this stage we have only provided our initial comments and a summary of our views as to the nature of the 'issues' which the Commission may wish to examine. We anticipate that in due course the Commission will seek our more detailed views, explanations and supporting evidence, and we look forward to assisting the Commission further in its investigation.

SECTION 1: DELOITTE AND ITS POSITION IN THE AUDIT MARKET

Background to Deloitte's business

Deloitte is one of the largest professional services firms in the UK, with approximately 13,000 partners and employees, operating out of offices in 23 cities and towns across the UK and Channel Islands, as well as in five locations in Switzerland. Deloitte is the UK member firm of Deloitte Touche Tohmatsu Limited (DTTL)[1], which is the network organisation for Deloitte globally, with a presence in over 140 countries and more than 160,000 people.

Although the firm's heritage is in auditing, it is now a very broad professional services firm, with activities spanning audit and accounting, corporate finance, tax and consulting. In the year ended 31 May 2011 Deloitte's revenues were £2,098m, an increase of 7% from the previous year, split across four service lines, as follows:

- Audit: £652m (31%)
- Tax: £534m (25%)
- Consulting: £517m (25%)
- Corporate Finance: £395m (19%)

The Audit service line encompasses accounting-related advisory services, enterprise risk services (including internal audit), risk and regulatory services, as well as statutory audit and audit related services. Furthermore, some statutory audit work is carried out in our other service lines. In the year ended 31 May 2011, the Deloitte's total revenue for statutory audit and audit related activities was about £510m (including amounts earned by other DTTL network firms on UK group audits). Of this £510m, about £137m was for statutory audit services to FTSE 350 companies. As is evident, the bulk of our audit revenue comes from clients outside of the FTSE 350.

Deloitte is one of the "Big 4" professional services firms which account for the majority of audits of large companies in the UK. The Big 4 have evolved through organic growth and mergers since 1987, when eight firms – the "Big 8" – occupied the position of the Big 4 today. No firms from outside the Big 4 or their antecedents have significant experience of auditing large companies in the UK.

[1] Deloitte Touche Tohmatsu Limited ("DTTL") is a UK private company limited by guarantee. Each member firm provides services in a particular geographic area and is subject to the laws and professional regulations of the particular country or countries in which it operates. DTTL does not itself provide services to clients. DTTL and each DTTL member firm are separate and distinct legal entities

The Big Four (in the UK) and their Antecedent Firms

The Big 8 in 1987	*The Big 4 today*
Coopers & Lybrand	PricewaterhouseCoopers
Price Waterhouse	
Deloitte, Haskins & Sells[2]	
Arthur Young	Ernst & Young
Ernst & Whinney	
Peat Marwick Mitchell	KPMG
Touche Ross[3]	Deloitte
Arthur Andersen[4]	

Deloitte's strategy for building presence in the market for large company audits

We have had (and continue to have) a deliberate focus and strategy to build on our position in the large company statutory audit market. In 1995 we held only 5 FTSE 100 audits, a far smaller share than any of the current members of the Big 4. As a result of the success of our strategy we now audit 22 of the FTSE 100 (of which only two were FTSE 100 clients in 1995). We gained 6 FTSE 100 audits as a result of the Andersen transaction in 2002 (of which 5 are current members of the FTSE 100), but the majority of our FTSE 100 audit market share growth has been organic.

Building a strong position in the large company statutory audit market requires investment across a number of dimensions:

- We, together with the other DTTL member firms, have invested considerable amounts in our international network. Through our membership of DTTL, we are able to work with other Deloitte member firms around the world, all of whom use aligned audit process and technology, have high quality standards and attract highly skilled people;
- We invest considerably in our audit technology platform;
- We invest significantly in hiring and developing the best people. Deloitte recruited 3,300 people in the year ended 31 May 2011, including more than 1,100 of the very best graduates. In the same year, we invested a considerable sum in learning and development

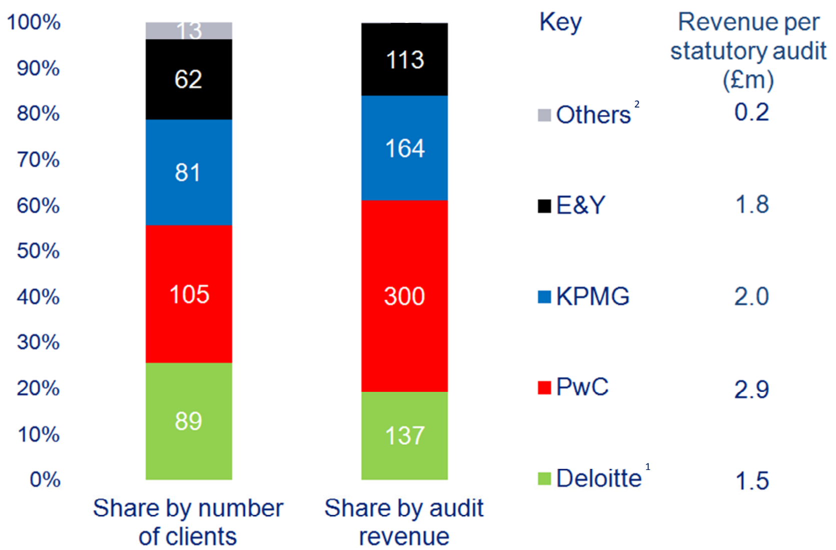
[2] Outside the UK, Deloitte, Haskins & Sells merged with Touche Ross but within the UK it merged with Coopers & Lybrand. Touche Ross later adopted the Deloitte name in the UK.
[3] Spicer & Oppenheim (at the time the ninth largest firm) merged with Touche Ross (at the time the sixth largest firm) in 1990.
[4] The assets of Arthur Andersen were acquired by a variety of different firms globally, but by Deloitte in the UK.

and received an award from The Sunday Times Best Companies judges for the scope and range of our training. In 2010 approximately 620 Deloitte practitioners gained chartered accountancy qualifications;

- We are committed to innovation: in May 2010 we launched a ten year partnership with the London Business School to create the Deloitte Institute of Innovation and Entrepreneurship, and we have created our own innovation centre;
- We invest significantly in solutions to deliver audit quality, as described later in this paper and set out in more detail in our audit transparency report held at http://annualreport.deloitte.co.uk/audit-transparency-2011/AT-report-2011.pdf.

The market for large company statutory audits

An indicative share of FTSE 350 audits by audit firm is shown below, showing approximate number of companies and global revenue (£M), based on latest available annual reports (these numbers are indicative only, due to companies moving in and out of the FTSE 350 and possibly subsequent changes in auditors. For example, Deloitte now audits 85 of the current FTSE 350 companies).



Source: Mint.

Note: there are four companies in the FTSE350 for which statutory audit fees to their auditor are not reported and this is information is not disclosed in their annual reports. Accordingly, the above graph does not include data for these companies when calculating audit revenue shares.

[1] Three of the 67 FTSE 250 companies audits by Deloitte are performed by another Deloitte member firm outside Deloitte UK.
[2] Share of audit revenue by Others is £2m (not shown).

Deloitte has the second largest audit market share by number of FTSE 350 clients, and the third largest by statutory audit revenue. Overall, Deloitte's average statutory audit revenue from FTSE 350 clients is significantly smaller than that of other Big 4 firms. There is not necessarily a direct correlation between market capitalisation and audit fee. As will be clear from each of the sections below, audit fee levels are related to range of factors relating to business model, the international footprint of the business, and the complexity of the business concerned.

Not all of the statutory audit revenues assigned to Deloitte in companies' annual reports accrue to the Deloitte UK firm. When we audit a company's operations overseas, the local Deloitte member firm earns the revenue associated with the activities it carries out for the company. This is particularly evident in the UK, where many of the largest listed companies have limited operations in the UK (e.g. many mining companies). On average, for our FTSE 350 audit clients, the Deloitte UK member firm earns about half of the revenues assigned to the DTTL network in the companies' annual reports.

The age of Big 4 firms' audit relationships

The OFT has commented about the age of the Big 4's statutory audit client relationships. Some of the statistics presented about auditor switching rates are skewed by a small number of audits that have been retained by the audit firm for many decades. These companies are not typical of most large companies.

Of the current FTSE 100, 16 companies have existed in their current form for less than ten years, and a further 16 have changed auditors in the last ten years. In addition, 4 (that we are aware of) have tendered but retained their auditors and 5 chose to switch from Andersen to Deloitte at the time of the Deloitte-Andersen transaction (this was not an automatic switch but resulted from a presentation of our audit proposition to each client).

Looking more broadly at the FTSE 350, of those companies that currently use a Big 4 audit firm, about 40% have been with their audit firm for 10 years or less. More specifically, for Deloitte, 41 of our current FTSE 350 statutory audit clients (48%) have been clients for 10 years or less. Our analysis shows that about 33% of PwC's audit relationships are less than 10 years old, for KPMG about 38% and for EY about 44%.

It is also worth emphasising that, no matter how long an audit relationship has lasted, an appointment is only ever made for one year – to continue as auditors the firm must be reappointed by the company's shareholders at the AGM each year.

The extent to which non-audit services are sold to audit clients

In recent years, the extent to which non-audit services have been sold to FTSE 350 audit clients has declined significantly. Before Sarbanes Oxley in 2002, audit firms earned about 60% of their revenue from their FTSE 350 audit clients from the provision of non-audit services, with about 40% being earned from the statutory audit (and related services). Since Sarbox, and save for a spike in 2005 caused by the introduction of International Financial Reporting Standards ('IFRS'), the percentage of fees earned from non-audit services has fallen steadily. We estimate that across the FTSE 350, the auditors will now be earning about 60% of their revenue from the statutory audit (and related services), and about 40% from non-audit services. This is in line with our experience. We expect the trend to continue.

Whilst our revenue for statutory audit services (and related services) for all our audit clients was about £510m, our revenue for non-audit services to those audit clients was about £185m. We believe that there may be a perception that audit firms earn lucrative consulting projects off the back of their audit relationships, but this is not our experience.

SECTION 2: THE AUDIT PROCESS

Introduction

Audit is not a commodity: it is a complex service requiring considerable investment in order to deliver a quality product, tailored to each company's business model and industry. As such, we believe that it is important for the Commission to understand the scale and complexity involved in auditing a FTSE 350 company, and the sophistication of the audit technologies and methodologies that we have developed to address these issues and to enable us to meet our clients' demands for a quality audit.

In addition to the core audit team and technical specialists within the audit service line, we expect to involve people from across the firm and outside of the audit service line, with different disciplines, such as actuaries and pension specialists, tax practitioners, technology specialists and so on. The number of man-hours spent will be measured in the thousands. Hundreds, if not thousands, of audit documents will be generated.

Timeframes are often very tight: for example, the largest companies with US listings are expected to publish audited consolidated group accounts within 60 days of year end.

Where the client has international operations (which is the case for the large majority of FTSE 350 companies today), there will be a substantial degree of interaction with the international subsidiaries' auditors (usually other DTTL member firms) in accordance with auditing standards. There will also be a huge degree of interaction with the client's management and employees – indeed, our audit teams will be on-site at most of the client's premises for a large part of the audit process.

We identify below a number of issues concerning the audit process for a FTSE 350 client. Rather than set out in detail what is actually involved in an audit of a FTSE 350 company, we would welcome the opportunity to walk the Commission through a FTSE 350 audit, perhaps (with the appropriate client consents) utilising an existing recent audit as a case study.

The auditor's duty

Save for owner managed businesses, shareholders do not usually participate in the day to day management of a company. Shareholders are, however, the body with ultimate stewardship of the company and in exercising those rights of stewardship, they are reliant upon the financial information which is made available to them by the company's management. However, they need a degree of confidence that the financial statements prepared by management are reliable. This is the purpose of the independent audit.

The auditor carries out an audit of the financial statements (to a specific level of materiality which is agreed in advance with the audit committee) and reports to the shareholders as to whether they show a true and fair view of the company's financial position as at a certain historic date, thereby giving the required degree of independent assurance to the shareholders.

In the leading case of Caparo v. Dickman in 1990[5], the House of Lords was required to consider the nature of the statutory auditor's duty. They decided that the auditor's duty is to the body of shareholders as a whole. That decision remains the leading authority on to whom an auditor owes a duty of care.

This is well understood by the market, as demonstrated by comments made by the Association of British Insurers in its submission to the recent House of Lords Economic Affairs Committee investigation into auditors:

> *"We consider the all-encompassing role of the auditor to be to reach a judgment that the accounts of the audited entity give a true and fair view in accordance with the requirements embodied in the Companies Act 2006. In carrying out this task, which will likely require substantial engagement with both company management and non-executive directors through the audit committee the auditor will have performed an important role within the governance framework, providing shareholders with the assurance that the financial information provided by the company will allow them to exercise their ownership responsibilities effectively."*

The need for independence

We have invested in best-in-class systems to enable us to maintain our independence and avoid conflicts of interest in client assignments. We monitor all staff (manager level and above) and partners' personal investments to ensure that we safeguard the independence and objectivity of Deloitte, our partners and our engagement teams. Our firm has a dedicated Ethics, Independence and Compliance Partner, as well as a large team of professionals to support our people with their compliance obligations. The Compliance, Independence and Ethics Partner works with the firm's leadership to set the strategy and priorities for ethics and compliance, and has operational responsibility for our compliance, independence and ethics programmes.

Our policies set out clearly that audit partners and staff are not and must not be evaluated or remunerated by reference to the selling of non-audit services to their audit clients. The Executive and Board have huge regard to this requirement in determining the level of reward for audit partners and staff.

Independence considerations play an important part in the market for audit services and the decision (normally) to appoint a single network to supply audit services to the whole group. If a material component of a group (for example, an overseas subsidiary), were to appoint a member of another accounting network as auditors, both networks would be restricted in their ability to

[5] Caparo Industries plc v Dickman & others [1990] 2 AC 605

perform non-audit services elsewhere in the group. This means that a decision to appoint more than one firm reduces competition and choice for non-audit services.

Dealing with these requirements and principles, in multiple jurisdictions and, in Deloitte's case, many thousands of complicated client groups and practitioners, is challenging and demanding, as discussed in further detail in Section 3 below.

The appointment process

Responsibility for auditor appointment

Under company law and regulation, the statutory responsibility for the appointment and remuneration of the auditor to FTSE 350 companies rests with the shareholders. The shareholders appoint the auditor, usually at the AGM, at which the previous year's financial statements are laid. The auditor will, generally, serve from the end of that meeting to the end of the next meeting. The directors have a big part to play, however, in that they propose a resolution for the (re)appointment of the auditor and such resolutions almost always authorise the directors to set the auditor's remuneration on the shareholders' behalf. The directors can also appoint an auditor in the event of a casual vacancy caused by the predecessor auditor's resignation to serve for the remainder of the year.

For FTSE 350 companies, there will be an audit committee appointed to look after the auditor relationship on behalf of the wider board and investors. Rule 7.1.3 in the FSA's Disclosure and Transparency Rules (DTR), which derives from the EU Statutory Audit Directive, states that:

> *"An issuer must ensure that, as a minimum, the relevant body must: ...*
>
> *(3) monitor the statutory audit of the annual and consolidated accounts;*
>
> *(4) review and monitor the independence of the statutory auditor, and in particular the provision of additional services to the issuer."*

Furthermore, DTR 7.1.1 requires that at least one member of such body be independent and at least one member must have competence in accounting and/or auditing. This has a critical bearing on the expertise of those who directly purchase audit services. As explained further below, these are expert buyers, who are well able to discern audit quality and to ensure that they are obtaining value for money.

The UK Corporate Governance Code ('the Code') goes further. Companies must either comply with the Code or explain the reasons why they have not done so. The Code requires the appointment of an audit committee comprised of at least three (or, outside the FTSE 350, two) independent non-executive directors, and that they should have terms of reference which include a requirement:

> *"to make recommendations to the board, for it to put to the shareholders for their approval in general meeting, in relation to the appointment, re-appointment and removal of the external auditor and to approve the remuneration and terms of engagement of the external auditor"*

Whilst the Chief Financial Officer ('CFO') has an important part to play, and must be able to have a working relationship with the auditor, ultimately the audit committee, which under the Code, comprises independent non-executives, is responsible for recommending to the board (and, therefore, to investors) the appointment of the auditor. This means that the audit committee acts as a strong check and balance on the appointment of the auditor as someone who will act in the shareholders' interests.

Expert buyers of audit services

The direct purchaser of audit services in the FTSE 350 is the audit committee of the company concerned (generally assisted by the CFO). These committees are made up of expert buyers (many of whom will sit on multiple FTSE 350 audit committees and have experience of all Big 4 firms). Audit committee members expect detailed interaction with the audit provider and are well able to discern both audit quality and the value proposition being offered. The indirect purchaser is the investor, who has the ability to vote for or against the reappointment of the incumbent auditor every year at the AGM.

The process for the appointment of auditors set out above means that the primary "buyers" of audit services – i.e. the audit committee, aided by the CFO – are expert purchasers, who are well able to discern audit quality and obtain value for money. Given this and our other comments below, we disagree with the OFT's statement that *"it may be difficult for Finance Directors and audit committees to distinguish between different suppliers in terms of their technical quality"*.

There is extensive information in the public domain to assist in the informed exercise of this function. In particular, the Audit Inspection Unit ('AIU') produces public reports which set out in detail the results of their inspections of individual firms that audit public interest entities, both large and small. The public reports with respect to Deloitte are included in our "Off the Shelf" response to the Commission.

Listed company audit committees should include at least one individual with experience and expertise in accountancy and/or audit, and in our experience as a group are expert in understanding the complexities of the audit service and are well able to challenge the auditor on its conclusions, methodologies and robustness of the audit opinion.

The OFT appears to imply that these senior and experienced people are, in a sense, blinded by "reputation", as if this was divorced from the actual quality of audit delivered. We firmly believe that Deloitte's reputation derives specifically from our continued investment in and delivery of high quality audit. We do not believe that people as experienced and expert as members of audit committees of FTSE 350 companies are swayed by some concept of "reputation" that does not relate to the actual delivery of high quality audit.

Audit committee members are also expert procurers of audit services. They are experienced and senior businessmen and women; they understand how to negotiate and ensure that they are getting a good deal; they understand how to test the value they are getting. The non-executive directors that sit on audit committees often sit on the boards of other companies, and as a result have often had exposure to multiple tender processes and multiple audit firms. We do not believe that they knowingly choose an approach that they are not confident generates optimal value for their shareholders in terms of price and quality. Indeed, customers explicitly told the OFT that they considered that the price performance of auditors was good: the Hundred Group of Finance Directors told the OFT that there was a "*high level of competition demonstrated during an audit tender process…in terms of fees paid*" and that "*audit firms know that we have a choice and that very often, is all you need to keep their pricing and the quality of their service honest*".

Moreover, they have the benefit of extensive transparency of audit fees paid by other companies, because of disclosure obligations, and so can use this as a further point of leverage in insisting on best value.

Disclosure with respect to audit appointment

The primary source of transparency of the auditor appointment is the annual report. By law, the identity of the auditor (and, since 2008, the audit partner) is disclosed in the audit report and the notes to the financial statements set out the fees paid to the auditor for audit and non-audit services. Guidance for Audit Committees, published by the Financial Reporting Council ('FRC'), recommends that audit committees go further in explaining their role. In our recent survey of corporate reporting, Gems and Jetsam[6], we looked at audit committee reporting by reviewing the reports of a random selection of 100 companies (a third in the FTSE 350, a third midtier and a third smallcap).

% of companies describing the audit committees role in:	Total	FTSE 350	Midtier	Smallest
Independence of auditors	69	82	73	52
Approval of, and monitoring of, non-audit services	79	94	82	58
Oversight of external audit	67	88	76	35
Effectiveness of internal audit	63	94	58	35

Note: Lack of disclosure does not mean that the audit committee did not perform this role; simply that they were not transparent as to what they did do.

These auditor appointment disclosure requirements have been in place for a number of years; more recently, in 2008, the FRC recommended that audit committees explain their auditor selection decision and subsequently 33% of all companies did so (up from 27% in the previous year), including 56% of FTSE 350 companies (41% last year).

In our submission to the House of Lords enquiry, we suggested that such disclosures should be made mandatory.

[6] Available here:
http://www.deloitte.com/view/en_GB/uk/services/audit/9531b48367b13310VgnVCM1000001a56f00aRCRD.htm

The audit engagement

The audit of a public interest entity in the UK is a demanding and challenging exercise for even the largest clients and their auditors. The accounting, corporate governance, disclosure and auditing standards are prescriptive and complex. Combined with the diversity and scale of the larger listed companies, there is a clear need for investment in specialism by discipline, industry sector, market and even geography.

As noted in the introduction to this Section, 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 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 scope of their 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 simply the finance function) and will need to understand and challenge the business model and risks with a high degree of expertise. This is not something to be undertaken lightly, and drives great value and insight for the entity itself. Auditors summarise their findings and recommendations to audit committees, and are – rightly – challenged to deliver value in doing so. The recommendations of the auditor provide a different external, and challenging, perspective to the audit committee and management, and in turn drive enhanced shareholder value as well as confidence.

We recognise that there is considerable value to our clients and to our wider stakeholders in providing clear and unambiguous reports of high quality in the context of applicable laws and regulations. Our communications with audit committees and boards of directors cover the scope of our audit, our consideration of any threats to our independence or objectivity, our risk assessment and the judgements made, issues arising during the audit, how decisions have been reached, as well as providing commentary around more qualitative aspects of financial reporting and management of clients' businesses, whilst always exercising an appropriate level of professional scepticism.

The audit report

The audit report itself is a regulatory and legal requirement, both in nature and form. However, it is by no means a straightforward proposition to draft and deliver. Whilst the wording is, to some degree, prescribed by auditing standards, there is a considerable amount of judgement and expertise in determining precisely which format of report should be used. The audit report is not, as many characterise it, a simply binary health check. The report can be modified for a variety of reasons, each of which requires careful consideration and, typically, extensive consultation with technical experts. For example, the assessment of the company's disclosures and conclusions in relation to going concern can be extremely complex, and are themselves the subject of specific guidance issued by the FRC. The report can be modified on the grounds of limitation of scope (not enough information provided to the auditor), disagreement with management (for example, on accounting treatment), the need to draw attention to particular matters (emphasis of matter) or may even be formally qualified.

Beyond the complexities of simply drafting the report, there are then other regulatory factors to consider. The audit partner is required to sign the audit report in his or her own name; not only is their appointment publicly visible, but their full name and the conclusions they have reached are disclosed publicly in the accounts.

Further, if the audit partner “knowingly or recklessly” signs an audit report that is misleading, then they commit an offence under the Companies Act 2006, as well as facing personal regulatory consequences (including disciplinary proceedings, exclusion from their professional body and financial penalty).

Audit related services

The statutory auditor’s core responsibility is to undertake the audit and to report to the shareholders as a body in accordance with the applicable law. Companies will, however, have an array of other needs which the client may request the auditor to provide.

The knowledge and insight gained from undertaking the audit, and the independence that is required to do so, combine to leave the auditor uniquely qualified to perform certain incremental roles in particular.

Regulators have, particularly in very recent times, sought support from auditors when discharging their responsibilities. For this reason, auditors are required to provide reports on, for example, the audited entity’s compliance with the requirements of the Financial Securities & Markets Act, consumer protection (e.g. ABTA and the CAA) as well as legal regulation. There is a wide range of similar assurance-based reporting which third parties require of companies and their auditors, for example, reporting on loan covenant compliance to financing parties, numerous public sector grant returns, and so on.

Audit committees are alert to these synergies and the rigour of the auditor’s challenge; accordingly they will often identify the auditor as best placed to provide challenge or assurance in relation to future transactions (whether as reporting accountant or due diligence provider).

There are comprehensive and prescriptive rules in place to ensure that auditors to not provide services to audit clients which compromise their independence. Audit committees and audit firms must consider and identify any potential threats, and then ensure they are fully safeguarded. If they are not, then the service cannot be provided.

SECTION 3: CAPABILITIES REQUIRED OF A FTSE 350 AUDITOR

The need for audit quality

The defining feature of the supply of audit to FTSE 350 companies is the demand of those companies, and their investors, for a high quality product. Deloitte's investment in quality is a direct result of the demands of both clients and our regulatory framework, and our belief that we can differentiate ourselves in their eyes as a result of the quality of our offering.

That demand arises as a function of the role of audit. The Institute of Chartered Accountants in England and Wales ('ICAEW') defines this as follows:

> *"The purpose of audit is to provide an independent opinion to the shareholders on the truth and fairness of the financial statements, whether they have been properly prepared in accordance with the Companies Act, and to report by exception to the shareholders on the other requirements of company law such as where, in the auditors' opinion, proper accounting records have not been kept. Directors are delegated responsibility for managing the affairs of the undertaking and the audit is an important mechanism that helps owners of companies assess the stewardship of directors, and in so doing provide an important stimulus for directors to place a proper emphasis on their fiduciary responsibility."*[7]

It is thus unsurprising that multiple studies and reviews, including those by the Select Committee on Economic Affairs, have underlined the centrality of audit quality, and the importance of ensuring that it is supported.

Auditor capabilities required by FTSE 350 companies

There are a number of capabilities that our FTSE 350 clients and potential FTSE 350 clients (and their investors and stakeholders) have told us that they require in their auditors. Our significant investment in developing these capabilities has been entirely responsive to this client demand. We were therefore surprised by the OFT's suggestion that such capabilities are barriers to entry. On the contrary, such capabilities make up the intrinsic skill set that is required to operate and compete in this market and to deliver the high quality and innovative audit service that clients demand. They are capabilities in which a firm with the requisite drive and vision must invest in order to participate. In summary, we believe that these capabilities include the following:

1. Highly skilled and professional partners and staff with specific industry experience, coupled with a substantial investment in developing and maintaining skills in those people
2. Comprehensive conflicts and independence systems and controls
3. Creation, management and evolution of sophisticated, innovative and flexible audit technologies and methodologies
4. Access to dedicated technical expertise
5. Challenging and robust quality review processes

[7] ICAEW, *Audit Quality – Fundamentals – Audit Purpose*, published June 2006.

6. An integrated quality, risk management and compliance framework
7. A demonstrable track record of delivering quality and acting with integrity and objectivity
8. Ability to devote adequate resources at required times
9. Access to an international network
10. Full client service offerings across a broad range of disciplines
11. Appropriate levels of risk financing, with access to sufficient levels of capital and professional indemnity insurance

Over many years, Deloitte has focussed on developing, maintaining and enhancing these capabilities. The journey has been a very long one, and the investment and commitment required has been both considerable and relentless. However, it is only as a consequence of following this strategy that we have been able to establish Deloitte as a major participant in the FTSE 350 audit market. It is a direct consequence of following that strategy that our presence in the market has grown to its current level of 22 of the FTSE 100 and 85 of the FTSE 350 audits.

We briefly describe below the way in which Deloitte has sought to accumulate these capabilities.

1 Highly skilled and professional partners and staff with specific industry experience, coupled with a substantial investment in developing and maintaining skills in those people

Talent Agenda

We invest significantly in hiring and developing the best people. Deloitte recruited 3,300 people in the year ended 31 May 2011, including more than 1,100 of the very best graduates. We invested a considerable sum in learning and development and received an award from The Sunday Times Best Companies judges for the scope and range of our training. In 2010 approximately 620 Deloitte practitioners gained chartered accountancy qualifications

Deloitte's audit partners and teams have years of relevant industry experience. Many also contribute actively to the audit industry's regulatory, legislative, governance and professional agenda. This allows us to make a valuable contribution to the environment within which our business operates, and to the development and understanding of technical accounting, auditing and industry standards, reflecting the needs of our clients and other market participants and enabling us to provide relevant advice and insight to our clients. Members of our specialist and technical expert teams have, for example, served as members of the CBI Companies Committee, the UK Accounting Standards Board, European Financial Regulatory Advisory Group, Urgent Issues Task Force, the international committee of the Auditing Practices Board, and the ICAEW Investigations Committee, Presidency of the ICAEW, chairmanship of the Financial Reporting Faculty and Ethics Standards Committee of the ICAEW, Consultative Committee of the Accountancy Bodies Ethics Group and of the stakeholder panel considering assurance aspects of the Stewardship Code for institutional investors.

Partner-led approach

Audit engagement partners remain fully responsible for the services they provide and for understanding their clients' businesses. Their involvement is required from the very outset of any client relationship and engagement, with partner-led audit planning key to our audit approach.

Our audit business is structured into specialist industry groups, led by senior partners with great depth of experience and expertise. These groups collaborate in order to share their understanding of market developments, risk assessments and emerging trends. This is particularly important at times of market turbulence and change. Our partners and people are continuously building their understanding of their clients' businesses and the industries in which they operate, helping us to better conduct our audits in a way most beneficial to all stakeholders.

All partners who act as the audit engagement partner for a statutory audit have to apply for, and be granted, 'Responsible Individual' status by the ICAEW (or other relevant regulatory body) under audit regulations. This is a personal status, for which the individual must provide supporting evidence and which can be withdrawn.

Professional scepticism

We are continually addressing the challenges of demonstrating enhanced professional scepticism as part of our commitment to maintaining and improving the quality of our audit work. We have done this through a combination of ongoing initiatives, including guidance, innovative audit techniques, benchmarking and analytics. We have also focused on behaviour and culture, and the sharing of knowledge to ensure our people have an appropriately challenging attitude in the approach to audit work. The key message remains for our audit professionals to challenge and look for what could be wrong or treated differently, and then to document that challenge fully.

Learning programmes

Our approach to continuing professional development is based around targeted learning programmes, including regular audit and industry specific training that keeps our people at the forefront of new developments and regulations, enabling them to deliver high quality audit services and adding valuable and up-to-date insight for our clients.

Over and above a comprehensive mandatory audit learning and development syllabus for our staff, we run monthly technical briefings and updates, which are available online for download. In addition, the firm provides mandatory annual accounting and auditing technical training, as well as specific learning modules where new developments require additional understanding.

Our online anti-money laundering, anti-bribery, information security and independence and ethics learning programmes are undertaken by everyone in the firm, using examples to translate independence and ethical questions into practical actions. A more focused

‘Personal Independence’ online learning programme is completed by all of our client-facing people of manager grade and above.

People development

Individual appraisals set considerable store by feedback provided on specific engagements. Our increasing use of web-enabled technology to capture 360 degree feedback from peers as well as team members and partners allows us to obtain a rounded view of individuals’ performance and development needs. The evaluation of our people for promotion involves a detailed scrutiny of their personal performance, by reference to our wide-ranging competency model, which includes competencies relating to quality, technical ability, service excellence, marketing and communication skills, management effectiveness and leadership effectiveness.

All of our people are required to complete annual returns regarding their fit and proper status and personal independence.

We are confident that these actions, led by our partners, create an environment where achieving high quality is valued, invested in and rewarded and that our appraisal and reward systems for partners and our people promote the characteristics essential to quality auditing.

2 Comprehensive conflicts and independence systems and controls

Dealing with conflicts and independence requirements and principles, in multiple jurisdictions and for, in Deloitte’s case, many thousands of complicated client groups and practitioners, is challenging and demanding. There are different, and complex, rules for clients with US listings (SEC rules), those with UK listings (the APB’s ethical standards) and generally (APB and ICAEW guidance), as well as international standards (IESBA) and standards across each of the other jurisdictions globally. The rules consider the personal independence of individual audit team members and the independence of the audit partner and the independence of the firm. There are complex prohibitions and limitations on the nature of services that can be provided, and by whom.

These complexities, and the rigorous monitoring to which conflicts and independence requirements are subject (both internally and externally), drive the need for audit firms to invest in comprehensive systems and in expert staff to support and advise. At Deloitte we have developed an expert capability in this area within a team in our central Practice Protection Group (‘PPG’) (which is independent from the audit service line). The partners report to the Managing Partner, Public Policy, Quality and Risk (who is a member of the firm’s Executive). The team also works closely with equivalent teams within other DTTL member firms, and has access and have been a key contributor to the development of the DTTL network’s global conflicts systems and databases.

Our engagement take-on, continuance, compliance, audit appointment and client database systems are all internally developed and comprise robust, sophisticated solutions to the complexity of regulatory requirements; the tools are designed to be intuitive to use whilst facilitating timely compliance, reporting and monitoring.

3 Creation, management and evolution of sophisticated, innovative and flexible audit technologies and methodologies

Our audit process and methodology encourage professional scepticism and a robust challenge. Our audit technology and tools, AuditSystem/2 (AS/2), provide a comprehensive framework for the planning, performance, documentation and review of our work in accordance with auditing standards and applicable professional, regulatory and legal obligations.

AS/2 has a particular focus on gaining a deep understanding of our clients’ businesses and key transaction flows. AS/2 includes DTTL’s Audit Approach Manual (AAM), common documentation and enabling software technology. The AAM is the methodology DTTL member firms apply in providing professional services relating to the audit of financial statements. The AAM provides the flexibility to serve the unique circumstances and complexities of our clients. This audit approach goes beyond testing controls, transactions and balances, to providing insights to directors and audit committees.

The way in which AS/2 has been developed allows us promptly to introduce considered changes and enhancements to methodology and documentation. This has enabled us to continue to roll out new requirements in rapid response to the current regulatory and economic climate, and related challenges to the markets and to our clients. Given the huge volume of audit, accounting, legal and regulatory material generated annually, we consider the flexibility of our supporting technology to be a great benefit to our clients, wider stakeholders and our people. We invest considerably in building and developing our audit technology platform.

4 Access to dedicated technical expertise

International accounting and auditing standards are increasingly stringent and complex. To assist our audit teams, outside of the engagement team itself, our people have ready access to our dedicated technical advisory team, being our National Accounting and Audit group (NAA), which provides expert and strong technical support on accounting, auditing and regulatory matters as they affect our audit clients and the audit work itself. In NAA we have a large team of people dedicated to supporting UK auditing and accounting matters, IFRS and our audit methodology. NAA develops and maintains numerous publications and databases to support quality and adherence to relevant requirements.

Expertise is also available from DTTL and other member firms; our audit policies and methodology are developed and implemented globally to help deliver consistency and quality within the international network. For example, we leverage the experience of specialist colleagues in the United States, Japan and China to provide support to teams undertaking audits in those regulatory environments.

In addition, the Audit Quality and Risk Management (AQRM) function works with a team of client-serving professionals who are fully integrated and embedded within our audit business' groups, offices and industry teams. This team, known as our audit "Quality Leaders", provide first-line support to our engagement partners and teams, whilst also gathering feedback and questions for AQRM and promulgating key messages within their parts of the business.

Further, the teams will be augmented by specialist colleagues from the relevant parts of the firm; these may include actuarial professionals, valuations specialists, tax experts, industry and geography leaders, financial instruments specialists, and other technical and subject matter expert colleagues.

5 Challenging and robust quality review processes

Our audit methodology is built on the principle that consultation and review is a strength, both at the individual and firm level. Audit work will be planned and scoped in advance, with the partner leading that process. As the audit is conducted, the partner remains close to the progress made and judgements exercised. Work is subject to review progressively up the chain of command within the audit team, with the partner closely reviewing key considerations and conclusions, and keeping the client apprised throughout.

For every FTSE 350 audit, in addition to the engagement partner or partners (on many audits there will be a number of audit partners with responsibility for different aspects of the audit), the engagement team will also include an engagement quality assurance review partner (EQAR). The EQAR role provides a second partner review, consultation and client service support.

Separately, and as required by auditing standards, for every FTSE 350 audit there will also be an independent review partner (IRP). The IRP acts as an independent third partner review, including an objective evaluation of the significant judgements made and conclusions reached. The IRP is not part of the client-facing team and is, therefore, able to bring a further independent viewpoint and challenge to the audit process.

All audits are subject to a "hot" review by our dedicated Professional Standards Review team (PSR), before the audit report is signed. We consider PSR to be a particularly strong feature of our firm's quality control procedures. The PSR team, reporting to AQRM, is operationally independent of the business units and audit engagements they are reviewing. PSR supports our high standards of professional scepticism and audit quality by providing a further independent challenge.

6 A quality and risk management framework

Our quality and risk management framework brings a rigorous approach across all of our service offerings in areas such as client and engagement acceptance, partner portfolio reviews, ongoing engagement risk mitigation and risk assessment of existing and proposed service offerings. The framework's primary purpose is to underpin our commitment to quality, integrity and ethical behaviour consistently throughout our business, whilst establishing that the responsibility for quality sits with those who interact directly with our clients.

Our audit practitioners are supported by a dedicated and full time AQRM team, led by a senior audit partner reporting jointly to the Managing Partner, Audit as well as to the Managing Partner, Public Policy, Quality and Risk.

The partner in charge of AQRM is supported by another partner, and together they lead a group of experienced audit practitioners in providing support to the audit practice. The team feeds into the development of quality control processes and learning materials, with a particular focus on embedding quality and risk management skills, values and knowledge in all of our audit practitioners. The AQRM team has responsibility for the firm's liaison with the audit regulators' monitoring teams throughout their extensive visits; we believe it is essential that responsibility for this activity is independent from the audit teams conducting the audit work potentially under review. The AQRM partner is also a member of the Audit Executive and contributes actively to the firm's strategic and commercial direction. This influence allows quality and risk management considerations to be addressed as an integrated part of our business strategy.

In addition, out audit practitioners are supported by PPG, which is our central compliance and risk management group. PPG provides the necessary support to enable our audit practitioners to make the right decisions in terms of client and engagement acceptance, and to assist in the assessment and management of risk and other complex issues.

7 A demonstrable track record of delivering quality and acting with integrity and objectivity

We believe that Deloitte has an exceptionally strong reputation in the market for delivering high quality bespoke services, competitively priced, adding real value to our clients and helping them grow and prosper. We also believe that Deloitte has a reputation for acting with the utmost integrity, and with complete objectivity. This is a reputation which has been earned over many years; it is a reputation which we guard most carefully and never take for granted. We accept that our reputation positions us well in the market, and we would hope and expect that it will enable us to retain audit appointments and win audit tenders.

However, "reputation" should not be considered as an unwarranted and unearned spin-off that Deloitte benefits from simply as a result of our size. Audit services are, to a degree, experience products for which the actual quality may only be able to be fully discerned in retrospect. History shows that the implications of audit failure can be dramatic, and failings in audit quality can lead to the demise of long-established, market-leading operators. Reputation therefore has to be constantly affirmed and earned. It is indicative of a market that is functioning well, rather than one which is suffering from barriers to entry.

AIU reporting on audit quality

The AIU is responsible for monitoring the audits of all listed and other public interest entities. The AIU currently inspects the Big 4, including Deloitte, as well as other firms, annually and reports publicly on individual firms. Our experience suggests that market participants place considerable emphasis on the AIU's reports when assessing audit firms and the public nature of the reporting acts as a very real incentive for audit firms to improve audit quality. The AIU published a report on the finding of its 2010/2011 inspection of Deloitte on 26 July 2011. The AIU's report identified our commitment to high quality audit work.

Challenges to our audit opinions

There are very few instances where our work or conduct is investigated by regulators, or where claims have been made or threatened. We are proud of our reputation and the fact such investigations are rare.

Client service assessments

We independently test and assess our performance and promote accountability at the highest level through our Client Service Assessment and Client Care relationship review programme. The latest results continue to show a high level of satisfaction among our stakeholders, and also reinforce that the trust placed in us cannot be taken for granted.

8 Ability to devote adequate resources

As will be apparent, to undertake an audit of a FTSE 350 audit requires the devotion of substantial resources, in particular human resources. The audit team will be sizeable, and for much of the time many of the team will be required to work exclusively on a particular audit, and often away at client sites both in the UK and overseas. Whilst the year-end process will be the most intensive, the other reporting processes that are required throughout the year (for example, the interim reviews) will also occupy much of the team's capacity at the relevant time. The audit firm has to be able to devote the necessary resources at each reporting cycle without impacting upon its ability to deliver quality audits to other clients. A failure to do so would impact adversely on audit quality. This necessarily leads to a certain capacity being required for any firm operating in the FTSE 350 market.

9 Access to an international network

In order to respond to the needs of a complex and cross border marketplace, and to deliver audit services to global clients to the quality demanded, Deloitte and other major auditors have sought to develop integrated networks of auditors in different countries in order to ensure that consistent levels of judgement can be applied across all elements required in auditing major international companies. With a workforce of some 160,000 professionals globally, the international network of DTTL delivers services to clients in 140 countries. The development of quality control through building integrated networks has proved essential in providing the requisite quality to clients and in ensuring that resources can be allocated across the network.

As the OFT has recognised, larger companies tend to be more geographically diverse and more complex; as with other markets, companies tend to look to a single network to appoint as auditors worldwide rather than having to run separate procurement exercises in each location. The nature of complex organisations is also different. With many services, it is possible to carve out a specific part of the service and appoint a specialist supplier. For an audit, the group auditor is solely responsible for the audit opinion on the group, and must therefore be satisfied about the work done and judgements made by everyone else who has participated in a part of the audit.

10 Full client service offerings across a broad range of disciplines

A diverse range of service offerings is important to the delivery of audit quality especially within the FTSE 350 market. This is primarily because of the need to bring in expertise from other disciplines in the firm to assist in the audit, as referenced in point 4 above (access to technical expertise).

The range of skills in a full service, multi-disciplinary firm also enhances the appeal of the firm itself to high quality staff, attracted by the potential varied career opportunities which will be open to them. Many of our partners and staff outside of the audit service line will have had an earlier grounding in audit. The skills that they developed whilst working in an audit practice are of immense value in their (non-audit) fields of practice. We firmly believe that this helps contribute to the provision by them of high quality and valuable (non-audit) services to their clients. This has real and substantial benefits not only to FTSE 350 companies, but to the market as a whole.

11 Risk Financing

The current audit liability regime effectively exposes auditors to unlimited liability. If an audit client is a FTSE 350 company, and it fails, the exposure faced by the auditor could be significant. Any firm operating in the FTSE 350 audit market therefore needs to ensure that it has appropriate levels of risk financing in place. Further, the ICAEW (and the other Institutes) requires that firms have adequate professional indemnity insurance in place to cover the significant risks to which they are exposed.

SECTION 4: COMPETITION AND QUALITY IN THE FTSE 350 AUDIT MARKET

Introduction

The OFT's reference decision identifies a number of features of the market which it considers may be preventing, restricting or distorting competition. Deloitte's experience in the auditing market for the largest companies leads to the conclusion that the OFT's concerns about such features are unwarranted. On the contrary, as summarised below, the significant majority of the features identified by the OFT are direct functions of client demands for audit quality - the fundamental driver of competition in the audit market. Rather than leading to customer detriments, such features provide directly for customer benefits and arise specifically in response to client needs and demands. We are confident that the evidence will show that the current market structure is delivering high quality audit in a way that is efficient, effective and competitive.

The features identified by the OFT are necessary functions of audit quality

The purchasers of audit services are well-placed to discern the technical quality of audits

The OFT claims that there is little incentive for companies to switch auditor. The OFT also notes that the technical quality of an audit is difficult to discern, and as a result, it may be difficult for CFOs and audit committees to distinguish between different suppliers in terms of their audit quality.

We do not agree with the OFT's conclusions for the following reasons. First, as discussed in detail at Section 2 above, the primary purchasers of audit services, namely audit committees and CFOs, are expert buyers of audit services and are particularly well-placed to discern audit quality and obtain value for money. To suggest that such sophisticated and experienced market participants are unable to discern differences in audit quality is not credible. Second, not only is the quality of a supplier's previous work discernable to the client from its own previous experience but, as discussed in detail at Section 3 above, objective information (including AIU reports) is readily available in the market to assist audit purchasers in discerning audit quality. The AIU reports, in particular, provide an authoritative benchmark demonstrating significant quality differentials between audit providers.

Switching costs and low levels of switching are not an indicator of limited competition

The OFT points to the fact that it can be costly for clients to switch auditor as a feature of the market which may prevent competition. We disagree with the OFT's assessment. Whilst switching costs affect how competition operates in a market, they do not *necessarily* make markets less competitive. Switching costs in the audit market are a necessary correlate of the fact that audit is not a commodity: there will necessarily be some learning costs for a new auditor and the audited entity if the new auditor is to deliver a high quality service. Any other approach would imperil audit quality.

We also disagree with the OFT's assessment that the low levels of switching observed in the audit market are indicative of there being limited competition in the market. The highly sophisticated individuals responsible for procuring audit services on behalf of their companies have the means and incentives to exert pressure on incumbent audit services suppliers to ensure that competitive pressures are not artificially constrained to the customers that switch suppliers. There are credible alternative suppliers to choose from: the threat or potential for switching is therefore real.

The fact that audit prices are transparent across the market through disclosure in the annual reports allows companies to observe the level of audit costs incurred by comparable companies and changes in those costs (including those that switch). Such transparency enables audit committees to exert continuous quality and pricing pressure on their auditors. The credibility of a threat to switch is reflected in the response of the Hundred Group of Finance Directors to the OFT's consultation, which stated that:

> "*Audit firms know that we have a choice and that very often is all you need to keep their pricing and the quality of their service honest.*"

To the extent that clients elect to retain their current auditors, it is we believe directly related to the high quality of service provided by such auditors over time; and the potential for the experience accumulated on the previous audit to add value to the clients going forward.

Size and reputation are direct functions of audit quality

The OFT states that companies focus on existing size and reputation, which according to the OFT's assessment imposes a barrier to entry on non-Big 4 auditors. However, size is only relevant to customers insofar as it is an aspect of audit quality for large and/or multinational firms. Large companies demand auditors who can cope with the scope (geographically and technically) of their business. The size of an auditing firm is therefore a function of the needs of its clients.

We note that the OFT peculiarly focuses on 'perceptions', as if customers were somehow blinded by reputation as if this was divorced from the actual quality of audits delivered: as we have noted in Section 2 above, this is implausible in the context of the expertise and sophistication of the purchasers of audit services and the importance of high quality audits to companies. Audit committees and CFOs make their choices of auditor rationally on the basis of genuine indicators of quality. Reputations are won (or indeed lost) on the basis of the quality of the audits provided. Deloitte's reputation for providing a high quality of service is not an unearned and unwarranted by-product of its size, but is as a direct result of the significant and ongoing investments in quality that it makes. These investments are a central element of Deloitte's competitive proposition.

Moreover, it is important to appreciate that reputation is only relevant insofar as it is an indicator of quality over time. Reputation can be very easily lost in the audit market. It should be abundantly clear from the investments in quality that Deloitte has made and continues to make that it is not "coasting" or "resting on its laurels": its reputation can be ensured only through continued investment in quality.

The attributes possessed by auditors auditing large companies are a direct function of client demands for audit quality

The OFT states that it is a feature of the audit market that large audit firms possess certain attributes for auditing large companies including, *inter alia*: access to an extensive, integrated network; greater experience of handling large and complex businesses; relevant sector experience; enhanced familiarity with the latest developments in complex regulatory standards; and the ability to recruit higher quality staff as attributes necessary for auditing large companies. Many of these attributes were addressed in detail in our summary at Section 3 above of the capabilities which we believe are required of a firm before it can deliver high quality audits of FTSE 350 companies. The OFT claims that such attributes may constitute barriers to entry. However, as seems self-evident from the OFT's characterisation of this feature, these attributes merely reflect aspects of the market that are a direct function of client demands for audit quality and efficiency. Not all firms possess these attributes as not all firms have made the investment necessary to develop them.

For example, it is clear that the existence of a network is very important for large (generally more international) companies – such companies need consistent audit standards across their business. The provision of such a network is directly responsive to client needs and expectations of quality. We note that a number of non-Big 4 auditors also participate in networks. Further, experience of performing complex audits is likewise critical to audit quality. Importantly, such experience increases the efficiency with which large audits can be undertaken, thereby operating to the benefit, rather than the detriment, of consumers.

The Big 4 firms make significant investments in thought leadership

To the extent that there is, as the OFT puts it, a 'perception' that the Big 4 are better placed than mid-tier firms to provide information on the latest developments in international accounting standards, it is founded on the significant investment that such audit firms make in thought leadership. A failure to recognise the importance of latest developments would clearly be detrimental to audit quality. In order to secure its reputation for providing high quality audits and to differentiate itself from its competitors, Deloitte invests a considerable amount of resources in establishing itself as an expert in the field of international accounting standards. Our thought leadership in this area plays a key role in raising the standard of audit quality across the audit market. Furthermore, it is always open to other firms to make a similar investment.

The recruitment and retention of high calibre staff is directly linked to quality

The OFT also cites the ability for the Big 4 to recruit higher calibre staff as a possible barrier to entry. Again, the recruitment and retention of high quality staff is a necessary correlate of providing high quality audits. Investment in staff is a major cost for large audit firms. Deloitte's recruitment offering is based not just on remuneration, or reputation, but, critically, on training in which Deloitte invests significant resources each year. Recruiting and retaining high calibre staff has a direct impact on our ability to deliver high quality audit.

Conclusions on features of the market

In summary, the majority of the features of the market identified by the OFT as ostensible barriers to switching are direct indicators of audit quality which provide for significant customer benefits, not customer detriments. These benefits experienced by customers provide strong evidence that the audit market is operating effectively. Few (if any) barriers to the expansion of smaller audit firms are identified by the OFT, and the purported barriers to switching could be addressed by a firm that was willing to invest in the capabilities necessary to deliver high quality audits of large companies. Deloitte's own growth story as described in Section 1 above evidences this well.

The OFT's observations about the difficulties of raising capital for expansion of small audit firms are without foundation. The partnership structure of audit firms is probably more conducive to long-term investment than a listed company structure (where there is more pressure for short term returns). Partners (whether audit or non-audit) will be willing to invest to support a good business case to build the large company audit practice. Such investment will be reflected in the value of their partnership share – it is simply not correct to say that older partners will not receive a return on their investment.

This is well-evidenced by the growth of other professional services firms in certain areas of their practices (e.g. geographic expansion), which has required investment from partners whose business is not directly affected by that expansion or who are 'older', but who nonetheless have supported good business cases for capital investment. The only other barrier to expansion identified by the OFT is bank covenants obliging the use of a Big 4 auditor. Whilst the prevalence of these clauses today is uncertain, Deloitte would in any event support their removal.

The dataset relied upon and the robustness of the OFT's analysis raise concerns

The Oxera analysis and its conclusions are questionable

The OFT has paid particular attention to a study by Oxera (2006) in considering whether there is a positive relationship between market concentration and the level of audit fees. It has itself sought to update the Oxera analysis to test whether the market for audit fees is competitive.

In its review of the Oxera study, the OFT suggests that there is some evidence to support the hypothesis that auditors with larger market shares exhibit greater market power and that an increase in the concentration in the provision of audit services is associated with an increase in audit fees. This evidence was based on the estimates of an econometric model using financial data for UK-registered companies over the period 1995-2004 and subsequently updated by the OFT, to examine the period 2001-2010.

In our view, the data upon which Oxera and the OFT rely is unreliable, and the findings flawed. In due course we will provide the Commission with a detailed technical paper explaining our view. However, the principle reasons for our view may be summarised as follows:

- we have identified numerous errors in the data used by Oxera and the OFT;

- the econometric methods used to estimate the effects of market share and market concentration are unreliable;
- the empirical specification cannot be derived from profit maximising behaviour; and
- there is significant measurement error in the data which could bias the results.

Once the model is set up in a way that avoids the pitfalls suffered by the Oxera and OFT analysis, the relationships that the OFT relied on to support a conclusion that fee rates are too high – namely that audit fees are positively related to market concentration and supplier share –falls away. We believe that it will become clear that the main element of evidence on which the OFT relies to argue that ineffective competition has led to prices that are too high does not withstand scrutiny.

Exogenous factors have not been taken into account in the OFT's analysis

We also have concerns about the extent to which the analysis carried out by the OFT has taken exogenous factors into account. Without consideration of these factors, any conclusions about audit pricing and switching may be misleading.

In practice the drivers of audit fees are numerous, complex and often highly company specific. There is a great deal of variability in the level of audit fees from year to year across the FTSE 350, and also for individual companies at different points in time. This leads to both increases and decreases in the audit fee charged year on year. Factors leading to fluctuations in the audit fee include: changes to the structure of the company such as mergers, acquisitions or disposals; and changes in the regulatory environment, such as increased or reduced reporting requirements or changes in the applicable financial reporting standards. Our own experience shows material variations in audit fees agreed from one year to the next for these and numerous other reasons, with intense and challenging negotiations with the clients taking place.

We are confident that the evidence will show that there is strong competition between the Big 4 in the FTSE 350 statutory audit market, reflected in competitive pricing of statutory audit services, and the delivery of efficient outcomes in terms of price, quality and innovation.

CONCLUSION

We are grateful for the opportunity to provide our initial thoughts to the Commission on the issues that we think will be most relevant to its investigation. We trust that the information provided in this submission will assist the Commission in understanding the provision of audit services to large companies in the UK and in framing its Issues Statement. As noted above, we would be very happy to walk the Commission through a FTSE 350 audit process.

We know that the Commission will also be interested to hear the views of our clients and those of other audit providers. We urge the Commission to seek their views on the attributes that they consider necessary for the delivery of audit services which are of an appropriate quality and which are suitable for businesses of their size, complexity and international scale. As highly sophisticated consumers of audit services, our clients are well-placed to inform the debate on the issues relevant to the investigation. As discussed in detail above, we believe that the large majority of the "features of the market" identified by the OFT have arisen in direct response to customer demands and needs and are unavoidable correlates of the delivery of audit quality.

As noted above, we are supportive of measures that will increase audit quality, and we play a very full role in forums which seek to promote it. We are aware every day that the work we do is complex and, indeed, risky: a quality failure could lead to serious consequences for a client and for its auditor.

We are firmly of the view that any changes to the audit market must not be to the detriment of audit quality and should not harm the UK's critical growth prospects, competitive advantages as a business location and centre for capital market activity. We urge the Commission to consider the importance of ensuring the continued competitiveness of the UK in this respect.

We would be happy to discuss any of the matters raised in this submission with the Commission at any time and look forward to working with the Commission.