KPMG response to Competition Commission Provisional Findings in the supply of statutory audit services market inquiry

22 March 2013

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KPMG response to Competition Commission Provisional Findings in the supply of statutory audit services market inquiry

Executive Summary

1 KPMG believes that the Competition Commission’s (CC) Provisional Findings in the supply of statutory audit services market inquiry (the “Provisional Findings”) should not be confirmed. The evidentiary basis for the Provisional Findings is unsound and the CC’s provisional conclusions contain material internal inconsistencies such that a finding of an AEC cannot, on the balance of probabilities, be supported.

Outcomes

2 On choice and concentration, the CC notes that a choice among four audit firms may suffice\(^1\) and indeed notes that efficient tendering may require no more than three or four bids for competition to be strong\(^2\). These observations undermine the suggestion that there is a lack of choice. The CC also overlooks evidence which suggests that competition for FTSE 350 engagements is already fierce. This also has the effect of undermining the CC’s first theory of harm in that it appears that companies do have sufficient choice in the current market.

3 On pricing, the CC admits that it can find no evidence of excess profits\(^3\) and that there are various potentially benign explanations for the patterns of pricing it observes\(^4\). When it considers variable engagement profitability the CC admits it has not tested whether complexity and/ or risk may explain the differences\(^5\), and further applies different and selective standards across the economic analysis it considers. Further, the fact that the CC’s own evidence finds that engagement profitability plateaus in the third year suggests that audit firms are responsive to competitive dynamics in the market and compete vigorously on price as well as on quality. Such downward pressure on engagement profitability would not be present if the CC’s views on the status of competition in the market were accurate. Consequently there is insufficient

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\(^1\) Paragraphs 9.23 and 9.56 of the Provisional Findings.

\(^2\) Paragraph 9.56 of the Provisional Findings.

\(^3\) Paragraph 7.70 of the Provisional Findings.

\(^4\) Paragraphs 7.36, 7.44 and 7.53 of the Provisional Findings.

\(^5\) Paragraphs 7.38 and 7.51 of the Provisional Findings.
basis in the evidence on these key points for the CC to conclude, to the requisite level, that there is an AEC.

4 On quality, the CC concedes that the case study evidence is generally positive\(^6\); indeed, it was so sure that FDs and ACCs would report satisfaction with their current auditors that it decided not to ask them\(^7\). It is true that there are “perceptions” that quality may at times be sub-optimal, but when tested these “widespread concerns” seem to come almost entirely from the results of a limited number of AQRT inspections. We categorically reject that concerns are “widespread” or indicate material issues in the level of quality in section 2.6 of our response and outline in detail the evidence to the contrary. Further, we note that the extensive evidence available on audit quality undermines the CC’s first theory of harm in that the barriers to switching do not appear to be particularly high in circumstances where companies have sufficient information to judge audit quality both within and outside of a tender process.

5 The AQRT has commented that “too many” audits needed improvement. There are two points relevant of context in this regard. First, the AQRT is concerned with audits both within and outside the reference market; only the former are relevant and yet in AQRT terms quality levels are demonstrably higher in the reference markets\(^4\). This undermines the notion that high concentration is associated with lower quality. Indeed, the highest quality is observed in the case of the largest and most complex companies, even though these companies pose the greatest challenge to an auditor. Second, given the ex-post nature of the AQRT review and the nature of their regulatory focus it is likely to be the case that even a small number of imperfect audits would be “too many”. The fact is that audits of increasingly large and complex organisations are themselves complex. They involve many difficult judgements and different professionals may not always agree in exactly how those are exercised. Perfection, especially as assessed by one party (the AQRT) in the light of ex post review of documented evidence, is therefore hard to achieve. Errors can and do happen and whilst further efforts can always be made to reduce them they cannot be entirely eliminated.

\(^{6}\) Paragraph 7.99 of the Provisional Findings.
\(^{7}\) Paragraph 7.97 of the Provisional Findings.
\(^{8}\) AIU Annual Report 2011/12, 13 June 2012, page 8.
In terms of competition, the important features of this market are: (i) the importance of reputation for quality to the competitive position of any audit firm, which the CC acknowledges\(^9\); and (ii) the scale of the activity that the audit firms put into quality control, which the CC also acknowledges\(^10\). In light of this the CC has no reasonable basis for ascribing the relatively rare lapses in quality to a lack of competition; indeed, the low number of audits said to require improvement after extensive ex post review is indicative of a generally high quality rather than the opposite. The AQRT indeed make this point in their annual report\(^11\).

On independence, the CC’s approach seems to rely on two characterisations. First, the CC makes much of the Financial Reporting Council (“FRC”) and US Public Company Accounting Oversight Board (“PCAOB”) references to losses of scepticism\(^12\). It seems to us that the CC is close to equating every judgement that ex post the FRC would second-guess as a lack of professional scepticism in a concession to management, and every such concession as a loss of independence. These concepts are distinct and should be treated as such in the absence of compelling evidence to the contrary. In our view, many audit judgement calls are difficult and finely balanced; there is room for professional disagreement here without opprobrium. Our systems are generally regarded as sound and well suited to protect our independence\(^13\). We believe the cases cited by the CC stem from such issues of judgement and do not reflect any alignment with management, as opposed to shareholder, interests. Consequently, the evidence the CC has proffered to say that such errors are due to a lack of professional scepticism is inadequate and further the CC has proffered no evidence to indicate that this in turn is due to a loss of independence.

Second the CC refers to the nature of the audit firm’s relationship with management being too consensual, given the statutory audit firm’s statutory powers\(^14\). This fails to recognise that the production of financial statements for large companies is a complex subjective process often involving many assumptions and judgements. An audit is a contemporaneous review of that process (and outcomes) which may well not be

\(^9\) Paragraph 9.211 of the Provisional Findings.
\(^10\) Paragraph 11.83 of the Provisional Findings.
\(^12\) See, for example, paragraphs 7.140, 7.142 and 7.143 of the Provisional Findings.
\(^13\) AIU Public Report on the 2011/12 Inspection of KPMG LLP and KPMG Audit Plc.
\(^14\) Paragraph 7.147 of the Provisional Findings
completely documented at the time. It is not an ex post inspection designed to establish a narrow range of objective facts which in itself may take many months to complete. There is therefore a fundamental need for a degree of cooperation as well as challenge in the process that is entirely consistent with there being effective competition allied to independence and scepticism. Indeed if this relationship breaks down an audit may become impossible – a fact we have recognised on occasion when we have taken the decision to resign from the appointment, or threatened to resign without improvements in corporate governance.

The CC itself considers that the quality of audit includes the quality of internal reporting to senior management and that in turn is best served by a reasonable balance of cooperation and scepticism. The inconsistencies in the CC’s arguments on auditor independence also have the effect of undermining its second theory of harm, in that there is much evidence to suggest that auditors are protective of their independence and would not misalign their interests with those of management at the expense of shareholders as the damage to their reputation would be so great.

On innovation, the CC’s views are inconsistent with the facts. The audit process and form of reporting is itself highly regulated. There is a public interest case for audits to be conducted to a consistently high standard and for audit reports to be prepared on a comparable basis as the CC recognises. The scope for innovation is not therefore open ended. Not to recognise as competitive innovation the substantial effort that has gone into innovating in the process of audit or its delivery and to making them efficient is perverse. These improvements have enhanced quality – both absolutely and in the level of quality achieved at reducing real cost. Again, given that the CC recognises the relevance of the quality of internal reporting to senior management it is perverse not to recognise that innovation in that element of the product has been significant and is a reflection of a high degree of competition.

Finally, on unmet demand there are a number of criticisms that mean the CC’s Provisional Findings with regard to this issue cannot stand and are inconsistent with

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15 Paragraph 6.12 of the Provisional Findings.
16 Paragraph 39 of Appendix 17 of the Provisional Findings.
17 Paragraph 39 of Appendix 17 of the Provisional Findings.
18 Paragraphs 5.37 and 7.156 of the Provisional Findings.
19 Paragraph 6.12 of the Provisional Findings.
the available evidence. The FRC states that consensus of what shareholders demand is difficult to discern\(^{20}\). At the same time, as noted above, there is both demand and a public interest in a reasonably comparable and consistent process of reporting. We would not therefore expect inconsistent demands from some shareholders which are expressed in general terms unspecific to a particular company to be met by competitive market forces.

Further, the CC has not clearly articulated whether that demand is for information about the audit (which is within the remit of the audit firms) or about the company itself. Company information is rightly controlled by management which, while observing (ever increasing) legislative requirements, need to balance such demand with protecting the company’s commercial position, which is also in the interests of shareholders. This latter aspect is really a matter of governance between shareholders and management, not of audit or competition.

In spite of the above constraints we, and other firms, are constantly engaging with investor groups, regulators and companies (ACs, boards and management) trying to develop a better model of audit (both in scope and reporting). In areas this may go further than management may feel is desirable. We would not be doing so if we were constrained by management to the extent hypothesised by the CC.

It follows that the CC has seriously overstated the “outcomes” and in fact it would appear that in many cases the CC’s Provisional Findings are inconsistent with the available evidence. As outlined above, choice, pricing, profitability and quality all suggest that the reference market is competitive. Moreover, the CC has failed to establish to the requisite standard that any issues that have arisen in the areas of quality, independence and unmet demand arise from their relationship with competition. The CC’s analysis of unmet demand is flawed and fails to take into account relevant factors. In other words, to the extent there are imperfect outcomes, they are due to matters other than the state of competition.

\(^{20}\) Paragraph 11.124 of the Provisional Findings.
The CC’s Theories of Harm

The CC’s Provisional Findings on its first theory of harm are that:

■ There are barriers to switching in that there are difficulties for companies in comparing competing offerings outside a tender process and in judging audit quality in advance more generally (13.3 (a) (i) and (ii)) and switching may lead to a loss of efficiency and increased risk in quality (ibid, (iii)); and there are significant opportunity costs for management in selecting and educating a new auditor (13.3 (b)). These features give rise to an AEC by weakening a company’s bargaining power outside of a tender process.

■ Mid-tier firms face experience and reputational barriers to selection (13.3 (c)) and that this feature gives rise to an AEC as companies have a more restricted choice of auditor than would otherwise be the case.

We submit that these Provisional Findings are seriously flawed.

The analysis that underpins the Provisional Findings at 13.3 (a) is the analysis of the framework for bargaining power. Importantly the CC concludes that the largest four audit firms have strong incentives to compete for engagements and that generally a company can expect “strong competition” on a tender, with the majority of the FTSE350 likely to ask “at least three of the Big 4” to bid. The CC therefore appears to conclude that there are alternative suppliers available and that competition can be “strong” within today’s market structure.

The CC also provisionally finds that companies had structures and people with the skills and experience to appraise the incumbent. The CC provisionally concluded there were obstacles to companies being able to appraise competitors’ offers, at least in the absence of a tender. We submit that the CC’s reasoning on this point and the relevance of a tender to a company’s bargaining position is not supported by its own evidence. In particular the prevalence of multiple directorships by ACCs and the role of NAS in enabling companies to get a feel for the quality of other firms (whether with or without a tender) undermine the CC’s Provisional Findings here. To the extent fees are difficult to judge in advance this seems to be inevitable given that many audits (whether on a switch or by an incumbent) raise issues of evolving scope of work (as

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21 Paragraph 9.7 and following of the Provisional Findings
22 Paragraph 9.56 of the Provisional Findings
23 Paragraph 9.23 of the Provisional Findings
the CC appears to recognise\textsuperscript{24}). It is perverse for the CC to conclude that something is an adverse feature of competition when, given that the CC says that audit is in part an experience good the scope of which changes after appointment, it is inherent in the nature of the product itself (in other words, any model of competition has to take these aspects into account). We submit that it is clear from the CC’s own investigation that the broader experience of FDs and ACs and the role of NASs (plus companies’ use of benchmarking) are entirely consistent with a competitive market for such a product. The CC’s own analysis therefore undermines the idea that review during a tender can be more effective on these two areas than review without a tender.

We therefore submit that the PFs at 13.3(a) (i) and (ii) are fundamentally flawed.

So far as concerns the Provisional Findings at 13.3(a) (ii), this seems to rest on the prior finding or assumption that a switch will lead to a loss of efficiency and a risk of poorer audit quality on a switch. This, we submit, is a fundamental point. Efficiency, quality and risk are very important. The CC is here acknowledging the advantages to the client of the investment made by the audit firm in the audit relationship. As the CC knows, we regard these as reflective of, and benefits from, the competitive process rather than as barriers to entry. The plateauing of prices after approximately year three of a relationship found by the CC suggests that incumbent audit firms do not exploit this position but are required to maintain engagements in a competitive state in the knowledge that a company can and will switch if the balance of price and quality is not met to the client’s satisfaction. That is entirely consistent with a competitive market. The CC has failed to afford this alternative explanation of the status quo proper consideration. Indeed the CC’s finding\textsuperscript{25} that the largest four audit firms will all have the incentive to target and win all potential clients in the FTSE350 and that any competition can or will be “strong”\textsuperscript{26} means that the incumbent can itself have no certainty that relationships will endure if it departs from the competitive level of service, quality and price.

\textsuperscript{24} Paragraph 9.179 of the Provisional Findings

\textsuperscript{25} Paragraph 9.56 of the Provisional Findings

\textsuperscript{26} 9.56, CC’s Provisional findings into the supply of statutory audit services to large companies
In any event, the CC’s own evidence also shows that the opportunity cost is not necessarily significant. The CC notes that “the responses of some suggest that there was no significant increase in internal costs whilst for others the experience of tendering and switching was disruptive and costly in terms of the opportunity cost of management time”. We therefore submit that the Provisional Findings at 13.3 (a) (iii) are flawed. We also note that the CC recognises that some companies are able to exercise buyer power in the absence of tenders which begs the question whether all other companies have this power but its exercise is latent. The CC has failed to explore this and, given the flaws in its analysis of engagement profitability, the CC has no reasonable basis for assuming this buyer power is not manifested more widely.

So far as concerns the CC’s observations about the position of mid-tier firms, our first point is that the CC clearly concludes that “strong competition” can occur between market participants as matters stand today when tenders are held. Further, companies are able to judge audit quality outside of a tender event and hence also assess the abilities of the mid-tier audit firms. On both these grounds, we see no justification for the CC’s provisional conclusion that reputation and experience are barriers to entry that make a material difference. If mid-tier audit firms can be part of a process that amounts to strong competition today, we cannot see how the CC can conclude that their reputation and experience is a barrier to entry that contributes to an AEC.

In any event, we submit that the relative position of the mid-tier firms is the result of a competitive process within the sector. Those firms have not invested to the same extent as the largest four audit firms and they have not targeted their competitive effort in order to compete at all levels of the supply of statutory audit. The CC notes this, and yet fails to recognise that the failings of individual competitors cannot be barriers to entry.

Turning now to the second theory of harm, again we believe the Provisional Findings are flawed and inconsistent with available evidence outlined above in terms of

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27 The CC states that “there is a general view that companies’ actual experience of switching shows these costs to be surmountable for many companies” (paragraph 9.175 of the Provisional Findings).
28 Paragraph 9.156, CC’s Provisional findings into the supply of statutory audit services to large companies.
29 Paragraph 9.217 of the Provisional Findings.
30 Paragraph 9.56 of the Provisional Findings.
31 Paragraph 10.31 of the Provisional Findings.
independence, quality and unmet demand. We believe that the Provisional Findings are based on a highly selective interpretation of the evidence. We submit that there are few circumstances in which management and shareholder incentives are misaligned and that robust corporate governance processes can and do generally address these. Moreover, the evidence before the CC is clear that the audit firms do behave, and can show that they behave, independently of management. This is particularly the case in those few circumstances where there is any significant misalignment between the objectives of management and shareholders. So far as concerns the specific issue of “unmet demand for further information” whatever concerns may legitimately arise here they are not a function of audit market competition.

25 In particular, it is clear that the AC and non-executive directors of a company (who under the UK corporate governance code (“UKCGC”) are required to be in the majority on FTSE350 boards) are the relevant decision makers for recommending audit appointments to shareholders. That is clear from corporate governance principles. FDs do have an influence but this should not be overstated.

26 Second, it is clear from the CC’s own surveys and case studies that FDs want and expect thorough and independent audits. The scope for a divergence in interests is therefore limited. If the CC is suggesting that it is in times or cases of financial distress that such a divergence may arise it is important for the CC to realise that those circumstances are those in which audit firms are obviously alert to the threats to their reputation from inappropriate judgement calls and, specifically, the potential for liability claims to arise should losses result from an inappropriate judgement. Audit firms’ systems of quality control are specifically designed to deal with these situations. Finally, any incoming audit firm would be highly likely to be sceptical and so there is no reason for the incumbent to feel it has to accommodate management in such circumstances in order to avoid a competitive tender.

27 The CC’s suggestion that ACs are not effective in assessing and ensuring audit quality and independence is not supported by its own evidence: ACs are comprised of high quality individuals; they are empowered and encouraged to call for extra resources.

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32 Paragraph 25(a) of Appendix 11 of the Provisional Findings.
33 Paragraph 9.66 and 9.99 of the Provisional Findings.
when they think it is needed\textsuperscript{34}; they are empowered and encouraged to test and challenge management thoroughly as an integral part of their role and as a matter of good (and therefore expected) governance so this is expected rather than to be avoided; and ACCs have generally confirmed to the CC that they have the resources and ability to carry out their functions\textsuperscript{35}, including the ability to request additional information where needed, which they do when necessary\textsuperscript{36}. The CC’s concerns about the unitary nature of the Board are misplaced as they are required to have a majority of non-executive directors (NEDs); the variation in the level, time and engagement can be explained by the range of complexity involved in different types and sizes of company and differential use of external support.

As to the position of audit firms, first, the professionalism of the accountants involved, and the internal quality controls of the audit firms already provide strong incentives to maintain professional scepticism. Second, even if it were true that a “failing” or lack of scepticism had a limited prospect of being revealed (which we doubt given that these are scrutinised by investors and shareholders, the regulatory review process and the firms’ own more extensive ex post review process, which is in turn also assessed by the AQRT), the consequences of that low risk/high impact event on the position of the individuals or the audit firm concerned, given the centrality of a reputation for competence and integrity mean that individuals and firms have much greater incentives than the CC provisionally finds. The importance of integrity and independence for companies in choosing an audit firm was of the highest ranking in the CC’s surveys\textsuperscript{37}. It would make no sense to risk general market reputation in order to try to retain an individual audit. From our own experience, we understand that companies, as well as audit firms, take AQRT reviews seriously.

Consequently the CC is incorrect about the independence of audit firms from management. So called errors are not automatically caused by losses of scepticism and further any losses of scepticism are certainly not indicative of any such lack of

\textsuperscript{34} Paragraph 9.77 of the Provisional Findings.
\textsuperscript{35} Paragraph 9.86 of the Provisional Findings.
\textsuperscript{36} Discussed further in paragraph 5.3.6.5 below.
\textsuperscript{37} In its first survey, reported in paragraph 25 (a) of Appendix 11 of the Provisional Findings, the CC notes that FTSE350 FDs were more likely to consider the following to be important in assessing the quality of the audit: a high degree of challenge by their auditor; an ability to detect misstatements; and the independence of the audit firm.
independence. The existence of errors or imperfections is not indicative of a failure to compete on the parameters of quality or independence.

30 So far as concerns the specific case of alleged unmet demand for information we refer to our comments at paragraphs 11 and 13 above. We do not believe the issues here stem from a lack of independence or indeed any failure in audit market competition. The CC itself noted that the FRC found consensus among shareholders on this demand was not clear. To allocate responsibility for these issues to audit firms’ relationships with management is not justified.

**Conclusion**

31 The CC recognises that it has encountered difficulties in obtaining certain types of evidence and that “to a greater extent than in many market investigations”, the nature of the evidence base means that clear-cut distinctions between competing explanations for a number of issues were difficult to determine. In these situations, the CC says that it has applied judgement having regard to all the available evidence otherwise.

32 Even if the CC is entitled to take into account of evidence “in the round”, this does not entitle it to place weight on defective evidence, particularly where there is better quality evidence which contradicts it. If the evidence is not clear, then the CC should be very cautious about using, and drawing any conclusions from, such evidence. It is also open to the CC to draw no conclusions where the evidence is not strong enough.

33 We believe that, in coming to its Provisional Findings, the CC has placed undue emphasis on defective evidence, treated certain evidence inconsistently and not exercised proper judgement when weighing up the evidence. In certain instances it has completely ignored relevant evidence. This has led it provisionally, and we believe incorrectly, to find that there is an AEC.

34 As regards the quality of evidence, the CC concedes that it had difficulties in obtaining evidence in relation to auditor independence, measuring the effectiveness of ACs.

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38 Paragraph 2.12 of the Provisional Findings.
39 Paragraph 8.23 of the Provisional Findings.
40 Paragraph 7.125 of the Provisional Findings.
41 Paragraph 11.33 of the Provisional Findings.
and audit profitability\(^{42}\) and pricing. For example, the CC admits that it found “no good evidence” on the profitability of the largest four audit firms and that its choice indicators on pricing are “limited”. This evidence should therefore have been discarded, or at the very least given less weight than other, more reliable evidence. The CC is not entitled to give material weight to this evidence, in the round or otherwise, in coming to its provisional view that the market is not working well in delivering competitive outcomes\(^{43}\).

The CC takes an **inconsistent approach** in its treatment of certain types of evidence. For example, the CC dismisses evidence that indicates that mean audit fees are decreasing over time, because of issues which affect the statistics\(^{44}\). However, it does not dismiss other evidence with exactly the same limitations e.g. changes in median audit fees following a switch. There are also inconsistencies with how the CC treats the same evidence. For example, the CC finds at paragraph 11.98 that ACs are a “powerful force” towards directing audit firms towards satisfying shareholder demand, however just four paragraphs later ACs are described as providing only a “level of support” to audit firms\(^{45}\).

The CC **does not exercise proper judgement** when weighing the available evidence. For example, it considers that the low level of claims against auditors in recent years is not a conclusive indicator of audit quality, but “may” be a function of the UK liability regime. In doing so it CC fails to take proper account of direct evidence of improvements in quality over the same period. Similarly, when assessing the effectiveness of ACs, the CC quotes at length concerns from one un-named investor about audit firm independence\(^{46}\), while completely ignoring evidence from the same survey that no investors want radical changes made to the role of ACs in monitoring auditors.

In conclusion, we have significant concerns about the quality of the evidence before the CC, and the way in which evidence has been weighed in the round, which we believe has incorrectly led the CC – provisionally, yet incorrectly – to find an AEC. We

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\(^{42}\) Paragraph 11.33 of the Provisional Findings.

\(^{43}\) Paragraph 7.94 of the Provisional Findings.

\(^{44}\) Paragraph 7.32 of the Provisional Findings.

\(^{45}\) Paragraph 11.102(c) of the Provisional Findings.

\(^{46}\) Paragraph 11.42 of the Provisional Findings.
therefore urge the CC to re-assess the quality of the evidence upon which it bases its Provisional Findings when coming to its Final Decision.
1 Introduction

1.1.1 This paper sets our response to the CC’s Provisional Findings. In a separate document we set our response to the CC’s Remedies Notice.

1.1.2 The CC provisionally concludes that:

- There are barriers to switching arising out of: the difficulties for companies in comparing competing offerings outside a tender process and in judging audit quality in advance more generally (13.3 (a) (i and ii); and the likelihood that switching will lead to a loss of efficiency and increased risk (ibid, (iii)); significant opportunity costs for management in selecting and educating a new auditor (13.3 (b)). These features give rise to an AEC by weakening a company’s bargaining power outside a tender process.
- Mid-tier firms face experience and reputational barriers to selection (13.3 (c)) and that this feature gives rise to an AEC as companies have a more restricted choice of auditor than would otherwise be the case.
- Misaligned incentives between auditors, shareholders, and company management are a feature of the market that produces an AEC.
- Auditors face barriers to the provision of information that shareholders demand (in particular from the reluctance of company management to permit further disclosure), which is a feature that distorts competition as firms compete on the wrong parameters for auditor appointment and leads to unmet shareholder demand.

1.1.3 The rest of this paper is structured as follows:

- In section 2 we set out our view that the CC’s evidence on outcomes and adverse effects is unreliable. We set out our views in relation to each of the outcomes considered by the CC: market structure and switching; price and margin patterns following a change of audit firm; engagement profitability; profitability of the supply of statutory audit services to FTSE350 audit services in aggregate; quality; independence; choice; innovation; and ‘unmet demand’.
- In section 3 we set out our views in relation to the CC’s provisional conclusion that companies’ bargaining power is weakened outside of tender events and that this is a feature that constitutes an AEC.
- In section 4 we set out our views in relation to the CC’s provisional conclusion that there are barriers to selection faced by audit firms other than the largest four and that this is a feature that constitutes an AEC.
- In section 5 we set out our views in relation to the CC’s provisional conclusion that misaligned incentives between audit firms, shareholders and company management constitute a feature of the market that produces an AEC.
In section 6 we set out our views in relation to the CC’s provisional conclusion that audit firms face barriers to the provision of information that shareholders demand and that this is a feature which distorts competition.
2. The CC has no robust evidence of adverse outcomes in the supply of statutory audit services to large companies

2.1 Our view on the CC’s evidence on outcomes

2.1.1 The CC examines various outcomes of the competitive process in relation to the supply of statutory audit services, namely market structure, switching and tendering rates; prices and profitability; audit quality; choice; innovation; and ‘unmet demand’. The CC provisionally concludes that the indicators it has examined “cumulatively ... add up to show that the market is not working well in terms of delivering outcomes to consumers (in particular, to shareholders)”\(^47\).

2.1.2 In our view that conclusion is incorrect. In particular, we are concerned that in reaching that conclusion the CC has:

- failed to understand key aspects of the audit product, including the way in which financial statements are produced and the role played in practice by FDs, ACs and other non-executive directors;
- relied on quantitative analysis that is not reliable and plagued by inconsistencies;
- drawn conclusions or made suggestions based on no sound methodology or evidence base;
- made unfounded assumptions about the causes of isolated lapses of quality and extrapolated these to draw inappropriate inferences about quality overall;
- placed undue weight on isolated examples without recognising the totality of the evidence base; and, more generally
- drawn conclusions that are not supported by sound economic principles, nor do they appear to be informed by a good understanding of the way competition works in the supply of audit services.

2.1.3 As a result, the CC has not produced sufficient evidence to show that there is any customer detriment arising from any of the features it identifies as part of its AEC finding\(^48\). While CC is entitled to take evidence ‘in the round’\(^49\), this does not entitle it to place any weight on unreliable or weak pieces of evidence. In the rest of this section we set out in more detail our concerns over the CC’s evidence base and analysis, for each of the indicators the CC has examined.

\(^{47}\) Paragraph 7.206 of the Provisional Findings.
\(^{48}\) Section 13 of the Provisional Findings.
\(^{49}\) Which it refers to for example in paragraphs 7.94 and 8.23 of the Provisional Findings.
2.2 Structure, tenure, frequency of tendering and switching

2.2.1 The CC provisionally concludes that the evidence it has gathered in relation to “high and stable levels of concentration, long length of audit tenure, low frequency of switching (particularly the low rates of switching driven by an attempt to gain a better offer), and infrequency of competitive tendering for engagements, may indicate an AEC”\(^{50}\).

2.2.2 However, it is completely incorrect for the CC to characterise these market outcomes as themselves indicative of an AEC. In fact, as we explained in numerous submissions\(^ {51}\), and as the CC has accepted in previous inquiries\(^ {52}\) these market outcomes are not in themselves associated with any direct customer detriment and are entirely consistent with competitive outcomes. The CC has not refuted the evidence and arguments we submitted and has not demonstrated how these outcomes either result from or lead to an AEC. In fact, the CC recognises that there are alternative explanations for such outcomes which are consistent with effective competition\(^ {53}\). As a result, the CC has erred in provisionally concluding that observed rates of switching and concentration may be indicative of an AEC\(^ {54}\).

2.2.3 Instead, it is the competitive process which results in the observed long-term relationships and the market structure. This, as we explained and evidenced in our previous submissions\(^ {55}\), is the outcome of audit firms seeking to satisfy customer demands efficiently and does not imply that competition is not working well, delivering low prices and high quality for customers.

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50 Paragraph 7.24 of the Provisional Findings.
51 Paragraph 274 of our Main Submission in response to the CC’s Issues Statement; paragraph 3.4.4 of our response to the CC’s working paper “Framework for the CC’s analysis and revised theories of harm”; paragraph 1.6 of our response to the CC’s working paper “Nature and strength of competition”; section 2.1 of our response to the CC’s working paper “Characteristics of companies with long audit tenure”; paragraph 3.9 of our final submission to the CC prior to the CC’s Provisional Findings.
52 For example, the London Stock Exchange plc / Deutsche Börse AG and Euronext N.V merger inquiries (paragraph 17 for example).
53 Which it dismisses in relation to its first theory of harm. We set out why the CC is wrong to do that in section 3 below.
54 Paragraph 7.24 of the Provisional Findings.
55 For example, see paragraph 231 of our main submission in response to the CC’s Issues Statement.
2.2.4 We discuss in more detail in the rest of this section our view that the evidence strongly supports there being no consumer detriment resulting from the way competition works in the supply of statutory audit services.

2.3 The effect of switching and tenure on engagement profitability and prices

2.3.1 Introduction

2.3.1.1 The CC concludes that a pattern of lower prices and profitability in the first year of an audit engagement, which increase over the subsequent two to three years, “may indicate an AEC resulting from a feature or a combination of features in the FTSE350 statutory audit market, since it demonstrates the ability of a new firm to increase its prices rapidly”\(^\text{56}\). The CC then considers existing patterns of prices and margins following a change of audit firm, and from these patterns draws conclusions about what prices and margins it may observe in the supply of statutory audit services following an increase in the rate of switching (for example as the result of mandatory rotation).

2.3.1.2 In fact, the CC can draw no AEC conclusion from its observations on pricing and margins in the first years of an engagement and we explain this in section 2.3.2 below. In addition, the CC cannot base a conclusion about prices and margins following an increase in the rate of switching (for example as a result of mandatory rotation) on current patterns of prices and margins. We discuss this further in section 2.3.3 below.

2.3.2 Our views on the CC’s conclusion that patterns of prices and margins ‘may’ indicate an AEC

2.3.2.1 The CC’s analysis leads it to make the following observations\(^\text{57}\) about price and engagement profitability patterns after a switch in audit firm\(^\text{58}\):

- Excluding only Arthur Andersen-related switches\(^\text{59}\) or restricting the analysis to only ‘direct switches’\(^\text{60}\), median audit fees decreased by 17 per cent in real terms in the

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\(^{56}\) Paragraph 7.52 of the Provisional Findings.

\(^{57}\) Paragraphs 7.39 to 7.41 of the Provisional Findings.

\(^{58}\) We note that the CC refers only to the median fee. It is unclear why the CC excludes mean audit fees. If this is because the mean audit fee fails to show the same pattern then we consider this further evidence that the CC’s analysis if not robust. The CC needs to explain its reasons for not using mean audit fees.

\(^{59}\) Paragraph 7.38 of the Provisional Findings.
first year after switching audit firm and increased by two per cent (compared to the previous year’s fee) in the third year.

The CC observed a small increase in the median audit fee of two per cent in the first year following a tender not resulting in a switch.\(^{61}\)

2.3.2.2 The CC notes that there could be alternative, competitive explanations for the observed patterns in prices and profitability after a switch of audit firm. Specifically, that audit firms might submit low bids to encourage switching and then increase fees to recoup loss leading\(^ {62}\). In our view, low bids are often offered to encourage a switch by offsetting any company costs incurred as part of a tender process and to offset any concerns on the part of the management or AC in relation to possible future quality. However, the CC dismisses these potential arguments because “engagements are profitable at the gross margin level”\(^ {63}\). The CC is wrong to do this and we explain why below.

2.3.2.3 This evidence leads the CC to provisionally conclude that incumbent audit firms have “power over price”\(^ {64}\), and that as the period from the last tender and switch increases, firms have the ability to increase their fee levels. The CC draws no link to a coherent theory of harm to support its dismissal of the competitive explanations for the pricing and margin patterns that it observes\(^ {65}\).

2.3.2.4 In our view the CC’s provisional conclusions are incorrect, for two reasons which we set out in the rest of this section. First, in provisionally concluding that audit firms have ‘power over price’ the CC fails to take into account changes in scope and other factors which are also important drivers of total audit fees and margins. In failing to do this, it applies inconsistent standards across the pieces of evidence it has collected. Second, the CC cannot dismiss competitive explanations for observed pricing patterns based on conclusions about gross margins, when it has not conducted an assessment of audit firms’ profitability.

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\(^{60}\) Direct switches exclude all switches associated with the collapse of Arthur Anderson, merger and acquisition activity and moves to or from joint audits. See paragraph 7.38 of the Provisional Findings.

\(^{61}\) Paragraph 7.41 of the Provisional Findings.

\(^{62}\) Paragraph 7.52 of the Provisional Findings.

\(^{63}\) Paragraph 7.53 of the Provisional Findings.

\(^{64}\) Paragraph 7.54 of the Provisional Findings.

\(^{65}\) The CC also does not explain how this conclusion is consistent with its finding at 11.94 that executive management are able to influence the behaviour of audit firms (which we dispute in section 5 below), because audit firms fear being replaced. The CC has not explained this apparent disparity, which severely undermines the cohesiveness of its analysis.
2.3.2.5 We discuss each of these two flaws in the CC’s analysis in turn.

_The CC’s analysis of prices and margins is flawed_

2.3.2.6 The CC’s analysis of prices and margins is fundamentally flawed, for a number of reasons:

- The CC does not recognise the importance of other factors in explaining audit fees and does not properly control for these in its analysis.
- The CC is inconsistent in dismissing evidence that goes against its provisional AEC finding.
- The CC relies on evidence on gross margins, which is not fully informative about the profitability or an engagement.

2.3.2.7 We discuss these flaws in more detail in the rest of this section.

2.3.2.8 As set out in paragraph 2.3.2.1 the CC presents an analysis of audit price changes for the median company following a switch in audit firm. The CC also notes the range in prices around that median value. This range is enormous. Such substantial variation in the data suggests that other factors also have a strong bearing on the fees, and fee changes, that are observed. As a result, any analysis that fails to control for other relevant factors, particularly in the face of such substantial noise, can provide no robust results.

2.3.2.9 The CC refers to PwC’s analysis of audit fees following a switch in audit firm. This analysis also finds that total fees decrease after a switch, though the effects are smaller in magnitude than the CC’s own analysis suggests (as set out in paragraph 2.3.2.1). The PwC analysis, unlike the CC’s own analysis, attempts to control for factors such as scope of the audit. The substantial reduction in the magnitude of the decrease in audit fees after a switch in the PwC analysis compared to the CC’s own analysis shows, importantly, that when other relevant factors are controlled for the magnitude of the effect that the CC observes decreases. However, even the PwC analysis does not control for all relevant factors.
2.3.2.10 In particular, as we have highlighted in numerous submissions to the CC, turnover is not an adequate proxy for the scope, size and complexity of an audit\(^{66}\), as these factors (which influence the cost of providing an audit) are likely to change over time in a way that is not necessarily related to turnover. The CC responds to our comments by recognising the limitations of turnover as a proxy for risk, complexity and scope, but noting that this “is, however, the best available measure for normalising audit fees”\(^{67}\). The fact that a measure is the ‘best available’ does not mean that it is appropriate to place reliance on it: doing so calls into severe doubt the robustness of the CC’s analysis. The CC should recognise the limitations of the data and discount this proxy measure in reaching its conclusions.

2.3.2.11 The CC also applies inconsistent standards across the analyses it considers. In particular, the CC notes that over the period 2006 to 2011, mean real audit fees per hour decreased by 19 per cent\(^{68}\). The CC dismisses this observation, which, particularly when combined with trends in margins (see section 2.4.3 below), strongly indicates a competitive market for the supply of statutory audit services, where customers are applying increasing pressure on audit firms.

2.3.2.12 The CC’s reason for dismissing this observation is that “there are issues affecting these statistics (eg they do not control for factors other than fee rates that may impact on the cost per hour such as the grade mix of engagement teams)”\(^{69}\). However, these limitations apply to many of the other analyses the CC has considered, including its analysis of median audit fees after a switch, its analysis of engagement margins across market segments and sectors and its analysis of ‘high-engagement-profitability’ audits (see section 2.4 below). The CC has therefore applied a wholly inconsistent and selective standard of proof across analogous pieces of analysis.

2.3.2.13 In fact, the problems associated with grade mix are far less likely to apply to the analysis of average audit fees over time than to the rest of the CC’s analysis in relation to prices and engagement profitability. For grade mix to impact trends in average fees

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\(^{66}\) For example, annex 3 of our Main Submission in response to the CC’s Issues Statement; paragraph 63c of our response to the CC-commissioned academic literature review; and our response to the CC’s working paper “Price Concentration analysis”.

\(^{67}\) Paragraph 7.51 of the Provisional Findings.

\(^{68}\) Paragraph 7.31 of the Provisional Findings.

\(^{69}\) Paragraph 7.32 of the Provisional Findings.
over time, there would have to be a systematic change over time (on average) in the way that audit firms organise their engagements. We are not aware of any reasons why this would be the case. When comparing different types of engagements however, as the CC does in relation to its engagement profitability analysis, grade mix is far more likely to impact the results as there are good reasons to suppose that there are systematic variations in grade mix across categories of engagements. We discuss this further in section 2.4.2 below.

2.3.2.14 Therefore, we fail to see how the CC can recognise this as a limitation of its analysis in relation to average fees over time, while also continuing to place weight on the rest of its observations in relation to fees and engagement profitability. The CC must fully explain this in its Final Report.

*The CC needs to take into account fixed costs*

2.3.2.15 In our analysis of the Return on Capital Employed (ROCE) of our audit function, submitted in our response to the CC’s working papers “Profitability parts 1 and 2”, we allocated fixed costs and intangible assets to our Assurance practice as a whole. We did not allocate these costs to FTSE350 audit engagements because in our view this cannot be done in a robust or meaningful way. However, it is critical that indirect costs are taken into account.

2.3.2.16 We provided the CC with an analysis of the ROCE for our Assurance function and showed that we do not make excess returns compared to the weighted average cost of capital (WACC). We critique the CC’s dismissal of our analysis and its subsequent conclusions in section 2.5.3 below. Our analysis clearly shows that we do not make overall excess profits and so there is no evidence to support a hypothesis that pricing and gross margin patterns are indicative of an AEC.

2.3.3 *Our views on the CC’s conclusion that more frequent switching would lead to lower prices*

2.3.3.1 PwC noted that if companies were to tender and switch more frequently audit firms would be unlikely to offer the same short-run price discounts, incur the same tendering

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It might be that complexity across FTSE350 companies has systematically increased over time, which might affect the way audit firms organise their engagement teams. However, we would expect this to lead to increases in fees and so this does not undermine the observed pattern of average fees over time.
costs or bear the same share of companies’ costs of transition. However, the CC dismisses this view on the basis that “PwC’s view that short-run price discounts were likely to disappear if companies were to tender and switch more often is based on the assumption that audit work generates a ‘normal return’.” The CC states that “this assumption has not been established.”

2.3.3.2 The CC’s basis for dismissing PwC’s view is incorrect in stating that PwC’s argument is predicated on audit firms making a ‘normal return’. It is not. In pricing an audit during a tender, an audit firm will implicitly take into account the likely duration of the engagement (although we note that this can never be known with certainty). Audit firms are willing to shoulder fixed costs of transition and tendering (rather than passing these onto companies), as well as potentially offering early year discounts, if it can expect to make this up over the life of an engagement. However, the shorter the life of the engagement the less an audit firm will be willing to shoulder these costs or offer any given discount. The CC offers no explanation of why this pricing behaviour should be predicated on audit firms making ‘normal returns’. In fact, the observed pricing pattern of a temporary reduction in price following a change in audit firm is entirely consistent with either competitive or high returns.

2.3.3.3 Furthermore, in dismissing PwC’s view because an assumption of ‘normal return’ has ‘not been established’, the CC shifts the burden of proof onto audit firms, implying it is incumbent on us to show that we have not made excess returns. That is fundamentally incorrect. The burden of proof is on the CC to establish that there is evidence of an AEC (which might include evidence of excess returns), and not on audit firms to prove the opposite. As we discuss in section 2.5 below, we have in any case provided extensive evidence that demonstrates we do not make excess returns which the CC has unreasonably dismissed. Given that there is evidence before the CC to suggest returns are normal and that the CC has not and cannot conclude that the returns are excessive, the CC in not justified in dismissing the argument for this purported reason. The CC must fully justify why it has not done so in its Final Decision.

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71 Paragraph 7.43 of the Provisional Findings.
72 Paragraph 7.44 of the Provisional Findings.
73 Paragraph 7.44 of the Provisional Findings.
74 Paragraph 79 of the CC’s revised draft market investigation guidelines.
2.3.3.4 It is therefore incorrect for the CC to dismiss the argument that if companies were to tender and switch more frequently audit firms would be unlikely to offer the same short-run price discounts, incur the same tendering costs or bear the same share of the costs of transition for companies. On the contrary, such arguments are consistent with our own commercial experience.

2.3.3.5 Specifically, the CC argues that:

“The PwC analysis suggests to us that a company (other than a bank or a financial service company) willing to tender or switch every three years could on average reduce its audit fees by 7 per cent per year, on the assumption that the current level of commitment by both companies and firms to the tender process was maintained. PwC analysis that included observations for banks and financial service companies found slightly larger short run price effects. Based on these estimates we calculated potential savings of around 11 per cent for companies to tender or switch every three years”75.

2.3.3.6 The CC’s argument is based on the assumption that current pricing patterns following a switch are a reliable guide to pricing patterns and levels following an increase in the rate of switching, mandated by regulation. By simply relating the level of pricing to the frequency of tendering, the CC appears to adopt the paradoxical view that the greater the frequency of tendering, the lower the price over the overall tenure. This is unrealistic and ignores the fact that firms will change their pricing strategies in response to increased tendering. As we set out in paragraph 2.3.3.2 above, audit firms are unlikely to offer the same discounts or shoulder as much of the cost of transition and tendering were rates of switching and tendering to increase. There is no evidence that prices overall would decrease following an increase in the rate of switching. In fact, the opposite effect might result due to the need to build into prices the costs of regular tendering and the increased uncertainty of tenure. The CC has not established how a change in the rate of switching would result in a price change in a way that accounts for the many determinants of prices in the industry.

2.3.3.7 In addition, companies that the CC has observed switching and putting their audits out to tender are likely to be those that are dissatisfied with the fees or quality they receive. Indeed, the CC’s customer survey shows that concerns over price and quality were two important reasons why companies decided to switch audit firm in the five

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75 Paragraph 7.45 of the Provisional Findings.
years. If the rate of switching was increased exogenously however, for example as a result of a mandatory rotation remedy, companies that were currently satisfied with their audit, including with its fee, would be forced to switch provider. Such companies are less likely to achieve the same level of fee reduction following a switch in audit firm as they have not gone out to tender because they viewed their current fee level as too high. This is a further reason why any current patterns of price reductions following a switch in audit firm are unlikely to be observed if the rate of switching increases, for example due to mandatory rotation. Finally, as we set out in section 4.2.3 of our response to the Remedies Notice, if the CC were to impose mandatory rotation on audit firms, this will likely result in reduced competition for audit engagements, which further puts into doubt any discounts and adds to the possibility that prices could even increase.

Overall, therefore, we believe the CC’s conclusion that companies could achieve 11 per cent savings if the rate of switching increased by regulatory intervention to every three years is unrealistic. This conclusion is reached by simply assuming incorrectly that firms will adopt the same pricing behaviour as currently observed in what would be a completely different market environment.

2.4 Engagement Profitability

2.4.1 Our views on the CC’s conclusions on engagement level profitability

2.4.1.1 The CC has not performed a profitability analysis for FTSE350 engagements in aggregate, and we discuss the failure of the CC to do that in section 2.5 below. Instead, in taking the provisional view that there is an AEC, the CC has referred to the following further observations in relation to engagement profitability (in addition to those discussed in section 2.3 above): the existence of ‘significant’ numbers of companies from which audit firms enjoy persistently higher profits than average; and the fact that audit firms do not monitor partner or staff costs at an engagement level.

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76 24 per cent of FTSE350 and 33 per cent of FTSE350 companies said that fees and quality respectively were one of the principal factors behind a decision to switch audit firm.

77 Paragraph 7.92 d) of the Provisional Findings.

78 Paragraph 7.93 of the Provisional Findings.
2.4.1.2 The CC’s analysis in this section is characterised by the following fundamental flaws:

- The CC’s analysis is based on gross margins, and therefore fails to take into account indirect costs. As a result, the CC cannot conclude that any engagements enjoy ‘high’ profitability.

- In comparing engagement margins across different groups of engagements the CC has failed to control for other factors, in particular complexity and risk which, because of difficulties in measuring partner time and the seniority of the partner time involved on certain engagements, makes the CC’s observations unreliable.

- In failing to control for other factors, the CC applies inconsistent standards across different pieces of its analysis, as we set out in paragraphs 2.3.2.11 to 2.3.2.14 above.

- Raw correlations in the data do not control for all relevant factors and are hence unreliable, but the CC has failed to establish that raw correlations actually exist since it has not conducted (or at least presented) full statistical significance tests for the correlations it alleges.

- The CC makes inferences based on observations about our operating model, which are unsupported by any evidence.

2.4.1.3 As a result, the CC’s observations on engagement profitability can provide no support to any AEC finding and should be given no weight. The CC notes that assessing the indicators of profitability ‘in the round’ it considers that the market is not delivering competitive prices\(^79\). In our view, the CC cannot validly draw such a conclusion, in the round or otherwise, that uses any of this analysis while ignoring its fundamental flaws.

2.4.1.4 Furthermore, the CC’s reference to taking the evidence in the round is misleading. In fact, many of the pieces of analysis the CC refers to are composed of different, but similar, cuts of the same data (for example, the ‘high-engagement-profitability’ audits analysis and the analysis comparing engagement margins across market segments are essentially the same). It is therefore misleading to suggest that the CC has considered a number of different pieces of evidence that in the round point to its conclusion.

2.4.1.5 We set out our concerns in more detail in the rest of this section.

\(^{79}\) Paragraph 7.94 of the Provisional Findings.
2.4.2 Patterns of engagement profitability across companies or across market segments are not reliable evidence of an AEC

2.4.2.1 In reaching its conclusion that the evidence on profitability is indicative of an AEC, the CC notes that there are “significant numbers of companies from which the firms enjoy persistently higher profits than average”\(^{80}\). In our view no weight can be put on this observation.

2.4.2.2 In any intermediate market, where services or products are bespoke and prices are negotiated bilaterally, it is inevitable that there will be a dispersion of margins, even when average profits are no higher than a ‘competitive level’. It is the nature of any average calculation that there will be observations above and below it, and it is not clear why or how the CC thinks it can draw anything from this fact. Focussing only on those engagements above the average is therefore selective and misleading.

2.4.2.3 In addition, we discussed in paragraphs 2.3.2.15 to 2.3.2.16 above that the CC has not allocated any indirect costs to engagements. As a result the CC can put no weight on the magnitude of average gross margins. Similarly, the CC suggests that profit levels are “sufficiently above cost”\(^{81}\), but without conducting any cost allocation it cannot conclude that revenue is so significantly above costs that it delivers an excessive level of profit.

2.4.2.4 The CC seeks to examine the characteristics of what it terms ‘high-engagement-profitability’ audits\(^{82}\) and explore what factors might explain the fact that the margins on these engagements are ‘persistently’ above average margins.

2.4.2.5 The CC notes that companies with ‘high-engagement-profitability’ audits were less likely to have switched audit firm in the last five years (and therefore have longer than average tenure). However, as the CC recognises, this observation is likely to be driven by ‘selection bias’ in its analysis\(^{83}\) because the CC has analysed only engagements above a certain length. It is not possible to conclude that companies with ‘high-

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\(^{80}\) Paragraph 7.92 d) of the Provisional Findings.
\(^{81}\) Paragraph 7.93 of the Provisional Findings.
\(^{82}\) Paragraphs 7.86 to 7.90 of the Provisional Findings.
\(^{83}\) In identifying engagements which had a consistent level of profitability, the CC limited its analysis to engagements that lasted for at least four years between 2006 and 2011. This approach automatically excludes companies that have switched in the analysed period, thus generating a bias in its sample.
engagement-profitability’ audits were less likely to have switched auditor in the period 2006-2011, since most of the companies who have switched have been excluded from the analysis. Therefore the CC’s analysis of ‘high-profitability-engagement margins’ provides no evidence that length of tenure has any impact on overall engagement profitability. Indeed, the CC’s analysis elsewhere shows that engagement profitability does not increase indefinitely with length of tenure.\(^{84}\)

2.4.2.6 The CC also observes that ‘high-engagement-profitability’ audits were more likely to be FTSE100 than FTSE250 companies\(^ {85}\) and elsewhere notes that, on average, margins for audits of FTSE100 companies are greater than those for FTSE250 companies. The CC tests the statistical significance of its results in relation to ‘high-engagement-profitability’ audits using a Pearson chi-squared test\(^ {86}\). The CC does not report the results from this test, which is necessary for audit firms to be given proper opportunity to scrutinise the CC’s analysis. In relation to examining differences of average margins across the FTSE100 and FTSE250, the CC appears not to have conducted any tests of the significance of the results it reports. In failing to do this, the CC appears not to have followed its own guidelines for “Suggested best practice for submission of technical economic analysis from parties to the Competition Commission”\(^ {87}\).

2.4.2.7 We considered the smaller set of KPMG engagements and we fail to see any clear pattern of higher or lower margin engagements. Any such difference is also not something that is relevant in the normal course of business. We note that beyond its statements, the CC has not drawn any link between the stated findings of its analysis and actual business experience, either from market views, internal documents or other evidence.

2.4.2.8 A similar example arises in relation to the CC’s statement that audit margins for non-FTSE350 companies are on average greater than those for FTSE250 companies. This provides further evidence to contradict the CC’s suggestion that market structure and

\(^{84}\) Paragraph 7.33 b) of the Provisional Findings.
\(^{85}\) Paragraph 7.87 a) of the Provisional Findings.
\(^{86}\) The CC does not report the results from this test, but our assumption is that the differences the CC reports are statistically significant. However, it should publish that analysis so that we are given an opportunity to scrutinise it.
\(^{87}\) Paragraph of 17 of the CC’s guidelines on “Suggested best practice for submission of technical economic analysis from parties to the Competition Commission”.
barriers to entry in the FTSE350 give rise to an AEC in that market. If that were the case, we might expect to see FTSE250 margins greater than non-FTSE350 margins. The fact that we do not is evidence against the CC’s overall Provisional Finding.

2.4.2.9 In addition, the CC does not seek to control for other factors that are likely to affect relative margins across different engagements and different market segments, and explain why some engagements’ margins are above the average for a number of years. The CC can draw no conclusions from these observations without fully addressing these issues\textsuperscript{88}. We note that the CC’s own guidelines for “Suggested best practice for submission of technical economic analysis from parties to the Competition Commission” state the that “omitted variables can be a common source of bias” and that submissions from parties should include “a consideration of what omitted variables there might be and the possible consequences their omission could have”\textsuperscript{89}. The CC has failed to follow its own best practice guidance and, as a result, drawn inappropriate conclusions from the existence of the omitted variables in relation its own analysis in this case.

2.4.2.10 In particular, as highlighted in our response to the CC’s engagement profitability working paper\textsuperscript{90}, the inability to measure properly the cost of partner time will introduce bias into the CC’s analysis. To the extent that any groups of engagements are likely to include more or less partner time, the inability to measure the cost of partner time will impair the ability to compare margins accurately across those groups. In addition, the mix of partner resources (ie junior versus senior partners) varies across engagements, and failure to properly measure the different costs associated with different partners impairs the ability to compare margins across engagements. The CC notes these weaknesses in its analysis\textsuperscript{91}, but fails to draw the logical conclusion from these weaknesses and dismiss the analysis - instead basing some of its conclusions on it.

\textsuperscript{88} We note that in Annex 3 of Appendix 14 the CC does calculate the Pearson’s chi-squared statistic to analyse the correlation between company characteristics and the differences in engagement margins that the CC observes. However, the CC fails to present the full results of this test. In addition, this test can only test for raw correlations and therefore cannot control for other important factors as we discuss in paragraphs 2.4.2.9 to 2.4.2.13.

\textsuperscript{89} Paragraph 15 d) of the CC’s guidelines for “Suggested best practice for submission of technical economic analysis from parties to the Competition Commission”.

\textsuperscript{90} Paragraph 2.4 of our response to the CC’s working paper “Engagement level profitability analysis”.

\textsuperscript{91} Paragraphs 169 and 170 of Appendix 14 of the Provisional Findings.
2.4.2.11 If partner time varied unsystematically across engagements, the inability to measure its cost might be less problematic for the CC’s analysis. However, as also set out in our response to the CC’s working paper on engagement profitability, and as accepted by the CC in its Provisional Findings\(^92\), a greater proportion of partner time, and the most senior partner time, is likely to be required for more complex and more international engagements. This means that the inability to measure the costs of partner time accurately will tend to lead to systematically overestimating the margins on more complex and more global engagements and as a result impair any comparisons without controlling for that factor. Again, the CC does not consider the implications of this analytical flaw.

2.4.2.12 Furthermore, as we set out in our response to the CC’s working paper “Engagement profitability”\(^93\), more complex engagements may require greater investments in certain capabilities such as IT, methodology and training. The CC, by analysing only gross margins (see paragraphs 2.3.2.15 to 2.3.2.16 above), does not take into account the costs of these investments and therefore the impact they have on profitability.

2.4.2.13 In sum, in our view the failure to control for complexity coupled with the inability to properly measure the costs of partner time could well account for the differences in average engagement margins across the FTSE100 and FTSE250 which the CC suggests is a factor that explains ‘high-engagement-profitability’ audits. This is supported by evidence in the CC’s first survey results which show that ‘high-engagement-profitability’ audits are more likely to be characterised by a number of factors that we would associate with more complex audits\(^94\), and the CC’s observation that ‘high-engagement-profitability’ audits are more likely to have higher audit fees is also consistent with these audits being more complex\(^95\).

2.4.2.14 We have analysed our own engagement margins in relation to the factors the CC has suggested. In particular we analysed the relationship between partner hours worked on a FTSE350 company’s audit and the index on which the company was listed, using

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\(^92\) Paragraphs 169 and 170 of Appendix 14 of the Provisional Findings.

\(^93\) Paragraph 2.3 of our response to the CC’s working paper “Engagement level profitability analysis”.

\(^94\) Including higher audit fees, higher turnover, place greater importance on sector-specific expertise and experience in reappointing an audit firm. See paragraph 184 of Appendix 14 of the Provisional Findings.

\(^95\) Paragraph 7.87c) of the Provisional Findings.
yearly data for our clients between 2006 and 2011\textsuperscript{96}. As set out above, given the complexity of auditing FTSE100 companies we would expect that the amount of partner hours worked on the audit of a FTSE100 company would be higher than for other audit engagements, both absolutely and as a proportion of total hours\textsuperscript{97}. Our results show that for FTSE100 companies the average number of total partner hours spent on the engagement is statistically significantly greater\textsuperscript{98} than for non-FTSE100-listed companies. This result is displayed in each year and when all years are aggregated.

2.4.2.15 A similar, if less powerful, result is obtained for partner hours as a share of total hours where the average proportion for FTSE100 companies is statistically significantly greater than for non-FTSE350 companies across each year and when all years are aggregated. The same result is observed for Other Listed companies, excluding the year 2011\textsuperscript{99}. Given the inability to fully account for the cost of partner time, this is likely to bias upwards the margins calculated for FTSE100 clients by the CC.

2.4.2.16 In light of the above, the CC has, without adequate explanation and inconsistently with its own best practice guidance, sought to rely on defective analysis, while dismissing other evidence, which goes against its provisional conclusions, for the same flaws. The CC must more fully explain why it is reasonable to do this in its Final Report.

2.4.3 \textit{Patterns of engagement profitability over time}

2.4.3.1 The CC notes that the profitability of engagements within the FTSE100 and the FTSE250 remained broadly constant over the period 2006 to 2011\textsuperscript{100}. In our view the CC has not properly considered this result in reaching its conclusion that its analysis of engagement profitability is indicative of an AEC.

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\textsuperscript{96} Taken from the engagement dataset. We tested results within each year as well as with all years pooled.

\textsuperscript{97} We compare data for companies in the FTSE 100 against data for FTSE 250 companies, Other Listed companies and Private companies.

\textsuperscript{98} All tests referred to in this paragraph use a t-test with a five per cent significance level.

\textsuperscript{99} For Private companies however significantly greater mean is only observed in three out of six years (2008, 2009 and 2010), although a statistically significant difference is observed in the aggregated data.

\textsuperscript{100} Paragraph 7.82 b) of the Provisional Findings.
2.4.3.2 In particular, the CC also notes that real audit fees have declined substantially over the same time period\textsuperscript{101}. The CC dismisses this result, but we set out in section 2.4.1 above our views on why the CC is incorrect to do so. Coupled with the pattern of engagement profitability over time, this suggests that audit firms have been successful in reducing their costs between 2006 and 2011 and, furthermore, that these reductions in cost have been passed on to audit firms’ customers in the form of lower fees. This is strongly indicative of a competitive market and the CC appears not to have considered this in forming its provisional conclusion.

2.4.3.3 Indeed, it is extremely difficult to see how the CC reconciles this pattern of declining real prices and stable average margins with a lack of competition. In particular in the context of increasing (or, since 2009, more stable) salaries in the labour market, and in a market where clients say price is second to quality. Furthermore, far from there being any evidence of a decline in quality, there is evidence that quality in fact has increased since regulatory scrutiny has been strengthened and the AQRT notes that overall quality is increasing (as set out in paragraph 2.6.2.2 below).

2.4.4 No conclusions can be drawn about the way audit firms monitor engagement costs

2.4.4.1 The CC expresses surprise that “no firm monitored actual partner or staff costs at an engagement level” and infers this is an indicator that “profit levels are sufficiently above cost to make close monitoring unnecessary”\textsuperscript{102}. We strongly challenge this inference.

2.4.4.2 In particular, the CC has provided no evidence to show that revenue is “sufficiently above cost”\textsuperscript{103} as it has done no cost allocation exercise or any analysis of the profitability of our business (as we discussed in paragraphs 2.3.2.15 to 2.3.2.16 above and we return to in section 2.5 below). There is, therefore, no basis for the CC’s suggestion.

2.4.4.3 We challenge the assertion that we do not monitor actual staff costs at an engagement level. Using average staff costs is the most efficient way to account for staff (ie non-

\textsuperscript{101} Paragraph 7.31 of the Provisional Findings.
\textsuperscript{102} Paragraph 7.93 of the Provisional Findings. In fact, we assume that the CC means ‘revenues are sufficiently above cost’, rather than profit being sufficiently above cost.
\textsuperscript{103} Paragraph 7.93 of the Provisional Findings.
partner) costs (given the relatively small variation within staff grades), and we monitor them extremely closely on an engagement by engagement basis. This includes monitoring the recovery of engagements against scale rates and how that changes compared to budget, but also close monitoring of actual engagement margins (which include staff costs). The monitoring and management of these measures of engagement performance is regular, and includes:

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2.4.4.4 The CC notes that factoring in the true cost of partner time on an engagement can impact on that engagement’s profitability\textsuperscript{104}. We agree, as we have set out above where we explained that this negates any conclusions that can be drawn about comparisons across different groups of engagements. However, this does not imply that the most efficient way to manage a business is to closely monitor the exact cost of partner time centrally, across all engagements. Using a notional “partner cost” is difficult both in terms of the specific numbers used and in terms of the interpretation of the figures that would be derived from this.

2.4.4.5 Instead, an audit partner will have the ability to invest his or her time on a number of activities, including on the audit of more than one client. The performance of each audit partner is monitored closely by the business to ensure audit services are delivered in a way that covers costs and delivers an acceptable return. The financial performance of the audit function overall is also monitored closely as that is a more appropriate level at which to consider the effectiveness of a lot of common investments, including partner time as well as other common costs. In addition, partner remuneration is closely linked to their performance, which needs to balance a number of factors including the profitability of their engagements, as well as other factors such as quality and risk management metrics\textsuperscript{105}.

\textsuperscript{104} Paragraph 7.93 of the Provisional Findings.
\textsuperscript{105} As set out in our response to question 6b) of the Market and Financial Questionnaire.
2.4.4.6 The CC’s assertion that audit firms not accounting fully for the true partner cost is indicative of revenue levels being ‘sufficiently’ above cost is therefore completely unfounded. The CC has no evidence to suggest what level of revenue would be ‘sufficiently’ above cost and no reliable evidence to show that our method for controlling and monitoring engagement profitability is not the most effective. The CC has not adequately explained why, in the absence of more robust evidence, it has drawn conclusions about our methods of monitoring engagement profitability, and must do so in its Final Report.

2.5 Profitability of FTSE350 statutory audit services and audit businesses

2.5.1 Introduction

2.5.1.1 As noted in paragraphs 2.3.2.15, 2.3.2.16 and 2.4.4.2 above, the CC has not undertaken profitability calculations using ROCE because it concluded provisionally that the uncertainties in performing such calculations would be so great as to render an attempt not worthwhile. It said that it was 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. Its reasons include the difficulty of determining a meaningful separation of partner rewards into salary and profit share elements, the valuation of intangibles, and the difficulty of determining the cost of capital for a partnership. Whilst we recognise the difficulties of conducting a ROCE analysis for professional service partnerships, we have conducted ROCE analysis, using reasonable assumptions to tackle uncertainties, which suggests that KPMG’s Audit Function’s ROCE is below its WACC.

2.5.1.2 Despite rejecting as impractical such robust ROCE analysis, the CC does appear to have regarded it as reasonable to form some views on profitability based on indicators which lack any degree of intellectual rigour. For example, it says that “audit partner rewards are attractive with average profit per partner at the Big 4 firms in 2011 of between £635,000 and £763,000”, that “partners receive a high level of return in relation to capital that they invest on entry to the partnership”, and that data on partner tenure indicates that “the risk/reward balance offered by the Big 4 firms to

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106 Paragraph 7.70 of the Provisional Findings.
107 Paragraph 7.69 of the Provisional Findings.
108 Paragraph 7.75 of the Provisional Findings.
109 Paragraph 7.92 of the Provisional Findings.
audit partners is attractive”110. It also stated that “Assurance (including audit) is a relatively attractive service line in comparison with other service lines”111. It considers that these and other “indicators” suggest that “the market is not working well in delivering competitive prices”112.

2.5.1.3 The CC’s observations do not support the CC’s apparent conclusion. Profitability Analysis, as set out in the CC’s draft revised market investigation guidelines113, defines the concept of ‘excessive profitability’ in relation to well-understood concepts of ROCE and WACC. Here, however, the CC uses the concept of “attractive” profits, based on “indicators” that are not grounded in any established theory or practice and that are not mentioned in the CC’s own draft revised market investigation guidelines. Indeed it is difficult to see that any professional partnership delivering highly skilled services would survive for very long if the rewards it provided for its partners were not “attractive”. This benchmark is simply not relevant – the CC needs to evidence that audit firms’ profitability exceeds that which would pertain in a competitive market. This it has failed to do and whilst it is not for the audit firms to prove that profits are not excessive there are alternative, well-established methodologies, which are consistent with the CC’s current and draft market investigation guidelines. These methodologies, which include the analysis we submitted, clearly point to a lack of excess profits.

2.5.1.4 In addition, the similarity of audit returns with those in other service lines is also strong evidence of no excess returns in the supply of statutory audit services. The CC suggests that the risk associated with audit is likely to be lower than that of other service lines, because of the greater predictability of work. We discuss the evidence that audit risk is not lower than the risk associated with other service lines in section 2.5.2 below. In addition, we note that non-audit service (NAS) lines include in their prices the risk associated with the unpredictable nature of some their work. As a result, the predictability of audit work cannot be used to dismiss the comparison of audit profitability with that of other service lines. Therefore, the similarity of audit returns

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110 Paragraph 7.76 of the Provisional Findings.
111 Paragraph 7.79 of the Provisional Findings.
112 Paragraph 7.94 of the Provisional Findings.
113 Section 2 of Annex A of the CC’s draft revised market investigation guidelines.
with those in other service lines provides strong evidence that there are no excess returns in the supply of statutory audit services.

2.5.2 The CC’s use of ‘indicators’

2.5.2.1 The CC makes a number of unsupported statements which it appears to have relied on in reaching its conclusion that “the market is not working well in delivering competitive prices”\(^\text{114}\). In this section we refer to each of these statements, and set out our views as to why the CC cannot draw any conclusions from them.

2.5.2.2 In paragraph 7.92 the CC states that:

“(b) The risk reward balance offered to audit partners is attractive; because:

(i) profits per partner are considerably above benchmarked salaries;”\(^\text{115}\)

2.5.2.3 We dispute this statement. The CC does not conclude on an appropriate benchmark for partner salary, and so we fail to see how it can conclude that partner pay is “considerably above” a benchmark\(^\text{116}\).

2.5.2.4 There is no evidence to suggest that partner pay is “considerably” above any reasonable benchmarked salaries. Audit partners’ remuneration reflects the fact that they are highly qualified and experienced professionals, and it is necessary to offer competitive partner remuneration to attract and retain talent. The CC has been presented with a number of benchmarks (although the CC does not identify which benchmark it considers appropriate) and KPMG’s partners’ remunerations cannot be reasonably considered to be “considerably above” any of them:

- PwC’s median partner benchmarked salaries\(^\text{117}\) ranged from £214,000 to £876,000. Between 2007-2011, KPMG’s audit partner total remuneration ranged from £\([\_\_\_\_]\) to £2,200,000 per partner\(^\text{118}\), with an average of £657,000 per partner over the period. The majority of KPMG audit partners fell within the PwC range. Further, if PwC numbers are medians, and that the top PwC benchmark figure may therefore be in line with the top KPMG audit partner reward.

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\(^{114}\) Paragraph 7.94 of the Provisional Findings.

\(^{115}\) Paragraph 7.92 of the Provisional Findings.

\(^{116}\) Paragraph 47 of Appendix 14 of the Provisional Findings.

\(^{117}\) Presented as part of its salary benchmarking exercise.

\(^{118}\) The maximum is considerably distorted by termination payments. In addition, we note that the PwC numbers are medians, and that the top PwC benchmark figure may therefore be in line with the top KPMG audit partner reward.
has not taken all components of remuneration into account\textsuperscript{119}, then the figures will be significant underestimates of the relevant employment costs\textsuperscript{120}.

- The median remuneration for a FTSE350 FD was £1,276,507 (before employers’ pension contributions)\textsuperscript{121}. The median total reward of KPMG UK’s audit partners was £\texteuro{}\texttimes{} (which effectively includes “employers’” pension contributions, as KPMG partners do not receive additional pension contributions). In our view, FDs are reasonable comparators for audit partners at the largest four audit firms since they tend to have similar backgrounds and qualifications; act as senior finance professionals and are closely involved in the running of large business units; and there are examples of audit partners leaving the largest four audit firms to join FTSE350 companies as FDs\textsuperscript{122}.

- Our own model of the KPMG Audit Function ROCE used a mark-up on the employment costs of KPMG audit directors. In our view, a base case mark-up of 100 per cent on audit directors’ employment costs is reasonable and relatively conservative given the typical career path of directors and partners. For our Audit Function, this results in an average audit partner employment cost over five years of £\texteuro{}\texttimes{}, which we note is slightly lower than the estimate of £473,000 that the CC stated in its Working Papers may be reasonable\textsuperscript{123}.

2.5.2.5 In paragraph 7.92 (b) the CC states:

“(ii) partners receive a high level of return in relation to the capital that they invest on entry into the partnership;”

2.5.2.6 We strongly dispute the relevance of capital invested on entry. Firstly, large amounts of funding for working capital and investment come not from capital subscriptions

\textsuperscript{119} We note that in its response to the CC’s working papers “Profitability part 1” and “Profitability part 2” PwC does not state that is has included the non-salary elements of partner employment costs.

\textsuperscript{120} The PwC benchmark numbers may also not represent the total relevant cost since in order to have a true comparison with partner reward, it is necessary to benchmark total employment costs including those benefits that partners have to provide for themselves out of their total remuneration. This includes, for example, pensions, bonus, stock options, national insurance costs, medical insurance and other benefits which are payable by the employer on the employee’s behalf.

\textsuperscript{121} As we set out in Paragraph 3.2.11 of KPMG’s response to the CC’s working papers “Profitability part 1” and “Profitability part 2”, information has been provided by Incomes Data Services (IDS), an independent research body. IDS collect remuneration data from company annual reports. Where information disclosed in these reports are not completely transparent, IDS refer to regulatory announcements or request additional information from the company directly. The data excludes individuals for which IDS was unable to provide data, or unable to provide complete data.

\textsuperscript{122} For example, Douglas Flint left KPMG to become FD at HSBC and Jon Symonds to become FD at AstraZeneca, both in the 1990s. We are aware of similar cases at other of the largest four audit firms, for example a PwC partner left to join Barclays around seven years ago and more recently, a PwC partner left the firm to join Schroders. There will also be far more examples of people leaving the largest four audit firms earlier in their careers to join FTSE350 companies and who will end up as FDs. Indeed, the evidence shows that many FTSE350 companies’ FDs formerly worked at the largest four audit firms (two third of the FDs/CFOs surveyed as part of the CC’s survey of FTSE350 companies had previously worked for the largest four audit firms).

\textsuperscript{123} Paragraph 43 of the CC’s working paper “Profitability analysis - Part 1”
made by partners, but from the retention of internally generated funds otherwise payable (in large part as employment costs) to partners, such that at any point in time the total investment by the partner group significantly exceeds the formal capital which they inject. A perfectly acceptable alternative model would be to require a very much higher level of initial investment and as in most other businesses pay salary as it is earned. Therefore it is meaningless to focus on the initial capital injection without recognising the rest of the investment made by partners.

2.5.2.7 Secondly, and again, crucially, in any case, in order to reach a conclusion that returns are “high”, they must be assessed against a benchmark, such as a cost of equity. The CC has not provided a benchmark for reaching a conclusion that returns are high. Therefore the CC’s conclusions are entirely unfounded.

2.5.2.8 In paragraph 7.92 (b) the CC states:

“(iii) the risks assumed by individual partners are not unusually high;”\(^{124}\)

2.5.2.9 We dispute this statement. We set out in our response to the CC’s profitability working papers\(^ {125}\) what we believe to be the considerable risks held by the KPMG audit partners. It is not clear what the CC considers the ‘usual’ level of risk to be, for example compared to other careers such as FDs.

2.5.2.10 The CC’s use of this indicator is in clear contradiction with its statement in the Provisional Findings that “the implications of this [partners being exposed to firm-specific and illiquidity risk] is that the returns from the audit market will need to be significantly higher to compensate for the additional risk”\(^ {126}\). In addition to firm-specific and illiquidity risk, the CC also needs to take into account the significant personal and reputational risk that is associated with being an audit partner, in an increasingly strictly regulated market. Furthermore, the Enron scandal proves the point that an apparently benign environment may in fact be subject to enormous risk and uncertainty. We discuss further the flaws in the CC’s analysis of the risks associated with audit in paragraph 2.5.3.11 below.

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\(^{124}\) Paragraph 7.92 of the Provisional Findings.

\(^{125}\) Paragraph 2.4.1.4 of our response to the CC’s working papers “Profitability part 1” and “Profitability part 2”.

\(^{126}\) Paragraph 66 of Appendix 14 of the Provisional Findings.
2.5.2.11 In paragraph 7.92 (b) the CC states:

“(iv) partners rarely leave voluntarily prior to retirement, having an average tenure of 14 to 18 years.”\textsuperscript{127} The CC suggests this is indicative of an ‘attractive’ risk to reward balance.

2.5.2.12 We dispute the relevance of this statement. Our reward structure is devised to be competitive with other industries and professions in an effort to attract and retain the highest quality individuals – but this is not indicative of any lack of competition. In addition, the majority of KPMG partners leave the partnership, either voluntarily or involuntarily, before reaching the maximum age for a partner (the “latest retirement date”). Indeed, the desire by audit firms to require partners to leave before the latest retirement age is a further factor that the CC needs to bear in mind when assessing the attractiveness of partner rewards. Our records suggest that, between 2003-2012, only around \textsuperscript{[\%]} per cent of audit partner leavers left the partnership at the latest retirement date. Around \textsuperscript{[\%]} per cent went into senior private sector roles, \textsuperscript{[\%]} per cent stepped down to director grade and \textsuperscript{[\%]} per cent went on to work as consultants for the firm\textsuperscript{128}. In our view the proportions of partners leaving prior to the latest retirement date are likely to be similar, or greater, in audit to any other profession. It is therefore not clear on what evidence the CC bases its conclusion.

2.5.2.13 Furthermore, it is not possible to assess the risk to reward profile of audit by considering only those partners who leave voluntarily. Whether a partner’s departure has been voluntary or not is not recorded. This applies to both partners continuing to work for the firm as directors or consultants, and partners leaving entirely. For example, as shown in the previous paragraph a substantial number of partners step down to director grade, which will often not be voluntary. The risk of being required to step down from the partnership is a relevant risk that the CC needs to consider.

2.5.2.14 Further, there is a sunk cost incurred by partners in terms of the time and effort they have invested in acquiring the required skills to reach the top of the audit profession.

\textsuperscript{127} Paragraph 7.92 of the Provisional Findings.
\textsuperscript{128} The remainder either retired completely, were unable to continue because of ill health, went on to hold non-executive directorship roles at other companies, went into the public sector, had a career change. There is a further 6 per cent of partner leavers for whom we don’t know their subsequent activities.
This means that partners do not walk away easily from their role, but does imply in any way that there are excessive profits in the supply of statutory audit services.

2.5.3 ROCE analysis

2.5.3.1 The CC has not given due consideration to evidence submitted to it, consistent with the CC’s draft revised market investigation guidelines, which suggests that audit firms are not earning excess returns. The CC appears to say\textsuperscript{129} that it is not persuaded by our analysis because of the uncertainties attached to four main issues. However, it does not provide any analysis of our approach to each of these issues in order to conclude whether or not it is reasonable, while elsewhere relying on analysis which appears to be similarly affected. We do not believe that the CC has adequately explained why the assumptions that we have made in conducting our analysis are not persuasive, particularly when the CC has discounted our evidence, which is consistent with the CC’s own Guidance, in preference to its own less rigorous analysis. It must do so in its Final Report.

2.5.3.2 We take those assumptions in turn.

\textit{Intangible assets}

2.5.3.3 The CC has stated that the intangible asset base is likely to be large\textsuperscript{130} and difficult to measure, and that therefore it has not attempted to do so. We estimated the value of our own intangible asset base by identifying the costs of creation of the assets, an approach which is in line with the CC draft revised market investigation guidelines\textsuperscript{131}. There is also precedent for this approach, for example the CC’s SME Banking market investigation. Our approach is consistent with (and in relation to training costs is particularly conservative relative to) the asset lives used by the CC in that case\textsuperscript{132}.

\textsuperscript{129} Paragraph 7.70 of the Provisional Findings.

\textsuperscript{130} Paragraphs 59 to 65 of Appendix 14 of the Provisional Findings.

\textsuperscript{131} Paragraph 13 of the revised draft market investigation guidelines state that “In establishing a value for intangible assets meeting the above criteria, the CC will have regard to similar principles as for other types of assets.”

\textsuperscript{132} In our analysis we have used an asset life of five years for marketing and recruitment and three years for training. In the SME Banking case, the CC noted that on balance a five year asset life for training is reasonable; used five years for the asset life for IT costs; capitalised 20 per cent of advertising and marketing costs and one third of sales development costs over the expected life of a customer with the bank.
2.5.3.4 The CC appears to reject our analysis of the intangible asset base mainly on the basis that there is uncertainty over its size. The CC also cites the difficulties in measuring the intangible base as one of the principle reasons why profitability analysis cannot be attempted. Our analysis shows that the ROCE is not in fact very sensitive to the assumed size of the asset base. For example, assuming an intangible asset base 25 per cent higher than the level we assumed in our analysis, would reduce the ROCE by only 0.7 percentage points. We therefore believe that reasonable sensitivities can be applied to the modelling which would allow the CC to reach conclusions on the likelihood, or not, of excess profits. We note that in previous cases, assumptions have been necessary in relation to the capitalisation of intangible assets, but by considering the available evidence the CC was able to come to a view. In our view, and in light of its previous practice, the CC has no reasonable basis for not doing this in this case.

2.5.3.5 As a further point on intangible assets, we note the CC’s comment on our approach to capitalising spending on business development (BD) and marketing. The CC has questioned whether all staff and partner time recorded as marketing and BD should be characterised as generating intangible assets. We would argue that:

- the CC has no evidence that some of the time spent on BD and marketing cannot be characterised as generating intangible assets and has provided no alternative explanation for what that time is spent doing;
- it is not surprising that a large amount of time is required to create sizeable and crucial intangible assets, which are the foundation upon which the entire business rests. Furthermore, we have been conservative as we have capitalised these assets over a relatively short asset life; and
- there is precedent for the CC treatment of ‘wasted efforts’ in terms of successful generation of these kinds of intangible assets, in the CC’s analysis from its SME banking market inquiry. There is no reason that a similar approach cannot be applied here.

Partner pay

2.5.3.6 The CC has rightly accepted the need to distinguish between partner employment costs and actual profit, although we note a few instances where the CC incorrectly refers to ‘partner salary’ rather than ‘partner employment/labour costs’\(^{133}\). None of the

\(^{133}\) Salary is lower than total employment costs which include other benefits such as health insurance, car allowance, and, importantly, pension contributions. The CC incorrectly conflates salary and employment costs in a number of places in its Provisional Findings, for example, at paragraphs 7.69 and 14.127.
largest four audit firms routinely estimates its partners’ hypothetical employment costs. The CC appears to have noted KPMG’s approach to estimating partner employment costs in our ROCE analysis without providing an opinion on its merit, although we note that it has adopted a similar, ‘mark-up on director employment costs’ in its engagement profitability analysis.

2.5.3.7 The CC also appears to see merit in an external benchmarking approach, as adopted by PwC. We believe this is a helpful analysis, as well as the sense check against the reward to Financial Directors. Both suggest that our assumptions are conservative. The CC has not undertaken its own assessment of partner employment costs because it notes that “given the level of uncertainty surrounding other aspects of a calculation of economic profits ... [this] would not, by itself, allow [the CC] to perform a reliable assessment of profitability”\textsuperscript{134}. Since we believe that reasonable assumptions can be made to deal with all the modelling issues, we also believe that partners’ hypothetical employment costs should be estimated. Our analysis of ROCE has done that and shows that even on relatively conservative assumptions about partner employment costs, KPMG’s ROCE is below our central estimate of WACC and approximately half a percentage point away from our low case estimate of WACC.

Cost allocation

2.5.3.8 We agree with the CC that it is possible to allocate costs to audit in a reasonable way\textsuperscript{135}, and indeed we have done this in our own analysis. We note that the CC did not attempt this allocation because it had already decided it could not reasonably deal with all the modelling issues. Since we believe that reasonable steps can be made to deal with all the modelling issues, we also believe that cost allocation should be conducted.

An appropriate benchmark for audit firms’ returns

2.5.3.9 The CC has not formed a view of the appropriate cost of capital for the supply of statutory audit services. Although it notes that PwC’s general approach did not appear unreasonable and that our suggestions in relation to audit firm betas have merit, it

\textsuperscript{134} Paragraph 47 of Appendix 14 of the Provisional Findings.

\textsuperscript{135} Paragraph 26 of Appendix 14 of the Provisional Findings.
ultimately dismissed both analyses. The CC also notes that there is some merit in the approach of uplifting the cost of capital to take into account the fact that investors in audit firms are not diversified (put forward by Oxera and by KPMG). However, overall, the CC argues that due to uncertainties with all the modelling issues it could not reach a reliable estimate. Since, as set out above, in our view all the modelling issues can be addressed it is incumbent on the CC to do that, as suggested by its own market investigation guidelines, rather than dismissing our analysis.

2.5.3.10 As noted in paragraph 2.5.2.8 above the CC does note that it considers audit to be a less risky service line than others offered by the largest four audit firms. As also noted in paragraphs 2.5.2.9 and 2.5.2.10 above, the CC’s arguments on this issue fail to take into account unsystematic risk which is fundamentally important in a partnership structure which precludes the firm’s owners from being fully diversified.

2.5.3.11 We provided reasonable estimates of the likely cost of capital impact of unsystematic risk. Oxera also noted the importance of taking into account this risk, estimating a level of uplift to the WACC to account for this risk greater than the uplift we submitted. We provided extensive evidence to show the greater risk attached to audit, in relation to the potential for liability claims and hence the affect on our insurance premia. The CC notes this evidence, and states that “the implication of this is that the returns from the audit market will need to considerably higher to compensate for the additional risk”\(^\text{136}\). However, the CC then fails to take proper account of it, suggesting that we can incur costs to manage this unsystematic risk which would already be accounted for in the profitability analysis. This reasoning is illogical – first, we can never manage all unsystematic risks; second it completely ignores the impact of partners having to bear liquidity risk and unsystematic risk on the cost of equity; and third, the evidence on insurance premia contradicts this.

2.5.4 Conclusion

2.5.4.1 Given all of the above, we do not think that the CC’s conclusions on profitability are supportable and in our view do not meet the test of a reasonable assessment of the evidence. The CC has presented no reliable evidence in support of its suggestion that prices are excessive. In fact, the CC has received evidence that profits are not

\(^{136}\) Paragraph 66 of Appendix 14 of the Provisional Findings.
excessive and has not given this proper or indeed any real consideration. This means that the CC’s own views of profitability (which are not based on any sound analysis) cannot be seen to provide support to the CC’s AEC finding.

2.5.4.2 In this respect, we take issue with the CC’s suggestion that by ‘considering all the indicators in the round’ it can come to a conclusion that prices are above competitive levels. It cannot. When all of the indicators that the CC uses to come to its ‘in the round’ judgement are seriously flawed (as the CC itself in many cases notes), none of them can be given any weight in any consideration of evidence, whether individually or ‘in the round’. Hence they provide no justification for an AEC finding. The only reliable indicators are those arrived at through an established and appropriate methodology, such as a comparison of ROCE and WACC, and this indicator shows that we do not make excess profits.

2.6 Quality

2.6.1 The CC’s Provisional Findings on Audit Quality

2.6.1.1 The CC’s provisional findings state that there are “significant, persistent and widespread concerns regarding the quality of audits delivered to FTSE350 companies as identified by the AQRT”\(^ {137}\). In particular:

- the AQRT reports indicate that there are significant issues surrounding the quality of some audits provided to FTSE 350 companies, and that the AQRT often identified shortcomings in audit reports that were not identified by the companies themselves\(^ {138}\); and
- the low levels of claims, settlements and insurance premia are not a conclusive indicator of the quality of audits\(^ {139}\).

2.6.1.2 According to the CC, this variation in quality is not what would be expected in a competitive market. The CC however does not explain what variation in quality it considers consistent with a competitive outcome.

2.6.2 Analysis of the CC’s Provisional Findings on audit quality

\(^{137}\) Paragraph 7.121 of the Provisional Findings.

\(^{138}\) Paragraph 7.119 of the Provisional Findings.

\(^{139}\) Paragraph 7.120 of the Provisional Findings.
2.6.2.1 We have implemented policies and procedures that are designed to maximise 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 cases will always be possible. As noted above, the CC has provisionally found that there are “significant, persistent and widespread” concerns regarding audit quality. However, the evidence contained in the CC’s report does not substantiate this conclusion.

2.6.2.2 Further, analysis of the data reported by the AQRT, shows that the actual number of FTSE350 audits requiring “significant improvement” are few when considered in light of the overall number of audits conducted and the complexity of the audit work involved. Indeed, in its most recent annual report the AQRT notes that:

“We have seen an improvement in overall inspection results, with a further reduction in the proportion of audits requiring significant improvements. These now account for less than 10 per cent of the audits reviewed. The proportion of audits assessed as good with limited improvements required remains consistent with previous years at around 50 per cent of the audits reviewed.”

(Emphasis added)

2.6.2.3 In our view, a number of the issues raised by the AQRT in its audit review process and in its final reports often indicate a difference of judgement on the extent of auditor evidence required to support individual assertions underlying a set of accounts. They do not negate the general approach taken to the audit or the overall opinion reached. In our experience, some companies are not significantly concerned by some of the points raised by the AQRT – this is because the ‘deficiency’ may relate to documentation or evidence on file available to the AQRT, whereas companies may have seen firsthand the audit process and understand the analysis undertaken by the audit firm. Further, the CC should recognise that an audit is a complex process (particularly for FTSE350 companies), involves the exercise of professional judgement and is manually intensive. In such circumstances, disagreements over the

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140 Paragraph 7.121 of the Provisional Findings.
141 The CC also states at 9.122 of the Provisional Findings that ‘the AQRT 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’.
fine judgements that need to be made are likely and minor mistakes are inevitable, even with the most extensive quality control measures.

2.6.2.4 Further, in a context where companies’ business models and processes are constantly changing, and where accounting standards are also periodically updated, it is inevitable that there will be variation across audit firms and some differences or errors of judgement as these changes are adapted to. The purpose of the AQRT is to ensure, as far as possible, consistency in this constantly changing environment.

2.6.2.5 The position in relation to non-FTSE 350 audit reviews in general is different, with the AQRT noting a larger number of audits requiring ‘significant improvement’\(^{143}\). In its 2010/11 Annual Report, the AQRT notes the following:

- The number of audits undertaken by major firms assessed as requiring significant improvements in 2010/11 was seven (10 per cent), compared with eight audits (11 per cent) in both 2009/10 and 2008/9. The proportion of audits undertaken by smaller firms assessed as requiring significant improvements, while lower than in the prior year, continues to be higher than at major firms (four out of nine audits (44 per cent), compared with 55 per cent in 2009/10 and 45 per cent in 2008/9)\(^{144}\).

2.6.2.6 It is interesting that a higher proportion of audits reviewed for non-FTSE350 companies require ‘significant improvement’ than audits reviewed for FTSE350 companies, while a larger number of firms provide statutory audit services to the former. This indicates that quality appears to be higher in the reference market than outside of it.

2.6.2.7 Further, in its follow-up research with ACCs, the CC:

- Found that for 64 per cent of respondents, the company’s external audit had been the subject of an AQRT report. Of those, 98 per cent saw a copy of the report. In many cases, respondents indicated that the report was positive or that only minor issues were raised\(^{145}\).

2.6.2.8 Given the CC’s general comments on the quality of ACCs\(^{146}\), this suggests that informed readers are seeing that the AQRT comments are not suggestive of material quality defects. This is inconsistent with and undermines the CC’s suggestion that

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\(^{143}\) Audit Inspection Unit, Annual Report 2010/11, 19 July 2011.  
\(^{145}\) Paragraph 40 of the Provisional Findings.  
\(^{146}\) In particular that they are experienced and well-qualified individuals, as stated in paragraph 9.66 of the Provisional Findings.
there are “widespread” concerns regarding audit quality, at least among those in the position best placed to judge it.

2.6.2.9 As noted above, and based on our own experience, this data may also indicate that the ACC took a different view to the AQRT regarding how serious an issue was, which may be because the ACC has direct experience of how the auditor undertook their analysis and exercised professional scepticism in practice.

2.6.3 Lack of sufficient evidence to support the Provisional Findings in relation to audit quality

2.6.3.1 We consider that the following shortcomings in the CC’s evidentiary base undermine its provisional finding that there are ‘significant, persistent and widespread’ concerns regarding audit quality.

*AQRT evidence is generally positive*

2.6.3.2 The CC relies on the views and data of the AQRT in reaching its Provisional Findings. However, the CC tends to overstate the negative findings of the AQRT and overlooks the generally positive assessment of audit firms conducting FTSE350 audits. In the period between 2007 and 2011, the AQRT found 10 instances out of the 149 FTSE350 company audits reviewed where quality was assessed as being in need of ‘significant improvement’\(^{147}\). It seems unusual to describe 10 instances out of 149 in a five year period as indicating “significant, persistent and widespread”\(^{148}\) concerns regarding audit quality. This is especially the case when one considers that the AQRT tends to focus on the more complex and risky FTSE350 audits when conducting its reviews\(^{149}\). Further, while the AQRT raised concerns regarding audit quality in its annual reports of 2008/09 and 2009/10, there appears to have been an overall industry decline in the number of audits reviewed as requiring ‘significant improvement’ in 2010/11 and 2011/12 compared with 2008/09 and 2009/10.\(^{150}\)

\(^{147}\) Paragraph 7.119 of the Provisional Findings.
\(^{148}\) Paragraph 7.121 of the Provisional Findings.
\(^{149}\) Paragraph 9.122 of the Provisional Findings.
\(^{150}\) Figure 7.1 of the Provisional Findings.
2.6.3.3 Relevantly, in its 2011/12 review of 14 of KPMG’s audits, the AQRT found general satisfaction with the basis on which significant audit judgements were made. The report specifically found that:

- KPMG places considerable emphasis on its overall systems of quality control\(^{151}\);
- and
- KPMG has appropriate policies and procedures in place for its size and the nature of its client base in the relevant areas, which are subject to review\(^{152}\).

2.6.3.4 We recognise the areas identified by the AQRT where improvements are required and take the findings of the AQRT review process very seriously. Formal commitments are made via a detailed action plan (which is included in the AQRT’s private report) to address the issues raised. We believe that the CC has failed to recognise the overall positive findings of the AQRT and the measures taken by audit firms to address those findings. Further, a number of the points raised by the AQRT relate to inadequate documentation or a failure to request particular evidence. In our view these individual lapses should be seen in the context of high overall audit quality and should not be overstated. They do not support the Provisional Findings.

2.6.3.5 \[^{[\ldots]}\]. This result represents \[^{[\ldots]}\] on 2011/12, when the AQRT found that one audit required ‘significant improvement’ and 2010/11 when two audits were found to require ‘significant improvement’. We are pleased with this \[^{[\ldots]}\] trend and believe it is due in large part to the continuing significant investment made to enhance audit quality and exceed regulatory standards.

\textit{QAD evidence is supportive}

2.6.3.6 We are also subject to audit review by the Quality Assurance Department (QAD) of the Institute of Chartered Accountants in England and Wales (ICAEW). As the CC is aware, the results of the QAD’s review and that of the AQRT are used by the Audit Registration Committee of the ICAEW in considering our continued registration as a registered audit firm in the UK. Accordingly, these reviews are taken very seriously by KPMG. While the QAD’s reviews do not focus on FTSE350 companies, we submit


that the views of the QAD are relevant in considering the overall quality of the audit services provided by KPMG and are indicative of the quality of service provided to FTSE350 companies.

2.6.3.7 The QAD also has a positive impression of our internal review and quality assessment process, the Quality Performance Review (QPR), which is outlined in section 2.6.4.6 below. In its 2012 report, the QAD notes:

"From our review of one audit included in the firm’s QPR, we concluded that the matters raised by the internal cold review were broadly consistent with our view."

Positive views of customers

2.6.3.8 In conducting its analysis, the CC deliberately did not ask companies in its survey or in its case studies whether they thought that their current audit firm was performing well. This was because it was assumed that companies could only answer ‘yes’. The basis for this conclusion is not made clear and we refute the suggestion that a company and ACCs in particular could not give a fair and balanced view of the performance of its incumbent auditor. While some individual shareholders may lack the information or skills necessary to appraise directly the quality of any particular audit, this is not the case for ACCs and FDs, who generally have extensive experience and appropriate qualifications to assess the quality of an audit. In any event, it seems unusual not to ask for companies’ views, given that they are the agents of the audit firm’s ultimate customers (shareholders). We submit that the CC should have sought the views of companies and ACCs specifically on this question.

2.6.3.9 Evidence given during the House of Lords Select Committee inquiry attested to high levels of quality in the provision of audit services, arising from competition between audit firms:

- The Chairman of the Hundred Group stated that this group is "content in general terms with the service provided and the competition that we observe in the market"

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154 Paragraph 7.97 of the Provisional Findings.
155 Paragraphs 9.66 and 9.99 of the Provisional Findings.
156 The group of Finance Directors of FTSE 100 companies.
today”. This witness added that “audit firms know that we have a choice and that very often it is all you need to keep their pricing and the quality of their service honest” 157.

Commenting on the delivery of the audit opinion, the Chief Finance Officer of Pearson and member of the Hundred Group stated: “Could we get it cheaper? Possibly, but there’s also an issue about quality. We want to make absolutely certain that we are getting the best advice” 158.

Commenting on the value-added services, provided to an auditor using insights picked up during the course of conducting work for the audit opinion, the Chairman of the Hundred Group noted that these services add “a lot of value to the audit committee and provides a lot of perspective, context, even assurance for the non-executive directors, which you wouldn’t get from an insurance policy but you can get from your auditors” 159.

2.6.3.10 The available evidence on audit quality provided to the CC by these individuals suggests that there are not “significant, widespread and persistent” concerns regarding audit quality. The fact that the CC has not considered this evidence to be relevant undermines the veracity of its Provisional Findings and calls into doubt the soundness of its investigation.

Corporate failures are not evidence of audit failure

2.6.3.11 The examples provided by the CC of corporate failures in the early 2000s, in both the United States and the United Kingdom 160, are now many years old and not necessarily instructive when one considers the extensive regulatory and structural changes to the financial services industry since that time.

2.6.3.12 The CC also notes the corporate failures that occurred as a result of the global financial crisis and indicates that “several cases 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.” 161 In relation to the role played by audit firms in such corporate failures, it is worth noting

159 House of Lords Select Committee on Economic Affairs, “Auditors: Market concentration and their role”, page 262.
161 Paragraph 7.139 of the Provisional Findings.
that the parameters and scope of the audit itself, which are set by statute, limit the role and engagement of the audit firm. Further, the CC’s conclusions in this regard are reached without sufficient evidence linking the corporate failure to a lack of audit firm independence or scepticism. In our view, the reasons for these corporate failures are inextricably linked to the causes of the global financial crisis itself and cannot easily be ascribed to one particular factor.

2.6.3.13 The CC also notes that the FRC and other reporting bodies reference a lack of evidence of sufficient challenge which is then assumed to be indicative of a lack of professional scepticism. However, a lack of documentary evidence does not of itself justify such a conclusion. As set out in further detail in paragraph 2.7.6.9 below, while a lack of documentation may represent a deficiency in quality by reference to relevant Auditing Standards, it does not necessarily mean that there has been insufficient professional scepticism applied by an auditor.

Fixed fee arrangements do not undermine audit independence

2.6.3.14 The CC’s report notes the FRC’s concerns 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. However, we do not believe that the FRC has evidence that this has occurred in practice (as opposed to being a theoretical concern). Equally, other than noting the FRC’s expressed concerns, the CC provides no evidence to indicate that there is a link between fixed fee arrangements and a reduction in audit quality. It is worth recognising that the FRC’s comments are contained in its discussion paper, Auditor scepticism: Raising the Bar, which, rather than outlining its own concluded views, is designed to raise issues and call for comment. In this particular context the FRC states:

“The audit market is competitive and such [fixed] fee estimates do not usually contain contingencies for dealing with the unexpected. Negotiations for additional fees after the audit has been completed can adversely impact client relationships.”

2.6.3.15 As noted, the FRC provides no direct evidence to support its conclusion regarding fixed fee arrangements. Further, the CC has not appropriately recognised the

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162 Paragraph 7.112 of the Provisional Findings.
context in which this statement was made; it is particularly interesting to note the FRC’s comments that the competitive nature of the audit market is resulting in downward pressure on fee arrangements. Statements such as this conflict with the CC’s Provisional Finding that the FTSE350 audit market is characterised by one or more AECs. In our experience, while a number of clients prefer ‘fixed fee’ arrangements there is scope within the terms of the client engagement to charge additional fees in certain circumstances, such as where the scope of the work changes or issues are uncovered during the initial review which require further analysis. However, such changes in the fees charged will often only be agreed after the audit has been completed.

2.6.4 Evidence not considered or given insufficient weight

2.6.4.1 In this section we outline the evidence that undermines the CC’s provisional view that there are “significant, persistent and widespread” concerns regarding audit quality. This evidence appears to have been given insufficient weight by the CC in reaching its provisional findings and effectively undermines those provisional findings.

Companies can effectively assess audit quality

2.6.4.2 The companies that participated in the CC’s case studies generally expressed a positive view of their auditor\textsuperscript{164}. As noted above and recognised by the CC in its report, companies (in particular FDs and ACCs) have the ability to effectively assess audit quality\textsuperscript{165}. The CC recognises that ACCs and FDs are typically well-qualified and experienced individuals, with many having extensive audit experience themselves\textsuperscript{166}. The CC does not appear to give sufficient weight to the survey findings that 91 per cent of ACCs stated that they were confident that audit work was being carried out to a satisfactory standard, and 100 per cent have confidence that their audit firm had sufficient understanding of the business as a going concern\textsuperscript{167}. Most ACCs surveyed also believed that they could assess audit quality outside of a tender process by a variety of means\textsuperscript{168}.

\textsuperscript{164} Appendix 2 and paragraph 7.99 of the Provisional Findings.
\textsuperscript{165} Paragraph 9.127 of the Provisional Findings.
\textsuperscript{166} Paragraph 9.66 and 9.99 of the Provisional Findings.
\textsuperscript{167} Table 11 of Appendix 4 of the Provisional Findings.
\textsuperscript{168} Paragraph 9.112 of the Provisional Findings.
Very few claims are made against audit firms

2.6.4.3 We submit that the lack of claims made by clients against audit firms is indicative of an increase in audit quality and improvements in risk management processes169. In the last 10 years, there have been relatively few settled claims of a significant size (over £1 million) and the number and value of claims has declined over the period 2002 to 2011. The CC appears to dismiss too readily the views of audit firms which suggest that the decline in claims in recent years has been due, in part, to enhanced quality control measures implemented by the audit firms themselves170.

Internal review procedures are effective

2.6.4.4 We have implemented a number of procedures and review processes to ensure that audit quality is monitored and assessed on a regular basis. We understand that other audit firms auditing FTSE350 companies have similar practices and procedures in place. In our view, the CC underestimates the value and effectiveness of these internal review procedures that contribute to the maintenance and enhancement of audit quality. These measures are designed not only to enhance our ability to compete effectively in terms of audit quality171, but also to meet the demands of management for a robust and comprehensive audit, which is evidenced in the following case studies considered by the CC in its report:

- The CFO of Company A advised that he did not wish to see reliance “just on controls” and wanted auditors to “bash the balance sheet”172. Auditors provided an external view of controls and the balance sheet and this “benefited the Board and shareholders”173.

- The CFO of Company C stated that the value in having an audit was that it kept management “on the straight and narrow and was absolutely indispensable to the integrity of the published accounts, given the temptations and pressures to produce accounts that presented a company in the most favourable light”174.

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169 Paragraph 7.114 of the Provisional Findings.
170 Paragraph 7.117 of the Provisional Findings.
171 We note that FDs interviewed as part of the CC’s first survey indicated that a high degree of challenge by auditors and the independence of an audit firm were important factors when selecting an auditor (as set out in paragraph 25(a) of Appendix 11 of the Provisional Findings).
172 Paragraph 22 of Company A Case Study in Appendix 2 of the Provisional Findings.
173 Paragraph 25 of Company A Case Study in Appendix 2 of the Provisional Findings.
174 Paragraph 40 of Company C Case Study in Appendix 2 of the Provisional Findings.
The FD of Company E stated that he wanted to “feel like we have been audited”\textsuperscript{175}.

The Company G Group Financial Controller advised that one trigger point for tender would be a slip in independence\textsuperscript{176}.

The FD of Company H explained that she wanted to ensure the books were correct and she was focussed on having “as clean a balance sheet as possible”\textsuperscript{177}.

The FD of Company I advised that the annual performance of the auditor is rated against independence and objectivity\textsuperscript{178}.

2.6.4.5 We have previously outlined, in our Response to the Market and Financial Questionnaire (“MFQ”)\textsuperscript{179}, the internal review procedures designed and implemented to monitor and enhance audit quality. These include KPMG’s QPR, the Quality Control Review, the Risk Compliance Program and the Global Compliance Review. The effectiveness of all these programs is also subject to assessment by the AQRT which compares the results with their own audit reviews, and which also notes that we place considerable emphasis on these processes and that they are appropriate, as we set out in paragraph 2.6.3.3.

2.6.4.6 Our QPR assesses audits on an annual basis and grades them in a manner similar to the AQRT’s three-tiered grading system. In the 2012 QPR:

- 93 per cent of audit engagements reviewed were graded as ‘satisfactory’;
- five per cent were graded as ‘performance improvement necessary’; and
- two per cent were graded as ‘unsatisfactory’.

2.6.4.7 The high level of audit quality observed by KPMG’s QPR indicates that although there is room for improvement, overall standards are high. We also note that as part of our engagement with shareholders we publish the QPR results in our annual Transparency Report. This report provides another means by which shareholders can assess audit quality in addition to those reports published by bodies such as the AQRT and FRC.

2.6.4.8 We devote substantial resources to ensure quality control. Such significant resources are invested in order to compete on audit quality, which surveys indicate is one of the

\begin{footnotesize}
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\item \textsuperscript{175} Paragraph 5 of Company E Case Study in Appendix 2 of the Provisional Findings.
\item \textsuperscript{176} Paragraph 22 of Company G Case Study in Appendix 2 of the Provisional Findings.
\item \textsuperscript{177} Paragraph 18 of Company H Case Study in Appendix 2 of the Provisional Findings.
\item \textsuperscript{178} Paragraph 17 of Company I Case Study in Appendix 2 of the Provisional Findings.
\item \textsuperscript{179} Our response to question 101 of the MFQ.
\end{enumerate}
\end{footnotesize}
major competitive differentiators in the relevant market\textsuperscript{180}. It is also clear from the CC’s report that other audit firms are making similar investments\textsuperscript{181}. This suggests that there is substantial competition on audit quality and that audit firms are acutely aware of clients’ demands in this area. We recognise that, as with any profession, there may be occasions when overall high standards in audit quality are not met but we submit that this is not because of a lack of competition in the relevant market. Rather, it is because of the complexity of the work involved (particularly when conducting a FTSE350 audit), the scope for discretionary judgement and the extremely rigorous review process undertaken and high standards set by bodies such as the AQRT and QAD ex post facto.

2.6.4.9 As mentioned above, \([\leq]\) emphasises not only our commitment to enhancing audit quality but also the effectiveness of our internal review and monitoring procedures.

2.6.4.10 In reaching its Provisional Findings, the CC appears to have given such internal reporting evidence insufficient weight. The CC also seems to have significantly underestimated the substantial investments audit firms have made to monitor and enhance audit quality. We find this shortcoming in the CC’s assessment particularly disappointing. In such circumstances the CC’s Provisional Findings that there are “significant, persistent and widespread” concerns regarding audit quality appear are undermined.

2.6.5 \textit{Concluding comments regarding audit quality}

2.6.5.1 The Provisional Findings on audit quality appear to lack substantive evidence. Most companies in the CC’s case studies had a positive view of their auditor and the AQRT data tends to indicate overall compliance with industry standards, with a very small number of FTSE350 audits reviewed by the AQRT requiring ‘significant improvement’. The examples of corporate failure noted by the CC do not clearly reflect a failure of the auditor or of audit quality. There is also no evidence to suggest that fixed fee arrangements have any detrimental effect on audit quality.

2.6.5.2 The CC also appears to have failed to consider relevant evidence in reaching its Provisional Findings or has given such evidence insufficient weight. Companies, in

\textsuperscript{180} Paragraph 9.104 of the Provisional Findings.
\textsuperscript{181} Paragraphs 14 to 44 of Appendix 17 of the Provisional Findings.
particular FDs and ACCs, can assess audit quality effectively and the very small number of claims made against audit firms further supports the view that audit quality is generally high in the reference market. The CC’s failure to recognise the significant measures taken by audit firms to monitor and enhance audit quality in recent years is disappointing and further supports the view that the CC has not fully understood the competitive nature of the relevant market and has relied selectively on particular evidence while ignoring other evidence that undermines its theory.

2.7 Independence

2.7.1 The CC’s Provisional Findings on independence

The Provisional Findings state that “losses of auditor independence occur, and that this would not be an outcome that we should observe if auditors were responding only to the demands of shareholders”\(^\text{182}\). In particular:

- Firms have incentives to maintain good relationships with company management. Firms 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. The CC concludes that this may not be compatible with the AEP’s role of independently examining the company’s account\(^\text{183}\).

- Companies can influence the composition of the audit team and can have the firm’s AEP replaced. This is a mechanism by which companies can undermine auditor independence\(^\text{184}\).

- The FRC and other bodies continue to raise concerns regarding a loss of independence. The CC relied on the anecdotal evidence of these bodies in the absence of other direct sources of evidence regarding the loss of auditor independence\(^\text{185}\).

2.7.2 Analysis of the CC’s Provisional Findings on independence

2.7.2.1 In reaching its provisional conclusion in relation to independence, the CC notes that it “encountered difficulties in gathering direct evidence” as to whether firms have shown insufficient independence\(^\text{186}\). The evidence that it refers to includes: US claims (which are not necessarily relevant to the reference market), UK claims that it has not

\(^{182}\) Paragraph 7.149 of the Provisional Findings.

\(^{183}\) Paragraph 7.146 of the Provisional Findings.

\(^{184}\) Paragraph 7.146 of the Provisional Findings.

\(^{185}\) Paragraph 7.148 of the Provisional Findings.

\(^{186}\) Paragraph 7.125 of the Provisional Findings.
considered in detail\textsuperscript{187}, several (redacted) cases which it found to be ‘suggestive of the potential’ for auditors to have demonstrated a higher degree of scepticism (although the CC suggests that the level which was exercised may not have given rise to a claim)\textsuperscript{188} and supervisory body reports. The CC does not provide any direct examples where a loss of auditor independence has occurred.

2.7.2.2 We set out below our principal concerns regarding the Provisional Findings on auditor independence and professional scepticism, which in summary include:

- The CC has failed to produce sufficient evidence to support its provisional finding that losses of auditor independence and scepticism occur.
- The CC has inappropriately conflated professional scepticism and auditor independence and has not provided sufficient evidence to support a connection between these concepts and a negative impact on competition in the relevant market.
- The CC has failed to consider the ‘third limb’ of audit quality which suggests that an effective relationship between management and audit firm is necessary to produce a high quality audit review.
- The CC has given insufficient weight to evidence which suggests auditors are very protective of their independence and that audit quality on the whole is high.
- The CC draws incorrect conclusions from the views of other reporting bodies without testing that evidence itself and without providing its own supportive evidence.

2.7.2.3 The CC also suggests that a lack of auditor independence leads to an audit firm seeking to satisfy the demands of senior management and that this results in a distortion of competition because firms compete on the “wrong parameters”\textsuperscript{189}. However, as discussed below in section 5.2, in relation to the CC’s second theory of harm, we consider that there is no evidence to suggest a misalignment between the interests of shareholders and senior management, and nor is it the case that audit firms seek to satisfy the demands of senior management in such circumstances. The CC’s conclusions on this point also seem to overlook the significance of the ‘third limb’ of audit quality which is discussed in detail below in section 2.7.4.

\textsuperscript{187} Paragraphs 7.136 to 7.138 of the Provisional Findings.
\textsuperscript{188} Paragraph 55 of Appendix 17 of the Provisional Findings.
\textsuperscript{189} Paragraph 11.103 of the Provisional Findings.
2.7.3  Conflation of ‘professional scepticism’ and ‘auditor independence’

2.7.3.1  We have already set out in section 2.6 our view that the CC has found evidence only of relatively few audit errors, and has little, if any, evidence to suggest that these are caused by a loss of professional scepticism. We are further concerned that the CC has failed to distinguish between professional scepticism on the one hand and auditor independence on the other. In our view, the two concepts are distinct and the former is not necessarily indicative of the latter. It is also concerning that the CC uses this conflation to conclude, without a cogent evidentiary basis, that insufficient professional scepticism and a lack of auditor independence reflect imperfect competition in the relevant market.

2.7.3.2  The FRC provides the following guidance on what ‘professional scepticism’ involves:

   "The appropriate application of professional scepticism in the audit requires a mind-set 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 judgements made in the course of the audit should be founded on the perspective of the shareholders (and other stakeholders). That mind-set demands the sort of hard evidence – to back each audit judgement 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."\(^{190}\)

2.7.3.3  The FRC has also previously mentioned that ‘auditor independence’ involves:

   "The effective identification and assessment of threats, the application of appropriate safeguards and the proper reporting of these to audit committees are critical to maintaining auditor independence."\(^{191}\)

2.7.3.4  It would thus appear that these concepts are distinct and it cannot be assumed, as the CC appears to, that insufficient professional scepticism necessarily results from a lack of auditor independence. The CC provides no direct evidence to support this causality. Audit work, particularly in relation to FTSE350 companies, is complex, involves the exercise of professional judgement and is manually intensive. Accordingly, mistakes (some of which may simply result from human error) may be made and while on occasion this could be indicative of a lack of professional scepticism it by no means

\(^{190}\)  [www.frc.org.uk/getattachment/1aecac64-6309-4539-a6d9-690e67c93519/Briefing-Paper-Professional-Scepticism.aspx](http://www.frc.org.uk/getattachment/1aecac64-6309-4539-a6d9-690e67c93519/Briefing-Paper-Professional-Scepticism.aspx), page 12.

indicates that the auditor lacks independence or is otherwise beholden to the interests of management. It is also understandable that such mistakes are far more readily observed in hindsight through an ex post review conducted by an external reporting body.

2.7.3.5 The CC states that “the reports produced by the AQRT identified a range of issues (of varying degrees of gravity) regarding quality and a lack of auditor scepticism across a large proportion of the relevant market”. However, when one reviews the 2011/12 AQRT report, the AQRT states:

“We have been and remain critical of the extent to which auditors have sometimes failed to exercise appropriate professional scepticism in relation to key judgements.”

(Emphasis added)

2.7.3.6 The AQRT also states:

“Firms have undertaken a number of good initiatives to reinforce the importance of exercising professional scepticism in the conduct of their audit work. These include additional training and specific communications to staff from key management personnel.”

2.7.3.7 The above statements of the AQRT would appear to be inconsistent with the CC’s own assessment. We also refer to our comments above in section 2.6 which show that audit quality on the whole is high, thereby undermining the CC’s concerns regarding insufficient professional scepticism.

2.7.3.8 Further, when one considers other comments of the CC in its own report there appear to be further discrepancies. For example, the CC notes that “auditors have in recent years on occasion failed to demonstrate appropriate levels of professional scepticism”. This does not to equate to “a lack of auditor scepticism across a large proportion of the relevant market” nor is it indicative of “significant, persistent and widespread” concerns regarding audit quality. Inconsistencies such as these undermine the Provisional Findings.

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192 Paragraph 11 of the summary of the Provisional Findings.
195 Paragraph 11.104 of the Provisional Findings.
2.7.4  **Failure to consider the ‘third limb’ of audit quality**

2.7.4.1 The CC has failed to consider that an effective relationship between the auditor and senior management is an essential input to achieve high audit quality, and is not inconsistent with auditor independence. While the CC frequently notes that auditor independence is an essential component of audit quality, the CC also states, at an early stage in its report, that the “technical quality of an audit also includes the quality of internal reporting to senior management and the AC”\(^{196}\). This is said to be important because the internal reporting to senior management and the AC “may assist them in audit planning and their assessment of the quality of the audit and in providing further disclosure of information to shareholders”\(^{197}\). Such information also indirectly contributes to the usefulness of the audit report and opinion to shareholders\(^{198}\). However, in conducting the rest of its investigation and reaching its Provisional Findings, the CC appears to have overlooked this ‘third limb’ of audit quality.

2.7.4.2 Comments by the CC which recognise the importance of the relationship between senior management and the audit firm are reasonable and it is unfortunate that the CC does not refer to this ‘third limb’ in greater detail in its assessment of audit quality and independence. We submit that an effective relationship between the AEP and senior management of the company is essential if the audit is to be conducted in a cost-efficient and thorough manner. Furthermore, this early recognition by the CC appears to be inconsistent with the following comments which appear later in its report:

> “...auditors have comprehensive legal rights of access to information and rights to require explanation. We consider that the auditors’ emphasis on maintaining good relationships for the purpose of inquiry is unusual among investigative bodies that have access to such extensive powers.”\(^{199}\)

2.7.4.3 Inconsistent statements such as these undermine the Provisional Findings on independence.

2.7.4.4 Further, this fails to recognise that the production of financial statements for large companies is a complex subjective process often involving many assumptions and judgements. An audit is a contemporaneous review of that process (and outcomes)

\(^{196}\) Paragraph 6.12 of the Provisional Findings.
\(^{197}\) Paragraph 6.12 of the Provisional Findings.
\(^{198}\) Paragraph 6.12 of the Provisional Findings.
\(^{199}\) Paragraph 7.147 of the Provisional Findings.
which may well not be completely documented at the time. It is not an ex post inspection designed to establish a narrow range of objective facts which in itself may take many months to complete. There is therefore a fundamental need for a degree of cooperation as well as challenge in the process that is entirely consistent with there being effective competition allied to independence and scepticism. Indeed if this relationship breaks down an audit may become impossible – a fact we have recognised on occasion when we have taken the decision to resign from the appointment.

2.7.4.5 In summary, we submit that there is a fundamental need for cooperation as well as challenge in the relationship between management and auditor that is entirely consistent with there being effective competition allied to auditor independence and professional scepticism. Indeed, if this relationship breaks down an audit may become impossible – a fact we have recognised on occasion when we have taken the decision to resign from the appointment. To suggest otherwise, without cogent evidence, indicates a lack of understanding of the audit market.

2.7.5 Lack of sufficient evidence to support Provisional Findings

2.7.5.1 The CC fails to provide sufficient evidence to support its Provisional Findings that losses of auditor independence occur in practice. A number of reasons are advanced as to why such losses might occur in theory, but no account is seemingly taken of countervailing influences, in particular the major damage that would be caused were an audit firm to be seen to positively align itself with management as opposed to shareholders, particularly where their respective interests diverge.

2.7.5.2 The CC infers that firms have incentives to maintain good relationships with company management and considers that this is consistent with the failures in professional scepticism that it has identified. Again, the CC provides no direct evidence of a link between maintaining a good relationship with management and the loss of audit firm

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200 We note that, at paragraphs 57 to 87 of Appendix 17 to the Provisional Findings, the CC sets out several examples “suggestive of the potential for auditors to have demonstrated a higher degree of scepticism” (see reference at paragraph 7.139 of the Provisional Findings). At the date of this response, however, we have not been given sight of these examples and so cannot comment on their probity to the CC’s Provisional Findings. This response therefore does not consider this evidence, and the CC can place no weight whatsoever on these examples unless and until it provides us and other firms with sufficient information about to allow us properly respond. In this regard, we reserve our rights to provide further submissions on this evidence as and when the CC discloses sufficient information to allow us to properly do so.

201 Paragraphs 11.103 and 11.104 of the Provisional Findings.
professional scepticism and independence. It appears unusual to suggest that audit firms should seek to have an ineffective relationship with those responsible for preparing the financial statements which they are required to review and simply rely on their statutory powers to undertake their engagement\textsuperscript{202}. We submit that it is perfectly reasonable, and necessary in the light of the third limb of audit quality, for an audit firm to be concerned about delivering a high level of service to senior management (including the FD/CFO) and the ACC. A theoretical problem arises only in circumstances where the interests of management actually conflict with the interests of shareholders. However, audit firms are acutely aware of the need to balance these interests, and the existence of the various internal review procedures outlined above emphasises the steps taken by audit firms to ensure the highest standards of audit quality and independence.

2.7.5.3 The CC provides no tangible evidence to support the view that the interests of shareholders and management generally conflict and as we demonstrate in section 5.2, we consider such risks are effectively mitigated, in any event, by the role of the AC, NEDs and, indeed, auditors. In fact, as noted below, the CC fails to take account of evidence which demonstrates the opposite.

2.7.5.4 In addition, the mandatory rotation of an AEP every five years means that the concerns raised by the CC regarding auditor independence are likely to be overstated as there is already sufficient regulatory intervention to prevent over-familiarity and a lack of independence arising.

2.7.5.5 It is then noted by the CC that audit firms invest significant resources 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\textsuperscript{203}. The CC considers that this may not be compatible with the AEP’s role of independently examining the company’s accounts\textsuperscript{204}. The CC appears to believe that such a transition is not desirable as it concludes that this is a mechanism by which companies can undermine auditor independence\textsuperscript{205}. However, the CC provides no evidence of this ever having

\textsuperscript{202} Paragraph 7.147 of the Provisional Findings.
\textsuperscript{203} Paragraph 7.132 of the Provisional Findings.
\textsuperscript{204} Paragraph 7.135 of the Provisional Findings
\textsuperscript{205} Paragraphs 7.132 and 7.133 of the Provisional Findings.
occurred\textsuperscript{206} and we are not aware of any instances where an AEP has been replaced to undermine the audit firm’s independence.

2.7.5.6 A “seamless” transition involves taking measures to ensure that the initial education process is as cost efficient and effective as possible when a change of AEP occurs. It does not mean that the new AEP unquestioningly adopts the opinions and methodology of the outgoing AEP in conducting its initial audit review. Indeed, we recognise the benefit of AEP rotation to ensure a fresh approach in conducting the audit review and selecting the methodology and procedures employed. The desire to ensure a “seamless” transition would also appear to be consistent with the ‘third limb’ of audit quality noted by the CC earlier in its report\textsuperscript{207}. Clear and direct lines of communication between an incoming AEP and senior management are fundamental to ensure the transition process is as smooth as possible and the potential for ‘audit risk’ is minimised. Hence, in our view, such an outcome is entirely consistent with high audit quality and the maintenance of independence.

2.7.6 Evidence not considered or given insufficient weight

2.7.6.1 As stated in our previous submissions to the CC, there are a number of factors that undermine the Provisional Findings that losses of independence occur on a regular basis. We are not aware of any instances where we have lost independence or otherwise failed to adequately have regard to shareholders’ interests.

2.7.6.2 It is important to recognise that the risk to an audit firm’s and an individual partner’s reputation would be significant if independence or scepticism were undermined\textsuperscript{208}. This is a fact noted by the CC\textsuperscript{209} and widely recognised by all audit firms. We submit that reputation for independence and integrity is 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. As noted above in section 2.7.4, evidence from companies suggests that they value auditor independence highly and look for an audit firm that will scrutinise the relevant data. In

\textsuperscript{206} Paragraph 7.133 of the Provisional Findings.
\textsuperscript{207} Paragraph 6.16 of the Provisional Findings.
\textsuperscript{208} Paragraph 39 of Appendix 17 of the Provisional Findings.
\textsuperscript{209} Paragraph 39 of Appendix 17 of the Provisional Findings.
our view, an AEP would not intentionally undermine their own or their firm’s reputation by submitting to the demands of a company’s senior management in order to secure or retain a specific client engagement.

2.7.6.3 Further, as noted in paragraph 2.7.5.5 above while the CC’s report states that companies “can” influence the composition of the audit team and, on occasion, “can” have the firm’s AEP replaced\textsuperscript{210}, no evidence of “friendly” AEP appointments by companies is provided to support the Provisional Findings\textsuperscript{211}. The CC also does not appear to recognise that replacing an AEP may be necessary for a variety of legitimate reasons and will occur as a matter of course in accordance with Ethical Standard 3. In our experience, while a client may ask for a change in their AEP, such a change would only occur with the approval of the ACC who would discuss the change with the outgoing AEP and other senior members of the company (such as the Chairman of the Board and the FD/CFO) to confirm the underlying reasons for the change. Any such request and the reasons therefore would also be considered very carefully by the audit firm in considering whether to agree and if so who the replacement should be to ensure above all else that audit quality is maintained.

2.7.6.4 Another point which the CC does not appear to have considered is that the extent to which an auditor will need to challenge the work undertaken by management will depend in large part on the quality of the work undertaken by management in the first place. If the work provided to the audit firm is accurate and the underlying evidentiary basis is sound there will be limited opportunity for the audit firm to challenge management. This is particularly the case in the relevant market, with FTSE350 companies investing significant resources to ensure that their reporting and accountancy processes are as efficient and effective as possible. We submit that such an outcome is indicative of an effective audit process. If an audit firm were to needlessly challenge management on all points the audit process would be inefficient and unnecessarily costly.

2.7.6.5 The ethical standards that were introduced by the APB in 2004, and implemented by individual audit firms, ensure independence by requiring:

\begin{itemize}
  \item \textsuperscript{210} Paragraph 7.146 of the Provisional Findings.
  \item \textsuperscript{211} Paragraph 7.133 of the Provisional Findings.
\end{itemize}
an AEP to conclude on any threats of objectivity and independence and whether these have been properly addressed before the issuance of an audit report\textsuperscript{212};

- the appointment of a suitably senior Ethics Partner who is responsible for assessing the effectiveness of the firm’s policies and procedures\textsuperscript{213}; and

- firms to monitor the length of time that partners and staff were members of each audit engagement team, including mandatory rotation of the AEP for listed clients\textsuperscript{214}.

2.7.6.6 The CC’s Provisional Findings provide a summary of the implementation of these ethical standards by individual audit firms, but the CC then fails to explain why they are not sufficient to ensure independence and are circumvented\textsuperscript{215}. We submit that these standards are appropriate and adapted to ensuring independence and that further regulatory intervention is, at this stage, not required. The implementation of these standards by individual firms also suggests that on the whole the industry has taken effective and proportionate measures to enhance audit quality and ensure auditor independence. While individual derogations from these standards may arise, the CC gives insufficient weight to the fact that there has been a general increase in audit quality in recent years as noted above in section 2.6, cannot be denied, yet the CC appears not to take account of this.

2.7.6.7 As we noted in paragraph 2.6.4.3, the lack of significant claims brought against audit firms results from an increase in audit quality and improvements in risk management processes, and as a result also supports the conclusion that losses of independence are not as prevalent as the CC appears to believe. The CC’s conclusion that the absence of claims for negligence being brought against audit firms in recent years “does not necessarily indicate that there is no problem”\textsuperscript{216}, appears to give insufficient weight to this evidence. To simply suggest that the litigation system in the UK is different to that in other jurisdictions and that this ‘may’ be the reason for the absence of claims\textsuperscript{217} is not a compelling justification when dismissing this evidence so readily. It is clearly the case that where companies do have a sound claim, they can bring it successfully in

\textsuperscript{212} Paragraph 8 of the Provisional Findings.
\textsuperscript{213} Paragraph 9 of the Provisional Findings.
\textsuperscript{214} Paragraph 11 of the Provisional Findings.
\textsuperscript{215} Appendix 17 of the Provisional Findings.
\textsuperscript{216} Paragraph 7.140 of the Provisional Findings.
\textsuperscript{217} Paragraph 7.120 of the Provisional Findings.
the UK, as they have in the past. The balance of evidence therefore suggests that the absence of significant claims for negligence being brought against audit firms in recent years is reflective of the extensive measures taken by those firms and the industry as a whole to enhance audit quality and ensure auditor independence, and not due to differences in litigation rules.

2.7.6.8 One of the CC’s main sources of evidence is the joint FSA/FRC report titled “Enhancing the auditor’s contribution to prudential regulation”. Included in FSA/FRC’s feedback statement on that report is the following statement which is not cited by the CC:

“There was widespread recognition from respondents that the application of professional scepticism is fundamental to the audit process. While regulated firms and their auditors noted that they believe auditors are already sufficiently sceptical, they expressed a willingness to debate the issue and explore various means of increasing the transparency of the audit, thereby improving the visibility of the challenge auditors pose to management. There remains a difference of views between us and the auditors on whether they were always being sufficiently sceptical. While recognising that this may be exacerbated by the fact that it is often difficult to identify in retrospect whether auditors have been sufficiently sceptical, we have each held or will hold separate meetings with individual audit firms to explain the specific matters that led to our conclusions. Our concerns include whether there was sufficient challenge in relation to particular judgements and whether scepticism is adequately embedded in the audit firms’ processes and training.” (FSA/FRC Feedback Statement, Enhancing the Auditor’s Contribution to Prudential Regulation, March 2011).

2.7.6.9 In respect of the FSA’s follow-up with KPMG undertaken as part of the review it was apparent that one of the concerns of the FSA/FRC was not so much a lack of scepticism but a lack of documentation to evidence the exercise of professional scepticism.

2.7.7 Incorrect conclusions from the views of other reporting bodies

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218 See our response to question 44 of the MFQ for details of the claim brought against KPMG in 2003 by the [ ], which resulted in a significant settlement.

219 Paragraph 46 of Appendix 17 of the Provisional Findings.
2.7.7.1 The CC’s findings on independence also appear to rely heavily on the views of other bodies such as the FRC and the PCAOB\textsuperscript{220}. First, as set out in paragraph 2.7.7.3 below it is not clear to us whether the views of the PCAOB apply to the reference market or any (or many) companies within it. We are also concerned about the CC placing undue reliance on the comments of other bodies rather than forming conclusions itself, albeit supported by expert advice. For example, the CC includes the concerns of a number of bodies that responded to the FRC’s discussion paper \textit{Auditor scepticism: Raising the Bar} \textsuperscript{221}. Again, while the concerns raised in response to this discussion paper by different bodies should be considered seriously, very little detail is provided and few actual examples are listed where a lack of auditor independence can be observed\textsuperscript{222}. As noted in paragraph 2.6.3.14, the CC also appears to quote very selectively from this discussion paper without recognising that the FRC’s paper is essentially designed to raise issues for comment rather than analyse auditor independence and professional scepticism overall.

2.7.7.2 Further, when referring to the FRC’s discussion paper, the CC fails to recognise the following about the academic research upon which the discussion paper relies:

\begin{itemize}
\item Due to the difficulty of gathering ‘real life’ situations, many studies detailed have relied upon hypothetical case studies tested using surveys or in settings outside practice rather than data drawn from actual audit engagements.
\item Much of the academic research in this field is US-based and the findings may not apply equivalently to auditors working in different jurisdictions.
\item Some of the academic research dates back to the 1990s and earlier. Accordingly, many recent developments in audit practice, as a result of recent financial and regulatory developments, will not be reflected\textsuperscript{223}.
\end{itemize}

2.7.7.3 The CC also notes the PCAOB’s concern that it has “continued to observe instances in which circumstances suggested that auditors did not appropriately apply professional scepticism in their audits”\textsuperscript{224}. Again, there is a lack of detail as to the nature of these instances and how significant these deviations were. There is also insufficient connection drawn between professional scepticism on the one hand and auditor

\textsuperscript{220} See for example, paragraphs 7.140, 7.142 and 7.143 of the Provisional Findings.
\textsuperscript{221} Paragraph 7.142 of the Provisional Findings.
\textsuperscript{222} Paragraphs 7.142 and 7.143 of the Provisional Findings.
\textsuperscript{224} Paragraph 7.143 of the Provisional Findings.
independence on the other. When one reviews the PCAOB’s Staff Audit Practice Alert the following salient features become apparent:

- The PCAOB’s views relate to audit reviews conducted in the United States, hence this material is outside of the reference market.
- The PCAOB’s Staff Audit Practice Alert includes only one specific case example where the parties are identified\(^\text{225}\). In the other four cases referred to by the PCAOB, very few details are provided and the parties involved are not identified\(^\text{226}\).
- In order to substantiate its own concerns, the PCAOB refers to the concerns raised in other jurisdictions such as Australia, Canada, Germany, The Netherlands, Singapore, Switzerland and the United States. However, the PCAOB does not provide any specific examples\(^\text{227}\).

2.7.7.4 Such heavy reliance by the CC on the views of other bodies without adequately recognising the context in which those views were expressed undermines the CC’s conclusions regarding supposed shortcomings in independence and scepticism. Quite simply, there is insufficient evidence for the CC to have reached its Provisional Findings. Further, the CC appears to have overlooked or given insufficient weight to evidence that does not support or conflicts with its theories of harm.

2.7.8 Concluding comments regarding independence

2.7.8.1 In summary, the CC has insufficient evidence to conclude that losses of independence occur. Further, the CC inappropriately conflates the concept of professional scepticism with the concept of auditor independence. While the two may be linked in certain circumstances, insufficient professional scepticism is not necessarily connected with a lack of independence. Even if there were evidence to support such a link, the CC has failed to substantiate its conclusion that this has had a detrimental impact on competition in the relevant market or that it is the result of an AEC.

2.7.8.2 We submit that in reaching its Provisional Findings regarding independence the CC has also failed to give relevant evidence sufficient weight, in particular:

insufficient recognition of the ‘third limb’ of audit quality and the need for an effective relationship between the audit firm and senior management;

- the lack of any evidence to suggest that companies seek to influence the selection and retention of the AEP or other senior audit staff and the CC’s own survey results which indicate that management and ACCs highly value independence and challenge from their auditor;

- the lack of any tangible evidence to suggest that the interests of shareholders and management generally conflict and, as set out in section 5.2 below, a failure to recognise the role of ACs, other NEDs and audit firms in effectively mitigating these risks;

- evidence from audit firms which indicates that the consequences for their reputation would be substantial if auditor independence were undermined; and

- the effectiveness of the ethical standards introduced in 2004 and implemented by individual audit firms to ensure auditor independence.

2.7.8.3 The CC’s lack of substantive evidence to support the Provisional Findings regarding independence also has the effect of undermining its conclusions regarding the competitive state of the relevant market. While we accept that there will always be room for improvement in the case of individual audits, the current external regulatory and reporting framework is effective in identifying any deficiencies and addressing them.

2.7.8.4 Individual audit firms have also made substantial investments to monitor and enhance audit quality and to ensure independence is preserved. Furthermore, adequate regulatory safeguards to preserve auditor independence are already in place which require, for example, AEP rotation every five years.

2.7.8.5 We submit that the CC should reconsider its Provisional Findings in relation to independence in light of the additional evidence provided in this response.

2.8 Choice

2.8.1 The CC’s approach to analysing choice is flawed

2.8.1.1 The CC’s provisional view is that the concentration of supply in the market and alleged barriers to entry and expansion might suggest that there is less choice of alternative suppliers in the FTSE350 statutory audit market than the CC would expect to see in a well-functioning market. The CC also notes that limited differentiation

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228 Paragraph 7.28 of the Provisional Findings.
between the offerings of the largest four audit firms might amount to a lack of choice\textsuperscript{229}.

2.8.1.2 In our view the CC has failed to establish any causal link between its observations on choice and its alleged AEC finding. This is for two reasons. First, because the CC’s approach to assessing and analysing choice in the supply of statutory audit services is fundamentally flawed. Second, even setting aside the concerns about the CC’s approach to assessing choice, the CC has failed to appropriately and consistently assess the evidence it has gathered. We consider the first of these issues in this section, then address the CC’s evidence base in sections 2.8.2 and 2.8.3 below.

2.8.1.3 The CC reasons that with greater choice of alternative suppliers, it may expect to see greater differentiation of offerings, across firms. The reasoning behind this view is not clear from a theoretical standpoint. In the supply of statutory audit services, firms are differentiated in relation to quality rather than offering ‘choice’ – to use the technical economic terms the supply of statutory audit services is a “vertically”, rather than “horizontally”, differentiated market. Quality differences across audit firms arise through differences between, among other things, firms’ global networks, sector capabilities and the quality and training of their staff\textsuperscript{230}. In addition, the quality of an individual audit engagement will be driven by the probability of the audit firm detecting and reporting a mistake, which is in turn driven by the quality of the audit professionals, the methodology used and the approach to risk, as well as the quality of internal reporting provided to management.

2.8.1.4 In arguing that it would expect to see more choice in a well-functioning market the CC fails to take into account this fundamental feature of statutory audit. Rather than demanding horizontal product differentiation, as might be found in numerous other industries in which quality is less of an important factor to customers, customers of statutory audit services will choose the audit firm that they judge to offer the highest level of quality (achieved by audit firms competing for the best talent and investing in training and quality improvements) at an acceptable price.

\textsuperscript{229} Paragraph 7.27 of the Provisional Findings.

\textsuperscript{230} See Section 5 of our Main Submission in response to the CC’s Issues Statement.
2.8.1.5 The CC discusses differentiation in the context of innovation, which we also discuss in section 2.9 below. However, these examples of innovation again largely lead to vertical differentiation – in other words they largely lead to audit firms being able to provide a higher quality audit product. For example, efficiency innovations which allow firms to allocate a greater proportion of the hours they work on an audit to areas of greater risk.231

2.8.2 Evidence which undermines the CC’s conclusions

2.8.2.1 The CC’s conclusion that there is less choice than it would expect to see in a well-functioning market is inconsistent with evidence and conclusions it has drawn elsewhere. In particular:

■ The CC’s provisional view is that if a FTSE350 company decides to go to tender it will have a choice of at least three of the largest four audit firms and that there is “strong competition” for the tender232. The fact that three audit firms give rise to strong and effective competition undermines the view that companies do not have enough choice of alternative suppliers among the largest four audit firms.

■ The CC has provisionally found that mid-tier audit firms consider233 that they have the capability to audit nearly all sectors within the FTSE350, which shows that companies can choose a supplier of audit services from a potential pool of not only the largest four audit firms but also the mid-tier firms.

■ The CC’s survey evidence shows that companies are informed about their outside options and, rather than desiring there to be more firms to invite to tender, in fact many companies have said that they restrict the number of firms invited to tender.234 This highlights the lack of evidence that there is any demand for greater choice on the part of customers.

2.8.3 The CC fails to understand the regulatory context that in the public interest limits choice and differentiation

2.8.3.1 The CC has failed to fully appreciate the regulatory context in which statutory audit services operate. There are advantages to consistency across different companies as it enables more reliable comparisons by shareholders (and also makes switching audit firm easier). Indeed this is recognised by the CC in relation to the benefits of accounts being prepared to the same accounting standards235 and audited against those

231 Paragraph 7.168 of the Provisional Findings.
232 Paragraph 9.56 of the Provisional Findings.
233 Paragraph 7.26 of the Provisional Findings.
234 Paragraph 9.19 of the Provisional Findings.
235 Paragraph 5.37 of the Provisional Findings.
standards, and these similarly apply to the audit product. It is therefore in the overall public interest to ensure a degree of comparability and hence standardisation both in terms of the audit process and reporting the results to shareholders, as we discuss in section 2.10.3 below. As a consequence the supply of statutory audit is highly regulated and there are therefore restrictions which limit the extent to which horizontal differentiation is possible.

2.8.3.2 In particular, one key objective of the statutory audit is to state whether the accounts give a true and fair view. The scope for variation in that output is limited. In addition, the audit reports issued by audit firms of companies in the FTSE350 are based on templates issued by the FRC and scope for variation from this format is limited by regulation. This is recognised by the CC but the CC has failed to take account of it when it concludes that choice would be greater in a well-functioning market.

2.8.3.3 In addition, audit firms liaise with investors as far as possible (though the scope for doing so is difficult given the fragmentation of investors and their views) and compete in order to provide services over and above the statutory audit report.

2.8.3.4 Given that firms differentiate themselves on quality in the ways stated above, and, given that the supply of statutory audit is highly regulated which places restrictions on the differentiation of the audit report possible, it is not at all clear why or how the CC would expect more choice to arise absent the features it identifies in section 13 of its Provisional Findings. In a setting of quality differentiation, economic theory predicts that competition will lead to a market structure with a smaller number of high quality firms, and a fringe of lower quality providers, which is consistent with the outcomes observed in the supply of statutory audit services. Overall, therefore, there is no evidence that the levels of choice are not what would be expected in a well-functioning market and that there is any customer detriment associated with a lack of choice.

2.9 Innovation

2.9.1 Introduction

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236 Paragraph 7.156 of the Provisional Findings.
2.9.1.1 The CC’s provisional view is that innovation is not at levels it would expect to see in a well-functioning market. The CC has defined neither what levels and type of innovation it has in mind in a benchmark well-functioning market nor a universal demand for additional services which might be met through increased innovation. If there was a universal demand for such additional services, which can already be procured as non-audit services, investors would have forced companies to provide these, and the fact that they have not showed that there is no such universal demand for additional services. The CC has failed to provide any probative evidence or coherent arguments to support its view that innovation would be greater absent the features it has identified. Similarly, the CC has provided no evidence of any customer detriment associated with any lack of innovation.

2.9.1.2 Instead, the CC has dismissed the considerable evidence of process and product innovation which it has gathered, and has reached a finding based on hypothetical arguments which are unsupported by evidence. This is not a sound basis for an AEC finding.

2.9.2 Evidence which undermines the CC’s conclusions

2.9.2.1 Throughout its analysis of innovation in the supply of statutory audit services the CC has shown that there is substantial innovation by auditors, within the regulatory constraints in which they operate. In particular:

- The CC has identified that although there are restrictions on innovation due to regulation, audit firms can and do provide additional testing and reporting (examples of this include our ‘extended audit’ product).
- The CC identifies that the audit report has changed little and is constrained by regulation. Nevertheless, innovation has taken place in reporting, and the fact that audit reports are relatively unchanged meets shareholders’ demand for consistency.
- The CC finds that there is scope for innovation in methodologies that allows the development of industry-specific audit approaches. Indeed, firms have identified that innovation has taken place through the use of industry-specialized modules.

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238 Paragraph 7.179 of the Provisional Findings.
239 Paragraph 7.173 of the Provisional Findings.
240 Paragraph 7.164 of the Provisional Findings.
241 Paragraph 7.174 of the Provisional Findings.
242 Paragraph 7.175 of the Provisional Findings.
243 Paragraph 7.161 and Appendix 8 of the Provisional Findings.
The CC finds that there has been innovation by the largest four and mid-tier audit firms in IT and systems.244

The CC finds innovation by some of the largest four audit firms with respect to their delivery model through using service centres.245 This change in approach is evidence of innovation (regardless of the significance of this at the present time, which is in any case increasing).

The CC finds evidence of extended reporting and extended audit arrangements246,247.

2.9.2.2 The CC appears to dismiss the evidence on innovation on the basis that much of the innovations the CC has identified are “primarily determinants of cost and operational efficiency”248. In other words the innovation the CC has observed is largely process rather than product innovation. The CC is incorrect to dismiss the evidence of innovation that it has gathered, because:

i) many of the examples of innovation that the CC has characterised as process innovation in fact also relate to product innovations;

ii) in any case, process innovation is an important part of innovation and the CC has no sound basis for discounting it; and

iii) such process innovation is evidence of strong competition to supply information to management, which is an inherent part of the audit product.249

2.9.2.3 We discuss point i) below before discussing points ii) and iii) in the next section.

2.9.2.4 The CC has incorrectly categorised certain areas of innovation as process-only innovations, when in fact they also impact on the product that is provided to audit firms’ customers. Specifically:

i) The process innovations identified by the CC which lead to efficiencies can also be categorised as innovations along the technical quality dimension of the audit product: they allow firms to allocate a greater proportion of the hours they work on an audit to areas of greater risk250, and this therefore raises quality for a given input of hours.

ii) The CC defines service as “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.\(^{251}\) Therefore innovations by firms to identify cost and operational efficiencies are in fact innovations on the dimension of service.

2.9.3  **The CC fails to produce sufficient evidence to support its provisional conclusion on innovation**

2.9.3.1  As noted above, the CC appears to place less weight on the substantial evidence of innovation in the supply of statutory audit services on the basis that it is process rather than product innovation. Given that the nature of the statutory audit product, and therefore that we would expect to see most innovation in processes rather than products, it is not clear to us why the CC has chosen to place more weight on product innovation when assessing the level of innovation in this market.

2.9.3.2  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. Although the audit product has evolved over the years, its format is prescribed by regulation.\(^ {252}\) For this reason, innovation largely occurs around audit firms’ delivery of that standardised product. However, like in other industries with a relatively standard final product (for example, oil, water, etc) this innovation has led to very substantial benefits for customers. The fact that our margin has been maintained, and prices fallen, in the face of significant increased regulatory burden is evidence of the benefits of process innovation.

2.9.3.3  In addition, in non-consumer goods markets more generally, innovation typically occurs further up the supply chain which is consistent with several examples of the innovation the CC has observed in relation to statutory audit services.

2.9.4  **To the extent that there is unmet demand, this cannot be solved through innovation**

2.9.4.1 The CC suggests that “if there is [unmet] demand, we expect firms should, absent some feature of the market, innovate to meet it.”\(^ {253}\) In section 2.10 below we set out our view that the CC has not provided robust evidence to show that there is significant and coherent unmet demand in the supply of statutory audit services. Further, to the extent that there may be unmet demand, we set out evidence of audit firms innovating and competing to meet this demand in the next section.

\(^{251}\) Paragraph 6.14 of the Provisional Findings.

\(^{252}\) Paragraph 7.156 of the Provisional Findings.

\(^{253}\) Paragraph 7.179 of the Provisional Findings.
2.9.4.2 In addition, we set out in that section why any unmet demand that may exist in relation to the supply of statutory audit services is not a function of the level of competition in the statutory audit market.

2.9.5 **Conclusions**

2.9.5.1 Overall, the evidence shows that audit firms compete through innovating in their process, products and services. The basis upon which it does this is not clear to us, and it must fully explain its reasons for doing so in its Final Report. Process innovation is important in driving more efficient audits, leading to lower prices that the CC has observed\(^\text{254}\) as we discuss in paragraphs 2.4.3.2 above, as audit firms pass on efficiency savings.

2.9.5.2 The CC has failed to place appropriate weight on this substantial evidence in reaching its view that innovation is not at levels it would expect to see in a well-functioning market. The alleged existence of unmet demand in the supply of statutory audit services provides no evidence in support of the CC’s conclusion. In addition, the CC has provided no alternative evidence to support its conclusion.

2.9.5.3 The alleged existence of unmet demand in the supply of statutory audit services is not probative to the CC’s consideration of this issue.

2.10 **Unmet demand**

2.10.1 **Introduction**

2.10.1.1 The CC finds that there is unmet demand for further or different information regarding audit of companies\(^\text{255}\). While it notes evidence of varying demand between different shareholders, its view is that this is to be expected, and that this demand would be met in a well-functioning market\(^\text{256}\). The CC identifies the main areas of consensus from shareholders who would like further information regarding: how aggressive accounting approaches to accounting policy compared to the industry norm, and the main areas of discussion between auditor and company\(^\text{257}\).

\(^{254}\) Paragraph 7.31 of the Provisional Findings.

\(^{255}\) Paragraph 7.204 of the Provisional Findings.

\(^{256}\) Paragraph 7.204 of the Provisional Findings.

\(^{257}\) Paragraph 7.186 of the Provisional Findings.
2.10.1.2 We disagree that the level of unmet demand is inconsistent with the functioning of a well-functioning audit market. In particular, we contend that (a) demand for further information has not in general been sufficiently coherent and significant and (b) there are certain demands which it would be inappropriate for audit firms to meet (indeed, there are benefits to not meeting them). To the extent that consistent demands emerge that can be met, audit firms are competing and innovating to meet them (and encouraging companies to do likewise), and regulatory initiatives have also been introduced, or are underway, to meet outstanding areas of unmet demand.

2.10.2 Lack of (coherent) and significant demand

2.10.2.1 Audit firms’ reporting obligations are to the shareholders of a company as a group, and their services are paid-for by shareholders as a group. It is therefore not the role of audit firms to satisfy the demands of any individual shareholders. Before satisfying any shareholder demand, it is therefore necessary to establish whether there is consensus among a company’s shareholders as a group (as opposed to demand from any individual or representatives of one of a number of investor groups). As the CC notes, shareholder demand is differentiated\(^{258}\), and it is very difficult (and rare) to obtain consensus among shareholders in general or amongst the shareholders of a particular company\(^{259}\).

2.10.2.2 As we have previously submitted\(^{260}\), while some investors have expressed a wish for further reporting, they do not generally translate those wishes into any economic imperatives for audit firms to provide more than the statutory minimum, nor for companies to require their audit firms to do so\(^{261}\). In our opinion, this suggests that the majority of investors are sufficiently satisfied with the information which is being supplied.

2.10.2.3 To the extent that there was cogent, significant unmet demand that was causing material issues in capital markets (e.g. inefficient investments in capital), then we would expect that:

i) professional investor groups would pressure companies to provide it; and/ or

\(^{258}\) Paragraphs 7.182 to 7.187 and 11.123 of the Provisional Findings.

\(^{259}\) Summary of the CC’s Hearing with FRC, cited at footnote 537 of the Provisional Findings.

\(^{260}\) Paragraph 41 of the summary of the CC’s Hearing with KPMG.

\(^{261}\) Paragraph 41 of the summary of the CC’s Hearing with KPMG.
ii) regulators acting as a proxy for shareholder demand would mandate it; and/or
iii) the relevant regulator (which may be a company regulator such as the UK Listing
Authority or an audit regulator) and/or Government would legislate to ensure that
such information was provided.

2.10.2.4 However, as the evidence before the CC shows, this has not happened: only 10 per
cent of ACCs in the CC’s follow-up survey of ACCs have been approached by
shareholders for more information262. Reasons cited by ACCs as to why in their view
more shareholders had not approached them included “not a demand for further
information”, “company accounts were already too long” and “shareholders were
satisfied with the information provided”263. We also note that there are a number of
investors who have expressed concerns that company accounts are already too long264.

2.10.2.5 Further, as noted by PwC, it is possible for shareholders to ask questions of audit firms
in the annual general meeting (AGM)265. The fact that this rarely happens in practice,
is consistent with other evidence, cited above, which suggests that demand for further
information, even from individual shareholders, may not be significant. There is also
no evidence to suggest that failing to provide shareholders with additional information
is a reflection of auditors’ incentives to respond to the demands of executive
management over shareholders, as the CC seems to imply266.

2.10.2.6 We therefore agree with Ernst and Young267 that it would be inappropriate for the CC
to draw any conclusions about market features leading to an AEC based on such
disparate and incoherent demand.

2.10.3 *Unmet demand does not mean competition is not working well*

2.10.3.1 To the extent that there is unmet demand (which we set out above is not, in any case,
sufficient or coherent) this does not, of itself, indicate that competition is not working
well.

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262 Responses to question E3 of the CC’s follow-up survey of ACCs.
263 Paragraph 7.189 of the Provisional Findings.
264 Paragraph 7. of the Provisional Findings.
265 Paragraph 11.114 of the Provisional Findings.
266 In paragraph 11.133 of the Provisional Findings, the CC states that the lack of provision of additional
information to shareholders at AGMs is “consistent” with its finding that auditors have an incentive to
respond to the demands of executive management rather than individual shareholders (to which, we
would note, auditors do not have a duty).
267 Paragraph 7.196 of the Provisional Findings.
2.10.3.2 The CC recognises that shareholders are not homogenous in their demands for information from audit firms (and potentially in their willingness to pay for it)\(^{268}\). As set out in the previous section and recognised by the CC\(^ {269}\), the auditor’s role is to represent the interests of shareholders as a group; not to respond to the demands of individual shareholders. The CC also recognises that for each company there is a single, bespoke audit product. It therefore follows that the product must be designed to meet the demands of shareholders at some average or aggregated level, rather than marginal customers and is then tailored to the needs of the individual client\(^ {270}\).

2.10.3.3 This is the norm in any markets where firms offer (vertically) differentiated products to a diverse customer base. Companies in competitive markets can only be expected to respond to demand where demand is (a) significant and coherent and (b) it is efficient to do so. Companies cannot be expected to commit resources to meet the wishes of individual shareholders, although this is what the CC seems to be implying in its Provisional Findings.

2.10.3.4 Furthermore, standardisation (either of financial reporting or audit reporting) is a necessary feature of the audit market, which allows shareholders to compare and contrast the performance of different companies. The CC recognises that there is a ‘network benefit’ in complying with established principles and practices\(^ {271}\), and that there is a demand for consistency of approach from management, shareholders and regulatory bodies\(^ {272}\). This has implications for the ability of auditors to provide further reporting in areas of subjectivity such as the aggressiveness of accounting treatments, with sufficient objectivity so as to be reliable\(^ {273}\).

\(^{268}\) Paragraphs 7.182 to 7.187 and 11.123 of the Provisional Findings.
\(^{269}\) Paragraph 11.140 of the Provisional Findings.
\(^{270}\) Indeed, the economics literature shows that in the absence of competition a monopolist firm might bias quality choice by focussing on the marginal customer, compared to a social planner that chooses quality at the level of demanded by the average customer. See Spence “Monopoly, quality and regulation”, Bell Journal of Economics (1975).
\(^{271}\) Paragraph 5.37 of the Provisional Findings.
\(^{272}\) Paragraph 7.156 of the Provisional Findings.
\(^{273}\) In addition, while auditors may be in a good position to challenge management decisions, they seldom if ever know more than management about the business. It may, however, be possible for companies to provide more disclosure in the financial statements on the most subjective accounting estimates and judgements, and indicate reasonably possible alternatives. In this regard we note the FRC’s proposals to enhance transparency in company reporting regarding the subjective judgments taken in putting accounts together).
2.10.3.5 Similarly, audits should not provide new information about the company itself (that should continue to be the purview of management).

2.10.3.6 Finally, as the CC recognises, companies have a legitimate interest in protecting certain information, particularly commercially sensitive information \(^{274}\), and accounting standards explicitly provide for this in certain circumstances. The CC also recognises that companies similarly have an interest in protecting some detailed aspects of conversations between auditors and companies, lest this impact on the openness of these discussions. \(^{275}\) In such circumstances, it would not therefore be appropriate to meet demand for this information.

2.10.3.7 Thus, there are limits on the demands for further information from shareholders that companies or auditors can meet without jeopardising the quality and value of the audit product itself.

2.10.3.8 Notwithstanding the lack of coherent and significant demand and the constraints which the CC identifies on meeting some demands of shareholders, the CC concludes that the failure of audit firms to satisfy unmet shareholder demand is a failure of competition in the audit market. However, from the CC’s reasoning it seems that the only way to ‘solve’ this problem (i.e. that there should be no unmet demand) would be for audit firms to provide all possible information requested from shareholders (and seemingly even the most extreme marginal shareholder). However, this would be inefficient (and potentially decrease the value of the audit product provided) and would also be inconsistent with a well-functioning market.

2.10.3.9 In any event, to the extent that there is unmet demand, we submit that it is not within the gift of auditors to meet it and, therefore, does not represent a failure of competition in the audit market. The CC accepts that auditors contract with companies, rather than shareholders, and are bound by confidentiality requirements to companies \(^{276}\). Thus, the information which audit firms have as a result of their engagement belongs to the company, and not the audit firm. Aside from the information which the audit firm is obliged to ensure is made public, it is the company which has the ultimate control over what information is released to shareholders.

\(^{274}\) Paragraph 11.119 of the Provisional Findings.

\(^{275}\) Paragraph 11.129 of the Provisional Findings.

\(^{276}\) Paragraph 11.109 of the Provisional Findings.
2.10.3.10 Therefore, to the extent that there is information which is not being provided to shareholders, but which it is not in the audit firm’s gift to provide, this cannot be a failure of the audit market, but is rather an issue of Corporate Governance and perhaps the effectiveness of regulation permitting the disclosure of certain company information. In this regard, as we noted in our Hearing with the CC277, and highlighted by the anonymous company cited at 7.190 of the Provisional Findings, there may also be a co-ordination issue which inhibits the willingness of companies to provide additional information. In our experience, companies tend to be hesitant to ‘make the first move’ in disclosing more information to shareholders, and given, for example the commercial advantage it might provide competitors. The fact that only a limited number of companies have sought to make more detailed disclosures to shareholders may also be indicative of the practical difficulties associated with providing additional information.

2.10.3.11 Finally, the CC has also not provided any evidence to suggest that the unmet demand it identifies is in any way linked to a lack of auditor independence, or competition within the ‘wrong parameters’ by audit firms. The fact that audit firms have been involved in trying to broker ways forward here is indicative of the positive role they have played, not an indication of their “capture” by management or any failure of competition.

2.10.4 Firms are innovating and competing, and regulations are changing, to satisfy changing shareholders’ demand

2.10.4.1 As the CC notes, firms recognise that there is some (albeit not cogent) unmet investor demand, and they 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. This is despite the limitations and difficulties associated with audit firms providing additional information, which the CC recognises278. Thus, firms are competing and innovating to meet shareholder demand, contrary to the CC’s assertion279.

277 Paragraph 11 of the transcript of the CC’s hearing with KPMG.
278 Paragraph 11.117 of the Provisional Findings.
279 Paragraph 7.179 of the Provisional Findings.
2.10.4.2 As an audit firm we have encouraged ACCs and companies in general to disclose additional information regarding the audit. Our Audit Committee Institute has promulgated specimen disclosures to over 2,500 UK AC members, which go far beyond the current level of detail disclosed in even the most fulsome annual reports (see the document attached as Annex 1 to our response). Also, along with the other major global auditing networks, we have regularly promoted the disclosure guidelines published by the Enhanced Disclosure Working Group, a group convened by the Global Auditor Investor Dialogue whose members include the major global auditing networks and leading global investors and shareowners.280 Again, these disclosure guidelines go far beyond the current level of detail disclosed in even the most fulsome annual reports. Our Audit Committee Handbook (published by our Audit Committee Institute) includes extensive extracts drawn from these guidelines.

2.10.4.3 In addition to competition between firms, regulatory changes have also either been introduced, or are underway, to increase the level of information provided to shareholders, including to provide additional reporting in relation to the main areas of discussion between audit firms and companies. For example, in 2012 the FRC issued revised ISAs (UK and Ireland), including ISA (UK and Ireland) 700, together with changes to the UK Corporate Governance Code (“UKCGC”). The FRC is also currently consulting on possible amendments to ISA (UK and Ireland) 700. A number of these proposed amendments are designed to increase disclosure about the audit process and how material accounting treatments have been decided. In overview, it is proposed that the amendments will require the audit firm’s report 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; and

(c) Provide a summary of the audit scope, including an explanation of how the scope was responsive to the assessed risks of material misstatement and the auditor’s application of the concept of materiality, as disclosed in the auditor’s report.”

2.10.4.4 Therefore, we support the need for audit firms to provide more information on the audit, but believe that the key is to fully understand what information investors are interested in obtaining from the audit firm. The audit firm already provides the AC with extensive information on the key areas of the audit, audit materiality and the audit scope. This is normally an extensive document and is discussed in detail with the AC in their meetings. Therefore, summarising this in the audit report in a way that is clear and concise will be important to ensure that the reader fully understands the context, especially where there is no mechanism for a two way conversation with investors. Therefore, we are fully supportive of the proposals but believe that more consultation is required to ensure that this provides investors with the information and the context that they require to properly utilise that information.

2.10.5 Conclusion on unmet demand

2.10.5.1 We dispute the CC’s contention that the level of unmet demand for additional information is at a level which would not be expected in a competitive market. As set out above, while there may be some unmet demand, the extent, and uniformity, of this demand is unclear. Further, the CC has failed to recognise that there is some demand which it would be inefficient, or inappropriate, for audit firms to meet.

2.10.5.2 There are impediments to audit firms sharing certain information, and the CC recognises this. Nevertheless, the evidence before the CC clearly shows that, to the extent information can be shared, audit firms have been innovating to do so (despite the lack of cogent demand). To the extent that some demand is not being met (because it would be inappropriate for audit firms to meet it), this is not a failure of the competition. Finally, we note recent regulatory changes, and expected future changes, are likely to result in further disclosures to shareholders.

2.10.5.3 On the basis of the evidence provided it is unclear to us why the CC finds this to be indicative of an AEC. In particular, we strongly dispute the CC’s finding that the level of unmet demand is inconsistent with a lack of audit firm independence from company management or with firms competing on the wrong parameters.\[281\]

\[281\] Paragraph 11.141 of the Provisional Findings.
3. Rebuttal of the CC’s Theory of Harm 1a: Companies’ bargaining power

3.1 Introduction

3.1.1 We set out in section 2 our view that the CC’s conclusion that observed market outcomes are indicative of an AEC is unsupported by any robust evidence. As a result, the CC has no reliable evidence of customer detriment or adverse outcomes in the supply of statutory audit services.

3.1.2 In its Provisional Findings, the CC then considers what market features may give rise to the outcomes it observes. The CC sets out its findings on features in relation to two theories of harm. In this section we discuss the CC’s reasoning in relation to the first of its theories of harm. In doing so, we set out our view that there is no evidence for this theory of harm and no causal link to the alleged outcomes the CC cites.

3.1.3 Overall, the CC has no sound basis for its conclusion that FTSE350 companies’ bargaining positions are weakened outside of tender processes. In reaching this conclusion the CC has improperly dismissed the large volume of evidence that shows competition working well and has produced no robust evidence in support of its conclusion. In addition, the CC has based its reasoning on a misunderstanding of economic theory, failing to consider a key aspect of audit firms’ uncertainty in the bargaining process between companies and audit firms, which we raised with the CC during its evidence gathering process.

3.1.4 As a result in our view the CC cannot validly reach a conclusion that the features it identifies in relation to barriers to switching give rise to an AEC.

3.2 The CC’s proposed bargaining framework

3.2.1 The CC sets out a number of factors it considers relevant to the assessment of companies’ bargaining power:

- the availability of alternative suppliers of a company’s audit services;
- the company’s ability to appraise accurately the offering that it is receiving from its current auditor;
- the company’s ability to appraise the offering of the available alternative suppliers;

282 Paragraph 9.7 of the Provisional Findings.
■ the costs to companies associated with search and switching;
■ the balance between the costs and gains from tendering and switching to companies; and
■ audit firms’ incentives to retain engagements.

3.2.2 The CC provisionally concludes that companies face ‘barriers to switching’, arising from: companies’ inability to compare offers of incumbent firms and alternative suppliers; companies’ inability to judge audit quality in advance; companies being unwilling to walk away from a relationship of trust with their audit firms; and company management facing significant opportunity costs in the management time involved in the selection and education of a new auditor283.

3.2.3 The CC then provisionally concludes that these factors are ‘features’ which give rise to an AEC, by weakening a company’s bargaining power outside of the tender process.

3.2.4 In our view the CC has weighed up the evidence in relation to companies’ and audit firms’ relative bargaining power incorrectly and come to an incorrect conclusion that features exist which weaken companies’ bargaining positions, and therefore the competitiveness of the supply of statutory audit services. In addition, in our view the CC has no evidence to support the view that companies are able to achieve competitive outcomes from their audit firms only some of the time.

3.2.5 In sections 3.3 to 3.9 below, we discuss in turn each aspect of the CC’s analysis of bargaining between companies and audit firms (set out in paragraph 3.2.1 above). In section 3.10 we set out our comments on the CC’s overall assessment of bargaining power and competitive constraints on audit firms.

283 Paragraph 9.260 of the Provisional Findings.
3.3 Availability of alternative suppliers

3.3.1 The CC provisionally concludes that “generally a FTSE350 company and its incumbent auditor can expect strong competition for the audit engagement if the company were to decide to tender”\(^{284}\). We agree with this overall provisional conclusion which is supported by a number of important pieces of evidence, summarised as:

- the largest four audit firms make considerable efforts to gain FTSE350 audit engagements\(^{285}\);
- audit firms have strong incentives to compete to win engagements\(^{286}\), inside and outside of tender processes;
- the largest four audit firms generally accept invitations to participate in tenders for audit engagements;
- the provision of NASs to tendering companies is not a barrier to competing for their statutory audits; and
- the largest four audit firms have strong incentives to perform well in tenders\(^{287}\), even if they are not successful in securing the audit.

3.3.2 This is therefore unequivocal evidence that companies have good and credible alternative suppliers (or “outside options”). We return to this in section 3.10 below.

3.3.3 The CC notes however that in “many sectors one or more audit firms may be at a competitive disadvantage given the importance of relevant experience, knowledge and expertise”\(^{288}\). As we explained in previous submissions\(^{289}\) audit firms strive to improve their services and be as attractive as possible to their customers. This is done by building expertise, and investing in a number of areas. Naturally, a product of this competitive process is that not all firms are equivalent in their services to customers at any one point in time. This is entirely consistent with a vigorously competitive audit market.

3.3.4 However, in our view it is important that the CC does not over-emphasise any differences between the largest four audit firms in relation to sector expertise. In fact,

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\(^{284}\) Paragraph 9.56 of the Provisional Findings.

\(^{285}\) Paragraph 9.45 of the Provisional Findings.

\(^{286}\) Paragraph 9.56 of the Provisional Findings.

\(^{287}\) Paragraph 9.50 of the Provisional Findings.

\(^{288}\) Paragraph 9.56 of the Provisional Findings.

\(^{289}\) For example, see sections 7 and 8 of our main submission in response to the CC’s Issues Statement.
all of the largest four audit firms have stated that they have the capabilities to audit companies in all sectors in the FTSE350, and in our experience all the largest audit firms are real and credible alternatives for companies. The CC has very limited evidence that to suggest that this is not the case.

3.3.5 As a result, the CC 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. In fact, the largest four audit firms use NASs and provision of audit services to companies in the same sector outside of the FTSE350 in order to gain sufficient sector expertise. In addition, market share figures in certain sectors can be skewed by the limited number of companies in that sector in the FTSE350, as we set out in our main submission in response to the CC’s Issues Statement. The CC has failed to take this into account.

3.4 Companies’ ability to appraise their incumbent audit firms

3.4.1 The CC finds that “FTSE350 companies have the expertise, resources and information to appraise their current auditor to a certain extent”. This is supported by a number of important pieces of evidence about companies’ ability to judge their incumbent audit firm, summarised as:

- FDs and ACCs for FTSE350 companies are typically well-qualified;
- FDs and ACCs for FTSE350 companies are typically experienced individuals; and for ACCs this experience includes sitting on multiple boards;
- with regard to quality the various sources of information would allow companies to make an assessment of whether a firm would have the capabilities that the company would require of its auditor.

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290 Paragraph 306 of our Main Submission in response to the CC’s Issues Statement.
291 In addition, we believe that the CC has incorrectly stated that in certain sectors certain of the largest four audit firms have lower share. For example, from inspecting the tables in Annex 1 of Appendix 5, it does not appear that EY has a particularly small share of FTSE350 company audits in the Financial Services, Insurance or Technology sectors. We would also query whether there are really only two of the largest four audit firms with high shares in the basic materials and consumer services sectors.
292 Paragraph 9.99 of the Provisional Findings.
293 Paragraph 9.66 of the Provisional Findings.
294 Paragraph 9.66 of the Provisional Findings.
295 Paragraph 9.114 of the Provisional Findings.
296 Paragraph 9.127 of the Provisional Findings.
in negotiating audit fees, FDs have a detailed understanding of the components of the audit fee (based on the previous year’s audit fee)\(^{297}\) and have the ability to sense check their fee against those of comparative companies (see section 3.5.3.2 below).

\(^{297}\) Paragraph 9.98 of the Provisional Findings.
3.4.2 Again, this provides strong evidence that companies are well able to appraise accurately their audit firm, which we return to in section 3.10 below. By stating that companies are only able to appraise their current audit firm “to a certain extent” the CC implies that there are material aspects of performance that customers are not in a position to appraise. However the CC has provided no explanation of what such aspects of performance may include, and it has offered no clear evidence to support this view.

3.4.3 The CC notes that the detailed work of an audit, such as the selection of sample sizes, may be less visible to ACs. In our response to the CC’s survey results on this issue we noted that in isolation these are not indicators of audit quality and hence they are not in themselves of concern to ACs. In any sizeable multinational organisation the audit will inevitably be risk-focused and will seek to test and wherever possible rely substantially on the controls implemented by management. Detailed substantive work using sample based testing, whilst important, would therefore have to be viewed in this context and the level of sample sizes will depend on the auditor’s judgement of inherent risk and assessment of the effectiveness of controls. Since in any major group this might vary significantly across different components there will probably not be “a sample size” applied to an aspect of the financial statements but rather an aggregation of different sample sizes based on materiality of different components. As a consequence, the AC’s activities are focused on understanding the overall scope of the audit (ie what components are directly covered), the levels of materiality applied, what the auditor has identified as the key audit risks, the overall approach to such risks (including the rigorous assessment of the entity’s controls and general extent of substantive work as appropriate) and the challenges of key judgements. In this way ACs can and do exercise appropriate oversight of the external audit. The CC needs to take this into account and cannot therefore put weight on the observation that ACs are less involved in certain detailed aspects of the audit work to support any AEC finding.

298 Paragraph 9.99 of the CC’s Provisional Findings on the supply of statutory audit services.
299 Paragraph 2.10 of our final submission to the CC prior to the publication of its Provisional Findings.
3.5 Companies’ ability to appraise the offering of alternative suppliers

3.5.1 Overview

3.5.1.1 The CC comes to a provisional view that “companies may encounter significant uncertainties in appraising potential auditors outside a tender, in particular in relation to the quality and fee of the audit offering”\(^{300}\). In our view the CC has failed to appropriately weigh the evidence in front of it in reaching that conclusion, which we discuss in the rest of this section.

3.5.2 Evidence that undermines the CC’s conclusion

3.5.2.1 There is substantial evidence to show that companies can and do accurately appraise the fees and quality of their outside alternatives:

- As the CC itself recognises, FTSE350 companies “regularly and actively make comparisons of the incumbent audit firms’ offer with that of rival firms”\(^{301}\). The CC’s own survey found that nearly all ACCs that it surveyed sat on or chaired another AC\(^{302}\). 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 NASs to gauge their quality\(^{303}\).

- External regulatory reports provide further information on audit firms’ quality\(^{304}\), which are considered carefully by ACCs\(^{305}\).

- Audit firms engage in extensive marketing efforts which provide companies with further information on their offers\(^{306}\), and companies are incentivised to respond to these audit firm initiatives\(^{307}\).

- We also provided the CC with extensive examples of companies undertaking comparisons\(^{308}\). These examples, which the CC refers to only in relation to quality, demonstrate 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.

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\(^{300}\) Paragraph 9.147 of the Provisional Findings.

\(^{301}\) Paragraph 9.141 of the Provisional Findings.

\(^{302}\) Paragraph 9.114 of the Provisional Findings.

\(^{303}\) Paragraphs 9.118-9.120 of the Provisional Findings.

\(^{304}\) Paragraph 9.122 of the Provisional Findings.

\(^{305}\) Paragraph 9.123 of the Provisional Findings.

\(^{306}\) Paragraphs 9.128 to 9.137 of the Provisional Findings.

\(^{307}\) Paragraph 9.138 of the Provisional Findings.

\(^{308}\) See Annex 2 of our response to the CC’s working paper “The nature and strength of competition”
3.5.2.2 The CC appears, without explanation, to have disregarded all of this evidence in reaching its conclusion that companies are less able to accurately appraise alternative suppliers outside of a tender process. Furthermore, the CC has, as far as we have seen, no reliable contradictory evidence at all, which we discuss in the next part of this section.

3.5.3 The CC has no reliable evidence to support its conclusion

3.5.3.1 As set out in paragraphs 3.5.2.1 to 3.5.2.2 above, the CC has seemingly disregarded a substantial body of evidence that companies are able to compare alternative audit providers outside of a tender process. The CC’s reasoning and evidence base for doing this is fundamentally flawed. The CC recognises 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 previous year”\(^{309}\). The CC’s conclusion that companies are unable to compare alternatives appears therefore to be based only on two considerations and we discuss each of them in turn below.

3.5.3.2 The first of the CC’s considerations is that, in relation to audit fees, the CC considers that it is difficult to obtain accurate information from published statutory accounts. In reaching this conclusion in relation to ability of companies to compare audit fees, the CC ignores the breadth of options that companies have to assess value for money:

- Audit fees may not be immediately comparable in published statutory accounts, however we note that this comparability has been facilitated by the December 2010 revision to the FRC’s Guidance to Audit Committees which recommended that companies (from 30 April 2011) set out, or cross refer to, the fees paid to the auditor for audit services, audit related services and other non-audit services. Also, companies are able to assess which other companies offer reasonable comparisons in terms of size and complexity, and form a view overall about the competitiveness of their audit fee\(^{310}\).

- Companies’ management and ACCs are also able to ask detailed questions of their audit firms, to examine closely changes in audit fee year on year, and in most instances ACCs can compare fees with the audit fees (and changes therein) charged to other companies of which they are Board members.

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\(^{309}\) Paragraph 9.98 of the Provisional Findings.

\(^{310}\) Such as those exercises conducted by Bunzl, Cable and Wireless Worldwide, Carillion, Diageo, Johnson Matthey, Prudential, Rolls Royce and Spirax-Sarco.
Companies are also approached by other audit firms, or can actively seek fee quotes from other audit firms, if they feel this would provide further information to judge their existing audit firm’s fees. We provided examples of this occurring in relation to [X], [Y] and [Z]. In addition, the CC’s customer survey shows that 88 per cent of companies have been approached in the last five years by a rival audit firm.311

3.5.3.3 The CC has not therefore provided sufficient evidence to show that companies experience particular difficulties in comparing audit fees and appraising the audit offerings of rival audit firms. On the contrary, the evidence available clearly points to companies being able to effectively compare the value for money of their offer.

3.5.3.4 The second of the CC’s considerations is the fact that, in relation to other (non-price) aspects of an audit, audit is an experience good. Many goods and services are experience goods and it is unclear to us why this intrinsic feature of the audit product is given such significant weight by the CC in reaching its AEC finding. In other contexts, customers wishing to purchase experience goods make use of proxies and available information which allows them to judge quality, including firms’ reputations.312 The same is true in relation to audit services.

3.5.3.5 In fact, there exists a broad range of effective ways to gauge audit quality in advance. These include:

- ACCs sitting on boards of other companies and having firsthand experience of alternatives;
- companies being able to observe quality in relation to NASs provided by alternative audit firms;
- external, independent reports into quality from the AQRT and (indirectly) Financial Reporting Review Panel ("FRRP") reports on company’s accounts;
- thought leadership pieces produced by audit firms;
- references from and discussions with other FDs and ACCs; and
- approaches from rival audit firms.

3.5.3.6 The CC is also inconsistent in its analysis of tender processes compared to negotiations outside of a tender. The CC has found that during tenders, companies are

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311 Paragraph 9.43 of the Provisional Findings.
312 For example, when purchasing a durable consumer good, the quality of the actual item purchased cannot be known with certainty in advance, but expectations are set by personal experience (for example buying goods from the same manufacturer previously), promotional material, external reports on quality (trade press, etc) and other observable proxies for quality.
able to accurately judge the quality of rival audit suppliers\textsuperscript{313} and that as a result tenders produce competitive outcomes as we discuss in section 3.9 below. Outside of tender events, on the other hand, the CC has found that companies are not able to do this. Indeed, the CC notes that “the balance of considerations often differs significantly between settings”\textsuperscript{314}. There is no evidence to show why companies should be significantly less effective in appraising quality outside of rather than during a tender event, and so the CC’s different conclusions in relation to these two competitive processes is unfounded.

3.5.3.7 The CC therefore has not demonstrated that it has sufficient evidence to support its finding that companies are not able to adequately compare audit quality outside of a tender process. Indeed, there is direct evidence before the CC which clearly points to companies being able to compare effectively audit quality. The CC has, without adequate explanation or justification, placed little or no weight on this evidence. The CC must fully explain its reasons for doing so in its Final Report.

3.6 The costs associated with search and switching

3.6.1 Overview

3.6.1.1 The CC has provisionally found that “there are significant costs associated with switching given the nature of the relationship between auditor and company, by which each invests in and places trust in the other”\textsuperscript{315}. The CC also provisionally concludes that there are “significant opportunity costs in the management time involved in the selection and education of a new auditor”\textsuperscript{316}.

3.6.1.2 In reaching these provisional conclusions, the CC has in our view misunderstood the nature and characteristics of an audit engagement and relationship. In addition, the CC appears to have very little (if any) evidence to support its conclusion. We discuss each of these flaws in the CC’s analysis in turn below.

\textsuperscript{313} Paragraph 9.221 of the Provisional Findings.
\textsuperscript{314} Paragraph 9.5 of the Provisional Findings.
\textsuperscript{315} Paragraph 9.173 of the Provisional Findings.
\textsuperscript{316} Paragraph 9.260 of the Provisional Findings.
3.6.1.3 Overall, our view is that the CC lacks any robust evidence base to show that any switching costs reduce the competitiveness of outcomes in the supply of statutory audit services.

3.6.2 The CC has misunderstood the nature of audit engagements and relationships between audit firms and companies

3.6.2.1 The CC has emphasised that audit firms and company management are unwilling to walk away from a relationship of mutual “trust”\(^{317}\) and suggested that the “close nature” of relationships between company management and audit firms is a “key contributory factor in the switching costs that [it has] identified”\(^{318}\). In doing this, in our view the CC has fundamentally mischaracterised the nature and important aspects of an audit relationship.

3.6.2.2 There are indeed reasons why companies have incentives not to switch away from their incumbent audit providers. However, while trust is important, as in any business relationship, this is not the key feature of an audit relationship and the CC has not provided any evidence to suggest otherwise. Rather the key reasons for companies having incentives not to switch audit firm relate 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\(^{319}\) 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).

3.6.2.3 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. Indeed, the CC itself recognises these inefficiencies that are associated with switching to a new audit firm\(^{320}\).

3.6.2.4 We note that the CC suggests that anticipation by investors of an increased risk of audit failure in the early years of an appointment could lead to adverse market

\(^{317}\) Paragraph 9.260 (iii) of the Provisional Findings.

\(^{318}\) Paragraph 11.105 of the Provisional Findings.

\(^{319}\) As recognised by the CC in paragraph 7.36 of the Provisional Findings.

\(^{320}\) Paragraph 9.159 of the Provisional Findings.
However, this is not supported by the evidence on investors’ views, which the CC summarises as showing that “for a large number of investors a change in audit firm was not seen to be an issue so long as the rationale for the change was explained by the company”\(^{322}\). This is further strong evidence of the efficiency of long term audit relationships, and needs to be taken into account by the CC in its analysis of the benefits of switching audit firms.

3.6.2.5 However, these incentives hold only so long as companies are also receiving good quality and value for money, and as result these incentives do not imply that companies achieve less than competitive outcomes. Recognising this important fact about the audit market is key to being able to interpret market outcomes correctly. It is precisely because of these relationship-specific investments that, as in many other competitive markets, interactions between market participants are characterised by longer relationships. This is the outcome of a competitive response to customer needs. There is ample evidence supporting this view, including that cited by the CC itself.

3.6.2.6 We discuss this further in section 3.10 below.

3.6.3 The CC should not overstate switching costs associated with management time

3.6.3.1 The CC has found that there are opportunity costs to a company associated with switching audit firm, in relation to management and others’ (eg ACs’) time in conducting a tender. However, in our view, and as expressed by almost all other audit firms (including mid-tier audit firms), it is important that these costs are not overstated. Indeed, the CC itself suggests that companies’ actual experience of switching costs shows these costs are surmountable for many companies\(^{323}\).

3.6.3.2 In particular, the CC’s point that during particular commercial or operational circumstances (for example, mergers, rapid growth or recent investment programmes) companies may have reduced bargaining power\(^{324}\) significantly overstates the effect of any of these circumstances. If companies’ bargaining power is impaired during the circumstances the CC has listed these are sufficiently short-lived for this not to have

\(^{321}\) Paragraph 9.161 of the Provisional Findings.
\(^{322}\) Paragraph 46 of Appendix 19 of the Provisional Findings.
\(^{323}\) Paragraph 9.175 of the Provisional Findings.
\(^{324}\) Paragraph 9.171 of the Provisional Findings.
an effect in practice. The CC dismisses the point made by us and other audit firms that we will not have any incentive to sacrifice a good relationship for the sake of short term opportunity\textsuperscript{325}. There is no logic to the CC’s conclusion and we have not seen any evidence to support it.

3.7 \textit{The costs and gains of tendering and switching}

3.7.1 \textit{Overview}

3.7.1.1 The CC provisionally concludes that “an incumbent firm is likely to have to under-perform or overcharge substantially in order to trigger a tender and that the fee on its own is unlikely to trigger a tender unless the incumbent attempts to impose a significant fee rise”\textsuperscript{326}.

3.7.1.2 In our view this provisional conclusion is incorrect as it is based on a misconception of companies’ incentives and of economic theory. In addition, the basis for the CC provisionally finding that companies do not switch unless there are ‘substantial’ drops in performance or increases in fees is unclear (as is what level ‘substantial’ is). In the next sections we address these weaknesses of the CC’s analysis.

3.7.2 \textit{There are flaws in the CC’s approach to considering gains and costs of switching}

3.7.2.1 As set out in paragraph 3.6.2.5 above, the gains from switching audit firm depend crucially on the performance of the incumbent. If the incumbent audit firm’s performance is high quality and good value, then naturally the gains from switching to an alternative audit firm will not outweigh the costs. Indeed, we made this point in our response to the CC’s working paper on “Evidence of switching costs (and implications for barriers to entry)”\textsuperscript{327} but the CC appears still to not have considered it. The CC has not explained why is has not considered this argument and the CC must do this in its Final Decision.

\textsuperscript{325} Paragraph 9.171 of the Provisional Findings.
\textsuperscript{326} Paragraph 9.187 of the Provisional Findings.
\textsuperscript{327} Paragraph 2.3 of our response to the CC’s working paper “Evidence on switching costs (and implications for barriers to entry)”.
3.7.2.2 The CC’s misunderstanding is evident in certain key statements in the provisional findings:

- In paragraph 9.187, the CC states that “the incumbent is likely to have opportunities to manage its relationship with the company in order to address any discontent that arises and in order to be satisfied that the benefits to switching are such that they outweigh the costs”\(^{328}\). It is not clear how the CC considers this to be a description of a market that is not competitive. Rather, audit firms’ responding to company dissatisfaction where it arises is an outcome that is in itself the clear description of strong competitive pressures in the supply of statutory audit services.

- In paragraph 9.177 the CC refers to a quotation from one of its case studies. This quotation makes clear that the costs of tendering and switching audit firm are viewed in the context of the company receiving excellent service from its incumbent audit firm\(^{329}\). The CC ignores this context when it places weight on companies’ observations about the costs of changing audit supplier.

- In paragraph 9.182 the CC notes that its survey results show that “generally clients must have reason to be dissatisfied with their existing auditor to consider switching”\(^{330}\). We fail to understand why the CC appears to find that this is evidence in support of an AEC finding. Rather, this is evidence of any normal, competitive market where companies switch provider if they are dissatisfied with their current provider’s offering. Further, given the CC’s acceptance that there are efficiencies associated with a long term relationship, it would be simply irrational and not consistent with a competitive environment for companies to switch without the view that they would receive a better service from a competitor.

- The CC’s survey evidence also shows that for over 60 per cent of companies ‘satisfaction with their current audit firm’ was the key reason why they did not tender their statutory audit in the last five years\(^{331}\). However, rather than taking this as consistent with competitive constraints on incumbent audit providers, the CC appears to dismiss this survey result on the basis that even some of these companies referred to switching costs\(^{332}\). The CC’s reasoning here is seriously flawed – the survey results do not show that in the event of dissatisfaction with the incumbent audit firm’s performance companies would not switch provider. As a result these results provide no evidence in support of an AEC finding. On the contrary, these survey results are consistent with a competitive market.

- This is further underlined in the quote from the survey responses that the CC sets out in paragraph 9.184b), where the company highlights that while there are costs from conducting a tender (including a reduction in quality), it has ‘other means to negotiate’ its audit services\(^{333}\).

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\(^{328}\) Paragraph 9.187 of the Provisional Findings.

\(^{329}\) Paragraph 9.177 of the Provisional Findings.

\(^{330}\) Paragraph 9.182 of the Provisional Findings.

\(^{331}\) Paragraph 9.152 of the Provisional Findings.

\(^{332}\) Paragraph 9.152 of the Provisional Findings.

\(^{333}\) Paragraph 9.184 b) of the Provisional Findings.
3.7.2.3 In addition, and importantly, the CC has consistently failed to take into account the efficiency of long term relationships in the supply of audit services, as discussed in section 2.7.2.1 above, despite its recognition\(^{334}\) that good relationships are an essential part of the delivery of the audit product (the ‘third limb’). We urge the CC, in its Final Report, to take proper account of the role of maintaining good relationships, which the CC recognises are an integral feature of the delivery of the audit product.

3.7.3 *The CC has no evidence for its conclusions.*

3.7.3.1 The CC provisionally concludes that “fee increases are unlikely to trigger a tender unless the incumbent attempts to impose a significant rise”\(^{335}\). In our view the evidence does not support this conclusion. The examples we provided in Annex 2 of our response to the CC’s working paper “Nature and Strength of competition” show that companies are able to put substantial pressure on audit fees\(^{336}\) and further there are examples of companies going out to tender without audit firms requesting a significant fee increase (for example, ITV’s recent tender process and the recent announcement from HSBC that it will tender its audit this year).

3.7.3.2 Indeed, the CC itself notes that “there is evidence that when companies ask firms to reduce fees, fee reductions have been secured”\(^{337}\). There couldn’t be a more direct and clear indication of a competitive market. In addition, the CC’s customer survey showed that 93 per cent of companies negotiated their audit fees\(^{338}\). As stated in paragraph 3.6.2.2 above, where firms invest in a bilateral relationship, competition is not about switching provider frequently, but rather focuses on obtaining good terms for the services received while maintaining a long term relationship. This provides both quality and good value services without incurring unnecessary costs by duplicating investments and possibly reducing the quality of the product. In these circumstances it is therefore unsurprising that tenders are not triggered, indeed it is consistent with a competitive market.

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\(^{334}\) Paragraph 6.14 of the Provisional Findings.

\(^{335}\) Paragraph 9.187 of the Provisional Findings.

\(^{336}\) We set out examples in relation to [\(\text{\textcopyright} [9\text{\textregistered}]\) Companies in Annex 2 of our response to the CC’s working paper “Nature and strength of competition”.

\(^{337}\) Paragraph 9.198 of the Provisional Findings.

\(^{338}\) Paragraph 9.95 of the Provisional Findings.
3.7.3.3 The CC has provisionally concluded that incumbent audit firms have to underperform or overcharge “substantially” in order to trigger a tender. However, the CC has not clarified what “substantial” means in this context and provides no evidence to show what this means in practice. The CC’s evidence on outcomes, in particular in relation to profitability, does not support this statement, as we have set out in section 2 above.

3.8 Audit firms’ incentives to retain engagements

3.8.1 The CC recognises that audit firms incur significant losses if they lose a client, which include the income stream from the engagement, a weakening of their experience base, and potential reputational damage.

3.8.2 Overall, the CC finds that this implies that on occasion companies can exert competitive pressure on their audit firm without a tender. In fact, this occurs constantly, not just on occasion and we have provided extensive examples to the CC. However, the CC suggests that “this does not show that all companies can obtain competitive outcomes on all occasions”. We have seen no direct evidence to show that some companies cannot obtain competitive outcomes. The CC suggests that it is consistent with its provisional conclusion that some companies have not obtained competitive outcomes on fees. However, we have already set out in section 2.3.2 above our concerns with the CC’s analysis of audit fees, which mean that the CC can put no weight on its analysis of pricing to support an AEC finding.

3.8.3 In sum, the CC appears to be reaching a provisional AEC finding based almost solely on speculation that some companies might not get good outcomes all the time. It is 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 will be down to scope and some may be down to the ability of firms to negotiate. This is entirely consistent with a competitive market.

339 Paragraph 9.187 of the Provisional Findings.
340 Paragraph 9.215 of the Provisional Findings.
341 Paragraph 9.217 of the Provisional Findings.
342 Annex 2 of our response to the CC’s working paper “Nature and strength of competition”.
343 Paragraph 9.217 of the Provisional Findings.
344 Paragraph 9.217 of the Provisional Findings.
Moreover, the CC does not explain what these less favourable outcomes may be or in what way and to what extent they may be unfavourable. The CC has provided no examples of any clients being in a “captive” relationship with any audit provider. Indeed it states that customers are able to successfully negotiate better terms. In other words, the CC has no evidence or analysis to support its speculation.

**3.9 Companies’ bargaining power during a tender process**

**3.9.1** The CC provisionally concludes that competition in tenders for FTSE350 engagements is strong. This is because:

- audit firms have strong incentives to compete intensely during a tender;
- the largest four audit firms generally participate;
- companies design the tender process to ensure good outcomes are obtained and are experienced in judging tenders; and
- audit firms have strong incentives to do well in a tender process even if they don’t win, so as not to damage their reputations.

**3.9.2** Again, this is strong evidence that companies have an effective bargaining position, and against an AEC finding. We discuss the CC’s overall provisional AEC finding in section 3.10.

**3.10 CC’s overall view on willingness to switch and bargaining power**

**3.10.1** The CC provisionally concludes that “a significant number of FTSE350 companies are reluctant to switch audit firms and instigate a tender process”.

**3.10.2** The CC reaches this conclusion following its analysis of the bargaining process between FTSE350 companies and audit firms. Overall, our view is that the CC’s analysis and assessment of this bargaining process is fundamentally flawed. This is because it has:

- failed to consider fully the relevant parameters in any economic assessment of bargaining; and

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345 Paragraph 9.255 of the Provisional Findings.
346 Paragraph 9.255 of the Provisional Findings.
347 Paragraph 9.259 of the Provisional Findings.
failed to properly take into account the full weight of evidence that shows the effectiveness of bargaining in exerting competitive constraints outside of tender events.

3.10.3 First, the assessment of the relative bargaining strength between two parties (in this case, audit firms and FTSE350 companies) requires an analysis of both parties’ outside options simultaneously. The CC has considered the following aspects of audit firms’ and FTSE350 companies’ outside options:

- **FTSE350 companies’ outside options**: Overall, the CC has found that FTSE350 companies have sufficient alternatives to generate a competitive outcome (in a tender process)
  
  The CC notes that in some sectors there may be fewer alternatives, but this does not contradict the CC’s overall conclusion
  
  In considering outside options it is also relevant to consider the costs of moving to one of these alternatives and in this regard the CC provisionally finds that there are switching costs associated with moving audit firm

- **FTSE350 companies’ uncertainty over their outside options**: the CC finds that FTSE350 companies may encounter significant uncertainties in appraising potential auditors outside a tender

- **Audit firms’ outside options**: The CC recognises that audit firms have a substantial amount at stake if they were to lose a client. This includes the loss of income stream from the engagement, a weakening of their portfolio in a given sector, reputational damage and costs associated with participating in a new tender and in targeting new clients

3.10.4 Overall the CC makes the conclusion that audit firms’ incentives to retain their clients do not imply that FTSE350 companies can always obtain a competitive offer through negotiations

3.10.5 We set out our concerns with the CC’s conclusions in relation to switching costs, companies’ ability to judge alternative suppliers and audit firms’ incentive to retain clients in sections 3.5, 3.6 and 3.8 respectively above. The issues we raise are, in our view, in themselves sufficient to undermine the CC’s provisional conclusion that companies’ bargaining power is weakened outside tender events.

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348 The CC refers to the alternatives in a tender process, but there is nothing in the Provisional Findings to suggest the alternative providers would be any fewer outside of a tender process. Paragraph 9.56 of the Provisional Findings.
349 Paragraph 9.56 of the Provisional Findings.
350 Paragraph 9.260 of the Provisional Findings.
351 Paragraph 9.260 of the Provisional Findings.
352 Paragraph 9.215 of the Provisional Findings.
353 Paragraph 9.262 of the Provisional Findings.
3.10.6 However, these are not the only errors the CC makes. In addition, CC has not taken into account a crucial piece of the bargaining framework. In particular, while the CC has considered the uncertainty on the part of FTSE350 companies (which in our view the CC has overstated) it has failed to take into account the uncertainty on the part of audit firms.

3.10.7 Significantly, audit firms face considerable uncertainty over the alternatives available to their clients. Not only are we unaware of whether clients have received alternative offers, but also how well-grounded and serious those offers are and whether they would subsequently be revised downwards. Instead, audit firms are aware that, in general, their clients have ample alternatives, are likely to be being frequently approached by our rivals, are experienced and knowledgeable buyers, conduct detailed assessments of their audit firm’s performance, are likely to have experience of at least some our competitors from the provision of NASs and can always decide to put the audit out to a highly competitive tender if they are dissatisfied with their audit firm’s performance. All of this means that audit firms do not, and cannot, seek to take advantage of any possibility of a lack of information about their alternatives on the part of FTSE350 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 in no way imply that a supplier of audit services to that company would be in a stronger bargaining position because of it. In other words, this uncertainty on the part of audit firms acts to reinforce the existing strong competitive constraints acting on audit firms during negotiations.

3.10.8 We set out this uncertainty on the part of audit firms in our response to the CC’s working paper on the “Nature and Strength of competition in the supply of statutory audit services”\textsuperscript{354}, and provided the CC with references to the importance of uncertainty in the economic literature\textsuperscript{355}. The CC has still failed to consider this important part of the bargaining process and we urge it to do so in its Final Report. Without doing so the CC is in no position to reach a conclusion about the competitive constraints acting on audit firms outside of tender processes.

\textsuperscript{354} Paragraph 2.2.6 of our response to the CC’s working paper “Nature and strength of competition”.
3.10.9 Finally, there is a clear inconsistency between the CC’s treatment of FTSE350 companies’ bargaining power across its theories of harm. In the CC’s second theory of harm, which we discuss further in section 5, the CC suggests that audit firms may be susceptible to management’s bargaining power in relation to independence. However, it is not clear why the CC considers that management has bargaining power in relation to independence but not in relation to other aspects of the audit offer. In fact, the binding constraints on audit firms in relation to independence are not those from company management but rather those relating to our personal and professional reputations, which prevent losses of independence. This is supplemented by the role of ACCs, which are designed to safeguard shareholders’ rights, and which the CC recognises have as their primary interest audit quality and independence. FTSE350 companies therefore have far more substantial bargaining power in relation to audit fees and other aspects of quality and so the CC’s overall conclusions are untenable.
Rebuttal of the CC’s Theory of Harm 1b: Barriers to entry and expansion

4.1 Introduction

4.1.1 The CC finds that the threat of expansion by mid-tier audit firms is not a competitive constraint on the suppliers of audit services to FTSE350 companies, as a result of these firms being restricted by their lack of significant experience auditing similar companies. The CC provisionally concludes that this constitutes a feature that gives rise to an AEC.

4.1.2 In our view the CC’s analysis of barriers to entry is seriously flawed, in broadly three important ways, and as a result the CC cannot find this to be a feature of that gives rise to an AEC. First, the CC has not demonstrated how barriers to entry or expansion (such that they exist) give rise to an AEC. Indeed, the CC’s own evidence shows that competition is already fierce between the largest four audit firms. Second, the CC overemphasises the importance of reputation and experience as barriers to entry and expansion. Third, the CC fails to take account of real quality differences between the largest four and the mid-tier audit firms. In the rest of this section we discuss the following three points in turn.

4.2 No evidence from outcomes that barriers to entry give rise to an AEC

4.2.1 We do not believe the CC has met the test required to determine whether barriers to selection are a ‘feature’ of the market giving rise to an AEC in the market for statutory audit services. In particular, it is not sufficient for the CC to reach an AEC finding to simply find that there are barriers to entry or expansion. Rather, the CC must show that these barriers have a negative impact on competition and on outcomes, which it has not done. As a result, the CC does 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. Similarly the CC has no evidence to show that the mid-tier audit firms’ presence would have any impact on outcomes outside of tender processes.

4.2.2 On the contrary, the CC’s own evidence and conclusions elsewhere in the Provisional Findings show that the mid-tier audit firms are already part of a market structure that generates competitive outcomes in tender events. In particular, the CC concludes that

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356 Paragraph 10.31 of the Provisional Findings.
tenders for FTSE350 companies’ audits are already competitive and that FTSE350 companies have sufficient alternatives during a tender to generate competitive outcomes\footnote{Paragraph 9.255 of the Provisional Findings.}. The CC also finds that companies do not invite more firms to tender than are necessary, and that, in fact, companies “recognize that inviting more firms than necessary to the tender could be damaging to the competitiveness of the process”\footnote{Paragraph 9.232 of the Provisional Findings.}. Therefore, it cannot be the case that any barriers to entry or expansion that restrict the mid-tier firms give rise to an AEC.

4.2.3 The CC states that “These barriers can […] mean that the choice that companies confront when considering switching is more limited than would be the case if more firms had the reputation and experience that the Big 4 firms enjoy. As such there is an AEC\footnote{Paragraph 10.33 of the Provisional Findings.}. This statement demonstrates the misunderstanding on the part of the CC as to the standards that would be required for barriers to entry and expansion to constitute a feature that gives rise to an AEC. Specifically, in this statement the CC confuses “choice” and “competition”\footnote{Economics shows that the relationship between the degree of product differentiations, or the number of providers (ie “choice”) and the intensity of competition is a complex one. Very competitive markets may be associated with few players and limited product differentiation. Therefore no inference from the amount of “choice” per se can be drawn as to the degree of competition in a market.} and appears to infer from the sole existence of alleged barriers to entry that these give rise to an AEC. Such inference is completely unsound.

As we noted in 4.2.1, the CC’s evidence shows that competition between the largest four audit firms is sufficient for tenders to be competitive.

4.2.4 The CC’s error in making this conclusion may arise from its (lack of) market definition analysis. In particular, the CC has not applied a hypothetical monopolist test to define the boundaries of the relevant market in the supply of statutory audit services. As we stated in our response to the CC’s working paper “Market Definition” we agree with this approach, as long as the CC properly takes account of the competitive constraints outside the relevant market.

4.2.5 However, the CC in our view has not done this. Specifically, the CC appears to have simply inferred the level of competitive constraint imposed by the mid-tier audit firms from these audit firms’ current market position. This is fundamentally incorrect – instead, the CC needs to consider what constraint the mid-tier audit firms would
impose should the largest four audit firms all worsen their competitive offer by some small amount. Whether or not the CC conducts a formal market definition exercise based on the “hypothetical monopolist” test, this is the appropriate way to consider the relevance and effectiveness of such constraints.

4.2.6 An audit firm’s competitive offering includes its price, its technical quality and quality of service, and the CC needs to consider the competitive constraint that the mid-tier audit firms would impose should the largest four audit firms worsen any of those aspects of their competitive offerings. The CC has not done this and therefore cannot conclude that the mid-tier audit firms are not an effective constraint in the supply of audit services to FTSE 350 companies. We believe that if the largest four audit firms were to fail to continue to invest in quality, or to increase audit fees even by a small amount (where this was not commensurate with enhanced quality or justified by changes in scope or inflation), the mid-tier firms would be able to exploit this.

4.2.7 The CC goes on to note that the barriers to expansion and selection that it finds in the market “tend to reinforce the market structure and outcomes that we describe in paragraphs 7.5 to 7.28”. We do not believe there is any substance to this statement. It is a tautology to say that the market share of the mid-tier firms is linked to the overall market structure. However, as we explain in section 2 above, the evidence does not suggest that the structure of the market gives rise to any adverse market outcomes.

4.2.8 Finally, the CC suggests that an adverse outcome arising from barriers to selection is that “without this barrier to selection, it may be that challenger firms could develop differentiated and/or innovative offers”. This appears to be pure speculation. There is no basis for suggesting that mid-tier firms are more innovative or would become so if they were to win more FTSE350 audit engagements, nor that they could not seek to differentiate themselves by such innovation. Also, as explained above in paragraph 2.8.1.3, the CC has established no link between the degree of competition and the degree of differentiation or the number of firms in the market.

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361 As we noted in our response to the CC’s working paper “Market Definition”, see paragraph 2.1.7 of the KPMG response to the CC’s Working Paper on Market Definition.
362 Paragraph 10.33 of the Provisional Findings.
363 Paragraph 10.34 of the Provisional Findings.
4.3  

4.3.1  The CC suggests that reputation and experience are key barriers to mid-tier audit firms being selected. However, the lower effort that mid-tier firms put into winning work, compared to the largest four audit firms, suggests this is likely to be a fundamental reason as to why they are less successful. Indeed, BDO itself notes that it could do more to target the key stakeholders at FTSE350 companies. The CC notes that the mid-tier firms “may not have done all that they could in order to target and win FTSE 350 engagements”.

4.3.2  The CC does not present evidence that suggests these firms have “infrequent” tender opportunities; in fact the evidence suggests mid-tier firms are invited to around a third of competitive tenders for FTSE 350 companies. In addition, the CC does not appear to have considered other elements of the survey evidence, including the level of approaches made to FTSE350 companies by the mid-tier firms. The survey showed that where mid-tier firms, notably GT and BDO, did regularly approach companies outside of a formal tender, they were more likely than the other mid-tier firms to be invited to a subsequent tender (although less likely than the largest four audit firms).

4.3.3  Similarly, the mid-tier audit firms are less likely to win NAS work, which, as the CC acknowledges, allows the largest four audit firms to demonstrate experience to potential clients and help to establish an understanding of the company required for its audit. There are no barriers preventing mid-tier firms from following a similar approach in using NASs to demonstrate their experience as the largest four audit firms.

4.3.4  The CC speculates that there is a “chicken and egg’ situation”, where mid-tier audit firms are less likely to invest in targeting new audit clients because they do not believe they will win them. First, we note that in any investment there is an element of risk. We and the other audit firms have accepted significant risks in investing heavily in improving their offer, and continue to do so. Second, we set out in the main party

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364 Paragraph 9.41 of the Provisional Findings.
365 Paragraph 10.31 of the Provisional Findings.
366 Paragraph 10.8 of the Provisional Findings.
367 Paragraph 10.16 of the Provisional Findings.
368 Paragraph 9.113 of the Provisional Findings.
369 Paragraph 10.13 of the Provisional Findings.
hearing and in our response to the CC’s working paper on “Barriers to entry: reputation and experience”, our view that there are certain clients in the FTSE350 which would provide a useful starting point for mid-tier firms in expanding their presence in the FTSE350 audit market. For example, we noted that there are a number of domestic companies in the FTSE350 (such as the supermarket chains) for which mid-tier audit firms would be an effective alternative. We see no barriers, including from reputation and experience, to the mid-tier audit firms targeting and winning the audits of these companies and continuing to expand from there.

4.4  The CC fails to recognise the real quality differences between the mid-tier and the largest four audit firms

4.4.1  The CC notes that it has not formed a view on whether a “real difference in the quality of the networks of Big 4 and Mid Tier firms” s a reason for the mid-tiers’ lack of expansion. We fail to see how the CC can reach a conclusion that experience and reputation are preventing the mid-tier firms from increasing market share for FTSE350 companies when they fail to form a view on the quality differentials between the audit firms. This shows that the CC’s own logic in reaching its conclusions is internally inconsistent.

4.4.2  The CC also fails to take into account the fact that the supply of statutory audit services is vertically, rather than horizontally, differentiated. The evidence shows that there is a real quality difference between the mid-tier and the largest four audit firms, in particular for certain FTSE350 companies. There are a number of companies in the FTSE350 which the mid-tier audit firms lack the capability to audit, as they themselves recognise. For example, BDO told the CC that there were around 35 of the largest UK listed businesses that it would currently not be able to audit, and GT stated that there were approximately 60 companies (with fees greater than £3 million, or with 75 per cent of turnover overseas) for which they were unlikely to bid in a tender process.

4.4.3  This is direct evidence of the disparity in quality between the largest four and the mid-tier audit firms. The above is supported by the AQRT results, which are proportionately worse for mid-tier than the largest four audit firms. The companies

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Paragraph 9.15(a) and 9.15(d) of the Provisional Findings.
audited by the mid-tier audit firms are also unlikely to be as complex as those audited by the largest four audit firms, which means these AQRT results are even stronger evidence of the quality disparity between the largest four and the mid-tier audit firms.

4.4.4 Even in respect of those companies where they do believe they have the capability and do participate in tenders they are not often successful. The CC noted that tenders are typically a thorough process leading to informed decisions and also concluded that it found no evidence of the largest four audit firms “low-balling” in response to participation of the mid-tier firms.

4.4.5 Overall, therefore, a “virtuous circle”371 is not the reason the mid-tier audit firms are less successful in winning work. Rather, their market share in the FTSE350 is a function of the existing fierce competition between the largest four audit firms; the mid-tiers’ choice to invest less, resulting in weaker targeting activities; and the real differences in quality between the largest four and the mid-tier audit firms, particularly for a substantial proportion of the FTSE100 companies.

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371 Paragraph 9.54 of the Provisional Findings.
5

Rebuttal of Theory of Harm 2a: Auditors do not seek to satisfy demands of management over shareholders

5.1

Introduction

5.1.1

The CC investigates two main concerns under its second theory of harm, which it refers to as ‘principal-agent issues’ \(^{372}\). First, it examines whether audit firms have incentives to respond to the demands of “executive management” where these differ from those of shareholders’; and, second, whether there are constraints that prevent auditors satisfying the demand of shareholders for better information \(^{373}\). We deal with the first of these in this section and the second of these in section 6.

5.1.2

Before proceeding to comment on the specific aspects of the Provisional Findings in relation to the CC’s second theory of harm, however, we note that the CC has, in places, confused or conflated the relationship between the Board, executive management, ACs/ACCs and shareholders. In particular, we are concerned that the CC’s emphasis on the role of FDs in appointing audit firms overlooks (and ignores in places) the fact that audit firms are appointed by shareholders, on a proposal from the Board \(^{374}\) itself based on a recommendation from the audit committee. If the board does not accept the AC’s recommendation, it should include in the annual report, and in any papers recommending appointment or re-appointment, a statement from the AC explaining the recommendation and should set out reasons why the board has taken a different position. This is critical because the Board and the individual directors have a fiduciary duty to act in the best interests of shareholders.

5.1.3

In this respect, the CC also does not appear to have fully appreciated the role that Non-Executive Directors (NEDs) play in the governance of FTSE350 companies. The CC comments that under the UKCGC, ACs monitor and review the effectiveness of the audit, but that they report to the Board \(^{375}\). However, in addition, the UKCGC requires FTSE350 companies to have NEDs constituting at least half of all Board members (excluding the Chairman who is also generally a non-executive director). The Board, in turn, reports and is answerable to shareholders.

\(^{372}\) Paragraph 11.1 of the Provisional Findings.

\(^{373}\) Paragraph 11.2 of the Provisional Findings.

\(^{374}\) The Board’s nomination is based on a recommendation made by the AC, into which FDs will have input.

\(^{375}\) Paragraph 27 of the Provisional Findings.
5.1.4 As we have previously submitted, as independent non-executive directors, ACCs have every incentive to act in the interests of shareholders. Indeed, under the UKCGC, the main purpose of NEDs is to provide independence and challenge to ensure that Boards do represent shareholders’ interests:

"Main Principle

As part of their role as members of a unitary board, non-executive directors should constructively challenge and help develop proposals on strategy.”

Supporting Principle

Non-executive directors should scrutinise the performance of management in meeting agreed goals and objectives and monitor the reporting of performance. They should satisfy themselves on the integrity of financial information and that financial controls and systems of risk management are robust and defensible. They are responsible for determining appropriate levels of remuneration of executive directors and have a prime role in appointing and, where necessary, removing executive directors, and in succession planning.”

(emphasis added)

5.1.5 In our view, this link between ACs and shareholders, and the role that all NEDs – not just those on the ACC – play in providing a level of challenge on FTSE350 Boards, has not been given sufficient weight by the CC, and this has significant implications for its analysis, in particular as it relates to the dynamics in the Board.

376 Paragraph 3.2.1 of our response to the CC’s working paper “Revised Theories of Harm”.
377 UK Corporate Governance Code, Section A4.
378 Although we note that all the NEDs of some companies sit on the AC.
5.2 Misalignment of management and shareholder demand

5.2.1 Overview

5.2.1.1 Although the CC concedes that finding reliable evidence from FDs about any difference in demand was difficult\(^{379}\), the CC provisionally finds that FDs “may” not have a consistent interest in the independence of the audit firm, that management demand and shareholder demand “can differ”\(^{380}\), and that “at times” there “may” be a divergence between the two\(^{381}\). Thus, “executive management may at times have the incentive to encourage auditors to accept treatments and judgments that portray the company in an unduly favourable light”\(^ {382}\).

5.2.2 Potential for misalignment

5.2.2.1 As we have previously submitted, while we believe that there may be a theoretical potential for misalignment between management and shareholder demand, the UKCGC regime, combined with the strong incentives on audit firms to avoid adverse regulatory findings and any damage to their reputation, effectively mitigate and address the risks of such misalignment\(^{383}\).

5.2.2.2 The CC cites the Cadbury Report for the proposition that a key underlying factor for this misalignment is the “competitive pressures both on companies and auditors which make it difficult for auditors to stand up to demanding boards”\(^ {384}\). The CC places significant weight on this statement and, in our view, such emphasis is misplaced.

5.2.2.3 The Cadbury Committee, which published its Report in 1992, was set up in response to concerns about accounting standards, the absence of a clear framework for ensuring that directors kept under review the controls of their business, and the competitive pressures cited by the CC\(^ {385}\). As a result of the Report’s recommendations, ACs have been a common feature of the UK Corporate Governance framework for almost 20 years. In 2003, following recommendations made by the Higgs Report in the wake of

\(^{379}\) Paragraph 11.17 of the Provisional Findings.
\(^{380}\) Paragraph 11.24 of the Provisional Findings.
\(^{381}\) Paragraph 11.26 of the Provisional Findings.
\(^{382}\) Paragraph 11.25(d) of the Provisional Findings.
\(^{383}\) Paragraph 3.5.4 of our response to CC’s working paper “Revised Theories of Harm”.
\(^{384}\) Paragraph 11.20 of the Provisional Findings.
\(^{385}\) Paragraph 2.1 of the Cadbury Report.
the scandals of the early 2000s (e.g. Enron), the Combined Code was amended to strengthen the role of NEDs and the level of challenge they provide, including by requiring that they comprise at least half of the boards of premium listed UK companies. Thus, we consider that the issues highlighted by the Cadbury Report – and the potential for misalignment between management and shareholder demand – have been effectively addressed. In particular, and as we set out in detail below, we consider that ACs to be highly effective in safeguarding shareholder interests.

5.2.3 **No evidence of management encouraging audit firms to accept unduly favourable accounting treatments**

5.2.3.1 The CC asserts that executive management may, at times, have the incentive to encourage audit firms to accept treatments that are unduly favourable to companies. This conclusion, it says, is based on its analysis at paragraphs 5.3 to 5.15 and 11.16 to 11.22 of its Provisional Findings.

5.2.3.2 At paragraphs 5.3 to 5.15 of the Provisional Findings, the CC discusses how principal-agent issues can arise, the detriments which can occur, and why both shareholders and management gain from external audits. At paragraphs 11.16 to 11.22 of the Provisional Findings, the CC accepts that there are difficulties in obtaining reliable evidence from FDs about demand, but notes that FDs have an interest in a competent audit. At paragraph 11.20 the CC states that FDs may not have a consistent interest in the independence of the audit firm, and that company management are likely, from time to time, to have incentives to portray company performance in an unduly favourable light.

5.2.3.3 In none of these paragraphs does the CC cite any evidence or examples of executive management actually encouraging auditors to accept unduly favourable judgements. Rather, the case study examples cited by the CC indicate that FDs (or equivalents) value audit firms precisely because they do not cede to management demands. Indeed, this fact is borne out in the majority of the case studies which we discussed in paragraph 2.6.4.4 in relation to the CC’s Provisional Findings regarding audit quality and independence.
5.2.3.4 In this context we would also refer to the impact of the work carried out by the FRRP which (under the auspices of the FRC) reviews reports and accounts and where appropriate publishes its findings and can request a company to revise its financial statements and/or narrative reporting. In our experience this acts as a powerful incentive for FDs (and ACs) to ensure such documents are properly prepared and furthermore to look to the audit firms for assurance that they are not running any risk of adverse regulatory criticism.

5.2.3.5 Further, we note that FDs interviewed as part of the CC’s 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\(^{386}\). In line with our observation in the previous paragraph our own experience supports this view.

5.2.3.6 Indeed, it is consistent with the CC’s own observation that management may benefit from the reports provided to them by audit firms – as a by-product of the audit service – because such reports give them an insight into the functioning of the company\(^{387}\). It would therefore be unrealistic to conclude from the above evidence that FDs would engage audit firms to provide additional reporting, over and above the scope of the statutory audit, and then pressure the audit firm to report only those findings which are favourable to the company. Surely such additional work would not be commissioned in the first place if FDs were concerned about disclosing any potential findings, yet this is the implication of the CC’s reasoning.

5.2.3.7 The above evidence contradicts and undermines any suggestion that management (as represented by the FD and/ or the Board as a whole) and shareholder demands are, in practice, misaligned. To the extent that the CC refers to management below the level of the FD, the CC’s Provisional Findings put forward no evidence that the checks and balances at FD, Board and audit level do not effectively keep any such misalignment in check.

\(^{386}\) Paragraph 25(a) of Appendix 11 of the Provisional Findings.

\(^{387}\) Paragraph 5.15 of the Provisional Findings.
5.2.4  

No evidence of adverse effects

5.2.4.1  
The CC asserts that, for individual shareholders, misalignments between principals and agents could result in a reduction of the value of investment from sub-optimal decision-making or, alternatively, dishonesty by management.\(^{388}\) It also identifies particular times when it might expect a divergence of interest to occur (i.e. when a company is under financial stress). However, despite having identified the conditions under which effects may be observed (which presumably would have assisted in identifying potential examples), the CC adduces no evidence that the current regulatory framework has failed to provide adequate protection.

5.2.4.2  
Further, as we set out in more detail below in paragraph 5.4.4.3, the reputational damage, aside from the potential liability claims and regulatory sanctions, which would result from audit firms knowingly signing off on accounts that had been dishonestly constructed ensures that auditors have a very strong incentive not to do so. Our resignation from theudit provides direct evidence of how seriously we take our duty to act with honesty and integrity.

5.3  

AC effectiveness in representing shareholder interests

5.3.1  
Overview

5.3.1.1  
The CC provisionally finds a number of limitations on the ability of ACs, under the leadership of ACCs, to ensure independence and quality. It provisionally concludes that the AC is not a comprehensive regulatory solution to the independence concerns that it has identified.\(^{389}\)

5.3.1.2  
As a preliminary point, we note that the AC is not, but nor is it intended to be, a comprehensive regulatory solution to ensuring auditor independence. Rather, it forms part of a wider framework which complements audit firms’ already strong reputational incentives to deliver quality audits and maintain their independence. The most important components of this framework are the FRC, including the independent quality reviews by the AQRT and the provisions of the UKCGC and audit firms’ own

\(^{388}\) Paragraph 5.7 of the Provisional Findings.

\(^{389}\) Paragraph 11.98 of the Provisional Findings.
quality review programs. ACs have demonstrated that they are more than capable, in this environment, of exercising the responsibilities of oversight entrusted to them.

5.3.2 **The CC’s evidence base**

5.3.2.1 The CC admits that it had difficulty in measuring the effectiveness of the AC, although it considers ACCs to be well qualified and experienced. The CC found that the key incentives on ACCs are professional pride and reputation, and case study evidence similarly suggested that ACCs are not motivated by remuneration. The results of the CC’s follow-up survey indicated that ACCs consider themselves to have a “considerable role” in ensuring the quality of external reporting and are sufficiently qualified to do so.

5.3.2.2 Further, the CC’s follow-up survey revealed that ACCs themselves felt confident or very confident that they could properly assess audits.

5.3.3 **Investor concerns**

5.3.3.1 The CC cites investor concerns about the level of auditor independence. We believe that the level of these concerns, as they pertain to FTSE350 companies, has been overstated by the CC.

5.3.3.2 As an initial point, we note the CC’s provisional conclusion that “any loss of independence on any given engagement… will not be visible to shareholders.” If the CC’s assertion is correct, then concerns raised by investors cannot be based on any direct and specific evidence. Such “concerns” can only be of a general nature, based on their perception. Thus, the CC can place only limited weight on such concerns and they cannot be relied on as evidence of anything other than the opinions of investors.

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390 Paragraph 11.33 of the Provisional Findings.
391 Paragraph 9.66 of the Provisional Findings.
392 Paragraph 11.47 of the Provisional Findings.
393 Paragraph 54 of Case Study C at 54 of Appendix 2 of the Provisional Findings.
394 Paragraph 9.76 of the Provisional Findings.
395 Paragraph 11.36 of the Provisional Findings. We note that the CC also states (at paragraph 11.34) that it did not ask ACCs to comment on the effectiveness of ACs, because it may be unreasonable to expect them to comment. While this may be the case, we consider that by not asking the question the CC may have denied the main parties to this investigation a potentially favourable piece of evidence, and so has potentially infringed on the main parties’ ability to fully represent their positions.
396 Paragraph 11.101 of the Provisional Findings.
5.3.3.3 The CC reports that a significant proportion of investors surveyed by PwC viewed ACs as not sufficiently independent of management\(^{397}\). However, the basis upon which this view was formed is unclear and no specific examples are cited in the survey. Further, as the CC notes, the survey was not restricted to investors in the UK, and covered 11 countries including some in emerging markets. Corporate Governance frameworks differ between countries, and concerns may have been greater in some countries than in others. Accordingly, this evidence cannot be used as a reliable indicator of investor concern regarding the effectiveness of FTSE350 ACs.

5.3.3.4 The CC also cites one un-named investor entity from the Oxera survey which raises concerns about auditor independence, implying that these concerns have arisen despite the existence of ACs. In summary, the concerns were: “(a) slightly more aggressive accounting practices than long term investors would like to see [...] ; (b) lack of transparency about accounting assumptions [...] ; and (c) a lack of ‘colour’: investors would appreciate more nuance”\(^{398}\). The CC does not substantiate the claims of this investor with any supporting evidence, nor does it explain how these concerns are directly related to any loss of independence (or how this is a short-coming of ACs).

5.3.3.5 We have significant concerns with the CC’s reliance on this evidence. As a preliminary point, we are concerned that the CC appears to have relied on evidence which has not been made available to us (and presumably the other audit firms)\(^{399}\). Turning to the evidence of the un-named investor, based on Oxera’s summary of the survey, it appears that the CC has taken these comments out of context and that they are not representative of the sentiments expressed by investors, and associations, in this survey. In this regard, we note that the consensus among those surveyed was that audit is expected to deliver “a fair and true, independent and objective assessment”\(^{400}\), and that the majority indicated that the audit process is delivering, or broadly delivering, on these expectations\(^{401}\). Further, we note that no investors were in favour

\(^{397}\) Paragraph 11.53 of the Provisional Findings.

\(^{398}\) Paragraph 11.42 of the Provisional Findings.

\(^{399}\) As the CC is aware, we consider it a matter of procedural fairness that we are given sufficient opportunity to comment on the strength of this evidence. As set out in our letter of 20 March 2013 we have requested that the CC provide us with non-confidential versions of all interviews with investors and associations as soon as possible. We reserve our right to make further submissions on this evidence as and when we receive it.

\(^{400}\) Page 4 of the Oxera investor survey report (on behalf of BDO and Grant Thornton).

\(^{401}\) Section 2.1 and Figure 2.1 of the Oxera investor survey report.
of a radical change in the role of ACs as the “agent of shareholders in selection and monitoring an auditor”\textsuperscript{402}. This suggests that the investors surveyed were not concerned about ACs’ ability to effectively supervise audit firms, and calls into question why the evidence of one investor was preferred to the views of others.

5.3.3.6 The CC also notes the IMA’s comments that, in response to the EC’s proposals for audit market reform, long periods of tenure may impact auditor independence\textsuperscript{403}. Again, we note that the CC does not provide any evidence to substantiate this claim, nor how this is connected to its argument that ACs are not discharging their duties appropriately. In any event, this reference is a single statement made in the context of a submission on the introduction of mandatory tendering (which the IMA is on record as opposing, together with mandatory rotation)\textsuperscript{404}. The opinion that the CC cites here is, therefore, not supported by any direct or robust evidence.

5.3.3.7 Indeed, our analysis of AQRT reporting over the past five years indicates that, of those audits that were graded as requiring “significant improvement”, the audit firm acting for eight out of 13 (62 per cent) of those companies had been in place for more than 10 years\textsuperscript{405}. This proportion is slightly lower than the proportion of FTSE100 companies that have had the same audit firm for more than ten years (67 per cent) and slightly higher than the proportion for the FTSE250 (52 per cent)\textsuperscript{406}. This analysis undermines the validity of the view that long audit firm tenure necessarily leads to a lack of independence and hence lower audit quality.

5.3.3.8 The CC also does not appear to have taken into account evidence which suggests that investor concerns may not be significant. For example, Moody’s stated that a lack of satisfaction with independence may result in the withdrawal of a rating or refusal to provide one, although no examples were cited of Moody’s ever having done this in the UK\textsuperscript{407}. We also note that no specific concerns regarding independence were expressed

\textsuperscript{402} Page 17 of the Oxera investor survey report (on behalf of BDO and Grant Thornton).
\textsuperscript{403} Paragraph 11.43 of the Provisional Findings.
\textsuperscript{404} We further note that, in the same (and subsequent) submissions to the EC, the IMA expressed concerns about the introduction of mandatory rotation, and so its comments around long auditor tenure must be read light of these views.
\textsuperscript{405} We note that five of these companies were FTSE100 companies at the time of the AQRT review, four were FTSE250 companies, two were ‘private’ and two were ‘other listed’.
\textsuperscript{406} Paragraph 7.12 of the Provisional Findings.
\textsuperscript{407} Paragraph 33 (c) of Appendix 19 of the Provisional Findings.
during the CC’s 16 April 2012 hearing with institutional investors, although audit firm independence appears to have been specifically discussed\textsuperscript{408}.

5.3.3.9 Thus, while the CC states that it has identified a general perception\textsuperscript{409} among investors regarding audit firm independence, none of the evidence presented demonstrates that any perceptions are general or a causal link between the concerns expressed and any actual losses of independence. Indeed, our analysis of the AQRT is evidence militating against such a conclusion.

5.3.4 Academic papers

5.3.4.1 The CC refers to a number of academic papers, and in particular Beattie, who is critical of the level of independence of ACs. As the CC notes, however, studies in the UK have been few and far between, and one study cited alludes to difficulties in assessing effectiveness\textsuperscript{410}.

5.3.4.2 The CC appears to rely on Beattie’s study to conclude that there are significant limitations in the ability of the AC, under the stewardship of the ACC, at least in its current incarnation, to ensure audit quality and the independence of the audit firm. No evidence other than this study is provided. We further note that Beattie’s paper is based primarily on research conducted in 2007/08; thus, it is not up-to-date and does not take into account the developments of recent years, particularly in respect of improvement in the dialogue between auditors and ACs, AQRT reports to ACs and AC reporting to shareholders.

5.3.4.3 The CC’s finding is also at odds with its description of the AC later in its provisional findings as a “powerful force” in directing audit firms towards satisfying the demands of shareholders\textsuperscript{411}. It is also inconsistent with the CC’s declared view of ACCs as well qualified, knowledgeable and diligent individuals who take the role seriously and have a reputation to protect\textsuperscript{412}.

\textsuperscript{408} Paragraphs 45 to 47 of the summary of the Provisional Findings.
\textsuperscript{409} Such misperceptions among investors are a key reason why KPMG welcomes further debate on how to engage investors more with both auditors and ACs.
\textsuperscript{410} Paragraphs 11.44 to 11.45 of the Provisional Findings.
\textsuperscript{411} Paragraph 11.98 of the Provisional Findings.
\textsuperscript{412} Paragraphs 9.66 and 9.99 of the Provisional Findings.
5.3.5  Limitations on ACs which impede their effectiveness

5.3.5.1  The CC sets out a number of factors (primarily drawn from the academic studies previously referred to) which it suggests limit the effectiveness of ACs (including ACCs). These can be categorised under the headings ‘relationship with Boards’ and ‘nature of the AC’s role’. We deal with each of these in turn.

Relationship with Boards

5.3.5.2  The CC finds that the ACCs’ (and other AC members’) positions as part of the Board may limit their effectiveness. In this regard, it finds that ACCs must establish good working relationships with other Board members and that there may be occasions where they need to balance responsibilities of shareholders with those of the Board. According to the CC, gaining a reputation for being uncompromising could damage an ACC’s relationship with other board members and inhibit his or her ability to carry out their responsibilities effectively.

5.3.5.1  As set out in paragraph 5.1.3 above, the CC seems to misunderstand the relationship between ACCs and Boards, as well as the duties owed by ACs, as a part of unified Boards, to shareholders. As NEDs, AC members not only have a fiduciary duty to represent the best interests of shareholders (as do all Board members), but also to provide challenge to, inter alia, financial controls to ensure that they are robust. The CC itself notes this. Thus, we are unable to envisage the circumstances in which ACCs would need to balance the competing demands of the Board and shareholders, unless the directors, as a whole, were collectively breaching their duties to shareholders. This is because ACCs are required to act in the best interests of shareholders at all times. We therefore consider the CC’s concern in this regard to be unfounded. We would also note that, to the extent that the Board and the AC cannot reach agreement, it is the AC that has the right to report the issue to shareholders.
5.3.5.2 The CC also fails to provide any examples of ACCs developing reputations for being “uncompromising” that have inhibited their ability to perform their role effectively. Further, given also that at least half of FTSE350 Boards are required by the UKCGC to comprise NEDs, whose role it is to provide challenge to the management of the company, ACCs are not in our experience reluctant to voice their honest views and challenge management in such an environment. This is supported by the CC’s survey, in which 31 per cent of ACCs advised that in the past three to five years their views had caused disagreement with executive directors. Moreover, of those who replied that disagreements had not arisen, 81 per cent advised that this was because there was an “open dialogue/ (healthy) debate through which agreement is reached”.

5.3.5.3 The CC (unsurprisingly, in light of this survey evidence) adduces no evidence to suggest that the position of either ACs or ACCs may limit their effectiveness. Indeed, this Provisional Finding is at odds with the direct evidence that the CC has gathered from the case studies and surveys, which indicates that ACCs take their role in representing the interests of shareholders very seriously.

5.3.6 Nature of the AC’s and ACC’s role

High level, supervisory role

5.3.6.1 The CC provisionally finds that the role of the ACC is high level and supervisory and that this limits its potential to ensure that shareholder interests are protected. Because the AC relies on the auditor to bring matters to its attention, the CC finds that the ACC may not be able to identify judgements taken to accommodate management aims.

5.3.6.2 We strongly disagree. The CC provides no evidence to show how the “high level” nature of the ACC role has limited its effectiveness in safeguarding shareholders’ interests. In our experience, ACCs actively seek out information from executive directors, other committees of the Board, external auditors, internal auditors, the ‘marzipan layer’ of management and third parties and also bring to bear their wider experience (for example from sitting on other companies’ Boards). ACs perform a

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418 Paragraph 18 of Appendix 4 of the Provisional Findings.
419 Paragraph 19 of Appendix 4 of the Provisional Findings.
420 Paragraph 11.55(a) of the Provisional Findings.
421 Paragraph 11.100 of the Provisional Findings.
similar supervisory role to FTSE350 Boards, focusing on big picture, strategic and key issues. This is how they best serve shareholders, and the CC accepts that “it is not their role to direct the auditors’ work and review it in detail”\textsuperscript{422}. Indeed, it is the AQRT and other independent quality assurance bodies which provide this level of review, conducting very detailed and time consuming reviews. The AQRT reports to ACs both generally, for each audit firm, and when they review a specific individual audit. These reviews play an important part in the overall regulatory framework which helps to ensure that the level of audit quality is high, and that auditor independence is maintained.

5.3.6.3 Where ACs need further information, they can and do request it, as demonstrated by the evidence cited by the CC cites in its report\textsuperscript{423}.

5.3.6.4 The evidence from the case studies shows that ACCs see themselves as acting in the best interests of shareholders and that they have the incentive to do a thorough job for reputational reasons\textsuperscript{424}. It would be curious if the very nature of the role of an AC – which was codified in 1994 to represent shareholders’ interests following the publication of the Cadbury report – was an impediment to them ensuring shareholder interests were adequately protected.

Visibility of auditor work

5.3.6.5 The CC finds that the detailed work of the audit firm may be less visible to the AC\textsuperscript{425}, and that, although they can call on further resources and there are no barriers to them doing so, they infrequently do so. This, the CC concludes, is a further indication of the high level nature of their role\textsuperscript{426}. We disagree. As noted in paragraph 5.3.6.3 above, the CC’s evidence from its follow-up survey of ACCs shows that they can and do request further information, where this is necessary.

5.3.6.6 In addition, the case studies discussed by the CC do not provide evidence that ACCs’ visibility of audit firms’ work is materially inhibiting their ability to effectively undertake their role. While the ACC of Company A said that ACCs generally had

\textsuperscript{422} Paragraph 11.54 of the Provisional Findings.
\textsuperscript{423} Paragraph 9.78 of the Provisional Findings.
\textsuperscript{424} Paragraph 11.47 of the Provisional Findings.
\textsuperscript{425} Paragraph 11.36 of the Provisional Findings.
\textsuperscript{426} Paragraph 11.56 of the Provisional Findings.
little visibility of what happened during the detailed audit process, the ACC wanted to understand the issues that the auditor encountered\textsuperscript{427}. It is unclear why the CC considers this to be inadequate oversight and what more (aside from detailed day to day review) could be done.

5.3.6.7 In one of the CC’s case studies, the ACC of Company C said that it could not know whether the audit firm was doing a poor job unless this was raised with management\textsuperscript{428}. However, we note other comments from this ACC which suggest that he or she has good visibility of audit firm’s work. For example, this ACC referred to a “continual dialogue” between AC, management and the audit firm\textsuperscript{429} as well as internal audit reporting which detailed internal control issues and how any issues raised by the auditors were being addressed. This suggests that he or she did have good visibility of the audit process.

5.3.6.8 The frequency with which ACCs request additional information, in and of itself, also provides no indication as to whether they are effective in discharging their duties. Approximately half of the respondents to the CC’s survey 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\textsuperscript{430}. Of respondents who indicated that they had not requested additional information, 72 per cent said that such information was not necessary as the existing information was adequate and 28 per cent said that information had been discussed with the audit firm in advance, pre-empting the need to ask for such material. The CC did not ask ACCs whether there was any information which they felt they needed but which was not available. It is our experience that all, or virtually all, would have replied ‘no’.

5.3.6.9 Overall, the CC’s own survey evidence undermines its Provisional Findings. The survey found that 91 per cent of ACCs stated that they were confident that work was being carried out to a satisfactory standard, and 100 per cent had confidence that audit firms had sufficient understanding of the business as a going concern. Further, 97 per

\textsuperscript{427} Paragraph 54 of Company A Case Study of Appendix 2 of the Provisional Findings.
\textsuperscript{428} Paragraph 73 of Company C Case Study of Appendix 2 of the Provisional Findings.
\textsuperscript{429} Paragraph 50 of Company C of Appendix 2 of the Provisional Findings.
\textsuperscript{430} Paragraph 8 of Appendix 4 of the Provisional Findings. Six per cent said the information had been provided through the internal auditor and ‘Other’ accounted for 13 per cent of responses.
cent had confidence that work had an appropriate level of review. This indicates not only that ACCs have confidence in their ability to safeguard shareholder interests, but also that they are taking an appropriate level of interest in the audit to allow them to effectively judge audit quality.

Time and resources spent by different ACCs

5.3.6.10 The CC suggests that differing ideas about the ACCs role, detail required and evidence of differences in the actual time being spent by ACCs support its conclusion that ACs do not ensure sufficient auditor independence. However, in our view, it does not necessarily follow that these factors should give rise to concern.

5.3.6.11 First, under the UKCGC (and since the introduction of the Combined Code in 2003), companies are required to provide ACs with sufficient resources to enable them to properly discharge their duties. The CC acknowledges this in Appendix 8. Hence, its statement that ACs have “limited” resources available to them therefore seems to imply that at least some FTSE350 companies are not complying with the provisions of the UKCGC, although the CC presents no evidence to support this.

5.3.6.12 Second, the fact that ACCs described the role that they perform in different ways is not surprising. As the CC acknowledges, audit is a bespoke product which is tailored to the particular company and there is also a wide variety of company sizes and complexities within the FTSE350. As such, we would expect there to be a wide range of approaches taken by ACCs. The fact that the ACC of a multinational financial institution approaches his or her duties in a different manner to the ACC of a UK department store chain is in no way an indication of the quality of his or her work.

5.3.6.13 The CC’s comparison of the number of hours spent on an audit by the ACC per month to the number of person hours spent on a FTSE350 audit is also meaningless and in no way suggests that ACCs are not an effective monitor of auditor independence. In this regard we note that, in general, the Boards of FTSE350 companies meet once per

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431 Table 11 of Appendix 4 of the Provisional Findings.
432 Paragraph 11.55(d) of the Provisional Findings.
433 Paragraph 242 of Appendix 8 of the Provisional Findings.
434 Paragraph 5.41(d) of the Provisional Findings.
month, which will obviously be far less than the number of hours spent by management on the day to day running of the company.

5.3.6.14 Further, the CC adduces no evidence to show that the time spent by an AC or ACC has not been sufficient to (a) perform his or her role thoroughly and effectively; (b) establish the independence of the auditor from management; or (c) allow him or her to effectively protect the interests of shareholders.

5.3.6.15 Finally we note that the FRC’s “Guidance on Audit Committees”, dated September 2012, recommends enhanced disclosure in the AC section of the annual report. For example, it should include an explanation of how the AC has assessed the effectiveness of the external audit process. It should also include the significant issues that the AC considered in relation to the financial statements and how these issues were addressed. This Guidance is designed to assist companies implement the UKCGC, which all FTSE350 companies must adhere to on a “comply or explain” basis, and is an additional measure to provide transparency as to the extent to which ACs carry out their tasks thoroughly.

5.4 Incentives for auditors to satisfy management or shareholder demand

5.4.1 The CC’s Provisional Finding on audit firms’ incentives

5.4.1.1 The CC provisionally finds that FDs are influential in appointing auditors and that audit firms have a strong incentive to appease FDs, even where such demands do not align with those of shareholders. The CC also finds that countervailing incentives on audit firms do not eliminate the incentive to accommodate management demands. The CC then concludes that the influence “in practice” of management on audit firms is a distortion of competition.

5.4.2 Audit firm appointment

5.4.2.1 The CC concludes that FDs are “the key” to the audit firm appointment process. In this regard we note that, while the FD is influential, the audit firm is appointed by

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436 Paragraph 5.2 of “Guidance on Audit Committees, FRC September 2012.
437 Paragraph 11.76 of the Provisional Findings.
438 Paragraph 11.94 of the Provisional Findings.
439 Paragraph 11.103 of the Provisional Findings.
shareholders on a proposal by the Board which, in turn, is based on a recommendation by the AC. As set out above, at least half of each FTSE350 Board is made up of NEDs, and so it can be expected that the FD’s view, while important, is subject to evaluation by the AC and the Board.

5.4.2.2 Further, we note the CC’s survey evidence which shows that the AC and ACCs, and not FDs, were most frequently cited as the most influential in selecting an audit firm. In the CC’s case studies, while executive management were seen as playing a key role in relation to five instances, the AC took the primary decision to recommend the audit firm in three others. This evidence led the CC to state that ACCs as well as FDs are “central to a company’s assessment” and this contradicts the CC’s assertion that the FD’s role is the most important.

5.4.2.3 We also note a 2011 survey conducted by Beattie found “[t]he CFO is found to have lost power over the auditor (this power has transferred to the ACC)” and this contradicts the CC’s assertion that the FD’s role is the most important.

5.4.2.4 Of course, in many cases it is likely that the AC’s view on the re-appointment of the auditor or the decision to tender the audit will be consistent with that of the FD and executive management – a potential conflict arises only if there are different views. Significantly, the CC has not presented any evidence to suggest that there are instances where the AC, or the ACC in particular, held a view on auditor re-appointment or tender which did not prevail and, we suspect, that this is because such instances are either non-existent or extremely rare.

5.4.3 The relationship between management and audit firm

5.4.3.1 The CC states that audit firms have an incentive to maintain good relationships with executive management, inter alia, to enhance their chances of being re-appointed. As a result, the CC finds that firms and AEPs have strong incentives to provide a service

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440 Paragraph 11.8 of the Provisional Findings.
441 Paragraph 11.10 of the Provisional Findings.
442 Paragraph 11.11 of the Provisional Findings.
443 Page 354, “Reaching key financial reporting decisions: how directors and auditors interact”, Beattie, V., Fearnley, S. and Hines, T., 2011, Chichester: Wiley. The quote continues: “the AP has gained power over the CFO due to the presence of the ACC, but lost some power within the company.”
that FDs demand, even if such demands do not align with shareholders.\textsuperscript{444} We fundamentally disagree with the CC’s provisional conclusion in this regard, as we set out in the rest of this section.

5.4.3.2 As we noted in paragraph 5.4.2.1, shareholders, voting on a proposal of the Board, elect a company’s audit firm. This proposal, in turn, is based upon a recommendation of the AC. The FD plays an important role in this process, but the hierarchy is clear: it is the AC’s role in approving the audit firm to be recommended to the Board which is paramount. The CC overlooks this fact.

5.4.3.3 As the CC notes\textsuperscript{445}, and as we discussed in section 2.7.4 above, the ability to establish a good working relationship with management is part of the ‘service’ aspect of an audit which constitutes the ‘third limb’ of audit quality. This must be handled efficiently to avoid additional cost and delay and support an effective audit process\textsuperscript{446}.

5.4.3.4 As noted in paragraph 2.7.4.1 the CC also recognises that management may benefit from audits as they provide them with an insight into the functioning of a company\textsuperscript{447}. In this respect, the CC notes that it received evidence from some FDs that audit firms are the “eyes and ears” of management\textsuperscript{448}. In order to deliver these benefits to management, it is therefore integral, and entirely appropriate, that good relationships are formed and maintained between audit firms and management.

5.4.3.5 As noted in paragraph 2.7.6.2, the CC also fails to take account of evidence which demonstrates that audit firms value their independence over and above their relationship with management. Our resignation from the audit of TUI is one example of this. We also note Kingston Smith’s statement that it has in the past lost clients as a direct result of its refusal to compromise in interpreting accounting or ethical standards\textsuperscript{449}.

\textsuperscript{444} Paragraph 11.76 of the Provisional Findings. As we set out at paragraph 3.10.9, above, there is a clear inconsistency between the CC’s treatment of FTSE350 companies’ bargaining power across its theories of harm. It is not clear why the CC considers that management have bargaining power in relation to independence but not in relation to other aspects of the audit offer.

\textsuperscript{445} Paragraph 6.14 of the Provisional Findings.

\textsuperscript{446} Paragraph 6.14 of the Provisional Findings.

\textsuperscript{447} Paragraph 5.15 of the Provisional Findings.

\textsuperscript{448} For example, paragraph 39 of Company B Case Study of Appendix 2 of the Provisional Findings.

\textsuperscript{449} Paragraph 61 of Appendix 19 of the Provisional Findings.
5.4.4 Incentives for auditors to remain independent

5.4.4.1 While the CC finds that audit firms have a strong incentive to conduct a thorough audit, it finds that external scrutiny of audit firms has raised concerns regarding a shortfall in professional scepticism. It further finds that the level of claims brought against audit firms suggests that these do not have serious consequences for them, and that steps taken to review technical quality do not address the alleged shortfall in auditor independence.

5.4.4.2 We strongly dispute the CC’s finding that audit firms do not have sufficient incentives to maintain their independence from management and, as we set out in sections 2.6 and 2.7, the CC’s view that there are material concerns as regards audit quality and independence are unfounded.

5.4.4.3 As we have repeatedly submitted to the CC, the risk to an audit firm’s and an individual audit partner’s reputation would be significant if independence were undermined. This is a fact noted by the CC and widely recognised by all audit firms and the broader industry. Although the likelihood of an audit report being scrutinised by a regulatory body in any one year is low, the financial accounts of the company will be scrutinised by investors and shareholders. Further, audit engagements are also scrutinised through our internal quality assurance programmes, which are in turn reviewed by the AQRT. In addition, even if the chances of detecting a lapse of independence in relation to any one audit client in any one year is relatively low, the potential impact of such detection is huge. As a result, it makes no sense to compromise independence on one audit and put at risk our reputation with all current and potential clients. The lessons of the collapse of Arthur Andersen are directly instructive here, and reflected in the measures that all audit firms take to maintain their reputation and independence.

450 Paragraph 11.93 of the Provisional Findings.
451 Paragraph 39 of Appendix 17 of the Provisional Findings.
452 Paragraph 39 of Appendix 17 of the Provisional Findings.
453 Paragraph 39 of Appendix 17 of the Provisional Findings.
454 Paragraph 11.99 of the Provisional Findings.
455 We note the measures taken by individual law firms to implement the Ethical Standards (outlined in paragraphs 14 to 44 of Appendix 17 of the Provisional Findings).
5.4.4.4 As set out earlier in section 2.7.6 we refute the suggestion that the level of claims against audit firms suggests that the consequences are not serious. It is nonsensical to judge the potential ramifications of findings against audit firms as not serious by the observed level of claims. It is our strong view that the low level of claims is consistent with high quality.

5.4.4.5 Such a finding also ignores “nuclear” events such as the collapse of Arthur Andersen, which is a much more appropriate comparator.

5.4.4.6 The CC finds that steps taken by firms to address technical quality and integrity issues do not resolve misaligned incentives.\textsuperscript{455} We reject this conclusion for which the CC provides no evidence. We, along with other audit firms, have implemented a number of procedures and review processes to ensure that audit quality is monitored and assessed on a regular basis, as we discussed in paragraph 2.6.2.1 above. As we also stated in paragraph 2.6.3.3 above, the CC underestimates the value and effectiveness of these internal programs which are themselves also assessed by the AQRT and the results published in our transparency report. These measures are designed to not only compete effectively in terms of audit quality, but also to meet the demands of management for a robust and comprehensive audit. We have previously outlined, in our response to the MFQ\textsuperscript{456}, the internal review procedures designed to monitor and enhance audit quality. We submit that these internal measures have the effect of not only addressing technical audit quality and integrity but also of focusing the audit firm’s attention on the interests of its customers (i.e. shareholders).

5.4.5 \textit{Mistakes, errors and lapses are not probative evidence of this theory of harm}

5.4.5.1 As noted above in section 2.7.3, shortcomings in professional scepticism and audit quality do not evidence a lack of audit firm independence. The CC has provided no evidence to support the existence of such a nexus and it is our view that while the latter may, in certain circumstances, result in the former, the concepts are distinct and should be treated as such.

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\textsuperscript{455} Paragraph 11.93 of the Provisional Findings.

\textsuperscript{456} Question 101 of the MFQ response.
5.4.5.2 As noted in paragraph 2.6.4.4 above, we invest substantial resources in order to compete on audit quality, which surveys indicate is one of the major competitive differentiators in the relevant market\textsuperscript{457}. It is also clear from the CC’s report that other firms are making similar investments and competing on the same basis\textsuperscript{458}. We recognise that, as with any profession, there may be mistakes, human error or other lapses in otherwise high standards but these are not sufficient indicia of a lack of auditor independence, insufficient professional scepticism or misaligned incentives. The complexity of the audit work being undertaken, particularly in relation to FTSE 350 companies means that, even with the most rigorous training and monitoring programs in place, mistakes, will on occasion, be made. However, we submit that this is the case in any profession where the application of discretionary judgement and scepticism is required and hence relatively minor lapses cannot be used as the principal basis for a finding a lack of independence\textsuperscript{459}.

5.5 Conclusion

5.5.1 The CC provisionally concludes that the introduction of ACs and regulatory developments since 1992, which includes the establishment of a robust, independent audit regulator, have not remedied the concerns. We disagree.

5.5.2 The developments which have taken place since the Cadbury Report have provided a strong and effective framework which ensures that audit firms are empowered and incentivised to act in the best interests of shareholders. Indeed, the CC’s own report highlights the positive impact that they have had. For example, the CC notes the impact that the introduction of the Combined Code (2003) and Smith Report (2003)

\textsuperscript{457} See, for example, section 8 of KPMG’s Main Submission to the Competition Commission.

\textsuperscript{458} Paragraphs 14 to 44 of Appendix 17 of the Provisional Findings.

\textsuperscript{459} In this regard, we note that decisions of independent Regulatory bodies are often over-turned. However, it would be incorrect to deduce from this that this is evidence that such bodies are not working properly. For example, we note that the European Commission, Federal Trade Commission, US Department of Justice, the OFT and the CC all have decisions over-turned from time to time, and yet they are recognised as the best competition agencies in the world. The fact that these bodies have decisions over-turnover does is not an indication of their independence or a lack of quality, but that mistakes can and do occur and that ex post reviews can highlight shortcomings which the reviewer of first instance (whether they be regulators or auditors) did not notice or did not ascribe the same importance to.
have had in making ACs more conscious of independence\textsuperscript{460}. This is cited by the CC as a reason why NAS fees have decreased\textsuperscript{461}.

5.5.3 The CC states that audit firms are selected and re-appointed by management. This is incorrect; as the CC notes elsewhere in its provisional findings, audit firms are reappointed by shareholders upon the recommendation of the Board, and not by management whose role has continued to diminish in recent years\textsuperscript{462}.

5.5.4 The CC also states that, although several regulatory bodies are designed to incentivise better auditing, they do not ensure the quality of each individual FTSE350 audit every year\textsuperscript{463}. Whilst it is difficult to see that anything other than a detailed check of every audit can “ensure” that each and every one is performed perfectly, this significantly underestimates the impact of the AQRT. First, the AQRT’s sample is not representative – it is risk-based and so deliberately slanted towards those audits where it believes it is most likely to find issues. Second, the AQRT performs substantial work on the audit firm’s own quality procedures (e.g. our QPR). Third, audit firms take account of, and respond to, the AQRT findings and, where appropriate, extrapolate lessons learned from specific file reviews to other audits.

5.5.5 The CC concludes that the influence “in practice” of management on external audit firms leads audit firms to compete to satisfy management demand rather than shareholder demand\textsuperscript{464} and that this is consistent with the market outcomes it has identified: that auditors have failed “on occasion” to demonstrate appropriate scepticism; and also the inability to identify the failure of some large companies\textsuperscript{465}.

5.5.6 As the CC recognises, there have been ‘occasions’ when the quality of certain aspects of particular audits have not been of an acceptable standard. However the fact that quality relating to a small subset of the reference market has “on occasion” required improvement, over the course of a number of years is an insufficient basis upon which to find an AEC. Further, as we note in section 2.6, above, audit quality across FTSE350 companies has been consistently improving.

\textsuperscript{460} Paragraph 11 of Appendix 20 of the Provisional Findings.
\textsuperscript{461} Paragraph 11 of Appendix 20 of the Provisional Findings.
\textsuperscript{462} Paragraph 3.10 of the Provisional Findings.
\textsuperscript{463} Paragraph 11.102(d) of the Provisional Findings.
\textsuperscript{464} Paragraph 11.103 of the Provisional Findings.
\textsuperscript{465} Paragraph 11.104 of the Provisional Findings.
5.5.7 We also very strongly object to the CC’s insinuation in its provisional findings that audit firms have in some way “failed” in not predicting the financial collapse of certain large companies. It is not the role of audit firms to provide forecasts of future events; and it is certainly not evidence of audit firms satisfying the demands of management over those of shareholders.

5.5.8 The CC has therefore not made its case “in practice” (as it claims) or in theory.
6 Rebuttal of Theory of Harm 2b: Audit firms face barriers to the provision of information to shareholders

6.1 The CC’s Provisional Findings

6.1.1 The CC finds that there are a number of features of the market which limit additional disclosures by audit firms to satisfy the unmet shareholder demand that it identifies\textsuperscript{466}; namely, constraints faced by auditors in providing information and the reluctance of management to provide further information\textsuperscript{467}.

6.1.2 The CC claims that management generally does not favour disclosure above statutory requirements and that this reluctance distorts competition because it restricts information to shareholders, causing firms to compete on the wrong parameters\textsuperscript{468}. The CC also notes that it considers that reluctance of management to disclose information also restricts the availability of information on which investors may judge quality, and leads to the unmet demand it identifies\textsuperscript{469}. This, the CC argues, also has the effect of increasing the risks and reducing the benefits companies can observe from switching audit firm\textsuperscript{470}. Finally, the CC argues that the fact that audit firms do not provide further information is consistent with the view that they respond to the demands of management and have less incentive to respond to demands of individual shareholders\textsuperscript{471}.

6.1.3 We strongly disagree with each of the CC’s provisional findings and set out below our principal reasons.

6.2 Existence of some unmet demand is not evidence of a misalignment between management and shareholders

6.2.1 The CC contends that, if there is unmet demand then it would expect audit firms to be competing to meet it\textsuperscript{472}, and considers that the evidence of unmet demand for better information is (further) evidence of a misalignment between management and

\textsuperscript{466} Paragraph 204 of the Provisional Findings.
\textsuperscript{467} Paragraph 11.133 of the Provisional Findings.
\textsuperscript{468} Paragraph 11.135 of the Provisional Findings.
\textsuperscript{469} Paragraph 11.136 of the Provisional Findings.
\textsuperscript{470} Paragraph 11.141 of the Provisional Findings.
\textsuperscript{471} Paragraph 11.140 of the Provisional Findings.
\textsuperscript{472} Paragraph 11.106 of the Provisional Findings.
shareholders\footnote{Paragraph 11.107 of the Provisional Findings.}. We have already commented at paragraph 2.10.3.3 that a competitive market does not typically lead to all “demands” from customers being met. However, despite the difficulties in determining consensus on shareholder demand, and the restrictions on audit firms in meeting this demand, the evidence before the CC suggests that audit firms are competing and innovating to satisfy the demands of shareholders and investors.

6.2.2 Indeed, audit firms are seeking to satisfy this demand, notwithstanding the fact that it is ultimately the company, and not the audit firm, which has the final say (subject to meeting statutory requirements) on what information may be disclosed. The CC accept that:

- firms are prevented from providing information of audit clients under their terms of engagement\footnote{Paragraph 11.134 of the Provisional Findings.};
- that there are legal constraints to audit firms providing information to individual shareholders or providing confidential information\footnote{Paragraph 11.134 of the Provisional Findings.}; and
- the quality of discussion between auditor and company may be reduced, if it took place in the knowledge that it would be disclosed.\footnote{Paragraph 7.187 of the Provisional Findings}

6.2.3 Nevertheless, the CC finds that, because audit firms rarely provide additional information to shareholders at AGMs, this is both (a) consistent with audit firms responding to the needs of management\footnote{The CC states that the lack of provision of additional information to shareholders at AGMs is “consistent” with its finding that auditors have an incentive to respond to the demands of executive management rather than individual shareholders (which, it should be noted, auditors do not owe a duty to).} and (b) evidence that management generally does not favour additional disclosure.

6.2.4 As we set out in paragraph 2.10.2.5 above, the fact that additional information is not provided at AGMs is in no way an indication of a misalignment of incentives; rather, it is a result of a lack of significant and coherent demand from stakeholders, as well as a product of constraints (which the CC recognises) on the ability of audit firms and companies to provide certain types of additional information and the benefits of having some level of standardisation (which the CC also recognises). In any event, it is ultimately not within the gift of audit firms to provide additional information and
thus compete in such a fashion (although firms have nevertheless been exploring ways to encourage increased disclosure).

6.3 **The CC over-states management reluctance to provide additional information**

6.3.1 The CC finds that the reluctance of management to provide information about audit judgements and audit processes distorts competition\(^{478}\). As a result, shareholders don’t receive full benefit of audit services (as the service may be slanted towards needs of executive management). The CC notes that “management do not have incentives to disclose more information than they are required to by regulation”\(^{479}\). In our view the CC over-simplifies the incentives of management in this regard which we explain in the rest of this section.

6.3.2 Whether to disclose certain information is a decision which it is 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.

6.3.3 Further, according to the CC’s logic, the initiatives of audit firms in engaging with regulators to encourage ACCs and companies in general to disclose additional information regarding the audit\(^{480}\) would risk antagonising management, with whom the CC claims auditors are anxious to maintain good relationships. This then begs the question as to why firms would risk doing this. This undermines the CC’s finding that audit firms tend to focus on meeting the interests of management rather than shareholders or the AC.

6.4 **No evidence of adverse effects**

6.4.1 The CC claims that management’s reluctance to provide further information to shareholders results in a lack of visibility of audit quality and differentiation between firms. It is suggested that this in turn has an adverse effect on increasing the risks and reducing benefits companies can observe from switching auditor\(^{481}\).

\(^{478}\) Paragraph 13.7 (b) of the Provisional Findings.

\(^{479}\) Paragraph 5.50 of the Provisional Findings.

\(^{480}\) Including as outlined by the CC in paragraph 7.194 and following of the Provisional Findings.

\(^{481}\) Paragraph 11.141 of the Provisional Findings.
6.4.2 We disagree. To the extent that there is unmet demand which could be satisfied, as set out above, shareholders have not identified with sufficient cogency what additional information should be provided. It would be inefficient to meet this demand and would actually diminish the overall benefits. Thus, meeting it cannot be what the CC would expect to observe in a competitive market.

6.4.3 Finally, the CC claims that auditors somehow “failed” to predict, and report, the collapse of a number of companies during the financial crisis. We disagree that this is evidence of an audit failure. Audits are designed to provide a true and fair reflection of the financial position of a company as reported in its financial accounts, conducted according to objective, and not subjective, criteria. They are therefore not, as currently conceived, a predictor of future events such as company failure caused in particular by unforeseen events. Indeed, the reports referred to by the CC\textsuperscript{482} state that there is no evidence that audits of banks which subsequently collapsed were deficient\textsuperscript{483}. The fact that the audits of these companies did not do something that they were not designed to do is therefore not a “failure” of auditors, contrary to the CC’s view\textsuperscript{484}.

\textsuperscript{482} Paragraph 7.202 of the Provisional Findings.

\textsuperscript{483} Although, as we have acknowledged previously, it does bring into question whether the scope of an audit or indeed financial reporting is appropriate, which is a subject we have been prepared to discuss and which the FRC is in part currently consulting on with its consultation on implementing the recommendations of the Sharman review.

\textsuperscript{484} Paragraph 11.104 of the Provisional Findings.