COMPETITION COMMISSION

STATUTORY AUDIT SERVICES FOR LARGE COMPANIES MARKET INQUIRY

Provisional findings report

Notified: 22 February 2013

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 Some numbers have been replaced by a range.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

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Glossary

Summary

The reference

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

2. We are required to determine whether any feature or combination of features of each relevant market prevents, restricts or distorts competition in connection with the supply or acquisition of any goods or services in the UK or a part of the UK,[1] ie results in an 'adverse effect on competition' (AEC).[2]

Background

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

[1] See section 134(1) of the Act.
[2] As defined in section 134(2) of the Act.

affect the auditors' opinion. The duties of auditors are owed to the company in the interests of the shareholders.

4. Statutory audits are extensively regulated. Auditors' reports are prepared in accordance with an international accounting standard[3] and use standard and formulaic wording. Statutory audit services must be supplied by auditors who are registered with a supervisory body. In addition, the Financial Reporting Council (FRC) monitors the quality of audits through its Audit Quality Review team (AQRT).

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

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

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[3] ISA (UK and Ireland) 700.

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

Market characteristics

8. We provisionally found that the relevant market was a single market for the supply of audit services to FTSE 350 companies, and not separate markets for audit services to segments of this group (for example, to FTSE 100 and FTSE 250 companies, respectively). The overwhelming majority of such audits are prepared by one of four firms[4] of auditors: Deloitte LLP, Ernst & Young LLP, KPMG LLP and Pricewaterhouse Coopers LLP (collectively, the Big 4 audit firms), although some FTSE 350 companies are audited by other firms such as BDO LLP, Grant Thornton UK LLP and PKF (UK) LLP. Under the Companies Act, a company may only engage an auditor for one year; however, in practice firms are frequently and repeatedly re-appointed, and some FTSE 350 companies have not switched auditor for many years. We found that 31 per cent of FTSE 100 companies and 20 per cent of FTSE 250 companies have had the same auditor for more than 20 years, and 67 per cent of FTSE 100 companies and 52 per cent of FTSE 250 companies for more than ten years.

9. Since such switching rates were not determinative of whether or not there was an AEC, we investigated the FTSE 350 statutory audit market to see if the outcomes of the competitive process we observed provided evidence of an AEC. With regard to profits and prices, it appears that companies which tender and switch their auditors

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

can, on average, obtain a price reduction, although one that erodes over approximately three years.

10. We were not able to reach a conclusion on whether audit firms were making profits above competitive levels or otherwise in this market. This was on account of difficulties in valuing capital employed; the intangible nature of the asset base in this market; difficulties in cost allocation (as firms offered both audit and non-audit services); and difficulties in identifying costs due to the partnership ownership structure. However, we found that the risk–reward balance offered to audit partners was attractive; and on balance it appeared to us that audit was a relatively attractive service line whose risks were not unusually high, when compared with other service lines. We also identified a number of companies from which audit firms appeared consistently to earn above average profit.

11. With regard to quality, it was difficult to identify an objective external metric to allow reliable comparisons between audits. However, 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. We also had some concerns that innovation appeared to be largely directed towards service delivery mechanisms, rather than delivering a service which best responded to shareholders' demand for assurance.

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

Features of the market

13. We framed our investigation of whether there are features of the relevant market which can be expected to harm competition by identifying a number of 'theories of harm', to help us focus our investigation. A theory of harm is a hypothetical explanation of how the characteristics and uncompetitive outcomes we identified may have arisen. We decided whether or not our theories of harm were correct by gathering, analysing and assessing the available evidence.

14. We considered companies' willingness (or not) to switch auditor and the extent to which companies are able to exert bargaining power in their negotiations with audit firms, thereby affecting competition and rivalry between audit firms. We also considered how well auditors represent shareholders' interests and the extent to which competition was focused on meeting management rather than shareholder demand. We did not look at each of these theories of harm in isolation, but considered whether there were links between them. We also considered theories of harm related to coordinated effects, bundling and regulatory distortions.

15. When assessing the competitive effect of potential features, we sought to apply a benchmark of what the market would be absent such features, and to consider whether the adverse outcomes would have arisen even if there were no features in the market preventing, restricting or distorting competition. We took into account all the evidence we found during our investigation when deciding whether any features or combination of features resulted in an AEC.

Companies' willingness to switch auditor and barriers to expansion and selection

16. Under our first theory of harm, we investigated why companies (acting on the advice of their executive management and ACs) did not switch auditor more frequently and

whether there were barriers to the expansion and selection of audit firms in the market.

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

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

19. We identified three factors that could make a company reluctant to switch auditor and so weaken its bargaining position. First, companies (including those representatives of the company who have the greatest influence in the (re)appointment decision) establish deep-rooted relationships of trust and confidence with their auditors (which auditors have strong incentives to cultivate). In general, companies do not lightly walk away from such relationships, which means that audit firms are likely to have to substantially underperform or overcharge before their tenure is put at risk. Second, it is difficult for a company to judge in advance the quality that an audit firm will provide, which means that any incumbent has an advantage against the uncertainty of what an alternative might provide. Third, companies face significant costs when switching auditor. In particular, we received evidence that running a tender process is onerous in terms of management time, and companies must invest considerable time in

educating a new auditor regarding its specific circumstances. This means that companies do not tender their audits as frequently as they would if they did not face such costs.

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

21. Audit firms told us that, when newly appointed, they made considerable investments in companies during the early years of an engagement (in terms of additional hours). We were told that it took perhaps two to three years before an audit firm fully understood the complexities of a company, but that this investment led to increased quality and efficiencies from which companies benefited. We were told that audit firms had much to lose should a company switch, in terms of income, reputation, and the ability to win further engagements. This meant, they said, that companies were able to ensure that their audit services were offered competitively, even outside a tender process.

22. We investigated why audit firms outside the Big 4 firms were not more successful in winning audit engagements of FTSE 350 companies and whether they might generally be expected to add an additional layer of competition for incumbent auditors. We did not identify any single large investment that they needed to make. However, we found potential customers looked for a substantial track record of experience of auditing FTSE 350 companies when selecting auditors, and only the Big 4 audit firms could point to such experience. We considered the use of ‘Big 4

clauses’ in some loan agreements added to the reputational barriers that Mid Tier audit firms face.

Auditors’ representation of shareholders’ interests

23. Under our second theory of harm, we investigated how well auditors represented shareholders’ interests and the extent to which competition was focused on meeting management rather than shareholder demand, leading to lack of appropriate scepticism on the part of the external auditors and unmet demand for better information as regards the audit process from shareholders.

24. We were satisfied that both management and auditors aim to perform their respective functions diligently and effectively. Nevertheless, we took into account the importance of audit as a safeguard that company accounts give shareholders a true and fair view of a company’s financial position. We investigated whether auditors sufficiently represented shareholders, given the evidence we had of issues regarding audit objectivity, auditor independence and the existence of unmet shareholder demand.

25. It appeared that shareholders, despite their legal rights, played very little role in any decision to appoint an auditor, while in contrast executive management was very influential. We considered how well the interests of executive management and shareholders were aligned with respect to audit. While, broadly, we found that each has an interest in the auditors detecting issues likely to lead to a material misstatement of accounts, we considered that each might have different incentives when it came to reporting the findings of those investigations, and in how issues requiring judgement were treated. In particular, we found that at times executive management had incentives to manage reported financial performance to accord with expectations

and present accounts in an unduly favourable light. We found that, in general, shareholders would have no such interest.

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

27. We also provisionally found that there were limited countervailing incentives of auditors to challenge executive management. In particular, we were told that loss of reputation (in terms of being seen as susceptible to executive management influence) would be very damaging to an audit firm. Audit firms make significant internal efforts to maintain quality and are subject to external regulation by the FRC and professional bodies. Under the Corporate Governance Code, ACs monitor and review the effectiveness of the audit. However, they report to the board, not directly to shareholders, and their limited resources are such that we do not think that they can ensure that interests of shareholders are fully protected in all cases.

28. We balanced these factors and considered the evidence that we had observed regarding the independence of auditors, in terms of appropriate scepticism and challenge to inappropriate assumptions and accounting techniques. We provisionally concluded that while most of the time audits were performed diligently and with appropriate challenge, any loss of audit objectivity or scepticism in conducting a given audit would not easily be detectible, and so it was possible that such loss of independence occurred without being known by shareholders. We provisionally found that the loss of independence arose because competition between audit firms was on the wrong parameters, as audit firms responded to demand from executive

management and not demand from shareholders, which is a restriction or distortion of competition.

29. In terms of the unmet demand with regard to the information supplied by auditors, we provisionally found that this arose from restrictions on auditors, in particular the reluctance of management to allow audit firms to disclose certain information to shareholders (for example, as to concerns about the assumptions made or the use of aggressive accounting techniques) beyond that contained in audit firms' formal reports. We found that these restrictions restricted or distorted competition because by failing to respond to shareholder demand, auditors again competed on the wrong parameters, and that this led to the unmet shareholder demand that we identified.

Other theories of harm

30. We considered whether the market conditions are conducive to coordination or that Big 4 audit firms engage in tacit collusion; that they bundle audit and non-audit services together in order to raise barriers to expansion to other audit firms; that they target the customers of Mid Tier audit firms with particularly low prices; or that they are able to exercise undue influence over the formation of regulation or on regulatory bodies through their extensive alumni networks. To date, we have not identified sufficient evidence to support these other theories of harm.

Provisional findings

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

    (a) Barriers to switching:

    - (i) companies face significant hurdles in comparing the offerings of an incumbent audit firm with those of alternative suppliers other than through a tender process;

(ii) it is difficult for companies to judge audit quality in advance due to the nature of audit; and

(iii) companies and audit firms invest in a relationship of mutual trust and confidence from which neither will lightly walk away as this means the loss of the benefits of continuity stemming from the relationship.

(b) Company management face significant opportunity costs in the management time involved in the selection and education of a new auditor.

(c) Mid Tier audit firms face experience and reputational barriers to expansion and selection in the FTSE 350 audit market.

(d) Auditors have misaligned incentives, as between shareholders and company management, and so compete to satisfy management rather than shareholder demand, where the demands of executive management and shareholders differ.

(e) Auditors face barriers to the provision of information that shareholders demand (in particular, from the reluctance of company management to permit further disclosure).

32. We provisionally found that the features listed in *(a)* to *(c)* above give rise to an AEC, either individually or in combination, by weakening a company's bargaining power outside the tender process. Incumbent auditors therefore face less competition for their ongoing engagements than they would were the company more willing to switch thereby reducing rivalry. The features listed in *(d)* and *(e)* above gives rise to an AEC as auditors, by being insufficiently independent from executive management and insufficiently sceptical in carrying out audits, compete on the wrong parameters for appointment as statutory auditor and fail to respond to the demands of shareholders.

33. As a result of the AEC, we provisionally found that companies are offered higher prices, lower quality and less innovation and differentiation of offering than would be

the case in a market without the features, and shareholders and investors (as potential future shareholders) have demand which is unmet.

Provisional findings

1. The reference

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

1.2 Our statutory remit is therefore to assess competition in the market or markets for the provision of statutory audits to large companies. We are required to determine whether any feature or combination of features of each relevant market prevents, restricts or distorts competition in connection with the supply or acquisition of any goods or services in the UK or a part of the UK.[6] If we find that there is such a prevention, restriction or distortion of competition, there will be an AEC.[7] We elaborate on this in paragraphs8.1 to 8.6.

1.3 The full text of the reference is set out in Appendix 1, together with a description of the steps we have undertaken in the course of our investigation so far. We must report by 20 October 2013.

1.4 These are our provisional findings. They are structured as follows. We:

(a) describe our evidence and its use (Section 2);

(b) introduce the legal framework of audit (Section 3);

(c) describe the suppliers of statutory audit services to large companies (Section 4);

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

(d) set out what we provisionally find is the economic function and characteristics of audit relevant to our investigation (Section 5);

(e) describe the audit product in more detail, in particular regarding its competitive parameters, and define what we provisionally find is the relevant market for our investigation (Section 6);

(f) set out our provisional findings with regard to market outcomes (Section 7);

(g) explain what amounts to a feature within the meaning of the Act and set out hypothetical explanations of the outcomes we observe (Section 8);

(h) assess whether FTSE 350 companies are reluctant to switch auditor and so whether companies have bargaining power with respect to their auditor (Section 9);

(i) assess whether barriers to expansion or selection reduce competitive pressure from outside the market (Section 10);

(j) assess whether auditors sufficiently satisfy the demands of shareholders (Section 11);

(k) assess whether coordinated effects, bundling or regulation have caused adverse effects on competition (Section 12); and

(l) in light of this, provisionally decide whether any feature or combination of features of the relevant market prevent, restrict or distort competition in connection with the supply or acquisition of any services in the UK or part of the UK, within the meaning of section 134(1) of the Act (Section 13).

2. Our evidence and its use

2.1 In order to inform our inquiry, we sought evidence by various means.

Case studies

2.2 We selected ten companies for case studies. We also conducted interviews with two investors who each invested in a majority of the case study companies and collec-

tively invested in all ten case study companies. Prior to selecting our subjects, we published a notice that set out how we intended to select case study subjects, inviting comments from interested parties. We were interested in the experience of large companies concerning competition in the provision of statutory audits. We received nine responses to our notice. We conducted interviews with the FD (or equivalent), the Audit Committee Chair (ACC) and the Audit Engagement Partner (AEP) for each company. For some of the case studies, we also interviewed the AEP of the company's previous auditor or the previous ACC of the company. In total we conducted 37 interviews.

2.3 The cases studies are at Appendix 2 in anonymized form: the ten company names have been replaced with letters A to J. We refer to them (using the allocated letter) throughout these findings, and take them to be illustrative rather than representative.

Survey

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

2.5 The surveys and key statistics are at Appendices 3, 4 and 5, and we refer to them as necessary.

Hearings

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

Public data set

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

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

Information requests

2.9 We issued detailed information requests to the main parties and client data requests to all UK audit firms that audited a FTSE 350 or Top Track 100 company in the

[8] See also Appendix 6.

period 2006 to 2011. This included 15 audit firms in total. The data request was developed following a series of data meetings with audit firms to ensure consistency in the data that could be provided.

Submissions

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

Academic research

2.11 We commissioned Professor Vivien Beattie of Glasgow University to conduct a review of academic literature relevant to the audit market.[9] We also commissioned Cardiff Business School to assist us in considering the prevalence of clauses in loan agreements that specify the auditor that a borrower may engage (see Appendix 7).

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

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

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

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

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

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

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

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

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

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

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

3.2 Appendix 8 contains a more detailed description of the legal and regulatory framework.

Companies' and directors' duties to prepare accounts

3.3 Directors have a duty to ensure that companies keep accounting records which disclose with reasonable accuracy at any time the financial position of the company at that time.[10] These records must contain entries of all sums of money received and expended by the company, a record of the assets and liabilities of the company and statements of any stock held by the company at the end of each financial year.[11]

3.4 The directors of every company must prepare accounts for the company for each of its accounting years.[12] In preparing these financial statements, the directors are required to:

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

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

(c) state whether applicable International Financial Reporting Standards (IFRS) as adopted by the EU have been followed.

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[10] Section 386(2)(b) of the Companies Act.
[11] Section 386(3) of the Companies Act.
[12] Section 394 of the Companies Act.

3.5 The directors of a company must not approve accounts unless they are satisfied that they give a true and fair view of the assets, liabilities, financial position and profit or loss of the company, or (in the case of group accounts) of the undertakings included in the consolidation as a whole.[13]

3.6 IFRS International Accounting Standard 1 'Presentation of Financial Statements'[14] requires management to make an assessment of 'going concern' (ie that the company is able to pay its debts as they fall due over the 12 months following the reporting date) and prepare the company's financial statements on that basis.[15]

3.7 The Companies Act requires the preparation of a Directors' Report, which is included with the annual report and financial statements,[16] and all non-small companies must prepare a business review, which includes a 'fair review of the company's business' and 'a description of the principle risks and uncertainties facing the company'.[17] The FRC interprets this to require a statement of whether a company is a going concern.[18]

3.8 Directors have additional obligations for accounts under the UK Listing Authority's Listing Rules (Listing Rules) and Disclosure and Transparency Rules. In particular, the directors must state explicitly that the business is a going concern, together with supporting assumptions or qualifications.[19]

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[13] Section 393 of the Companies Act.
[14] IAS 1, paragraph 25. http://eifrs.ifrs.org/eifrs/bnstandards/en/2012/ias10.pdf
[15] International Accounting Standards form part of the IFRS suite of standards.
[16] Section 415 of the Companies Act.
[17] Section 417 of the Companies Act .and SI 2008/410, Schedule 7.
[18] Financial Reporting Council, Going Concern and Liquidity Risk: Guidance for Directors of UK Companies 2009.
[19] Listing Rules 9.8.6R(3).

The obligation to commission an audit

3.9 Companies have a duty to commission statutory audits each financial year.[20] The Companies Act defines a statutory audit[21] as an audit conducted by a person appointed as a statutory auditor, that is to say an audit conducted by a person appointed by a company[22] in accordance with the provisions of the Companies Act. The appointment or reappointment is usually made formally by the shareholders by ordinary resolution in the annual general meeting. Shareholders may also dismiss an auditor at any time by passing an ordinary resolution at a general meeting.

3.10 An auditor of a public company holds office as auditor for one year only. The auditor may then be reappointed for a further period of one year upon passing of a resolution by the shareholders.[23] This process of annual reappointment may be repeated in each subsequent year until the directors propose appointment of a different auditor.

The auditor and auditing functions

3.11 An individual or audit firm[24] is eligible to be appointed as a statutory auditor if the individual or audit firm is a 'fit and proper person',[25] who is a member of a recognized supervisory body (see paragraph 3.33) and is eligible for appointment under the rules of that body.[26]

3.12 The two main functions of a statutory auditor are: *(a)* to obtain audit evidence and conduct an audit in accordance with International Standards on Auditing (UK and

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[20] Under section 475 of the Companies Act, as modified in the case of limited liability partnerships by article 33 of the Limited Liability Partnerships (Accounts and Audit) (Application of Companies Act 2006) Regulations 2008 (SI 2008/1911). Until 6 April 2008, the duty was on an auditor to audit the accounts, not on the company. An exemption from the duty to commission an audit is available for small companies that qualify and do not exceed certain turnover and balance sheet thresholds—see Appendix 8, paragraph 15.

[21] Section 1210(1) of the Companies Act.

[22] Under section 485 (private companies) or section 489 (public companies) of the Companies Act.

[23] Section 491(1)(b) of the Companies Act.

[24] For these purposes, 'firm' means any entity, whether or not a legal person, which is not an individual, and includes a body corporate, a corporation sole and a partnership or other unincorporated association: section 1261(1) of the Companies Act.

[25] Paragraph 8 of Schedule 10 to the Companies Act.

[26] Individuals who have retained Companies Act 1967 authorization, but are not otherwise eligible for appointment, may only audit an unquoted company (section 1222 of the Companies Act) in the cases to which the Companies Act section 1222 applies (individuals retaining only Companies Act 1967 authorization).

Ireland); and *(b)* make a report to the company's shareholders on the annual accounts of the company identifying the financial reporting framework and the auditing standards that have been applied and, in particular, expressing an opinion on whether the annual accounts give a true and fair view of the state of affairs of the company at the end of the financial year, and of the profit or loss of the company for the financial year. This report must be laid before the company in a general meeting in the case of a public company.

3.13 An auditor has a general right of access to information for the purpose of preparing this report. This includes a right of access to the company's books, accounts and vouchers and a right to require any officer or employee of the company to provide such information or explanation as the auditor thinks necessary.[27]

3.14 The report must state clearly: *(a)* whether in the opinion of the auditor the annual accounts give a true and fair view of the state of the company's affairs and of its profit or loss as at the end of the financial year of the company; and *(b)* whether in the opinion of the auditor the accounts have been properly prepared in accordance with the relevant financial reporting framework, the requirements of the Companies Act and, where applicable, Article 4 of the International Accounting Standards Regulation.[28] This opinion must cover the 'going concern' statement provided by the directors (see paragraph 3.8).

3.15 The auditor's report includes an opinion on the financial statements which must be either unqualified or qualified, and must include a reference to any matters to which the auditor wishes to draw attention by way of emphasis without qualifying the

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[27] Section 499 of the Companies Act.
[28] Section 495 of the Companies Act.

report.[29] 'Qualified'[30] means that the report does not state the auditor's unqualified opinion that the accounts have been properly prepared in accordance with the Companies Act.

3.16 If the auditor is of the opinion that: *(a)* adequate accounting records have not been kept; or *(b)* the company's individual accounts are not in agreement with the accounting records and returns, then that fact must be stated in the report.[31] If the auditor is of the opinion that the accounts are not in agreement with the accounting records, or if the auditor fails to obtain the information and explanations needed for the audit, this must be stated in the report.[32] The auditor must also state if the requirements[33] as to disclosure in the accounts of directors' benefits, remuneration, pensions and compensation for loss of office are not complied with, or requirements[34] are not complied with as to information concerning the auditable part of the directors' remuneration report.

Auditors' duties and audit failure

3.17 The substance of an auditor's role and to whom the auditor owes a duty have been considered by the courts. The legal position is that the duties of an auditor are founded in contract and the extent of the duties undertaken by contract must be interpreted in the light of the relevant statutory provisions and the relevant Auditing Standards. The duties are duties of reasonable care in carrying out the audit of the company's accounts. They are owed to the company in the interests of its

[29] ISA 705 uses the term 'modified' not 'qualified', and establishes three types of modified opinion: qualified opinion; adverse opinion; and disclaimer of opinion. Where the auditor expresses a qualified opinion due to a material misstatement in the financial statements, ISA 705 requires the auditor to state that in the auditor's opinion, except for the effects of the matters described, the financial statements give a true and fair view or have been prepared in all material respects in accordance with the applicable financial reporting framework.
[30] Section 539 of the Companies Act.
[31] Section 498(2) of the Companies Act.
[32] Section 498 of the Companies Act.
[33] Under section 412 of the Companies Act.
[34] Under section 421 of the Companies Act.

shareholders. No duty is owed directly to the individual shareholders. This is because the shareholders' interests are protected by the duty owed to the company.[35]

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

> An auditor is not to be confined to the mechanics of checking vouchers and making arithmetical computations. … His vital task is to take care to see that errors are not made, be they errors of computation, or errors of omission or commission, or downright untruths. To perform this task properly, he must come to it with an inquiring mind—not suspicious of dishonesty, I agree—but suspecting that someone may have made a mistake somewhere and that a check must be made to ensure that there has been none.[36]

3.19 The auditor must conduct the audit in such a way as to make it probable that material misstatements in financial documents will be detected.[37]

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

> Reasonable assurance is a high level of assurance. It is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk (that is, the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated) to an acceptably low level. However, reasonable assurance is not an absolute level of assurance, because there are inherent limitations of an audit which result in most of the audit evidence on which the auditor

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[35] *Moore Stephens (a firm) v Stone Rolls Limited (in liquidation) [2009] 1 AC 1391,* Lord Phillips of Worth Matravers.
[36] *Fomento (Sterling Area) Limited v Selsdon Fountain Pen Co Ltd [1958] 1 WLR 45 (HL)*, p61.
[37] *Barings plc v Coopers & Lybrand [1997] 1 BCLC 427*, CA, Leggatt LJ.

draws conclusions and bases the auditor's opinion being persuasive rather than conclusive.[38]

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

3.22 However, even if there is no question of legal liability, where a company discovers that its reported accounts are 'wrong', then it must issue a restatement.[39] It became apparent to us (during the course of our case study hearings and hearings with audit firms) that all parties (whether auditor, FD or AC) were highly motivated to avoid such restatements. While they might prove necessary for purely technical reasons (as happened at Company H[40]), restatements must always be explained, generally arouse suspicion, and may cause adverse effects on share prices (at least in the short term). In more significant cases, they publicly reveal weaknesses in a company's control systems or more substantial problems (as happened at Company A[41]). From our discussions with investors, it became apparent that they were wary of change and did not like surprises, and a restatement could amount to both.

3.23 Even where no restatement proves necessary, a user of a set of financial statements may have expectations regarding the accuracy of those financial statements. The role of the auditor is to provide reasonable assurance that accounts are free of

[38] International Standard on Auditing (UK and Ireland) 200 – Overall objectives of the independent auditor and the conduct of an audit in accordance with International Standards on Auditing (UK and Ireland), paragraph 5.
[39] Under section 454 of the Companies Act and IAS 10: http://eifrs.ifrs.org/eifrs/bnstandards/en/2012/ias10.pdf.
[40] Appendix 2, Case Study H, paragraphs 42 & 43.
[41] Appendix 2, Case Study A, paragraphs 27, 28, 117–119.

material errors, therefore as part of planning and performing an audit, auditors must establish a suitable level of materiality.[42] However, users of the financial statements may not appreciate the nature of materiality or the legal and regulatory requirements of audit and may expect audited financial statements to be completely free of error.[43] Any difference between a user's expectation of the nature of an audit and the audit in practice has been referred to as the 'expectation gap'. We consider this issue further in paragraphs 7.180 to 7.204, where we assess if there is a demand from shareholders that is not currently met by audit.

3.24 The financial statements should present the financial performance and position of a company accurately not only at the reporting date, but also taking into account information that becomes available before the financial statements are authorized for issue by the board.[44] However, events may occur after the reporting date or the date that the financial statements are authorized for issue. In such circumstances, users' perceptions of the accuracy of the financial statements and the perceived quality of the audit may be affected if these events are not reflected in the financial statements. As a result, the expectation gap may lead to a perception of audit failure if users of the financial statements expect that the auditor should have either detected or foreseen such events. Examples occurred during the 2008 banking crisis where companies with audited accounts (which included 'going concern' statements) subsequently needed bailing out.

[42] ISA (UK&I) 320 'Materiality in planning and performing an audit' states that an error is considered material if it could 'reasonably be expected to influence the economic decisions of users'.
[43] ISA (UK&I) 320 'Materiality in planning and performing an audit' states that an auditor is able to assume that users of financial statements understand that they are audited to a level of materiality.
[44] Such information may affect the assumptions used in accounting estimates. For example, if a court case relating to events before the reporting date concludes after the reporting date but before the financial statements are authorized for issue, the value of any provision or disclosed contingent liability relating to the case would need to be amended. How such information should be used is governed by IAS 10 'Events after the reporting period'.

The Audit Committee

3.25 ACs were first proposed by the Cadbury Report on corporate governance in 1992.[45] The Cadbury Report considered that the benefits of ACs, if operated effectively, would include strengthening the position of the external auditor, by providing a channel of communication and forum for issues of concern and providing a framework within which the external auditor can assert his independence.[46] Since 1994, the Listing Rules have required listed companies to appoint an AC or to explain why they do not have one.

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

3.27 The AC is responsible for (among other things) making recommendations to the board as to the appointment and reappointment of external auditors, monitoring the effectiveness of the external audit process and reviewing the independence and objectivity of external auditors (with particular regard to external auditors supplying non-audit services (NAS)). Appendix 8 provides further details on the role of ACs, and we return to the issue of the role of ACs in Sections 9 and 11.

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[45] *Financial Aspects of Corporate Governance* (December 1992). The report recommended that companies should establish an AC, comprising at least three non-executives.
[46] *Financial Aspects of Corporate Governance* (December 1992). Appendix 4, item 4.

Regulatory supervision of auditors

Financial Reporting Council

3.28 The FRC is the UK's independent regulator responsible for promoting high-quality corporate governance and reporting in order to foster investment. It has statutory and non-statutory responsibilities, in relation to audit. See further Appendix 8, paragraphs 145 to 202.

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

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

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

(a) The Audit Quality Review Team (AQRT) (formerly known as the Audit Inspection Unit)[47] monitors the quality of the audits of listed and other major public interest entities and the policies and procedures supporting audit quality at the major audit firms in the UK.

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

(c) The Professional Oversight team has a number of statutory responsibilities delegated to the FRC by the Secretary of State for Business, Innovation and Skills,

[47] Throughout these findings we use the term AQRT, even if at the relevant time it was still the AIU.

and by agreement with the six chartered accountancy bodies (see below), the team also exercises independent oversight of the regulation of the accountancy profession by the professional accountancy bodies.

The professional accounting bodies

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

3.33 Audit firms which wish to be appointed as a statutory auditor in the UK must be registered with, and supervised by, a Recognised Supervisory Body.[48] The Recognised Supervisory Body must have procedures in place to register and de-register statutory auditors and supervise work undertaken by these individuals and firms, and to this end it carries out four main tasks: audit registration; audit monitoring; arrangements for the investigation of complaints; and procedures to ensure that those eligible for appointment as statutory auditor continue to maintain an appropriate level of competence. See further Appendix 8, paragraphs 207 to 210.

3.34 Individuals responsible for audit at registered firms must hold an audit qualification from a Recognised Qualifying Body, which award the qualifications necessary to undertake audit work.[49] Under the procedures followed by ICAEW, ICAS and CAI, an individual who wishes to undertake audit work must hold an audit qualification and be approved as a 'Responsible Individual'. See further Appendix 8, paragraph 209.

Auditing is just one part of corporate governance

3.35 Finally, we note that the requirement for a statutory audit operates in conjunction with other legal and regulatory provisions concerned with promoting effective corporate

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[48] These are the Association of Chartered Certified Accountants (ACCA); the Association of Authorised Public Accountants (AAPA) (now part of the ACCA); the Institute of Chartered Accountants in England and Wales (ICAEW); the Institute of Chartered Accountants in Ireland (CAI); and the Institute of Chartered Accountants of Scotland (ICAS).

[49] There are five: ACCA, ICAEW, CAI, and ICAS and the Association of International Accountants.

governance and trust and confidence in financial reporting and markets. For example, Listing Rules and insider trader regulations seek to prevent the existence and exploitation of privileged access by existing shareholders, management and others to information on the future prospects of the company. The FRC publishes the UK Corporate Governance Code which sets out standards of good practice in relation to board leadership and effectiveness, remuneration, accountability and relations with shareholders (further detail is contained in Appendix 8, paragraphs 238 to 245, and its Annexes B and C).

4. The suppliers of statutory audit services

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

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

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

4.2 Appendix 9 provides a brief portrait of each of nine larger audit firms which have provided statutory audit services to large[50] listed companies in the UK in turn: Baker Tilly UK Holdings Ltd[51] (Baker Tilly), BDO LLP (BDO), Deloitte LLP (Deloitte), Ernst & Young LLP (EY), Grant Thornton UK LLP (GT), KPMG LLP (KPMG), Mazars LLP (Mazars), PKF (UK) LLP (PKF) and Pricewaterhouse Coopers LLP (PwC).

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

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[50] By 'large' in this context we are including a wider group of companies than just FTSE 350 companies (Mazars has not audited a FTSE 350 company in the last five years) and we are not using the definition of large companies set out in our terms of reference .

[51] Statutory audit is provided by Baker Tilly UK Audit LLP.

The audit firms and their international networks

4.4 Eight of the UK member audit firms discussed here are incorporated as Limited Liability Partnerships (LLPs). The exception, Baker Tilly, operates through a group of companies limited by shares and LLPs, with the audit function contained within a specialist LLP. An LLP is a body corporate and is much like a company limited by shares, but rather than being owned by shareholders it is owned by its members (partners).[52] A partnership or members' agreement will also usually state the method by which profits will be distributed among the partners.[53] Under UK law, a member of an LLP can be an individual, a company or another LLP.

4.5 The Big 4 firms are members of international networks of broadly similar scale. Each operates in approximately 150 territories, comprising and employing between 145,000 and 182,000 partners and staff in total, and their combined global revenues range between £14,500 million and £18,500 million. The individual networks and their UK audit firms are compared in Table 4.1 below. The member firms of the networks share a name, brand, a commitment to audit quality standards and common methodologies but member firms remain legally separate, and are typically independently owned and controlled. Member firms are brought together by common membership of a central network body or entity. The EY network differs through its greater level of 'global integration' from other Big 4 firms (see Appendix 9).

4.6 Most of the other larger audit firms (Baker Tilly, BDO, GT and PKF) are also members of networks (Mazars by contrast has adopted a global 'integrated partnership').[54] The legal structure of these networks is broadly similar to those of the

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[52]The nature of being a 'member' in a company limited by guarantee and in an LLP differs on the point of ownership.
[53] The actual remuneration received by each partner in the firms is based on a number of elements such as the nature of the portfolio and responsibility held, as well as a performance assessment based on a 'balanced scorecard', and will be subject to review by a remuneration panel of some form.
[54] Mazars is included in the comparisons of networks.

Big 4 firms. These networks have member firms in between 69 and 135 countries.[55] The number of staff and partners employed globally by these networks ranges from 13,000 to 49,000 and their combined global revenues range between £815 million and £3,573 million. The individual networks and their UK firms are compared in Table 4.1 below.

4.7 For all of the audit firms covered by this section, there is a central coordinating entity (the 'network body').[56] Seven of the nine network bodies are incorporated in the UK as companies limited by guarantee.[57] Individual national firms become members of the network by being members of the network body (or by contract). The relationship between the member firms and the network will be determined by a legal agreement between each member and the network body, as well as the constitutional documents of the network body. Pursuant to these documents member firms agree to be bound by policies set by the network body. Some networks have different types of member firm. The terminology used to describe the different types of membership differs in each firm. In all of the nine networks discussed in this section, the UK firm is a full member of the network, and is subject to all of the network's policies, branding, methodology and quality assurance requirements. Other national firms, particularly in developing markets, may be 'affiliate firms' which carry out audit work on behalf of the member firms, but which may not necessarily be subject to the full policies of the network. There is variation between networks regarding the number of territories covered by networks rather than affiliate firms.

[55] Mazars' integrated partnership is arranged around a central network entity, Mazars SRCL. In each country there will be a separate legal entity, which is owned by its partners. These local firms have signed a cooperation agreement with Mazars SRCL. The members (partners) of a firm will also be members of Mazars SRCL. The majority of Mazars UK partners are partners of Mazars SRCL, and these partners share profits with other partners globally; Mazars member firms are also members of the Praxity alliance of independent firms, which provides additional coverage.
[56] In this report, 'the network body' refers to the central entity that coordinates and provides services to firms.
[57] KPMG International is a Swiss Cooperative, which is the equivalent of a Company Limited by Guarantee, and Mazars SCRL is similarly the Belgian equivalent.

4.8 There is no pooling of profits at an international level with the exception of Mazars, and to a small extent KPMG UK. The amount paid to the network body by each member firm to fund the network body's running costs is based on the level of revenue that a member firm generates.

The UK firms in context

4.9 Table 4.1 shows that the UK firms each generate revenues that equate to between 8 and 16 per cent of the aggregate revenues of the member firms of their respective networks. With the exception of the Mazars network, the US member firms are significantly larger, generating approximately 30 per cent of revenues received by member firms.[58]

TABLE 4.1 **UK firms and networks**

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

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

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

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

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

TABLE 4.2 **Statutory audit revenue, 2011**

£'000

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

Sources: 'Other Business Info' submitted by parties.

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

4.11 The networks via their member firms serve a number of large, international clients and audit work relating to subsidiaries of these clients may be undertaken on behalf of the group auditor by other member firms in the same network.[59] Member firms generate referred income as a result of another member firm winning the group audit.[60]

The emergence of the Big 4 firms

Networks

4.12 The international networks of the current UK firms emerged from the late 19th century through two routes:[61]

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

[59] For example, half of Deloitte's FTSE 350 audit fees are paid to overseas member firms to audit the subsidiaries of Deloitte's clients (Deloitte's non-confidential initial submission, p2).
[60] However, as noted in paragraph 4.18, when international networks have merged, such as Deloitte Haskins and Sells and Touche Ross, not all member firms have transferred into the combined network.
[61] See Figure 4.1 in paragraph 4.15 for an overview of merger activity from 1987 to 2002.

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

Merger activity—international networks and effect on the UK

4.13 Over the course of the 20th century, international networks developed. By the 1980s, there were eight networks that were recognized as being larger than any others and were referred to as the 'Big 8'. All had member firms in the UK.[62,63]

4.14 A merger of two networks would require the member firms of both networks in each country to agree to create a single firm in each territory, with a new set of network arrangements.[64] If a member firm in a territory chose not to merge, it would effectively be excluded from the network.[65]

4.15 The most significant period of merger activity began in 1987 with Peat Marwick strengthening its position as one of the eight large firms by merging with the relatively new European network of KMG.[66] Figure 4.1 provides an overview of the merger activity between the international networks beginning in this period.

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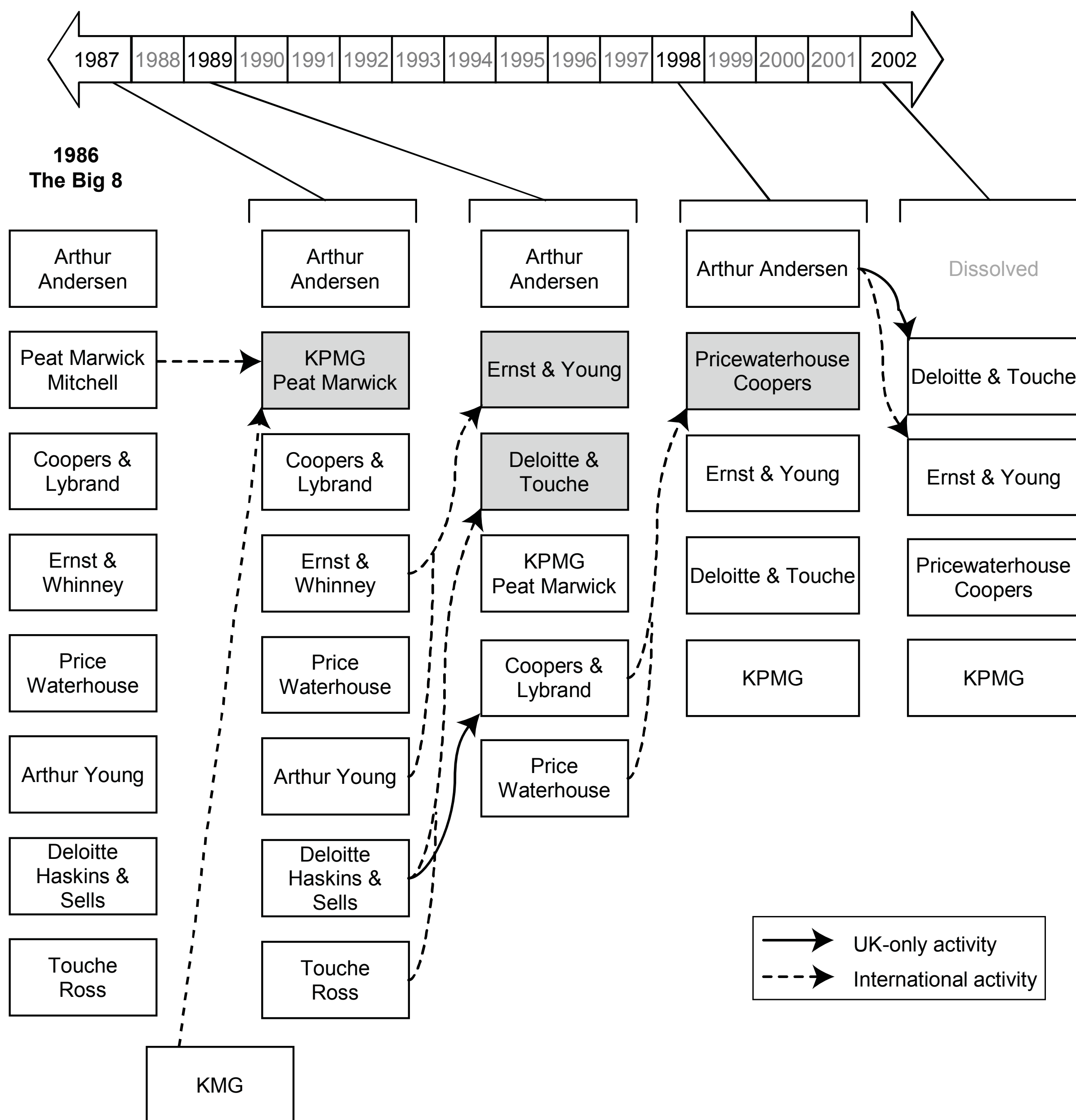
[62] The eight were Peat Marwick, Ernst & Whinney, Deloitte, Haskins & Sells, Arthur Young & Co, Touche Ross, Price Waterhouse, Coopers & Lybrand and Arthur Andersen. A significant element of the Arthur Andersen practice was devoted to servicing UK subsidiaries of US companies, rather than UK-owned companies.
[63] Deloitte was established in the UK in1845 and opened a New York office in 1880.
[64] Prior to the advent of LLPs in 2000, a merger of partnerships would essentially require a redrafting of a partnership agreement to decide on the respective value of capital introduced by each of the firms and the subsequent division of profit. There would not necessarily need to be any financial consideration paid.
[65] Deloitte in the UK joined Coopers & Lybrand rather than merge with Touche Ross into a combined network.
[66] KMG was not one of the Big 8.

FIGURE 4.1

Merger activity of international networks, 1987 to 2002



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

4.16 Most of the 'Big 8' international networks originated from a founding firm in the UK.[67]

The Arthur Andersen, Arthur Young and Ernst and Whinney networks developed

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

from a US base, expanding through their cooperation with pre-existing UK firms before continuing international expansion elsewhere.

4.17 Mergers between the 'Big 8' began in 1989 with the creation of the present day Deloitte network, followed a few months later by the EY network, creating a period in which there were the 'Big 6' firms, which lasted until 1998.[68]

4.18 The Deloitte & Touche network was formed from the merger initiated in the USA, of the firms of Deloitte, Haskins & Sells and Touche Ross. The merged international network was named DRT International (Deloitte Ross Tohmatsu International). Most of the member firms in both networks followed suit and merged their own practices in their domestic territory. However, several firms chose not to merge. The UK firm of Deloitte Haskins & Sells chose not to merge with the UK Touche Ross firm, but instead merged with Coopers & Lybrand (which initially traded as Coopers & Lybrand Deloitte, and did not drop 'Deloitte' from its name until June 1992). Touche Ross was not allowed to use the Deloitte name in the UK until 1 February 1996 when it was renamed Deloitte & Touche. The international network changed its name in 1992 from DRT International to DTTI (Deloitte Touche Tohmatsu International), and in 1998 to DTT (Deloitte Touche Tohmatsu). In September 1997, the international networks of Coopers & Lybrand and Price Waterhouse announced plans to merge, and as a result the member firms in each network (including in the UK) made preparations to merge. The European Commission began a merger inquiry.[69]

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

[68] Deloitte, EY, KPMG, Arthur Anderson, Coopers & Lybrand and Price Waterhouse.
[69] Case No IV/M.1016 – Price Waterhouse/Coopers & Lybrand.

4.20 The Price Waterhouse/Coopers & Lybrand merger received approval from the European Commission, and the PricewaterhouseCoopers network was created.[70]

4.21 The last major structural change in the large company audit market occurred in the aftermath of the collapse of Enron in 2002 and the breakup of Arthur Andersen. The actions of Arthur Andersen, both in its audit procedures and subsequent actions (such as allegations of destruction of evidence), led clients to desert and member firms to leave the Arthur Andersen network. Initial discussions for Arthur Andersen member firms to join the KPMG network ultimately failed. Most international member firms of Arthur Andersen then joined the EY network, merging with local member firms. In the UK, however, Deloitte & Touche acquired the assets and some of the partners and staff of Arthur Andersen.[71]

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

5. The economic function and characteristics of an audit

5.1 We have introduced the legal framework of audit (Section 3) and described the principal suppliers of statutory audit and how they emerged (Section 4). In order to

[70] As part of its inquiry, the European Commission had considered the merger in conjunction with the KPMG/EY merger and its preliminary findings suggested that had the EY and KPMG merger not fallen through voluntarily, the proposed transactions together would be 'consistent with a hypothesis of collective dominance' (paragraph 110 of European Commission findings).

[71] The transaction was subject to European Commission scrutiny: http://ec.europa.eu/competition/mergers/cases/decisions/m2810_en.pdf.

understand how competition operates and may operate in the supply of statutory audit, this section sets out our view of:

(a) the economic function of audit (paragraphs 5.3 to 5.15);

(b) why audit services are regulated as they are (paragraphs 5.16 to 5.39); and

(c) the key characteristics of the supply of audit services (paragraphs 5.40 to 5.64).

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

The economic function of audit

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

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

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

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

Shareholder demand

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

Principal–agent issues

5.6 An agency relationship arises when one or more persons (principals) engage another person to act on their behalf (agent). The shareholder–management relationship is an example of this: shareholders engage managers to act on their behalf. For such relationships to work well, the principal must be able to ensure that the agent acts sufficiently in the principal's best interests. Where interests align, the agent will act in the principal's interests regardless of information asymmetries. Where there are no information asymmetries, the principal can effectively supervise the agent regardless of misaligned interests.

5.7 However, problems can arise where there is both a misalignment of objectives, and there are information asymmetries (typically the agent is better informed than the principal). A misalignment of objectives is the term used to describe situations where an individual or organization has incentives to exploit a professional or official capacity in some way contrary to the interests of someone to whom it has obligations or duties.[72] For individual shareholders, the potential detriment arising from a misalignment of objectives and information asymmetries would be a reduction in the value of their investment arising from sub-optimal decision making or dishonesty by management.

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

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

Freeriding

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

5.10 Incentives to freeride may be exacerbated by the highly fragmented ownership of shares in FTSE 350 companies. Rarely will one shareholder, or a small group of shareholders, have a controlling interest in the organization. The result could be that no shareholder has sufficient incentives to monitor the activities and performance of management, resulting in a less than desirable amount of effort expended by shareholders as a whole in the oversight of the company and its management.[73]

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[73] These freerider problems do not arise with concentrated ownership, since the majority shareholders capture most of the benefits associated with their monitoring efforts. In these circumstances, the problem instead may be more one of dominant shareholders exercising control at the expense of minority investors.

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

Management demand

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

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

5.14 Further, auditors in the process of carrying out an audit have contact with many individuals and scrutinize activities across the organization and, as a result, make observations and gain knowledge of the business. Although companies have internal audit functions and management can access internal information, some FDs or CFOs have described auditors to us as the 'eyes and ears' of senior managers, as they provided management with information or alerted them to issues that they discovered as they carried out their investigations.[74]

[74] For example, see Appendix 2, Case study B, paragraph 39.

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

Why are audits regulated as they are?

5.16 Given the demand for audit we identified (immediately above in paragraphs 5.3 to 5.15) from shareholders and management stemming from the principal–agent problem, we considered why audits are regulated as they are, since if the demand was adequate, audit should be provided even without regulation.

5.17 The form of regulation regarding the preparation of accounts, the conduct of audits and the accounting profession generally has evolved since 1844 in relation to perceived shortcomings typically due to specific cases of corporate fraud and misreporting, and to take account of increases in international trade (see Appendix 10). The regulation of the provision of statutory audits has developed in terms of content, form, who may undertake audit, and how it is supervised (both internally in the company in terms of ACs, and externally in terms of the institutional architecture) (as detailed in Appendices 8 and 10).

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

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

(a) The risks of freeriding by shareholders (see paragraph 5.9) and adverse selection (see paragraph 5.23) of published and independently verified financial statements for publicly listed companies means that without such regulation there may not be sufficient investment in auditing.

(b) There are the broader benefits (ie public good elements) associated with the preparation and publication of audited financial statements that would not be taken into account if there were not such regulation (see paragraphs 5.27 to 5.36).

(c) Auditing financial statements in accordance with certain principles and standards gives substance to the obligation to undertake an audit and makes the assurance provided more valuable as financial statements of different companies are easier to compare (ie there are 'network benefits'—see paragraph 5.37).

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

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

Freeriding and adverse selection

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

5.23 As explained above (paragraph 5.9), in the case of public companies, small shareholders would have an incentive to freeride on the control on management exercised by other shareholders. This would include any investment that other shareholders may make in audit services. The problem is essentially one of coordination: while each shareholder has an interest in an audit being undertaken, none may have sufficient interest to justify its cost. Privately forging the agreement necessary to overcome this coordination problem may be very difficult if not impossible where there are a large number of shareholders. The result could be an underinvestment in the auditing of accounts.

5.24 Management might see the cost (financial and in terms of management time) of an audit as too high to justify the benefit to it, and would not adequately take into account the benefit to shareholders. Companies not commissioning audits (and so not incurring the relevant costs) might have a competitive advantage over those voluntarily commissioning audits (this is the adverse selection problem described above in the footnote to paragraph 5.7).

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

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

Broader benefits of audit

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

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

5.29 The OECD said that an effective corporate governance system, within an individual company and across an economy as a whole, contributes to providing the confidence that is necessary for the proper functioning of a market economy.[75] As a result, the cost of capital is lower and firms are encouraged to use resources more efficiently, thereby underpinning growth. When this trust is undermined, lenders and investors are said to lose their appetite for risk, and shareholders to sell their equity, resulting in lost value and reduced availability of capital. The principles of corporate governance of transparency and accountability are said to be crucial to the integrity and legal credibility of our market system.

5.30 The publication of annual reports and accounts that have been independently verified has some elements of 'public goods'. Once such products or services have been created, individuals cannot be effectively excluded in their use, and use by one individual does not significantly reduce availability to others. The provision of public

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

goods is often subject to a freerider problem, ie individuals can make use of a good or service without contributing to its creation.

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

5.32 We consider that the broader benefits of audit are recognized to some extent in the history of audit regulation in the UK.[76] The obligation on most companies to carry out a statutory audit, introduced by Companies Act 1900, may be seen as a quid pro quo for the privilege of limited liability for companies.

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

5.34 There may be alternative sources of information regarding companies. Due diligence reports, reporting accountant reports and analyst reports also provide financial information regarding specific companies. These are not, however, substitutes for regular published, audited financial statements. Due diligence and accounting reports are

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

prepared for particular purposes and are not always publicly available: due diligence reports are prepared for a potential acquirer of a company or its assets; and reporting accountant reports in preparation for Initial Public Offerings. The information contained in these reports may not be widely available outside the company or its advisers. Analyst reports may be prepared for debt or equity investors by bringing together and analysing various sources of information and rely heavily on the audited financial information.

5.35 KPMG considered that the provision of audit services was an important part of the economy and the governance of corporate life. It said that an effective assurance industry, of which statutory audit comprised an integral part, was important to the robust and efficient operation of financial markets. However, it objected to our reference to such broader stakeholders and benefits, on the basis that its legal duties lie to the company and its shareholders only.[77]

5.36 We accept that KPMG has accurately reported the legal duties of audit firms. In practice, via Individual Savings Accounts and stakeholder pensions, very large numbers of people are directly, or via investment funds indirectly, shareholders. However, we think that audit does have a broader purpose (as noted in paragraphs 5.27 to 5.34).

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

5.37 An obligation to conduct an audit without specifying its content might prove meaningless. That shareholders can be confident that audited accounts have been prepared in accordance with accepted accounting standards is essential to the trust that they can place in the information provided. Further, the more widely understood the par-

[77] KPMG response dated 11 September 2012 to CC's working paper 'The frameworks for the CC's assessment and revised theories of harm', paragraphs 2.1.2, 2.1.3.

ticular accounting standard adopted in undertaking an audit, the more valuable the assurance it provides, and it makes accounts of different companies easier to compare. This is a ‘network benefit’ from compliance with established principles and practices. For example, that auditors are required to comply with certain practices aimed at protecting independence which are widely understood increases the trust that shareholders and other users of audited financial statements can place in their reliability. Given the large number of organizations involved (including audit firms, companies, shareholders and other users, and professional bodies and regulators), achieving this outcome without regulation could be very difficult. This is another example of a coordination problem.

Supplementary principal-agent problems

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

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

Key characteristics of the supply of audit services

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

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

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

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

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

(d) that each audit is bespoke;

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

(f) the statutory audit product is mandatory.

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

Nature of and conflict inherent in auditing role

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

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

5.45 Auditors that we spoke to during the course of our case studies told us that this was a central challenge of their role: to establish sufficiently close and effective working relationships with the management of companies to enable efficient execution of the

audit, yet to retain sufficient distance to be able to investigate thoroughly and to challenge accounting treatments that they considered incorrect. In their view, they sought to reconcile this conflict by maintaining professional integrity whilst fostering good working relationships.

5.46 PwC said:

> There is significant investment by both ourselves and the company in the relationship. For us, this involves learning about the company's business in the UK and around the world and dedicating a large number of people to the audit in circumstances where there is no guarantee that the relationship will be renewed each year. For the company, this involves building a relationship of openness, trust and confidence and taking the benefit of the advice and support of the audit firm, as well as recognising that a crucial aspect of the auditor role is always to challenge, and at times to be critical. Because of this, the relationship is not without tension. For us the preservation of independence and maintenance of professional scepticism are overriding requirements and this sometimes means asking difficult questions and giving the company messages it would prefer not to receive.[78]

5.47 Although we accept that good relationships are compatible with a thorough investigation, for any audit firm, it has both a financial interest in maintaining its relationship (and the associated income) and a countervailing interest in maintaining its reputation for integrity (by investigating thoroughly and reporting openly), since losing that reputation would invalidate its opinion and its livelihood. We consider these financial and reputation interests further in Sections 9 and 11.

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

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

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

5.49 If a company were prepared to share more information with its shareholders, shareholders would be less reliant on the audit, since any shareholder would be able to perform its own analysis of this information.[79] However, such disclosure would be likely to aid commercial rivals. It might also lead to inefficient duplication as all shareholders would have to conduct their own analysis. For the reasons explained above, the outcome might also be insufficient investment by shareholders in the analysis of a company's financial performance, and some shareholders being better informed than others. Additionally, there would be loss of the expertise and insight provided by auditors.

5.50 We note that rules designed to prevent insider trading constrain how companies (and auditors) communicate potentially sensitive information to shareholders and non-shareholders. Further, management do not have incentives to disclose more information than they are required to by regulation. We investigate this issue in paragraphs 11.106 to 11.122.

Financial accounts require judgement

5.51 Financial accounts in practice are not the product of a straightforward arithmetical process but require the application of judgement and policies to the particular circum-

[79] Subject to the freeriding problem identified above.

stances of the company in such areas as: the timing of recognition of income, capitalization of costs, amortization of costs over multiple periods and recognizing losses or potential impairment of asset values. The exercise of judgement is guided by the use of accounting standards, but these still leave significant areas of discretion. The audit of financial accounts is similarly subject to factors of judgement, as the auditor gathers sufficient evidence in order to be able to form an opinion as to whether the reports prepared by the company are 'true and fair'.

5.52 As PwC said:

> For many of the issues that arise in an audit—particularly those involving valuations or assumptions about the future—there is often no single right answer, so the auditors bring their judgement and experience to bear. … The words 'opinion' and 'true and fair' are deliberately chosen to show that judgement is involved. They underline the fact that the auditor's report is not a guarantee.[80]

Bespoke product

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

[80] Demystifying audit: www.pwc.com/us/en/pwc-investor-research-institute/publications/demystifying-audits.jhtml.

they are able, and while some audit partners become specialist in certain sectors, others we spoke to had audited companies in a wider range of sectors.

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

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

5.55 An experience good is one where it is only possible to determine its quality in retrospect. Audit (like many services) is such a good, since a company cannot be certain of how well any potential auditor will perform in advance. This results, in particular, from the bespoke nature of audits referred to in paragraph 5.53 and the various aspects of audit (outlined in paragraphs 6.8 to 6.16) that are not apparent in advance. However, all the companies that we are concerned with must commission an audit every year. This means that they do have experience of their current auditor (although certain aspects of the audit process may not be visible to them). Equally, (as a company) they do not have direct experience of the audit service that a rival auditor might offer (unless they have switched recently). We consider the knowledge that the individuals who choose a company's auditor may in fact have of their own and other auditors in Section 9.

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

The audit product is mandatory

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

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

5.59 In a typical market, if prices are above competitive levels, then fewer customers buy the relevant product, which produces a 'total welfare loss'. In this market, as noted, the demand for statutory audit is inelastic since every FTSE 350 company must buy an audit. There would, however, be a cost to shareholders of higher audit fees. There would be a total welfare loss if auditors were not supplying output at competitive quality. For individual shareholders there might be a reduction in the value of their investments as a consequence of the poorer-quality information available to shareholders on the performance of management. More generally, there might be a wider detriment to the economy if investors were to supply less capital or there was a misallocation of capital. Given the credence nature of the audit product (see paragraphs 5.55 and 5.56), doubts among investors regarding the quality of a small number of audits could have seriously undermined their trust in the information provided by statutory audits.

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

Firms' submissions

5.61 We received detailed submissions from Deloitte and PwC.[81] Comments made by other firms are captured by these.

5.62 Deloitte said that there were other aspects of the market that seemed more central to a proper understanding of the market for FTSE 350 audits (than those we listed in paragraph 5.41). In particular:

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

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

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

(d) *The mechanisms for aligning the interests of shareholders, directors and auditors.* Deloitte said that the interests of investors, directors, management and

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

auditors were well aligned in relation to the delivery of a high-quality audit. Directors were very conscious of their duties and responsibilities to shareholders including as regarded financial reporting and audit.

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

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

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

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

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

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

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

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

6.1 In Section 3 we set out the legal obligation on companies to commission an audit and outlined the relevant legal requirements, and in Section 5 we set out what we think is

its economic role, and key characteristics. This is background necessary to understanding the nature of the product and its supply. We now turn to considering competitive conditions in theory and practice.

6.2 Accordingly, in this section we:

(a) provide a description of what appear to be the main attributes of the product delivered by an auditor when it audits a FTSE 350 company, including a summary of the views of parties on the definition of audit quality (paragraphs 6.3 to 6.16); and

(b) provisionally define the market relevant to our investigation (paragraphs 6.17 to 6.24).

Description of an audit

6.3 In Section 3, we defined the relevant product in statutory terms. However, as KPMG pointed out, the statutory definition says no more than that an audit is a task performed by a statutory auditor.[82]

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

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

[82] KPMG response dated 4 May to 'Law and Regulation' working paper, Appendix 1, comment on paragraph 3.6.

nature of the large majority of FTSE 350 companies' businesses means that there will be a significant degree of interaction with the auditors of foreign subsidiaries (normally other DTTL entities, given the client demand for consistency of audit across the international business). The audit process and team will operate at all levels of the audited entity, visiting the group's locations, liaising with all key members of staff (far beyond the finance function) and will need to understand and challenge the business model with a high degree of expertise.[83]

6.5 However, we note BDO's submission that the supply of audit services to FTSE 350 companies is not homogeneous and includes a wide variety of companies, such as [✂] which employs fewer than 200 people and had many characteristics of small owner-managed businesses, and retail companies which were relatively straightforward to audit.[84]

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

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

(a) the audit fee paid by the company;

[83] www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/deloitte_initial_submission.pdf, p13.
[84] www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/bdo_hearing_summary_13_feb_12_excised.pdf, paragraph 18.

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

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

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

Fee

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

6.9 In 2010 the published real audit fees (in March 2005 prices) for FTSE 350 companies were in the ranges of £0.014 million to £44.5 million. The median fee was £0.58 million.[85]

6.10 All firms said that the proportion of the audit fee accounted for by audit-related services varied significantly by client and was estimated to be in the range of 0 to around 30 per cent, with averages of between 10 and 20 per cent.[86] Such services include reviews of interim financial information, reporting on regulatory returns and reporting to a regulator on client assets.[87]

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[85] Appendix 5, Table 3 (paragraph 32).
[86] Appendix 11, paragraph 16.
[87] Appendix 11, paragraph 14.

Technical quality of the audit and opinion

6.11 De Angelo (1981)[88] proposed a definition of audit quality as: the market-perceived joint probability that an auditor will both *(a)* discover a breach in the client's accounts and *(b)* report the breach. We interpret a 'breach' to include the variety of factors that could lead to a possible material misstatement of accounts including inaccurate recording, inappropriate application of accounting policies and overly aggressive accounting judgements. We consider that the technical quality of the audit encompasses this definition but should not be limited to it.[89] The first part of the De Angelo definition relates to the effectiveness of audit scrutiny, whereas the second part highlights the requirement for sufficient independence of the auditor. Both aspects are required if shareholders are to rely on the audit opinion.

6.12 We think that a fuller definition of the technical quality of an audit also includes the quality of internal reporting to senior management and the AC that may assist them in audit planning and their assessment of the quality of the audit and in providing further disclosure of information to shareholders. This information indirectly contributes to the usefulness of the audit report and opinion to the shareholders. Such internal reporting might include reporting of the audit methodology such as sampling methods and materiality thresholds, risk and control assessment and areas where auditors were required to exercise judgement on accounting treatments.

Additional reporting and commentary

6.13 This takes two forms: *(a)* additional commentary and reporting in relation to the audit itself that might be provided to managers and the AC; and *(b)* the commercial and operational insights provided by auditors as a by-product of the process of carrying

[88] DeAngelo, L E (1981a), 'Auditor size and audit quality', *Journal of Accounting and Economics*, 3(3): 93–199.

[89] While we found this definition attractive, probability *(a)* cannot be calculated: the unknown unknowns (ie what the audit failed to detect) necessarily mean that the denominator of the fraction is uncertain. Probability *(b)* may be somewhat clearer, since it may be more visible if an auditor discovered something but did not report it. There should be a paper trail that might be uncovered, but when this might happen, and by whom, is uncertain. The 'market-perceived' aspect, however, means that this definition does not amount to probability calculation, but rather amounts to a more general assessment of an auditor's reputation. We have, however, used the distinction between investigation and reporting in considering audit quality.

out an audit. Auditors in the process of carrying out an audit have contact with many individuals and scrutinize activities across the organization and, as a result, make observations on, and gain knowledge of, the business. The management of the company may also gain from the wider knowledge and experience gained by auditors —for example, how the company's procedures and practices compare with established best practice.

Service

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

Firms' submissions on definition of audit quality

6.15 Deloitte, EY, KPMG and PwC commented on the definition of audit quality in various submissions.[90] We consider their key points to be:

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

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

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

(c) High quality requires: professional scepticism and judgement in determining the scope of the work required; an ability to apply accounting standards appropriately to complex businesses; sector expertise and experience; and the ability to challenge management.

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

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

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

6.16 We consider that the issues raised by these comments are captured by the description of an audit given above in paragraphs 6.7 to 6.14. We use that description of the different attributes of audit in understanding the dynamics of competition in the supply of audits to large companies.

Market definition

6.17 Defining the relevant market in a market investigation assists the CC to identify the market participants and products that might be central to the identification of features that have an AEC. It therefore provides a framework for the assessment of the effects on competition of features of a market.[91]

6.18 The identification of the relevant market does not limit the factors the CC considers in conducting its assessment of whether a feature or combination of features may give rise to an AEC. We have taken into account constraints from outside the market and any segmentation within it.[92]

6.19 We provisionally find that the relevant product market in this investigation is the provision of statutory audit services to companies that are currently, or have recently, been listed on the London FTSE 100 and FTSE 250 indices (collectively known as the 'FTSE 350'). Appendix 11 presents supporting evidence. In summary:

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

(b) Demand-side characteristics: auditing FTSE 350 companies is likely to (but may not always) differ from that of other companies in terms of complexity, international scope and the demands of companies in terms of degree of challenge

[91] This is set out in *CC3, Market Investigation References: Competition Commission Guidelines*, June 2003, paragraph 2.2, as well as in our draft market investigation guidelines, which are currently being consulted on. See www.competition-commission.org.uk/publications/consultations-open/cc-review-of-market-investigation-references-guidlines.
[92] Revised market investigation guidelines, paragraph 133.

required of the auditor; its ability to detect misstatements; and the independence of the audit firm.

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

(d) Our definition is in line with product markets identified by the European Commission, in the provision of audit and accounting services, in its investigation into the merger between Price Waterhouse and Coopers & Lybrand,[93] and the later merger between Deloitte & Touche and Andersen UK.[94]

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

6.21 While some FTSE 350 audits may be more complex than others and some require certain sector or other expertise (which suggests that not all auditors may be able to provide statutory audit services to every company within the FTSE 350), we provisionally decided not to define separate markets within the supply of audit services to FTSE 350 companies. However, we stress that this did not stop us assessing

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[93] *Case No IV/M 1016—Price Waterhouse/Coopers & Lybrand*, 20 May 1998.
[94] *Case No COMP/M 2810—Deloitte & Touche/Andersen UK*, 1 July 2002.

competition within sub-segments of the FTSE 350 and we considered these whenever relevant.

6.22 Submissions that we received broadly accepted this market definition as a pragmatic view, but stressed the importance of considering different conditions that may prevail within subsections of this overall market. BDO in particular warned about the dangers of over-attribution, ie the specific demands of particularly large and complex companies with regard to their audits did not apply throughout the FTSE 350.[95] KPMG recognized the difficulties of market definition in this case and said that the CC should focus on ensuring that in its broader analysis it took into account the competitive constraints imposed by audit firms providing statutory audit services that fell outside of whatever definition of the relevant market the CC arrived at.[96]

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

6.24 We provisionally find that the relevant geographic market is national on the basis that the statutory framework is set by UK legislation. By this definition, we mean that UK-based firms are not generally competing with audit and accountancy firms based outside the UK for the supply of statutory audit services to FTSE 350 companies. The exception to this is FTSE 350 companies that are not based in the UK. These tend to be audited by a firm based in the company's country, supporting our view that markets are national. Further detail is also in Appendix 11.

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[95] BDO, paragraphs 1.2 & 1.3 of the response to the 'Market definition' working paper.
[96] KPMG, paragraph 1.1.4 of the response to the 'Market definition' working paper.

7. Market outcomes

7.1 Our task under section 134 of the Act is to decide whether features, or a combination of features, in the market prevent, restrict or distort competition within it. We recognize that it is generally unrealistic to seek a theoretical measure of a 'perfectly competitive' market. In identifying features, or combinations of features, we consider an appropriate benchmark against which to determine how the market is performing and how it could be more competitive. In previous cases, the CC has defined such a benchmark as a 'well-functioning market', generally in the limited sense of the market envisioned without the features causing the AEC.[97] When considering how the relevant market could be more competitive in this investigation, we have not departed from this approach as we do not consider there to be a realistic alternative benchmark for the market in question.

7.2 We investigated the outcomes of the competitive process in the relevant market since such outcomes may be an indicator that there is an AEC resulting from a feature, or combination of features, in the market. Although outcomes may differ in character, there may be linkages between them, and we did not consider each outcome in isolation.[98]

7.3 In particular, we examined the following outcomes, to see if they indicated that there may be an AEC in the market:

(a) structure, tenure and switching rates in the relevant market (paragraphs 7.5 to 7.25);

(b) choice (paragraphs 7.26 to 7.28);

(c) prices charged by firms and the profitability of firms, their partners and specific engagements (paragraphs 7.29 to 7.93);

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[97] CC Guidelines for market investigations, consultation draft (*CC3* revised), paragraphs 84 & 311.
[98] *ibid*, paragraphs 105 & 107.

(d) indicators of audit quality (paragraphs 7.95 to 7.121);

(e) auditor independence (paragraphs 7.122 to 7.149). We note that auditor independence is an aspect of audit quality. However, given its significance and the possibly different causes of any adverse effects, we have considered it in a separate subsection;

(f) innovation (paragraphs 7.150 to 7.179); and

(g) unmet demand regarding the product audit firms provide (paragraphs 7.180 to 7.204).

7.4 We then set out our provisional views (paragraphs 7.205 and 7.206).

Structure, tenure, frequency of tendering and switching

7.5 We reviewed the OFT's findings[99] and conducted our own data-gathering exercise. Our provisional findings follow regarding:

(a) structure;

(b) tenure; and

(c) frequency of tendering and switching.

7.6 We *(d)* set out our provisional views.

Structure

7.7 The supply of statutory audit services was highly concentrated. Between 2001 and 2010 the Big 4 firms consistently had a share of over 95 per cent[100] of FTSE 350 audits and over 99 per cent of FTSE 350 audit fees. The supply of statutory audit services was less concentrated for non-FTSE-350 companies: the Big 4 firms had a

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[99] www.oft.gov.uk/shared_oft/markets-work/oft1357MIR. Footnotes omitted.
[100] Includes Arthur Andersen 2001–2003.

share of over 80 per cent of audit engagements between 2001 and 2010 on non-FTSE-350 companies in the public data set, accounting for 90 per cent of fees.[101]

7.8 The shares of individual auditors remained broadly stable over time both in terms of number of FTSE 350 engagements and the value of FTSE 350 engagements. PwC had the highest share of audit fees (ranging from 41 to 46 per cent between 2001 and 2010).[102,103]

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

per cent

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

Source: CC.

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

per cent

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

Source: CC.

7.9 The number and presence of suppliers varied across industries. While there were only a small number of banks and telecommunications companies within the FTSE 350, only three (PwC, Deloitte and KPMG) of the Big 4 firms supplied audit services to these FTSE 350 companies in 2010. EY also had only a 5 per cent share of indus-

[101] Appendix 5, Annex 1, Figures 1–3–4.
[102] We note that there are some differences between the shares of audit engagements and shares of real audit fees for firms in individual years, more so when considering industry shares in Tables 7.3 and 7.4 below. Where there are a small number of engagements, the individual market shares are sensitive to the relative sizes of the engagements.
[103] Appendix 5, Annex 1.

trial company audits in 2010. Considering shares of audit fees (rather than number of engagements), there were a larger number of industries where only three auditors had a share greater than 5 per cent in 2010. In the consumer goods and oil and gas industries, there were two suppliers accounting for the vast majority of audit fees (more than 95 per cent) in 2010. Tables 7.3 and 7.4 below show the market shares in terms of number of engagements and share of audit fee by industry in 2010.

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

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

Source: CC.

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

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

Source: CC.

7.10 PwC said that given constant changes in the composition of the FTSE 350, failure to compete actively would lead to market share loss.[104] A presentation on PwC's website records around 330 companies that have exited the FTSE 350 over the period from 2001 to 2010.[105]

7.11 We agree that there has been considerable movement in and out of the FTSE 350 companies,[106] and that this movement could cause a firm's share of FTSE 350 engagements to change, but not necessarily to fall. Existing clients might enter as well as leave the FTSE 350 index. This movement means that the set of FTSE 350 engagements across which firms are competing will be changing over time.

Tenure

7.12 The tenure of existing auditors was longest among FTSE 100 companies. In particular, we found that the current auditor was appointed for more than ten years at 67 per cent of FTSE 100 companies. This compared to 52 per cent of FTSE 250 companies.[107] We also found that 31 per cent of FTSE 100 companies had audit engagements exceeding 20 years compared with 20 per cent of FTSE 250 companies.

7.13 As regards147 companies which have been in the FTSE 350 for ten years, and for which we have ten years' data, 82 per cent have not switched auditor in the last ten years.

7.14 This is consistent with our first survey results. 55 per cent of the FTSE 100 companies in the survey had not switched auditor for more than ten years, compared with 40 per cent of FTSE 250 companies in the survey. The results also suggest that length of auditor tenure is longer for FTSE 350 companies than for other companies.

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[104] PwC pre-provisional findings closing submission, paragraph 24
[105] www.pwc.co.uk/en_UK/uk/who-we-are/ftse350/index.html.
[106] Appendix 5, paragraphs 105–110.
[107] Appendix 5, Figure 10 (paragraph 71).

Only 21 per cent of FTSE 350 companies have an auditor with tenure of five years or less compared with 39 per cent for non-FTSE 350 companies. Over 55 per cent and 40 per cent respectively of FTSE 100 and FTSE 250 companies have auditors with tenures of more than ten years compared with 29 per cent of non-FTSE 350 companies.[108]

7.15 Where we did not have information on the date of the first year of an audit engagement, we assumed it to be either the first year for which data was submitted or the year 2000 where data was submitted for each year.[109] GT said that this assumption resulted in a significant underestimate of average auditor tenure by failing to take into account accurately those audits which had been in place for much longer than the period under consideration.[110] BDO and Mazars made the same point.[111,112] We acknowledge this point in Appendix 5,[113] and for this reason have not given estimates of average auditor tenure. Rather, using the public data set and the survey results, we looked at evidence on the proportion of companies with tenure of more than so many years (see paragraphs 7.12 and 7.13 above).

Frequency of tendering and switching

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

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[108] Appendix 3, paragraph 28 & Table 7.
[109] Appendix 5, paragraph 69.
[110] GT response to the 'Descriptive statistics' working paper, paragraphs 2.1 & 2.2.
[111] BDO response to the 'Descriptive statistics' working paper, paragraph 1.2.
[112] Mazars response to the 'Descriptive statistics' working paper, paragraph 4.
[113] Appendix 5, paragraph 73.

Switching rates

7.17 Annual switching rates among FTSE 350 companies ranged between 1.5 and 3.5 per cent between 2001 and 2010 (excluding switching by Arthur Andersen clients). The average annual switching rate among FTSE 350 companies was 2.4 per cent. The average annual switching rate for FTSE 350 companies was lower than for non-FTSE-350 companies, which varied between 2.8 and 8.2 per cent.[114]

Discussion

7.18 The decision to switch auditor could be triggered for different reasons.[115] We were primarily interested in the frequency of switching for reasons such as cost or quality (rather than external or merger activity reasons) as an indicator of the willingness of companies to switch auditor to gain a better offer. We consider the triggers for switching further in paragraphs 9.178 to 9.189.

7.19 We could not observe directly the reasons why companies decided to switch auditor. However, further analysis suggests that 20 per cent of switching (excluding switching associated with the collapse of Arthur Andersen) by companies in the FTSE 350 during the period 2001 to 2011 was associated with movement into the FTSE 350 in the year of or the year before switching. Between 16 and 33 per cent was associated with merger and acquisition activity.[116] The Big 4 firms' estimate of the proportion of switching associated with merger activity was lower than this, as their definition of such activity was limited to takeovers of a FTSE 350 company by a company outside of this index and was based on firms' market intelligence. There were also a small number of switches where the company moved to or from joint audits. Overall these

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[114] Appendix 5, Table 4 (paragraph 41).

[115] For example, a company might decide to switch auditor if it believes it is paying too high a fee, receiving too low a level of quality or for reasons of good corporate governance. A company may also change auditor due to external reasons (for example, the collapse of Arthur Andersen) or the desire for a single auditor after the merger of two companies with different auditors.

[116] We define switching events associated with merger and acquisition activity *(a)* using estimates provided by the firms and *(b)* to be those events where a company had been involved in some merger activity in the year of or the year before a switch of auditor. We consider that the latter may overstate the extent of switching resulting from merger and acquisition activity as the data used includes all deals including small acquisitions of non-FTSE-350 companies that would have been unlikely to give rise to a need for a FTSE 350 company to review its external audit appointment. See Appendix 5, paragraph 45, for further details.

factors were associated with around one-half of switches. These results indicated that many observed switches in auditor by FTSE 350 companies may have been for reasons other than a desire on the part of the company to gain a better offer.

7.20 We were also interested in the proportion of engagements for which there had been an open competition for the engagement. We considered that this was less likely to have been the case where the switch in the auditor was: *(a)* as a result of the collapse of Arthur Andersen (as we know that much of Arthur Andersen's audit business transferred to Deloitte); *(b)* associated with merger and acquisition activity; or *(c)* due to a move to or from a joint audit (for the same reason). If we excluded these events, we estimated that there were between 50 and 70 (depending on the definition used of merger and acquisition activity) other occasions when FTSE 350 companies switched auditor in the last ten years.[117]

7.21 Based on information provided by parties, we estimated that there had also been about 33 occasions when a FTSE 350 engagement was tendered but this did not result in a switch in the auditor in the period 2001 to 2010.[118] Given these results, we estimated that there had been between 83 and 103 competitive tenders over the last ten years for existing FTSE 350 engagements. Audit firms were able to provide us with information relating to 52 tenders of FTSE 350 engagements over the five-year period 2007 to 2011.[119]

Firms' submissions

7.22 PwC said that a more rigorous approach was important to the analysis of how competition worked in the sector, and therefore classified switches and tenders into three categories: *(a)* direct switches; *(b)* consequential switches, where a company

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[117] Appendix 5, Tables 5 & 6.
[118] Appendix 5, paragraph 62.
[119] Appendix 24, paragraph 2.

changed its auditor as a consequence of another decision (eg following the demise of Arthur Andersen or where the relevant company was taken over by another company that was not in the data set but where the original company remained in the data set following the company takeover); and *(c)* tenders without switches.[120]

7.23 We agreed that the circumstances in which companies switched auditors and the frequency of tendering, whether or not this resulted in a change in auditor, were important to our assessment of our theories of harm (see in particular Section 9).

Provisional view

7.24 It is our provisional view that the evidence we saw of high and stable levels of concentration, long length of audit firm 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 resulting from a feature or a combination of features in the FTSE 350 statutory audit market.

7.25 We noted, however, that there were alternative explanations for such outcomes, which were consistent with effective competition between the Big 4 firms (see paragraphs 8.22 and 8.23. In Section 9, we explore the evidence that may help to distinguish between these competing explanations. As we have noted (paragraph 2.12), this is not straightforward and has required the use of judgement.

Choice

7.26 As set out in paragraphs 7.7 to 7.10, the FTSE 350 statutory audit market is highly concentrated, with the Big 4 firms having over 95 per cent of market share, whereas the provision of statutory audit is less concentrated in other index designations. We observed low levels of switching and infrequency of tendering in the FTSE 350 statu-

[120] PwC submission 'An econometric analysis of the prices of large company audits' paragraph 1.5(i) & (ii), 7/12/2012.

tory audit market. Between 2001 and 2010, 82 per cent of changes in auditor in the FTSE 350 market were from a Big 4 firm to another Big 4 firm. There were only three examples of a switch from a Big 4 firm to a Mid Tier firm. However, the larger of the Mid Tier firms considered that they had the capability to audit nearly all sectors within the FTSE 350 (see paragraph 9.15). We therefore considered whether these factors in combination were indicative of an AEC.

7.27 We noted there was evidence of limited differentiation in offering between the Big 4 firms (paragraphs 9.184 to 9.186). We therefore considered whether such a lack of differentiation might amount to a lack of choice for companies in alternative suppliers of audit services, and thus be a factor in the infrequency with which FTSE 350 companies tender their audit engagements.

7.28 The concentration of supply in the market and the barriers to entry and expansion which reinforce it (see Section 10) may suggest that there is less choice of alternative suppliers in the FTSE 350 statutory audit market than we would expect to see in a well-functioning market. In a market with greater choice of alternative suppliers, we may expect to see a greater differentiation in offerings between firms.

Price and profitability

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

(a) the evolution of fee levels (paragraphs 7.30 to 7.32);

(b) the effect of switching and tenure on engagement profitability and prices (paragraphs 7.33 to 7.55);

(c) undertaking a price-concentration analysis (paragraphs 7.56 to 7.62); and

(d) profitability, at levels of firms' FTSE 350 engagements, partner, business line and engagement (paragraphs 7.63 to 7.93).

Evolution of fee levels

7.30 PwC said that the CC's data showed that median FTSE 350 audit fees had fallen by 15 per cent over the last five years, implying larger declines in real terms, and that this was evidence that prices were competitive.[121]

7.31 Our analysis of the engagement data set, which only considers the UK part of the audit, indicates that over the period 2006 to 2011 the mean real fee per hour for FTSE 350 engagements has decreased by 19 per cent and the mean number of hours decreased by 4 per cent.[122]

7.32 However, 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). Accordingly, we did not place weight on them.

The effect of switching and tenure on engagement profitability and prices

CC analysis

- *Profitability and tenure*

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

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

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[121] PwC pre-provisional findings closing submissions, paragraph 15.
[122] Appendix 5, paragraph 89.

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

(c) There was no indication that Big 4 firms consistently offered very low initial prices (referred to by some Mid Tier firms as 'low-balling'[123]) to reduce engagement profitability to zero (ie only covering direct costs) or incurred a loss in the first years of an engagement before increasing fees significantly in subsequent years.[124]

7.34 Some firms (Deloitte, KPMG and PwC) stated that the observed lower profitability in early years of engagements was consistent with their experience as they bear the cost of getting up to speed and understanding the business of the company, reducing audit risk, and improving efficiency (as well as offering a reduced price). GT noted that this could also reflect various other factors, such as an incumbent taking advantage of its position and reducing the level of resource devoted to an engagement (that is, once appointed offering a lesser service in the belief that a client would be unable or unwilling to switch again in the short run).[125]

7.35 A number of firms identified that the analysis was partly dependent on assumptions on partner cost. EY did not consider the measure of profitability used in our engagement profitability analysis to be appropriate.[126] BDO and GT noted that the stable level of profits over the period may be an indicator of an increased likelihood of excess profits.[127]

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[123] ie Big 4 firms offered to undertake audits for certain companies at low rates in order to win the clients of those Mid Tier firms, and that this excluded those Mid Tier firms from the market in a way that was anti-competitive.
[124] Appendix 14, paragraphs 178–179.
[125] GT response to CC working paper 'Engagement level profitability analysis', 5 December 2012, paragraph 1.3.
[126] EY believed the calculation of cost per hour of labour understated the hourly cost and thus overstated profits and also identified that the analysis did not include indirect costs. EY response to CC working paper 'Engagement level profitability analysis', 29 November 2012.
[127] BDO response to CC working paper 'Engagement level profitability analysis', 5 December 2012, paragraph 5; GT response to CC working paper 'Engagement level profitability analysis', 5 December 2012, paragraph 1.4.

7.36 The fact that engagement profitability increases over the early years of an auditor's tenure is consistent with our analysis on the additional work undertaken by a new audit firm as it becomes familiar with its new client (see Appendix 12, paragraphs 85 to 89).

- *Prices*

7.37 For companies that switched auditor during the period for which data was collected, we calculated the percentage real change in total audit fee and percentage real change in total audit fee per £1 million turnover in the years after switching auditor (see Appendix 5 paragraphs 52 to 58).

7.38 We carried out this analysis first for all switching events excluding those associated with the collapse of Arthur Andersen. We then repeated the analysis excluding all events associated with the collapse of Arthur Andersen, merger and acquisition activity and moves to or from joint audits. We refer to these as direct switching events, adopting PwC terminology, as these remaining events are those most likely to have followed a competitive tender for the engagement (see paragraphs 7.18 to 7.20). The approach may also control to some extent for differences in fees related to changes in the size or complexity of the audit. Finally, we looked at occasions where there was a competitive tender but the incumbent retained the engagement.

7.39 Excluding only Arthur Andersen related switches, the results indicated that audit fees generally decreased in real terms the year after a switch and returned to the previous fee level in the third year after switching. The median company obtained a 17 per cent real decrease in fee in the first year after switching and had a 2 per cent real increase (compared with the previous fee) in the third year. There was considerable variation in the changes of audit fee: in the first year after switching auditor, fee changes ranged in real terms from an 86 per cent decrease to a 218 per cent

increase. 74 per cent of companies obtained a real decrease in audit fee in year one (ie the first year after switching).[128,129]

7.40 The results were broadly similar for direct switching events. We observed a median real decrease in audit fee of 17 per cent and by the third year a median 2 per cent real increase in fees. 78 per cent of these direct switching events resulted in a real reduction in fee in the first year and 48 per cent in the third year.[130]

7.41 Finally, where there was a tender but no switch, we observed a small real increase in the median audit fee of 2 per cent in the first year following the tender, and that 48 per cent of these companies obtained a reduction in audit fee in the first year.[131] Given that on average fees increased after the tender, it is possible that for many firms the tender may have been associated with a change in the scope of the audit. For this reason, we did not draw any conclusions on the potential gains from tendering an engagement based on this finding. Nevertheless we noted that nearly half of those who tendered, but did not switch, achieved a fee reduction.

PwC's submissions on the effect of tendering and switching on price

7.42 PwC submitted its own econometric analysis of the prices of large company audits, using the data set developed for the CC's investigation.[132] PwC's analysis found that the price of audits fell following direct tenders or switches, but that these price effects were temporary. Taking into account the dynamic structure of PwC's model,[133] in the first and second year after tendering or switching, companies enjoyed an audit price reduction of 9 per cent and 8 per cent respectively, relative to the price obtained if no

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[128] Appendix 5, Table 8.
[129] The analysis does not control for whether the real audit fee would have differed absent the switch and thus may under- or overstate the effect on audit fee of switching.
[130] Appendix 5, Table 11.
[131] Appendix 5, Table 10.
[132] The report is called 'Econometric analysis of the prices of large company audits' and was reviewed and endorsed by Professor Andrew Chesher of University College London.
[133] The model specification includes the previous year's audit fee as an explanatory factor for this year's audit fee. Such a dynamic structure implies that effects estimated for a specific year partially carry forward into the next year, and so forth.

tender or switch had occurred. It obtained indications of a price reduction of 4 per cent in year 3 and a price increase of 3 per cent in year 4.[134]

7.43 PwC concluded from its findings that, in the long run, companies that tendered or switched did not obtain lower prices than companies that did not tender or switch. PwC said that this suggested that competitive pressures were effective outside a formal tender process. PwC also noted that tendering and switching was costly, due to the management time involved, the potential risk to audit quality, and forgone price reductions from passed-on long-term cost efficiencies. Finally, PwC suggested that if companies were to tender and switch more frequently, audit firms were 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.[135] PwC said that this was because audit profitability currently generated only a normal return on audits.[136]

7.44 In our view, one possible explanation for the erosion of price gains after direct tendering or switching was that audit firms made unsustainably low bids to obtain a new engagement, and in the following years increased the audit fee to a sustainable level. An alternative explanation was that there was a certain information asymmetry due to the bespoke characteristics of statutory audits, so that companies did not know what the competitive price of an audit was. The direct tender or switch resolved this information asymmetry, but only for a limited amount of time. We note 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'. This assumption has not been established. We consider this and the underlying profitability of engagements in paragraphs 9.30 to 9.36.

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[134] The estimated price effects in years 3 and 4 were not statistically significant.
[135] See PwC's response to five working papers concerning audit prices, engagement level profitability, costs, tenure and switching: www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/engagement_level_profitability_analysis_pwc.pdf.
[136] See PwC's submission 'Observations on the assessment of audit profitability'. It was reviewed and endorsed by Professor Ian Cooper of the London Business School.

7.45 The PwC analysis suggests to us that a company (other than a bank or financial service company) willing to tender or switch every three years could on average reduce its audit fees by 7 per cent per year,[137] on the assumption that the current level of commitment by both companies and firms to the tender process was maintained.[138] PwC analysis that included observations for banks and financial service companies[139] found slightly larger short-run price effects.[140] Based on these estimates, we calculated potential savings of around 11 per cent for companies willing to tender or switch every three years.[141]

7.46 To put an estimated price gain of 7 per cent per year into perspective, in the sample used for the estimation, the average audit and audit-related services fees per year were £1.16 million. If the sample was restricted to companies that at some point were in the FTSE 350, the average audit-related fees per year were £1.43 million. The estimation results therefore implied average savings of around £100,000 a year over the first three years after switching.[142]

7.47 PwC's sample included all companies in the public data set. We estimated that if the sample was restricted to direct tenders and switches of FTSE 350 companies only, the average savings would be slightly higher.[143]

7.48 We considered that PwC's analysis was likely to understate the average price benefit of switching as some of the switches in the sample might have been caused by concerns about audit quality,[144] and so may not have affected price.

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[137] This is calculated as follows: (9+8+4) / 3 = 7. See Appendix 30, paragraph 10.
[138] A methodological note with regard to the interpretation of the results is that the causality of the estimated effects was not clear. The audit fee level itself could also have had an effect on the likelihood of a direct tender or switch. See Appendix 30, paragraph 15.
[139] These observations are excluded from the preferred model due to missing inventory data, and account for around 20 per cent of the total number of observations and around 30 per cent of the audit fees. However, with pragmatic assumptions and a slightly altered specification, PwC managed to resolve the data issue.
[140] The point estimates for the price effects of the model including observations for banks and financial service companies are larger than those obtained by the model excluding them, even though the difference between the estimates is not statistically significant.
[141] Appendix 30, paragraphs 17 to 31.
[142] Appendix 30, paragraph 11.
[143] Appendix 30, paragraph 24.

7.49 A further limitation of this analysis is that it estimated the average price gains from switching auditor across a group of FTSE 350 and other companies. There would have been variation around this average. With the exception of testing for the effect of excluding banking and financial services companies from the sample, PwC did not explore further whether there are particular companies or types of companies that might be expected to achieve higher than average fee reductions. We recognize that the available sample size may have been a factor affecting this.

Other firms' submissions on the effect of tendering and switching on price

7.50 KPMG said that using a client's data to calculate the ratio of audit fee and turnover to control for the size of the client in the analysis of audit fees did not accurately capture the size and complexity of different FTSE 350 companies' audits and therefore the results based on this variable should be considered with caution.[145] PwC made a similar point stating that *(a)* for some companies, there was little correlation between audit scope and turnover (where instead there might be a high degree of correlation between audit scope and the company's assets); *(b)* where there was correlation between audit fee and turnover, the increase in audit fees tended to be proportionately much less than the extent of higher turnover; and *(c)* the ratio of the maximum to minimum values for this variable (audit fee divided by turnover) was very much greater than when the absolute level of audit fee was used.[146] KPMG said that for at least 14 of the proposals it had agreed fees for periods of between two and four years, and that any observed changes in fee in this period would have been due to changes in scope or inflation, which may differ from CPI.[147]

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[144] The initial CC survey found that the aspect most frequently identified as very likely or likely to prompt a company seriously to consider switching was the complacency of the audit firm followed by a problematic working relationship between auditor and management.
[145] KPMG response to 'Descriptive statistics' working paper, Appendix 1, paragraph 4.
[146] PwC response to 'Descriptive statistics' working paper, paragraph 8.
[147] KPMG response to 'Descriptive statistics' working paper, Appendix 1, paragraph 22.

7.51 We agree that use of turnover to control for variation in the size and complexity of engagements has its limitations. This is, however, the best available measure for normalizing audit fees.[148]

Provisional view

7.52 It is our provisional view that this pattern (of reduced first-year prices and profitability, which rapidly increases over the subsequent two to three years) may indicate an AEC resulting from a feature or a combination of features in the FTSE 350 statutory audit market, since it demonstrates the ability of a new firm to increase its prices rapidly.

7.53 We acknowledge that there may be explanations of this pattern compatible with a competitive market, such as firms submitting low bids in order to give incentives to a company to switch, but that they have to increase fees to recoup such loss leading over subsequent years. However, we have no evidence that first-year audits were not profitable despite the additional efforts that firms typically make in the early years of an engagement to understand the company. On the contrary, we think that even in the early years, engagements are generally profitable at the gross margin level, as we note in paragraph 9.33.[149]

7.54 Accordingly, in our provisional view, this pattern (of an initial reduction in profitability and price reduction which rapidly erodes) indicates that incumbent auditors have power over price, and that as the period from a tender and switch increases, firms are able to increase their fees to the level that would have been charged by the previous auditor.

[148] See Appendix 5, paragraphs 27–28.
[149] We do not consider this reduction in audit fees to be 'low-balling'. See 'Other theories of harm: coordinated effects, bundling, regulatory distortions', paragraphs 12.6–12.8 of these provisional findings.

7.55 We think this evidence must be considered in combination with other evidence, which we do in paragraphs 7.91 to 7.94.

Price concentration analysis

7.56 For the reasons given in Appendix 13, while we had data to carry out a price concentration analysis (PCA), we were not persuaded that the results would be reliable. In particular, we were not able to identify a way of overcoming problems arising from the fact that the number of separate economic markets that we could identify would be too small to investigate any relationship between concentration and price. We also had concerns around missing supply- and demand-side variables, and the implications they would have for our ability to draw robust conclusions.

7.57 In the light of these shortcomings, we decided not to pursue this line of investigation.

Firm submissions

7.58 Several firms agreed that a PCA analysis was not suitable and would not produce robust results.[150,151]

7.59 However, Oxera, on behalf of BDO and GT, acknowledged the empirical challenges, but said that there might be ways to mitigate their effect. It said that qualitative evidence might help evaluate the direction and size of any problems resulting from omitted costs variables. It also suggested that financial services might be considered a treatment group (in which, for exogenous, institutional reasons, the number of competitors is lower and hence the product market concentration is higher), with all other sectors considered the control group.[152] Oxera agreed that more narrowly-defined markets based, for example, on industry sector might not constitute separate

[150] PwC response to five working papers concerning audit prices, engagement level profitability, costs, tenure and switching.
[151] KPMG response to PCA working paper.
[152] www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/pca_oxera.pdf.

economic markets. Nevertheless Oxera said that there was value in considering such an analysis. In summary, Oxera was of the view that a detailed review of the many existing PCA studies in audit would be informative, and that some form of PCA remained feasible and potentially valuable, albeit perhaps less conclusive than in other applications.[153]

7.60 It was our view that Oxera did not propose ways of overcoming the missing variable problems. We agreed that the engagement level data would provide further information on costs, but there might remain significant omitted cost and other factors. More importantly, we did not agree that an analysis based on a small number of separate markets or on market definitions which were not reflective of demand- and supply-side conditions could be informative. For further details, see Appendix 13.

7.61 Mazars noted that there had been a substantial rise in audit fees for FTSE 100 companies, and that the rise was far higher than for FTSE 250 companies or other listed companies, all of which were required to move from UK GAAP to IFRS in the period. Mazars said that, given that switching rates were lower in the FTSE 100 than the FTSE 250 and the opportunities for switching auditors generally thought to be less, the rise in fees might be thought to be the result of high concentration and low competition, which was more marked in the FTSE 100 than other parts of the listed market.[154]

7.62 We did not accept that the evidence was sufficient to draw such a conclusion. Concentration[155] in the FTSE 100 audit market has remained stable over the last ten years, and there are other possible explanations. For example, the change from UK

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[153] www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/pca_oxera.pdf.
[154] Mazars response to 'Descriptive statistics' working paper, paragraph 3.
[155] Market concentration was calculated based on audit firms' shares of audit fees.

GAAP to IFRS may have been more costly for FTSE 100 companies than FTSE 250 companies.[156]

Profitability

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

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

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

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[156] See KPMG response to 'Descriptive statistics' working paper, Appendix 1 & Figure 6.

7.66 We had difficulty in accurately factoring in partner costs (and staff costs to a lesser extent) in our assessments of engagement level profitability, because firms did not capture the costs of individual partners or staff on engagements (we comment on this absence in paragraph 7.93). Hence our assessments of engagement level profitability are a measure of profits taking into account staff and partner hours spent on the audit at representative (or average) rates, and do not take into account other costs which are not directly incurred on an engagement.

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

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

(b) partner;

(c) business line; and

(d) individual engagement.

Firms' FTSE 350 audit engagements in aggregate

7.68 We are interested in whether the profits from FTSE 350 audit engagements for firms representing a substantial proportion of the market have exceeded the appropriate cost of capital over a sustained period.[157] We considered whether we could obtain appropriate data from the firms' management accounts to assess the profitability of FTSE 350 statutory audits. There were a number of issues to consider in assessing profitability, including: *(a)* cost allocation; *(b)* partner remuneration; *(c)* capital base; and *(d)* the appropriate benchmark cost of capital.

7.69 We encountered significant problems with each of these issues. In the case of large professional services firms, much of the asset base is intangible in the form of clients, reputation, human and intellectual capital, and much of this capital (and other types of costs) is shared with other service lines, and we found no reliable way to identify or

[157] Guidelines for market investigations consultation document, June 2012, paragraphs 118–122.

measure the appropriate costs. Further, the partnership structure of firms gives rise to difficulties because partner remuneration is a combination of salary and profit share and it is difficult to differentiate between the two in a reliable manner. Lastly, there is no established framework for measuring the cost of capital given the nature of partners' investments in the firm.

7.70 We set out in detail our consideration of these issues and the views of firms in Appendix 14, paragraphs 14 to 76. In summary, there were significant uncertainties attaching to each of the four issues identified in paragraph 7.68, which precluded us from generating economic profitability measures on which we could rely. Due to the multiple layers of uncertainty, particularly the difficulty of measuring the appropriate asset base and an appropriate measure of partner cost, we did not undertake detailed economic profitability calculations using return on capital employed (ROCE). PwC proposed an adjusted return on sales (adjusted ROS) type analysis[158] but we considered that this measure was subject to the same difficulties and uncertainties as ROCE, if it were to be used in an economically meaningful way. In particular, in our view, it does not avoid the need to identify an economically meaningful asset base and measure of partner cost. As a result, we were not persuaded by the analysis that PwC and KPMG had undertaken that there was not an excess return in the market on the basis of the adjusted ROS/ROCE calculations that they submitted (see further Appendix 14). We were unable to conclude, based on analysis of profitability, whether firms had earned profits above the cost of capital on their provision of FTSE 350 audit services.

Profits per partner

7.71 We considered trends in profits as an indicator of changes in the competitive environment. We considered the total remuneration earned by audit and non-audit partners

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[158] For details of PwC's proposed adjusted ROS calculation, see Appendix 14.

for the largest six firms over the eight-year period from 2003 to 2011 (see Appendix 14, paragraphs 106 to 111). The data indicated that there was no systematic difference in remuneration per partner for audit and non-audit partners. Over the eight-year period, three out of four of the Big 4 firms had seen an increase in audit partner remuneration in real terms. However, in recent years (since 2007/08) remuneration per partner had fallen in real terms.

7.72 We considered whether it was possible to benchmark partner remuneration to establish whether the absolute level could be said to be too high or too low. We considered analysis submitted by PwC (see Appendix 14, paragraphs 92 to 98). Its average total remuneration per audit partner was £[✂] in 2011. It conducted a benchmarking exercise and found that on average, its partners might be able to earn £[✂] in comparably 'sized' roles within the finance functions of UK companies. PwC provided information to indicate that the median benchmarked salary for each of its four 'partner levels' ranged from £214,000 to £876,000. PwC's benchmarking indicated that the role performed by its most junior grade of partner corresponded to the Head of Internal Audit or Financial Controller at a company with revenues of £1–£5 billion and its most senior partners were benchmarked to the Group FD of listed companies with a market capitalization of £1–£3 billion.[159]

7.73 It explained the difference as reflecting remuneration being calculated based on the total profits of the multidisciplinary firm, where partners had a mix of audit and non-audit roles and other responsibilities, the significant intangible asset base that PwC had built up over time from its reputation for quality and an element to reflect the

[159] See Appendix 14.

financial investment in the business that the partners had made (we note that average capital investment in the firm is on average of £[✄] currently).[160]

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

7.75 However, we consider that audit partner rewards are attractive with average profit per partner at the Big 4 firms in 2011 of between £635,000 to £763,000.[161,162] They are on average considerably above benchmarked salary levels for equivalent roles in industry (see paragraph 7.72). As noted above (paragraph 7.74), we consider the difference between total remuneration and benchmarked salary to reflect partner reward for their capital investment in the firm. On average, partners receive a high level of return in relation to the capital they invest on entry to the partnership.[163] One reason for this is that partners do not buy their investment in the firm at market value (see Appendix 14, paragraphs 48 and 130). We do not think that audit partners face an unusually high degree of risk. We found that the risks were capable of mitigation: the incidence and amount of claims paid out by firms was low, and claims were rarely made against individual partners. We found that firms were able to obtain adequate levels of professional indemnity insurance, but in the exceptional event that a negligence claim succeeded against a firm and was not fully covered by insurance,

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[160] www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/mph_summary_pwc.pdf, paragraph 8.
[161] Of the Big 4 firms, EY reported the lowest profit per partner £653,000 (EY LLP y/e July 2011, p1) and PwC the highest at £763,000 (PwC Annual Report 2011, p1).
[162] We note in Appendix 14 table 7 that average remuneration per audit partner is generally not significantly different from average remuneration per partner.
[163] For the avoidance of doubt, this does not represent a ROCE assessment.

the partners' liability is generally limited to the amount of their capital contribution to the firm. See further Appendix 15.

7.76 We considered the incidence of audit partners leaving Big 4 firms and considered the reasons for this. From the data provided, it appeared to us that partners rarely leave voluntarily prior to retirement. We found that around 1 to 2 per cent of partners resign in each year to take up new posts. We calculated average partner tenure to be 14 to 18 years. This further indicates to us that the risk/reward balance offered by the Big 4 firms to audit partners is attractive.

Business line profitability

7.77 We considered the relative profitability of each firm's service lines in detail . We found that Assurance[164] (as a business line within firms predominantly comprising audit and audit-related services), on the basis of the cost allocation choices of the parties, had comparable margins (both gross and net) to other service lines (see Appendix 14, paragraph 162). This suggests that audit/Assurance is profitable.

7.78 Some Big 4 firms submitted that their Assurance business was their highest risk line of service (in terms of the potential damage to a firm's reputation and unlimited financial liability if the audit work is criticized (see Appendix 14, paragraphs 152 to 161)). Deloitte, in particular, said that Assurance having comparable margins with other service lines was evidence of a lack of excess profit in the market (see Appendix 14, paragraph 153).

7.79 In our provisional view, Assurance (including audit) is a relatively attractive service line in comparison with other service lines because the low switching rates imply that

[164] The firms all report an Assurance business unit/service line that encompasses their statutory audit work and several other services, not all of which are similar to statutory audit work. The components of the Assurance business unit/service line differ between the firms.

this is generally a more stable form of income than other service lines. Having weighed the evidence, we were not persuaded that the risks of conducting audit business were unusually high; the incidence and size of claims has in recent years been relatively low. (See paragraph 7.75 and Appendices 14 and 15.)

Engagement profitability

7.80 A key measure of engagement level profitability used by the firms was revenue recovery rate (RRR). This compared actual fees charged with ‘scale rate’ (or ‘charge-out’) revenue. RRR is similar to contribution-based approaches in that it avoids the need for detailed cost allocation. It appeared that no firm (Big 4 or Mid Tier) calculated a profit per engagement that closely reflected actual costs. The focus for management in using RRR is in comparing relative performance of engagements (between one another and over time) rather than indicating absolute levels of profitability of engagements. The firms’ measures of RRR were not comparable with one another, due to the differences in firms’ scale rates.[165]

7.81 We considered the average profitability (using only direct costs[166]) as a percentage of income from statutory audit engagements within firms in respect of a number of characteristics to understand whether any characteristics of the market might indicate that competition and competitive pressures varied with respect to different categories of company. We were unable to establish an appropriate and reliable measure of partner labour cost for individual firms and we have based partner labour cost on director costs.[167] Detail is contained in Appendix 14, paragraphs 166 to 181.

7.82 On this basis (ie margin as described in paragraph 7.80), with respect to the index classification of the client company (eg FTSE 100/250 or other), we found that:

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

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

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

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

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

7.84 'Industrials' industry engagements consistently achieved the lowest average audit margins, whilst 'Financials' industry audits achieved the highest average engagement profitability.[168]

7.85 In terms of firms' views:

(a) BDO noted that profits calculated in aggregate were greater than the average profit of individual engagements and thus indicated that larger engagements were likely to be more profitable.[169]

(b) Deloitte noted that [✂] engagements were typically less profitable than [✂] engagements.[170]

[168] These industry classifications are per the Industry Classification Benchmark, developed by Dow Jones and FTSE. There are further sub-classifications, which the engagements have not been analysed by due to the potentially large number of categories and low number of corresponding data points.
[169] BDO response to CC working paper 'Engagement level profitability analysis', 5 December 2012, paragraph 6.

(c) EY considered that our measurement of profitability was flawed because of the nature of cost rates used (and a number of firms identified that the assumption on partner cost affected the findings of the analysis).[171]

(d) KPMG observed that the differences in the engagement margins that were earned across the different market segments were very low.[172]

(e) PwC expressed doubt as to the reliability of observations on the relative profitability engagements by market segment (ie that FTSE 100 audits appeared more profitable than FTSE 250 audits and that top track audits were somewhere in between) as there were a number of aspects the analysis did not take into account: (i) FTSE 100 audits generally demanded more time from senior (and therefore more costly) partners; (ii) indirect costs were not controlled for whereas they were particularly relevant for audits of the larger and more complex companies (eg software); and (iii) the benchmark group of non-FTSE 350 companies was incomplete. PwC presented some additional external evidence from its Transparency Report.[173]

- *Engagements of above-average profitability*

7.86 In examining engagement level profitability, we considered the characteristics of the most profitable FTSE 350 engagements. For each firm, using two selection criteria, we identified 59 FTSE 350 engagements that had consistently achieved a greater profitability than the firm's average engagement profitability for the period 2006 to 2011. Using the public data set and our first survey results, we investigated the characteristics of these more profitable audit clients compared with those for other FTSE 350 companies. See Appendix 14, paragraphs 182 to 184, for further details.

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[170] Deloitte response to CC working paper 'Engagement level profitability analysis', 3 December 2012.
[171] EY response to CC working paper 'Engagement level profitability analysis', 29 November 2012.
[172] KPMG response to CC working paper 'Engagement level profitability analysis', 4 December 2012, paragraph 1.3.
[173] For the purposes of transparency, PwC voluntarily publishes audit operating profit margins in addition to audit revenues in its Transparency Report. See Annex 4 of PwC's submission 'Observations on the assessment of audit profitability' (dated 7 August 2012).

7.87 We found that the higher profitability clients were more likely to be in the FTSE 100 than in the FTSE 250, to have longer audit tenure and to have higher audit fees than other clients in the FTSE 350. In particular:

(a) Among the group of companies with higher engagement profitability, 44 per cent were FTSE 100 companies.

(b) Among the group of companies with higher engagement profitability, 12 per cent had an auditor with tenure of 0 to 5 years compared with 22 per cent among other FTSE 350 companies, although this could be due to our definition of higher profitability clients which required a company to have had the same auditor for at least three years.

(c) Among the lowest (highest) 20 per cent of audit fees paid in 2010 a lower (higher) proportion were for companies in the higher engagement profitability group: 12 (28) per cent of companies in the higher engagement profitability group were in the lowest (highest) 20 per cent of audit fees compared with 22 (18) per cent of other FTSE 350 companies.

7.88 Our first survey results indicated that, compared with other FTSE 350 clients, these higher engagement profitability clients: had a higher average turnover and audit fee; had a longer average tenure; were less likely to have tendered their engagement over the last five years; attached less importance to price in the (re)appointment of the auditor; and were less likely to switch auditor in response to a substantial price increase. The proportion of the fee accounted for by non-UK activities for these higher profitability engagements was similar to that for other FTSE 350 companies.

7.89 We recognize that there are limitations to this analysis. In particular, we do not have the data to look for persistence in engagement profitability over periods of six years or more. Also these results are based on average staff costs within grade bands. We recognize that this approach may understate the costs of more complex engage-

ments which require the use of more experienced staff or staff with particular expertise and overstate the cost of others.

7.90 Nevertheless we consider that this analysis provides evidence that: *(a)* all firms have some FTSE 350 engagements that have been persistently more profitable for them than average; and *(b)* that these engagements are more likely to be the more complex audits and to be for companies that are less willing to switch auditors (which may itself reflect the complexity of the audit).

Provisional view regarding pricing, profitability and switching

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

7.92 However, we have found evidence that:

(a) Companies that switch firm enjoy a significant, if transient price cut (see paragraphs 7.33 to 7.52).

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

(i) profits per partner are considerably above benchmarked salaries;

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

(iii) the risks assumed by individual partners are not unusually high; and

(iv) partners rarely leave voluntarily prior to retirement, having an average tenure of 14 to 18 years.

(c) On balance, we think that audit is a relatively attractive service line whose risks are not unusually high, when compared with other service lines (see paragraphs 7.71 to 7.75).

(d) There appear to be significant numbers of companies from which the firms enjoy persistently higher profits than average (paragraphs 7.86 to 7.88).

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

7.94 As noted, our choice of indicators is constrained by data limitations in this market. However, assessing these indicators in the round, we consider that together they indicate that the market is not working well in delivering competitive prices.

Quality

7.95 We set out in paragraphs 6.11 to 6.16 our view, and the views of firms, regarding the definition of quality in the context of an audit process. This definition is not readily

susceptible to an objective metric. In this subsection, we consider indicators of the quality of audits in practice, in particular:

(a) company and shareholder views of audit quality;

(b) regulator views of audit quality; and

(c) litigation activity and insurance claims.

7.96 One aspect of audit quality is the independence and objectivity of the auditor, and as noted given its importance and the particular challenges to this aspect, we consider it separately in paragraphs 7.122 to 7.149.

Company and shareholder views of audit quality

7.97 We deliberately did not ask companies in our survey or in our case studies if they thought that their current auditor was performing well: they could only answer ‘yes’, unless they were taking active steps to improve or change their auditor.

7.98 Instead, our inquiries were focused on the companies’ conduct and ability to obtain a competitive audit, as discussed in Section 9. Our first survey asked respondents how important they considered certain factors to be in assessing the quality of an audit. The intention behind this question was to explore how important various aspects or dimensions of the product provided by auditors were to the customers. For both FDs and ACCs, the aspects most frequently identified as important were the ability to detect misstatements, a high degree of challenge by the auditor, the efficiency of the audit process and the independence of the audit firm. The importance of worldwide consistency was an important factor for those where a higher level of their audit fee was accounted for by non-UK activities.[174]

[174] Appendix 3, paragraphs 29–32.

7.99 Our case study companies (see Appendix 2) generally expressed a positive view of their auditor. Minor concerns were raised regarding price (see Appendix 2, Company B, paragraph 17), service (Appendix 2, Company J, paragraph 23), or that a firm was still learning about the company (Appendix 2, Company A, paragraph 61).

7.100 Shareholders, as noted in paragraph 5.56, lack the information necessary to appraise directly the quality of any particular audit, and must rely on company management (and the AC) and the audit firm, and regulators, to ensure the quality of the audit.

Regulatory views of audit quality

7.101 The AQRT is the only external source of information we identified on individual audit reports that had access to detailed information including audit files for public interest entities (PIE) in the UK.

7.102 According to the FRC's website,[175] the AQRT monitors the quality of the audits of listed and other major PIE and the policies and procedures supporting audit quality at the major audit firms in the UK. It monitors and promotes improvements in the quality of auditing of listed and other major PIE. It applies a risk-based approach in selecting individual audits for review, utilizing a risk model covering listed and AIM-listed entities.[176] Its reviews of individual audits emphasize the appropriateness of audit judgements key to reaching the audit opinion and the sufficiency and appropriateness of the audit evidence obtained. Its reviews of firm-wide procedures are wide-ranging and include an assessment of how the culture within firms affects audit quality. See further Appendix 8, paragraphs 171 to 175.

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[175] www.frc.org.uk/Our-Work/Conduct/Audit-Quality-Review.aspx. See Appendix 8, paragraph 171.
[176] See Appendix 8, paragraphs 173–175.

7.103 The Big 4 firms are subject to inspection on an annual basis by the AQRT and 'Other Major Firms' (which include BDO, GT, Mazars and PKF) on an extended cycle of up to three years.[177]

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

7.105 The AQRT produces both private and public reports:

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

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

7.106 Table 7.1 shows the results by firm of the AQRT inspections for the last two reviews.

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[177] 'Major firms' are those which audit ten or more entities which fall under the AQRT's scope: www.frc.org.uk/Our-Work/Conduct/Audit-Quality-Review.aspx.

TABLE 7.1 **Public results of AQRT inspections of largest six firms for the last two review periods (includes PIE audits and not just FTSE 350)**

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

Source: FRC website.

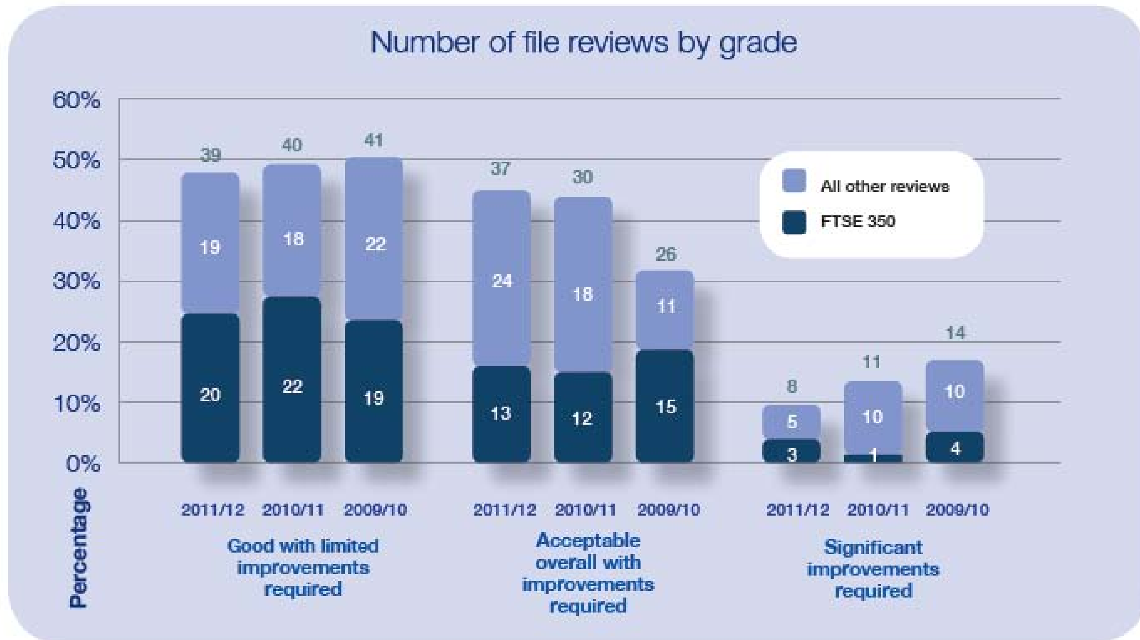
7.107 [✂][178]

7.108 The AQRT's file review gradings (excluding follow-up reviews) for 84 audits in 2011/12 and 81 audits in both 2010/11 and 2009/10 are summarized in Figure 7.1 below.

[178] Or were rated grade 5 under old scheme (unacceptable).

FIGURE 7.1

AQRT report outcomes, 2009/10 to 2011/12



Source: FRC report.[179]

7.109 Each of the AQRT's reports on firms provided a list of key findings and areas to which the firm should pay particular attention.[180]

7.110 The AQRT raised concerns about audit quality in its annual reports for 2008/09 and 2009/10. A key message of its 2009/10 annual report was the need for audit firms to demonstrate greater professional scepticism. It said that the number of audits requiring significant improvement remained too high and suggested that firms were not always applying significant professional scepticism in relation to some key audit judgements. The issue of professional scepticism is considered further in paragraphs 7.122 to 7.149.

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[179] www.frc.org.uk/getattachment/98e3e7dd-cdbe-4e45-9078-14e07bf0d7d8/Audit-Quality-Inspections-Annual-Report-2011-12.aspx.
[180] www.frc.org.uk/Our-Work/Conduct/Audit-Quality-Review/Audit-firm-specific-reports.aspx.

7.111 The FRC also noted the effect of pressure on engagement fees as a result of the current economic conditions:

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

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

Litigation activity and insurance claims and cover

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

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

7.115 We set out in Table 7.2 the total value of claims from statutory audit clients against insurance[181] for each firm in each year from 2002 to 2011.

TABLE 7.2 **Value of claims against insurance**

£'000

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

Source: CC analysis.

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

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

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

(a) Deloitte stated that the best mechanism to avoid or defend any potentially catastrophic claim or reputational issue was the quality of their work and the integrity of their people.[182]

(b) KPMG stated that the relatively low level of claims in the UK during the last ten years was not inconsistent with the threat of these claims being strong but rather, to a significant extent, a function of the enhanced quality assurance measures the largest audit firms had put in place.[183]

(c) PwC stated that claims by FTSE 350 companies against audit firms had declined over the last 12 years for three reasons: *(a)* a sustained emphasis on quality in the provision of audit; *(b)* enhanced risk management processes; and *(c)* a

[181] We note, however, that firms may choose not to recoup the costs of settling a claim from insurance arrangements and may have an excess or deductible to pay. We also note that the claims may not reflect all costs including legal costs.
[182] Deloitte submission, 5 October 2012.
[183] KPMG submission, 5 October 2012.

reasonably stable economic environment (up until 2008). The success of firms in reducing their litigation exposure is testimony to the improved levels of quality in the provision of the audit and to the investment in risk management processes which assist in identifying and resolving potential issues as they arise in individual audits.[184]

7.118 Table 7.3 shows the total value of premiums paid by the firms in relation to PII arrangements with captive or commercial insurers. These relate to all professional business carried out by the firm, including statutory audit. In the period 2002 to 2011 there were significant year-on-year fluctuations in the premiums paid by some firms. However, with the exception of [✂], the value of annual payments of premiums by firms has decreased for all firms.

TABLE 7.3 **Total value of premiums paid**

£'000

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

Source: CC analysis.

Provisional view

7.119 We acknowledge the regulatory context within which AQRT reports are prepared. However, we consider that the reports provide a sufficiently sound evidential basis in the context of our market investigation from which to draw conclusions. 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 short-

[184] PwC submission, 19 October 2012.

comings in audit reports that were not identified by the companies (whether FDs or ACs) themselves. In the period 2007 to 2011, the AQRT found ten instances out of the 149 FTSE 350 audits reviewed where quality was assessed as being either unacceptable or in need of significant improvement.[185] 78 per cent of FTSE 350 audits over this period were identified as requiring some level of improvement.

7.120 With regard to the low level of claims, settlements and insurance premiums, firms told us that this was a consequence of the high quality of the audits they provided (see paragraph 7.117). While we accept that this may explain the levels we observe, equally we think it may be a product of the liability regime (see paragraph 3.17 and Appendix 8), by which firms are only liable to companies under specific conditions. In addition, we note the difficulty, in the UK, of pursuing class-action style litigation by which shareholders may pursue joint claims against audit firms. On balance, we do not think that the low levels of claims, settlements and insurance premiums is a conclusive indicator of the quality of audits.

7.121 Our provisional view is that there are significant, persistent and widespread concerns regarding the quality of audits delivered to FTSE 350 companies as identified by the AQRT. This variation in quality is not what we would expect in a competitive market. Accordingly we consider that this outcome indicates an AEC.

Independence

7.122 At the outset, we note that while both firms and applicable regulation discuss and provide for auditor 'independence', this is not in the sense that would be recognized within the meaning of, say, Article 6 of the European Convention on Human Rights,[186] or UK administrative law. That an auditor is both selected and paid for by

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[185] The grading system has changed over the period.
[186] www.echr.coe.int/NR/rdonlyres/D5CC24A7-DC13-4318-B457-5C9014916D7A/0/Convention_ENG.pdf

the company it is scrutinizing would disqualify it from being seen as 'independent' in that rigorous sense.

7.123 The FRC provides guidance on professional scepticism:[187]

> the appropriate application of professional scepticism in the audit requires a mindset which rigorously questions and challenges management's assertions with a degree of doubt that reflects the expectations of shareholders (and other stakeholders) for whose benefit it is performed. All judgments made in the course of the audit should be founded on the perspective of the shareholders (and other stakeholders). That mindset demands the sort of hard evidence – to back each audit judgment and, ultimately, the board's assertion that the financial statements give a true and fair view - that would be convincing and persuasive to shareholders (and other stakeholders), given the auditor's risk assessment.[188]

7.124 There is extensive regulation regarding threats to independence, in particular 'Ethical Standard 1: integrity, objectivity, and independence' (ES1)[189] which describes the importance of integrity, objectivity and independence for an auditor; ways of complying with ethical standards (policies and procedures, leadership, ethics partner); identification and assessment of threats and safeguards; and engagement quality control review. (See further Appendix 8, paragraphs 81 to 88).

7.125 In considering whether firms have shown insufficient independence or scepticism, we encountered difficulties in gathering direct evidence. In particular, no AEP and no firm told us that they had ever lost independence. Realistically, they could not, since the

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[187] www.frc.org.uk/getattachment/1aecac64-6309-4539-a6d9-690e67c93519/Briefing-Paper-Professional-Scepticism.aspx.
[188] ibid, p12.
[189] www.frc.org.uk/images/uploaded/documents/ES%201%20revised%201210%20updated%201211.pdf.

value in having an audit comes from the independence of the review. To admit a loss of independence is to admit that the service provided lacked value.

7.126 However, we have considered the direct and indirect evidence available to us regarding whether auditors can and do lose sufficient independence. In particular, we considered: *(a)* the effect of AEP rotation; *(b)* the evidence that case studies provide; *(c)* firms' conduct; *(d)* direct evidence of loss of independence; and *(e)* firms' submissions and AQRT reviews.

The effect of AEP rotation

7.127 AEPs may only serve for a single five-year term on any engagement, given the risk that an AEP may become overfamiliar with the company he or she is auditing.[190] No AEP that we spoke to as part of the case studies identified any instance of a significant accounting judgement that he or she had changed on taking over as AEP from another partner of the same firm for a given company. Further, a Big 4 firm told us that it aimed to achieve a 'seamless transition' between AEPs.[191] Other firms also worked hard to ensure smooth transitions.[192] However, GT indicated that it would be concerned about compromising the independence of the incoming AEP.[193]

7.128 GT said that from an audit quality stance, it was right that the rotation introduced a fresh pair of eyes. A five-year rotation for the listed companies was perhaps too short as it took a long time to understand the complexity of a FTSE company. It was also only when a company changed its audit provider that it obtained a completely fresh perspective in terms of approach and technical issues.[194]

[190] Appendix 8, paragraph 127.
[191] See Appendix 2, Company I, paragraph 88.
[192] For examples, see Appendix 2, Company C, paragraph 111; and Company E, paragraph 106.
[193] GT hearing summary, 20 December 2012, paragraph 29.
[194] GT hearing summary, 20 December 2012, paragraph 30.

7.129 The FRC told us that the requirement of ‘partner rotation’ was to refresh the independence of the audit partner, not the audit firm. It noted that the effectiveness of the rotation was very much dependent on the individual auditor. There was a possibility that if partners had risen through the ranks of the audit engagement team in question, then there may be a less innovative change to the audit.[195]

Case studies

7.130 In our case studies, we heard how certain AEPs had debated issues with management,[196] but we found that firms, individual AEPs and indeed FDs and ACCs were reluctant to criticize either firms or company managements, and so we lack examples where auditors failed to challenge issues sufficiently. However, Company A provided an example of where the internal and external control measures appear to have gone awry (though not sufficiently for regulatory action to be taken).

Firms’ conduct

7.131 We note the examples set out in paragraphs 9.200 and 9.201 that indicate that company executives can and do influence their incumbent auditor. While generally as a competition authority we welcome customers’ exercising bargaining power to the extent that it increases competition, in the case of audit (and in particular the issue of auditor independence), the situation is more complex. In particular, to the extent that shareholders’ interests are not adequately represented by executive management, the exercise by executive management of bargaining power may be to the detriment of auditor independence and so of shareholders.

7.132 We note that the role of the AC, comprising non-executive directors, has an important role in promoting auditor independence. The examples we saw of management

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[195] www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/frc_hearing_summary_26oct12.pdf , paragraph 9.
[196] See, for example, Appendix 2, Case study G AEP, paragraph 100.

requiring firms to change AEP (eg at Company I) are ambiguous: they might ensure that the firms perform well; however, they might ensure that the firms provide a partner that is more amenable to management views. Equally, when AEPs rotate, firms offer companies a selection from which to choose their preferred AEP (again, see Company I). Again, this represents an opportunity for company management to select the partner that they consider most amenable.

7.133 It is not possible for us to decide on a case-by-case basis whether this occurred. However, this is a way in which companies can undermine auditor independence.

7.134 We set out in Appendix 16, the efforts that firms expend in maintaining good relationships with company managements. Equally from our case studies, it was apparent that all AEPs saw it as a part of their role to maintain good relationships with FDs.

7.135 The Company A AEP gave the most nuanced description, which we think worth quoting at length. He said that there was a balance to be struck in any audit relationship, as the AEP needed to establish a good working relationship with management as well as with the ACC and the NEDs. It was necessary to have a good relationship to understand an individual's motivations, as well as having a formal dialogue with them. However, the auditor needed to maintain independence. Accordingly, this was a balancing act between the three parties (auditor, management, ACC) which formed a triangle (paragraph 85). There was a tension in the triangle relationship, since if the auditors were to share observations with the ACC but not with management, the relationship with management might break down, making the auditors' role more difficult. Communication therefore needed to be managed properly so that the auditor had a good working relationship with management and could get under the skin of the company (paragraph 87). Auditing was not just about picking up some numbers

and confirming them against underlying records. Auditors needed to understand how a set of numbers were put together and what motivated the team who produced them. The auditor needed to understand this so that he knew where the management team might have placed their cards in terms of the range of possible answers, ie whether they had taken an aggressive or conservative approach. This could only be done if the auditor really understood what was going on in terms of the way the management team was actually running the business, the issues it was facing, the pressures it was under, the pressures the non-executives were putting on it, the pressures the shareholders were putting on it, and the structure of the bonus scheme (paragraph 88).

Direct evidence of loss of independence

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

7.137 The US financial reporting scandals of 2001/02, including Enron, Global Crossing, Tyco, HealthSouth and Worldcom, were followed by a wave of regulations on both sides of the Atlantic introducing stricter rules on the provision of NAS to audit clients, as well as tighter corporate governance rules (see Appendix 8), in an attempt to prevent similar scandals in the future.

7.138 The UK has had its own financial reporting scandals, for example Equitable Life, London International Group, Independent Insurance, TransTec, Wickes and ERF Holdings. These cases were subject to disciplinary investigations by the FRC, which noted audit failings including instances of over-reliance on management representations, failure to investigate conflicting explanations and failure to obtain appropriate third party confirmations, suggesting that the auditors in these cases were not sufficiently sceptical.[197] We have not considered these cases in detail ourselves and recognize that significant changes have been made to the regulatory regime in the intervening period.

7.139 We considered whether there were more recent examples that could be illustrative of a lack of auditor scepticism, notwithstanding the additional regulatory controls that had been established post-Enron. We found that several cases ([✂]—see Appendix 17) were all suggestive of the potential for the auditors to have demonstrated a higher degree of scepticism, whether or not the threshold was reached for a successful claim to be mounted against the firm. We do not consider this list to be exhaustive.

7.140 Claims for negligence are hard to bring against auditors, partly because corporate downfalls may be the result of a combination of events such as fraud, misrepresentation, or misjudgement by management, or unforeseen events, and these may or may not be compounded by a lack of challenge or scepticism by the auditor. The extent to which auditors are implicated in these downfalls is often difficult to prove in court, in part due to the lack of visibility of the audit process, but also due to the relatively high legal hurdle required to bring a claim (as described in paragraphs 3.17 to 3.19). Hence we consider that the relatively low incidence of claims against auditors in

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[197] From *Auditor Scepticism: Raising the bar,* FRC, August 2010: www.frc.org.uk/getattachment/2a1e0146-a92c-4b7e-bf33-305b3b10fcd2/Discussion-Paper-Auditor-Scepticism-Raising-the-Ba.aspx.

recent years does not necessarily indicate that there is no problem. In this regard, we note the concerns raised by the Treasury Select Committee, the Financial Services Authority (FSA) and others in relation to the role of auditors in the banking crisis.

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

7.142 Responses to the FRC's discussion paper from investors indicated that a lack of scepticism on the part of auditors continued to be problematic. The Local Authority Pension Fund Forum said that scepticism was not directed to those places where it was most required and that problems occurred wherever there was a scope for overstatement of earnings. The International Corporate Governance Network said that a lack of sufficient audit scepticism had been widespread in recent years, including the period leading up to the financial crisis. The Investment Management Association (IMA) said that modifications to the regulatory framework post-Enron had not been fully effective in enhancing auditor scepticism.[198]

[198] www.frc.org.uk/Our-Work/Publications/APB/Discussion-Paper-Auditor-Scepticism-Raising-the-Ba/Responses-to-Discussion-Paper-Auditor-Scepticism-R.htm.

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

Firm submissions and firm-specific AQRT reports

7.144 Applicable regulation has developed the requirement regarding independence (see Appendix 8, paragraphs 82 to 88). Ethical Standard 1, in particular, states:

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

7.145 Appendix 17 details applicable regulation, how firms have responded, and the FRC's view of their efforts. We found that the firms put processes in place to ensure compliance with the regulations but that the AQRT reported areas that individual firms needed to improve across their audit practice (as well as examples of good practice) and some specific cases of engagements where firms had not demonstrated full compliance.

Provisional view

7.146 We have identified that companies can influence the composition of the audit team, and on occasion can have the firm's AEP replaced. We have not identified if this is always in response to inadequate AEP performance or whether it is on occasion to

obtain an AEP more amenable to management's views. However, this is a mechanism by which companies can undermine auditor independence. We have also identified that firms have incentives to maintain good relationships with company management (see paragraphs 9.190 to 9.222]). They put in significant efforts to ensure that AEP rotation is 'seamless', and even offer companies a choice of candidates when an AEP is due to rotate off an engagement. In our provisional view, this may not be compatible with the AEP's role of independently examining the company's accounts.

7.147 We noted in paragraph 3.13 that 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.

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

7.149 We note the extensive regulation that surrounds this issue (and that it is an obvious and well-recognized concern regarding auditing), but the evidence we have seen leads us to conclude provisionally 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 demand of shareholders.

Innovation

7.150 Innovation is one of the ways in which firms generally compete: high rates of innovation suggest vigorous competition while sluggish competition suggests that markets

are not competitive. The nature of statutory audits is determined to an extent by legislation, originating in both the UK and the EU, and professional standards issued by both UK and international bodies. In particular, the regulatory framework sets certain minimum requirements on the purpose of an audit, the duties of an auditor and the output of the audit, and firms are required to demonstrate compliance with the International Standards on Auditing (ISAs). These standards do not, however, state the method an auditor must use to test specific account areas, or the specific level of testing necessary to reach a conclusion.

7.151 We asked firms various questions relating to innovation as part of a competitive strategy to win or retain clients and the impact of regulation on innovation. The responses to these questions are summarized in Appendix 18.

7.152 In this section, we consider:

(a) constraints on innovation;

(b) areas where innovation may be possible; and

(c) drivers of innovation; and set out

(d) our provisional views.

Constraints on innovation

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

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

7.155 The requirements of an auditor's report with respect to the financial statements and the duties of the auditor in reaching those conclusions under the Companies Act can be summarized as follows:[199] an auditor must be satisfied that *(a)* proper accounting records are kept, *(b)* the financial statements are consistent with those records, *(c)* the financial statements are prepared on the basis of financial reporting standards, and *(d)* where any material divergence is found and not corrected, this should be noted in the audit report.

7.156 The format of the audit report is largely standardized. The audit reports issued by the auditors of the FTSE 350 are based on templates issued by the FRC. The scope for variation from this format is limited by regulation.[200] KPMG was the only firm to refer directly to regulation inhibiting it innovating and experimenting with the format of the audit report. We note that the demand for consistency of approach from management, shareholders and regulatory bodies as well as the UK Listing Authority may also be a constraint.[201] Given these restrictions, to the extent that innovation in reporting occurs, it is most likely to take the form of additional sections to the standard audit report.

[199] Auditors are also required to report on the consistency of the annual report with the financial statements and the accuracy of the remuneration report. Companies Act, Part 16, Chapter 3.
[200] These have been issued as Bulletins by the APB with exemplars for different types of company and their group structure.
[201] In addition to regulations set by the FSA acting as the UK Listing Authority, the London Stock Exchange publishes Admission and Disclosure Standards.

7.157 The auditor is required to provide additional reports to those charged with governance of a company as required by ISAs over the course of the audit, principally communicating the planned scope and timing of the audit and findings arising from audit work. These requirements can be seen as a minimum level of reporting.[202]

7.158 Acceptable accounting treatments are determined by financial reporting standards, with listed companies required to use IFRS. Those preparing financial statements may adopt different interpretations of those standards, and may adopt 'industry norms' for certain areas such as accounting estimates. However, where a presentation as indicated by IFRS is not considered to be a fair reflection of the economic substance of the balance or transaction, it is possible to adopt alternative accounting policies.[203]

7.159 If firms wish to innovate their offering, they may need to seek regulatory approval and appropriate consideration by regulators of a proposal may prevent new products being offered in the short term. KPMG's proposal to offer statutory audit within a broader 'extended assurance' product is an example of such a situation (see Appendix 18, paragraph 159).

Areas where innovation may be possible

7.160 Regulation is seen by firms as setting the nature of statutory audit and in some respects a set of minimum criteria. However, firms gave evidence of a number of changes in the regulatory environment over the past ten years which have led to

[202] The requirements on communicating with those charged with governance are set out in International Standard on Auditing (UK and Ireland) 260 Communication with those charged with governance (ISA 260).
[203] Both HSBC and National Express are examples of companies which have diverged in certain instances from IFRS. The Financial Reporting Review Panel has also stated that it would only challenge a company's choice of accounting policy if it were clearly unreasonable. *True and Fair*, FRC, July 2011.

changes in the performance of audit, and in some cases these have required innovation in the delivery of individual audit engagements.[204]

Process

7.161 With regard to audit process, the firms identified the following as areas of innovation (see Appendix 18, , for a summary of submissions):

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

(b) use of industry specialized modules;

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

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

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

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

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

7.163 In the case of data-mining and analytics, the ability of the auditor to employ such techniques is dependent on the nature of a client's systems.[205]

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[204] The example of the length of time that listed companies are given to publish their annual reports was provided by Deloitte, which has led to a compression of the post-year-end audit timetable. For reporting periods commencing after 20 January 2007, the deadline for publishing annual reports was reduced from six to four months. .

[205] Firms indicated that more advanced analysis, such as 'real-time' testing, was both driven by and dependent on clients' use of Enterprise Resource Planning (ERP) systems.

Reporting

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

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

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

(c) financial reporting benchmarking[206] clearer communication in annual reports to improve the quality of discussions at the AC; and

(d) the quality and flow of the annual report which comprises the directors' report and business review and other disclosures required under the Companies Act (ie the 'front end' of the accounts) [207,208] and extent of disclosures of financial statements to other companies.

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

7.166 Firms also identified the following as areas for innovation outside the audit process:[209] benchmarking of financial performance; access to knowledge base, thought leadership articles and networking events; partner access for general advice; marketing; and audit-related services.[210]

7.167 We were provided with examples of companies which have included innovation as a section of their invitation to tender when selecting an auditor, which indicates that

[206] See Appendix 18, paragraph 13.
[207] See Appendix 18, paragraph 39.
[208] Appendix 2, Company G, paragraph 115.
[209] See Appendix 18.
[210] There may be some scope to innovate these, but they will be subject to their own requirements.

there is scope to use evidence of innovation when competing in a tender situation.[211] The ability for auditors to encourage the companies they audit to enhance disclosure appears to be limited: their duties are to the company as a whole and they are bound by duties of confidentiality to that company. Further, because such reports are prepared by or on behalf of the AC, the auditor cannot dictate the nature or level of disclosure the AC makes, although it may be able to exert influence. See further Section 11.

Drivers of innovation

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

7.169 As discussed above (paragraphs 7.154 to 7.156), we believe that innovation may be restricted by regulation in some respects, but likewise changes in regulation may lead to innovation as firms and companies are forced to respond to these changes. On the other hand, regulations can be changed in response to pressure from firms and companies.

7.170 We understand that the use of Enterprise Resource Planning (ERP) systems by large businesses has increased over time. The audit approach adopted by audit firms for these companies has necessarily changed to respond to the need to test databases with large volumes of transactions. The increased use of data-mining tools and

[211] KPMG response to CC working paper 'Nature and strength of competition', Annex 2, paragraph 4.1.3, provides three examples of companies which have included innovation as a section, or part of a section, on an invitation to tender.

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

7.171 The firms have indicated that their innovation is driven by client demand for an audit which delivers the greatest value, either on the grounds of cost, its focus on key financial and operational risks or the insights delivered in reporting to management and the AC. [212]

Provisional views

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

7.173 First, we consider that whilst strict compliance with ISAs is likely to be the most cost-efficient way of delivering an audit, it does not prevent firms from determining the type and extent of testing they undertake. There is therefore the possibility of additional testing and reporting, which offers potential for auditors to differentiate their product by offering a greater level of assurance than the standard audit product. Examples of this are KPMG’s ‘extended audit’ and a number of other detailed reports issued by the firms (see Appendix 18).

7.174 Second, we note that whilst the aim of an audit has remained broadly similar[213] over time, how that work is documented and the focus of auditing financial statements has changed. However, other than some changes to terminology and structure, the audit report has changed little and its form is constrained by regulation.

[212] See Appendix 18.
[213] See Appendix 10, paragraph 3.

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

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

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

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

7.179 This issue is closely linked to the issue of unmet demand: if there is such demand, we expect firms should, absent some feature of the market, innovate to meet it. In our provisional view, innovation is not at levels we would expect to see in a well-functioning market.

Unmet demand

7.180 In this Section 7, we have assessed various indicators of whether outputs in the relevant market are competitive in terms of price, quality (including independence) and innovation. In this subsection, we set out the evidence that the product delivered does not satisfy the demands of shareholders in terms of information provided by the audit. We consider:

(a) evidence provided to us by shareholders;

(b) evidence provided to us by ACCs;

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

(d) firms' submissions and initiatives.

7.181 We then *(e)* set out our provisional views.

Views of shareholders

7.182 We sent written questionnaires to 18 major equity investors, in addition to speaking with two investors as part of our case studies and holding hearings with Hermes[214] and Institutional Investors.[215,216] We appreciate that statutory audit is provided for the benefit of shareholders (although others also benefit), and it is in their capacity as shareholders (or their agents) that we were interested in these investors' views.

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

[215] This included representatives from the Association of British Insurers (ABI), the Investment Management Association (IMA) and the National Association of Pension Funds (NAPF).

[216] www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/institutional_investors_hearing_summary_16_april%202012.pdf.

7.183 Their views are summarized in Appendix 19. Information they would find useful includes:

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

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

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

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

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

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

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

7.184 Institutional investors that we spoke to thought that the auditor's report could identify issues that had been scrutinized in detail by the company during the audit process, an indication of the most contentious issues, and an identification of the accounting treatments that the auditor thought most aggressive.[217]

7.185 These views are broadly in line with a survey conducted on behalf of GT and BDO for our investigation,[218] but also by PwC in 2011, which found:

> The investment professionals interviewed do not believe they currently receive adequate information about the audit process; they offered

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[217] We note that these investors made similar views in their response to the EU Audit Proposals Section 6—proposals on audit report.
[218] www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/oxera_investor_survey_report.pdf.

suggestions of where more information would be valuable. These areas include: the auditors' debates with management; aggressiveness of accounting treatment; likely areas of material misstatement; and going concern. However, there are understandably significant concerns over the practicalities involved …

7.186 Accordingly, we found demand on the part of shareholders for additional information. The main areas of consensus among those who desired more information were the provision of further information on how aggressive approaches to accounting policy compared with industry norm, and the main areas of discussion between the auditor and the company. See Appendix 19.

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

Views of ACCs

7.188 We asked the ACCs in the follow-up survey what they thought shareholders might want by way of additional information in relation to an audit that they did not get at the moment. Of those that responded (44 per cent), the types of information identified included: the scope of the audit, levels of materiality, key financial risks, areas of

accounting judgements, details of the work undertaken by the auditors, issues discussed at the AC, and performance of the business at a more granular level.[219]

7.189 10 per cent of FTSE 350 ACCs we spoke to in the follow-up survey said that they had been approached by shareholders for further information. We asked those who had not been approached why they thought this was the case. The responses suggested that many were of the view that among shareholders there was not a widespread demand for further information. In particular, the reasons given included: there was not a demand for further information; company accounts were already too long; and shareholders were satisfied with the information provided.[220]

7.190 The ACC of case study Company [✂] increased the level of disclosure on the interaction between the company and its auditor through a detailed ACC report. The company AEP believed the reluctance of other companies to publish similar detailed reports was because they wished to gauge market reaction to the disclosures made by other companies first. He also stated that the ACC had been a front runner in the process and the extra disclosure had been driven by the company itself rather than the AEP.[221]

FRC's views

7.191 We note that the revised FRC guidance contains requirements for the contents of the AC's report (a section of annual report and accounts) which appear to recognize that there is a demand from shareholders for further information.[222.]

[219] See Appendix 11, paragraph 34.
[220] See Appendix 11, paragraph 34.
[221] [✂]
[222] See FRC Guidance on audit committees, paragraph 5.2: www.frc.org.uk/getattachment/6ec23196-28ee-406e-8f56-89ab9d1dc06d/Guidance-on-Audit-Committees-September-2012.aspx.

7.192 In 2011, the FRC published a consultation document aimed at enhancing corporate reporting and audit, called *Effective Company Stewardship*. This document included a recommendation that fuller reports by ACs on the approach taken to the discharge of their duties would support the board's declaration that the annual report properly and fairly describes the business and its financial performance.[223]

Firms' submissions and initiatives

7.193 The Big 4 firms acknowledged the demand in the shareholder community for further information.

7.194 Deloitte stated that it had recognized specific concerns among investors as to the usefulness of audit reporting.[224] Deloitte said that it had actively engaged with investors for a number of years.[225] Deloitte supported the initiatives of the International Auditing and Assurance Board in its efforts to improve audit reporting. Specifically: in its response to the IAASB's consultation,[226] Deloitte supported the following aspects of the Invitation to Comment:

(a) auditor commentary that:

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

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

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

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[223] FRC, *Effective Company Stewardship: Enhancing Corporate Reporting and Audit,* January 2011.
[224] Deloitte response to the 'Framework for the CC's assessment and revised theories of harm' working paper, paragraphs 5.12 & 5.18.
[225] Deloitte response to supplementary questions received following the hearing, question 6.
[226] www.ifac.org/sites/default/files/publications/exposure-drafts/comments/Final%20DTTL%20Response%20-%20IAASB%20ITC%20on%20Auditor%20Reporting.pdf.

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

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

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

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

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

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

7.195 Deloitte also said that in its recent survey of narrative reporting investigating compliance with reported best practice by listed companies, it found that: 98 per cent of relevant companies described the work of the AC in the annual report; 56 per cent of FTSE 350 companies provided detail of key matters considered by the AC such as key accounting assumptions and judgements; and 56 per cent of FTSE 350 companies gave an explanation of their auditor appointment decisions.[227] Deloitte also gave two examples of current reporting best practice, Barclays and Pearson, which gave significant additional information to investors about the work of the AC and the auditor. Other major companies such as BP (which sets out in detail the activities of the AC over the year) and RBS (which explains the issues on which the AC has

[227] Deloitte response to the 'Framework for the CC's assessment and revised theories of harm' working paper, paragraph 5.15.

spent most time over the year and explains in detail its policies with regard to the appointment of its auditor) have been increasing the information provided to investors in the annual report.[228]

7.196 EY said that there was not a commonality of interest within any single category of stakeholder, let alone across the range of different categories of stakeholder. Although some (but not all) institutional investors would like more to be included in the audit report, there was no consensus among institutional investors on what should be included, and therefore there was no clear consistent 'unmet demand'. It said that considerable regulatory attention had been focused on what, if anything, additional features should be included in audit reports, with all interested parties having the opportunity to contribute their views. Significant proposals (which EY generally supported) were under consideration by appropriate regulators. In the absence of any clear evidence of consistent views on 'unmet demand', EY said that it would be inappropriate for the CC to draw any conclusions about the existence of 'features of the market leading to an adverse effect on competition'.[229]

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

7.198 KPMG also said that investors had expressed wishes for various improvements to both corporate disclosure and audit reporting, although they had never translated those wishes into any economic imperatives for audit firms to move beyond the

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[228] Deloitte response to the 'Framework for the CC's assessment and revised theories of harm' working paper, paragraph 5.15.
[229] EY response to CC 'Views of investors and other stakeholders' working paper, paragraph 4.

statutory minimum. It tended to be corporate governance specialists who made these requests. There was said to be more limited discussion between those making investment decisions, companies and auditors.

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

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

7.201 According to BDO, PwC's investor survey 'Audit today and tomorrow' of 2011 showed that investors wanted more reporting on going concerns, more information

about issues discussed with ACs, more narrative reporting, and information about the reliability of earnings releases.[230]

7.202 In this context, we noted that the House of Commons Treasury Committee in its Ninth Report of Session 2008–09[231] had questioned the value of audits. For example, the Committee stated:

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

And the Committee concluded:

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

7.203 Similarly, we noted that the report of the ICAEW, *Audit of Banks—Lessons from the Crisis* (2010), stated:[232]

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[230] www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/mph_summary_bdo.pdf, paragraph 11.
[231] www.publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/519/51909.htm.
[232] Audit of Banks, 2010.

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

Provisional views regarding unmet demand

7.204 We received evidence from shareholders, the FRC and from the Big 4 firms that there was a demand for further or different information regarding the audit of companies. We note that the evidence indicates that different shareholders may demand different information, but we think that this is to be expected: suppliers in markets often face varying demands from their customer base. We think these unmet demands indicate that the market contains features that may prevent, restrict or distort competition, since in a well-functioning market, customer demand should be satisfied. We consider the issue further, and in particular the submissions we received from the audit firms themselves, in considering whether auditors sufficiently represent the interests of shareholders (ie under our second theory of harm), and whether there are in fact such features.

Provisional views regarding outcomes

7.205 We have set out our views throughout this section regarding the specific issues we examined. We have considered whether market outcomes in terms of price, quality, innovation and output are at the levels that we might anticipate in a competitive market. While clear indicators have been hard to find, given the nature of the issues

and the availability of data, we have identified concerns with each of the issues that we examined:

(a) With regard to profits and prices, we have found that on average, firms' prices and profits increase over the first three to five years of an engagement, but then plateau. In our view, this pattern (of an initial fall followed by rapid recovery) following appointment indicates that firms have some market power and can increase their prices once they are appointed. Further there are some indications that the Big 4 firms are making attractive returns on a partner basis. There also appears to be a population of companies from which firms earn higher returns than average.

(b) Audit quality is not amenable to measurement by an objective metric. However, the AQRT has identified significant, persistent and widespread concerns regarding the quality of audits delivered to FTSE 350 companies. This includes concerns regarding a loss of scepticism by AEPs as they perform their audits.

(c) While firms retain the ability to innovate, rates of innovation are below those we would expect to se. This issue links to our final concern in *(d)*.

(d) Unmet demand. There is evidence from various sources (shareholders, the FRC, the Big 4 firms themselves) that there is significant shareholder demand that is not currently met.

7.206 While this does not demonstrate conclusively that the market is not competitive, it is indicative that competitive forces are muted. In our provisional view, cumulatively these indicators add up to show that the market is not working well in terms of delivering outcomes to customers (in particular, to shareholders). We appreciate that some of these indicators might be explained either by reference to the existence of features or a combination of features in the FTSE 350 audit market that have an AEC, or by alternative explanations. In the following sections, we set out the

competing explanations for these outcomes using our theories of harm as a framework for assessment.

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

Features

8.1 Under section 134(1) of the Act, it is our statutory task to determine if any feature or a combination of features of the market or markets in the provision of statutory audits to FTSE 350 companies prevent, restrict or distort competition in the UK (see paragraph 1.2). To conclude that there is an AEC in a market, we must identify such features or combination of features (ie the sources of harmful effects in a market). We interpret the phrase 'prevents, restricts or distorts' in the Act broadly to cover any adverse effect, whether actual or potential. We therefore consider features that prevent the market becoming more competitive as well as those that affect the existing market.[233]

8.2 The Act states that the following may be a feature of the market:[234] *(a)* the structure of the market concerned or any aspect of that structure; *(b)* any conduct (whether or not in the market concerned) of one or more than one person who supplies or acquires goods or services in the market concerned; or *(c)* any conduct relating to the market concerned of customers of any person who supplies or acquires goods or services.

8.3 The Act does not require us to state whether particular features of a market are structural features or some aspect of conduct. It may not always be clear in which category the feature fits. Provided the relevant feature falls within at least one of these categories, the categorization is of little practical importance.[235]

8.4 The concept of a feature is broad, allowing us the flexibility to investigate a wide range of possible market features, each of which may have effects on competition, in

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[233] CC3*,* paragraph 1.6 and CC Guidelines for market investigations, consultation draft (*CC3* revised), paragraph 83.
[234] Section 131(2) of the Act.
[235] See paragraph 302 of the Explanatory Notes to the Act.

both its static sense of price, cost and profit levels and its longer-term dynamic sense of, for example, innovation, differentiation and/or development of products and markets. Moreover, a feature need not necessarily be the immediate cause of harm to competition; in most cases, the harm results from a causal chain of factors, each of which can be identified as features.[236]

8.5 Structural features may include high market shares, high concentration, lack of buyer power and high entry barriers. Structural features may include other aspects of market structure such as government regulations and information asymmetries. Conduct features may include the conduct of any market participants (whether sellers or buyers). As stated in the Act, conduct includes any failure to act, whether intentional or not and any other unintentional conduct.[237]

8.6 Since the behaviour of customers can sometimes limit competition between firms, such behaviour can be categorized as a conduct feature of a market. Market investigations allow us to look at customer behaviour and customer vulnerability in relation to its implications for competition, instead of just looking at it as a consumer protection issue. In some circumstances, several features may in combination harm competition.[238]

Theories of harm

8.7 In conducting its assessment of whether or not there is an AEC in a given market, the CC will seek to establish whether or not any of the possible features, or any combination of them, can be expected to harm competition. Assessing the competitive effects of features means that any AEC finding should be grounded in a clear understanding of why competition in a market may be harmed. As noted in

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[236] CC Guidelines for market investigations, consultation draft (*CC3* revised), Part 3.
[237] CC Guidelines for market investigations, consultation draft (*CC3* revised), Part 3.
[238] CC Guidelines for market investigations, consultation draft (*CC3* revised), Part 3.

paragraph 7.1, the CC recognizes that the theoretical benchmark against which to measure an AEC cannot be a 'perfectly competitive' market. In past market investigations the CC has used the term 'a well-functioning market', generally in the limited sense of the market absent the feature or combination of features, as such a benchmark.[239] This has been our approach in this investigation as we do not consider there to be a realistic alternative comparator for the relevant market.

8.8 To provide the necessary focus and structure for our assessment of the way competition is working in the market, the CC sets out 'theories of harm'. A theory of harm is a possible explanation of what might be the sources of harmful effects in a market (ie the features) and of what mechanism may be leading from these sources to the observed characteristics and outcomes in the market.[240] The CC typically devises such theories at the outset of its investigations, to focus its consideration and evidence gathering.

8.9 Accordingly, we published an issues statement that included several theories of harm,[241] and we subsequently refined them to two principal theories.[242] The first is that customer behaviour and market structure produce adverse outcomes in that companies may be reluctant to switch auditor and so lack bargaining power with respect to their auditor and be unable to obtain competitive outcomes in terms of price, quality and innovation. The second is that the principal-agent issues discussed in paragraphs 5.5 to 5.8 produce adverse outcomes, in particular since the demands of executive management may differ from those of shareholders and audit firms may direct their competitive efforts towards satisfying management rather than share-

[239] CC Guidelines for market investigations, consultation draft (*CC3* revised), paragraphs 84 & 311.
[240] CC Guidelines for market investigations, consultation draft (*CC3* revised), paragraphs 153–155.
[241] www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/111207_issues_statement_final.pdf.
[242] www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/framework_for_the_ccs_assessment.pdf.

holder demand. This may mean that shareholders do not obtain competitive outcomes in terms of some aspects of quality and innovation in audit reporting.

8.10 As noted, our provisional view is that the term 'customers' for the purposes of our investigation includes the shareholders of large companies as a class and that in considering whether competition is working effectively in the market for statutory audit services we should consider the extent to which it is efficiently and effectively meeting the needs of those customers.[243] We note that, under the Act, the concept of customers includes future customers.[244]

8.11 Our issues statement also contained theories of harm relating to coordinated effects, bundling by the Big 4 firms, and regulatory distortions. Our investigation has not so far identified evidence to support them. See further Section 12, and Appendices 20, 21 and 22.

Customer behaviour and market structure produce adverse outcomes

8.12 Our first theory of harm relates both to the conduct of FTSE 350 companies in the appointment and reappointment of their auditors, and the structure of the market, including the number and capabilities of auditors providing audit services to FTSE 350 companies and barriers to entry, expansion and selection in the market. In investigating this theory of harm we considered factors relating to demand and supply, and how they interact.

8.13 In paragraphs 7.7 to 7.15, we provisionally concluded that the supply of statutory audit services was highly concentrated, with the shares of the Big 4 firms broadly stable over time both in terms of number of FTSE 350 engagements and value of those engagements. In our provisional view, these levels of concentration, together

[243] CC3, paragraphs 1.16 & 1.17 and CC Market Investigation Guidelines (consultation draft) paragraph 8.
[244] Section 134(5) and 134(8) of the Act.

with the length of tenure of audit engagements, and infrequency of switching and tendering for engagements that we identified indicate that there may be an AEC resulting from a feature or combination of features of the market and so we have sought to investigate this in more depth.

8.14 On the demand side we have assessed whether long periods of tenure, and low frequency of tendering that we have observed in the relevant market (see paragraphs 7.5 to 7.25) are caused by search costs, switching costs or other barriers, which make it less likely (than absent any such barriers) that a FTSE 350 company will tender its audit or switch auditor, resulting in limited competition between auditors for these engagements. We have also considered whether information asymmetries make it more difficult for management to assess the value for money or the quality of the audit product or service provided by their auditor and the potential gains from switching which may limit their incentives to switch.

8.15 On the supply side, we investigated how audit firms compete to win and retain FTSE 350 audit engagements both outside and within tenders run by FTSE 350 companies. We also investigated the relationships which firms cultivate with their clients and the implications these have for competition, in particular the willingness of companies to switch auditor.

8.16 We examined these issues by considering the willingness of a company to switch auditor and of its bargaining power with its auditor bearing in mind the concentrated market structure that we have identified, both outside and within a tender process: see Section 9. In doing so, we noted that even on occasions where a company can exert sufficient bargaining power outside the tender process (for example, because of its importance as a ‘flagship’ client to the audit firm), the existence of significant

switching costs could lead to long tenures and 'stickiness' in the market (see paragraph 9.2).

8.17 We also investigated the nature and extent of barriers to entry to those firms not currently auditing FTSE 350 companies and barriers to expansion and selection to those firms that currently audit a very small number of FTSE 350 companies: see Section 10.

8.18 We consider that weak competition could have an adverse effect on all aspects of the audit product and its delivery. In particular, weak competition could reduce the incentives of audit firms to reduce audit fees, to ensure that audits are carried out effectively and efficiently, and to invest in their people, expertise and systems. Weak competition could lead to audit firms reducing the range and depth of their investigation. The result would be higher audit fees, a reduced quality of service; and a reduction in the quality of the audit investigation and opinion and low rates of innovation on the audit product supplied. Our consideration and provisional views regarding such outcomes are set out in Section 7.

Principal-agent issues

8.19 Under our second theory of harm, we considered possible competition problems arising in the supply of audit services to FTSE 350 companies as a result of specific features of this market that have the effect of restricting or distorting competition between audit firms in respect of some aspects of the audit product or service, broadly under the heading of principal-agent issues.

8.20 We discuss these principal-agent issues in Section 5. In particular we investigate whether the demands of executive management differ from those of shareholders and whether audit firms direct their competitive efforts to satisfying management

rather than shareholder demand, which we consider would amount to a restriction or distortion of competition. We investigate whether the activity of the AC and other supervision mechanisms are sufficient to mitigate this.

8.21 We investigated whether auditors' relationships with management undermine the independence of auditors so that they do not apply sufficient scepticism when conducting audits (see paragraphs 7.122 to 7.149). This would have a detrimental effect on shareholders. We also investigated whether the audit reporting process is supplying the information that shareholders demand. For example, whether audit reports provide shareholders with the level of disclosure or judgement that they demand. See paragraphs 7.180 to 7.204.

Alternative explanations

8.22 The Big 4 firms submitted that the outcomes we observed were the result of a competitive process.[245] In summary:

(a) companies were expert and well-informed purchasers; they could tell if their auditor was underperforming, and could institute a tender at any time;

(b) companies had sufficient alternatives among the Big 4 firms in particular, though Mid Tier firms might be an option for some;

(c) ACs were highly professional and fully represented the interests of shareholders;

(d) auditors had strong incentives to maintain their reputations for competence and integrity, and so their interests were well-aligned with those of shareholders;

(e) there were some costs when a company switched auditor, but these should not be overstated;

(f) firms invested heavily in individual companies, and they had much to lose if they lost an engagement: this increased companies' bargaining power; and

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[245] This is a brief summary of multiple submissions from and hearings with the Big 4 firms, and is not comprehensive. We consider their submissions on specific issues throughout. However, see, for example, KPMG submission prior to provisional findings dated 21 December 2012; and PwC working papers submission dated 7 January 2013.

(g) low switching rates indicated that companies were content and were able to obtain competitive outcomes by bilateral negotiation.

8.23 We kept such alternative explanations of the outcomes we observed in Section 7 in mind throughout our investigation, and aimed to consider all the evidence we obtained in the round, in order to provisionally determine the cause of the outcomes that we observed. In doing this, the difficulties with some of our evidence (as noted earlier (see paragraph 2.12), meant that we had to weigh the evidence in its totality and apply our judgement accordingly.

9. Assessment of companies' willingness to switch and bargaining power (our first theory of harm)

Introduction

Theory of harm in more detail

9.1 We described our first theory of harm in paragraphs 8.12 to 8.18. In more detail, our theory is that there are features of the market that make companies reluctant to switch auditor. These features relate to information asymmetries, switching costs or barriers to entry and selection. These features prevent, restrict or distort competition by reducing companies' bargaining power with regard to their incumbent auditor or by limiting a company's choice of alternative auditor and thereby ultimately reducing rivalry between firms. We investigate whether this reluctance to switch combined with the market structure may produce the outcomes set out in Section 7, namely the prices (paragraphs 7.29 to 7.55), quality (paragraphs 7.95 to 7.121) and innovation and differentiation of offerings (paragraphs 7.150 to 7.179) that we observe.

9.2 We do not think that this theory substantially explains the outcomes we observed with regard to independence (paragraphs 7.122 to 7.149) and unmet demand (paragraphs 7.180 to 7.204). We think that these may be explained by our second

theory of harm (see Section 11). However, we consider that the two theories of harm are connected:

(a) The elements of the negotiation process, combined with barriers to entry and expansion in the market, discussed under this first theory of harm, may contribute to a lengthy relationships between audit firms and companies (illustrated by the low levels of auditor switching by FTSE 350 companies). This lack of movement in the market reinforces the likelihood of the principal-agent problems considered under our second theory of harm occurring.

(b) The incentives for auditors to invest in maintaining good relationships with executive management, discussed under our second theory of harm, may have the effect of raising the costs faced by companies of switching auditor and thereby contribute to the reluctance of management to switch auditor considered under this theory of harm.

9.3 We have assessed our first theory of harm from the perspective of the companies comprising our relevant market. We have taken this approach since, in this market, customers must purchase an audit and cannot switch to another product. Given that each audit is to some extent bespoke, firms tailor their offering for any one company so that prices are individually negotiated. This means that companies that cannot obtain a competitive offering on an individual basis could not be protected by a prevailing market price set to satisfy those companies that are able to obtain a competitive offering.[246]

The possibilities for competition

9.4 Under the Companies Act, auditors are appointed for a single year at a time, and typically a company negotiates the terms of the audit engagement with its auditor each year. At this point, in principle, the company may either decide to reappoint the

[246] Unlike, say, a retail market in which suppliers fix a single price for all shoppers, even though some may be more active than others in comparing rival offerings.

incumbent auditor or to initiate some competition for the engagement. The evidence is that usually the incumbent auditor will be reappointed without a competition for the engagement. When there is such competition, this typically takes the form of a tender, but there are other options available to companies.

9.5 Bargaining power may be exercised by companies both outside and within a tender process: while many of the underlying issues (namely the factors set out in paragraph 9.7) are the same, the balance in considerations often differs significantly between settings. Since the perceived infrequency of tenders was a reason for this reference, we consider the position outside tenders first.

Factors that affect a company's bargaining position and the structure of our assessment of this theory of harm

9.6 In general, we think that the strength of a company's bargaining position is underpinned by the strength of its outside option: ie how good (in terms of quality and price) its best alternative auditor is, and how easily a company can switch. If a company is perceived by its incumbent auditor to have poor alternatives or high switching costs, the incumbent firm might worsen its offering, judging that the company would be in a poor position to switch.

9.7 We have identified specific factors that we think will determine the extent of a company's bargaining power as it negotiates with its incumbent auditor, which we consider in turn in the remainder of this section. They are:

(a) the availability of alternative suppliers of its audit services (see paragraphs 9.9 to 9.57);

(b) the company's ability to appraise accurately the offering that it is receiving from its current auditor (see paragraphs 9.58 to 9.100);

(c) the ability to appraise the offering of the available alternative suppliers (see paragraphs 9.101 to 9.147);

(d) the costs to companies associated with search and switching (see paragraphs 9.149 to 9.176);

(e) the balance between the costs and gains from tendering and switching (see paragraphs 9.177 to 9.187); and

(f) the firms' incentives to retain engagements. These are also relevant to understanding the balance in bargaining power, since if firms suffer significant losses with a loss of a particular engagement, they may be expected to strive to retain the engagement, enhancing quality and lowering price (see paragraphs 9.188 to 9.217).

9.8 Following our assessment of those factors, we *(g)* examine bargaining power in the context of a tender process (paragraphs 9.219 to 9.256). Finally, *(h)* we set out our provisional views on the willingness to switch and bargaining power (paragraphs 9.257 to 9.264).

Availability of alternative suppliers

9.9 To assess whether companies have alternative suppliers of their audit, in this subsection we *(a)* identify the suppliers of audit services to large companies and the capabilities of these suppliers; and *(b)* set out the views of companies on the options available to them. We also consider *(c)* whether firms have incentives to take on new engagements. Alternative suppliers must be both able and willing to substitute for incumbents if they are to act as credible outside options.

The suppliers of audits to large companies

9.10 As an indicator of firms' capabilities to supply audits to large companies, we considered *(a)* their success to date in the relevant market (in terms of market and sector shares), and *(b)* their own appraisals of their capabilities.

Market and sector shares

9.11 We consider the evidence provided by the shares that firms have had of *(a)* FTSE 350 audit engagements overall, and *(b)* FTSE 350 audit engagements by sector to be indicative of the capabilities of firms and, given the importance of demonstrable expertise and experience in the selection of auditors,[247] of their credibility among FTSE 350 companies as an alternative supplier.

9.12 Details of firms' market shares are set out in Section 7 and Appendix 5. These show that the Big 4 firms have consistently had a share of over 95 per cent in the supply of FTSE 350 audits and over 99 per cent of FTSE 350 audit fees. The presence measured by fee of Mid Tier firms has been limited largely to the supply of audit services to real estate companies (see Section 7, Table 7.3), Mid Tier firms have 5 per cent of the financial services engagements and 6 per cent of mining engagements in the FTSE 350 (also see Section 7, Table 7.3).

9.13 These also show that whilst each of the Big 4 firms has a presence in the supply of FTSE 350 audit services in most sectors, there are many sectors where for one or two of these firms this has been relatively and consistently weak measured by their shares of engagements and fees. For example, over the last ten years EY has consistently had a relatively small share of FTSE 350 audit fees and engagements in the FTSE 350 banking, financial services, industrials, insurance, technology, telecommunications and utilities sectors. There are a few sectors where two firms have high shares, particularly shares of fees, namely basic materials, health care, oil & gas, consumer goods and consumer services (see Section 7, Table 7.3). We recognize that in some sectors this will be a reflection of the small number of engagements.

[247] Appendix 5, Tables 1–40.

9.14 Our first survey provided evidence on the importance of relevant experience, including sector experience, to FTSE 350 companies in the appointment of auditors.[248] (See paragraphs 9.52 and 9.52(c) for further discussion on this point.)

Firms' self-appraisals

9.15 In terms of firms' self appraisals of their capability and willingness to audit FTSE 350 companies:

(a) BDO considered that there were only about 35 or so of the largest UK-listed businesses that it would currently not be able to audit, such as the very largest financial services, oil, pharmaceutical and telecom companies. It was confident that it could audit the rest of the FTSE 350.[249]

(b) Deloitte said that there was no industry category in which it did not provide statutory auditor services to FTSE 350 companies. There was no technical or capability limitation which would prevent it from being active in any sector and it considered itself well placed to provide audit services to any FTSE 350 company regardless of size and sector.

(c) EY said that the firm offered and had the capability to offer statutory audit services in all FTSE 350 industry sectors although there were certain sectors where it did not currently have audit clients.

(d) GT said that 290 out of the FTSE 350 companies were comfortably within its scope and competency and there were approximately 60 companies with fees greater than £3 million, or with 75 per cent of turnover overseas for whose audits it was currently unlikely to bid.[250,251]

(e) KPMG said that it competed with a number of alternative providers to provide statutory audit services to clients in all sectors. In some sectors it had not been

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[248] Appendix 3, Table 13.
[249] Summary of hearing with BDO held on 13 February 2012, paragraph 7.
[250] Summary of hearing with GT held on 30 January 2012, paragraph 11.
[251] Summary of hearing with GT held on 4 October 2012 paragraph 18.

successful in winning the audits of any companies which were currently in the FTSE 350.

(f) Mazars said that it would be capable of auditing the large majority of FTSE 350 companies on a sole basis and all others, with the exception of one or two of the very largest companies, on a joint basis.[252]

(g) PKF told us that although its international network was not nearly as large (in staff numbers) as the Big 4 firms', it could provide audit services for FTSE 350 companies.[253]

(h) PwC said that it operated in all industry sectors. It did not believe there were any industry sectors where it was not able to provide a quality audit service. [✂][254]

9.16 As noted (paragraph 4.22), BDO and PKF have announced their intention to merge.

The views of companies on their options

9.17 We considered the observed behaviour of companies in the selection of auditors to be evidence of which firms the large companies in practice consider to be their possible auditors. We present the evidence provided by *(a)* the survey, *(b)* the case studies and *(c)* the public data set.

Survey results

9.18 The survey we commissioned did not specifically ask respondents how many options they thought they had when selecting an auditor. However, it asked which firms had been invited to tender where the surveyed FTSE 350 companies had gone to tender in the past five years.[255] Of the 44 companies that had tendered in this period, 40 were able to recall which firms had been invited to tender. The responses indicate

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[252] Summary of hearing with Mazars held on 13 February 2012, paragraph 13.
[253] Summary of hearing with PKF held on 25 June 2012, paragraph 10.
[254] PwC submission and response to the issues statement dated 12 January 2012.
[255] Forty-four (or 23 per cent) of the 195 FTSE 350 companies surveyed had tendered the engagement in the last five years, and 40 of these companies were able to provide information on the tender lists. See Appendix 3, Table 16, and paragraphs 50 & 52.

that: 62 per cent of FTSE 350 companies thought that they had a choice of at least four firms (including Big 4 and Mid Tier firms); 72 per cent of the tender lists included at least three of the Big 4 firms; and 42 per cent all four of the Big 4 firms.[256] Five out of the 40 invited just two Big 4 firms and a further six companies included one or two Big 4 firms as well as Mid Tier firms.[257]

9.19 We also asked questions aimed at understanding the factors that would limit choice. In particular, we asked companies why their tender lists had been limited to the firms they mentioned. About 20 per cent of FTSE 350 companies said that they had shortlists in order not to waste time and that the number of firms invited to tender was sufficient to ensure a competitive process, suggesting that these respondents, at least, had the option of inviting more firms to tender had they thought this necessary to ensure an effective competition. Around 70 per cent identified one or more of the following as limiting factors: the specialist knowledge of the audit firm, the regional and geographic coverage of the audit firm; and the size of the firm.[258]

9.20 We also asked respondents which firms their company would formally consider if their current statutory auditor were to cease trading. These results suggest that 78 per cent of FTSE 350 companies have a choice of at least four firms (including Mid Tier firms and their existing auditor).[259] Over 70 per cent of FTSE 350 companies said that they would formally consider only Big 4 firms if their current auditor ceased trading.[260] The most frequently mentioned reason for this, by both FDs and ACCs, was the size and geographic coverage of the Big 4 firms. Sector knowledge and

[256] Appendix 3, paragraph 52 and Table 18.
[257] Appendix 3, Table 18.
[258] Appendix 3, paragraph 55.
[259] Appendix 3, paragraph 82.
[260] Appendix 3, paragraphs 80.

experience, reputation, better calibre/trained staff and size and complexity of the audit were other frequently mentioned reasons.[261]

9.21 We asked the FDs and ACCs who said that their company would consider only Big 4 firms (if their current auditor ceased trading) whether there were factors that would limit choice between Big 4 firms. For FTSE 350 companies, 60 per cent of FDs and 65 per cent of ACCs said that there were no factors limiting choice between Big 4 firms. For those that did, the most frequently mentioned factor was the provision of non-audit services (NAS) (21 per cent of FDs and 15 per cent of ACCs) and some also mentioned conflict of interest/independence issues (4 per cent of FDs and 3 per cent of ACCs).[262]

9.22 Firms said that such issues (ie conflicts of interest and independence) could generally be resolved given some time, and that it would be in the interests of companies to facilitate this if they considered it necessary for a competitive tender.[263] Further, it would not be in a firm's interest to decide not to compete for an audit engagement in order to retain non-audit work that would create a conflict of interest as this would be damaging to its relationship with the company.[264,265]

9.23 These results suggest to us that the majority of FTSE 350 companies, if the audit engagement were tendered, would invite at least three of the Big 4 firms to bid. Some might also invite Mid Tier firms. There are factors that have the effect of limiting the choice of potential bidders, in particular, the experience and capabilities of the firms. These factors are, however, more likely to be reasons for not inviting Mid Tier firms than particular Big 4 firms. Nevertheless, the results suggest that for some companies choice between the Big 4 firms may be limited.

[261] Appendix 3, paragraphs 85–87.
[262] Appendix 3, paragraph 89–91.
[263] Deloitte response to the CC working paper 'Nature and strength of competition', paragraph 7.19.
[264] Deloitte response to the CC working paper 'Nature and strength of competition', paragraph 7.20 (c).
[265] KPMG response to the CC working paper 'Nature and strength of competition', Annex 1: paragraph 126.

Case studies

9.24 Review of the case study companies suggested that their FDs and ACCs saw their options principally among the Big 4 firms. Some companies (eg Companies E, I and J) considered Mid Tier firms as suitable suppliers, for other companies Mid Tier firms might be considered suitable although there were some doubts (Companies D and H). Some companies saw Mid Tier firms as unsuitable (Companies A, B, C, F and G).[266] We noted (see Appendix 11, paragraph 34) that at Company G (a bank) and Company C (an insurance company), interviewees expressed a view that one of the Big 4 firms was weaker than its competitors. If this were a representative view, it would mean that the choice available to companies in these sectors was different to other companies in the FTSE 350, though we note that the ACC of Company C still thought that all of the Big 4 firms could compete for its audit. We consider the barriers to expansion and selection for Mid Tier firms in Section 10.

9.25 In terms of possible alternative suppliers we noted that the option of shared audit (by which one firm might audit a geographic area or subsidiary, and report to another firm conducting the Group audit) was not considered attractive. At Company A, such a shared audit had been in place at one point, and was considered in part responsible for control issues.[267] Likewise, at Company G, there was a shared audit, but this was considered 'an added complication, rather than an added assurance'.[268]

The public data set

9.26 Observing those firms to which companies actually switch indicates which firms are considered by companies to be suitable alternative suppliers. From 2001 to 2010, we identified 83 occasions (excluding switches away from Arthur Andersen and instances where a company changed to or from a joint audit) in the public data set

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[266] Appendix 2 at Case Study C the reasons given by the FD and ACC for not using/considering a Mid Tier firm differed.
[267] Appendix 2, Case Study A, paragraphs 32 & 59.
[268] Appendix 2, Case Study A, paragraph 15.

when a FTSE 350 company switched auditor: approximately 82 per cent of these switches were from one Big 4 firm to another, and 13 per cent were from a Mid Tier firm to a Big 4 firm. There are three examples of a company switching from a Big 4 firm to a Mid Tier firm, and one of a company switching from one Mid Tier firm to another. For FTSE 350 companies the observed switching has overwhelmingly been either between Big 4 firms or to a Big 4 firm.[269]

9.27 We consider that overall these results suggest that: for many FTSE 350 companies a Mid Tier firm is unlikely to be considered to be a credible alternative supplier of audit services; that for the majority of FTSE 350 companies at least three Big 4 firms (including their existing auditor) would be credible bidders for the audit engagement. Nevertheless, given the importance of relevant experience to companies in the selection of auditors, in many sectors at least one firm may be a less credible alternative, and there appear to be companies for which the choice of auditor may be restricted to two or three suppliers.

Incentives of alternative firms to take on new engagements

9.28 In addition to capability, potential suppliers must have incentives to take on a FTSE 350 engagement, if they are to be good outside options for any given company (and so increase that company's bargaining power when it negotiates with its incumbent auditor). We consider that a firm's incentives may differ between engagements and by firm since they depend on: the expected incremental profit to the firm from gaining the engagement; and the opportunity an engagement may give the firm to maintain, build and demonstrate sector and other expertise and experience, and thereby increase its chance of winning other audit engagements.

[269] Appendix 5, paragraphs 49–51, Table 7.

9.29 We consider that the strength of these incentives to take on an engagement is indicated by the following factors, which we consider in turn:

(a) the size and profitability of audit engagements;

(b) the efforts made by firms to gain new clients (which are also relevant to companies' ability to appraise rival firms, see paragraphs 9.128 to 9.136);

(c) the competitive value of demonstrable experience and expertise which securing a FTSE 350 appointment brings; and

(d) firms' willingness to participate in tenders when invited to do so.

Profitability of audit engagements

9.30 The greater the fees generated by, and the profitability of an engagement, the more attractive it is to a potential auditor (and so the greater the likely competition for that engagement).

9.31 In 2010 the published audit fees (in March 2005 prices) for FTSE 350 companies were in the range of £0.014 million to £44.5 million. The median fee was £0.58 million. For FTSE 100 companies the median fee was £2.8 million.[270]

9.32 Using data provided by parties on their individual audit engagements, we created a database of the audit fees and the level of staff resources used in each year's audit; by combining this data with information on employment costs we are able to estimate the gross profit margin generated by individual engagements. This gross profit margin is stated after the costs of staff and partners[271] who work directly on engagements and any costs directly incurred in delivering the audit.

[270] Appendix 5, Table 3, and Annex 1, Table 41.

[271] We included partner time at twice the value of a director's time. We tested the sensitivity of our findings on the relative level of profitability in each of the market segments we considered, ie FTSE 100/FTSE 250 and other engagements, by increasing this ratio to four times director cost and observed similar trends.

9.33 The data indicates that statutory audit in the reference market is profitable at the gross margin level, but that the gross profit achieved by a firm from a given audit engagement may vary considerably, both with respect to other engagements and over time (see Section 7 on outcomes and Appendix 14).

9.34 As noted in Section 7, we found some indication that engagements were on average less profitable in their first years, with profits increasing after initial engagement, and with the average level of profitability levelling off after five years. However, even in the early years, revenue from engagements generally covers direct costs (including salary costs for partners).[272] Given the current low level of switching, firms may on average expect to retain engagements for relatively long periods, hence the prospect of lower returns in the initial years of an engagement is unlikely to affect their incentives to bid for work. We noted that firms did not undertake internal rate of return (IRR) calculations for their audit engagements or calculate the payback period for recovery of costs incurred in tenders: this suggests that these upfront costs are also unlikely to affect incentives to bid for work.

9.35 For the reasons discussed in paragraphs 7.69 to 7.70 we were not able to assess economic profitability in this market. However we consider FTSE 350 audits to be an attractive business proposition for firms. A comparison of the profit margins of the individual service lines indicates that Assurance service lines achieved comparable gross margins to other service lines across the firms. Given the need to purchase a statutory audit each year and the low levels of switching, we consider that the provision of audit services provides a stable and predictable revenue stream for firms. Our analysis suggests that net margins, after allocations of costs that are incurred by the Assurance service line, are positive (see Appendix 14, Annex 1,

[272] We were unable to assess the adequacy of the contribution that engagements made on average to fixed costs in the first years of engagement.

Table 6) additional engagements may therefore be expected to generate a positive contribution to the fixed cost base of the firm and partnership profits.

9.36 As a result we consider that firms have good incentives to compete for audit engagements if the opportunity arises.

Efforts made by firms to gain new audit engagements

9.37 The extent of efforts made by firms to win FTSE 350 engagements may show how attractive those engagements are to firms. This in turn indicates firms' willingness to take on an engagement: all else equal, the greater the willingness of firms to take on an engagement the more credible the threat to the incumbent auditor that the client may switch auditor.

9.38 All the Big 4 firms have programmes for targeting new clients[273] including FTSE 350 companies.[274] The firms identify particular companies they want to target and each FTSE 350 company may be allocated an individual partner to lead and coordinate efforts for building a relationship. Partners' individual lists of target clients may be included in their goals and objectives against which their performance is appraised and remuneration decided. The Big 4 firms select companies for targeting on a number of bases including either establishing or increasing a presence in certain industry sectors, those companies with which they had strong existing non-audit relationships, or where specific circumstances were identified that would make a change in auditor likely. Some firms made reference to their international network identifying target clients or sectors.

[273] See Appendix 25; KPMG response dated 19 October 2012 to the CC working paper 'Nature and strength of competition', Annex 2; PwC response dated 29 October 2012 to the CC working paper 'Nature and strength of competition', paragraph 36 e) i) and initial submission, paragraphs 4.29–4.39.
[274] Appendix 16.

9.39 The Mid Tier firms target particular FTSE 350 clients where they believe they have existing sector expertise and Mid Tier firms have adopted a similar partner remuneration structure to the Big 4 firms (ie that some partners are incentivized to win new work from specific clients.[275]

9.40 Partners may draw up plans for targeting each client and maintain records tracking their progress. Relationships may be built through introductions and periodic meetings between a partner and senior management at a potential client, or it may involve undertaking a number of non-audit engagements. The benefits of such an approach are twofold: the first is making the firm, and potentially an audit team, known to the target company and the second is that the firm is able to develop its own knowledge of the client's operations and business risks and use this in any subsequent tender.

9.41 BDO said it could do more to target the CFOs, CEOs and ACCs. BDO held activities such as running a non-executive network at which it regularly spoke. BDO's partners also man-marked non-executive directors. This activity was designed to target a particular tier of non-executives to extend BDO's influence and to understand their priorities, as well as increase BDO's chances of being asked to participate in an activity with them.[276]

9.42 GT considered that an average of [✂] hours a year felt about right for the amount of time for its audit partners to invest in business development with the FTSE 350. If there was a significant increase in switching, GT would significantly increase the numbers of hours spent in marketing activity. GT's current approach to the FTSE 350

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[275] Appendix 16.
[276] BDO hearing summary, paragraphs 55 & 56.

audit market was based on its assessment of what was realistic, ie building sustainable relationships with a number of companies.[277]

9.43 Our survey found that among FDs for FTSE 350 companies 88 per cent have been approached in the last five years by a rival firm offering to audit the company. The figure for ACCs is 53 per cent. These approaches are predominantly by Big 4 firms.[278]

9.44 The case studies provide further evidence that building relationships, either informally or through other work, with potential audit clients is an important element of the firms' strategies as they seek to win engagements: the ACC at Company D received regular marketing material from the Big 4 firms,[279] the ACC at Company E had accepted non-executive forum invitations from Big 4 firms[280] and the AEP (from a Mid Tier firm) of Company J had run training courses for companies in the sector which he thought was why his firm was invited to tender.[281]

9.45 We consider that the evidence indicates that the Big 4 audit firms make considerable efforts to gain FTSE 350 audit engagements by targeting the clients of rival audit firms and seeking to build relationships with these companies. The evidence suggests that the Mid Tier firms are less engaged in such activity.

Willingness to participate in tenders when invited to do so

9.46 If firms generally participate in tenders when given the opportunity, and do so actively, the stronger the potential competition for engagements and so the more credible the threat that a company will tender its audit.

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[277] GT hearing summary, paragraph 11.
[278] Appendix 3, paragraphs 76–78.
[279] See Appendix 2, Case Study D, paragraph 68.
[280] See Appendix 2, Case Study E, paragraph 55.
[281] See Appendix 2, Case Study J, paragraph 70.

9.47 Our analysis indicates that the Big 4 firms generally accept invitations to participate in tenders for audit engagements. In rare circumstances firms may decide not to accept an invitation to tender if they believe chances of winning are low or the audit risk is too high.[282] In terms of Mid Tier firms: as noted, GT said that it was unlikely to bid for engagements where the fee exceeded £3 million or 75 per cent of a company's turnover was overseas. BDO and Mazars indicated that of the FTSE 350, there were some 35 companies for which they considered themselves unable to provide an audit service on a sole basis (see paragraph 9.15). See further Section 11 and Appendix 16 regarding firms' acceptance criteria, by which they establish if they would be willing to audit a company.

9.48 Our survey results suggested that firms may be prevented from bidding for audit engagements given conflicts of interest or independence issues. We have been told that often such situations are manageable given some notice, for example, where a firm is conflicted by its non-audit work for a prospective audit client.[283] We consider that where this is possible it will also be in the company's interests to assist to ensure competitive tenders. Firms have also said that it would be damaging to a firm's relationship with a client to decline to tender on whatever grounds including a wish to continue providing NAS (see paragraph 9.22 above). This suggests that the potential loss of NAS fees would not be a factor for firms in a decision on whether to participate in a tender (although loss of a firm as a supplier of NAS may result in a company not inviting a particular firm to tender for audit work). In certain circumstances, a company may not wish to be audited by a firm that also audits a close rival. In our first survey 2 per cent of FTSE 350 FDs and 8 per cent of FTSE

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[282] Appendix 23, paragraphs 41–48.
[283] Deloitte response to the CC working paper 'Nature and strength of competition', paragraph 7.18.

350 ACCs identified, as a factor limiting choice between the Big 4 firms, the fact that certain auditors provide audit services to competitors.[284]

9.49 Firms also said that they have a strong incentive to participate actively in tenders as a poor performance would be damaging to the firm's reputation with the client and with individuals who may have positions in other FTSE 350 companies that are existing or potential clients. In addition, even if a firm fails to win the tender a good performance is an opportunity to develop its relationship with a client with future prospects in mind.

9.50 Overall we consider that if invited to tender, generally the Big 4 firms will accept the invitation to do so and will have strong incentives to perform well in the tender.

The competitive value of experience and expertise in the appointment process

9.51 The more valuable any given engagement is to a firm (in terms other than direct profits, which we considered above), the greater its incentives to win an engagement (and so the greater the competitive constraint on the incumbent auditor).

9.52 The firms emphasized the importance of sector experience in winning engagements. Companies wish their auditor to have sector expertise, which gives firms with this experience a competitive advantage. For example, we noted that:

(a) In the tenders we examined, companies always required details of the experience and credentials of the team that will carry out the audit. Particular regard is given to partners and managers, but information on the experience and business and industry knowledge of other team members is usually requested. Tender

[284] Appendix 3, Table 20.

proposals frequently give details of the firm's relevant experience including lists of well-known clients and clients in the relevant industry.[285]

(b) In feedback given by companies to firms that have participated in a tender process, the most frequently mentioned reason for a firm not being appointed to the engagement has been its lack of experience or competition from a firm with more experience.[286]

(c) Our first survey provided evidence of the importance of relevant experience in the selection process. For FTSE 350 FDs and ACCs the factor most frequently identified as important in the appointment or reappointment of an auditor is the experience and knowledge of the AEP followed by good working relationships with the audit team, the experience and knowledge of the team and the reputation of the audit firm with investors etc.[287]

9.53 We found that while all Big 4 firms had experience of audits in most sectors, there are many sectors where one or two firms have a relatively small share of the engagements (see paragraph 9.13). Sector experience might be gained with non-FTSE-350 clients. This suggests to us that the strategic value of winning a particular engagement might differ between firms. KPMG said, for example, that audit relationships were likely to be valued differently by different audit firms depending on the benefits that an audit was likely to bring in terms of learning by doing, reputation and other factors.[288,289]

9.54 We therefore consider that the benefits to a firm of winning a new engagement are likely to be greater than the profits earned on the engagement, if winning the engagement by adding to the experience of the firm will increase its chances of

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[285] Appendix 23, paragraphs 33, 73 & 76.
[286] Appendix 24, paragraph 53.
[287] Appendix 3, Table 13.
[288] KPMG's submission in response to the CC's issues statement, paragraph 347.
[289] Appendix 22, Annex 1, paragraph 31.

winning other clients with similar demand (this assumes, and our evidence indicates, that those further engagements will be profitable). We consider the effect of this 'virtuous circle' as a barrier to expansion further in Section 10.

Provisional view on the availability of alternatives

9.55 The Big 4 firms considered themselves capable of auditing any company in the FTSE 350 (though they might have reasons not to seek the audit of a particular company, for conflicts, risk or independence reasons). BDO and Mazars considered themselves capable of auditing all but approximately 35 companies in the FTSE 350 on a sole audit basis, and GT all but approximately 60 companies. We note that firms outside the Big 4 have had very limited success in obtaining FTSE 350 audit clients to date.

9.56 Whilst the majority of FTSE 350 companies appear to have a choice of at least three Big 4 firms (including the incumbent auditor), the results suggest that in many sectors one or more firms may be at a competitive disadvantage given the importance to companies of relevant experience, knowledge and expertise in the selection of auditors. Nevertheless, we think that the Big 4 firms have strong incentives to compete to win engagements when the opportunities arise demonstrated by the profitability of FTSE 350 engagements and the efforts that firms make to win engagements. We therefore consider that generally a FTSE 350 company and its incumbent auditor can expect strong competition for the audit engagement if the company were to decide to go to tender.

9.57 However, the availability of alternatives is only relevant to the extent of bargaining power if customers can both compare the current supplier with those alternatives, and switch to one of those alternatives. We consider one element of comparison, the companies' appraisal of the incumbent auditor in the next subsection.

Companies' appraisal of their incumbent auditor

9.58 We considered whether companies (mainly their FDs and ACCs) can accurately appraise the quality of the audit product and service provided and the fees charged by their incumbent. Before they might even contemplate a switch in auditor, they would need to be able to form a view of the competitiveness of the service that they are receiving. We do not think such a view can be formed in isolation: it must necessarily be a comparison with other options (and we consider companies' ability to appraise potential auditors in the next subsection: see paragraphs 9.100 to 9.147).

9.59 Therefore to understand how and the extent to which FDs and ACCs can appraise incumbent auditors, we consider: *(a)* the qualifications of those principally making the buying decision (namely FDs and ACCs); and *(b)* their resources and the information available to them regarding their current auditor when they decide to reappoint. We consider their incentives (and the potential of those incentives to prevent or distort competition), under our second theory of harm in Section 11).

The qualification of FDs and ACCs

FDs

9.60 While there is no requirement that FDs are qualified accountants, they often are, and in our survey (ie including FTSE 350, private and other listed company respondents),[290] we found that two-thirds (66 per cent) of the FDs/CFOs surveyed had previously worked for one of the Big 4 firms (20 per cent had worked for Deloitte; 11 per cent for EY; 15 per cent for KPMG; and 28 per cent for PwC). This proportion was similar for FDs/CFOs of FTSE 350 companies.[291]

9.61 We interviewed ten CFO/FD equivalents in our case studies, of whom seven had trained at a Big 4 firm, and a further two who having trained elsewhere then went on

[290] Appendix 3, paragraph 24.
[291] Appendix 3, paragraph 24.

to work for a Big 4 firm. Most had practised as an auditor at a Big 4 firm, although one was a tax practitioner and another (who had joined after qualifying) worked on management consultancy. One CFO/FD equivalent had previously been an audit partner at a Big 4 firm.[292] The one FD who had never worked for a Big 4 firm had trained as a management accountant (CIMA) in industry (rather than in public practice).[293]

ACCs

9.62 With regard to ACs, the FRC's Guidance on ACs (the FRC Guidance) requires that at least one member of the AC has recent and relevant financial experience.[294] The FRC Guidance does not specify that this person should be the ACC.

9.63 Around 60 per cent of the ACCs we surveyed had previously worked for one of the Big 4 audit firms (15 per cent for Deloitte; 18 per cent for EY; 16 per cent for KPMG; and 20 per cent had worked for PwC). Again the proportion is similar for ACCs for FTSE 350 companies.[295]

9.64 In our follow-up survey of FTSE 350 ACCs, we found that 39 per cent of the ACCs in that survey were on the AC of multiple[296] FTSE 350 companies, mostly in the role of ACC. 6 per cent were also a member of the board at another FTSE 350 company, but not on the AC. Almost all of the respondents were professionally qualified accountants (89 per cent) and had professional experience directly relevant to their

[292] Appendix 26, paragraph 34.
[293] Appendix 26, paragraph 36.
[294] www.frc.org.uk/getattachment/6ec23196-28ee-406e-8f56-89ab9d1dc06d/Guidance-on-Audit-Committees-September-2012.aspx, paragraph 2.3.
[295] Appendix 3, paragraph 24.
[296] Generally two or three, but for some up to four FTSE 350 companies.

position as ACC for a FTSE 350 company.[297] 82 per cent of respondents had been active in their current role of ACC for three years or longer.[298]

9.65 During our case studies, we interviewed ten ACCs, of whom seven had trained at a Big 4 firm, and three had subsequently become audit partners at a Big 4 firm. Of the three ACCs who had not trained at a Big 4 firm two subsequently went on to work in audit at a Big 4 firm for a time after qualifying. The one ACC who had never worked for a Big 4 firm (either as a trainee or after qualification), had trained as a management accountant (CIMA) in industry (rather than in private practice).[299]

9.66 We consider that this evidence shows that FDs and ACCs for FTSE 350 companies are typically well-qualified and experienced individuals.

Role, resources, and information of FDs and ACs

9.67 In order to assess if these individuals were in a position to form an accurate opinion of the audit product and service provided by the incumbent auditor, we consider the role of *(a)* FDs (paragraphs 9.68 to 9.70 and *(b)* ACs (paragraphs 9.71 to 9.85) and the resources available to them. We then *(c)* consider the information available to both FDs and ACCs through the appraisals that companies carry out on their auditor (see paragraphs 9.87 to 9.98).

FDs

9.68 FDs are responsible for producing the company's accounts. They manage the reporting of the company and are respondents to the auditor in the conduct of the audit. Typically the FD will take the lead in the negotiation with the AEP on the terms of engagement and will be involved in discussion of the audit scope and plan at the

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[297] Of particular note was that of the ACCs surveyed 28 per cent had previously been audit partners and 54 per cent had previously been FD/CFOs of a FTSE 350 company.
[298] See responses to the CC follow-up survey of FTSE 350 ACCs, questions A1 to A8.
[299] Appendix 26, paragraph 60.

beginning of the audit cycle. We found that in general the FD's role was to discuss areas of judgement regarding accounting treatment with the auditors and to discuss any issues that had arisen in the course of the audit, prior to meetings with the AC. Audit issues were resolved at the appropriate level of management. For example, at Company C, if an issue arose in an overseas business, the first stage would be for the local audit team to discuss it and seek to resolve it with the local management.[300] Any significant issues were escalated to regional and then Group teams. This would occur where something was not resolved satisfactorily, but more often than not the issues that were flagged to the Group auditors were where there was an uncertainty that needed a considered judgement, which accordingly should be discussed with the AC. The FD and AEP would typically attend AC meetings, FDs wanted audit issues to be resolved in advance of these meetings. Depending on the company, there might be far more frequent contact. The FD at Company I for example, said he had very frequent contact with the senior AEP during the year, approximately every two weeks. This was most frequent during the interim and final audit processes.[301]

9.69 All the FDs we spoke to in our case studies in effect had a 'no surprises' policy with their auditor, so that any audit issues would be escalated up through a hierarchy and discussed with the FD before presentation to the AC.[302] Since the auditors are in effect scrutinizing the data produced and judgements reached by the financial function of each company, the FD is accountable for the work that the auditor is scrutinizing. It is his or her staff that answer the questions that the auditor asks, and produce the documents and data requested in the first instance.

9.70 In this role FDs will be in a position to draw upon the resources of the financial reporting functions within the company.

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[300] Appendix 2, Case Study C, paragraph 90.
[301] Appendix 2, Case Study I, paragraph 5.
[302] The larger and complex the company, the more elaborate the issue resolution hierarchy: see, for example, Appendix 2, Case Study G, paragraph 16.

ACCs and ACs

9.71 With regard to ACCs and ACs we considered: *(a)* their role in principle and practice; and then *(b)* the resources (in terms of their own time and external assistance) available to them in completing their task.

- *Role in principle and practice*

9.72 The AC is responsible for overseeing the appointment and reappointment of external auditors, monitoring the effectiveness of the external audit process and reviewing independence and objectivity of external auditors (with particular regard to external auditors supplying NAS). See Appendix 8, paragraphs 2.41 and 2.42.

9.73 The FRC Guidance sees the AC as part of the corporate governance framework intended to ensure that the interests of shareholders are protected in relation to financial reporting and internal control,[303] particularly in supporting the independence of external audit. Many of the core functions of ACs specified in the FRC Guidance are expressed in terms of 'oversight', assessment' and 'review' of a particular function. It is not the duty of ACs to carry out functions that properly belong to others, such as the company's management in the preparation of the financial statements or the auditors in the planning or conducting of audits.[304] However, the high-level oversight function may lead to detailed work, and the AC must intervene if there are signs that something may be seriously amiss.[305]

9.74 Under the FRC Guidance, ACs have wide-ranging, time-consuming and sometimes intensive work to do and companies need to make the necessary resources available.[306] The AC should have access to the services of the company secretariat

[303] FRC, Guidance on Audit Committees, paragraph 1.3.
[304] Ibid, paragraph 1.8.
[305] Ibid, paragraph 1.9.
[306] Ibid, paragraph 1.10.

on all AC matters.[307] The board should make funds available to the AC to enable it to take independent legal, accounting or other advice when the AC reasonably believes it necessary to do so.[308]

9.75 ACCs were involved in discussing and approving the audit plan (although they saw it as the responsibility of the auditor to draw up the plan). In our case studies, there were typically four AC meetings each year (though they were more frequent in larger companies), and the ACC would meet the AEP in advance of each meeting. These meetings would involve discussion of the auditors' work undertaken on material areas of audit judgement and risk. There would be a part of the meeting where only the AEP was present. ACCs received reports of the auditors' work.[309] See also paragraphs 11.38 and 11.39 regarding the case study ACCs' views of their role.

9.76 The results of our follow-up survey indicate that FTSE 350 ACCs consider themselves to have a considerable role in ensuring the quality of external financial reporting and auditing, concerning themselves with the accounting policies applied by the company and auditor, the firm's audit plan and methodology (and how well it is executed), the extent of company disclosures and how audit issues have been resolved, among other things. A sizable minority indicated that they were less involved in the detail of the audit work (such as sample sizes or review within the audit firm).[310]

- *Resources*

9.77 According to our follow-up survey of FTSE 350 ACCs, about 80 per cent of respondents indicated that they spent two days a month or less in their role as ACC,

[307] Ibid, paragraph 2.12.
[308] Ibid, paragraph 2.14.
[309] By way of examples, see Appendix 2, Case Study A, paragraphs 50, 51 & 52; Case Study B, paragraphs 37 & 38; Case Study C, paragraphs 48, 49 & 51; Case Study D, paragraphs 48, 50, 53 & 54; Case Study E, paragraphs 39 & 41; Case Study F, paragraphs 37 & 38; Case Study G, paragraphs 52, 53, 54, 56 & 58; Case Study H, paragraphs 53, 54, 55 & 60; Case Study I, paragraphs 37, 38 & 39; and Case Study J, paragraph 34.
[310] See Appendix 4, responses to questions B1 to B3.

even though there was substantial variation in this number. With the exception of a single respondent that indicated spending eight days a month in this role, the upper limit of time spent as ACC was five days a month.[311]

9.78 About half of respondents indicated that in the past three to five years the AC had requested supplementary information, beyond that which one would expect to receive as part of a normal AC agenda. Such supplementary information was typically requested on a yearly basis and covered areas such as accounting standards, a deeper review of specific topics or areas, and benchmarking the company's internal procedures to those of its peers. Respondents that indicated they had not requested additional information did not do so mostly as it was not necessary or because they could obtain such information from internal sources.[312]

9.79 About one-quarter of the ACCs surveyed indicated they had engaged resources independent of the company and its external auditors to obtain advice on an external audit or financial reporting issues. In general these respondents indicated they had done so around once a year or less and that they were mainly looking for a second opinion, either to obtain additional assurance, or because there were doubts about the information that had been provided. Another common reason for engaging additional resources was the necessity of additional expertise in areas other than statutory audit, such as valuation or legal matters. The majority of ACCs that indicated they had not engaged additional independent resources had not done so as it had not been necessary.[313]

9.80 We asked our case study ACCs about the conduct of their role. The amount of time spent varied depending on the size of the company and if there were particular

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[311] See Appendix 4, paragraphs 20 & 21.
[312] See Appendix 4, paragraphs 22 & 23.
[313] See Appendix 4, questions C8 to C12.

issues that required their attention (for instance, the Company G ACC reckoned he spent perhaps a day a week on its audit[314]), and the state of the company (the Company A ACC spent more time than he had anticipated due to control issues within the company[315]).

9.81 ACCs were typically on fixed salaries, unrelated to the number of hours they spent on audit issues. In 2010 average non-executive director remuneration for FTSE 100 companies was £59,000, with ACC's receiving on average an extra £15,000.[316]

9.82 PwC identified seven examples of ACCs calling for external resources (where either PwC was the auditor or it had been called on to provide advice with respect to an audit conducted by another firm) and PwC said that this was likely to happen:

> in particularly complex or contentious areas where ACCs may seek the additional comfort of a second opinion from another audit firm on an issue or ask a different firm of specialists, eg, a law firm, to advise on an aspect related to the accounts or audit or where we are sometimes requested to provide advice or assistance by ACCs of companies which are not our audit clients. This is more often commissioned by the company, sometimes after discussion with the ACC, rather than directly by the ACC and we would not necessarily know the extent of ACC influence.

9.83 KPMG also identified seven examples of ACs calling for external resources, and noted that it would not necessarily have full visibility of all instances where work was commissioned by, or on the instruction of, the AC.

[314] Appendix 2, Case Study G, paragraph 51.
[315] Appendix 2, Case Study A, paragraph 55.
[316] www.incomesdata.co.uk/news/press-releases/FTSE_100_NEDs_2010.pdf.

9.84 Deloitte said that third party firms or professionals might be commissioned by a company to advise on issues relating to external audit arising during the normal course of process. Examples could include specialist advice on provisions required in companies' accounts for taxation, litigation or environmental risks or specialist advice on property or other asset valuations. These professionals would be typically hired by the company CFO or finance function and not by a non-executive director such as the ACC. Although it is possible that the ACC could have been the catalyst behind the request for this external advice. Further, it was aware that ACCs might commission other firms to perform work from other suppliers on other matters in exceptional circumstances. For example, a separate firm might be commissioned to investigate circumstances around a fraud.

- *Provisional view regarding role and resources of FDs and ACCs*

9.85 We consider that this evidence (regarding their role and resources) indicates that the role of FDs in the audit process requires a detailed knowledge of the work undertaken by the existing auditor. In particular, FDs typically take the lead in the negotiation of the terms of the engagement, are involved in the agreement of work plans, and will discuss issues arising with the auditor prior to meetings with the AC. FDs will be able to draw upon the resources of the finance team.

9.86 In contrast the ACC whilst involved in many of the same matters has an oversight role. ACCs generally considered themselves to have the resources which they considered necessary to carry out their responsibilities.

Information available to FDs and ACCs

9.87 Having considered their roles individually, we consider the information available to both FDs and ACs on which they might base an assessment of the performance of the incumbent auditor.

9.88 We consider that in carrying out their responsibilities both FDs and ACCs will acquire considerable information on the audit product and service provided by the auditor. Based primarily on the results of the case studies it appeared to us that there was significant overlap in the information that the FD and the audit team had regarding the audit process, methodology and fees. The FD is likely to be better informed than the auditor on the fundamentals and facts of a company (an auditor has to be selective in its scrutiny and testing of financial data and does not know what it has not found),[317] and the auditor knows better than the FD the detailed work it has undertaken in carrying out the audit. However, the asymmetry of information (between FD and auditor) will vary with the time available and the effort made by the FD to understand what the audit team did, for example on the extent of substantive testing. We understand that FDs do not have access to the detailed audit files compiled by firms to record their activities.

9.89 In the follow-up survey we asked ACCs for their views on the degree of confidence they have in their ability to assess various aspects of the audit.[318] Generally more than 90 per cent of the respondents were either 'very confident' or 'quite confident' in their ability to make an assessment of the listed aspects, such as the appropriateness and sufficiency of the expertise and experience of the audit team or the robustness and perceptiveness of auditors in handling key judgements on accounting policies. Their responses suggest that the detailed work of the auditor may be less visible to ACCs and ACs than other aspects of the audit. These detailed areas include sample sizes, internal reviews and tests, and staffing questions such as the quality of more junior staff and the overseas audit teams.[319]

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[317] For example, Appendix 2, Case Study E, paragraph 33; Appendix 2, Case Study C, paragraph 39.
[318] Details on these aspects and the ACCs' responses are contained in Appendix 4.
[319] See Appendix 4, paragraph 25.

9.90 FDs and ACCs may obtain further information from the auditor reviews that companies typically carry out following each reporting round. We consider the information these provide with regard to quality and fee.

- *Quality*

9.91 With regard to quality, in our first survey, we found that most companies regularly carry out reviews (internal or with their auditors) of audit quality and service based, in general, on staff opinions drawn from their interaction with auditors. 91 per cent of FTSE 350 companies carry this out annually and 99 per cent at least every five years.[320]

9.92 These results are consistent with the findings of the case studies. All case study companies reviewed the auditors' performance before reappointment in some way. There was a mix of formal review processes (for example, a written questionnaire) and informal processes (for example, oral feedback).[321]

9.93 Firms said that annual reviews were detailed processes involving a significant number of personnel who had interacted with the auditor allowing for a detailed appraisal of the existing auditor's performance.[322]

9.94 For example, KPMG said that 74 per cent of its FTSE 100 audit clients had extensive review procedures in place with the audit partner during which their client reviewed the terms of audit including fees and the scope. Governance and price were found to be the most frequent drivers for these reviews, and service and mergers and acquisitions the next most frequent.[323] KPMG also provided evidence in relation to surveys, reviews and benchmarking exercises carried out by its clients. Whilst the

[320] Appendix 3, Table 14.
[321] Examples included: Appendix 2, Case Study B, paragraphs 16 & 18; Case Study C, paragraphs 25 & 26; Case Study E, paragraphs 18 & 19; Case Study F, paragraph 49; and Case Study G, paragraphs 17, 18 & 19.
[322] For example, Deloitte response to the CC working paper 'Nature and strength of competition', paragraph 5.2.
[323] KPMG response to the CC working paper 'Nature and strength of competition', paragraphs 3.2.2–3.2.5.

scope of these activities varied, many were wider ranging covering areas such as: fees; the audit team; technical expertise and support; relationships and communication; audit approach, plan and scope; quality of judgements, independence and objectivity; audit firm and internal quality controls; and interaction with Internal Audit.[324]

- *Fees*

9.95 With regard to fee, from our survey, we found that 93 per cent of companies negotiate their audit fee every year, and all companies negotiate their fee at least every five years.[325]

9.96 Our case studies suggest that companies also requested granular fee details to assess the competitiveness of the audit fee. For example, Company B received a fee per subsidiary.[326] Company G negotiated a fee on a business-by-business basis.[327] Company I negotiated fee on a subsidiary level and requested the hourly rates charged for each grade and the number of hours taken on the audit.[328]

9.97 Our assessment of submissions made by firms and case studies suggests that when an auditor is reappointed, the scope of the audit and fees in the previous year is the starting point for the vast majority of discussions. The survey results suggest that around 60 per cent of FTSE 350 companies would require firms to make formal proposals or presentations before reappointment at least every five years.[329]

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[324] KPMG response to the CC working paper 'Nature and strength of competition', Annex 2, paragraphs 3.3.3–3.3.45.
[325] Table 14.
[326] Appendix 2, Case Study B, paragraph 25.
[327] Appendix 2, Case Study G, paragraph 30.
[328] Appendix 2, Case Study I, paragraph 26 & 27.
[329] Appendix 3, paragraph 42.

9.98 We consider that the evidence indicates that this process of negotiating audit fees will give the FD, in particular, a detailed understanding of the components of the audit fee although based on the fee in the previous year.

Provisional view on companies' ability to appraise their incumbent auditor

9.99 Our provisional view in light of each of the above is that for some aspects of the audit process FTSE 350 companies (in particular their FDs and ACs) have the expertise, resources and information to appraise their current auditor to a certain extent (see paragraphs 9.88, 9.89, 9.91 and 9.98). We note that the information asymmetry between FDs and auditors may vary and the detailed work of the audit team such as sample sizes and internal reviews and tests may be less visible to ACs.

9.100 However, in the context of our assessment of bargaining power, it is important to note that the appraisal of the incumbent must be comparative, ie exercised in combination with knowledge of available alternatives and ability to switch, and we turn to those issues next.

Companies' ability to appraise alternative suppliers outside the tender process

9.101 In this subsection, we assess how effectively companies can appraise alternative suppliers' offerings. We:

(a) consider the evidence on the frequency with which companies attempt to compare the offering of the incumbent auditor with that of other firms and the extent of these comparisons (paragraphs 9.102 to 9.110).

(b) consider other sources and quality of the information available to FDs and ACCs (paragraphs 9.111 to 9.138); and

(c) set out our provisional views (paragraphs 9.139 to 9.147).

Frequency and extent of benchmarking

9.102 The term 'benchmarking' has been used by firms to describe comparative exercises by which companies attempt to compare the offering of the incumbent auditor with that of rival firms. Since it is a direct comparison, it is relevant to both companies' appraisals of their own and rival auditors. Benchmarking exercises are said to be based on comparisons with companies in the same sector or with similar characteristics. Those making the comparison can take into account relevant similarities and differences in the characteristics of companies to the extent that these are observable.

Evidence

9.103 Our survey found that about two-thirds of FTSE 350 companies carry out some form of benchmarking or other formal comparisons with auditors at least every five years (and 25 per cent every year), and suggested that about 90 per cent make informal comparisons.[330] About three-quarters of companies that carry out benchmarking exercises or other formal comparison compared their audit fees with those paid by other companies in the same sector and/or of a similar size and complexity.

9.104 Nearly half of companies said that they looked at the expertise, experience and reputation of the audit firms and the audit team when making a comparison. Only 5 per cent of respondents did not mention any of these three factors. The next most frequently mentioned factors were: quality of service (21 per cent), geographical coverage of the audit firm (20 per cent), audit techniques, approach and accounting treatments (10 per cent). A number added that they also made comparisons based on informal discussions with other FDs, auditors etc.[331]

[330] Appendix 3, Table 14.
[331] Appendix 3, Table13 and paragraphs 4 & 47.

9.105 The use of benchmarking the audit fee against other companies to assess its competitiveness was widely used across the case study companies, although views varied as to its effectiveness.[332]

9.106 3i Group plc told us that it had instructed the buying team to assist in negotiating fees at the last review and would typically engage someone outside the direct audit engagement. The buying team was an external procurement consultancy that would not be swayed by any relationship issues and which had experience across the largest four auditors to identify best practice, time estimates and differing rates.[333]

Firm submissions

9.107 The Big 4 firms said that companies were able to assess the relative, as well as absolute, performance of the existing auditor on price and quality using a range of tools. They said that companies were well informed on the competitiveness of their incumbent firm's offering.[334]

9.108 The firms said that benchmarking on fees is based on a detailed analysis of factors that will inform the audit fee of different companies taking account of industry sector, turnover, market capitalization and the extent of international activities. Those making the analysis are knowledgeable about the characteristics of other major companies in the same sector or with similar characteristics, and will commonly test the reasons why another company might or might not be considered an appropriate comparator. Comparisons are made by reference to hourly rates or proposal prices seen in other contexts. Firms said that our first survey showed that benchmarking was widespread and regular and this strongly suggested that this was seen to be a useful tool for

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[332] See, for example, Appendix 2, Case Study A, paragraph 70; Case Study B, paragraph 25; Case Study C, paragraph 37; Case Study D, paragraphs 37 & 91; Case Study E, paragraph 60; Case Study G, paragraph 30; Case Study H, paragraph 39; Case Study J, paragraph 16.
[333] 3i Group plc summary of conference call, paragraph 12.
[334] Deloitte response to the CC working paper 'Nature and strength of competition', paragraphs 5.9–5.15; KPMG response to the CC working paper 'Nature and strength of competition', paragraphs 1.5 and 2.2.1–2.2.14; PwC response to the CC working paper 'Nature and strength of competition', section 2.

assessing value for money. They said that the case studies provided further evidence on this point.[335]

9.109 The firms said that comparative quality is assessed by means of considering the approach of other firms to any non-audit work they undertake for the company, audit and non-audit work they undertake for other companies with which other directors have a relationship and from the directors' own accounting and audit backgrounds.

9.110 We note that in 2011 the six largest audit firms reported NAS revenue from the FTSE 350 (both audit and non-audit clients) of £1.3 billion of which 99 per cent was received by the Big 4 firms. BDO and GT had relationships, in a given year, with around one-third as many companies as each of the Big 4 firms.

Other sources and quality of information outside the tender process

9.111 In our follow-up survey of FTSE 350 ACCs, the respondents were asked to what extent they were able to assess the quality of the audit that could be delivered by audit firms other than their current auditor, outside of a tender process.

9.112 Some of the respondents indicated that this was difficult or only possible to a limited extent, but most felt they could assess quality outside of a tender one way or another. Many of the ACCs surveyed had themselves worked with various audit firms, and therefore felt they had an understanding of the service quality offered. Alternative sources of information regarding quality were feedback from contacts in their professional network, the general reputation the audit firms have in the market, and regulatory reports. As useful indicators for the quality of audit firms the ACCs

[335] Deloitte response to the CC working paper 'Nature and strength of competition', paragraph 5.12; PwC response to the CC working paper 'Nature and strength of competition', section 2, paragraph 36.

mentioned their people (how they presented themselves, whether they understood the sector), and the firms' global coverage.[336,337]

9.113 Accordingly, we identified the following ways (which we consider in turn) in which FDs and ACCs obtain information on potential auditors, short of a formal tender process:

(a) experience FDs and ACCs obtain of firms' audit service via roles in other companies;

(b) experience of firms' capabilities via provision of NAS;

(c) regulatory reports; and

(d) firms' marketing efforts, including their websites that promote their audit capabilities, along with contacts for those interested.

Experience of non-incumbent firms' audit service via roles in other companies

9.114 Nearly all ACCs we surveyed sat on or chaired another AC (of these 33 per cent on one other, 34 per cent two others, 20 per cent three others, 8 per cent four others, and 5 per cent five or more). The proportions are similar for ACCs of FTSE 350 and other companies.[338]

9.115 This was consistent with our case studies, where ACCs were typically part-time and had other roles on ACs, or had previous experience of other auditors through FD roles. Some were former AEPs or FDs themselves.[339]

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[336] See Appendix 4, paragraphs 29 & 30.
[337] In its submission to the CC prior to the provisional findings 21 Dec 2012, paragraphs 2.13 & 2.14, KPMG points out that the answers given for questions D7 (evaluating audit quality in a tender procedure) and D8 (evaluating audit quality outside of a tender procedure) of the follow-up survey were similar. In particular it pointed out that in a number of instances ACCs provided the same answers, which suggested that they noted no distinction.
[338] Appendix 3, paragraph 24.
[339] See Appendix 2. The Company A ACC was previously a senior audit partner with a Big 4 firm and a member of the Audit Practices Board (paragraph 49); the Company D ACC could benchmark against another firm that audited the company at which she was the FD (for fee and overall performance) (paragraph 61); the Company E ACC had extensive experience, having held FD roles with a number of companies. He had held a number of ACC roles, the first of which was in 2005. The ACC was also the Chairman of a plc and held a number of non-executive director roles (paragraphs 37); the Company F ACC was also an FD at a FTSE 350 company, and so had direct experience of another firm (paragraph 35); at Company G, the ACC was also

9.116 The broader experience of individuals at a company was also used to benchmark fees. At Company E, the ACC had extensive retail experience and contacts at other companies to whom he could talk about fees;[340] and at Company F, the AEP said that various FDs [✂] shared information with one another fairly freely in relation to fees and how fee deals had been agreed.[341] Although the CFO at Company C said that such a process was never conclusive.[342]

9.117 All the Big 4 firms considered that large companies were experienced and knowledgeable purchasers of audit services. For instance, PwC said that directors (including FDs and ACCs) who made audit purchasing decisions had a wealth of current and past experience accumulated at different companies and with different audit firms. It provided specific examples of concurrent director appointments.

Experience of firms' capabilities via provision of NAS

9.118 Our case study companies tended to limit the extent of NAS provided by their auditor in order to maintain its independence. However, this provision of NAS was also a

chairman of two plcs (paragraphs 49); the Company H ACC had spent the majority of his career at KPMG as an audit partner. He was also a non-executive director at a private oil company, four investment trusts and a local development agency (paragraphs 51 & 52); the Company J ACC was ACC of two other investment trusts which used a mixture of Big 4 and Mid Tier audit firms. He was also Chairman of one other investment trust and a director of another (paragraph 32).

[340] Appendix 2, Case Study E, paragraph 60.

[341] Appendix 2, Case Study F, paragraph 89.

[342] Appendix 2, Case Study C, paragraph 37.

source (for some of them) of information regarding potential auditors.[343,344,345,346,347,348,349].

9.119 PwC said that some companies had relationships with a number of firms at one time allowing them to make comparisons and test alternative audit firms, and it gave examples of companies both where PwC was the external audit firm and other Big 4 firms or Mid Tier firms provided internal audit services, and vice versa. It also gave instances of companies making changes to their suppliers of assurance and NAS to give them greater experience of the Big 4 firms and/or to reduce the proportion of non-audit fees paid to their auditor.

9.120 Firms also saw provision of NAS as a way of demonstrating their capabilities to potential clients (see Appendix 26, paragraphs 34 to 37 on marketing strategy).

Regulatory reports

9.121 We set out our understanding of the AQRT reporting on audit quality in Appendix 8, paragraphs 171 to 182. The AQRT produces various different reports, both private and public.

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[343] See Appendix 2. Company A tendered most non-audit work to two or three firms. The start point was that the auditors should not be used which meant that, for some work, the auditors missed out even when they were well placed (paragraph 48).
[344] See Appendix 2. At Company B all outsourced NAS were put to competitive tender and different firms were selected for each piece of work (paragraph 32); According to the ACC, the company tended to use other firms for non-audit work. This was partly due to company policy and partly as it allowed the company to keep an eye on other firms from time to time. The ACC said that in the past, performing NAS could be an advantage in tenders but this was not the case now (paragraph 57).
[345] See Appendix 2. Company D's policy was to limit non-audit work performed by the current auditor to less than 100 per cent of the audit fee for two reasons: *(a)* the main one being to avoid any conflict with the auditors' independence; and *(b)* also to keep things competitive by having a relationship with, and sharing work around, a number of firms (paragraph 44).
[346] See Appendix 2. At Company F the FD was very keen on auditor independence. He preferred to instruct another firm to undertake non-audit work. The other Big 4 firms were all capable of providing the non-audit work to a high standard (paragraph 33).
[347] See Appendix 2. Company G would not appoint its auditor to work on advisory assignments in operating platform, strategy or IT. Any work for the incumbent that was over £100,000 in value would need to be approved by the AC (paragraphs 47 & 48).
[348] See Appendix 2. At Company H the FD was very strict about giving the auditor non-audit work in general. For work such as tax advisory, due diligence and other general advisory services the FD preferred to give the work to other firms. There was always a benefit of other firms having an understanding of the business. If the company wanted to change auditor it was beneficial to have people who had that understanding and had established creditability with the company's employees. The company used Mid Tier firms for non-audit work. See paragraphs 45, 47, 48 & 86.
[349] See Appendix 2. Company I's policy was not to use the auditor for NAS. See paragraph 34.

9.122 Private reports on issues arising from the review of specific engagements are sent to the audit firms and the professional accounting bodies. Audit firms are expected to provide copies of these reports to the directors of the audit clients concerned. These reports can therefore be seen by the ACs, whose members may hold positions with other FTSE 350 companies (ie the effect of the information may be felt more widely than just at that one company). The AQRT publishes individual reports on the inspections of major firms (the Big 4 firms plus six others) on the FRC's website. The frequency of AQRT reviews of individual company audit engagements varies across the FTSE 350. 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. Over the five years to 31 March 2013 it said that some 143 FTSE 100 audits had been reviewed which implied that on average a FTSE 100 audit was inspected between every six and seven years. In the same five-year period 112 FTSE 250 audits would have been inspected and this implied that a FTSE 250 audit was inspected on average every 11 years.

9.123 Our case studies showed that the use of AQRT reports on individual audits varied among companies, with some but not all making changes to the audit approach as a result.[350] In general, it appeared to us that such reports were considered carefully by ACCs.

9.124 In our follow-up survey of FTSE 350 ACCs, 64 per cent indicated that the company's external auditor had been the subject of an AQRT report (this could refer either to AQRT reports on firms as a whole, or to AQRT company-specific reports). Of those, 98 per cent saw a copy of the report. In many cases the report indicated there were

[350] See, for example, Appendix 2, Case Study A, paragraphs 77 & 78; Case Study I, paragraphs 32 & 33.

no concerns or only minor issues raised, and no changes were made as a result of the report.[351]

9.125 Our case studies provided some views on the usefulness of the AQRT reports. With regard to the firm-wide reports which are available publicly, Company G's ACC said he used the AQRT reports as a measure of the quality of the audit firm.[352] The Company H ACC said that the AQRT review regarding the incumbent auditor was more helpful than Financial Reporting Review Panel letters (which were usually to do with accounting treatment or disclosure).[353] The Company J ACC noted that the FRC had sent him the AQRT report into the current auditor. He had been a little disappointed with the results as two out of ten audits reviewed had been flagged as requiring significant improvement. He had raised this with the AEP. These issues did not relate to audits in the relevant sector for Company J but were still of concern. The incumbent auditor had undertaken to improve.[354]

9.126 The audit firms generally regard the AQRT reviews as providing a public measure of audit quality. BDO and GT said that these reviews indicated that the quality of their audits were comparable with the quality of Big 4 audits.[355,356] Deloitte said:[357] 'A reader of the [AQRT] reports can assess the quality of a firm's audit work in both absolute terms and can compare those results with other firms. The public nature of the reporting acts as a real incentive for audit firms to maintain and improve audit quality.'

9.127 We found that FDs and ACCs can draw on personal experience, firms' provision of NAS, regulatory reports and firms' marketing efforts as sources of information on the

[351] See Appendix 4, paragraphs 38–40.
[352] Appendix 2, Case Study G, paragraph 76(b).
[353] Appendix 2, Case Study H, paragraph 83.
[354] Appendix 2, Case Study J, paragraph 54.
[355] BDO response to the issues statement, paragraph 1.6.3.
[356] GT response to the issues statement, paragraph 1.5.
[357] Deloitte response to the issues statement, paragraph 2.6.

offer of alternative audit firms. We consider that the quality of the information provided by these sources will vary between companies. With regard to fees, the quality of the information depends on the availability of suitable comparators. We consider that such comparison will be imprecise given difficulties controlling for factors that determine fees on which information may not be available such as fees for audit-related services. With regard to quality, we consider that the various sources of information available would allow companies to make an assessment of whether a firm would have the capabilities that the company would require of its auditor.

Firms' marketing efforts

9.128 Detail on the information that firms provided to us about their competitive strategies is contained in Appendix 16. Part of these strategies is to inform potential clients of a firm's capabilities, to increase its chances of being invited to participate in any tender, and its chances of success in any such tender.

9.129 The most obvious strategy is for a firm to offer to audit a company in place of an incumbent firm. According to our survey, 71 per cent of FTSE 350 FD/CFOs and 46 per cent of FTSE 350 ACCs had been approached by an audit firm offering to audit their company in the past five years.[358] The majority of these approaches were by the Big 4 firms, though some had been made by BDO and GT, as well as smaller Mid Tier firms.[359] In total, 64 per cent of FTSE 350 companies had been approached in some way.

9.130 However, none of the firms stated that they made unsolicited bids to potential new clients on a frequent basis.[360] Some of the Big 4 firms indicated that they had used them on occasion but had not been successful in winning audit engagements in their

[358] Appendix 3, paragraphs 76–78.
[359] Appendix 3, paragraphs 76–78.
[360] Appendix 16, paragraphs 54, 98, 124, 168, 205 & 240.

own right.[361] However, these may inform companies of what other firms could provide and at what approximate price.

9.131 PwC told us that some prospective clients (as was the case with [✂] recently) sought indicative proposals before deciding whether or not to proceed to a full tender.[362]

9.132 All the firms told us they sought to win work from new clients, or sought appointments as auditors for clients for which they already provided NAS, and the firms consistently referred to the importance of building relationships with clients before a tender situation occurred. These relationships may be built through introductions and periodic meetings between a partner and senior management at a potential client, or it may involve undertaking a number of non-audit engagements. The benefits of this approach are twofold: the first is making the firm, and potentially an audit team, known to the target company and the second is that the firm is able to develop its own knowledge of the client's operations and business risks and use this in a subsequent tender.

9.133 The most common strategies that we identified firms used to develop a potential client's awareness of a firm and an appreciation for its service offering were:

(a) provision of NAS to develop relationships with key individuals;

(b) regular face-to-face contact with key potential client staff, regardless of whether any services are provided; and

(c) developing a strong reputation for quality and experience in the sector through work with companies in the same market as the target client, as well as demonstrating its ability to deliver large, high-quality, audits more generally.

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[361] Appendix 16, paragraphs 54 & 168.

[362] PwC response to the CC working paper 'Nature and strength of competition', p11, footnote 52.

9.134 According to the firms, the need for a prospective auditor to demonstrate sector credentials requires initial entry to a sector either through previous audit or non-audit work. For firms without this audit experience, non-audit work can therefore be used as a way of developing a professional relationship with a company and increasing the likelihood of being invited to tender for audit should the opportunity arise. Such engagements develop personal relationships and the firm's understanding of a company's business, which could then be employed in preparing a formal audit tender at a later date. Further, when undertaking this work for other companies, the firm develops a more holistic appreciation of a sector which may give rise to the opportunity to provide value added insights to a prospective client.[363] Several firms referred to arranging or attempting to arrange meetings with staff at prospective clients to offer information. Our first survey shows that ACCs and FDs are in regular contact formally and informally with rival audit firms and are often approached by rival audit firms. When approaching clients of rival firms, firms may explain their proposed audit approach and fees.[364] However, Mazars noted that it had struggled to gain access to key decision-makers and influencers of companies where it did not have an existing connection.[365]

9.135 In circumstances where approaches are not answered, an enhanced programme of sponsorship or thought leadership publications might be used to improve the receptiveness of target company staff to approaches from the firms (and this was the case for both Big 4 and some Mid Tier firms).

9.136 BDO, Deloitte, EY, KPMG and PwC referred to assembling shadow teams and making their presence and potential to service a prospective client known.[366] Such

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[363] Appendix 26, paragraph 31.
[364] Deloitte response to the CC working paper 'Nature and strength of competition', paragraph, 5.13; PwC response to the CC working paper 'Nature and strength of competition', section 2, paragraph 36 e).
[365] Appendix 3.
[366] Appendix 16, paragraph 238.

teams are not full audit teams, but rather designated individuals within the firm given the task of building and developing relationships with a specific company, drawing on available firm resources. They exist outside any announced tender process, and allow the firm to advertise to a target company a team of named individuals with specific experience and skills. Accordingly, they are a way for a firm to demonstrate to a company its capability, and may be a way of destabilizing the current incumbent. It is also a strategic competitive tool, developing knowledge and understanding of a company before any tender opportunity arises. Only BDO of the Mid Tier firms referred to the use of standing shadow teams.

9.137 We found that the Big 4 firms usually knew about tenders before they were officially launched. It appears that the Big 4 firms monitored potential 'trigger points' in a company. These events might be the breakdown in the relationship between management and the company's auditor, or any change in key staff, including particularly where a new FD or ACC is either an alumnus or has had a previous commercial relationship with the firm. Capturing this information depends on a close ongoing relationship with staff across a client company.

9.138 We think that companies have incentives to respond to these firm initiatives, on the basis that the better informed they are about potential alternative suppliers, the stronger their bargaining position with respect to their current auditor.

Provisional view on companies' ability to appraise alternative suppliers outside tenders

9.139 In the context of an assessment of bargaining power, the credibility of the threat to the incumbent that a client might switch to an alternative auditor depends on the accuracy of the information available to that client, both regarding its incumbent auditor, and its alternative auditor(s).

9.140 One firm said that the case studies showed the extent and value of the annual reviews of auditor performance. Against a backdrop of the standards expected and experienced by AC members and other senior management in their roles at other companies where they encounter other audit firms, they provide important insights and evidence enabling companies to evaluate and compare auditor performance.[367]

9.141 We have found that the majority of FTSE 350 companies regularly and actively make comparison of the incumbent auditor's offer with that of rival firms. These comparisons can take the form of structured benchmarking exercises in which companies typically attempt to compare the fees they pay with published fees for comparable companies, and the experience of the incumbent auditor with that of rival firms. Such comparisons may also be informed by other less structured activity including discussions with peers and/or rival audit firms which might be more wide ranging in scope than fee and experience.

9.142 We have identified and assessed the quality of the information available to companies without them incurring the expense of a tender. This information derives from the personal experience of FDs and ACCs, firms' provision of NAS, regulatory reports and firms' marketing efforts. The quality of the information these provide individually and cumulatively will vary between companies as discussed below in paragraphs 9.143 to 9.146.

9.143 With regard to information on fees, the fee paid for each FTSE 350 audit must be published. We note that in practice, however, it is generally difficult for FTSE 350 companies to compare the audit fees they pay with those paid by others since each

[367] PwC response to the CC working paper 'Nature and strength of competition', section 2, paragraph 36 c).

FTSE 350 audit is tailored reflecting a range of factors. The published audit fee may also include fees for audit-related services,[368] which need not be published.[369]

9.144 Therefore with regard to fee, we think that benchmarking does provide some information with regard to how fees paid by one company compare with its peers, but given the tailored nature of each audit and that other services might be contained in the published audit fee, the comparison is generally imprecise. Given the structure of the FTSE 350, any insights will be restricted almost exclusively to information as to fees charged by Big 4 audit firms. Firms need significant amounts of information to bid accurately, and that information is typically provided only within the context of a tender.

9.145 With regard to other aspects of an audit, we note that FDs and ACCs may have personal experience, and may have access to regulatory reports of other firms. Firms also engage in efforts to alert potential customers of their abilities. However, it appears to us that the quality of the team undertaking an audit is key, and their identity and the quality of the service that they would deliver cannot be known in advance. Our survey showed that for FDs and ACCs the most important factor in the selection of auditors is the experience and knowledge of the AEP and this was followed by good working relationships with the audit team and the experience and knowledge of the audit team.

9.146 This illustrates the general point that audit is an experience good: it is only possible to determine its quality with precision in retrospect. While the company will be familiar with the quality and performance of its current auditor, there will be significant uncertainties in assessing these factors in advance with regard to potential auditors.

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[368] Appendix 11, paragraphs 15–17.
[369] Firms said that the proportion of the total fee accounted for by audit-related services (as opposed to the audit itself) varied significantly by client and estimated a range based on hours and/or fees of between 0 and 30 per cent.

9.147 Accordingly, our provisional view is 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. This incomplete picture is unlikely to provide companies with sufficient information to be able to assess accurately whether they may obtain a better service from an alternative audit firm.

9.148 We have so far assessed companies' possible alternative suppliers and their ability to compare their incumbent auditor against those alternative suppliers, and therefore the ability of a company to identify whether there are benefits that could be had from switching. If a company had identified such benefits, it should consider whether these benefits might be expected to outweigh the costs of searching and switching. We consider such costs next.

Search and switching costs

9.149 Search and switching costs are relevant to our appraisal of companies' willingness to switch and so of their bargaining power, since such costs must be set against any benefit that a company might expect from switching. If such costs were sufficiently high, a company might feel obliged to continue to reappoint its incumbent, even if it thought that an alternative firm could provide a better offering. Accordingly, the higher the search and switching costs, the greater the expected benefits from any switch must be in order to prompt a company to switch audit firm.

9.150 Any cost to a company of identifying and assessing rival offers is a search cost. In this case the search costs are the costs to the company of conducting a tender. Any loss to a company arising from a switch may be seen as a switching cost. Below, for convenience, reference to switching costs encompasses both search and switching costs unless otherwise stated. Evidence on the cost of tendering for companies is considered in paragraphs 9.250 to 9.254.

9.151 We considered evidence on: *(a)* the existence and prevalence of switching costs for FTSE 350 companies; *(b)* the nature and scale of these costs; and *(c)* firms' investments to mitigate switching costs.

Existence and prevalence of switching costs

9.152 In our first survey we asked respondents at companies that had not tendered their audit engagement in the last five years, why this was the case. Over 60 per cent of FTSE 350 companies responded that this was because they had been satisfied with the performance of their current auditor. We do not, however, take this to mean that for these companies there would not be any cost to them of switching auditor, rather that the primary reason for these companies not switching was their satisfaction with the offer provided by the incumbent auditor. This is illustrated by some of the 'positive' responses to the survey question, which indicated that even 'satisfied' companies were concerned about switching costs, in terms of management time and the risk of switching auditor.[370]

9.153 We consider that the responses to this question provide strong evidence that: there are costs for companies associated with tendering and switching their audit engagement; that these costs are greater for some companies than others; and that companies in deciding whether to reappoint their current auditor or go to tender are making an assessment of the balance between the potential gains and costs of these options.[371]

9.154 Both the Big 4 and Mid Tier firms warned against the risk of overstating switching costs. PwC alone stressed the importance of not underestimating the cost involved for large companies.[372] In particular PwC said that switching costs could be poten-

[370] See Appendix 3, Annex 2, Table 2.
[371] Appendix 3, paragraphs 56–62 and Annex 2.
[372] PwC response to the CC working paper 'Switching costs', paragraph 9.

tially significant for large companies and that the larger (often more international) and more complex the company, the greater the switching costs are likely to be.

9.155 Mid Tier firms said that our first survey evidence highlighted that those FTSE 350 companies that had switched auditors had not found the process particularly burdensome or the costs particularly high. BDO highlighted the contrast in views of those who had switched compared with those who had not and considered the perception that costs were high to be unjustified.[373] KPMG[374] considered that there was no perception gap (and no evidence to suggest that there was a perception gap). PwC also considered that there was no perception gap and in particular considered that undue weight should not be given to the experience of companies that had switched given that those companies were largely dissatisfied customers (who, according to the first survey results, had switched mainly due to price, previous poor auditor performance, etc).[375] PwC considered that the FDs and ACCs who selected the audit firm could accurately assess the costs involved in switching.[376]

9.156 We asked companies that had switched in the last five years what their experience had been, including what the impact had been on audit quality internal costs. We had responses for the 33 surveyed FTSE 350 companies that had switched in this period. With respect to audit quality, 19 said quality had been better, six that there had been no material impact, three that quality had been poorer (two in the first year only) and five did not know. With respect to internal costs, the responses suggest that some understood the question to be asking about internal audit costs or other expenditure relating to internal audit or financial reporting functions. Nevertheless, the responses (which are reported in full in Appendix 3, Annex 3) suggest a mix of experiences in terms of costs incurred through switching auditor. The responses of some suggest

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[373] BDO response to the CC working paper, 'Evidence on switching costs' paragraph 1.2.1.
[374] KPMG response to the CC working paper 'Evidence on switching costs', paragraphs 1.2 & 1.3.
[375] PwC response to the CC working paper 'Evidence on switching costs', paragraph 13.
[376] PwC response to the CC working paper 'Evidence on switching costs', paragraph 4.

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. Where respondents thought there was an increased cost the cost was greatest (and often only) in the first year after a switch.[377]

9.157 Our view is that our first survey does not provide evidence of a gap between the perception and reality of switching costs. As noted above (see paragraph 9.153), we consider that the evidence is that the costs of switching are greater for some than others. Also some of the switching costs identified are risks associated with switching (see paragraph 9.159). Firms said that the inherent risks were well recognized and considerable efforts were made to mitigate them (see paragraph 9.172). We therefore expect for some companies the experience of switching to be less costly than expected. Nevertheless, risks associated with switching (which may or not be realized) are costs that a company might incur if it were to switch and so costs that would be relevant to a decision on whether to either reappoint the incumbent auditor or contemplate switching.

The nature and scale of switching costs

9.158 The survey and case study provide evidence on the nature and scale of switching costs. We identified two broad categories of switching costs: *(a)* the loss of the benefits of continuity in the client-auditor relationship; and *(b)* the opportunity cost of management time involved in the selection and education of a new auditor. We summarize our evidence and appraise each below.

[377] Appendix 3, paragraphs 70 & 71.

Loss of benefits of continuity

9.159 We received evidence that companies valued long-lasting relationships, particularly as incumbent firms acquired significant company-specific expertise over time, and established relationships with companies. If a company switches auditor it loses the benefits of this relationship, in particular the expertise acquired by its incumbent auditor the consequences of which might be *(a)* reduced efficiency in the conduct of audit; *(b)* increased risk in relation to the technical quality of the audit particularly in early years of the engagement; and *(c)* a loss of the commercial insight provided by the incumbent firm.

9.160 Our survey provided evidence of the presence of these continuity benefits. All responses to this question are provided in full in Appendix 3.[378] Our case studies also supported the presence of continuity benefits and the costs to a company associated with the early years of an engagement.[379,380,381]

9.161 To the extent that there is anticipation by investors of an increased risk of audit failure in the early years of an appointment, it could result in an adverse market reaction. This may increase the risk of switching for listed companies that have particularly complex audit requirements. In addition, a negative market reaction could be triggered, for example where the company was experiencing financial or operational difficulties or otherwise wished to portray stability and continuity.[382]

9.162 Generally the Big 4 firms agreed that there are such continuity benefits, but did not accept that the loss of such benefits should be considered to be a cost of switching.

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[378] Appendix 3, Annex 2, Table 2.
[379] Appendix 2. The Company A ACC rated the auditor (a Big 4 firm) at six out of ten and felt that, for a first-year audit, it had done pretty well and he would have been surprised if it had done better: 'having done a number of first-year audits as an auditor, they are scary because you do not know everything, and you just do not know who has got what angle within the management of the company until you get to know them and work with them' (paragraph 61).
[380]Appendix 2. At Company B, the AEP said that it was not completely unfair to categorize him as being at the top of his game when he did his fifth audit of the company, although he said that there were benefits to having a fresh look (paragraph 107).
[381] Appendix 2. At Company F, the ACC thought that there was a time for fresh eyes but five years was too short a period before switching, as the company lost the benefit of knowledge acquired by the auditors (paragraph 53).
[382] Appendix 12, paragraph 46

(a) Deloitte said that a long-term relationship with an audit client allowed it to provide more insights of value to the client.[383]

(b) KPMG said that a key part of audit quality and client demand was for it to have a detailed understanding of the audit client's business, and this entailed learning about the client's business and its complexities; developing relationships with the key personnel at the client, at all levels of seniority; and providing specific staff members with expertise for that client's needs.[384] KPMG said that in order to obtain client-specific knowledge, audit firms needed to learn from the client's management about its commercial arrangements, its reporting practices and requirements, its structure, its transactions-processing arrangements and so on. This required significant management time and effort on the part of the company to ensure that the audit firm had the required degree of knowledge. In addition, time and effort was required in developing relationships with the audit firms, in particular for more complex organizational structures (for example, global groups with a large number of subsidiaries). These investments on the part of the company's management and ACs impacted on the quality of the audit service that the audit client received. Investing in developing the audit firm's knowledge of the company's business would ensure that the auditor was best placed to identify and address audit risks. In addition, it would minimize management time further down the line, by ensuring that the learning took place early on and the audit was delivered efficiently as soon as possible.[385]

(c) PwC said that while there were switching costs, these were not the main reason that companies did not tender—rather there were enhanced quality benefits accruing from the knowledge and experience gained over time by the existing auditor, and companies could take advantage of these benefits while the threat of

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[383] See Appendix 12, paragraph 48.
[384] KPMG response to the issues statement, paragraphs 210 & 211.
[385] KPMG response to the issues statement, paragraphs 5.2.1 & 5.2.2. We use the terms 'company' where KPMG used the terms 'audit client', for consistency with these provisional findings.

tender ensured competitive pressure was placed on the audit firm.[386] It said that a thorough knowledge of the business allowed the auditor to 'provide insight and advice on issues such as: the effectiveness of the company's operating and financial management systems; the design and implementation of its internal controls; and recommendations for improvement'.

9.163 As explained above (see paragraph 9.150), we consider any loss to a company arising from switching to be a cost of switching which we would expect companies to factor into any assessment of the overall gains to be had from switching auditor.

Opportunity cost of management time involved in the selection and education of a new auditor

9.164 Management and staff time is a frequently cited cost: before, during and after a tender or switching process. The larger, more international and complex the company, the greater the costs. We note that companies can generally plan a tender process around their corporate reporting cycle, to mitigate costs of switching to some extent.

9.165 Based on responses to our survey, these costs mainly comprise: the time commitment for management in running a tender process and the opportunity cost of this time; and if a company switches auditor, the time management has to give educating a new auditor.[387] These costs are illustrated by some of the responses to our survey contained in Appendix 2. Just as firms have said that they make considerable effort to mitigate the inherent risks associated with switching, we consider that the additional time commitment for management in the earlier years of an audit engagement may reflect efforts made by the company to minimize the risks associated with switching resulting from a loss of continuity.

[386] PwC response to the issues statement, paragraph 1.11(c).
[387] Appendix 3, paragraph 61.

9.166 We have some evidence of external costs for companies tendering or switching their audits (as in some cases companies do instruct external consultancies to assist).[388]

- *Timing issues*

9.167 Further, the survey results provide evidence that commercial or operational circumstances (such as recent merger activity, rapid growth, or recent investment programmes) may have the effect of raising the opportunity cost of management time.

9.168 Our case studies supported the view that at certain times, management time will be at a premium. We have evidence of instances where, at a particular point in time, switching auditor was not feasible, particularly when management is preoccupied with other concerns (eg significant transactions; financial stresses; or any other reason where the company wishes to portray stability).

9.169 PwC agreed that at certain times (for example, during restructuring, refinancing and acquisitions or disposals) switching auditors would not be practicable or might risk a company's reputation. At such times investors were likely to prefer that company management focused on immediate issues, and these were precisely the times when the existing firm's knowledge was valuable. Nevertheless, PwC said that the periods in which a company would not choose to tender were relatively short, meaning that auditors remained keenly aware of the threat of a tender even during these periods.[389]

9.170 Other firms also expressed a similar view that timing issues were short-term and that incumbents would not take advantage of this as it was not in their long-term benefit. Deloitte said it did not believe any audit firm would exploit short-term situations as

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[388] www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/summary_of_conference_call_25_january_2012.pdf, paragraph 18.
[389] PwC response to the CC working paper 'Evidence on switching costs', paragraph 11.

this would result in a significant increase in the risk of losing the client.[390] KPMG said that timing issues were not a continuous barrier and so would not enable an incumbent to reduce the competitiveness of its offering, since if it did so companies would switch audit firm once short-term constraint on tendering and switching were relaxed.[391]

9.171 We do not consider that it would be in the interests of firms to act in ways that are potentially damaging to their relationship with clients in which they have invested heavily if gains are short-lived or could trigger a tender in the near future. However, there are likely to be times at which companies will have reduced bargaining power, and firms will be able to gauge this. Whilst firms may not actively exploit this situation to increase prices or reduce service quality, we do not think that at these times the company will be in a strong bargaining position with respect to price or service quality.

Firms' investments to mitigate switching costs

9.172 Firms said that the challenges of a first-year audit were well-known, and incoming firms went to considerable efforts to mitigate these (in particular via transition plans and enhanced hours in the first years of an engagement).[392] Our data analysis[393] suggested that audit firms tend to do more work in the early years (and use more senior resource in the first year) than the previous auditors. Whilst this may mitigate the inherent risk of an audit error (as discussed above, see paragraph 9.161), we recognize (as stressed by PwC[394]) that this does not mean that there is no cost to the company in ensuring the new auditor provides an effective audit in the early years (for example, in terms of opportunity cost of management time).

[390] Deloitte response to the CC working paper 'Switching costs', paragraph 3.2.
[391] KPMG response to the CC working paper 'Switching costs', paragraphs 3.3.2–3.3.4.
[392] Appendix 12, paragraphs 74–89.
[393] See Appendix 12, paragraphs 88 & 89.
[394] PwC response to the CC working paper 'Switching costs', paragraph 10.

Provisional view

9.173 We provisionally find 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. We think that companies do not lightly walk away from such a relationship (see paragraph 5.41). We think this operates at both a corporate and personnel/personal level: if company staff trust and work well with the audit team supplied by the firm, we anticipate that there will be a reluctance to disturb those relationships unless strictly necessary. This applies in particular at a senior level (ie FDs and ACCs) where trust in the incumbent firm and the AEP in particular means that the company's decision-makers will be disinclined to switch absent high levels of dissatisfaction.

9.174 We consider that the larger and more complex the company is, it is likely that the greater the company investment to educate the auditor will be.[395] Once the company has made the investment, it can look to the audit firm to keep itself informed (and educate new audit team members) on a rolling basis, so that its own costs remain low relative to the cost of educating a new auditor.

9.175 We recognize that firms from both the Big 4 and Mid Tier warned against the risk of overstating switching costs. PwC alone stressed the importance of not under-estimating the cost involved for large companies: the larger (often more international) and more complex the company, the greater the switching costs are likely to be. There is a general view that companies' actual experience of switching shows these

[395] We note the views of the ACC at Appendix 2, Company G, who said that for a bank in particular, switching auditor would be a huge exercise and had a huge risk associated with it.

costs to be surmountable for many companies.[396] We consider other factors that may make a company reluctant to switch in Section 10.

9.176 We think companies will be minded to go to tender only if they have reasonable expectation that the benefits to be had from doing so in terms of quality and/or fee will outweigh the costs of searching and switching. We consider next factors that might be relevant to the companies' assessment of the potential gains and costs of switching.

Balancing the costs and gains from tendering and switching

9.177 We consider that the survey results provide evidence that companies in deciding whether to tender their audit engagement are making an assessment of the balance between the costs and gains of tendering and switching. For example, a FTSE 350 responded when asked why the company had not been to tender in the last five years: 'we also took into account the management time and effort involved in the tender process and whether we would get any benefit from the tender process'. Another summarized the issues as follows:

> Because we get excellent service from [AUDIT FIRM OMITTED] and we think it's good value for money. The other reason is tendering and changing auditors, which I've done three times in my career as a CFO, is an incredibly expensive and disruptive process. It's expensive in terms of time and the money it incurs and it's disruptive and takes probably two years for new audit team to get really up to speed and familiar with our business and really understand both our financial systems processes control as well as our operating business and our business model. So, it's incredibly disruptive and it's not something you do lightly. If it's working well and you're happy with it, and there's the

[396] Deloitte response to the CC working paper 'Switching costs', paragraph 1.3; BDO response to the CC working paper 'Switching costs', paragraph 1.2.1.

right level of challenge, efficiency, advice, no significant issues, personalities fit, it's something you do not want to undertake lightly.

9.178 In Section 7 we assess the effect on fees of switching. We have evidence that switching auditor is typically associated with a fee reduction (paragraph 7.37 to 7.41). However, that benefit tends to be transitory, and on average within approximately three to four years, fees appear to stabilize at around pre-switch levels.

9.179 We also consider that the performance of a new auditor is inherently uncertain. A company cannot tell in advance how easy the new auditor will be to work with, and whether it will form disruptive views regarding the company's judgements and financial treatments. Firms and companies alike said that there was a two- to three-year education process as the company invested in educating its auditor and the auditor likewise had to invest significant resources in becoming expert in the specific company. This means that companies may fear that switching auditor is an onerous process that may in the short term produce a less good audit (at least in terms of service provision efficiency), as the new auditor acquires information that the former one held.

9.180 We also note that audit as an assurance business is an area in which it appears that companies are disinclined to take risks. In certain circumstances, companies may perceive a risk of adverse market reaction to an announcement of a change of auditor. Such risk aversion would be a further reason why companies are disinclined to switch auditor.

9.181 We consider that the nature of the assessment that management would have to make on the balance between the costs and benefits of switching auditor would be materially different depending on whether or not the company was content with the

quality of the audit product or service provided by the incumbent auditor. If content, the question for the company would be whether it might negotiate a reduction in fees (which might be short-lived) sufficient to outweigh the costs and risks associated with tendering and switching. If not content, some of the risks associated with switching auditor may not be present. For example, if its dissatisfaction relates to the quality of service, the company may be less concerned that a consequence of changing auditor would be a less-efficient audit process. In these circumstances the question for the company would be whether the expected gains in audit quality would outweigh the transition costs.

9.182 Our survey provides evidence on the circumstances likely to trigger a company to switch. We asked all respondents to consider events that would cause a company seriously to consider switching auditor. The results suggest that generally clients must have reason to be dissatisfied with their existing auditor to consider switching. The potential trigger most frequently identified as very likely or likely to prompt a company seriously to consider switching is the complacency of the audit firm (86 per cent of FTSE 350 FDs and 94 per cent of FTSE 350 ACCs) followed by: a problematic working relationship between auditor and management (61 per cent of FTSE 350 FDs and 69 per cent of FTSE 350 ACCs); a substantial increase in the audit fee (particularly among FDs) (71 per cent of FTSE 350 FDs and 55 per cent of FTSE 350 ACCs); and pressure from shareholders, bankers, lawyers or analysts (particularly among ACCs) (54 per cent of FTSE 350 FDs and 62 per cent of FTSE 350 ACCs).[397]

[397] Appendix 3, Table 20.

9.183 We asked whether there were any other triggers (not mentioned by the interviewer). Over 55 per cent of FDs and over 40 per cent of ACCs for the FTSE 350 companies said poor quality audit.[398]

9.184 The survey results on the reasons for not tendering provide further evidence that price is a secondary consideration. In particular, many of those who said that they were satisfied with the performance of their auditors focused on audit quality and independence. The following statements illustrate that price is a secondary consideration:

(a) 'Because, when we look at the criteria for appointment of auditor, we are satisfied that [✂] at least meet those criteria, and they're as strong as any of [✂] competitors. It comes back to the criteria and I think the main criteria are independence, quality of service, and that would be in terms of technical audit knowledge, technical accounting knowledge, industry knowledge and global reach, so knowledge of the environment in which we work. Then the last criteria is value for money and efficiency.' (FTSE 100 FD/CFO.)[399]

(b) 'Because quality is of paramount importance and ultimately we have to make a judgement of the cost of a tender and change-out, not just the cost of a tender itself. First there is the erosion of quality it will bring versus the potential benefit in price that can be achieved. Price is not the predominant consideration in the choice of our external auditors, it is quality. An audit service is typically an area where longer tenure brings advantages and we have other means to negotiate the costs of the audit service.' (FTSE 100, FD/CFO.)[400] We also consider that whether rival firms might be expected to offer a company some choice on how they would conduct the audit to be relevant to a company's assessment of the potential gains to be had from switching, and therefore to the incentives a

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[398] Appendix 3, paragraph 75.
[399] Appendix 3, Annex 2.
[400] Appendix 3, Annex 2.

company may have to contemplate switching auditor. In our survey we asked respondents for companies that had not tendered the audit in the last five years why they had not done so. Some respondents said that a perceived lack of choice or differentiation between auditors was a factor. For example:

(a) 'In our experience differences between firms are much less significant than differences between audit partners, so there are times when the engagement partner must stand down after a certain period and you will get another partner with the same firm and the experience can be very different' (FTSE 250 FD/CFO).[401]

(b) 'There is actually little to choose between big firms and the most important thing from my perspective is that we have an audit partner with the right stature and experience' (FTSE 250 ACC).[402]

(c) 'I think over recent years there's been a trend in large companies not to see much differentiation among the Big 4 and what they offer, nor have they been particularly active in trying to promote non audit services to audit clients. I don't think there was much incentive or market practice to encourage regular audit tendering, and there was no pressure from shareholders either' (FTSE 100 ACC).[403]

(d) 'No particular pressure to change and a limited choice of alternatives' (FD/CFO, FTSE 250).[404]

9.185 Deloitte, in a strategy document based on a summary of client interviews, said 'its clients typically do not see us as materially differentiated from our competitors'. It quoted the following remarks from clients (note that the letters here do not refer to our case study companies):

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[401] Appendix 3, Annex 2.
[402] Appendix 3, Annex 2.
[403] Appendix 3, Annex 2.
[404] Appendix 3, Annex 2.

(a) 'I do not see Deloitte as being distinctive, but neither are any of the other Big 4' (Company P).

(b) 'Personality and relationships are the biggest differentiator, and we don't think that any of the Big 4 have that solved' (Company Q).

(c) 'The Big 4 are all very similar. When we deal with you, there is very much the feeling that we are getting the same old same old' (Company G).

(d) 'There is no distinction at all between the Big 4... the real difference between one firm and the next is the teams, not the brand' (Company A).

9.186 This suggests to us that from the point of view of some companies there is little perceived differentiation between the Big 4 firms in terms of the audit product supplied. In particular that the firms adopt similar methodologies and approaches in conducting audit. Rather the differentiation that there is tends to derive from the composition and expertise of the audit team that a particular firm can offer to a company.

9.187 Overall it is our provisional view that an incumbent firm is likely to have to underperform or overcharge substantially in order to trigger a tender. We reached this view because the incumbent is likely to have opportunities to manage its relationship with the company in order to address any discontent that arises and because the company will need to be satisfied that the benefits to switching are such that they outweigh the costs. The fee on its own is unlikely to trigger a tender unless the incumbent attempts to impose a significant rise.

Firms' incentives to retain engagements

9.188 So far, we have considered the bargaining process principally from the company's perspective, in terms of its ability to perform a cost-benefit analysis of switching auditor. However, the firms' incentives are also relevant.

9.189 If a firm has much to lose if it loses an engagement then such potential losses will increase the company's bargaining power, as the firm will be eager to avoid those losses and retain the engagement. Accordingly, the company will be better able to extract a competitive offer from the incumbent firm, the greater the losses that the firm may incur should it lose the engagement. The company needs to know of such potential incumbent firm losses in order to bring them to bear in a negotiation.

9.190 Firms have said that they have a strong incentive to compete to retain audit engagements. PwC said that the significance of losing an FTSE 350 audit meant that firms invested considerable efforts in ensuring that they provided the requisite service and quality to their current audit clients in order to avoid a formal tender.

9.191 KPMG said that audit firms had strong incentives to retain their existing clients, and this exerted competitive pressure as the consequences to audit firms of losing a FTSE 350 client's audit were substantial and went beyond the lost profit on that particular engagement. KPMG said that the firm would lose the value of the relationship-specific investments and reduce its ability to win and retain other clients in future.[405]

9.192 In addition to the evidence set out above in paragraphs 9.28 to 9.53 regarding firms' incentives to win engagements, we consider below the evidence of the costs to firms of losing engagements provided by:

(a) the efforts that firms engage in to retain clients;

(b) costs of participating in tenders;

(c) the likelihood of an audit firm retaining a client in the event of a tender;

(d) the importance of the experience of the audit firm and the audit team to companies when companies select auditors; and

[405] KPMG main submission, paragraphs 259–264.

(e) the incremental costs to a firm of gaining new clients.

The efforts that firms engage in to retain clients

9.193 The efforts that firms expend to retain an engagement indicates how much they might lose if they are not reappointed. The strategies most commonly referred to are the use of annual surveys and performance reviews with clients when the audit is complete, used to monitor the performance of the audit firm and to understand what clients want from their auditor.

9.194 All the Big 4 firms said that they carried out detailed annual reviews of their own performance with audit clients. These reviews are generally compulsory for large clients. In some of the Big 4 firms, partners not involved in delivering a given audit undertake the interviews of key clients. Most firms also carry out surveys of their audit clients asking them to rate their performance on factors such as: industry knowledge; competitive fees; speed of response when accounting guidance is needed; insight into different areas of the business; and frequency and quality of interaction.[406] Where issues are identified on receipt of the survey or review, partners must deal with these in the next year's audit approach. In extreme cases, this may lead to a replacement of members of the audit team. The firms collate these findings and share common trends across their staff and partners.

9.195 PwC said that it was acutely aware that any (actual or perceived) failure in its performance increased the risk of a tender, and it therefore always regarded the possibility that a company would consider switching auditors to be realistic and serious.[407] PwC also said that its Audit Relationship Diagnostic tool had been developed specifically to monitor such threats and allow it to act quickly to mitigate

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[406] Appendix 16, Review of 'Off the shelf' material submitted by the firms.
[407] PwC response to the CC working paper 'Nature and strength of competition', paragraph 3.19.

concerns where they arose, and that its client satisfaction process always focused on this point.

9.196 We found that firms have regular opportunities throughout the audit process to assess the satisfaction of the company and to take action to address any concerns. Typically the company will negotiate the terms of the audit engagement with its auditor each year (see paragraph 9.4). These negotiations will generally be informed by the detailed reviews of the previous year's engagement (see paragraphs 9.90 to 9.98). During the audit process the AEP will have regular contact with the FD and, although less frequently, the ACC (see paragraphs 9.68 to 9.76).

9.197 We were also told that a client contemplating putting its audit out to tender will usually discuss this possibility with the incumbent auditor before deciding to do so. The company may ask the incumbent to re-tender, or to renegotiate the scope and fees in a more informal way.[408]

9.198 There is evidence that when companies ask firms to reduce fees, fee reductions have been secured. For example:

(a) In renegotiations with PwC in 2012, [✂] received an unsolicited proposal from [✂] offering to audit the company for £[✂] compared with an initial PwC fee proposal of £[✂]. [✂] agreed a fee of £[✂] with PwC.

(b) In 2011, [✂] had a quote from PwC of £[✂], compared with a fee of £[✂] that KPMG was charging. KPMG and [✂] agreed a fee of £[✂].

(c) [✂] threatened to tender during its 2008 renegotiation with KPMG, which resulted in a base fee fixed for three years at a reduced level.

9.199 There were also instances where companies had the actual or proposed lead partner changed where they were dissatisfied with performance:

[408] Appendix 23, paragraph 15.

(a) Company A had concerns about the quality of a partner overseeing one division of the business. This partner was replaced and another partner was also added to oversee the division.[409]

(b) At Company G, [✄].[410]

(c) At Company I during a period of refinancing there had been serious quality issues with the audit firm. As a result the AEP was changed which the ACC thought had led to an improvement in quality.[411]

9.200 We also saw examples of where case study companies had negotiated fees down or changes in audit scope.[412,413,414,415]

9.201 One counter influence to the downward fee pressure exerted by management was the ACC. ACCs stressed that their priority was to obtain quality and would pay the necessary fee. A question asked of auditors by some ACCs was whether the fee was high enough for the auditors to do the job properly. Although, we were told by some AEPs that the audit firm could not say 'no' to this question as effectively by that stage it had agreed to do the work. [416]

9.202 Firms provided evidence of pressure to provide high-quality service and competitive fees. PwC gave examples of where it had changed team members in response to client dissatisfaction, including adding more resources and/or more qualified/ specialized individuals, and of how companies applied pressure on fees at various

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[409] Appendix 2, Case Study A, paragraph 102.
[410] Appendix 2, Case Study G AEP, paragraph 122.
[411] Appendix 2, Case Study I, paragraphs 46–48.
[412] Appendix 2. At Company B, the audit fee was frozen for the current year and had been frozen for the last couple of years. The FD thought this was a good result as the business had grown by approximately 10 per cent. The FD was open with the auditor about wanting to switch auditor due to the high audit fee (paragraphs 26).
[413] Appendix 2. At Company F, in agreeing the fee with KPMG, the tender fee was not altered but the company requested more partner hours. The fee was agreed on a fixed basis for three years (subject to inflation and scope changes), paragraph 30.
[414] Appendix 2. Company G had undertaken a cost reduction programme across the business. It had asked PwC to find a [✄] per cent saving in one year. The AEP agreed to seek opportunities for a £[✄] ([✄] per cent) reduction over two years: paragraph 108.
[415] Appendix 2. At Company J, during the AEP's tenure the requirements for the audit increased, and he proposed fee increases to the four unit trust ACs for which he was responsible. Three of the ACs accepted the increase, acknowledging that more work had to be done. The other ACs refused the increase, resulting in the larger audit being conducted for the original fee: paragraph 77.
[416] Appendix 2, Case Study B, paragraph 99.

points in the annual audit cycle, and almost always challenged fees in the annual renegotiation. It said that companies could and often did explicitly threaten to tender in order to achieve competitive fees and improved service.

The costs of participating in a tender

9.203 If an incumbent firm is forced to participate in a tender, it will have to incur the associated cost. Such avoidable cost provides the firm with incentives to try to retain the engagement (whether by reducing its fee or increasing its quality).

9.204 We sought to quantify the costs to firms of participating in tenders. Using data on 49 recent tenders we calculated the total staff hours and staff hours by grade allocated to a case, and estimated the cost to the firms of these hours. We found that the costs of tendering are proportionate to the size and the complexity of the audit, and differ significantly between engagements, representing on average 20 to 60 per cent of the first year audit fee. We also found that the mix of staff used was senior as compared with audit teams. Much of the time allocated to tenders was partner and senior manager time. Nevertheless, all firms have said that the cost of tendering was not a barrier to participating in tenders when invited to do so.

The likelihood of an audit firm retaining a client in the event of a tender

9.205 The smaller the chances of an incumbent firm winning an audit tender, the greater its incentives to try to persuade the company not to go to tender at all.

9.206 The firms have said that the incumbent will be aware that its chance of winning a tender is low where triggered by dissatisfaction on the part of the client. Our first survey found that the incumbent retained the audit engagement in around 20 per

cent of tenders.[417] These tenders may include events triggered by circumstances such as mergers and acquisitions or a policy of tendering auditor regularly, and so the chances of retaining a client may be lower than 20 per cent absent such circumstances.

9.207 We consider this to be consistent with our findings on the search and switching costs (paragraphs 9.173 to 9.176). In particular, given these costs, we think that generally a company will be reluctant to go to tender unless it expects there to be sufficient gains to outweigh the costs. We consider that the extent of these perceived gains are related to the extent of the company's dissatisfaction with the performance of its incumbent auditor.

9.208 Our first survey results suggest that continued dissatisfaction with the quality of the audit would be likely to trigger a tender. In particular, 86 per cent of FTSE 350 FDs and 94 per cent of ACCs said that complacency on the part of the firm would be likely to trigger a tender. The survey results suggest that dissatisfaction with price is less likely to trigger a tender: 71 per cent of FTSE 350 FDs and 54 per cent of FTSE 350 ACCs said that a substantial increase in fees would be likely to trigger a tender.[418]

The importance of experience and reputation to companies when they select an auditor

9.209 The more important experience and reputation are to companies when they select a new auditor, then the greater the incentives an incumbent firm will have not to lose any given FTSE 350 engagement, as having that engagement allows the incumbent firm to demonstrate relevant experience when it comes to bidding for new engagements.

[417] For the tenders of FTSE 350 engagements during the period 2007 to 2011 on which we have information, 23 per cent were won by the incumbent. See Appendix 24, paragraph 48.
[418] Appendix 3, Table 20.

9.210 Our first survey found that for both FTSE 350 FDs and ACCs the factors most frequently identified as important in the appointment of an auditor included the experience and knowledge of the engagement partner and the experience and knowledge of the team[419]). The reason for a firm losing in a tender most frequently mentioned by companies has been a lack of experience or competition from a firm with more experience.[420] KPMG said that losing an audit client implied a reduction in the ability to win or retain other audit clients in future. In particular, the loss of an audit client of a certain size or complexity or in a certain sector represented a loss in the audit firm's relevant experience base. The experience base was said to be an important aspect of quality and to provide a signal to shareholders on a firm's competence. In this way a loss of a current audit client was said to decrease its probability of winning new clients.[421]

9.211 We consider that the loss of an engagement on grounds of poor audit quality or quality of service could, if this were to become more widely known, be damaging to the reputation of the firm. The impact of this might be wider than that resulting from the loss of sector or other specific expertise. Our first survey results indicate that the reputation of the firm with investors, corporate brokers, analysts and external advisers is an important factor for FDs and ACCs in the appointment of an auditor.

9.212 KPMG also said that the loss of an audit client might damage a firm's reputation for quality. KPMG said that any aspects of poor quality of service were likely to become common knowledge across company management as FDs and ACCs sat on multiple boards whereby issues around audit firms' quality could be communicated.[422]

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[419] Appendix 3, Table 13.
[420] Appendix 24, paragraph 53.
[421] KPMG main submission, paragraph 262.
[422] KPMG main submission, paragraph 263.

The incremental cost of gaining new clients

9.213 If winning new audit clients is expensive for a firm, then firms have strong incentives to retain their existing engagements. All the Big 4 firms have programmes for targeting new clients[423] including FTSE 350 companies. We consider the relevant costs to be the incremental costs incurred by a firm to gain a new client. We have found that firms identify particular companies they want to target and each FTSE 350 company may be allocated an individual partner to lead and coordinate efforts for building a relationship.[424]

9.214 We also found that when an audit engagement becomes available firms allocate considerable resources including senior partner time to the process of preparing a bid.[425] Finally, analysis of the hours allocated to engagements suggests that firms in the first few years of an engagement typically allocate considerable extra resource which is not reflected in higher audit fees: we estimated that the number of hours increased by 24 per cent compared with the previous auditor in the first year after a switch. We have characterized this as an investment made by the firm at the start of an assignment in building their knowledge of the business and in establishing relationships with the FD, ACC and other relevant individuals in the company.[426] This may also reflect the efforts made by firms at the start of an engagement to minimize the costs to companies associated with switching auditor.[427] This indicates to us that winning new engagements is expensive, and inevitably entails the costs of becoming familiar with the company. The low incidence of tendering (as set out in paragraphs 7.16 to 7.23) in our view also increases incentives to retain engagements, since the loss of one engagement may not quickly be made good by the acquisition of another.

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[423] See Appendix 16; KPMG response dated 19 October 2012 to CC working paper 'Nature and strength of competition'; and PwC response dated 29 October 2012 to CC working paper 'Nature and strength of competition', paragraph 36 e) i) and response to the issues statement, 12 January 2012, paragraphs 4.29–4.39.
[424] Appendix 16.
[425] Appendix 24, paragraphs 32–33.
[426] Appendix 5, paragraph 97.
[427] Appendix 12, paragraphs 74–93.

Provisional view on the losses firms may incur if they lose an engagement

9.215 Our provisional view is that firms may incur significant costs if they lose a client. They lose the income stream of the engagement; their portfolio of engagements in any given sector is weakened (although the extent to which this matters will depend on the strength of the retained portfolio); and they may suffer reputational damage depending on the circumstances of the loss. Given that a new auditor must be selected, the incumbent may have to participate in a tender and incur the associated costs. Targeting and obtaining replacement engagements may be expensive: tenders are infrequent, and if successful, the firm must incur the costs in becoming expert regarding that company's business.

9.216 However, these costs will vary by firm, and with respect to each company. The loss of one company may not matter to a given firm if it has a large portfolio. All tender processes are not equally expensive. It may be that an expert audit team can easily acquaint itself with the business of a new client company.

9.217 We think that the examples given show that companies can on occasion exert competitive pressure on their incumbent firm without moving to a tender process. However, this does not show that all companies can obtain competitive outcomes on all occasions, and the evidence in Section 7 indicates that some companies have not obtained competitive outcomes on fees.

9.218 Our provisional view of bargaining power overall is set out in paragraphs 9.257 to 9.264, once we have considered the position within a tender process.

Bargaining power in the context of a tender process

9.219 In the section below, we consider companies' bargaining power within the context of a tender process and accordingly how competitive the outcome is likely to be. Our

detailed evidence is contained in Appendices 23 and 24 and is summarized below. As set out above (see paragraph 7.21) we estimate that on average there have been about ten tenders for FTSE 350 audit engagements a year.

9.220 This subsection describes:

(a) the tender process;

(b) tender lists;

(c) firms' incentives in participating in tenders;

(d) firms' costs in tendering;

(e) company costs in tendering; and sets out

(f) our provisional view on competiveness of tenders.

The tender process

9.221 The tendering of FTSE 350 audit engagements is typically a structured and thorough process which can be expected to provide bidders with the access and information they need to prepare informed proposals; and the selection committee with the information they need to make an informed decision.

9.222 The tender process might last for a period of six weeks to three months from the issuing of invitations to tender to the appointment of the auditor. Throughout the process there will be interaction between key individuals in the company and the bidding audit firms.

9.223 Before invitations to tender are issued, there is a period of internal debates within the company and informal discussions between the company and the incumbent audit firm. The company may also have discussions with competitor audit firms.

9.224 Invitation to tender letters are signed by a company's FD and provide an indication of the expected time scale of the tender process and the deadline for receiving the tender proposal, details of the selection committee, the service or services that the company requires, and information on the company. The letters also set out procedures for giving bidders access to further information and people in the company.

9.225 Invitation letters require that firms state the level of fee proposed and sometimes require further details such as charge-out rates by grade of staff and a breakdown of hours by partner, manager and other staff. In some circumstances, companies may also require firms to provide the basis for agreeing fees in future years, and fees that will be charged for additional services.

9.226 The invitation letters typically request that proposals provide details on: the firm's internal processes for ensuring independence and quality assurance; the team that will carry out the audit; the firm's service approach; and how the firm proposes to manage the switching process.

9.227 Invitation letters usually require firms to describe their approach to the audit including: an outline timetable; a risk assessment and proposed audit response to these risks; the proposed balance of work between reliance on internal controls and substantive testing; issue resolution; and adaptability to changes in the company's group. Companies may also require firms to specify in their proposals the audit objectives, the use of IT, the communication methods, value added services, the ability to be proactive and innovations.[428]

[428] See, for example, [✂].

9.228 The selection committee usually consists of the FD, the ACC, AC members and the CEO. Depending on the company, others may be involved, such as the Group Financial Controller, the Group Director of Tax, and the Head of Internal Audit.

9.229 Prior to submitting the proposals the firms may have preliminary meetings with management or request further information allowing them to better understand the business and its requirements.

9.230 Our analysis of 145 tender proposals covering the period 2007 to 2011 suggested that the proposal documents submitted typically provide information on the following:[429] the proposed fee; the proposed approach to the audit; the qualifications and experience of the audit team and the partner who will conduct the audit; the relevant audit experience of the firm including sector experience; the firms' approach to quality assurance and risk assessment; and the use of UK offices and, where necessary, the international network.[430]

9.231 In some circumstances the client and the firm can discuss the firm's proposal as to how they will reduce switching disruption for the company. Transition plans include discussion regarding how the firm proposes to familiarize itself with the company's organization.[431]

9.232 Firms may or may not provide a breakdown of staff hours by grade, and international and local offices. In the tender documents we received, a minority provided details on fees by grades, type of work and location.[432] Some set out the number of meetings that will occur along the year, while usually firms only provided a high-level

[429] Appendix 24, paragraph 2.
[430] Appendix 23, paragraphs 60–99.
[431] Appendix 23, paragraph 35.
[432] Appendix 23, paragraphs 32 & 69.

timeline.[433] Some provided details of their IT systems and the software used to conduct the audit, but did not generally give further details on the methodology proposed.[434]

9.233 There are few examples of proposals where firms offered non-audit-related benefits such as the offer of a preferred supplier status, invitations to public events organized by the firms, networking opportunities, and access to publications, such as studies and reviews of sectors and industries. In a minority of cases we found that firms may offer discounts on NAS. Incumbent auditors that participate in tenders usually offered a significant reduction in the fee.[435] There were also some cases of the incumbent offering retrospective reductions in audit fees or to negotiate on their price if other proposals were cheaper.[436]

9.234 The tender proposals did not appear to vary in their form, content or detail with the number or identity of the firms invited to tender.

9.235 Following the submission of proposal documents, firms give a formal presentation to the selection committee at which the members of the committee will have the opportunity to ask the bidders questions. This is followed by a contract negotiation phase, when the audit engagement contract is completed with the winning auditor, and feedback may be given to losing bidders.

9.236 As mentioned above, the reasons most frequently given by companies for a firm losing in a tender are a lack of experience or competition from a firm with more experience. The second most mentioned reason is a rival firm having a stronger

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[433] Appendix 23, paragraphs 34 & 68.
[434] Appendix 23, paragraphs 34, 79 & 81.
[435] Appendix 23, paragraphs 70–72
[436] Appendix 23, paragraph 70.

relationship with the company. International strength, lack of chemistry and the level of fees were also cited more often than other reasons.[437]

Tender lists

9.237 As explained above (see paragraphs 9.18 to 9.23) survey results suggested that the majority of FTSE 350 companies considered that they had a choice of at least three Big 4 firms. Firms stated that only rarely would they decline an invitation to tender and that potential conflicts of interests were frequently resolvable (see paragraphs 9.46 to 9.53). Nevertheless, the results also suggest that for some companies the availability of credible alternative suppliers of audit services is more limited (see paragraph 9.27).

9.238 The survey results indicate that companies do not invite more firms to tender than is necessary for a competitive tender. In particular, when asked why tender lists had been limited to the firms mentioned, about 20 per cent of FTSE 350 companies mentioned that they had shortlists, the need not to waste time and that the number of firms invited to tender was sufficient to ensure a competitive process.[438]

Firms' incentives in participating in tenders

9.239 We consider that firms have an incentive if they participate in a tender to take the process seriously and make best efforts to impress the client. Given that the demand for statutory audits by FTSE 350 companies is fixed in terms of numbers of available engagements, to expand their FTSE 350 client base, firms must displace competitors. Firms said that only rarely had they acquired new FTSE 350 engagements without participating in a competitive tender.[439]

[437] Appendix 24, Table 10.
[438] Appendix 3, paragraph 55.
[439] Appendix 23, paragraph 11.

9.240 We could not determine the precise number of tenders that have taken place over the last ten years. However, the firms provided data on 52 tenders for FTSE 350 audit engagements between 2007 and 2011.[440] Our analysis of switching data and information provided by firms indicated that over the period 2001 to 2010 (see Appendix 5 for further details), on average there have been between eight and ten tenders a year for FTSE 350 engagements (see paragraphs 7.20 and 7.21).

9.241 We consider that with this low frequency of opportunities to acquire new engagements, firms have a strong incentive to compete intensely for engagements when the opportunities arise (assuming that the firms expect the engagement to be profitable).

9.242 There is also evidence that companies recognize that inviting more firms than necessary to tender could be damaging to the competitiveness of the process (see paragraph 9.238). We consider that this contributes to the incentives that firms have to compete in tenders in two ways: each firm will be invited to participate in fewer tenders; and, all else equal, the probability that a given firm will be successful in winning the engagement is higher once it has been invited to participate.

9.243 Further, firms stated that even if they failed to win an engagement it was important that they performed well in the tender process. A good performance was an opportunity for the firm to demonstrate its capabilities to the company and build its relationship with the company, and the possibility that this might generate work in the future. A poor performance could be damaging to the reputation of the firm with the company and those individuals involved in the process (see paragraph 9.49).

[440] Appendix 24, paragraph 2.

9.244 We consider that the costs incurred by firms in participating in tenders are further evidence of the incentives they face to compete intensely. We consider the evidence on this point next.

Firms' costs in tendering

9.245 Firms stated that the costs of preparing tenders fell into two categories: direct and indirect costs.

9.246 The direct costs incurred by the firms in preparing for the tender are mainly the costs of the time allocated by the pitching team. Deloitte explained that the factors that could influence the cost of submitting a tender were the mix of pitching team, the specifics of client requests, the extent of overseas visits, the number of meetings during the tender process, the length of the tender process, and any additional costs associated with innovative approaches in the pitch. They varied from company to company and depended largely on the complexity of the assignment and the requests of the clients.[441]

9.247 The indirect costs are said to be not easily quantifiable and include *(a)* the time spent before the tender, to increase the probability of being invited if a tender opportunity emerges, such as the costs of building a relationship with the client; and *(b)* the opportunity cost of staff not working on other projects while preparing for the tender.[442,443]

9.248 All firms agreed that the more complex the tender, the more time firms spent in the preparation, and the higher its cost. It also appeared that the pitching team was generally more senior than the team required for the delivery of the audit service. For

[441] Appendix 24, paragraph 20.
[442] We report here firms' views on the matter, but recognize that accounting for opportunity costs creates the risks of double counting direct time costs.
[443] Appendix 24, paragraph 21.

example, GT explained that engagement and audit partners, audit senior managers, managers and bid managers were those in the team that spent most time in preparing the tender. EY stated that a typical tender team consisted of a lead engagement partner and reviewing partner or committee, audit senior manager or director and pursuit leader who could be either a specialist or an engagement partner.[444]

9.249 From our analysis of the tender and engagement data, we found that the average staff costs of tendering as a proportion of the proposed fee for the first year of the audit by firm range from 20 to 60 cent and that for some engagements the ratio of costs to fees was considerably higher than the average.[445]

Company costs in tendering

9.250 We consider that: *(a)* the costs that FTSE 350 companies incur when they have tendered the audit engagement are evidence of their commitment to the process; and *(b)* if the costs to a company of tendering an engagement are high we would expect a company that has taken a decision to go to tender to want to ensure that the process delivers a good outcome. These costs largely take the form of the opportunity cost of the time committed by management to the process (see paragraphs 9.164 to 9.166).

9.251 We do not have quantitative data on company tender costs. However, our first survey asked why companies had not tendered in the last five years. Among FTSE 350 companies that had not tendered their audit engagement in the last five years, around 20 per cent mentioned the costs involved in tendering and switching as a reason for this. The responses suggested that the costs of running a tender process can be high, in particular the opportunity costs.[446] For example, one respondent said

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[444] Appendix 24, paragraph 22.
[445] Appendix 24, paragraphs 36.
[446] Appendix 3, paragraph 59 and Annex 2.

that tenders were very expensive and time consuming, and another that tendering an audit was hugely disruptive in terms of management time.

9.252 From our case studies and hearings:

(a) The Company B FD said the tender process itself was straightforward, but needed to be run efficiently so the decision could be announced and the new auditors could start in a timely way for the new reporting year.[447]

(b) The Company C CFO said that the selection (ie tender) process itself was somewhat onerous and time consuming but the real issue was educating the new audit team. The company was never very far away from issuing results to the market as it reported quarterly. Therefore it was a logistical exercise in appointing the auditors in time to conduct the audit: it required D-day style planning.[448] During the process, the ACC attended about 20 meetings with the bidding firms. He was available to all parties at any stage of the process.[449]

(c) At Company H the bidders submitted written submissions at the first stage of the tender. In preparation, the bidders were offered access to whomever they wanted at the company. Two firms made presentations to the AC, the other board members and some members of the finance team at the second stage of the tender. Each gave a presentation of 2 and a half to 3 hours.[450] At Anonymous 1, the tender process entailed a thorough appraisal over a two-month period. An invitation to tender was issued at the end of March/early April 2011, regional meetings followed, and final presentations were made in June. This process had to fit into the company's reporting cycle. It had a calendar year end. The tender was specified at both local and group level. Each of three firms made three presentations to the company's regional teams, which amounted to around 40 sessions in total across all the firms. Final presentations were made to the AC

[447] Appendix 2, Case Study B, paragraph 20.
[448] Appendix 2, Case Study C, paragraph 29.
[449] Appendix 2, Case Study C, paragraph 59.
[450] Appendix 2, Case Study H, paragraphs 24 & 25.

and the regional CFOs and senior group finance team. The company's non-executive directors were heavily involved (many of them were themselves ex-FDs with large organizations).[451]

9.253 Accordingly, while we do not have quantitative data, it appears that running a tender process can be onerous for some companies: the cost, principally in management time, appears related to the size, complexity and geographic spread of the company. We note that very senior management time is required.

9.254 We consider that these costs are reflective of the effort made by FTSE 350 companies to ensure that tenders have been effective and competitive processes. We have set out above the evidence on how tenders for FTSE 350 engagements have operated. It appears that companies design the process to ensure that firms have access to company information and employees that they need in preparing a bid. The selection panel comprises senior people in the company. The process will involve frequent interaction between the company and firm when companies will have the opportunity to test the capabilities of the firms bidding.

Provisional view on competitiveness of tenders

9.255 Our provisional view is that competition in tenders for FTSE 350 engagements is strong in relation to the factors on which selection is based, namely the capabilities and experience of the firms and the audit team, the reputation of the firm and the audit fee. In particular:

(a) Given that the demand for statutory audits by FTSE 350 companies is fixed in terms of numbers of available engagements, to expand their FTSE 350 client base, firms must displace competitors and tenders are the principal means to do

[451] www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/summary_of_conference_call_25_january_2012.pdf, paragraphs 15 & 16.

that. Therefore we consider that audit firms have the incentive to compete intensely during tender processes.

(b) If invited to tender, Big 4 firms will generally participate. Tender lists typically include at least three Big 4 firms although the analysis of sector experience suggests that some firms may be better placed that others in competing for the certain engagements. Mid Tier firms appear to be invited to participate in only about one-third of tenders, but the performance of these firms in the tenders for FTSE 350 engagements suggests that they were not the strongest competitors.

(c) The tender process is designed to ensure that firms have strong incentives to compete intensely for the engagement. To address the advantages the incumbent may have, companies build into the process opportunities for all firms to gather information and to interact with key individuals in the company. Shortlists are used to avoid diluting incentives to compete.

(d) The tender instructions are detailed ones in which firms make submissions responding to company specifications. One consequence of this may be intense competition on the parameters specified by limited product differentiation between firms in their offers. Typically proposal teams are made up of senior individuals with a considerable proportion of the time allocated accounted for by partners.

(e) The tender selection process is led by FDs, CFOs, and ACCs who are usually experienced individuals and many have trained with or worked for one of the Big 4 firms (ie they have relevant experience of the main suppliers). Most ACCs hold more than one AC position.

(f) For the company, there is a (possibly significant) opportunity cost in senior management time of launching and running a tender (which may vary given other issues that may call for management attention). Accordingly, having taken the decision to tender the audit, we expect that management and the AC take the process seriously. For example, we know that the process allows firms to have

access to the individuals and information they need to prepare tenders. This includes contact with the FD and ACC.

(g) For the audit firms, participating in a tender is a time-consuming and costly process and potentially damaging to their reputation with the potential client if they do not perform well. For this reason, firms are unlikely to participate unless they intend to take the process seriously.

9.256 Accordingly, in our provisional view, formal tenders provide the best opportunity for a company to obtain the information and weigh the factors necessary to enable them to obtain the most competitive offerings available in the relevant market (as listed in paragraph 9.7), and so to maximize their bargaining power.

Provisional view on willingness to switch and bargaining power

9.257 In paragraphs 9.9 to 9.217 we examined the criteria listed in paragraph 9.7 that we think determine the extent of a company's bargaining power. Having regard to the structure of the market, we consider that overall the competitive pressure that a company can exert in negotiations with its existing auditor depends on the firm's assessment of the risk of losing the engagement if it does not provide the audit at a competitive price and to a high quality, and the consequential costs for the firm. This risk in turn depends on the strength of a company's outside option, the information available to it on its outside options, and its costs of switching.

9.258 It is our provisional view that:

(a) Generally FTSE 350 companies have a choice of alternative suppliers, although we note the more limited choice that may prevail in certain sectors (such as for large financial institutions) (see paragraph 9.27) and that they will tend to focus on the Big 4 firms.

(b) FTSE 350 companies (in particular their FDs and ACs) generally have the expertise, resources and information to appraise their incumbent auditor's offer to a certain extent on many aspects of the audit. (See paragraph 9.98.)

(c) Although there are sources of information available to FDs and ACs regarding alternative auditors, the information available to them outside a tender process leaves significant uncertainties in assessing the prospective performance of these alternatives in terms of price and quality (and this makes uncertain the benefits of switching). See paragraph 9.148.

(d) There are significant costs to companies associated with switching (see paragraphs 9.174 to 9.176):

  (i) the close nature of the company-auditor relationship of trust and confidence means that companies do not walk away from established corporate and personal relationships unless the incumbent auditor significantly under-performs or overcharges;

  (ii) the significant costs companies must incur in educating a new auditor; and

  (iii) the direct costs of running the tender in terms of management time and (possibly) external consultants.

(e) A company will contemplate switching auditor if the gains to be had are expected to outweigh the cost of tendering and switching (see paragraphs 9.177 to 9.187). Relevant to this are:

  (i) the inherent uncertainty regarding the abilities of any new auditor and therefore the gains to be had from switching (however rigorous the tender process undertaken);

  (ii) evidence that on average any reduction in price may be short-lived;

  (iii) a perception that there is a lack of choice or differentiation between the Big 4 firms; and

  (iv) the likely risk aversion of those taking auditor reappointment decisions (and which may be encouraged by a firms' stressing of the risks of switching).

(f) There are also costs to firms if they lose an engagement that may be significant (paragraphs 9.188 to 9.217), and where present such costs will strengthen the bargaining position of a company.

9.259 Given these factors, in particular the uncertainties around the potential gains from switching including the performance of any prospective auditor identified in paragraph 9.258(c) and other switching costs identified in paragraph 9.258(d) we provisionally find that a significant number of FTSE 350 companies are reluctant to switch auditors and instigate a tender process.

9.260 In light of each of the above factors, we therefore identified particular aspects of the relevant market around information asymmetries and switching costs as follows.

(a) There are barriers to switching:

(i) companies face significant hurdles in comparing the offerings of the incumbent firm and alternative suppliers outside of a tender process, (paragraphs 9.99, 9.100 and 9.141 to 9.147) and this affects their ability to assess fully the benefits of switching;

(ii) it is difficult for companies to judge audit quality in advance due to the nature of audit (paragraph 9.146); and

(iii) companies and firms invest in a relationship of mutual trust and confidence from which neither will lightly walk away as this means the loss of the benefits of continuity stemming from the relationship. In particular, the loss of the expertise and knowledge of the incumbent arising from a loss of continuity may lead to reduced inefficiency in the conduct of the audit and increased risk in the technical quality of the audit (paragraphs 9.159 to 9.162 and 9.173).

(b) Company management face significant opportunity costs in the management time involved in the selection and education of a new auditor (see paragraphs 9.164 to 9.168, 9.171, 9.174 and 9.250 to 9.254.

9.261 We provisionally found that each of these aspects amounted to a feature of the market which individually or in combination prevents, restricts or distorts competition.

9.262 Given our findings on the structure of the market, we provisionally found that the features identified above either individually or in combination give rise to an AEC by weakening a company's bargaining power outside the tender process. Given the extent of contact between auditor and company, firms can accurately gauge the extent of company discontent, and adjust the dimensions of the audit (in terms of personnel and fee) accordingly, and so mitigate the risks of a tender. As a result the firm need not 'give away' any more than is necessary to retain a client. Companies are less well-placed when it comes to determining at what point (ie how low a fee can be) a firm would be unwilling to act. Incumbent auditors therefore face less competition for their ongoing engagements than they would were the company more willing to switch, thereby ultimately reducing rivalry between firms.

9.263 We are of the view that these features are pervasive throughout the FTSE 350 statutory audit market but their impact will be uneven across companies. How a feature or combination of features impacts on an individual company's strength of bargaining power will vary over time and depend on its particular circumstances.

9.264 As a result of the AEC, we provisionally found that companies are offered higher prices, lower quality and less innovation and differentiation in offerings than would be the case in a market without the features.

10. Barriers to expansion and selection

10.1 If a supplier increases its prices above competitive levels, its customers may switch to other suppliers. If enough of them do this, the price increase becomes unprofitable. However, if there are barriers to entry or expansion by rival suppliers, the customers may not be able to switch, and so the initial supplier may be able to sustain its price increase. Accordingly, a barrier to expansion may be defined as any characteristic of the market that gives incumbent suppliers a cost or other advantage over efficient potential suppliers.

10.2 The prospect of timely expansion on a sufficiently large scale is important to our assessment of competition, as it can counter adverse effects arising from other sources. If rival firms could expand rapidly and with low risk, incumbent firms would be unable to increase prices or lower service quality without being substituted.

10.3 We note that high concentration in a market does not always indicate weak rivalry as suppliers with large market shares could be vulnerable to entry and expansion which might constrain market power. Conversely, suppliers with a high market share have less incentive to compete vigorously with rivals where there are significant barriers to entry and expansion.[452]

10.4 We have considered structure, tenure, and frequency of tendering and switching in the relevant market in paragraphs 7.5 to 7.25 and choice and differentiation between firms in paragraphs 7.26 to 7.28 and 9.184 to 9.186.

10.5 In this section, we have considered in particular the position of Mid Tier firms, such as BDO, GT, Mazars and PKF. These are large firms with significant audit practices and extensive international networks: see Appendices 9 and 25. However,

[452] CC Guidelines for market investigations, consultation draft (*CC3* revised), paragraphs 171 & 174.

collectively they have only few engagements among the FTSE 350, and just one engagement within the FTSE 100.

10.6 We assess the competitive pressure that Mid Tier firms exert on the Big 4 firms. We consider: *(a)* the frequency with which Mid Tier firms are invited to tender and their success rates; *(b)* companies' awareness of Mid Tier firms; possible barriers to expansion to the Mid Tier firms in the form of *(c)* investments and sunk costs, *(d)* strategic behaviour by the Big 4 firms; and *(e)* regulation.

10.7 We also consider barriers to selection in the form of *(f)* experience and *(g)* reputation. We use the term 'barriers to selection' to refer to these reasons, to distinguish them from potential barriers to expansion such as economies of scale or sunk investment costs.

Frequency of invitation to participate in tenders and success

10.8 We considered how frequently Mid Tier firms were invited to participate in tenders and their subsequent success. Mid Tier firms were invited to 33 per cent (of 40) tenders (for which we had tender lists) at surveyed FTSE 350 companies and 51 per cent (of 123) tenders at surveyed non FTSE 350 companies in the past five years (see Appendix 3). The success of Mid Tier firms in these tenders appeared limited. A Mid Tier firm was successful in winning only one of the 40 tenders (a switch from one Mid Tier firm to another). A Mid Tier firm was the incumbent of five companies and in four out of five the result was a return to a Big 4 firm.[453] We also asked FDs and ACCs which audit firms their company would formally consider if their current

[453] Appendix 3, paragraphs 53 & 54.

statutory auditor were to cease trading. 23 per cent of FTSE 350 FDs and ACCs said that they would formally consider both Big 4 and non-Big-4 firms.[454]

10.9 In this context, we considered a model provided by Oxera on behalf of BDO and GT, looking at the potential profitability of entry by a Mid Tier firm. The model showed that it was not economic for Mid Tier firms to incur the costs of tendering for FTSE 350 audits given the probability of winning.[455]

10.10 GT said that the low levels of switching made it extremely difficult for it and other suppliers of audit services to destabilize the position of the four largest audit firms and grow market share, particularly when FTSE 350 audits were tendered infrequently.[456]

Companies' awareness of Mid Tier firms

10.11 We considered the evidence of companies' awareness of audit firms and their capabilities. Our survey results showed that 77 per cent of the FTSE 350 companies had been approached in relation to the audit of their company by only Big 4 audit firms (and not Mid Tier firms).[457] In our case studies the interviewees (all FDs or ACCs of FTSE 350 companies) generally had much better awareness of the capabilities of the Big 4 firms than they had of the Mid Tier firms.

10.12 Deloitte, KPMG and PwC all submitted that weaker market awareness of Mid Tier firms was driven by Mid Tier firms' less significant efforts to target larger companies. (See Appendix 26, paragraphs 8 to 10.)

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[454] Appendix 3, paragraph 80.
[455] www.competition-commission.org.uk/our-work/statutory-audit-services/evidence/initial-submissions.
[456] GT response to the CC working paper 'Descriptive statistics', paragraphs 2.6.
[457] Appendix 3, paragraph 78.

10.13 However, this is a ‘chicken and egg’ situation. If Mid Tier firms do not believe they will win FTSE 350 audits they have no commercial rationale to invest more in marketing to FTSE 350 companies. If companies are not aware of Mid Tier firms’ capabilities then they are unlikely to invite them to tender.

Investment and sunk costs

10.14 As noted in paragraph 9.15, BDO, GT, Mazars and PKF considered themselves able to audit FTSE 350 companies. They considered that it was not the lack of investment in capability or international network that meant they were not winning FTSE 350 audit engagements.

10.15 We broadly accept this submission, to the extent that we have not identified any specific large sunk investment that they would need to make in order to expand in the market. The largest Mid Tier firms have substantial international networks and have invested substantial amounts in IT and compliance software, and do currently audit some FTSE 350 companies. However, we note the views of Big 4 firms that there is a real difference in the quality of the networks of Big 4 and Mid Tier firms and that this is a real reason for their lack of expansion in the reference market (see Appendix 26, paragraphs 41 and 42). We have not formed a view on this. We found no evidence of significant economies of scale such that the Big 4 firms had lower costs than large Mid Tier firms.[458] Our consideration of investments in international networks and non-staff costs can be found in Appendix 25.

Strategic behaviour by Big 4 firms

10.16 We considered whether there was evidence of strategic behaviour by Big 4 firms to exclude smaller firms. Under this heading, we considered whether there was

[458] See Appendix 28, paragraph 96, and Appendix 29. We note that given the limited number of engagements for Mid Tier firms in our data set, we could not expect this analysis to identify economies of scale in staff costs that are realized at levels below which the Big 4 operate. Our assessment of economies of scale in non-staff costs was limited to three specific areas of expenditure (marketing, IT and property costs) which we identified as areas where firms might achieve an economy of scale.

evidence of bundling or tying audit with NAS (see Section 12 and Appendix 20) and whether there was evidence of aggressive targeting of Mid Tier firms' clients by Big 4 firms (see Appendix 27). We found no link between the profitability of engagements and the level of NAS provided and this did not therefore support the view that firms strategically price their audits at a low level to win NAS work. In the four specific cases of aggressive pricing we investigated, we found evidence of price pressure both during and outside of formal tender processes. However, we did not find evidence that the Big 4 firms were specifically targeting BDO's clients with aggressive pricing and in some cases found that the Big 4 firms had proposed price increases to BDO's clients.

Regulatory framework

10.17 We also considered whether there were aspects of the regulatory framework that were acting to restrict entry. Under this heading we considered liability and insurance requirements, independence requirements (including limits on fees from single clients, and ownership requirements), see Appendices 15 and 21. In particular, although it has not been possible to make a direct comparison of the cost of insurance between firms, we have seen no evidence to suggest that Mid Tier firms cannot obtain adequate levels of insurance cover or pay disproportionately more for cover than do the Big 4 firms. More generally, we found that the regulatory framework applied equally to all firms and we found no evidence that it restricted entry by Mid Tier firms.

Experience

10.18 As noted in paragraph 5.41(e), the provision of audit services (like many services) is an experience good for company management, in that it is hard to know with confidence the quality of the audit in advance. Unlike other services, it is not possible for audit firms to show prospective clients examples of audit work for other

companies, since the audit file is confidential, and there is little information in the published audit report to allow firms to demonstrate their ability.

10.19 In paragraphs 9.111 to 9.138 we consider the sources of information available to companies when considering possible alternative suppliers. In practice it appears that the most convincing way for a firm and its audit partners to demonstrate capability to a prospective client is to point to audit engagements that they have delivered for similar companies. FTSE 350 companies look for firms that have experience of auditing large, complex, international audit clients who are listed on the main market, and may also look for specific sectoral expertise. We think this generates a virtuous circle for firms that have a significant number of FTSE 350 clients. Those engagements generate experience and expertise for a firm and its partners, which in turn helps them to acquire further clients.[459]

10.20 The converse is also true: having only a limited number of (or no) FTSE 350 audit engagements means that the Mid Tier firms are less likely to be able to demonstrate significant audit experience in relevant sectors or with relevant companies. Only the Big 4 firms can cite substantial experience of the largest, most complex listed companies. Such experience may also be considered valuable to smaller, less complex listed companies with ambitions to grow (even if they currently have no need for such expertise). We have received evidence of cases where a larger Mid Tier firm was considered capable in theory but, when the company came to make its final decision, the lack of experience in the FTSE 350 audit market meant that a Big 4 firm was chosen. See further Appendix 26, paragraph 29. Another way by which an audit firm can demonstrate its capabilities to a prospective audit client is by establishing a working relationship with the company in a related area, for example the provision of NAS such as tax, due-diligence, internal audit or systems work. We

[459] We also note that other benefits may also be conveyed such as the ability to attract and retain graduates who may be attracted by the opportunity to work on prestigious and/or international listed company audits.

found that some of the larger Mid Tier firms had fewer and lower-value NAS relationships with FTSE 350 companies than Big 4 firms (see Appendix 26).

Reputation

10.21 By reputation, we mean ‘perceived ability’, and it is the perception of those making the appointment decision that is key. In this market, we think that it is the views of the ACCs and FDs that are most influential in selecting auditor (paragraph 11.8), however, they take into account the perceptions of other parties such as investors. As discussed above, reputation is often based on experience and may to some extent be synonymous with it, because of the difficulty of gauging quality in another way. Reputation can attach to a firm, or to an individual audit partner.

10.22 To the extent that reputation is an accurate reflection of capacity, quality, expertise, and efficiency, it allows companies to distinguish between potential suppliers of audit services and select the most appropriate for their needs. However, if it is not an accurate reflection, then any inaccuracy may distort companies’ decisions as to choice of auditor, and so amount to a barrier to selection to the Mid Tier firms.

10.23 Our survey indicated that ‘reputation’ was an important or very important factor in auditor selection for 84 per cent of FDs/CFOs and 82 per cent of ACCs. [460]However, of the companies that stated they would not formally consider any firms outside of the Big 4, only 23 and 11 per cent of FDs and ACCs respectively indicated ‘reputation’ as the reason.[461]

10.24 Some case study companies favoured the Big 4 firms. Equally, some of the investors that we spoke to or contacted favoured the Big 4 firms, though most expressed a nuanced view: depending on the company (size, sector etc). While some investors

[460] Appendix 3, Table 12.
[461] Appendix 3, Table 23.

considered the Big 4 firms to be better able to audit large companies (ie FTSE 100), most investors seemed to be comfortable with a larger Mid Tier audit firm auditing FTSE 250 companies. (See Appendix 19.)

10.25 Given this view, and the view of larger Mid Tier firms that they were capable of auditing all but the very largest FTSE companies, we considered why Mid Tier firms could not retain clients as they grow and join the FTSE 350. We also noted that the Mid Tier firms appear to have a relatively low market share of audit engagements for companies listed on the main market but outside the FTSE 350.[462] In considering these issues, we asked various providers of capital, and corporate advisers, about their influence on auditor selection.

10.26 We found a tendency to prefer Big 4 auditors by private equity houses, institutional investors, and investment banks (see Appendix 7). We also found 'Big 4 clauses' in some syndicated leveraged loan agreements that mandate the use of a Big 4 auditor (see Appendix 7). We consider that such clauses add to the reputational barriers to Mid Tier firms expanding or entering the FTSE 350 audit market.

10.27 This commonly held 'City' view, in our view, is a factor that companies preparing to list on the main market, or who are already listed, are likely to take into account in their decisions about auditors. It implies that Mid Tier firms face difficulties in retaining audit clients who are planning to raise private equity or list on the main market and is supported by the evidence we received from many institutions that most companies already had Big 4 auditors when they approached them for private equity capital or to underwrite an equity issue. Whilst the preference for Big 4 firms is not universal, companies interact with a large number of institutions during the process of preparing to raise capital. Given a preference for Big 4 firms by many

[462] We have not investigated the share of supply of audit outside of the FTSE 350. Oxera (2006) found that the Big 4 had approximately 80 per cent of audits of companies listed on the main market but outside of the FTSE 350.

institutions, it appears rational for a company to appoint a Big 4 firm. Further, the tendency for financial market participants to prefer Big 4 auditors indicates some risk for a listed company in switching from a Big 4 firm to a Mid Tier audit firm. An adverse reaction from the City could increase the risks of switching from a Big 4 firm to a Mid Tier firm for a listed company on the main market.

10.28 BDO and GT submitted that the so-called 'IBM effect' prevailed in the sector (the phrase quoted to us was that 'you never got sacked for using IBM'[463]). (See Appendix 26, paragraph 93.)

10.29 The evidence we have of companies' views of their options is set out in paragraphs 9.187 to 9.267. The view was succinctly summed up by the ACC at Company E who thought that a Mid Tier firm would be able to perform the company's audit. However, there was pressure for a PLC to use a Big 4 firm and that the larger the company the greater the pressure was. He thought it was very hard to move away from the Big 4 and that 'no one lost their job for appointing a top four'.

10.30 We found that it was the case that some companies felt 'safer' by engaging a Big 4 firm, and that they thought that not to choose such a firm would be to step out of line with peer companies (see further Appendix 26, paragraph 70).

Provisional view of barriers to expansion and selection

10.31 We provisionally find that the threat of expansion by the Mid Tier firms is not a competitive constraint on the auditors of FTSE 350 companies (which, in the large majority of cases, means one of the Big 4 firms). We think that to date Mid Tier firms have been held back by their inability to point to significant experience of auditing equivalent companies. We note that they may not have done all that they could in

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[463] In case of doubt, we conducted no investigation and have no view of the merits of IBM.

order to target and win FTSE 350 engagements but that this may reflect infrequent tender opportunities and a low expectation of winning engagements.

10.32 We think that experience conveys reputation; the Big 4 firms have a reputation for capability in the large listed audit market which is shared by companies and City institutions alike. The tendency of City institutions to favour Big 4 audit firms for large listed clients is likely to be a factor that companies take into account when appointing auditors.

10.33 We provisionally find that these barriers to selection amount to a feature that prevents, restricts or distorts competition within the relevant market. These barriers can either individually or in combination with the other features we have identified 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. Further, these barriers tend to reinforce the market structure and outcomes that we describe in paragraphs 7.5 to 7.28.

10.34 Without this barrier to selection, it may be that challenger firms could develop differentiated and/or innovative offers which would increase the benefits of switching and thus increase switching frequency. We note that in the current market, to this extent companies have a lack of choice of audit supplier and differentiation of audit product, and that, the offers of the Big 4 audit firms do not appear to be clearly differentiated and the level of innovation has not been high.

11. Assessment of our second theory of harm: principal-agent issues

11.1 Under our second theory of harm, described in paragraphs 8.19 to 8.21, we considered features of the market related to principal-agent issues in the relationships between shareholders, executive management, the AC, and the auditor, that have the effect of restricting, preventing or distorting competition.[464]

11.2 We investigated two main concerns:

(a) Whether audit firms have incentives to respond to management demand rather than shareholder demand, in circumstances where the demands of executive management may differ from those of shareholders. This would result in an adverse effect on competition, to the extent that firms compete on demands that differ from those of shareholders. We identified in Section 7 that audit firms on occasion were insufficiently sceptical in carrying out audits, and that lack of scepticism would result in an impairment of the independence and objectivity of the relevant audit firm and have a detrimental effect on shareholders. We also considered whether the activity of the AC (and other factors) was sufficient to mitigate such detrimental effects.

(b) Whether there are constraints that prevent auditors from supplying the demand of shareholders for better information provided by the audit, as discussed in paragraphs 7.180 to 7.203. We found in paragraph 7.204 that there is a significant demand from existing and potential shareholders for further or different information regarding audits that is not currently being met. As a result of this, shareholders might not be able to appraise adequately either the performance of the companies in which they hold shares or the quality of the audit.

11.3 We set out our analysis in the following subsections.

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[464] The concept of principal-agent issues was explained in paragraphs 5.6–5.8.

Whether audit firms have incentives to respond to management demand rather than shareholder demand, in circumstances where the demands of executive management may differ from those of shareholders

11.4 In this subsection we:

(a) consider who is the buyer of the audit and what is their demand (paragraphs 11.5 to 11.27);

(b) consider AC effectiveness in representing shareholder interests (paragraphs 11.28 to 11.56);

(c) consider the incentives for auditors to satisfy either management or shareholder demand (paragraphs 11.58 to 11.94); and

(d) set out our provisional views on the demand that auditors are competing to satisfy in the supply of audit services and how this differs from the demand of shareholders (paragraphs 11.95 to 11.105).

The buyers and their demands

Role of shareholders

11.5 As a matter of law, it is the shareholders as a body that appoint or reappoint the auditor by ordinary resolution in an AGM (see paragraph 3.9). Ultimately, they pay for the audit. We set out in paragraphs 5.5 to 5.8 how we perceived their demand, namely to have reliable financial information about the company, so that they can accurately appraise its performance and that of its managers and so take well-informed decisions.

11.6 However, we consider that shareholders may be poorly placed to judge the performance of their auditors and therefore unable to tell if fees are too high or the quality too low (which we think would be key reasons to vote for a change in auditor). Even if they had a view, it may be hard in practice for shareholders to oppose the recommendations of company management.

11.7 Given these factors, we found that, in practice, shareholders follow the recommendations of company management, and that company management is the buyer, in practice, for the reasons given in the next subsection.[465] We think that this may be due to a combination of the coordination problem and information asymmetries we have identified (paragraphs 5.23 and 5.49 above).

Role of executive managers and ACs

11.8 Based on evidence obtained from our first survey, for FTSE 350 companies it appears that in selecting the auditor, the key individuals are the FD/CFO, the ACC and the other members of the AC. The AC/ACCs were most frequently identified as the most influential. FDs consider themselves to have more influence than they are perceived to have among ACCs.[466] Equally, in the case studies (see Appendix 2), we were told that the ACC and FD are key in the decision to recommend an audit firm for appointment, but that there was also input from the wider management team.

11.9 The case study evidence indicates that the external auditor recommended to shareholders by the board is generally a joint decision between the executive and non-executive management.[467,468,469,470,471] The descriptions of tender processes showed that both were involved (and this accords with our review of the tender data—see Appendix 23).

[465] We have not identified any instance of shareholders (as a body) not following the recommendation by the management of a FTSE 350 company to (re)appoint an auditor.
[466] CC first survey results, paragraphs 33 & 34.
[467] Appendix 2, Case Study B, paragraph 69. The whole board made the assessment (the former ACC noted that the company's board was small and this would not be a suitable approach for all companies).
[468] Appendix 2, Case Study C, paragraph 22. The Big 4 firms submitted a written proposal and presented to a selection committee comprising (approximately nine people) the ACC, CEO, CFO, Corporate Finance Director and the senior management in each of the directly affected teams. The selection committee selected two firms to make a final presentation to the AC.
[469] Appendix 2, Case Study E, paragraphs 85 & 86. Each firm had access to the company via three to four fixed meetings with management. The initial meeting was with the Group Financial Controller discussing the audit approach and issues from previous years. There was also a site visit which the FD and FC attended, where the current auditor could question [✂] managers about processes, systems and controls. The current auditor had a call with the ACC for an hour to discuss governance and there was a final meeting with the FD. The AEP thought he had as much access as he needed. The process culminated in a presentation to four people: the ACC, CEO, FD and Group Financial Controller.
[470] Appendix 2, Case Study F, paragraph 25. Four individuals at the company were involved in the selection process (the FD, CEO, ACC and GFC).
[471] Appendix 2, Case Study H, paragraph 25. EY and KPMG made presentations to the AC, the other board members and some members of the finance team at the second stage of the tender. Each gave a presentation of 2 and a half to 3 hours.

11.10 We found that executive management often had a key role in recommending a particular audit firm for the ACC and AC to approve.[472,473,474,475,476] However, in other case studies the AC position was seen as primary to any decision.[477,478,479]

11.11 Given this evidence, we think that it is the preferences and perceptions of FDs and ACCs that are central to a company's assessment of its current and potential auditors (and therefore to how external auditors shape their services as they seek to retain and obtain engagements). This will include the perceptions these individuals have in relation to what is important to shareholders and other stakeholders, to the extent that they take into account the views of others as to the appointment of the external auditor.

Executive management demand

11.12 Under our first theory of harm we assessed FDs' and ACCs' ability to appraise their incumbent auditor. Under this second theory of harm, we are concerned to determine if there is a difference between the demand of executive management and that of shareholders, so that auditors have economic incentives to deliver a product which does not match shareholder demand. We consider the role of ACs in the next subsection (paragraphs 11.28 to 11.55).

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[472] Appendix 2, Case Study B: The FD made a recommendation whether to reappoint or switch auditors. Prospective firms would pitch to the FD, CEO and ACC. The ACC would be guided by the FD and the AC as to who he wanted to include in any process. The AC and ACC had to see that the process had been run on a fair, objective and independent basis. If this was the case then they would tend to allow the CFO, with the endorsement of the CEO, the final say on auditor selection (paragraphs 16, 48; see also 72).

[473] Appendix 2, Case Study C, paragraph 98. The management team gave a recommendation to the AC which had the final say.

[474] Appendix 2, Case Study D, paragraphs 15 & 91. The FD described his role in auditor selection as involved and influential, but as part of the board. The FD had a lead role in the re-tender but the decision was taken by the AC as a whole.

[475] Appendix 2, Case Study E, paragraph 18. While the ultimate decision rested with the board, via the ACC, consideration of the auditor was within the FD's remit and if there were issues with the auditor he would be the first person to be aware of them.

[476] Appendix 2, Case Study H, paragraph 67. The ACC said that he would have the final say on auditor selection but would be influenced by management's views.

[477] Appendix 2, Case Study A, paragraph 35. The AC, led by the ACC, would make recommendations to the board, for shareholder approval, on any change in auditors. In practice, this would be instigated by a recommendation from the CFO and ACC together.

[478] Appendix 2, Case Study E, paragraph 49. The ACC said that he was fully involved in decisions about the auditor. In previous roles the ACC had been through three tender processes, and in each case he had been fundamentally involved in the decision to tender and the decision to appoint the auditor.

[479] Appendix 2, Case Study F, paragraph 7. The FD was clear that the auditors reported to the AC and not to him—it was the AC that appointed the auditors and directed their work. The auditors were there to check the FD's (and his team's) work.

- *Firm submissions*

11.13 Some firms did not accept that there was a misalignment of interests between management and shareholders as management took seriously the duties they owed to their shareholders. Deloitte[480] stated that FDs took seriously their fiduciary duties to act in the best interests of the owners of the company. PwC stated that ACCs and FDs were engaged with the audit process and acted in accordance with their duties to the company and shareholders, and placed value on the quality, objectivity, and independence of the external audit above other characteristics.[481]

11.14 Deloitte also stated that the evidence showed that management and investors highly valued a wide range of facets of audit quality including both technical and service quality, and that there was therefore no misalignment of incentives as between management and investors as to the delivery of audit quality.[482]

11.15 KPMG stated that there was in general the potential for a misalignment between management and shareholder objectives: indeed this potential provided the underlying rationale for the statutory audit requirement.[483] However, given the requirement for an audit, KPMG said it was not clear from the evidence that any misalignment in the interests of managers and shareholders as regard the provision of that service existed in practice, and in any case the UK corporate governance regime was designed to mitigate the risks of any such misalignment.[484] In addition, KPMG noted that there were a number of other factors which governed audit firms' incentives as well as any role of management in the context in which an audit firm was (re)appointed; for example, the effect on reputation of adverse regulator findings.

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[480] Deloitte response to the CC working paper 'The framework for the CC's assessment and revised theories of harm', paragraph 2.31.
[481] PwC response to the CC working paper 'The framework for the CC's assessment and revised theories of harm', Annex, p11, a ii) and iii).
[482] Deloitte response to the CC working paper 'The framework for the CC's assessment and revised theories of harm', paragraph 2.10.
[483] KPMG response to the CC working paper 'The framework of the CC's assessment and revised theories of harm', paragraph 3.5.4.
[484] ibid, paragraph 3.5.4.

This ensured that audit firms acted in line with shareholder interests and conducted an audit of high technical quality, regardless of any misalignment of incentives.[485] KPMG also said that ultimate responsibility for the selection of the auditor rested with the AC, not management.[486] In this regard, PwC stated that there was potential for principal-agent issues to arise as between management and shareholders but that this was precisely the reason why audits existed, why ACs had been introduced and why their role had developed over time. PwC went on to explain that, for such a misalignment to exist, this would mean that ACs were failing to perform the principal tasks entrusted to them by law and regulation and were acting contrary to their obligations and integrity as professionals, but that no evidence existed to demonstrate this.[487]

- *Evidence and discussion*

11.16 We sought evidence regarding the demand of executive management. In our first survey we asked FDs how important they considered certain factors to be in the selection of auditors (and so what they looked for in the mandatory product). The findings are set out in Appendix 3.[488]

11.17 However, we noted that obtaining reliable evidence from FDs themselves about any difference between the demand of FDs and that of shareholders was difficult, as any FD answering our questions would have strong incentives to say that his or her demand aligned with that of shareholders when it comes to audit.

11.18 We considered the incentives of executive management as regards an external audit, distinguishing (in line with De Angelo's definition of audit quality—see paragraph

[485] ibid, paragraph 3.5.6.
[486] ibid, paragraph 3.5.7.
[487] PwC response to the CC working paper 'The framework for the CC's assessment and revised theories of harm', paragraph 7(b)(i) and (iv)).
[488] CC first survey results, paragraphs 37–39.

6.11) between the technical competence of the external auditor and the independence of reporting.

11.19 We think that generally FDs have an interest in a technically competent audit, particularly for remote areas of the company or group. This interest may be weaker in areas under the direct control or influence of the FD. From our case study interviews, it appeared to us that FDs and ACCs were strongly incentivized to avoid restatements of company accounts (for the reasons given in paragraphs 3.17 to 3.24).[489,490]

11.20 However, we were told that an audit was not just about picking up some numbers and confirming them against underlying records. The auditor needed to understand how the numbers had been put together, what motivated the team who produced them, the assumptions being made, and whether management had taken an aggressive or conservative approach to matters such as accounting standards and valuations (see paragraphs 7.136 to 7.143). The FD may not have a consistent interest in the independence of the auditor. Listed companies are under pressure to meet market expectations of financial performance. It has long been recognized that executive management in general and the FD in particular are likely, from time to time, to have strong incentives to manage reported financial performance to accord with expectations and to portray performance in an unduly favourable light. This was a view underpinning the Cadbury Report:[491] 'Companies too are subject to competitive pressures. They will wish to minimise their audit costs and they are likely to have a clear view as to the figures they wish to see published, in order to meet the expectations of their shareholders' (paragraph 5.3(d)) and 'the underlying factors

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[489] Appendix 2, Case Study A, paragraph 69. From the AC's perspective the focus was about quality and getting it (the audit) right, because another restatement in this business would be disastrous.
[490] Appendix 2, Case Study H, paragraphs 42 & 43. Restatements were embarrassing and if they happened regularly would raise issues about auditor quality.
[491] www.icaew.com/~/media/Files/Library/subjects/corporate governance/financial aspects of corporate governance.pdf, paragraph 5.3(b).

were seen as ... competitive pressures both on companies and on auditors which made it difficult for auditors to stand up to demanding boards' (paragraph 2.1).

11.21 As the Company C FD stated:

> The value in an audit was not in the auditor finding points or arguing with management but that an audit kept people on the straight and narrow and was absolutely indispensible to the integrity of the published accounts, given the temptations and pressures to produce accounts that presented a company in the most favourable light.
> (Appendix 2, Case Study C, paragraph 40.)

11.22 The AEP for Company A also noted the issue of management incentives to manage financial reporting:

> Auditors needed to understand how a set of numbers were put together and what motivated the team who produced them. The auditor needed to understand this so he knew where the management team might have placed their cards in terms of the range of possible answers ie whether they had taken an aggressive or conservative approach.
> (Appendix 2, Case Study A, paragraph 88.)

Provisional view

11.23 In paragraphs 5.3 to 5.11 we explained that the primary economic function of a statutory audit is to provide the shareholders of a company with assurance regarding the financial statements prepared by the management of the company (and in particular to give an opinion as to whether the accounts prepared by the directors give a true and fair view of the company's finances).

11.24 Further, the demand for this arises from principal-agent issues in the relationship between the shareholders and the management of a company (paragraphs 5.6 to 5.8): in particular that executive management may have interests that at times diverge from those of shareholders (see paragraph 11.20).

11.25 Our provisional view is that:

(a) we should primarily have the interests of shareholders in mind when considering whether the FTSE 350 audit market is working well: they are customers within the meaning of the Act (as the audit is commissioned for their benefit and, being owners of the company, they ultimately pay for it);

(b) despite their legal role and powers, in practice, shareholders are not influential in selecting and appointing auditors: they overwhelmingly follow the recommendations of company management;

(c) the evidence we have seen shows that executive management is very influential in the selection of an auditor and in any decision to tender an audit engagement; and

(d) given our analysis in paragraphs 5.3 to 5.15 and 11.16 to 11.22, executive management may at times have incentives to encourage the external auditor to accept treatments and judgements that portray the company in an unduly favourable light.

11.26 Accordingly, our provisional view is that executive management demand can differ from shareholder demand (which amounts to saying that we consider that the underlying rationale for conducting an audit, as recognized since 1846, remains valid).

11.27 The need to ensure that shareholders' interests are properly represented led to the emergence of a formal corporate governance framework in the form of the UK

Corporate Governance Code 2012 (see Appendix 8, paragraphs 158 to 159). An important aspect of this framework is the AC, and we turn to considering its effectiveness next.

AC effectiveness in representing shareholder interests

11.28 We recalled that an issue facing shareholders is that, although they collectively own the company, they have significantly less information than the management of the company regarding its performance and financial standing. Such information asymmetry creates uncertainty for shareholders and provides scope for management to act in ways that might not be in the best interests of shareholders. We accept that it is not the role of the AC to discover and satisfy shareholder demand for information relating to the company's financial reports,[492] but ACs do have a duty to ensure, on behalf of the board, that the interests of shareholders are properly protected in relation to financial reporting, and in paragraphs 9.71 to 9.75 we identified the role of ACs as being designed to ensure that auditors satisfy shareholder demands rather than management demands. Accordingly we consider:

(a) the role of ACs and evidence of their effectiveness (paragraphs 11.30 to 11.45);

(b) ACCs' incentives (paragraphs 11.46 to 11.48); and

(c) firms' submissions on AC effectiveness and ACCs' incentives (paragraphs 11.49 to 11.51).

11.29 We then (d) set out our provisional view (paragraphs 11.52 to 11.56).

[492] www.frc.org.uk/getattachment/6ec23196-28ee-406e-8f56-89ab9d1dc06d/Guidance-on-Audit-Committees-September-2012.aspx, paragraph 2.2.

The role of ACs and evidence of their effectiveness

- *AC role*

11.30 Article 41.1 of the Audit Directive requires every PIE to have an AC, which has at least four functions: *(a)* to monitor the financial reporting process; *(b)* to monitor the effectiveness of the company's internal control, internal audit where applicable, and risk management systems; *(c)* to monitor the statutory audit of the annual and consolidated accounts; and (*d)* to review and monitor the independence of the statutory auditor or audit firm, and in particular the provision of additional services to the audited entity.

11.31 ACCs are appointed by the board on the recommendation of the nomination committee, as are other members of the AC in consultation with the ACC. Shareholder approval would be required for an appointment of new non-executive directors.

11.32 The AC is made up of independent, non-executive directors, at least one of whom must have recent and relevant financial experience, and is a committee of the board, like other committees to which particular responsibilities are delegated (such as the remuneration committee*).* The principle of the unitary board is preserved; all directors remain equally responsible for the company's affairs as a matter of law. Any disagreement within the board, including disagreement between the AC members and the rest of the board, should be resolved at board level.[493]

- *Evidence of AC effectiveness*

11.33 ACs and ACCs are not subject to external supervision, although companies and ACs should carry out effectiveness reviews annually.[494] There are several factors that

[493] See Guidance on Audit Committees, FRC, September 2012, paragraph 1.4: www.frc.org.uk/getattachment/6ec23196-28ee-406e-8f56-89ab9d1dc06d/Guidance-on-Audit-Committees-September-2012.aspx.
[494] Corporate Governance Code, section B: www.frc.org.uk/getattachment/a7f0aa3a-57dd-4341-b3e8-ffa99899e154/UK-Corporate-Governance-Code-September-2012.aspx; FRC Guidance on Audit Committees, paragraph 3.3: www.frc.org.uk/getattachment/6ec23196-28ee-406e-8f56-89ab9d1dc06d/Guidance-on-Audit-Committees-September-2012.aspx.

make it difficult to measure the effectiveness of the AC. Notably the visibility of AC activity is low and much of it takes place behind closed doors in informal interactions with the auditor and executive management.

11.34 In addition, we recognize that it might be unreasonable to expect ACCs to comment critically on the effectiveness of ACs in carrying out their responsibilities. Our approach was therefore to explore with them their understanding of the role of the AC, how they approached their responsibilities and the resources available to them.

11.35 In this subsection we consider evidence from *(a)* our follow up survey; *(b)* case studies; *(c)* the FRC; *(d)* investors; and *(e)* academic research regarding the effectiveness of ACs in ensuring that shareholders interests are protected. We set out evidence regarding ACCs' ability to appraise their incumbent auditor in paragraph 9.58.

◦ *Survey evidence*

11.36 Results from our follow-up survey of FTSE 350 ACCs indicated that in general ACCs felt confident or very confident that they could assess various aspects related to the audit (such as the robustness and perceptions of auditors in handling key judgements on accounting policies). However, their responses suggest that detailed work of the auditor may be less visible to ACs.[495] The results are discussed in more detail in paragraph 9.89 and Appendix 4.

11.37 The follow-up survey also suggested that on occasion the ACCs act independently of executive management in their review of the external financial reporting and auditing. In particular, the evidence suggests that ACCs requested the provision of supplementary information from time to time (52 per cent of those surveyed had done so in

[495] See responses to the CC follow-up survey of FTSE 350 ACCs, questions D1 to D6.

the last three to five years) and have been able to engage additional resources independent of the company when they have considered this to be necessary (24 per cent of those surveyed had done so in the last three to five years).[496]

- *Case studies*

11.38 The ACCs that we spoke to during our case studies saw their role as maintaining financial controls and looking after the interests of shareholders, but there appeared to be differences in how they discharged this role.[497] For example, we were told by some that the ACC would want to understand what issues the auditors had found and should have a very good understanding of the audit process and the key judgements made.

11.39 We were told by others that it was difficult for an AC to examine in detail the work that the auditors had undertaken and that it was not its role to do so. Examples from our case studies illustrate the practical limitations of the AC.

(a) At Company B the ACC had little visibility of what happened during the actual auditing process. The ACC wanted to understand what issues the auditors had found and what decisions the AEP wanted the AC to take if there were to be any adjustments to the accounts prepared by management (paragraph 54).

(b) At Company C the ACC could not know if the auditor was doing a poor job unless management raised an issue or something came to light after the event (paragraph 73).

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[496] See responses to the CC follow-up survey of FTSE 350 ACCs, questions C5 and C8.

[497] For example, the Company B ACC did not view the role of auditors as protecting shareholders from management. She saw the auditors' role as to ensure that the accounts gave a true and fair view of the company's trading position and balance sheet (paragraph 39); the Company C ACC saw his role as to see that the company was well run and controlled. He was there to represent shareholders and other stakeholders (paragraph 56); the Company D ACC saw her role on behalf of the shareholders to make sure that management was managing the business and that the results were credible and reliable. The AC's role was to address any issues that were raised as a result of the audit process and to act as a safeguard between the management and the shareholders to help the shareholders to have some confidence that the numbers were true and fair (paragraph 57); the Company G ACC saw part of his role as to protect the auditor on big judgemental issues. He needed to ensure that the auditor was not being hit too much on fee. It was important to have a relationship with the auditors that was based on trust. He said in any constructive relationship there would be disagreements and the auditors could do a better job if supported by the AC (paragraph 57); the Company H ACC said that the AC needed to ensure that the relevant standards were applied and that the auditors were satisfied with the final decisions (paragraph 64).

- *FRC*

11.40 The FRC told us that in its experience the standard of corporate governance varied significantly from company to company. It considered that the level of resources devoted to corporate governance within companies declined further down the FTSE index.[498]

- *Investors*

11.41 PwC's interviews with investment professionals in a number of countries, including the UK, indicated that investors thought that ACs were not sufficiently independent of management, with 39 per cent of respondents disagreeing that ACs were sufficiently independent of management.[499]

11.42 We noted that despite the presence of the AC, some investors were concerned about auditor independence. For example, Oxera's survey on behalf of BDO and GT reported that one investor, [✂], said that auditors were much too close to company management, in particular to finance staff and did not act in the best interests of shareholders. Although that was not to say that auditors did not fulfil what was required of them. The misalignment of incentives resulted in, for example: *(a)* slightly more aggressive accounting practices than long-term investors would like to see, for example the banking sector, where certain accounting practices were accepted (eg recognition of profit upfront) that were not in the interests of long-term shareholders; *(b)* a lack of transparency in accounting assumptions. Long-term investors had a preference for simplicity and transparency, and when an auditor had become embedded to a company, there was a concern that they would include something complicated and potentially misleading; and *(c)* a lack of colour: investors would appreciate more nuance, eg general commentary about how the accounts were put

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[498] Summary of hearing with the FRC held on 26 October 2012, paragraph 8.
[499] PwC 'Assurance Today and Tomorrow' Global Investor Survey 2012. www.pwc.com/gx/en/audit-services/publications/investors-views-survey.jhtml.

together and the relative aggressiveness of accounting—but was not sure how this could be done given the cosy relationship between the auditor and management.[500]

11.43 The Institutional Investor Committee (IIC) comprising representatives from the ABI, the IMA and the NAPF said in their response to the EU Audit Proposals[501] that 'the long periods auditors hold office can impact their independence and objectivity'.

- *Academic research*

11.44 AC effectiveness is a subject that has been considered in the academic research, although there are relatively few recent UK studies. Relevant studies include Song & Windram[502] (2004) which noted a significant shift in AC function from one of traditional financial reporting to a greater focus on internal controls and risk management. The study notes lack of time, pressure from executive directors, and an unclear remit as impediments to the effectiveness of the AC. Spira[503] (2003) questions the potency of the AC against a backdrop of ambiguity and complexity surrounding the AC role. Turley & Zaman[504] (2007) note that AC effectiveness is very difficult to measure and that qualitative research approaches are 'nearly impossible' to operationalize due to access and sensitivity concerns. Other studies, such as Spira (2002)[505] and Zaman and Collier (2005)[506] express reservations about the AC's ability to discharge enhanced responsibilities post Cadbury.

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[500] Appendix 19, paragraph 89(b).
[501] IIC response to the EU Audit Proposals, Section 3, Proposals for the mandatory rotation of audit.
[502] Song, J and Windram, B, 'Benchmarking Audit Committee Effectiveness in Financial Reporting', *International Journal of Auditing*, Vol 8, No 3, pp195–205, November 2004. Available at SSRN: http://ssrn.com/abstract=605160.
[503] Spira, L F, 'Audit Committees: Begging the Question?' *Corporate Governance: An international Review* 11(3), pp180–188.
[504] Turley, S and Zaman, M, 'Audit Committee Effectiveness: Informal Processes and Behavioural Effects', *Accounting, Auditing & Accountability Journal*, 20(5), pp765–788.
[505] Spira L F, *The Audit Committee: Performing Corporate Governance*, Boston, MA: Kluwer Academic Publishers.
[506] Zaman M and Collier P (2005), Convergence in European Corporate Governance: The audit committee concept', *Corporate Governance: An International Review*, 13(6) 753–768.

11.45 Beattie (2012)[507] in a study of AC and ACC engagement in audit-related matters in UK-listed companies finds less than full engagement. The study notes the following key relevant policy findings: relatively low priority of engagement with risk; incomplete engagement by ACs with key audit-related issues; varying patterns of engagement based on company size, audit firm size and AC composition, and a relatively high level of engagement by the CFO with audit fees and NAS. The author concludes: 'ACs are not a panacea for all auditing problems'.

ACC incentives

11.46 Having considered the available evidence regarding how effective ACs are in practice, we considered the incentives of individual ACCs.

11.47 The key incentive we identified for ACCs to be effective was professional pride and reputation. In three of the case study companies the ACCs expressed a view that the incentive of the ACC to do a thorough job was the effect on their professional reputations.[508] Another ACC thought that individuals did not accept the role of ACC with remuneration in mind (as it was not linked to the amount of time actually needed).[509] ACCs also stated that they saw their role as acting on behalf of shareholders.[510]

11.48 We asked firms for examples of the ACC suffering adverse consequences (whether loss of role or other) where financial statements were restated due to error. We accept that they may have limited visibility of such issues, although generally we found that the Big 4 firms were well-informed regarding the corporate governance of FTSE 350 companies. BDO, Deloitte, EY, GT and PwC were not aware of this happening, although PwC identified three instances of an ACC being changed or

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[507] Beattie, V, Fearnley, S, and Hines, T (2012) 'Do UK audit committees really engage with auditors on audit planning and performance?' *Accounting and Business Research*, 42 (3) pp349–375. ISSN 0001-4788.
[508] Appendix 2, Case Study E, paragraph 48; Case Study G, paragraph 51; Case Study I, paragraph 44.
[509] Appendix 2, Case Study C, paragraph 54.
[510] Appendix 2, Case Study D, paragraph 57; Case Study F, paragraph 48.

resigning. KPMG identified four instances of ACCs leaving the position early, fairly or unfairly, and cited adverse consequences.[511]

Firm submissions on AC effectiveness and incentives

11.49 We considered the submissions that firms made regarding the effectiveness and incentives of ACs. As noted, they generally accepted that there might be a difference in demand between FDs and shareholders (see paragraphs 11.13 to 11.14), but firms thought that ACs would ensure that shareholders' interests were protected.

11.50 KPMG stated that the AC's interests were aligned with those of shareholders and that ACs could and did exercise proper scrutiny of the audit firm. As independent non-executives, AC members had no incentive to act other than in the interests of shareholders. The obligations placed on ACs and the personal reputational damage that might ensue in the event that the job was not performed adequately provided ACs with a powerful incentive to act in the best interests of the shareholders. These obligations were said to be well codified and to leave no uncertainty as to the time and effort required.[512] KPMG also said that ultimate responsibility for the selection of the auditor rested with the AC, not management.[513]

11.51 PwC said that there was no misalignment of incentives between shareholders and the AC such as to introduce new principal-agent problems, given that the specific role of the AC was to represent the shareholders' interests in respect of an audit. In

[511] Enron Inc, where the ACC's reputation suffered considerably due to his position as ACC during the well-documented fraud by some of the company's executive directors. This was despite a previous distinguished parliamentary and business career; RBS plc, where the ACC came under significant and widespread criticism at the time of the Government rescue of the bank following the controversial acquisition of ABN Amro. This was part of some more widespread governance issues highlighted at RBS; the ACC at the time of Northern Rock Plc's collapse and Government rescue, despite his previous outstanding reputation in business and Government, never received another appointment before his death in 2012; HBOS plc—the ACC at the time of its forced acquisition by Lloyds had no new appointments since 2009:
[512] KPMG response to the CC working paper 'The framework for the CC's assessment and revised theories of harm' paragraphs 3.2.1–3.2.5.
[513] ibid, paragraph 3.5.7.

PwC's view the evidence showed that this was a role that the ACs took seriously and performed to a high standard.[514]

Discussion and provisional views

11.52 We encountered difficulties in evaluating the evidence on AC effectiveness. Whilst ACCs that we spoke to felt confident that they could discharge their responsibilities effectively and thought that they were properly resourced to do so, we are mindful of the caveats in paragraph 11.34 that it might be unreasonable to expect ACCs to comment critically on the effectiveness of ACs in carrying out their responsibilities.

11.53 We note the view of a significant proportion of investors surveyed by PwC that ACs were not sufficiently independent of the board (see paragraph 11.41 above) and the view of investors that, despite the presence of ACs, auditors were not sufficiently independent of management (see paragraphs 11.42 and 11.43).

11.54 ACCs and other AC members are typically senior individuals with an established professional reputation who should act with integrity. We think that ACs have incentives to ensure that auditors carry out a thorough investigation, although we accept that it is not their role to direct the auditors' work and review it in detail. The impression that we have formed from our survey and from our case study interviews with ACCs is that they are well qualified, knowledgeable and diligent individuals who take the role seriously and have a reputation to protect.

11.55 Nevertheless, it is our view (supported by the views of external commentators such as Beattie (2012)) that there are limitations in the ability of the AC under the stewardship of the ACC, at least in its current incarnation, to ensure audit quality and independence of the auditor:

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[514] PwC response to the CC working paper 'The framework for the CC's assessment and revised theories of harm', p12, paragraph b(ii).

(a) The role of the ACC is configured and resourced as a high-level, supervisory role which limits its potential in acting as a shareholder representative in ensuring that auditors supply the assurance that shareholders demand rather than responding to the demands of executive management (see paragraph 11.30).

(b) As members of the board appointed by the company, ACCs and other AC members are part of the unitary board (see paragraph 11.32). Any conflict that there is between the positions of different members of the board should therefore be resolved in the board. This would include any disagreement between ACCs and the FD. To carry out their responsibilities ACCs must therefore establish good working relationships with fellow board members which may on occasions require them to balance their responsibilities to the shareholders with those to the board. For example, for an individual board member to gain a reputation for being uncompromising and therefore difficult to work with could be damaging to their relationship with other board members and, as a result, their ability to carry out their responsibilities effectively.

(c) ACCs describe their roles in a variety of different ways and have different ideas about the level of detail at which they were required to operate (see paragraphs 11.38 and 11.39).

(d) In our survey we found that 77 per cent of ACCs spend two days a month or less on their duties and in this time commitment the ACC has to deal with broader AC commitments, such as the company's internal control framework, as well as the issue of external audit.[515] We consider that this limited time commitment contrasts with the scale and complexity of a normal audit engagement of a FTSE 350 company which as noted previously (see paragraph 6.4) will typically involve many thousands of man hours and extensive international involvement. We also

[515] FRC Guidance on Audit Committees, September 2012: www.frc.org.uk/getattachment/6ec23196-28ee-406e-8f56-89ab9d1dc06d/Guidance-on-Audit-Committees-September-2012.aspx.

note that many ACCs have other roles which may limit their ability to increase the time commitment that they invest at a particular company should the need arise.

11.56 Although they can call on the company to provide additional resources and reported no barriers to do so, in general ACCs only use this facility infrequently. We consider this to be another indication of the high-level supervisory nature of the role (see paragraph 11.37).

The incentives for auditors to satisfy either management or shareholder demand

11.57 We have set out how the demands of executive management and shareholders may differ, and why we think that the presence of ACs may not be sufficient to ensure that auditors respond to shareholder demands rather than those of executive management. We now consider in turn the incentives for auditors to satisfy executive management and shareholder demand.

The incentives of auditors to satisfy executive management demand

11.58 In this subsection we consider the incentives of auditors and the extent to which they may result in competition being directed in large part towards satisfying executive management demand, at the expense of the interests of shareholders, in particular:

(a) the relative involvement of the FD and AC in auditor appointment and re-appointment decisions; and

(b) incentives for auditors to identify closely with executive management.

11.59 In the following subsection we consider the countervailing incentives for auditors to respond to shareholder demand.

- *The relative involvement of the FD and AC in auditor appointment decisions and appraisals*

11.60 In paragraphs 11.5 to 11.11 we set out evidence that established that it is company management (in the form of the FD and the non-executive members of the AC) that purchases the audit and that shareholder influence was very limited.

11.61 The descriptions of tender processes showed that both executive management (including the CEO, CFO, and FC) and non-executive management (primarily the ACC) were involved (and this accords with our review of the tender process—see Appendix 23).

11.62 As noted above (paragraph 11.10) some of our case studies indicated that executive management had a key role in recommending a particular audit firm for the AC to approve, although at other companies the AC had the primary role in any decision on auditor (re)appointment. We also saw from our case studies that the views of executive management are reported to the AC during the annual appraisal process.[516]

11.63 The evidence that we have seen suggests that the influence of executive management in the auditor reappointment and selection decision is variable but it is generally influential and in some cases highly so.

[516] At Company A, an auditor effectiveness review was conducted annually, completed by both management and the AC paragraph 60; Company C: There was a formal process leading up to the decision to recommend reappointment or not. Management took soundings about the audit experience from the business and presented a management view to the AC, which also had views on the audit process and how it had been communicated. It also appears that the annual reappraisal questionnaire was completed by members of the AC, the Chief Auditor, General Counsel and regional senior management (paragraphs 25 & 101); Company D: The company reviewed the current auditor's performance on an annual basis. The company issued questionnaires to the finance teams of each individual business and each divisional team. These were relatively detailed, focusing on how the audit was performed and whether it was efficient etc. The FD also conducted an informal assessment based on his observations at the Group head office throughout the year. His reports to the AC included his observations of the audit and its effectiveness (paragraph 92); Company E: There was no formal evaluation of the auditors' performance on an annual basis, but there were informal discussions at all levels of the business. The FD would ask the finance team how the audit team performed and whether they covered all the issues. The ACC would ask the FD how his team had interfaced with the auditors (paragraph 19).

11.64 We also saw evidence that it was generally the executive management that had responsibility for fee negotiation with auditors. A typical process cited to us was that fees were negotiated by the CFO and signed off by the AC.[517]

- *Incentives for auditors to identify closely with executive management*

11.65 In this section we consider the incentives of auditors which could encourage them to identify with, or accommodate, the accounting judgements and treatments and disclosures favoured by executive management, possibly at the expense of shareholders. We consider in turn:

(a) the importance of the auditor relationship with the FD and his staff;

(b) the significance of fees on individual audit engagements to the fees of the audit firm; and

(c) AEP incentives.

  - *The importance of the auditor's relationship with the FD and his staff*

11.66 We note (paragraphs 7.131 to 7.135) the efforts that firms expend in maintaining good relationships with company management, including executive management. From our case studies, it was apparent that all AEPs saw it as a part of their role to maintain good relationships with FDs. We also discuss this in paragraphs 9.196 to 9.197. At times there may be a tension between maintaining a good relationship and applying appropriate scepticism.

11.67 In our first survey (see paragraph 9.91) we found that most companies regularly carry out reviews of audit performance (internal or with their auditors) based, in general, on staff opinions drawn from their interaction with auditors. In addition we found that firms also carry out detailed annual reviews of their own performance with audit

[517] See Appendix 2, Case Study A, paragraph 40.

clients, to ensure that the companies are satisfied with the service they receive (see, for example, paragraphs 9.193 to 9.194).

11.68 The FRC stated in a recent paper on auditor scepticism:[518]

> Audit firms place considerable importance on retaining their client base. Emphasis on client service planning and relationship management within the firms may act as a disincentive for auditor scepticism if audit teams believe that by demonstrating scepticism they risk having an 'unhappy client'.

◦ *Significance of individual engagements*

11.69 In Section 7 we considered firms' financial interests in audit engagements. Firms' incentives to obtain and retain engagements were also discussed in detail in Section 9.[519] In particular, firms have financial incentives to win and retain FTSE 350 audit engagements because they are profitable in themselves, may enhance the prospect of winning audit-related and non-audit work from the same company, and because obtaining audit engagements will enhance a firm's ability to win further audit engagements.

11.70 We note that the financial significance of any one engagement to a firm varies. While we have encountered some difficulties in establishing engagement-level profitability (see Appendix 14), it can at least in principle be calculated. We think that the more important a client is to any firm, the greater the financial incentive on the firm to retain the engagement. As audit engagements are generally lengthy (paragraphs 7.12 to 7.15) and the relationships with FDs are important and in part built around trust, audit firms have incentives not to damage these relationships.

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[518] FRC discussion paper, 'Auditor Scepticism: Raising the Bar', August 2010, paragraph 27: www.frc.org.uk/getattachment/2a1e0146-a92c-4b7e-bf33-305b3b10fcd2/Discussion-Paper-Auditor-Scepticism-Raising-the-Ba.aspx.
[519] Paragraph 9.28 onwards, and paragraph 9.192 onwards.

11.71 Regulation provides that total fees for both audit and NAS receivable from a listed company by the audit firm may not regularly exceed 10 per cent of the annual fee income of the audit firm, and must consider appropriate safeguards to eliminate or reduce the threat to the auditor's objectivity and independence where the proportion is between 5 and 10 per cent for a listed company (Appendix 8, paragraph 126). We have estimated the proportion of revenues accounted for by the largest engagements of the six largest firms.

TABLE 11.1 **Financial significance of the five largest FTSE 350 UK audit fees for each audit firm (UK element of the group audit fee as a proportion of total firm revenue)**

per cent

BDO		*Deloitte*		*EY*		*GT*		*KPMG*		*PwC*	
Randgold Resources	[✂]	RBS	[✂]	BP	[✂]	Sports Direct	[✂]	HSBC	[✂]	Lloyds Banking Group	[✂]
Bwin.Party Digital Entertainment	[✂]	WPP	[✂]	Aviva	[✂]	Perform Group	[✂]	Prudential	[✂]	Barclays	[✂]
Derwent London (DL)	[✂]	Balfour Beatty	[✂]	Resolution	[✂]	Fidelity China Special Situations	[✂]	BAE Systems	[✂]	Royal Dutch Shell	[✂]
RPS Group	[✂]	BSkyB	[✂]	British Airways	[✂]	Anglo Pacific	[✂]	Standard Chartered	[✂]	GSK	[✂]
London & Stamford Property Plc	[✂]	Anglo American	[✂]	Investec	[✂]	Fidelity Special Values	[✂]	Old Mutual	[✂]	BT Group	[✂]

Source: CC analysis.

11.72 While even the largest engagements fall short of the levels that would engage applicable 'independence' regulation, equally, their loss would be significant to even the largest firms, particularly when considered in the context of the firms' Assurance businesses, as opposed to the overall revenues, as set out in Table 11.2.

TABLE 11.2 **Financial significance of the five largest FTSE 350 UK audit fees for each audit firm (UK element of the group audit fee as a proportion of total assurance revenue)**

BDO		*Deloitte*		*EY*		*GT*		*KPMG*		*PwC*	
Randgold Resources	[✂]	RBS	[✂]	BP	[✂]	Sports Direct	[✂]	HSBC	[✂]	Lloyds Banking Group	[✂]
Bwin.Party Digital Entertainment	[✂]	WPP	[✂]	Aviva	[✂]	Perform Group	[✂]	Prudential	[✂]	Barclays	[✂]
Derwent London (DL)	[✂]	Balfour Beatty	[✂]	Resolution	[✂]	Fidelity China Special Situations	[✂]	BAE Systems	[✂]	Royal Dutch Shell	[✂]
RPS Group	[✂]	BSkyB	[✂]	British Airways	[✂]	Anglo Pacific	[✂]	Standard Chartered	[✂]	GSK	[✂]
London & Stamford Property Plc	[✂]	Anglo American	[✂]	Investec	[✂]	Fidelity Special Values	[✂]	Old Mutual	[✂]	BT Group	[✂]

Source: CC analysis.

- *AEP incentives*

11.73 We considered the incentives of individual AEPs, and the pressures on them to retain clients. Each firm has a different structure for the remuneration of its partners which may consist of a combination of the level of their equity contribution, role, experience and personal performance.[520] The proportion of distributable profit which is allocated as performance-related pay varies by firm and over time (both as a result of each firm's remuneration policy and the overall level of distributable profit).

11.74 Of the firms which gave us their structure of partner remuneration, the performance-related element ranged from 10 to 100[521] per cent of distributable profits.[522] All of the firms stated that achieving a certain level of fee income was not a universal requirement. However, our review of partner performance frameworks indicated that all included scope for the financial performance of a partner's engagements to be included as an objective. Some firms provided example partner objectives which included a level of target revenue. Some objectives included references to maintaining an audit client during potential trigger points.

[520] Not all partners within a firm will necessarily receive a performance-related award.
[521] [✂]
[522] We understand from submissions from parties that this is a notional allocation of distributable profits and the base pay element does not necessarily relate to the economic value of a partner's labour.

11.75 Our review suggests that the firms use a balanced scorecard approach that assesses a partner's performance in a number of categories. The loss of an audit client would appear therefore potentially to affect the level of an individual partner's remuneration. However, the potential effect of this on a partner's remuneration appears to vary significantly by firm. A poor partner performance score could potentially lead to a partner being reallocated to a different role profile which would affect their remuneration.

- *Provisional view*

11.76 Firms' audit incomes depend on the retention of audit engagements. Individual AEPs might have even stronger incentives not to lose a client. FDs are influential in any decision to reappoint an auditor for the following year's engagement, and this provides those firms with strong incentives to provide the service that FDs demand, even if such demands do not align with those of shareholders.

Countervailing incentives of audit firms to satisfy shareholder demand

11.77 To set against these factors that might provide incentives for firms and AEPs to identify closely with executive management, we also considered factors relevant to incentives of firms and individual AEP to maintain their reputation for quality and independence. We considered: *(a)* firms' submissions on reputation; *(b)* their engagement acceptance criteria; *(c)* their internal efforts to maintain quality; and *(d)* regulatory supervision.

- *Firms' submissions on reputation*

11.78 We made a distinction between a reputation for competence, that might be affected by claims or allegations of negligence without compromising the viability of a firm (on the basis that companies and their shareholders accept that some mistakes are occasionally inevitable), and a reputation for honesty and integrity.

11.79 Firms stated that while individual claims for negligence may be managed, the loss of the reputation for integrity was likely to prove catastrophic and the example of Arthur Andersen was frequently cited. BDO stated that the risk it faced was one of confidence because 'audit is a product of confidence' and Arthur Andersen failed because people lost confidence in their audit.[523]

11.80 In this regard, KPMG said that reputational damage was most probably caused either by a number of audit failures, pointing to systemic failings, or a deliberate act involving senior personnel at the firm which undermined the firm's reputation for integrity.[524] KPMG said that 'isolated audit failures are financially damaging, reputationally survivable. Losing our reputation for integrity and honesty is deadly'.

11.81 Deloitte stated that the incentives of shareholders and auditors were aligned for three reasons: auditors needed to be responsive to management's requirements whilst maintaining an independence of mind to be reappointed; the risk to the auditor's own reputation which was founded on continued delivery of high quality; and the auditor's own financial risk meant that they were strongly incentivized to pursue high levels of quality.[525]

- *Firms' engagement acceptance criteria*

11.82 Firms told us that they considered the risk to their reputations in taking on or retaining any particular engagement, and had structured processes to assist them do this: audit failure (ie failing to detect or report an issue that might materially affect accounts (see paragraphs 3.21 to 3.24)) could damage a firm's reputation for competence and/or integrity, depending on the circumstances. These processes covered the firms' own ability to conduct the audit, their independence (in accordance

[523] Summary of hearing with BDO held on 13 February 2012.
[524] KPMG response dated 5 October 2012 to the CC working paper 'Liability, insurance and settlements', p3.
[525] Deloitte response to the CC working paper 'The framework for the CC's assessment and revised theories of harm', paragraph 5.6.

with applicable regulations), money laundering regulations, but also the risk the engagement might pose to the firm's reputation. Further detail of firms' criteria is contained in Appendix 16.

- *Firms' internal efforts to ensure quality*

11.83 Firms told us that they invested heavily to ensure the quality of the audits they provided. Detail is contained in Appendix 17, and we summarize here. All of the firms undertook some form of internal audit file review and a periodic assessment of their quality control framework. These reviews were intended to comply with International Standard of Quality Control No.1 issued by the International Federation of Accountants.[526]

11.84 All firms operated 'cold' file reviews after an audit report has been issued. These will be a detailed review of an audit file to confirm that the firm's methodology has been followed, appropriate documentation has been inspected and the audit opinion was correct. Audit files are graded by the firms depending on the nature of the issues found.

11.85 Cold reviews typically led to at least one audit led by each Responsible Individual (RI) in the firm being reviewed every three years. The proportion of files reviewed varied by firm, but in all cases there was a greater focus on large, high-risk, listed or PIE clients. Typically if an audit file is found to be of poor quality, it will be reviewed the following year and a number of firms made reference to reviewing additional files overseen by the same AEP the next year. If an AEP failed to improve the quality of their audits, their RI status might be removed and some firms stated this had occurred in recent years. Internal quality review scores are not communicated to clients.

[526] www.ifac.org/sites/default/files/downloads/a007-2010-iaasb-handbook-isqc-1.pdf.

11.86 Audits which have been assessed to be of lower quality are subject to a formal response which may relate to the AEP specifically or to the firm's guidance (such as where ambiguity may lead to a divergence from ISAs or best practice). Several firms made specific reference to quality ratings feeding into the AEP's performance appraisal.

11.87 Some firms made reference to 'hot' reviews, which focused on whether the proposed audit opinion was correct before the audit report was issued. One firm made reference to undertaking hot reviews on all audit opinions before an audit report was signed by the AEP.

11.88 The length of time taken to review a file varied depending on the size and complexity of the audit, and the nature of the review but extended to up to two weeks for a cold review.

- *Regulatory supervision*

11.89 As noted in Section 3 and detailed in Appendix 8, the provision of audit is regulated, both in terms of who may undertake an audit and its substance. That regulation is enforced by the FRC and the Recognised Supervisory Bodies (RSBs) in the UK, and the PCAOB in the USA.

11.90 We asked firms about complaints that had been made by statutory audit clients to such external bodies in the last ten years including complaints instigated by the regulatory body itself. (In addition to these specific complaints, in Section 7 we considered the investigations of the FRC into specific audits.)

11.91 A summary of the number of complaints and outcomes is shown in Table 11.3.[527] The regulators found against the firms in 13 out of 60 cases (22 per cent). The largest fine imposed was £1.4 million (reduced from £2 million for cooperation) by the Accountancy and Actuarial Discipline Board (AADB) against PwC. When costs are included, EY paid the greatest amount, when it received a fine from the Joint Disciplinary Scheme of £500,000 with costs of £2.4 million.

TABLE 11.3 **Complaints made to regulators 2002 to 2012**

Firm	*Number of complaints**	*Complaints upheld*	*Value of financial awards*
BDO	[✂]	1	£10,000 + costs of £15,799
Deloitte	8	2†	£140,000 + costs of £20,000
EY	11	3‡	£580,000 + costs of £2.4 million
GT§			
KPMG	13	3	£[✂] + costs of £[✂] million
Mazars¶	[✂]	[✂]	£[✂] costs
PKF	[✂]	[✂]	Nil
PwC	13	1	£1.4 million + costs

Source: The audit firms.

*These include [✂] relating to BDO and three cases relating to PwC which have not been concluded on.
†Neither of these cases related to a FTSE 350 company.
‡In one of the three EY complaints, the finding was against two individuals and not the firm.
§GT does not maintain a record of complaints to regulators in a format which enables the relevant data to be extracted in a practicable manner.
¶[✂]
Note: Investigations and disciplinary cases handled by the ICAEW, Joint Disciplinary Scheme and AADB respectively have differing standards of public reporting.

- *Provisional views*

11.92 We think that auditors are subject to significant pressures to retain a reputation for integrity. We accept that a case of lack of integrity, if it became public and indicated a systemic problem in the audit firm, might prove fatal to their reputations and so their businesses (as was the case with Arthur Andersen). Nevertheless we found that external scrutiny on firms has raised concern regarding a shortfall in professional scepticism on the part of auditors (see paragraph 7.110).

11.93 Whilst firms are subject to external scrutiny, this is only on a sample basis, and the chances of any one audit being scrutinized in any given year is small. The evidence

[527] The firms submitted data on the number of complaints made against them and we believe these all relate to the audit of UK companies. As not all firms provided client details we are not able to establish how many relate to the audit of subsidiaries of foreign companies or how many of the complaints relate to FTSE 350 companies.

of claims brought against firms by companies suggests that these generally do not have serious consequences for the firms concerned. The fact that firms take steps to review technical quality and integrity issues does not appear to address the problem we have identified that audit firms may have a misaligned incentive to accommodate the demands of management when carrying out audits.

11.94 Our provisional view is that executive management is influential in any decision to reappoint an auditor for the following year's engagement, and this provides those firms with strong incentives to provide the service that FDs demand, even if such demands do not align with those of shareholders. We have investigated counter-vailing incentives of audit firms to satisfy shareholder demand, but find that these do not eliminate the incentive to accommodate the demands of management.

Provisional views on the demand that auditors are competing to satisfy

11.95 Auditors are subject to the pressures of the need to win and retain engagements, to make the best return possible from those engagements (taking into account relevant quality regulations) and to retain their reputations for competence and integrity through thorough investigation and open reporting. They are supervised and inspected by the FRC (and its AQRT) and professional bodies. A key question for us is the extent to which the balance of these pressures is well-aligned with the demand of shareholders.

11.96 In terms of pressures to accommodate management, the principal one we identified was the influence that FDs have over the selection procedure: they are key to this process. Further, they have frequent contact with the auditors throughout the audit investigation, and any issues that the auditor identifies tend to be escalated though the finance function, as part of a 'no surprises' policy.

11.97 Any one engagement typically comprises a small share of any firm's revenues, although each of the Big 4 firms had an engagement comprising approximately [✂] per cent of their assurance business turnover. We think that the larger the engagement, the greater the financial incentive to accommodate the management's proposed accounting treatments: equally the greater the possible adverse effect on a firm's reputation of any audit failure. Individual AEPs may face pressures not to lose engagements, and so are keen to keep the goodwill of FDs. We see regulation and its sufficient enforcement potentially as a factor that would favour audit quality, and give firms incentives to apply appropriate scepticism to accounting treatments proposed by executive management. We think that there are two critical aspects to this, first the role of the AC and second the inspection regime of the AQRT.

11.98 As regards the role of the AC, we accept that the AC is an important and, by and large, powerful force in directing audit firms towards satisfying the demands of shareholders. However, we noted: *(a)* the scope for differences in interpretation as to the role of the AC; *(b)* the limited time and resources the AC had available to attend to audit-related matters; *(c)* that as part of the unitary board its position was less than wholly independent; and *(d)* the influential role of the FD in the conduct of the relationship with auditors, especially as regards appointment and reappointment. For these reasons, we do not think that ACs provide a comprehensive regulatory solution to the problems we have identified concerning a degree of lack of independence of external auditors.

11.99 In relation to the AQRT inspection regime, we think that those incentives are related to the frequency of review and rigour of enforcement action. We noted that the average frequency of review among FTSE 350 firms is currently once every ten years and this may not be sufficiently frequent to generate substantial incentives. From our case studies we note that companies do not necessarily respond strongly to poor

AQRT reviews, and that adverse reports do not appear to have had serious consequences for the relevant firm. In terms of what these pressures mean for aspects of auditor performance, we think that auditors have a strong incentive to conduct a thorough investigation. It damages their reputation for competence if they fail to identify an issue that is subsequently identified by the company. Even if the issue is not disclosed outside the company, and does not lead to any restatement, the company may become more inclined to tender. Firms' internal efforts to ensure quality indicate that they consider the thoroughness of their investigations is important.

11.100 In terms of independence and reporting, our provisional view is that an audit opinion only has value to the extent that it is objective and reliable. As the AC relies on the auditor to bring matters to its attention it may not be in a position to identify judgements of the auditor which have been taken to accommodate management's aims.

11.101 Any loss of independence on any given engagement (or in practice, on any particular treatment within a set of accounts) will only be apparent to those directly involved in the process (ie the FD, the AEP and their respective teams, and, in circumstances where the issue has been escalated, to the ACC). It will not be visible to shareholders.

11.102 Accordingly, we have considered whether the introduction of ACs and the regulatory developments since 1992 have been able to remedy any detriment arising from a misalignment of auditor incentives with those of shareholders. At this stage in our investigation, we do not think that they have. This is based on the following:

(a) The fundamental structural issue remains: auditors are selected and reappointed by company management, and the FD has an influential role in such selection. It

is his or her view that directly decides whether an auditor is reappointed or whether the audit should be put out to tender.

(b) If an auditor performs well (in the eyes of executive management) then it knows that it is likely to be reappointed (given the current incidence of tendering and switching (paragraphs 7.16 to 7.21) and so has strong incentives to do so;

(c) Despite extensive developments in regulation, there remains a range of legitimate accounting treatments, and FDs will at times have strong incentives to select one over the other. We think that while ACs provide a level of support for auditors to form an independent judgement, it remains difficult for auditors to stand firm against a particular accounting treatment if it is permitted within the standards (as the Cadbury Report pointed out).[528]

(d) There are several regulatory bodies designed to incentivize better auditing, but they do not (and are not designed to) ensure the quality of each FTSE 350 audit each year.

11.103 Taking into account the above, it is our provisional finding that the influence in practice of executive management on external auditors is a feature of the market that may prevent, restrict or distort competition by providing incentives for firms to respond to the demands of executive management rather than the different demands of shareholders, and thereby distorting competition by causing firms to compete on the wrong parameters.

11.104 We consider that this finding is consistent with the evidence on market outcomes, in particular: *(a)* the concerns raised by the FRC and AQRT (see paragraphs 7.101 to 7.112), that auditors have in recent years on occasion failed to demonstrate appropriate levels of professional scepticism; and *(b)* the failure of auditors to identify the impending financial collapse of some large companies.

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[528] www.icaew.com/~/media/Files/Library/subjects/corporate governance/financial aspects of corporate governance.pdf, paragraph 5.3(a).

11.105 We consider that the incentives discussed here for auditors to invest in their relationships with the executive management of companies are important for our understanding of the issues discussed in Section 9. The close nature of these relationships is a key contributory factor in the switching costs that we have identified that lead to a lack of tendering and switching in the market.

Unmet shareholder demand for the provision of further information

11.106 In Section 7 we identified that there was an unmet demand from shareholders for better information regarding the audit process. In principle, if the interests of the auditors, AC and shareholders are well-aligned and there is a demand among shareholders for better information, the auditor should respond. Furthermore we would expect auditors to be competing to meet this demand. Indeed we noted that firms had made efforts to respond to this demand but had limited take-up among FTSE 350 companies (see paragraphs 7.193 to 7.201).

11.107 We have established above that auditors compete to satisfy the demand for audit services as expressed by company management. We therefore consider the evidence of an unmet demand of shareholders for better information (and failure of firm initiatives) to be evidence that the demands of management are not aligned with those of shareholders. We investigated the constraints on auditors and ACs to provide better information, to see if there were features of the market that prevented this demand from being satisfied. In particular:

(a) why auditors are not able to respond directly to shareholder demand for additional information (paragraphs 11.109 to 11.116);

(b) why this demand for additional information is not expressed in the demand of company management (paragraphs 11.117 to 11.130);

(c) whether this unmet demand and the barriers to providing it are further evidence of differences between the demand of company management and that of shareholders (paragraphs 11.131 to 11.136); and

(d) whether the barriers to providing further information are a regulatory or a competition issue (paragraphs 11.137 to 11.142).

11.108 We then *(e)* set out our provisional views.

Constraints on auditors

11.109 Auditors' engagement contracts are with the company. The company discloses significant information to the auditor to allow it to perform the audit. It is bound by confidentiality requirements and cannot disclose detail of its work (beyond that required by applicable regulation) without the company's consent.

11.110 EY said that there were practical and legal constraints on how far any desire for more direct engagement with the auditors could be met, including the confidentiality and insider information issues and the additional costs entailed.[529]

11.111 Deloitte also said that in providing additional information to investors it was mindful that: *(a)* price-sensitive information could not legally be given to some investors and not others. In practice this meant that auditors could not give information about specific companies outside of the company's reporting process or the company AGM; and *(b)* the role of the auditor was not, and could never provide watertight guarantees to investors or other stakeholders in relation to future performance of the company.

[529] EY response to the CC working paper 'The framework for the CC's assessment and revised theories of harm', paragraph 12.

11.112 Deloitte recognized that there needed to be a debate on audit reporting between all interested parties including regulators, investors and audit firms, and it was actively participating. However, with regards to constraints on auditors it said that concerns around audit liability would most likely result in audit firms maintaining audit reporting around accepted norms.

11.113 PwC told us that *(a)* the auditor had a duty of confidentiality to the company (under the ICAEW Code of Ethics and at common law), notwithstanding (and independent of) its duty of care to the shareholders which the auditor might breach if it were to disclose, without permission from the company, information which went beyond the audit report and was not in any other published documents; and *(b)* the auditor's duty of care was to the shareholders as a body (not individually) (as established by the House of Lords judgment in *Caparo Industries v Dickman*) and the auditor would need to be careful, in opting voluntarily to respond to questions, not to take on an expanded duty of care to individual shareholder(s) who ask a question at the AGM.

11.114 Auditors do, however, attend AGMs, and that is a possible forum for them to answer shareholders' questions (free from concerns about insider dealing[530]). In this regard, PwC said that the well-advised auditor would turn to the Chair to ask to be released from his duty of confidentiality to the company; cite the disclaimer in his audit report (the '*Bannerman* disclaimer'[531]) as a preface to his response in order to remind those present that there would be: *(a)* no extension of his 'general audit duty' (under the

[530] It is insider dealing, and an offence, if a person who has access to information by virtue of his employment, office or profession discloses that information to another person otherwise than in the proper performance of the functions of his employment, office or profession (section 52(2)(b) Criminal Justice Act 1993) but it is a defence if that person shows he did not expect that any person would deal in securities because of the disclosure, or that the dealing would result in a profit attributable to the fact that the information was price-sensitive information in relation to the securities (section 53(3) CJA 1993).
[531] From the decision in Royal Bank Of Scotland Plc v Bannerman Johnstone Maclay [2005] ScotCS CSIH_39.

Freightliner judgment[532]); and *(b)* no duty owed to any specific party as a result of answering the question.

11.115 In practice, we understand that this rarely, if ever, happens. None of the shareholders we spoke to or contacted cited this as a source of useful information for them regarding the audit. For example, one investor told us that it had raised questions addressed to the auditor in general meetings in the past but the Chairman controlled access and had blocked the questions.[533] Another investor told us that it had approached audit firms to discuss the key accounting risks faced by the companies it invested in but that it had been a 'one way street'.

11.116 EY noted that principles under the Audit Firm Governance Code (issued January 2010) committed audit firms and shareholders to have a dialogue with each other. EY said that it had followed these principles through regular meetings with a number of institutional investor groups to discuss matters of mutual interest that were consistent with its confidentiality obligations.[534]

Constraints on ACs and ACCs

11.117 We were told that there were two main reasons why ACs and ACCs (whose responsibility it is to promote the interests of shareholders) are reluctant to disclose information about the audit process unilaterally: *(a)* concerns regarding the disclosure of sensitive information and *(b)* the differing interests and demand of shareholders and the difficulties and risks this creates for ACs and ACCs in the disclosure of information to shareholders. In addition to these reasons, parties *(c)* mentioned several other potential constraints. All of these are discussed below.

[532] Man Nutzfahrzeuge AG & Anor v Freightliner Ltd & Anor [2008] Lloyd's Rep FC 77.
[533] Summary of hearing with institutional investors held on 16 April 2012.
[534] EY response to the CC working paper 'The framework for the CC's assessment and revised theories of harm', paragraph 12.

11.118 We note at the outset that, as currently framed, it is not the role of the AC to discover and satisfy shareholder demand for information relating to the company's financial reports.[535] However, ACs do have a duty to act in the interests of the company by ensuring, on behalf of the board, that the interests of shareholders are properly protected in relation to financial reporting.[536]

Sensitivity of information

11.119 The disclosure of information about the audit or about the financial position of the company that is not otherwise in the public domain could be damaging to the interests of the company and its shareholders if it reveals commercially sensitive information to competitors. In addition, disclosure of price-sensitive information to a limited group of shareholders could risk breaching rules on insider trading.

11.120 Given these risks, the ACC as a member of the board will be concerned about damage to the company and its shareholders if the AC discloses confidential or otherwise sensitive information. There could be personal reputational risks for individual members of ACs, and ACCs in particular, of taking a decision to disclose further information if the result is damaging for the company and its shareholders.

11.121 In our follow-up survey of FTSE 350 ACCs, 17 per cent said that there are barriers to the provision of further information. Of these, many said that the commercial sensitivity of the information would be a barrier to further disclosure, and suggested that this was the primary barrier.[537]

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[535] www.frc.org.uk/getattachment/6ec23196-28ee-406e-8f56-89ab9d1dc06d/Guidance-on-Audit-Committees-September-2012.aspx, paragraph 2.2.
[536] www.frc.org.uk/getattachment/6ec23196-28ee-406e-8f56-89ab9d1dc06d/Guidance-on-Audit-Committees-September-2012.aspx, paragraphs 5.2, fourth bullet.
[537] See responses to the CC follow-up survey of FTSE 350 ACCs, questions E1 and E2.

11.122 PwC said that companies were generally advised to be cautious about the disclosure to the marketplace due to liability issues. This is particularly true for Securities and Exchange Commission registrants given the litigious environment that prevails in the USA. An example of such caution is around risk reporting where the threat of legal challenge frequently leads to extensive disclosure of all possible risks, rather than just key risks, in case a risk is excluded which subsequently has a significant impact on the company.

Differing interests of shareholders

11.123 That shareholder demand was differentiated emerged from the evidence we obtained (see paragraphs 7.182 to 7.187).

11.124 The FRC told us that shareholders generally did not have an agreed view as to what they might like in the way of enhanced reporting. This difficulty extended to obtaining a single view from individual shareholder groups (different fund managers may have different views). In the FRC's experience, there had been very few occasions when it had been possible to obtain a consensus from shareholders as to what they wanted on any given issue.[538]

11.125 Deloitte said that it was important to recognize that investors were not a single homogenous group. Some were broadly content with the audit market and the way that audits were conducted and reported whilst others had said that they would like changes in the audit report.

11.126 EY said that there was not necessarily any commonality of interest within share-holders, particularly within the FTSE 350. It said that the conflict in interests between different shareholders was patently apparent at many AGMs. Indeed, as the

[538] Summary of hearing with the FRC held on 26 October 2012, paragraph 12.

Blackrock case study indicated, a single shareholder may adopt very different approaches and so have different interests in relation to different investments.[539]

11.127 Oxera's investor survey on behalf of BDO and GT also highlighted differing views of investors in relation to the information that could be provided by an audit. In reviewing Oxera's interview summaries, we noted that one investor specifically said that they would prefer to try and get a view on anything else directly from companies, rather than through the audit. This investor said it was not clear how this colour could be provided within the audit report and some investors might want certain information to remain private and not put into the financial statements. However, another investor said that there was a lack of colour in the accounts and that investors would appreciate more nuance, for example general commentary about how the accounts were put together and the relative aggressiveness of accounting treatment (see Appendix 19, paragraph 89).

Other constraints

11.128 PwC said that the FRC consultation document aimed at enhancing corporate reporting and audit, 'Effective Company Stewardship', published early 2011 included recommendations, suggesting that fuller reports by ACs on the approach taken to the discharge of their duties would support the board's declaration that the annual report properly and fairly described the business and its financial performance.

11.129 PwC said that the responses to the FRC's consultations were consistent with those made to PwC by those audit clients who expressed reservations about increasing transparency in this area. In summary, the risks of increased disclosure identified by companies included: *(a)* a possible constraint on free speaking during debates between ACs and auditors; *(b)* disclosure of debate around complex matters could

[539] EY response to the CC working paper 'The framework for the CC's assessment and revised theories of harm', paragraphs 8 & 9.

lead to confusion and misinterpretation; *(c)* disclosures could be commercially sensitive; *(d)* providing backward-looking information highlighted past problems that might have since been resolved; and *(e)* likelihood of boilerplate or purely process-related reporting which would add additional volume for little value.

11.130 Deloitte also indicated other constraints: *(a)* moving away from a tightly prescribed form of audit report wording introduced the possibility that there was a loss of clarity and consistency of message between audit reports making it harder for investors to interpret audit reports; *(b)* variability in the levels of disclosure between companies could impact capital markets through impacting share prices differently. Finally, it thought it important to note that such constraints were neither caused by a lack of competition between audit firms, nor did it lead to a lack of competition between audit firms.

Provisional view on constraints to supply of information

11.131 As set out in Section 7, we found evidence of a demand from shareholders for better information regarding the audit opinion and audit process. Further, the fact that firms have recently sought to actively engage with stakeholders (ie their audit clients, investors, professional bodies and regulators), suggests to us that they also perceive an unmet demand.

11.132 We note that dialogue between audit firms, the FRC, and investor groups has historically not been extensive; there has been more activity in this area recently. We also note the FRC's February 2013 consultation document proposing revisions to the auditor's report.[540]

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[540] www.frc.org.uk/getattachment/d24bb652-e319-46a4-add5-793d518a035b/Consultation-Paper-Revision-to-ISA-(UK-and-Ireland.aspx.

11.133 We consider that there are constraints faced by auditors in the provision of information to shareholders about the audit. Audit firms have some limited ability to provide information to shareholders as a body, for example in the AGM, but in practice this does not happen. In our view this is consistent with our finding (see paragraph 11.102) that audit firms have incentives to respond to the demands of executive management rather than the different demands of shareholders, and further that management do not generally favour additional disclosure of information.

11.134 We accept that there are legal constraints on disclosure of information to individual shareholders or disclosure of genuinely commercially sensitive information. However we were not persuaded that these constraints extend to providing better information about the audit process to the body of shareholders as a whole, other than the reluctance of management to make further disclosures.

11.135 Management do not generally favour additional disclosures above and beyond statutory requirements (although we note that this is not universal, some companies do make voluntary disclosures in addition to the statutory minimum). We consider that this reluctance to disclose information about the performance of the company is a feature of the market that prevents, restricts, or distorts competition because it restricts the information which auditors provide to shareholders, thereby causing firms to compete on the wrong parameters.

11.136 We consider that the evidence we have seen shows that this reluctance of management to disclose information in a statutory audit both restricts the availability of information on which investors may judge the quality of the audit process and leads to the unmet demand cited in paragraphs 7.180 to 7.203.

Regulation or competition issue?

11.137 We note that KPMG said that any failure of the audit market to provide shareholders with the information they wanted was a regulatory and not a competition matter. In particular, KPMG said that we had recognized that: the incentives of managers and shareholders to commission audits were likely to be insufficient to ensure that the social demand for independently audited accounts was satisfied; the requirements for audit and their exact scope needed to be mandated by legislation and regulation; and the need for audits to comply with a clearly articulated standard also meant that an extension of assurance services was only likely to happen at an industry level.[541]

11.138 We consider that competition and regulatory issues are not separable in this way. Audit firms are not appointed by a regulator, but compete for appointment as a company's auditor. Our guidance[542] describes competition as being a process of rivalry that creates incentives for firms to meet the existing and future needs of customers as effectively and efficiently as possible. It states that where this process is hampered or otherwise hindered, by features of the market, competition may be adversely affected. Our view is that structural features, such as regulation and information asymmetries, can give rise to an AEC.[543]

11.139 We consider that the regulation applying to the provision of statutory audits creates a framework within which audit firms compete, for example by mandating an 'independent' audit and specifying the form of the outputs delivered. Regulation may therefore have the effect of restricting or distorting competition directly by specifying the product that is to be delivered or indirectly if it affects the behaviour or preferences of those involved in the selection and appointment of auditors. Further,

[541] KPMG response to the CC working paper 'The framework for the CC's assessment and revised theories of harm', paragraphs 2.1.7 & 2.1.8.
[542] *CC3*, paragraph 1.17; and CC Guidelines for market investigations, consultation draft (*CC3* revised), paragraph 8.
[543] For example, in BAA Airports (2009) the CC decided that the applicable regulatory system for airports was a feature which restricted or distorted competition between airports (paragraph 23). The CC also decided that aspects of the planning system were a feature which restricted and/or distorted competition, by acting as a barrier to entry of new airports and expansion of existing ones (paragraphs 12 & 13).

regulation may set a minimum standard, while competition provides incentives for suppliers to provide better products.

Provisional view

11.140 Our provisional view is that auditors have an economic incentive to respond to management and to that extent have less incentive to respond directly to the demands of individual shareholders. In particular, when management is reluctant to permit disclosure of additional audit information this restricts firms from responding to shareholders' demand.

11.141 We think that this is not a failure to provide shareholders with prescribed information (which would be a matter solely for regulation) but is a failure to compete on the right parameters (by failing to provide shareholders with the information that they demand) and that this affects competition because:

(a) shareholders are not able to get the full benefit from the audit services (as these may be slanted towards the needs of executive management).

(b) it contributes to the lack of visibility of audit quality, and lack of differentiation between audit firms, that we consider in paragraphs 9.101 to 9.139 and which we consider have adverse effects on competition because they increase the risks and reduce the benefits that companies can observe from switching auditor.

11.142 It is therefore our provisional view that the reluctance of company management to provide information about the audit judgements and audit process is a feature that prevents, restricts, or distorts competition.

12. Other theories of harm: coordinated effects, bundling, 'low balling', regulatory distortions

Coordinated effects

12.1 Our issues statement said that some of the conditions that are conducive to tacit coordinated behaviour appeared to exist in the audit market, including: high concentration; significant barriers to entry; limited competitive constraint by Mid Tier firms; price transparency (since audit fees are publicly disclosed in a company's annual report and accounts); existence of switching costs; stable demand due to statutory requirement for an audit; and stable market shares.[544]

12.2 Our provisional view is that certain features in the supply of audit services to FTSE 350 companies may be conducive to tacit coordination based on the identity of clients. However, there appear to be other factors, in particular, the lack of price transparency, the low frequency of switching, uncertainty around which engagements will become available and when, and differences between firms in the value of engagements which would not be conducive to tacit coordination on price or the identify of clients.

12.3 Accordingly, whilst there are some market conditions conducive to tacit coordination, there are also some that are not. Moreover, we do not currently have evidence that there has in practice been tacit coordination. On this basis, our provisional view is that there has not been tacit coordination in the relevant market. Further detail and consideration of parties' submissions is provided in Appendix 22.

Bundling by the Big 4 firms

12.4 Bundling of audit services together with audit-related and/or NAS (within the regulatory rules for audit independence) may create barriers to entry and expansion

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[544] www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/111207_issues_statement_final.pdf, paragraph 46.

in these markets. This could take the form of pure bundling (ie refusing to supply any of the individual services separately), mixed bundling (ie audit and NAS are available either separately or bundled at a lower price than the sum of the individual prices) or tying (ie one of the services is available individually, but the other is available only if bought in a bundle).[545]

12.5 We found no evidence that the Big 4 firms undertook pure bundling or tying. See Appendix 20. We found a tendency for companies to buy fewer NAS from their auditor over recent years, both in absolute terms and as a percentage of the audit fee. In relation to mixed bundling, we did not find evidence that firms were discounting audit fees to encourage the purchase of NAS. However, we found some evidence that firms would offer NAS at a discount to scale rates if appointed as auditor. The extent to which this represents a discount on market prices is unclear.[546] Overall, we have provisionally found no evidence to support the view that the bundling of NAS with the statutory audit acts as a barrier to entry. Companies may request firms to include the price for certain services in their tender but we do not believe that these services exclude any of the largest challenger firms. Further, evidence from our customer survey does not indicate that NAS are a significant consideration when selecting an auditor (see Appendix 3).

12.6 Accordingly, our provisional view is that there has not been bundling in the relevant market that prevents, restricts or distorts competition.

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[545] www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/111207_issues_statement_final.pdf, paragraph 34.
[546] Given the disparate nature of NAS, it is not clear how discounts would be identified. To assess if discounts were offered it would be necessary to assess the profitability of all NAS work performed by the firm and be confident that any variation in profitability was driven by discounts offered to audit clients. Such an approach would need to consider whether discounts on additional pieces of NAS were not offered to existing NAS clients.

‘Low balling’

12.7 In addition, some Mid Tier firms stated that Big 4 firms undertook ‘low-balling’, ie they offered to undertake audits for certain companies at low rates in order to win the clients of those Mid Tier firms, and that this excluded those Mid Tier firms from the market in a way that was anticompetitive.

12.8 We did not find evidence to support this. When we investigated four specific allegations made by BDO we found little evidence to support the interpretation suggested and we found evidence that other Mid Tier firms were also prepared to offer significant reductions on the incumbent’s fee during a tender and that the Big 4 firms had in two cases submitted a tender proposal with a fee greater than BDO’s. We found that in some cases a reduced audit fee coincided with an ongoing deterioration of the financial performance of a company. It appeared that in these specific examples, there was evidence of competition between firms, and that the basis of competition was on the perceived merits of the firms and not merely on price. When considering the profitability of the specific engagements to the Big 4 firms, they did not appear to be below the normal range of profitability (using the firms’ internal metrics by which they assess relative client profitability).

12.9 Accordingly, our provisional view is that there has not been ‘low balling’ in the relevant market that prevents, restricts or distorts competition.

Regulatory distortions

12.10 In our issues statement, we identified three risks to investigate: *(a)* since the market is highly concentrated, the Big 4 firms may have excessive influence on the regulators; *(b)* the fear that one of the Big 4 firms may fail or exit the market, which could represent a systemic risk to the wider economy, and might induce the regulator to protect the four largest firms, for example through tailored interventions in their

favour; *(c)* there could be a suboptimal level of regulation in the market. On the one hand, under-regulation may facilitate entry, but could result in a low-quality service. On the other hand, over-regulation could act as a barrier to entry and expansion for smaller firms.[547]

12.11 We considered whether there was any evidence for regulations being skewed in the larger firms' favour. We looked at various aspects of the regulatory system, including partner rotation requirements, regulations on joint/shared audits and limits on maximum fee income from a single client. We did not find any evidence that these or other aspects of the regulatory framework were unduly favourable to the larger firms or that they restricted Mid Tier firms' ability to compete (see Appendix 21).

12.12 In this context, we also looked at the composition of the FRC's committees. We noted that a significant number of members of FRC committees were Big 4 partners, staff or alumni, however, we did not think that the proportion of Big 4 partners, staff and alumni (around 50 per cent) appeared to be inappropriately high but noted that although there were a number of senior representatives from other institutions there was little direct representation of other audit and accounting firms. We consider that while it is possible that influence of the Big 4 firms on standard setting may be a factor tending to favour increased complexity, there appear to be other, more fundamental, factors at work, such as increased complexity and globalization of reporting organizations.

12.13 Accordingly, our provisional view is that there are not regulatory distortions in the relevant market.

[547] www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/111207_issues_statement_final.pdf, paragraphs 43–45.

13. Provisional findings

13.1 As noted in our draft guidance on market investigations, the CC recognizes that the theoretical benchmark against which to measure an AEC can never be a ‘perfectly competitive’ market. In past market investigation reports the CC has used the term ‘a well-functioning market’ in the limited sense, generally, of a market without the features causing the AEC.[548] This has been our approach in this inquiry.

13.2 We have investigated outcomes in the relevant market, in terms of price, quality (including auditor independence), innovation and the outputs supplied by auditors. We have identified concerns with respect to each, as set out in Section 7. We have considered carefully the submissions of the Big 4 firms, and the explanations that they provided for the outcomes we observed.

13.3 However, for the reasons given in Sections 9, 10 and 11 we provisionally identified the following as relevant features of the market.

(a) Barriers to switching:

(i) companies face significant hurdles in comparing the offerings of the incumbent firm and alternative suppliers outside of a tender process.

(ii) it is difficult for companies to judge audit quality in advance due to the nature of audit.

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

[548] CC Guidelines for market investigations, consultation draft (*CC3* revised), paragraph 84.

(b) Company management face significant opportunity costs due to the management time involved in the selection and education of a new auditor.

(c) Mid Tier firms face experience and reputational barriers to selection in the FTSE 350 audit market.

13.4 We provisionally found that the features listed in 13.3 (a) and (b) above give rise to an AEC either individually or in combination by weakening a company's bargaining power outside the tender process. We are of the view that these features are pervasive throughout the FTSE 350 statutory audit market but their impact will be uneven across companies. How a feature or combination of features impacts on an individual company's strength of bargaining power will vary over time and depend on its particular circumstances.

13.5 We provisionally found that the feature listed in 13.3 (c), either individually or in combination with the other features, gives rise to an AEC as companies have a more restricted choice of auditor than would otherwise be the case.

13.6 As a result of the AEC, we provisionally found that companies are offered higher prices, lower quality and less innovation and differentiation in offerings than would be the case in a market without the features.

13.7 For the reasons given in Section 11 we provisionally find that:

(a) Misaligned incentives between auditors, shareholders, and company management are a feature of the market that produces an AEC, namely that audit firms may compete to satisfy management rather than shareholder demand, where the demands of executive management and shareholders differ. This results in shareholder detriment as auditors are not sufficiently independent from executive management and therefore insufficiently sceptical in carrying out audits. The

activity of the AC (and other factors) is not sufficient to mitigate this detrimental effect.

(b) 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 appointment as auditor, and results in an unmet shareholder demand for better information regarding audits and means that shareholders cannot adequately appraise the performance of the companies in which they hold shares or the quality of the audit.

13.8 Accordingly, in our provisional view, auditors are less independent and less responsive to shareholder demand than they would be in the absence of such features, compared with what we would expect to observe in a well-functioning market.

13.9 In our provisional view, most companies and most auditors perform their functions diligently and effectively most of the time. However, the point of audit is not to act as a redundant safeguard, but to be effective at times of conflict and financial pressure. We are not currently satisfied that it is.