

**DELOITTE LLP**  
**RESPONSE TO ISSUES STATEMENT**

**12 January 2012**

**1. INTRODUCTION AND SUMMARY**

1.1 As we explained in our initial submission (the *Initial Submission*) to the Competition Commission (the *CC*) dated 11 November 2011, the investors and audit committees of FTSE 350 companies:

- (a) require their auditors to be able to provide a consistent and independent level of support, in all of the territories across the globe in which they (the companies) operate, delivered at a consistent high quality;
- (b) need their auditors to be innovative and to add real value to their businesses as part of the audit service;
- (c) expect their auditors to understand the complexities of the industries in which they (the companies) operate;
- (d) require their auditors to have expert knowledge and understanding of the business and accounting issues which the companies face;
- (e) expect their auditors to field highly skilled and trained engagement teams; and
- (f) insist on value for money.

1.2 It is therefore necessary for any firm wishing to participate in this market to make determined and focused investment in the requisite capabilities, without which a firm could not provide the level of service large companies (and their investors) demand, nor could it effectively mitigate the risks to which the audit would expose the firm and the audited entities.

1.3 Deloitte made the necessary investment and transformed its presence in relation to the market for the audit of large companies in the UK.

1.4 The Issues Statement published by the CC on 7 December 2011 (the *Issues Statement*) sets out a number of theories of harm and potential adverse effects on competition which are at odds with these realities of the market. We are confident that the evidence that the CC gathers will show that the theories of harm are unfounded and that the market is working well to deliver good outcomes for companies, investors and other stakeholders.

1.5 This response is structured as follows:

- (a) **Section 2:** audit quality
- (b) **Section 3:** pricing and non-audit markets
- (c) **Sections 4 to 9:** the theories of harm set out in the Issues Statement
- (d) **Section 10:** conclusion

1.6 By way of summary:

- (a) the demand for audit quality is driven by companies, investors and other stakeholders such as policymakers, who uniformly make clear their desire for higher, not lower, standards of quality;
- (b) Deloitte has invested very significantly in meeting this demand. It is also incentivised to pursue the same goal by the risk attaching to the audit activity – particularly audit of FTSE 350 clients – given the unlimited liability which applies to audit work;
- (c) the adverse outcomes set out in the Issues Statement are unfounded, and Deloitte urges the CC to engage with FTSE 350 companies with respect to their views on the audit service they obtain. We believe that the market is producing good outcomes – in terms of both quality and value – for companies and their investors; and
- (d) the theories of harm set out in the Issues Statement similarly do not stand up to scrutiny. We are confident that the evidence being gathered by the CC will show that certain specific capabilities (including those listed above) are required in order to deliver acceptable audit services to FTSE 350 companies, and that the market operates competitively in response to that demand.

## 2. NO ADVERSE OUTCOME: AUDIT QUALITY

### *Why quality is important*

2.1 Audit quality is important as the purpose of auditing is to give confidence to companies' investors and other stakeholders, which in turn has a direct impact on a company's cost of capital. A lessening of audit quality could lead to a position where the service is simply "not fit for purpose" from the point of view of companies, investors and other stakeholders. The importance of quality is the reason audits are so heavily regulated.

2.2 Quality is also critical from the audit firm's point of view. Since the audit firm bears responsibility for the quality of its audit – and faces unlimited liability (and potentially regulatory action if there is an audit failure) – it is imperative that the auditor has the requisite degree of confidence in the robustness of the outputs and processes. This risk is particularly significant in the context of the reference market – because of the complexity of the business of FTSE 350 companies, and the potential magnitude of the liability in the event of an audit failure. This provides a critical incentive in relation to the maintenance of audit quality (and auditor independence, which is a crucial underpinning of audit quality). The Issues Statement posits propositions suggesting that audit quality may be too low or, in the alternative, too high<sup>1</sup>. We address each proposition in turn.

### *The market is not producing unduly low levels of audit quality*

2.3 The first adverse outcome posited in the Issues Statement is based on the notion that low levels of competition are producing sub-optimal quality<sup>2</sup>. As our own audit quality is demonstrably high, and we are kept to those high standards by sophisticated and knowledgeable clients, regulators and the risk occasioned by our unlimited liability, this premise cannot hold.

### *Companies are able to discern and measure audit quality*

2.4 Companies invest very significant effort in ensuring that the audit product that is delivered to them is of sufficiently high quality. Those responsible for engagement with auditors within FTSE 350 companies – primarily the CFO and the members of the audit committee – are invariably highly capable and experienced personnel, well able to assess the work of the auditor. Many audit committee members and CFOs also sit on the boards of other companies, and so have exposure to the work of multiple audit firms.

2.5 Their level of engagement should not be underestimated: they engage with the auditor throughout the process to ensure that a high quality job is being undertaken. Audit committee members, company management and others within the company have extensive dealings with many members of the audit team and are able to (and do) evaluate the competence of the audit team and the quality of its work. The questioning of the process

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<sup>1</sup> See paragraph 13 *et seq* of the Issues Statement.

<sup>2</sup> Paragraph 13 of the Issues Statement.

can be expected to be detailed: do the audit team members understand the business and the way it operates, identify and evaluate the key issues, work through problems and propose solutions, robustly challenge and display appropriate scepticism, and add value to the business?

2.6 In addition to their own experience, there are external sources available to audit committee members, investors and other users of audited financial statements to help assess the ability of the auditor to deliver a quality audit service, both in absolute terms and relative to other firms. We identified some of these sources in our Initial Submission<sup>3</sup>: they include, in particular, the annual Audit Inspection Unit (*AIU*) reports. A reader of the AIU 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.

2.7 The AIU published a report on the findings of its 2010/2011 inspection of Deloitte on 26 July 2011. The AIU's report identified our commitment to high quality audit work. The AIU's analysis also demonstrates clearly different levels of audit quality from different firms.

2.8 In addition, firms are subject to other regulatory interventions that can lead to public findings. For example, if an adverse finding is made in relation to the work of an audit firm by one of the disciplinary bodies (primarily the Professional Institutes and the Accountancy and Actuarial Discipline Board (the *AADB*)), this will invariably lead to a publicly reported censure. Also, if a claim is successfully brought against an auditor, the judgment will invariably be publicly reported.

*The auditor's incentives are aligned with those of companies*

2.9 Furthermore, the auditor's incentives are aligned with the company (and its investors) as regards audit quality. It would be entirely contrary to an auditor's own interests to allow the quality of its audit to fall. This is because of the potentially catastrophic impact on the firm in the event of an audit failure, both in terms of the impact on reputation and on financial resources. While we have appropriate insurance arrangements in place, there is no affordable insurance to underwrite the largest potential losses; further the most effective way to mitigate the risks we face is by providing a high quality audit service. Even taking insurance into account, an audit failure in the context of a FTSE 350 company could put the auditor out of business (a damaged reputation can put an audit firm out of business overnight, as was experienced by many of Deloitte's partners whilst partners at Andersen in 2001).

2.10 By way of example, in the mid 1990s the firm of Binder Hamlyn, at the time a successful mid-tier firm of auditors/accountants, faced a claim in relation to the failure of its auditing of Britannia Securities Group Plc (*Britannia*) and subsequently collapsed. The claim arose out of ADT's acquisition of Britannia Securities Group in 1990. In making the acquisition, ADT claimed it had relied on the accuracy of Britannia's latest accounts for the

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<sup>3</sup> See page 26 of the Initial Submission.

year ended 30 June 1989 which were signed by Binder Hamlyn as joint auditors of Britannia, together with certain representations made by the Binder Hamlyn partner. Damages, interest and costs of £105 million were awarded and it has been reported that £34 million of this award was not covered by insurance. These numbers are very significant, even by today's standards, but a similar claim today may be many times higher given the higher value of M&A transactions generally. It is clear the scale of the risks to which auditors in this market are exposed is significant.

2.11 As we explained at the CC's site visit at Deloitte on 11 January 2012 (the *Site Visit*), the audit partner – with the support of the firm as a whole – therefore has the strongest incentives to ensure that the standards of quality do not slip and are uniformly high across all the processes that form part of the audit.

*The market is producing strong innovation*

2.12 The possible adverse outcomes set out in the Issues Statement also include a potential failure to innovate, specifically in the auditor's methods of investigation or by a failure to keep abreast of trends in corporate reporting or financial strategy<sup>4</sup>. We believe that the evidence will show the reverse to be the case.

2.13 As we explained in our Initial Submission<sup>5</sup>, we have invested, and continue to invest very substantial resources into our global audit methodology. We are currently building our next generation audit system, an investment (shared between the Deloitte network to ensure consistent approach, methodology and quality across our international network) [REDACTED].

2.14 As regards keeping abreast of trends in corporate reporting, corporate governance and auditing, a significant focus of our [REDACTED] National Audit and Accounting (NAA) team is precisely that. In addition to our internal publications and material which this team produces, and the advice and support that the team provides to our audit practitioners, it also produces electronic material and publications for client and external consumption on precisely this subject<sup>6</sup>. We have no doubt that we have to be at the forefront of trends in corporate reporting and financial strategy to compete effectively in this market: it is a baseline requirement for our clients.

*Failings of audit quality cannot simply be inferred from companies in financial difficulties*

2.15 In paragraph 16 of the Issues Statement, the CC suggests that a fall in audit quality may be evident from the fact that there are high-profile cases of apparently successful companies, with audited accounts, experiencing severe financial difficulty. In fact, a company's failure or financial difficulties does not imply that there must have been an audit failure. For example, in September 2008 XL Leisure Group collapsed and

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<sup>4</sup> See paragraph 13 of the Issues Statement.

<sup>5</sup> See page 20 of the Initial Submission.

<sup>6</sup> For example, two recent reports published by NAA are "GAAP 2012 IFRS reporting in the UK" and "GAAP 2012 Annual report disclosures for UK listed groups".

administrators were appointed - less than four months after BDO issued an unqualified audit opinion on the financial statements for the year ended 31 October 2007. The AADB investigated the audit work of BDO but did not identify any acts of misconduct (including failures in audit quality) on its part. Likewise, in March 2004 the Mayflower Group collapsed, just over a year after an unqualified audit opinion had been provided by auditors PwC on the financial statements for the year ended 31 December 2002. The AADB investigated the audit work of PwC, and convened a tribunal, but the tribunal did not find PwC liable for misconduct.

2.16 It is important to understand in this context the specific role that policymakers have decided that auditors should have. The purpose of an audit is to test and confirm that the financial statements give a true and fair view of the company's financial situation at a specific given date. The purpose of an audit is not to test the business model of the company, nor take a prospective view. If policymakers wish to give auditors such responsibilities, we would be very happy to engage in that debate.

***The market is not producing unduly high levels of audit quality***

2.17 We believe it is implausible that the market is delivering quality that is inappropriately high (a problem that might be described as ‘gold-plating’ of services). We are proud of the quality we deliver and we know that it reflects the demands of regulators, investors and others. See, for example, the following comments<sup>7</sup>:

<b>AIU</b>	<i>“The importance of audit quality should be reinforced... at all levels within audit firms” “Audit firms take the AIU’s findings very seriously” “The actions taken by firms in response to the AIU’s inspection findings continue to contribute to an improvement in the overall quality of audit work in the UK”<sup>8</sup></i>
<b>CBI</b>	<i>“Audit quality underpinned by an effective and proportionate regulatory regime is a very important factor in securing the attractiveness of the UK capital market and to achieve wealth and job creation for the community and the UK economy”<sup>9</sup></i>
<b>NAPF</b>	<i>“Good quality consistent audit reporting is a cornerstone of maintaining investor confidence in the companies in which they are invested. Investors need the reassurance that such audits bring.”<sup>10</sup></i>
<b>Hermes</b>	<i>“Hermes takes a close interest in the audit market as its purpose is to provide us with comfort that those who run companies on our behalf are doing so effectively and efficiently, ensuring that they remain fully accountable. Shareholders pay for the audit and are the party for whose benefit it is carried out. We therefore have a keen interest in ensuring that the audit market provides us with a quality product.”<sup>11</sup></i>
<b>Iain Richards, Aviva</b>	<i>“The principal interest of shareholders in a healthy audit market is on seeing the focus and dynamic squarely on robust and effective audits i.e. audit quality.”<sup>12</sup></i>
<b>Robin Freestone, the Hundred Group and Pearson, CFO</b>	<i>“What I rely upon the auditors for is to make sure that we get the numbers right, and that’s why we want high quality at a reasonable cost.”<sup>13</sup></i>
<b>Martin ten Brink, Executive Vice President, Royal Dutch Shell</b>	<i>“Having access to consistent and high quality audit services in multiple locations, and therefore, contracting with a firm that has that global reach is important to us.”<sup>14</sup></i>
<b>House of Lords</b>	<i>“All concerned need to insist on the highest possible standards of</i>

<sup>7</sup> Sources: AIU Annual Report, 2010-2011; Responses to FRC on Promoting Audit Quality, 2007; submissions to House of Lords Economic Affairs committee, 2010-2011; European Commission draft Directive (December 2011).

<sup>8</sup> AIU Annual Report 2010/2011.

<sup>9</sup> CBI response to the FRC’s Promoting Audit Quality paper, 2007.

<sup>10</sup> NAPF response to the FRC’s Promoting Audit Quality paper, 2007.

<sup>11</sup> Hermes response to the FRC’s Promoting Audit Quality paper, 2007.

<sup>12</sup> House of Lords (2011), Economic Affairs Committee - Second Report, Auditors: Market concentration and their role, Volume II (HL Paper 119-II), Supplementary Memorandum by Mr Iain Richards, ADT 44, Submitted to House of Lords on January 11th 2011, para 1.3.

<sup>13</sup> House of Lords (2011), Economic Affairs Committee - Second Report, Auditors: Market concentration and their role, Volume II (HL Paper 119-II), Examination of Witnesses 7 December 2010, response to Q 321.

<sup>14</sup> House of Lords (2011), Economic Affairs Committee - Second Report, Auditors: Market concentration and their role, Volume II (HL Paper 119-II), Examination of Witnesses 7 December 2010, response to Q 304.

<b>Economic Affairs Committee</b>	<i>rigour, clarity and quality of accounting and audit</i> <sup>15</sup>
<b>European Commission</b>	<i>“Robust audit is key to re-establishing trust and market confidence.”</i> <sup>16</sup>

2.18 Regulators do not tell us that we can relax our focus on quality – on the contrary, they urge us to continue to focus on delivering ever higher quality. As standards and regulations change frequently, this requires a constant and ongoing focus.

**Conclusion**

2.19 For all of these reasons, we do not believe that the posited adverse outcome can be said to be consistent with market realities. The CC is right to consider that audit quality is of critical importance in this market, but the evidence will show that the market is delivering audit quality effectively.

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<sup>15</sup> House of Lords (2011), Economic Affairs Committee - Second Report, Auditors: Market concentration and their role, Volume I (HL Paper 119-I), March 15th, Chapter 5, para 129.

<sup>16</sup> European Commission Staff Working Paper: Executive Summary of the Impact Assessment, Brussels, 30.11.2011, SEC(2011) 1385 final.

### **3. NO ADVERSE OUTCOME: PRICES AND NON-AUDIT MARKETS**

3.1 The Issues Statement sets out two further possible adverse outcomes: relating to the possibility of higher prices and costs, and relating to effects in non-audit markets<sup>17</sup>. We deal with each in turn below.

#### *The market is delivering good value to companies*

3.2 The Issues Statement considers that it may be the case that the market is not delivering good outcomes in terms of prices and costs<sup>18</sup>. In fact the contrary is the case: the audit service generally offers good value for money and there is no evidence that non-competitive levels of price or cost are present in the reference market.

#### *There is no evidence of a correlation between price and concentration*

3.3 The Issues Statement notes research by Oxera, updated by the OFT, suggesting that an increase in market concentration may be associated with an increase in audit fees<sup>19</sup>. The Issues Statement has also rightly noted the previous challenges to the reliability of that research<sup>20</sup>.

3.4 We have undertaken extensive research and analysis of the Oxera report<sup>21</sup>. We consider the research (including the underlying FAME dataset) to be materially flawed. In particular, we have concerns relating to the chosen methodology, the absence of any consideration of risk factors and a critical level of inaccuracies and omissions in the FAME dataset. We have sought to recreate the data on which Oxera based its analysis and have undertaken our own analysis of that data. When the corrected dataset and sound methodology are utilised, there is no demonstrable causal relationship between the level of concentration and level of audit fees. We will be submitting this work to the CC shortly.

#### *There is no evidence of excessive profitability*

3.5 In paragraph 18 of the Issues Statement, it is suggested that auditors in this market may be able to earn profits in excess of their cost of capital. We believe that this is not the case, certainly so far as Deloitte is concerned. We believe that Deloitte is not excessively profitable and that our profits reflect the level of risk that our partners bear in providing audit services, particularly to large UK companies<sup>22</sup>. We also believe that our profits are comparable to those of other professional service firms. This position reflects our experience of the pricing pressure exerted by clients and competitors in the reference market.

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<sup>17</sup> See paragraphs 18 and 21 of the Issues Statement.

<sup>18</sup> See paragraph 18 of the Issues Statement.

<sup>19</sup> See paragraph 19 of the Issues Statement.

<sup>20</sup> Ibid.

<sup>21</sup> Oxera, *Competition and choice in the audit market*, April 2006.

<sup>22</sup> For clarity, Deloitte would welcome the opportunity to discuss with the CC the appropriateness of applying capital-based measures to assess profitability in the context of a professional services market.

*There is no evidence that audit firms are operating inefficiently*

3.6 It is suggested in paragraph 20 of the Issues Statement that if, in fact, large company auditors are not earning excess profits, that might be due to cost inefficiencies (for example due to unnecessary or inefficient procedures, inadequate cost control or ‘gold-plating’ of services<sup>23</sup>).

3.7 We are confident that we are not operating an inefficient audit practice. Deloitte’s costs are tightly controlled, and the particular nature of the partnership model reduces the risk of inefficiency. As a partnership, partner remuneration is directly and explicitly related to the profits of the business. The partners who would benefit from improved profitability are the same people who have control over the costs of the business.

3.8 The FTSE 350 audit market is not a distinct operating business within Deloitte. As we noted in our Initial Submission<sup>24</sup>, FTSE 350 audit contributes about £137m (approximately 25%) of Deloitte’s total statutory audit (and related services) revenue of approximately £510m<sup>25</sup>. It would be uncommercial to operate an inefficient audit practice to the detriment of 75% of our audit revenues (or their profitability) merely to secure a marginal increase in our audit revenues (or their profitability) in the reference market.

*There is no evidence of an adverse effect in non-audit markets*

3.9 Deloitte and several other audit firms provide a range of professional services to FTSE 350 companies. There is no evidence, though, of any adverse effect in any such market arising out of any theory of harm posited in the Issues Statement.

3.10 Indeed, accountancy firms with significant numbers of large company audit clients are subject to important limitations to which their non-audit competitors are not subject. As has been recognised by the CC in paragraph 21 of the Issues Statement, independence rules restrict the statutory auditor’s ability to provide non-audit services to its audit clients, so it is not the case (as appears to be suggested in paragraph 22) that the incumbent statutory auditor is in a preferred position in relation to the provision of non-audit services. The position is reinforced by the Financial Reporting Council’s Guidance for Audit Committees, which requires companies to disclose the reasons why purchasing services from their auditor unrelated to the audit is in the best interests of shareholders. The result of these limitations is that the proportion of non-audit work done by audit firms for their FTSE 350 audit clients is limited and declining<sup>26</sup>.

3.11 Furthermore, these markets are highly competitive. In particular, FTSE 350 companies regularly instruct professional services firms other than the largest audit firms

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<sup>23</sup> We address the issue of ‘gold-plating’ directly in Section 2 above.

<sup>24</sup> See page 4 of our Initial Submission.

<sup>25</sup> The £137m and £510m referred to here include revenue earned by other DTTL network firms on UK group audits.

<sup>26</sup> For Deloitte, approximately 60% of revenues from FTSE 350 audit clients are attributable to the statutory audit, a figure that has increased markedly since (in particular) the enactment of Sarbanes Oxley. We believe that this figure is likely to be typical.

for these services. For example, Grant Thornton has stated that it provides one in four of the FTSE 100 companies with non-audit services. It would be reasonable to suppose that it also provides non-audit services to a meaningful proportion of FTSE 250 companies.

3.12 There are also a very large number of competitors in addition to accounting firms:

- (a) in consulting, according to Gartner Dataquest, the combined global market share of the four largest accounting firms was just 16% in 2009<sup>27</sup>;
- (b) in tax, the largest audit firms compete against a wide variety of different players, including:
  - (i) Thomson Reuters, Accenture and others in tax software and tax management consultancy;
  - (ii) law firms in tax issues related to M&A and dispute resolution;
  - (iii) niche firms and chartered surveyors in areas like R&D tax credits and capital allowances; and
  - (iv) a wide a range of audit firms and other consultancies in tax compliance;
- (c) in corporate finance, the large firms compete against investment banks and boutique advisory firms; and
- (d) in administration and receivership, for the year ending 30 November 2011, based on the number of appointments, we note that the OFT estimated the share of the four largest audit firms at 14% in its recent study of the market.

### ***Conclusion***

3.13 For the above reasons, we believe that there is no evidence to support either of the further adverse outcomes posited in the Issues Statement. In particular:

- (a) we believe that large companies in the UK receive good value from their auditors: there is no evidence to show higher prices than the competitive level or that auditors of large companies are excessively profitable; and
- (b) there is no evidence of adverse outcomes in non-audit markets: these markets are highly competitive and are contested by many different providers.

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<sup>27</sup> “Top 10 Consulting Providers’ Revenue, Growth and Market Share, Worldwide and Regional, 2009”, Gartner Dataquest, 2010 [3<]

#### **4. THEORY OF HARM (A): HIGH CONCENTRATION AND BARRIERS TO ENTRY, LEADING TO MARKET POWER**

4.1 The first theory of harm set out in the Issues Statement<sup>28</sup> is based upon the proposition that (a) there is high concentration in the market, (b) that there are high barriers to entry, and that (c) together these factors lead to the largest audit firms having market power.

##### ***Concentration levels***

4.2 Concentration measures are, as the competition authorities recognise, only a limited indicator of the levels of competition in the market. What really matters is the extent of competition between market participants and the outcomes for customers. It is these two factors that need to be considered in order to reach any conclusion on how effectively competition is operating.

##### ***Barriers to entry***

4.3 In paragraph 26 of the Issues Statement, the CC lists four possible barriers to entry:

- (a) the specific knowledge required to operate in the market;
- (b) the costs of raising capital for audit firms other than the four largest firms;
- (c) the costs of attracting and training staff; and
- (d) the fact that the existing size and reputation of an auditing firm plays a crucial role in a company's choice of auditor.

##### ***Specific knowledge required to operate in the market***

4.4 In order for any professional services firm to provide services to a client, the firm must have the requisite expertise and knowledge to undertake the work. Otherwise the firm is either not going to be appointed or would be appointed and then fail in its professional responsibilities and to meet the client's needs. An auditor is in no different a position.

4.5 The expertise and knowledge required to audit a FTSE 350 company is considerable, given the nature, complexity and breadth of such companies' operations. Developing the requisite expertise and knowledge is a major commitment which takes sustained focus, determination and investment. In our Initial Submission we identified the capabilities that we believed are required and explained how Deloitte has endeavoured to acquire and develop those capabilities over a long period of time<sup>29</sup>. We did so specifically in order to grow our FTSE 350 audit business – a goal in which we succeeded and in which we continue to invest.

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<sup>28</sup> See paragraph 25 *et seq* of the Issues Statement.

<sup>29</sup> See page 16 of the Initial Submission.

4.6 In paragraph 28 of the Issues Statement, the CC makes reference to international networks that the largest audit firms have developed. It is important to note that networks are not the exclusive preserve of this group of firms. Both Grant Thornton and BDO have networks with more than 100 member firms operating out of more than 100 countries. Of course, the strength of the networks is of importance to clients: it is not a mere presence in a country but a consistent capability across a network of countries that matters. In addition, it is important that the network firms provide a consistent and high level of audit quality and use integrated, consistent and highly evolved audit methodologies. This takes sustained investment to achieve and maintain, but it can be done.

4.7 In summary, the need to acquire the requisite knowledge, expertise and to have access to a strong and integrated international network cannot properly be characterised as a barrier to entry. These are not costs that are borne only by entrants: they are borne and continue to be borne also by those already in the market. They are attributes which a firm is *required* to possess and continue to invest in to provide audit services to the largest UK companies and they are driven by the needs and demands of the companies themselves, their investors and other stakeholders.

#### *The costs of raising capital*

4.8 We note that mid-tier firms have made it clear (for example to the House of Lords Economic Affairs Committee<sup>30</sup> and in submissions to the CC<sup>31</sup>) that they do not consider that the cost to them of raising necessary capital is a barrier to entry.

4.9 Furthermore, it is for each partnership to adopt the business model that it thinks is most aligned with its interests – in terms of partner capital, distributions, risk, debt, etc. There is very significant flexibility available to firms to structure their business in a way that can be growth-generative (but possibly necessarily more risky) or more conservative (and less risky). Firms can and must adapt their model – and risk appetite – accordingly.

#### *The costs of attracting and training staff*

4.10 Our clients, including our FTSE 350 audit clients, are highly sophisticated and intelligent people and organisations, operating complex businesses in challenging markets. Consequently, they need and demand access to the best services that are available. That means that we must seek to recruit and retain the best people, whether at graduate level or as experienced hires.

4.11 That strategy of course comes at a cost, but it is a cost that we have recognised we must bear if we are to serve those clients.

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<sup>30</sup> See paragraph 62 of the report of the House of Lords Economic Affairs Committee on *Auditors: Market Concentration and their Role*, which notes that BDO and Grant Thornton submitted that there was no need to access more capital to expand their operations.

<sup>31</sup> See, for example, the initial submission of Mazars LLP to the CC of 11 November 2011 (page 2).

4.12 Staff costs should not therefore be characterised as a barrier to entry. They are a necessary and inherent feature of a firm that is capable of meeting the demands of clients in this market.

*Role of size and reputation in choosing auditor*

4.13 It is not surprising that a customer will choose a professional services firm by reference to its own view as to the capability of that firm to provide the services required. That view will inevitably be driven by the reputation that the firm has for delivering those services. That reputation will be derived from a combination of the customer's past experience with the firm and its awareness of the firm's performance in the market – essentially a combination of the firm's private reputation with the customer and its public reputation generally. We do not believe that statutory auditors, or FTSE 350 companies, are any different.

4.14 Audit committees are expert, sophisticated and challenging buyers of audit services. They are capable of discerning the quality of an audit proposition, whether that is being put forward by the incumbent or potential future auditor. In our experience, companies expect their auditors to make the necessary investments in people, in technology and support functions, in quality control processes, and in international networks. They expect a commitment to developing and maintaining the capabilities required to deliver a high quality audit. They want to appoint auditors who have a reputation for doing precisely that – investing in the highest quality of capabilities.

4.15 We believe that we have a justified reputation for doing just that, based on a sustained and focussed strategy over many years. Our market reputation is a direct result of that investment. Similarly, it is not something on which we can continue to rely without continued investment: a quality failure could lead to the loss of that reputation (and therefore our clients and business) in short order.

4.16 As regards a company's previous experience of working with an audit firm, this is not limited to the provision of statutory audit services. The previous experience of dealing with a firm in the context of non-audit services can also be significant. Also of relevance will be the company's experience in dealing with the firm in other contexts: for example, where the firm has been engaged by another party to a transaction. In this context, it is important to note the wide range of audit firms to which FTSE 350 companies have exposure (see paragraph 3.11 above in relation to Grant Thornton's work for the FTSE 100).

4.17 The CC suggests that size is a crucial component of the decision. We do not agree that size is in itself determinative. Rather it is relevant in determining whether the firm has the ability to deliver the necessary level of quality: for example, whether the firm can devote the necessary resource to the audit, or whether the firm has a network member firm

in a particular location of sufficient scale and expertise to deliver the audit requirements in that location<sup>32</sup>.

### ***Conclusion***

4.18 In conclusion, the CC's posited theory of harm is unfounded:

- (a) it characterises certain features of the market as barriers to entry where they should properly be understood as capabilities demanded by companies and investors in order to deliver the audit quality that they need;
- (b) it fails to recognise that reputation is based on the ongoing delivery of a service of sufficient quality. Deloitte's reputation for high quality audit work is hard-earned and justified;
- (c) in addition, the other stakeholders in the reference market are sophisticated purchasers, audit committees and regulators, exercising effective procurement of audit services, good corporate governance and regulatory oversight; and
- (d) it is therefore not the case that Deloitte has, or can exercise, market power in the large firm audit market.

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<sup>32</sup> In any event, it is wrong to conclude that firms such as Grant Thornton or BDO are not themselves large. Grant Thornton states on its website that it has more than 4,000 employees in the UK in 27 offices, and that its international network comprises more than 30,000 employees in more than 100 member firms in more than 100 countries. BDO reports similar statistics, with over 3,000 partners and staff in the UK, and 44,000 people working in its international network in 110 countries.

## **5. THEORY OF HARM (B): BUNDLING TO CREATE BARRIERS TO ENTRY IN THE MARKET FOR AUDIT AND RELATED MARKETS**

5.1 The second theory of harm set out in the Issues Statement is based on the proposition that, whilst the statutory audit may be fairly standardised, the largest audit firms have the ability and, because it might create a barrier to entry, an incentive to bundle the provision of audit and non-audit services together<sup>33</sup>.

### ***Deloitte does not bundle non-audit services with audit and audit-related services***

5.2 As the CC has noted<sup>34</sup>, in addition to statutory audit services, large audit firms (in accordance with regulation and independence requirements) provide (and offer to provide) a variety of non-audit services to their audit clients (as do smaller audit firms to their own audit clients). However, Deloitte does not bundle non-audit services with the statutory audit in any of the forms identified by the CC (or in any other way).

5.3 We do use non-audit partners and staff (from our tax, consulting and corporate finance service lines) in the delivery of statutory audits, bringing to bear their specialist knowledge and expertise as part of delivering a high quality audit. This ensures that we have the highest quality of relevant experience applied to some of the most complex aspects of the audit.

5.4 Certain non-audit services which are directly related to the statutory audit would typically be undertaken by the statutory auditor, often contemporaneously with the statutory audit work. These services may best be understood as necessary concomitants to the audit itself. They are, though, limited in scope – for example, the auditor’s review and reporting on a company’s interim financial statements and announcement.

5.5 Deloitte does not bundle audit and non-audit services. Customers acquire non-audit services on terms which are determined quite separately from the audit engagement.

5.6 In any event, independence considerations limit the extent to which non-audit services may be provided to audit clients, and in most circumstances the consent of the audit committee is required for the auditor to provide non-audit services. As we noted in our Initial Submission<sup>35</sup>, the perception that may exist that audit firms earn lucrative consulting projects off the back of their audit relationship is not consistent with our experience. Our consulting revenues from our audit clients represent only about [8] of our total revenues from these clients. It is far more common for clients to source such services from alternative providers<sup>36</sup>. Further, the proportion of non-audit services

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<sup>33</sup> See paragraph 33 *et seq* of the Issues Statement.

<sup>34</sup> Ibid.

<sup>35</sup> See page 7 of the Initial Submission.

<sup>36</sup> See further paragraph 3.12 above.

provided to audit clients has declined steadily in recent years (particularly among FTSE 350 clients), as explained further in our Initial Submission<sup>37</sup>.

5.7 As we highlighted in our Initial Submission<sup>38</sup>, our audit partners and staff are not (and by virtue of our professional regulations must not be) evaluated or remunerated by reference to the selling of non-audit services to their audit clients. This significantly reduces any incentive to cross-sell, let alone to “bundle”.

### ***A group audit is not a form of bundling***

5.8 The CC has suggested in paragraph 37 of the Issues Statement that the provision of a group audit might be considered as bundling together the various components of the group audit, namely the parent audit and the various subsidiary audits. We do not think that a group audit by a network can properly be characterised as bundling. Rather, in our experience multinational companies (many of which are to be found in the FTSE 350) prefer a single network to audit their group, wherever the subsidiaries may be located. They are no doubt aware as we are, that some of the most significant company failures in which audit failings have been alleged have arisen in cases where there was no one network of firms appointed as auditor to the company group (e.g. Polly Peck, Parmalat and BCCI).

5.9 Moreover, since the legal structure of a company may not be reflected in its financial structure (a group may, for example, have certain combined or shared financial centres representing many or all companies within that group), it is unavoidable in many cases that the audit will cover activities in multiple countries.

### ***The statutory audit is not standardised***

5.10 Finally, we note the suggestion in paragraph 33 of the Issues Statement that the statutory audit is standardised (due to prescriptive rules and standards). This view is entirely mistaken. Statutory audit is a bespoke service tailored to each individual company. Whilst there are detailed sets of accounting and auditing standards and rules which apply, this does not make the audit itself standardised.

### ***Conclusion***

5.11 In conclusion, the CC’s posited theory of harm suffers from a number of flaws:

- (a) Deloitte does not bundle non-audit services with audit (and audit-related) services in any of the ways indicated by the CC;
- (b) it is not correct to consider the provision of audit-related services (such as the interim review) or global audits as a bundling of services: these are services requested to be provided by our clients from its auditors; and

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<sup>37</sup> See page 7 of the Initial Submission.

<sup>38</sup> See page 10 of the Initial Submission.

- (c) there is no evidence of any detriment to clients by virtue of the way that we provide non-audit services to them: there are extensive protections in place to ensure that the provision of non-audit services is not detrimental to audit quality. Our audit clients only appoint Deloitte to provide non-audit services where they believe there is a benefit in doing so, by comparison with appointing any other service provider.

## **6. THEORY OF HARM (C): CUSTOMER CONDUCT LIMITS COMPETITION, PARTICULARLY BY TENDERING INFREQUENTLY**

6.1 The third theory of harm set out in the Issues Statement<sup>39</sup> - that infrequent tendering by customers limits competition – is misconceived for two reasons:

- (a) first, it disregards the reasons why a company may choose not to conduct a tender or, if it does, not to switch auditor; and
- (b) second, it disregards the manner in which competitive pressure may be placed on auditors absent a tendering process.

### ***Decisions not to switch auditor may be quality-driven***

6.2 Given the nature of the audit service, one would not necessarily expect frequent switching in this market. That said, rates of tendering in the reference market appear to be increasing; Deloitte is aware of [X] tenders in the reference market [X] in the past 12 months [X].

6.3 After careful consideration of the alternatives, companies may quite rationally consider that the quality of the audit service they receive is best ensured by continuing to work with their current auditor. This is supported by audit customers' comments<sup>40</sup>. Possible adverse outcomes in terms of audit quality (and cost) may arise from switching due to an auditor's inevitable initial lack of knowledge, understanding and familiarity with the company, its operations and its people. In our experience, this leads to a need for the auditor to spend a considerable amount of additional time and resource in the first year or two of the audit appointment to acquire the necessary degree of knowledge and understanding of the company and its operations, and to develop the relationships with key personnel within the company, whether at audit committee level, management level or operational level.

6.4 The greatest concern is the possibility that frequent switching could lead to a reduction in the reliability of financial statements. In the first few years of an audit relationship, the auditor's knowledge and understanding of the business will naturally not be as developed as in later years. There is, therefore, a greater chance that the auditor will not identify that certain transactions are unusual for the business. With greater knowledge and experience of the company gained over a period of time, the auditor will be better

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<sup>39</sup> See paragraph 39 *et seq* of the Issues Statement.

<sup>40</sup> Iain Richards, Aviva Global Investors (January 2011, House of Lords Select Committee on Economic Affairs) in response to the following question – “Would investors welcome mandatory rotation of audit firms, perhaps every five or seven years, to improve audit independence (perceived or real) and audit quality, and possibly leading to non – ‘Big 4’ audit firms becoming more active in the large company audit market?”

*“No. Mandatory rotation of auditors over a short time horizon, of the kind envisaged, might create risks for audit quality. Even if, for instance rotation were required every nine years, you risk creating lower quality audits for the first two years, as the firm goes through its learning curve, as well as potentially for the last two years as the best quality audit staff are rotated off onto new and ongoing audit relationships. This would give you a cycle of four years of potentially lower quality audits, for a five year period of “full service” audits”.*

placed to identify such transactions and to challenge management as to their purpose. This means that even if the auditor conducts the audit entirely properly, there is an increased risk in the earlier years that material errors in the financial statements will go undetected. Indeed, the literature/research seems generally to support the notion that, in the earlier years of an audit relationship, there is an increased risk of unreliability of the financial statements.<sup>41</sup>

6.5 In circumstances where Deloitte has taken on a new audit client, it has employed additional efforts in the early years of the relationship [§<] in order to ensure that this risk is minimised. [§<].

6.6 We also note that ESCP Europe (in its work for the European Commission<sup>42</sup>) considers the issue of frequent switching in its evaluation of the impact of mandatory rotation of auditors. It cites research undertaken by the Federation of European Accountants<sup>43</sup> which identifies the challenges faced by auditors during the first two years of an audit mandate. These include:

*“The auditor may not have developed a full understanding of the business. This requires both understanding of the industry and detailed knowledge of the client’s activities. This process takes time, as the learning curve for the key decision makers in the audit team cannot be accelerated simply by allocating more resources. Without this knowledge, it is very difficult to identify unusual transactions whose purpose may not be fully apparent to the auditor or to assess audit risk effectively.”*

*“When disagreements arise between management and auditor, they are most effectively dealt with in the context of an open, straight-talking relationship. This relationship also takes time to develop and it is understandably more difficult to deal with an area of disagreement in the early stages.”*

*“Teamwork between the members of the worldwide audit team of a multinational company needs to be developed. This is not simply a matter of appointing partners in each location, but more a task of developing relationships so that there is a shared understanding of audit risks and open communication of audit conclusions and concerns. Formal inter-firm reports and reviews of working papers will only cover the tangible results of the audit work at*

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<sup>41</sup> The relationship between auditor tenure and audit quality has been explored in the academic literature. Ghosh and Moon (2005) conducted some research into the relationship between auditor tenure and audit quality. Their results are generally consistent with the hypothesis that reported earnings are perceived as being more reliable as auditor tenure increases. Additionally, Myers, Myers and Omer (2003) suggest that in the current environment longer auditor tenure, on average, results in auditors placing greater constraints on extreme management decisions in the reporting of financial performance. The Public Company Accounting Oversight Board (PCAOB) reviewed several studies on the relationship between auditor tenure and audit quality between 2002 and 2010. It found that: “Many, though not all, tend to support the view that engagements of short tenure are relatively riskier”.

<sup>42</sup> “Study on the effects of the implementation of the acquis on statutory audits of annual and consolidated accounts including the consequences on the audit market”, Paris, November 9<sup>th</sup> 2011

<sup>43</sup> Federation of European Accountants study, “Mandatory Rotation of Audit Firms”, October 2004

*subsidiaries. A deeper relationship is needed before those involved will be comfortable sharing tentative concerns which are often the first sign of something amiss”.*

6.7 Companies may thus rationally consider that longer term audit relationships support quality for the reasons stated above. Other benefits may relate to efficiency: for example, the enhanced ability of the auditor to identify ways in which company’s underlying financial systems, and therefore efficiency and effectiveness of the audit process, can be enhanced. This leads to a more efficient and reliable process within the company for the preparation of the financial statements and a more efficient, and therefore potentially more cost-effective, audit process.

6.8 Furthermore, the level of confidence that companies, their management and audit committees and, indeed, their investors, have in their auditors (unless an issue as regards quality arises) generally increases over time. This level of confidence is an important factor, because it creates confidence within the company, its investor population and the wider market as to the reliability of the financial statements. Coupled with auditors’ deep knowledge built up over time, this is, in our experience, of immense value in helping these companies through periods of change and uncertainty, whether arising from issues specific to the company (such as a major transaction, change in senior management or change in the business) or from wider and challenging national and global market conditions<sup>44</sup>. The independent scepticism that auditors bring to their task is of most value to companies when exercised on an informed basis.

### ***Companies can apply competitive pressures without tendering or switching***

6.9 Our experience is that companies and their audit committees recognise that they are well placed to apply competitive pressures on the incumbent auditor to help ensure the continued provision of a high quality audit at a reasonable price. In particular:

- (a) as we have explained<sup>45</sup>, these companies are experienced and sophisticated buyers of professional services, including statutory audits;
- (b) audit fees are transparent for benchmarking purposes – purchasers of audit services can, and in our experience do, undertake benchmarking of fees based on publicly available data;
- (c) audit fees are subject to annual approval and renegotiation – this process is often extensive and involves a detailed justification of the proposed audit fee;
- (d) clients can and do threaten competitive tenders, which they may undertake if the incumbent auditor does not respond appropriately;

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<sup>44</sup> For example, introduction of new regulation, periods of economic turbulence, major corporate transactions.

<sup>45</sup> See paragraph 2.4 above.

- (e) clients can ascertain quality (and in our experience are prepared to pay more for higher quality offerings) and can and do switch auditors when they have concerns over quality; and
- (f) clients receive unsolicited bids for statutory audits and, in our experience, will take these bids seriously. Indeed, there is nothing to stop any audit firm from soliciting a statutory audit from a FTSE 350 company; their chance of success will depend upon the strength and reliability of their offering.

6.10 Companies recognise that they can ensure value for money even in the absence of formal tendering, and recognise that audit quality may be more consistently supported by continuing to work with their current auditor. In this sense, the contestability of the audit market is not accurately measured by the frequency of tender and less still of switching.

### ***Conclusion***

6.11 In conclusion, the CC's posited theory of harm is unfounded:

- (a) there may be good reasons – driven by the need for audit quality – why companies choose to develop enduring relationships with their auditor rather than switching frequently;
- (b) companies have multiple means to ensure value for money from their auditor, even in the absence of a formal tender process or in the absence of switching. Audit committees are highly experienced and sophisticated purchasers of professional services; and
- (c) there is no evidence of any adverse outcomes occasioned by the conduct identified by the CC: customers appear to consider that they obtain a service that is high in quality at a price they find satisfactory.

## **7. THEORY OF HARM (D): HEIGHTENED RISK OF REGULATORY FAILURE**

7.1 This theory of harm is based on the mistaken premise that the larger audit firms somehow have the benefit of a more favourable regulatory environment than smaller firms, or that they are somehow able to shape the regulatory environment to their advantage. The CC has identified three potential concerns<sup>46</sup>: (1) that the largest audit firms may enjoy excessive influence on the regulators; (2) the fear that one of the largest audit firms might exit the market may induce the regulators to protect them; and (3) that there could be a suboptimal level of regulation in the market.

### ***Larger audit firms do not enjoy unusual levels of influence over standards***

7.2 The principal standards – or parameters within which auditors must operate – are International Standards on Auditing (*ISAs*) and related standards which are set by the International Auditing and Assurance Standards Board (*IAASB*), a part of the International Federation of Accountants (*IFAC*), an independent global organisation. The IAASB describes itself as:

*“an independent standard-setting body that services the public interest by setting high-quality international standards for audit... engagements. In doing so, the IAASB enhances the quality and uniformity of practice throughout the world and strengthens public confidence in the global auditing and assurance profession.”*

7.3 In the UK, the Auditing Practices Board (*APB*), a part of the Financial Reporting Council (*FRC*), overlays additional UK-specific requirements resulting in the standards which must be applied for all UK audits. These are commonly known as ‘ISAs (UK and Ireland)’. The APB also sets the UK’s ethical standards that govern independence matters, including the provision of non-audit services. As with the IAASB, the FRC is independent of the profession, with the Chair and Deputy Chair appointed by the UK government. The FRC operates on behalf of, and reports to, the Department for Business, Innovation and Skills.

7.4 The larger audit firms do not have any unusual or excessive influence over standard setting bodies such as the IAASB and the APB. These bodies are independent of audit firms and the profession as a whole and their reputation and ability to exert influence globally and nationally are reliant on this independence. Membership of these bodies, and therefore participation in the debates on standard setting, is drawn from a wide pool of market participants. This includes individuals from firms outside of the four largest firms as well as a range of non-accounting organisations (lawyers, public sector bodies, investment and asset managers, companies and academics).

### ***Larger audit firms do not enjoy unusual levels of influence over regulation***

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<sup>46</sup> See paragraph 42 *et seq* of the Issues Statement.

7.5 The larger firms do not have any more influence over regulators and the enforcement of standards than do other firms or stakeholders.

7.6 The principal regulator in the UK for the audits of listed and other public interest entities is the AIU. The AIU is independent of the profession, and is a part of the Professional Oversight Board (**POB**), itself part of the FRC. In this regard, the FRC describes itself as:

*“the UK’s independent regulator responsible for promoting high quality corporate governance and reporting to foster investment.”*

The FRC operates on behalf of the Department for Business, Innovation and Skills.

7.7 The AIU was set up following the UK government’s review of the regulation of the UK accountancy profession, which reported in January 2003. A wide range of bodies were consulted on the establishment, remit and operation of the AIU. Since its establishment, there have been a number of changes to the AIU’s scope of work and reporting, including the commencement of public reporting of findings in December 2008 in respect of the 2007/2008 inspection cycle. The AIU inspects the work of the four largest audit firms and the other audit firms that perform work within its remit.

7.8 The AIU produces both public and private reports: it reports on the profession as a whole, and separately on each of the major firms. The AIU’s reports on individual audits are also required to be shared with the audit committee of the audited entity.

7.9 In addition to the AIU, other regulators exist in the audit market including the Quality Assurance Department (**QAD**), part of the Institute of Chartered Accountants of England and Wales (**ICAEW**) (and regional equivalents); the Accountancy and Actuarial Discipline Board (**AADB**), part of the FRC; and the Public Company Accounting Oversight Board (**PCAOB**), the US regulator which oversees the audits of public companies (including UK listed companies with a dual or secondary listing in the US). Similar to the standard setters and the AIU, the larger firms do not have any substantive, let alone excessive, influence over or within these bodies.

7.10 The CC refers to the possibility that the larger firms could lobby standard setters for higher standards and levels of regulation, in order to prevent smaller firms from entering the market. This suggestion is at odds with the independence of the relevant regulatory and standard-setting bodies, and the necessary linkage to overarching global requirements. It also fails to recognise that the standards and regulation are driven by consumers: investors, audit committees and companies themselves. We are certain that the relevant bodies will themselves confirm the extent of their independence from audit firms.

7.11 An allegation of ‘gold plating’ of regulation at the behest of the larger firms is based on a failure to understand the key drivers in the market. The Sarbanes-Oxley Act in the US, which had a significant impact on auditing of large companies in the UK, is an example of the requirements of the market driving applicable regulation; this Act was the product of intense pressure and concern from investor and governmental bodies. Its

enactment was the result of detailed consideration by policymakers. It was not driven by the larger audit firms.

***There is no evidence that regulators are induced or inclined to “protect” larger audit firms***

7.12 We have seen no evidence to support a view that regulators may moderate their interventions in relation to the larger firms. Where our regulators have imposed disciplinary and related sanctions against the larger firms, there is nothing to suggest a regime tilted in their favour. Indeed, recently the AADB tribunal imposed the biggest fine ever imposed on an audit firm to date on PwC in connection with their client money reporting work on JP Morgan (where no JP Morgan client loss was incurred) – a fine which was about six times higher than the fine the AADB tribunal recently imposed on Robson Rhodes in connection with their statutory audits of iSoft Plc. These outcomes are not consistent with the view that the largest firms enjoy some form of protection from our regulators.

7.13 However, notwithstanding the important role of liability risk in incentivising audit quality, we do support measures intended to reduce the risk of the collapse of an audit firm. We continue to believe that the current liability regime for auditors leaves a disproportionate level of exposure with the auditor. We also consider that a balanced regulatory regime is essential to ensure that the reputations of the firms and the profession are fairly presented to the public. Contingency planning (or ‘living wills’) also has a place, and would provide additional protection for the market. For our part, we are active in pursuing this concept with our regulators<sup>47</sup>.

7.14 Whilst none of the measures referred to above should be unduly protective or act as any form of bail out, their development in the UK regulatory framework would provide added protection for stakeholders and address one of their key concerns: that one of the larger firms exits the market.

***There is no evidence of a non-optimal level of regulation***

7.15 A further hypothesis posited in the Issues Statement is that a suboptimal level of regulation could either force down quality or create a barrier to entry by unnecessary over-regulation<sup>48</sup>.

7.16 We have seen no evidence of under-regulation. The audit market, particularly for larger listed companies, is highly and robustly regulated in the light of the work with which auditors are tasked. There is a strong emphasis on quality by the firms, standard setters and regulators. In our view, the system is, if anything, tougher in relation to the audits of larger listed companies (and, by extension, to those firms in that marketplace). We have noted above the universal push for quality, to which auditors must respond<sup>49</sup>.

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<sup>47</sup> The CC raises issues relating to failure of a large audit firm in paragraph 58 of the Issues Statement. We would be happy to discuss these points, and the steps we are taking to mitigate the risk, with the CC.

<sup>48</sup> See paragraph 45 of the Issues Statement.

<sup>49</sup> See paragraph 2.17 above.

7.17 In terms of the potential for over-regulation, however, there is no evidence to suggest that regulators are determining the level of regulation by reference to the ability of audit firms to participate in that regulated market. They are determining the level of regulation by reference to the needs and demands of the companies themselves and of their investors. We believe that the CC's inquiry will show that companies, shareholders and other stakeholders do not believe that there is material over-regulation of auditors.

7.18 Indeed, we believe that investors and other stakeholders consider that the UK enjoys a particularly well-regulated audit market, giving a comparative advantage to the UK as an investment location.

### ***Conclusion***

7.19 In conclusion, the CC's posited theory of harm suffers from a number of misconceptions:

- (a) there is no evidence that larger audit firms enjoy an unusual degree of influence over standards or regulation;
- (b) regulators apply the highest standards to audit by the largest firms; and
- (c) we do not believe that there is any evidence of a non-optimal level of regulation.

## 8. THEORY OF HARM (E): TACIT COORDINATION

8.1 This theory is based upon the proposition that there could be conditions in the FTSE 350 audit market that might be conducive to tacit coordination between the largest audit firms, and that market outcomes could therefore reflect tacit coordination<sup>50</sup>.

8.2 The theory fails for three reasons:

- (a) auditors do not have the incentive to engage in tacit coordination;
- (b) they do not have the ability to do so; and
- (c) there is no evidence of tacit coordination in this market.

### *No incentive to engage in tacit coordination*

8.3 The Issues Statement suggests that the four largest audit firms may have similar business models<sup>51</sup>.

8.4 In fact, the firms differ materially, in particular with respect to:

- (a) *size*: PwC has a significantly larger audit practice than the other larger firms performing FTSE350 audits (both by revenues and number of clients);
- (b) *growth*: Deloitte has grown its share of FTSE100 audits significantly over the past 15 years<sup>52</sup>;
- (c) *balance of services*: Deloitte has four similarly sized service lines (Audit, Tax, Consulting and Corporate Finance). In the other largest firms, audit (including related assurance and advisory) services typically accounts for a much larger proportion of the firm's overall revenues;
- (d) *international organisation*: these differ significantly across the four firms. Deloitte operates under a network of member firms. KPMG operates with a single European LLP. Ernst & Young's global management has much greater influence in the UK firm than that of the other three firms;
- (e) *client base*: Deloitte's revenues from FTSE100 audits are the smallest of the four firms, though its revenues from FTSE250 audits are the highest; and
- (f) *client and people experience of the firm*: feedback informs us that there are a number of intangible differences between firms in terms of culture, style and operational and service elements of the firms.

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<sup>50</sup> See paragraph 46 *et seq* of the Issues Statement.

<sup>51</sup> See paragraph 47 of the Issues Statement.

<sup>52</sup> See further paragraph 8.6 below.

8.5 The Issues Statement also suggests that the degree of regulation of the large company audit market contributes to a similarity of business models<sup>53</sup>: in fact, no such similarity in business model exists, irrespective of regulation.

8.6 Similarly, the Issues Statement wrongly suggests that the market is relatively stable<sup>54</sup>: as we identified in our Initial Submission<sup>55</sup>, we have seen our share of the FTSE 100 audit market grow very substantially (from 5 to 22 appointments) over the past 15 years (and the scope of the audit services provided to our audit clients has also changed in this period as their businesses have grown and changed).

***No ability to engage in tacit coordination***

8.7 There is no evidence that the four largest audit firms would have the ability to engage in tacit coordination for a number of reasons:

- (a) audits are not homogenous products – they are bespoke services tailored to the specific needs and complexities of international companies and those needs commonly change from year to year;
- (b) audit fees for these bespoke offerings are individually negotiated with audit committees, who are expert and well-informed buyers; while they can be benchmarked at an aggregate level, it would not be possible to discern a deviation from alleged coordinated behaviour by a firm given the multiplicity of factors that are reflected in the audit fee;
- (c) although audit fees are publicly disclosed in the audited companies' financial reports, this is the fee for the previous year's audit, not the fee for the current year's audit. This lack of immediate transparency means that it would not be possible for any significant deviation from the prevailing behaviour by a firm to be observed by other firms in the market;
- (d) substantial differences in business structures between audit firms reduce the ability (as well as the incentive) to coordinate – e.g. differences in the size and value of the customer base mean that the firms could not easily identify a common, optimal, price; and
- (e) even if it were possible to reach a tacitly agreed position, it is not clear that there exist ways for the firms to enforce any such agreement, thereby undermining its stability.

8.8 The Issues Statement suggests that tacit coordination could take place with respect to price, geography and industry sector<sup>56</sup>. We address each in turn.

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<sup>53</sup> Ibid.

<sup>54</sup> See paragraph 46 of the Issues Statement.

<sup>55</sup> See page 1 of the Initial Submission.

<sup>56</sup> See paragraph 49 of the Issues Statement.

### ***No tacit coordination on price***

8.9 We do not believe that the conditions for tacit coordination on price are present in the audit market. While the audit fees paid by clients are visible, as the CC has itself noted<sup>57</sup>, these are subject to extensive negotiation with the client, and reflect the client's current position (which may be very different from the previous year – for example, as a consequence of an acquisition or disposal, entering new markets, corporate restructurings, system implementations and so on), the bespoke nature of the audit service, and the auditor's approach and audit methodology. The extent of variation highlights the fact that the audit service cannot be considered a homogenous service, requiring the same inputs in the same proportions from client to client and from year to year.

8.10 These factors undermine both the ability and incentives to coordinate. Moreover, the Issues Statement acknowledges that the risk of coordination with respect to price may be mitigated by the presence of negotiation or tender<sup>58</sup>.

### ***No tacit coordination on geography***

8.11 We also do not believe that the conditions for tacit coordination on geography are present in the audit market. Auditing of FTSE 350 companies is not a service that is provided within defined sub-regions (unlike, for example, bus transport or retail operations), either nationally within the UK or internationally. The companies themselves determine where they will locate their headquarters in the UK and where they will locate their operating centres and these can, and do, change.

8.12 Likewise, it is the companies that determine those jurisdictions in which they will be present and the distribution of their operations across those jurisdictions. There is no meaningful way in which, even if they were minded to do so, the largest audit firms could seek to coordinate on a geographical basis. Many audit firms have offices in all major cities across the UK (for example Grant Thornton report that they have 27 offices across the UK, which compares to 24 Deloitte locations, including three offshore). Moreover, their international networks will also include member firms in most major jurisdictions across the globe.

8.13 For these reasons, it is difficult to understand the suggestion that the market could be characterised by or susceptible to tacit coordination on a geographical basis.

### ***No tacit coordination on industry sector***

8.14 Further, we do not agree that the conditions for tacit coordination on a sector/industry basis are present in the audit market.

8.15 In general, the largest audit firms provide audit services across almost all industry sectors. Where there are exceptions, such as banking and mining, these are industries

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<sup>57</sup> See paragraph 46 of the Issues Statement.

<sup>58</sup> Ibid.

where, in the FTSE 350, there are a limited number of companies. Further, decisions in relation to which industries to operate in, such as banking, will depend upon the firm's own risk appetite. In respect of mining the decision to operate will depend upon whether the firm's international network has a sufficiently robust audit capability in the jurisdictions where the mining operations actually take place. There is no sense in which these complex factors are susceptible to tacit coordination.

8.16 Our own experience clearly demonstrates that there has been no tacit coordination by industry sector. Our FTSE 350 wins over the past 15 years have been spread across all sectors. Furthermore, we are currently actively considering investing in the necessary capabilities where we believe we are under-strength. We are constantly monitoring the opportunities offered in each sector and we structure our activities accordingly. We see the threats from competitors as real and as part of the normal process of intense competition in the large company audit market.

### ***Conclusion***

8.17 In conclusion, the CC's posited theory of harm suffers from a number of flaws:

- (a) market conditions are not conducive to tacit coordination: the largest audit firms have neither the incentive nor the ability to engage in tacit coordination; and
- (b) there is no evidence of tacit coordination. Indeed, Deloitte competes aggressively, and successfully, for reference market clients across the board. This is evidenced in the growth that Deloitte has achieved and its plans for the future.

## **9. THEORY OF HARM (F): INFORMATION ASYMMETRIES AND CONFLICTS OF INTEREST**

9.1 This theory of harm is based upon the proposition that information asymmetries between the directors and shareholders, and between the directors and shareholders collectively, and the auditors may allow the largest audit firms to maintain market power<sup>59</sup>.

### ***Information asymmetries do not contribute to any market power***

9.2 We do not consider that these information asymmetries in any way help to create or maintain market power.

9.3 With respect to the posited asymmetry related to shareholders:

- (a) there is a direct duty of care in law owed by the auditor to the shareholders as a body (rather than to the directors); and
- (b) there is real visibility of the outcome of the auditor's service (in the form of the published audit opinion). There are also opportunities for the shareholders to question directly the auditors in general meeting (usually at the AGM when the financial statements are presented) and to decide whether those auditors should be reappointed, adding to the many other sources of information on performance which shareholders use. This level of visibility and opportunities is rarely, if at all, available in respect of any other professional adviser engaged by the directors.

9.4 With respect to the posited asymmetry in relation to directors, the position is similar: the information asymmetry concerns are lower, not higher, with respect to audit than with respect to other professional services.

9.5 In paragraph 52 of the Issues Statement, the CC suggests that it may be difficult for the directors to assess the quality of the audit, especially (but not limited to) in advance of the audit work. As we have explained above<sup>60</sup>, we do not believe that to be the case. We have explained why we believe that the directors, particularly those members of the audit committee are very capable of assessing audit quality and making an informed decision as to the capability of the auditor and the quality of the audit offering – before, during and after the audit assignment.

9.6 Furthermore, the audit is a collaborative process (far more so than many professional services). The directors themselves, particularly those on the audit committee, must have a significant degree of knowledge of accounting principles as the Board has ultimate responsibility for preparing the financial statements in accordance with accounting standards and the company's accounting policies. The audit is also an intrusive process, with constant interaction throughout the year (not just at the year end) between the audit team and company personnel (at all levels within the organisation). The degree of

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<sup>59</sup> See paragraph 50 *et seq* of the Issues Statement.

<sup>60</sup> See paragraph 2.4 above.

knowledge and understanding of accounting principles is heightened within a FTSE 350 company as compared to smaller, non-listed, companies, because of the need for the company to meet the specific requirements of the listing authorities.

9.7 Hence, unlike many professional services, we believe that there is no information asymmetry between directors and the audit committee on the one hand and the audit firm on the other that might in some way lead to the audit firm benefitting from market power.

### *Conflicts of interest and independence*

9.8 The CC also suggests that conflicts of interest may further restrict the choice of auditor<sup>61</sup>. In a sense this is true, in that if a firm has a conflict of interest (e.g. as a result of work for a competing company, giving rise to a commercial conflict) or an independence issue (e.g. as a result of non-audit work for the same company), then that firm cannot be appointed as auditor, and so there is one less firm from which to choose. This, however, is an inevitable consequence of the regulatory rules which have been put in place by policy-makers after careful consideration, especially on independence, but it does not in itself give rise to any market power for the largest audit firms.

9.9 In paragraph 54 of the Issues Statement the CC refers to the possibility that a lengthy audit appointment may result in management/directors having an inappropriate degree of influence over the auditors, thereby impairing the auditor's independence and adversely affecting quality. This is not inherently a competition issue, but rather an issue about corporate governance and auditor independence. As regards corporate governance, the conduct of directors is a matter for the FSA/BIS/FRC and the listing authorities. We would note, however, that the roles and responsibilities of the independent non-executive directors, which all FTSE 350 companies are required to have, are designed to be an effective safeguard against the undue influence of the executive directors.

9.10 Similarly, as regards auditor independence, it is difficult to see how this is an issue most appropriately within the purview of the competition authorities. The rules and regulations regarding auditor independence are complex, especially for those companies with listings in other jurisdictions. Moreover, protections are already in place: rules include the requirement on the audit firm to rotate the audit partner after a certain number of years and the need to have an independent review partner who is not part of the client facing team.

9.11 In any event, as the CC recognises in paragraph 55 of the Issues Statement, it is not in our interest to allow us to be improperly influenced by company management. Such improper influence might adversely impact the quality of audit service, leading to the risk of substantial financial and reputational damage in the event of an audit failure or finding that our independence had been compromised.

9.12 It is also noteworthy that there is no evidence in the literature or in AIU inspection reports that quality reduces over the duration of an audit relationship. In fact, as we have

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<sup>61</sup> See paragraph 53 of the Issues Statement.

explained previously<sup>62</sup>, there is a greater risk to audit quality and to the reliability of financial statements in the early years of an audit relationship.

***Conclusion***

9.13 In conclusion, the CC's posited theory of harm suffers from a number of misconceptions:

- (a) it fails to understand that information asymmetries are likely to be lesser – not greater – in relation to audit by comparison with other professional services, given the collaborative nature of the audit process;
- (b) there is no evidence that audit tenure has a negative effect on independence, or, in turn, on audit quality; and
- (c) conflict rules have arisen as a result of deliberate decisions by policy-makers taking into account a number of factors including, but not limited to, competition between auditors.

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<sup>62</sup> See paragraph 6.2 above.

## 10. CONCLUSION

10.1 Deloitte welcomes engagement with the CC on these issues. As we have noted in this response and our Initial Submission<sup>63</sup>, we would encourage the CC to engage with the FTSE 350 companies and their audit committees and investors in order to understand their requirements, the capabilities and qualities that they look for in their auditors, their views on audit quality and pricing and, ultimately, what drives their decisions as to which firm to appoint and on what terms.

10.2 Our experience is that the FTSE 350 audit market is competitive and rivalry between the players is strong. In particular, competition between the largest audit firms for business in this market is strong. We do not recognise any of the three possible adverse outcomes which the CC has suggested could arise: those outcomes do not exist in the current market and we do not see any realistic prospect of those outcomes arising in the future.

10.3 We do not believe that any of the theories of harm set out in the Issues Statement are sustainable or that they give rise to the adverse outcomes which are posited. To the contrary, we believe that the market is operating highly competitively and is delivering good outcomes in terms of quality, price, efficiency and innovation. We believe that the evidence which the CC will gather during its investigation, whether from audit firms, the purchasers of audit services, investors or other stakeholders, will show this to be the case.

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<sup>63</sup> See page 31 of the Initial Submission.