STATUTORY AUDIT SERVICES MARKET INVESTIGATION

Summary of hearing with Deloitte held on 2 May 2013

Background

1. Deloitte expected other regulators, its clients and policymakers globally to take a lead from the CC's findings in the audit market investigation. Deloitte had been taken aback by the CC's conclusions on the outcomes that customers were receiving in the marketplace. Deloitte fundamentally disagreed with the CC's findings on: pricing and profitability; quality; independence; and innovation. In its view, there was overwhelming evidence to suggest that the market was working well. On the flip side, Deloitte believed that evidence supporting the contrary view had been stretched far beyond the weight that it could carry, and it considered that in some cases the evidence was wrong.

2. Deloitte said that the conclusions that had been drawn on the basis of the Audit Quality and Review team (AQRT) reports were out of line with any reasonable use of evidence. It noted that nearly 93 per cent of AQRT reports were in the top two categories, either good or acceptable, and yet the CC alleged that auditors had committed significant, persistent and widespread failings across a large proportion of the market.

3. Deloitte hoped that the CC would get to grips more fully with some of the changes that had been taking place in the market over the last few months. The introduction of mandatory tendering by the FRC had led to a number of very high-profile companies already going out to tender. This made it clear how material the change was and Deloitte was surprised that the provisional findings did not consider this more fully.

4. Whilst Deloitte felt strongly about some of the conclusions in the provisional findings, it wished to engage positively to ensure that the CC's proposed remedies, many of which it supported, were effective and practical.

5. Deloitte welcomed several findings, including no evidence of audit firms behaving inappropriately or of tacit collusion; bundling or tying of services; low-balling; or excessive influence on regulators. Deloitte also welcomed the findings that most companies and most auditors performed their functions diligently and effectively most of the time, noting that most companies conducted regular reviews of audit effectiveness. Deloitte said that firms had incentives to maintain high quality and to compete and noted that the CC had found that Finance Directors and Audit Committee Chairs (ACCs) were highly experienced and expert in what they did.

6. Deloitte said that the provisional findings did not recognize how much the market was changing already. It did not believe that customer behaviour or market structure produced adverse outcomes. Deloitte considered that evidence of low switching rates and long tenure was largely now irrelevant. This was because since the investigation had started, changes by the Financial Reporting Council (FRC) had come into effect and there was strong evidence of a lot of very significant change happening in the marketplace. Deloitte noted the examples of HSBC, Schroders, RSA and BG Group all having gone out to tender, following long tenure periods. Deloitte indicated that a number of its own clients had told it that they would be going out to tender as a result of the new requirements and that it would not be on the tender list because they wished to show a switch to the market. The audit market was completely different from a year ago.

7. Deloitte considered that many commentators, investors and companies had welcomed the FRC requirements and had told the CC that any additional remedies beyond what the FRC had recently introduced were unnecessary.

8. Deloitte did not agree with the CC's findings that companies faced significant hurdles in comparing the offering of the incumbent auditor with alternative suppliers other than in a tender process or that it was difficult for companies to judge audit quality in advance. Companies that responded to the CC's provisional findings shared Deloitte's views. The GC 100 and a number of companies had pointed out that there was no difference between appointing an auditor and any other professional services provider and that in fact there was more information about audit quality, as a result of regulatory reviews, then there was about many other professional services. Deloitte considered that it was easier to compare auditors than lawyers.

9. The evidence showed that companies had the expertise and resources to appraise their current auditors and they did this regularly and effectively, outside a tender situation, using benchmarks of price and quality.

10. There was no significant evidence that showed that the incentives of auditors, directors and shareholders were misaligned. Deloitte considered that much of the CC's analysis in relation to this theory of harm was hypothetical and theoretical, with little, if any, tangible evidence to support it. It was not appropriate to base the conclusion of an adverse effect on competition without evidence.

11. The theory only held if the demands of management were misaligned with those of shareholders, of which there was no evidence. This CC conclusion had been comprehensively rejected by all companies that had responded to the CC. Deloitte considered that the only evidence the CC quoted was from the Cadbury Report, which was more than 20 years ago and had seeded the very effective corporate governance structure currently in operation. The regulatory and accounting landscape was very different then. Deloitte thought that the CC needed to consider the strength of the legal, regulatory and reputational drivers which incentivized auditors and directors to act honestly and with integrity and with due regard to shareholder interests. If there was any material difference between the interests of shareholders and directors, that would have manifested itself within evidence, such as audit failures; management failures; commentary by investors; case studies and surveys. Deloitte said that it had not and this should be instructive to the CC.

12. Deloitte considered that the CC had conflated auditor independence and professional scepticism and that these were very different. The CC had failed to cite any contemporary examples of the loss of independence and the provisional findings' conclusions seemed to be based on confusing loss of independence with some instances of the FRC raising some concerns around professional scepticism. The CC had justified its conclusions of a lack of independence on the basis that auditors failed to identify the impending collapse of some companies. There was no basis for this conclusion and it should be struck out from the findings.

13. There was real evidence that profitability was not too high in the reference market. It was not sufficient evidence to conclude that prices were too high on the basis that prices fell after tenders; rewards to partners were attractive; and there were companies for which firms enjoyed persistently higher profits. Deloitte considered that it was naturally pro-competitive that prices should fall after a tender.

14. If auditors had a power over price, prices would rise indefinitely after a tender and they would be able to force through price rises without any justification. This was not the case. To conclude that rewards to partners were attractive had no economic

basis. The corollary, ie to prove an efficient market, would be to show that rewards to partners were unattractive. This finding also ignored the fact the partners were owners of the wider business and not just the audit service line and their rewards reflected the profitability of the business as a whole. It was not relevant to state that profits for some clients were persistently higher. It was normal to expect a range of profitability among a portfolio of clients. The CC could equally have stated that some companies benefited from persistently lower profits. Deloitte's profitability for FTSE 350 clients followed an approximately normal distribution.

15. Deloitte's audit service line made comparable profit margins to its other service lines. It noted that the CC had found that engagement profitability of non-FTSE audit engagements were higher that FTSE 250 engagements. Deloitte's fees had declined in real terms over the last five years and the FRC had publicly stated concerns over adverse pricing pressures on pricing levels and the impact of real terms fee decreases.

16. Deloitte noted that in 2009/10, the AQRT had stated that the overall quality of major public company audit work was fundamentally sound and said that since then the findings from the AQRT had improved. The CC had misunderstood the basis for the AQRT reviews, which were not intended to be a balanced scorecard. Selection of audits was on a risk-based approach and the review culture was one of continuous improvement. Deloitte noted that only four of the 19 audits classified as requiring significant improvement were in the reference market. The 2009/10 AQRT report had recommended that auditors should increase the level of professional scepticism. This was targeted at certain areas of the audit, particularly goodwill and going concern, which were persistent concerns at the time given the financial crisis. It was not evidence of a widespread problem and did not allow the CC to conclude that there was a lack of scepticism across a large proportion of the market. If that were the case, audits would not be effective.

17. Deloitte said that it was misleading of the CC to have linked the six cases it had identified in Appendix 17 of its provisional findings to a lack of professional scepticism. The CC's treatment of the [✂] was a good example of the unfairness of this part of the provisional findings: the way in which the provisional findings purported to link [✂] to the AQRT finding was entirely wrong.

18. Deloitte accepted that there was an unmet demand from investors. It recognized that recently some investors had expressed a desire to receive additional information about the audit, although it considered that these were inconsistent demands expressed in general terms. It was important to corral these into something that could be put into the right regulatory framework if it was to be addressed effectively. However, Deloitte did not think that this was a competition problem but a regulatory problem. It did not think this demand existed five or ten years ago.

19. Investors already had a forum to ask questions on the audit at the AGM. Deloitte did not think this had ever happened, which demonstrated some of the complexity and difficulty for auditors to determine how to satisfy shareholder demand. That said, Deloitte indicated that it was taking steps to address this issue by innovating the audit process to address communication with Audit Committees and investors.

Provisional findings

20. Deloitte's audit profitability had been declining in line with declining audit fees. It had shown that recovery rates had declined, although the CC contended that declining recovery rates did not necessarily indicate declining profitability.

21. Audit engagements were significantly less profitable in year one and [✂] because of the extra costs of becoming familiar with the client. Deloitte indicated that it nevertheless pitched at this level because it considered engagements over an expected period of return, which would vary by company. In the current framework, where companies were required to tender for their audit every ten years, Deloitte would look at different ways of addressing the costs: if it were conducting many more transitions, it would see if there were better ways of doing this. It would consider if companies should start to bear first-year costs.

22. Deloitte's clients never sought to query in detail the transition costs Deloitte was bearing and to understand how, as a result, fees would evolve over subsequent years. Companies were content that Deloitte was bearing transition costs and allowed it to get on with the audit. It considered that this might change going forwards depending on the length of tenure for an audit.

23. The evidence Deloitte had submitted showed that in real terms, over the last five years, prices for audits had decreased. The reason why prices almost always fell after a tender was to reflect compensation for the company to reflect the cost of switching. In the current framework, where tendering occurred not necessarily because companies were unhappy with the price, quality or service of the audit but because they had to tender under the FRC's Code, Deloitte had seen prices increase after a tender (eg in the case of BG Group audit).

24. Deloitte said that following the recent FRC changes, it had done some analysis which showed that between now and 2015, half the FTSE 100 and 100 of the FTSE 250 would need to tender. It was already having conversations with ACCs about plans for when that would take place. Companies that were not its clients were saying that they were not going to include their incumbent auditor in their next audit tender unless the incumbent was able to demonstrate a significantly higher level of ability to justify retention and overcome perception issues.

Mandatory tendering

25. Deloitte supported mandatory tendering and considered that it would stimulate more competition in the marketplace. It might also address some perceptions around long tenure. However, there could also be some unintended consequences. Deloitte gave the example of [✂], which ended up with a choice of just two auditors because other firms were conflicted, or did not have appropriate expertise, or otherwise chose not to tender.

26. Under the current framework, where a steady state of 35 audits per year may be expected, audit firms would need to choose which audits they tendered for. Historically, it would be rare for Deloitte not to tender for an audit in the FTSE 350 market. In the future, where tenders were required once every ten tears, Deloitte would need to decide which audits it tendered for because of resource constraints.

27. Deloitte believed that in the first instance, the requirements for a tender should be left to ACCs, Audit Committees and management. It would be in their interests to run an effective tender with the right level of information provided. Companies understood where the key judgements were, where the key operations in the organization were and they did not need to be told how to provide that information to those tendering.

28. Deloitte did not think that within the context of going out to tender once every ten years, companies would re-evaluate the way they conducted audit tenders.

29. Audits were so bespoke to individual companies that no aspect of the tender process could be commoditized, even if tenders were taking place more frequently. Deloitte had been told by companies that if it did not think it had received enough information through a tender process to make its proposition, then it should ask for more information, which went against the suggestion that tender processes could become more streamlined.

30. Investors Deloitte had spoken with had said that, in a 'comply or explain' context, they might accept explanations from companies, instead of tenders, for one or maybe two years, but not longer—and even this would be exceptional. Deloitte considered that it would be very rare for companies to 'explain' persistently. Deloitte did not see the need for a limit on the number of times a company could 'explain' or when it must go to tender because in practice shareholders would force companies to comply with the ten-year requirement.

31. At the moment, Deloitte felt that it had to almost repitch every year to demonstrate why it was good value and should be kept on for the following year. A fixed mandatory tendering period might lead to an assumption that auditors were in place for that period. Having too frequent tendering periods would lead to excessive disruption for management. Deloitte said that after taking all this into account, this was the reason why the FRC settled on a ten-year period. Costs for companies and firms to go through tendering every five years would be excessive.

32. Deloitte did not think more frequent tendering would open up more opportunities for it. It did not think it had the resources or that the resources existed in the market for firms to accommodate and take advantage of more frequent tendering. Asking Deloitte's cadre of highly experienced audit partners who routinely executed high-quality FTSE 350 audits to participate in more frequent tenders would be a massive exercise for it to manage to ensure that there was no impact on audit quality. It would have a high impact on the focus of the working life of a partner.

33. Deloitte said that it would not be the case of reducing partner resource currently utilized in targeting potential clients and devoting more of that to tender activity because it was not exclusively its audit partners that targeted potential clients. If tenders were mandated more frequently than every ten years, there was a real danger of confusing its audit partners about their main priority, ie executing high-quality audits in the interests of shareholders, or spending more time participating in audit tender processes.

34. Deloitte said that providing input by senior professionals to companies was the most expensive part (for it) in a tender process, because companies wanted to meet the team that would be working on their audit. In multinational organizations this would include meeting the key partner in each territory. Companies wanted local management to meet their territorial teams and to vote on them. Often, they would also expect the audit engagement partner to have visited all of those particular territories as well. Deloitte did not think there could be any commoditization of this process. It considered that if companies went through a less rigorous process, then they may be just going through a process without any real expectation of change. Deloitte did not think tendering every five years would increase the perception of independence more than tendering every ten years.

35. Deloitte did not think it desirable to introduce a mandatory open-book process for tenders, because in practice companies provided what was needed in each individual case. Nevertheless, if such a requirement were to be introduced, it should provide: previous interim audit reports; controls around the finance function; external Audit Committee reports made to the Audit Committee; and the structure of the organization.

Mandatory rotation

36. Deloitte did not favour mandatory rotation. When Deloitte was required to rotate partners, it would try to ensure that a new partner understood the key judgements being made and had an opportunity to input at that point if there was going to be any disagreement. Companies were positive about the refresh that partner rotation brought, but accepted that it might not completely offset the concerns about independence that investors might have. Deloitte noted that there were rotation implications for other partners and senior staff that participated on an audit, who were required to rotate as well.

37. Mandatory rotation could result in a loss of customer benefits caused by a loss of investment in the relationship between an auditor and a company. This was because enforcing change when the company did not think it was in the best interests of shareholders was taking away choice. As a result of investment made by the incumbent, it may already be offering the best audit available in the market, but a company may not obtain the benefits of that investment because it would not be allowed to continue its relationship with the incumbent. If the CC were minded to introduce mandatory rotation, Deloitte did not think it unreasonable, with mandatory tendering in place, to have a 25-year backstop of mandatory rotation.

38. However, as a point of principle, the ACC was the person best placed to make the decision as to when a company should change its auditor. Any perceptions that a company had had its auditor for too long would be addressed by mandatory tendering on a 'comply or explain' basis because that would give shareholders the opportunity to express a desire for change, if that was what they wanted. As an example, [✂].

39. Deloitte did not think there was any length of tenure that would prejudice competition and choice. Long tenure might give rise to a *perception* of loss of independence.

Expanded remit and/or frequency of AQRT reviews

40. Deloitte considered that companies would find it useful if AQRT reports could be changed to be more representative to provide evidence of a more informed choice of auditor. To achieve this, Deloitte considered that the sample selected for review would have to be structured in a slightly different way. The current engagement process was transparent and the output was provided to the entity whose audit had been undertaken, and Deloitte thought this was valuable.

41. Deloitte considered that it would be a challenge to undertake and make public AQRT reviews on a single audit basis rather than on a firm basis because the report would be perceived as a commentary on the audited company and its accounts rather than the auditor. However, the entity may suffer consequences because of what the auditor had done, noting that it would be an inspection of the auditor's own engagement files, which the entity would not have access to. If this information was made public, it might be misinterpreted. Making AQRT reports more widely available than to the companies on which the review was conducted could be damaging to UK companies and could make the UK a harder place in which to do business.

42. Deloitte said that every five years was a sensible period for AQRT reviews. This was the time period in which it conducted internal practice reviews, to tie in with the partner rotation cycle, and would mean that every audit would be reviewed through an individual engagement partner's tenure.

43. It was difficult to compare the Public Company Accounting Oversight Board and AQRT processes other than to note that they both had experienced, well-trained teams that understood auditing; understood Deloitte's audit methodology; and asked very challenging questions.

Prohibition of Big-4-only clauses in loan documentation

44. Deloitte was supportive of extending the prohibition of Big-4-only clauses to all forms of capital raising.

Strengthened accountability of the external auditor to the Audit Committee

45. Deloitte considered that practice in this area had undoubtedly changed over the last three to five years. Probably for all of its FTSE 350 clients, ACCs felt they were responsible for having oversight of the Audit Committee process. ACCs and Audit Committees met privately with the audit partner, outside of executive management and ACCs had oversight of fees. Deloitte considered that, to some extent, the requirement was to codify how this should happen and to codify what was currently happening in practice, to achieve uniformity in practice.

46. Deloitte would be concerned if any requirement were brought in that meant the Finance Director was bypassed every time the auditor found an issue. It did not think it would be practicable to conduct an audit without the involvement of the Finance Director. Deloitte said that at the moment, once it had established all of the facts and had agreement on them and it felt there was still an issue, then it would go to the ACC.

47. Deloitte's current practice was to inform the Audit Committee, when it started its planning process, of the key issues it thought would need to be addressed. It would then work with management to develop these fully and would then present its findings to the Audit Committee.

Enhanced shareholder–auditor engagement

48. Deloitte thought a lot of shareholder/company dialogue took place 'behind the scenes', which was why questions were never asked of the auditor at AGMs. Deloitte noted that the Investment Management Association and others had said that they found it more effective to have meetings with management to discuss issues rather than raise them at AGMs. Deloitte recalled that in the past, where there were exceptionally high levels of non-audit work conducted by the auditor, questions would be asked of the board, but not too much of the auditor itself. There was also some ceremonial reading out of audit reports.

49. Deloitte considered that the company was best placed to provide information about the company; the auditor could only disclose information about the audit. The audit report and information from the auditors should be universally available to all shareholders, not just those that chose to attend the AGM. Company boards were responsible for the preparation of the financial statements; the auditor was responsible for giving an opinion on the truth and fairness of those financial statements.

50. Deloitte noted the recent FRC consultation about including information about materiality in the audit report. Its view was that the best way to communicate with shareholders as a body was through the audit report. It did not think there was much support from investors for additional presentations at the AGM. This might end up with a formulaic approach of the auditor reading out the audit report at the AGM.

51. Deloitte was concerned that it would not be able to assure the quality of any observations made by an audit engagement partner at an AGM. Engagement partners were not authorized to sign audit opinions unilaterally. They required clearance through Deloitte's quality and assurance processes. Deloitte could not see a way of providing real-time quality and assurance around complex matters in an audit, which may have required careful judgement and were typically complex.

52. Deloitte considered that there was a risk that its efforts to execute high-quality audits, and the quality of the financial statements, might be undermined by partners being required to respond to potentially hostile shareholders, without being able properly to quality-assure observations and comments.

53. Where this might end up was with Q&A sessions carefully scripted, with management restricting themselves to explaining the report with words that were already in the report. Deloitte's preference was to provide more information in the audit report about how it arrived at its conclusions, which would provide information for investors to discuss with company management in private meetings, or whatever forum they wanted. This would also provide an easier and effective comparison of audit firms based on what was provided in their reports. Deloitte was happy to engage with shareholders to explain how audits worked but was concerned about having company-specific conversations.

54. Deloitte did not think shareholders would exercise their powers, in the current framework with tenders every ten years, to require companies to tender their audit contract in subsequent years. They were more likely to just see out the tender period.

55. Deloitte did not support the option of a choice of two auditors being provided by Audit Committees, denoting a preferred choice after a tender, for shareholders to vote on. Management and the board were best placed to make the decision on choice of auditor. As a practical matter, it would be difficult to expect the non-preferred team to remain on standby in case shareholders did not opt for the preferred choice. As an example, Deloitte noted the change of auditor at [✂]. It noted that the new auditor had been going through a process, over the last six months, of transitioning and getting up to speed. The AGM, where the formal selection of the new auditor would be made, had yet to take place. Deloitte said that it would have been impractical to have had a second choice to be on standby in case the shareholders voted against the decision to appoint the preferred candidate.

56. In Deloitte's view, the current level of shareholder engagement in audit reflected their actual concerns with audit and that in fact they were reassured with the checks and balance that audit was providing.