

PwC Response to the Nature and Strength of Competition Working Paper

- 1 This paper sets out our comments on the Nature and Strength of Competition working paper (the **NSCP**). In this response, we explain that while there are a number of matters on which we agree with the Competition Commission (**CC**), we do not accept the CC's initial view that competition is relatively weak outside of tenders and that large companies must tender to be capable of achieving an effective audit service. For the reasons we explain below, large companies can and do achieve a competitive audit service in the current market, where they tender only when they consider it necessary.
- 2 We also provide:
- a point-by-point response to the CC's initial views in Annex 1;
 - more detailed comments on the NSCP in Annex 2;
 - economic evidence on the effects of switching in Annex 3; and
 - an opinion by Professor Steffen Huck on the optimal number of competitors for a market with the characteristics of audit services in Annex 4.

Summary

- 3 There is an inherent contradiction that runs through the initial views expressed in the NSCP:
- (a) on one hand, the CC recognises that "*competition in tenders for FTSE 350 engagements is strong*",¹ and that audit purchasers are "*sophisticated*",² "*experienced*"³ and "*knowledgeable*";⁴ but
- (b) on the other hand, the CC states that "*outside of a tender process, [a company's bargaining position] is weakened*",⁵ and yet it suggests these same "*sophisticated*", "*experienced*" and "*knowledgeable*" purchasers do not seek to remedy this by tendering more frequently to secure competitive outcomes.
- 4 In reaching this view, the NSCP fails to recognise audit firms' efforts to retain and win clients outside of formal tenders. It is precisely because the formal tender process is intense and effective, with an existing audit firm retained in less than 20% of cases,⁶ that the threat of a tender and switch is very real and continuous to audit firms. This threat to the current audit firm ensures that large companies are capable of achieving a highly competitive audit service in terms of quality and price – and the evidence on outcomes demonstrates that they do. In the

¹ Paragraph 165 of the NSCP.

² See for example paragraph 76 of the NSCP.

³ See for example paragraph 74 of the NSCP.

⁴ See for example paragraph 75 of the NSCP.

⁵ Paragraph 141 of the NSCP.

⁶ Paragraph 140 of the NSCP.

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words of the Hundred Group: “*Audit firms know that we have a choice and that very often is all you need to keep their pricing and the quality of their service honest*”.⁷ (Emphasis added)

- 5 This inherent contradiction is exposed by consideration of the evidence in relation to:
- A the ability of audit purchasers to judge the quality of the product they are acquiring;
 - B the efforts made by audit firms to win and retain clients outside of tenders; and
 - C the fact that outcomes are competitive despite many companies choosing not to tender regularly.
- 6 We cover each of these points below, but also wanted to note our concern at the degree to which the NSCP appears to have overlooked or understated the evidence available to the CC, in particular:
- (a) there are several arithmetical errors and misrepresentations of evidence from the CC’s Survey⁸ upon which weight has been placed in the NSCP;⁹
 - (b) the NSCP appears to make selective use of the evidence and focus on minority views rather than majority views which show competition to be effective;¹⁰
 - (c) the CC did not take the opportunity to ask company representatives in the case studies or the CC’s Survey key questions which would have clarified whether they feel the concerns the CC has set out in the NSCP are justified, for example:
 - (i) whether they believe they are able to secure competitive outcomes without tendering;
 - (ii) whether they believe they have sufficient information to be able to judge auditor performance without requiring a tender; and
 - (iii) if not, why they do not tender more often.

A ACCs and FDs are experienced, knowledgeable and sophisticated purchasers

- 7 The NSCP acknowledges that those who are principally responsible for purchasing audit services - audit committees (**ACs**) and audit committee chairs (**ACCs**), as well as finance directors (**FDs**) and other directors and executives at FTSE 350 companies¹¹ - are “*experienced*

⁷ Mr Ashley Almanza, Chairman of The Hundred Group (of Finance Directors of FTSE 100 companies) and Chief Financial Officer of BG Group. In evidence to the House of Lords Economic Affairs Select Committee, see <http://www.publications.parliament.uk/pa/ld201011/ldselect/ldeconaf/119/11905.htm#n14>.

⁸ The IFF Research Presentation of the CC Survey Results dated July 2012 (the **CC’s Survey**).

⁹ See paragraphs 36(b)(ii) and 52 below.

¹⁰ For example, focussing on the 40% of companies who said they believed there was some restriction in their choice between the large audit firms, as opposed to the fact that no company said restriction of choice was a reason for it not having tendered in the last five years. See also Section C below (“*There are no concerns regarding the incentives companies have to tender*”).

¹¹ We note the CC consistently refers to FDs ahead of ACCs in its documentation, notwithstanding the survey evidence indicating that the audit committee - including ACCs - plays the more significant role in audit appointments (slide 45 of the CC’s Survey). In practice, no single individual dominates the audit purchasing and monitoring process, with a

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and knowledgeable purchasers of the audit services... particularly familiar with what the Big 4 firms can offer".¹²

- 8 In discharging their duties when selecting the appropriate auditor for the company, it is important to recognise that:
- (a) Audits are of importance to FTSE 350 companies because of the role they play in separating ownership from management and in accessing capital. This means the selection and performance management of the company's auditor is taken very seriously by those responsible.
 - (b) ACCs, other AC members, FDs and other company executives are some of the most senior individuals in the business community, and very familiar with the audit process from years of experience across a wide range of companies and audit firms, with a majority having spent time themselves as auditors.¹³ This gives companies numerous individual reference points on audit quality and price informed by previous and concurrent experience as purchasers of audit services,¹⁴ as well as knowledge of working within the service providers from whom they are purchasing. Companies typically use firms other than their current auditor for non-audit work and often this is undertaken as a deliberate tactic to compare providers.¹⁵ This gives the company practical insight into the quality of people and service, approach to fees, sector expertise, etc., offered by rival audit firms.
 - (c) Given that there are potentially high switching costs involved in changing auditor, companies generally choose not to go through an unnecessary tender process because they have effective means available of ensuring a competitive outcome on quality and fees without doing so. The audit firm's knowledge that a company could tender at any time (and that this is likely to lead to its displacement if held because of dissatisfaction with the auditor's performance) gives the company a powerful tool to ensure competitive service provision, with this implicit threat of tender backed up by explicit threats if necessary, with which the company will follow through if its concerns are not addressed.

wealth of experience from the various AC members and other senior company executives and finance executives all being closely involved and interested in the audit outcome. We refer to ACCs and FDs throughout this response, but in many contexts this should be read to include other AC members and executives or directors who may have an active role in the management of the audit process and, indeed, individuals overseeing large transactions in the course of their every day business.

¹² See paragraph 75 of the NSCP.

¹³ See paragraphs 24(a) and 24(b) of the working paper on the CC's Survey (the **Survey WP**): around 60% of the ACCs surveyed had previously worked for one of the four largest audit firms; similarly, two-thirds of the FDs/CFOs surveyed had previously worked for one of the four largest audit firms.

¹⁴ See paragraph 24(c) of the CC's Survey WP: "nearly all ACCs surveyed sit on or chair another audit committee (of these, 33 per cent on 1 other, 34 per cent on 2 others, 20 per cent on 3 others, 8 per cent 4 others, and 5 per cent 5+). The proportions are similar for ACCs of FTSE 350 and other companies."

¹⁵ See evidence from the case studies. For example, according to the ACC, Company B tended to use other firms for non-audit work. This was partly due to company policy and partly to keep an eye on other firms (paragraph 57). Similarly, for Company D the FD stated that the company had a general preference of not using the current auditor for non-audit services for two reasons: (i) avoiding any conflict with the auditors' independence and (ii) keeping things competitive by having a relationship with, and sharing work around, a number of firms (paragraphs 43-44). The FD of Company H stated that other firms providing non-audit work and developing an understanding of the business helps if the company wants to switch auditor (paragraph 47-48).

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- 9 The CC explains that *“the tender process is further evidence that FDs and ACCs are sophisticated purchasers of audit services”*.¹⁶ However, despite this unsurprising acknowledgement of the general capabilities of ACCs and FDs as purchasers of audit services, including of their ability to run a highly effective tender process, the CC questions whether these same individuals are capable of ensuring an effective and competitive audit service from their existing auditors outside of tenders. Furthermore, the CC does not address the question of why, if the company not tendering allows the existing auditor to supply a less than competitive service, these sophisticated purchasers do not rectify this through a tender.
- 10 While the CC states that *“FTSE 350 FDs and ACCs are experienced individuals who can use the threat of switching to obtain better terms”*,¹⁷ this acknowledgement is tempered by the suggestion that there are a number of factors that weaken the bargaining position of the company. We respond in more detail below to any suggestion that large companies have weak bargaining positions, are not able to judge value for money, have inadequate access to information on audit providers, or that switching costs inappropriately inhibit companies from tendering and switching.¹⁸ The overriding point is that the experience, knowledge and sophistication of the ACCs and FDs makes them more than capable of triggering and conducting highly competitive tenders when they decide this is the most appropriate course of action - but also makes them equally capable of ensuring their existing audit firm delivers a high quality and value for money audit service through other means.

B The four largest firms compete vigorously to win and retain clients outside of formal tenders

- 11 The CC acknowledges that the four largest audit firms *“engage in strategies which appear to be aimed at building reputation and relationships with potential audit clients with the expectation that this will increase the chances of the firm being invited to participate in a tender and increasing its chances of winning the engagement”*¹⁹ and that they all *“invest heavily in attributes that underlie reputation and strategies aimed at building relationships with potential FTSE 350 audit clients”*.²⁰
- 12 Much of the evidence we have provided (which has not been cited in the NSCP or other working papers) shows clearly how, in the words of one FTSE 100 company, *“all 4 firms are ‘at the door’ with their best advisers”*²¹ - a situation which inevitably means that companies are well informed as to the options available to them, and ensures that the existing auditor feels pressure to perform.

¹⁶ Paragraph 76 of the NSCP.

¹⁷ Paragraph 192 of the NSCP.

¹⁸ Paragraph 141 of the NSCP.

¹⁹ Paragraph 154 of the NSCP. See also:

- *“There is evidence that all the Big 4 firms actively target companies that are currently audit clients of rival firms...”* (paragraph 155 of the NSCP); and
- *“Amongst FTSE 350 companies, 88 per cent of FDs and 55 per cent of ACCs had been approached, formally or informally”* (paragraph 156 of the NSCP).

²⁰ Paragraph 155 of the NSCP.

²¹ [§<], which was provided as Exhibit 3 to the Submission and Response to the Issues Statement of 12 January 2012 (our **Initial Submission**).

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- 13 Further, although the CC acknowledges that there are “*substantial costs to a firm associated with losing a client... [not] limited to the lost profits on the relevant engagement*”²² and that “*...firms seek feedback from companies by conducting surveys and reviews of their performance...*”,²³ very little weight is attached to these important issues in the CC’s initial views. Indeed, the coverage of audit firms’ efforts to retain clients is striking in its brevity in the NSCP - it consists of one paragraph (paragraph 177). This contrasts with the wealth of contemporaneous evidence that we have provided to the CC, including that drawn from our reviews of companies’ opinions on their auditors, their competitive options and the level of competition. In our Initial Submission, we provided explanations and numerous examples of Client Perspective Reviews and Independent Senior Partner Reviews which we carry out regularly to get feedback on our performance from clients, as well as Client Satisfaction Surveys. We also provided examples of formal Post-Decision Reviews which are carried out after tenders and are designed to get feedback on our performance and how we could improve (whether or not we were successful), and our Audit Relationship Risk Diagnostic which monitors the potential risks of tender in relation to each of our audit clients across a range of criteria.²⁴ Our efforts in gathering this information from companies would be illogical and wasteful if we did not feel a need to respond to their concerns in light of the competitive pressure we face.²⁵
- 14 The CC’s lack of regard to the efforts made by firms to retain existing clients belies an important feature of competition in this market. The CC has not explained why audit firms would go to such efforts to prompt and win tenders, yet not make similar efforts to ensure that their existing clients did not go out to tender. The evidence shows that in fact all audit firms not only target each other’s clients but go to very considerable lengths to ensure their existing clients are satisfied with their audit service. The views of existing and prospective clients are of critical importance in this regard, which is why we invest considerable resources in our client feedback programmes. In particular, the Client Perspective Reports are collated and reviewed every year and the key findings are analysed to ensure that lessons are learned and efforts are made to improve our service.²⁶ Some examples of where we have been recognised by companies as having responded to concerns raised in the past include the following:
- (a) [§<]: “*PwC has responded well to the feedback from last year and relationships have moved to ‘another level’.*”²⁷
- (b) [§<]: “*pleased PwC had looked seriously at their concerns over fee and approach... felt we had responded appropriately.*”²⁸

²² Paragraph 195 of the NSCP.

²³ Paragraph 177 of the NSCP.

²⁴ There were 150 Exhibits to our Initial Submission, the vast majority of which were examples of company feedback.

²⁵ See also paragraph 2.67 of our Initial Submission where we describe the material and data we collect as part of our usual business activities to help us understand the views of current and prospective audit clients. See also the various examples of such feedback that we provided to the CC as exhibits to our Initial Submission in addition to the exhibits we provided in response to Q99 of the Market and Financial Questionnaire of 24 February 2012 (our **MFQ Response**).

²⁶ [§<]

²⁷ [§<]

²⁸ [§<]

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- (c) [§<]: *“There has been significant improvement in the relationship between PwC and Central IT following last year’s feedback”. “It’s tremendously improved from last year - the lines of communication are now open.”*²⁹

C Market outcomes show large companies are effective buyers

15 That large companies are able to achieve competitive outcomes as a result of their current approach of tendering only when they deem necessary³⁰ is demonstrated by the following evidence:

- (a) prices have fallen in recent years;³¹
- (b) auditors respond to their inability to raise prices by focussing on innovations to increase efficiency;³²
- (c) audit firms do not take advantage of companies that have recently switched (in the period when they are unlikely to re-tender) by raising prices;³³
- (d) audit firms have found it difficult to persuade companies to accept limited liability agreements, despite being legally entitled to do so;³⁴
- (e) there is no evidence of correlation between pricing, profits and concentration, and the evidence of audit profitability is consistent with what would be expected in a competitive market;³⁵ and
- (f) there is no evidence of poor audit quality (and plenty of evidence of innovation to improve quality).³⁶

²⁹

[§<]

³⁰

Indeed, this is recognised in the NSCP and other working papers (see for example paragraph 192 of the NSCP: *“FTSE 350 FDs and ACCs are experienced individuals who can use the threat of switching to obtain better terms”* and paragraph 9 of the NSCP: *“we consider that a threat—explicit or implicit—that a client could put an engagement out to tender (possibly as a result of an approach by a rival firm) could be a source of competitive pressure”*), but without the overarching conclusion that should follow that the market is working effectively.

³¹

The CC’s analysis shows that companies have been successful in driving down audit fees; average auditor hours per engagement have remained broadly static from 2006 to 2011, while average auditor fee per hour has fallen around 15% in nominal terms (and therefore by a higher amount in real terms). See paragraph 35 of the CC’s working paper on Descriptive Statistics and Figure 9 (with which we were provided by the CC in a putback dated 5 September 2012 - *“Engagement Data Descriptive Statistics - PwC”*).

³²

See, for example, paragraph 30 of the NSCP where the CC says that areas of innovation such as standardisation of the audit approach, “off-shoring”, and use of industry specialised modules are *“primarily determinants of cost efficiency and not necessarily specific to a particular audit client.”* See also paragraph 9 of the CC’s Firms’ Stated Competitive Strategies WP where the CC says that *“because of the uncertainty in implementing fee increases, the firms place much greater emphasis on reducing costs and identifying efficiencies in their processes.”*

³³

Paragraph 196 of the NSCP.

³⁴

See paragraphs 14 to 23 of the CC’s Liability, Insurance and Settlements WP.

³⁵

See the Price Concentration Analysis WP, paragraph 1. See also our Observations on the Assessment of Audit Profitability (submitted to the CC on 7 August 2012), Table 1. Profitability I WP, paragraph 8 and Profitability II WP, paragraph 46. Indeed, the most thorough piece of evidence that is available to the CC (our own profitability submission, which is also endorsed by Professor Ian Cooper), shows that our profits are consistent with a competitive market.

³⁶

The CC’s Survey shows the vast majority of companies have not tendered in the last five years due to factors related to receiving competitive price and quality from their auditors (slide 60), but that they would be likely or very likely to tender if there was any sign of auditor complacency (slide 74).

16 In the sections below, we focus on three key areas in which we believe the NSCP comes to inappropriate views:

- Section 1: why tenders are not necessary to achieve effective outcomes;
- Section 2: how companies effectively assess and demand quality and price without a formal tender; and
- Section 3: that there are no concerns regarding the incentives companies have to tender.

Section 1: Tenders are not necessary to achieve effective outcomes

In this section, we explain that:

- **Tenders are not a one-off stand-alone process; rather, the threat of tenders brings discipline and credibility to the continuous competitive process.**
- **The evidence shows competitive pressure is faced by firms in the retention of FTSE 350 engagements because:**
 - **the threat of tenders is real and credible and continually felt by the current audit firm;**
 - **there are frequent trigger points for a potential tender;**
 - **ACCs and FDs can use the threat of tender (and hence likely removal) when negotiating with existing firms;**
 - **audit firms make substantial efforts to retain existing clients; and**
 - **the outcomes achieved by companies that do not tender are comparable with those that do tender and switch.**

17 The NSCP initially concludes that there are concerns in respect of the bargaining position of companies with their existing auditors³⁷ and in respect of the competitive pressure faced by firms in the retention of FTSE 350 clients.³⁸ These concerns are derived from what is characterised as the relative infrequency of tendering, with companies supposedly lacking the necessary information to assess auditors outside of tenders,³⁹ but competition within tenders recognised as being informed and intense.⁴⁰ The NSCP suggests therefore that there is a clear correlation between market competitiveness and the frequency with which companies tender.

18 We agree that the prospect of a tender is an important competitive discipline and a very real feature of the market. In particular, we recognise that when companies tender, the process is intensive and produces competitive outcomes with audit firms being keen to participate and with the incentive to compete intensely during the process.⁴¹ Where we strongly disagree with the CC is as to whether tenders have to take place more frequently than they presently do for competitive pressures to be effectively brought to bear.

³⁷ Paragraph 141 of the NSCP.

³⁸ Paragraph 194 of the NSCP.

³⁹ The NSCP states that “*only by going out to tender are companies in a much better position to assess the competitiveness of all aspect [sic] of the audit product provided by the incumbent*” (paragraph 141 (c)), and “*as the time since an audit engagement was last tendered increases, companies may not have the information to assess effectively the competitiveness of the audit product and service provided by their existing audit*” (paragraph 194). By contrast “*competition in tenders for FTSE 350 engagements is strong in relation to the factors on which selection is based, namely the capabilities and experience of the firms and the audit team, the reputation of the firm and the audit fee*” (paragraph 165).

⁴⁰ Paragraph 162 of the NSCP, where the CC states that “*opportunities for firms to gain an audit client arise infrequently*”. This is an entirely subjective judgement. The frequency of tendering reflects the needs, and decisions, of customers - who the CC acknowledges are sophisticated and experienced, and who the evidence shows achieve competitive outcomes with or without tendering.

⁴¹ Paragraph 165(a) of the NSCP.

Tenders are not a one-off stand-alone process

- 19 The CC views tendering as a one-off, stand-alone process but this is contrary to the evidence. The CC suggests that tenders stimulate competition if they take place but, without them, auditors do not face real competitive pressure and are not affected by the prospect of a tender.⁴² The CC also suggests the longer the period since a company ran a tender, the less able it is to judge the effectiveness of the existing auditor.⁴³ There is no evidence to support these views. They ignore (a) the abundant evidence of information which experienced purchasers have to ascertain whether they are receiving a competitive service, and (b) the evidence showing that companies which decide to tender do not achieve substantially better outcomes over time than those which do not.
- 20 The implication of the CC's position is that buyers of any professional services that do not involve regular formal tenders - non-audit services, management consultancy, legal services, investment banking or broking services, advertising or PR agency services - lack the requisite information to make informed choices, and so competition suffers. Audit purchasers' "*sophistication*" and "*experience*" of working with and as auditors means they are very well placed to purchase such services - and have a wealth of relevant information to refer to in doing so.
- 21 In reality, the threat of tender brings discipline and credibility to the ongoing competitive process - the existing auditor's awareness that if a company goes to tender it is likely to lose (with significant consequences) means that it is incentivised to perform competitively. This allows companies to use their knowledge of the market to secure a competitive output from the existing audit firm without needing to incur the costs of tendering.
- 22 Any suggestion that a decision not to tender is indicative of complacency on the part of the company is misguided.⁴⁴ In fact, it is the outcome of an informed business decision in relation to an important purchase made by "*experienced*", "*sophisticated*" senior executives. This apparent concern may be due to the CC wrongly importing concepts relating to competitive effectiveness that may have value in consumer or SME markets into the context of business-to-business relationships involving a finite number of some of the largest and most sophisticated customers in the country; i.e. while for consumers, a decision not to switch supplier may indicate complacency, a lack of awareness of alternatives, or lack of ability or resource to manage the procurement of a product or service, this is clearly not the case for FTSE 350 companies acquiring an important repeat service each year. On the contrary, the evidence shows that companies can, and do, exert significant pressure on their auditors, on the basis of an intimate understanding of the comparative merits of different firms, with the threat of tender ever present.

⁴² Paragraph 141(d) of the NSCP.

⁴³ Paragraph 194 of the NSCP.

⁴⁴ The CC states that "*there are some FTSE 350 companies that are not so active in the management of their audit relationship*" and cites that 40% of FTSE 350 companies had either tendered the audit more than ten years ago or never tendered the audit (see paragraph 193 of the NSCP).

The evidence shows competitive pressure is faced by firms in the retention of FTSE 350 engagements

23 The CC says assessment of the evidence on the strength of competitive pressure faced by firms in the retention of FTSE 350 engagements is “*key to [the CC’s] overall position on the strength of competition in the market*”, and that “*[the CC] consider the bargaining position of audit clients to be key to this assessment*”.⁴⁵ In carrying out this assessment, the CC should take greater account of the following:

(a) The threat of tenders is real and credible:

- (i) There have been on average about 14 tenders in the FTSE 350 every year⁴⁶ - a sufficient number to ensure that the threat of tender is always real.
- (ii) Audit firms understand that any failure to perform on their part is highly likely to result in the company going to tender.⁴⁷
- (iii) While firms make significant efforts to understand which companies are likely to tender⁴⁸ - and seek to provoke tenders - they cannot predict this with certainty, as they do not know what internal deliberations companies are having. Consequently, the pressure on the audit firm to perform is constant.
- (iv) Therefore the threat of tenders provides considerable leverage for companies in dealing with auditors, and ensures the current auditor responds by offering a competitive service.

(b) There are frequent (and early) trigger points for a potential tender:

- (i) Audit engagements have to be formally considered on an annual basis and there is a major change at least every five years when the engagement partner rotates.⁴⁹
- (ii) Management and audit committee membership also change frequently - bringing new views and new experience (including those of other audits and of other audit

⁴⁵ Paragraphs 169-170 of the NSCP.

⁴⁶ See paragraph 91 of the Evidence relating to the Selection Process WP which records that 69 tenders took place between 2007 and 2011.

⁴⁷ The CC’s Survey shows that 94% of ACCs and 86% of FDs would be likely or very likely to tender if faced with auditor complacency, while only 13% of ACCs and 2% of FDs would be unlikely to tender if faced with substantial fee increases (slides 74 and 68).

⁴⁸ Our Audit Relationship Risk Diagnostic tool, as described in paragraph 2.67 (and provided as Exhibit 102 of our Initial Submission) is designed specifically to monitor this in relation to our own clients, while our targeting programmes, such as *Tanks on lawns* and *Net 635* evaluate the possibilities in relation to our rivals’ clients. Companies also make us aware of competitor activity to prompt us to improve performance, e.g., [X] told us “[X] are active in trying to position themselves should [a tender] happen.” [X]

⁴⁹ Partner rotation is seen as a major change: for instance, the Global Financial Controller of the Company G reported that “[t]he new AEP had taken time to understand and be comfortable with his firm’s approach to auditing the company and to judgement issues” (paragraph 42 of the Company G case study) and this was not an overall change of audit firm. Similarly, the ACC of Company F observed that “[t]o do a really good job the auditors had to understand the fundamentals of the business. Overly rapid rotation risked losing this understanding” (paragraph 51 of the Company F case study).

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firms) to the company, and requiring auditors repeatedly to demonstrate their capabilities to these new audiences.⁵⁰

- (iii) The complexity of auditing FTSE 350 companies frequently means there are challenging issues which have to be addressed between management, auditors and audit committees, and if auditors fail to address these satisfactorily, companies consider their options. These options include escalating matters within the audit firm,⁵¹ or increasing contacts with other potential suppliers - including potentially requesting submissions of quasi-proposals.⁵²

(c) ACCs and FDs can use the threat of tender when negotiating with existing firms:

- (i) Less than 20% of existing audit firms are successful if the company goes to tender⁵³ and switches are often highly publicised with reputational consequences for the unsuccessful audit firm.⁵⁴ The value of threatening a tender as a bargaining tool is self-evident to experienced ACCs and FDs - a threat does not have to be explicit to be effective given that its existence and credibility are known to both purchasers and suppliers.
- (ii) This acts as a major competitive constraint⁵⁵ incentivising the audit firm to ensure that it offers a competitive and responsive service. Indeed, as the CC's Survey shows, the vast majority of companies do not tender because they recognise they currently receive a quality and high value service.⁵⁶
- (iii) Companies' ability to leverage this (generally implicit, but nevertheless real) threat in negotiations is the reason why there is not more formal tendering. Were it impossible to apply effective competitive pressure without more tenders, as the NSCP suggests, then it is inconceivable that the effective and sophisticated purchasers the CC has identified would not tender more frequently to rectify

⁵⁰ We have seen numerous examples where changes in a board or composition of an AC resulted in increased risk and pressure for us as auditors - for example (see paragraph 5.27 of our Initial Submission), when [redacted] appointed a new CFO we were told we faced a "big risk" if we did not get aligned with the CFO's agenda, while with [redacted] we were told "A new AC chairman would come on board following the AGM and he may have other views [on considering a change of auditors] given PwC had been the auditor for many years."

⁵¹ For example by contacting a senior partner - as was the case with [redacted], as explained at our hearing, which resulted in substantial changes to the audit team.

⁵² As mentioned recently at our hearing, some prospective clients (as was the case with [redacted]) seek indicative proposals before deciding whether or not to proceed to a full tender.

⁵³ Paragraph 140. We believe the success rate is likely to be even lower for those tenders which are triggered by company dissatisfaction with the current audit service.

⁵⁴ The potential impact on reputation is recognised by the CC: "The costs of losing a client may be greater than the lost profit on the engagement, for example, if it affects a firm's capacity or reputation in a sector" (in paragraph 182 of the NSCP). As an example, see the recent media coverage on BG's choice to switch to Ernst & Young as its new auditor, after 16 years with PwC (<http://www.accountancyage.com/aa/news/2219614/bg-group-chooses-ernst-young-over-pwc-for-audit#ixzz2AETHBL2I>).

⁵⁵ As recognised in the NSCP, paragraph 9.

⁵⁶ The CC's Survey shows that the three main reasons why companies do not switch auditor are all related to receiving a competitive service: slide 60 shows that "receive high quality service", "receive good value for money", and "happy as things are" are the most common responses with 70% of companies citing one or more of these reasons. Indeed, the "positive" reasons for not tendering total 133% of FTSE 350 responses, with only 29% offering "negative" responses relating to cost or disruption, and a further 10% stating the time was not right for an immediate tender - as these responses were unprompted and companies evidently offered more than one response in several cases, it is likely that "negative" responses were accompanied by "positive" responses in many cases. It is entirely understandable that, given the costs and disruption associated with tenders and switches, sophisticated purchasers avoid these where they achieve favourable service without them, rendering them an unnecessary cost and disruption.

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matters. The evidence, including from the CC's Survey and case studies, shows that companies are clear that they would tender if they did not achieve a good service.⁵⁷

(d) Audit firms make substantial efforts to retain existing clients:

- (i) Audit firms appreciate the harm to their reputation and business of losing FTSE 350 audit clients⁵⁸ and take steps to avoid tenders wherever possible. That is why we, and (we understand) the other large firms,⁵⁹ invest heavily in monitoring companies' satisfaction with our work, the market's view of our performance,⁶⁰ and in checking the quality of the work we produce.⁶¹
- (ii) The NSCP acknowledges that the large firms invest heavily in developing relationships with potential and actual FTSE 350 clients⁶² - we do this not only with the aim of targeting clients of rival firms but to retain existing clients in the face of targeting by rivals.⁶³ Such activity is wholly incompatible with the idea of a market in which, outside of the tender process, competitive pressure is limited to annual price discussions.⁶⁴

(e) The outcomes achieved by companies that do not tender are comparable with those that do tender and switch:

- (i) If it was the case that more tenders were necessary to increase competitive pressures on audit firms, one would expect differential outcomes depending on whether there has been a tender. In fact, the evidence is that over time prices are similar for companies whether or not they tender.⁶⁵

⁵⁷ Slides 68 and 74 of the CC's Survey shows that 94% of ACCs and 86% of FDs in FTSE 350 companies would be likely or very likely to tender if their auditor showed signs of complacency. See also, for example, Company G where the GFC said that "[t]he trigger points for a tender would be a slip in independence, skills or value for money" (paragraph 22).

⁵⁸ As recognised in the NSCP, paragraph 182.

⁵⁹ See the Annex to the CC's Firms' Stated Competitive Strategies WP.

⁶⁰ We invest significantly in monitoring market perceptions of our performance through our annual Brand Health Index survey, copies of which have been provided to the CC (on 11 November 2011 as part of our response to the First Day Letter (our **FDL Response**)) and referred to in Q27 of our MFQ Response and in Box 4 of our Response to Certain Third Party Submissions dated 6 August 2012 (our **Response to Third Parties**). This investment is made precisely because of our awareness of the importance of maintaining a high quality reputation with our client base through all of our actions.

⁶¹ As discussed in paragraphs 6.53 to 6.58 of our Initial Submission, we have detailed internal KPI assessments and engagement compliance reviews (ECRs) to monitor and continuously improve the quality of service that we offer. In relation to both of these measures, we have consistently achieved high scores albeit against incrementally rising benchmarks. This performance results in positive customer feedback (as gathered in extensive customer feedback exercises we undertake described further in paragraph 13 - for example, with [PwC] recognising "PwC is 'ahead of the pack' predominantly reflecting a higher quality of people across the organisation." (See paragraph 6.60 (c) of our Initial Submission.)

⁶² Paragraph 155 of the NSCP.

⁶³ The NSCP refers in paragraph 177 to the efforts made in this respect to retain audit clients - but understates the extent of these efforts. We provided a significant volume of evidence in relation to our activities in this respect which has been largely overlooked in the NSCP. See paragraph 2.67 and Annex 3 of our Initial Submission which set out details of these various activities.

⁶⁴ As the NSCP suggests in paragraph 192 - although we note that these annual price discussions produce competitive outcomes for companies without needing to tender, as evidenced in the CC's analysis (see paragraph 35 of the CC's Descriptive Statistics WP and Figure 9 (with which we were provided by the CC in a putback dated 5 September 2012 - "Engagement Data Descriptive Statistics - PwC").

⁶⁵ See Annex 3, which sets out economic evidence on the effects of switching.

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- As the CC's evidence shows, prices fall immediately after tenders. However, it is important to recognise that those who tender are companies which were often dissatisfied with the price they were able to obtain prior to the tender.⁶⁶
 - The evidence suggests that companies are able to negotiate hard on price without tendering, and that they are just as able to secure competitive services from auditors as those who do tender.⁶⁷
 - Similarly, to the extent that there may be an observed improvement in quality after a switch, as the CC recognises, this largely reflects the fact that a tender process is more likely to be initiated where there are concerns about quality.⁶⁸
- (ii) It follows that there is no basis for the CC to assume that sophisticated purchasers achieve less than optimal outcomes in deciding not to tender.

⁶⁶ Slides 64-67 of the CC's Survey show that companies generally achieve improved quality and/or lower prices following a tender. As the CC acknowledges, in paragraph 186 of the NSCP, this result is likely to show selection bias as these companies are likely to have been dissatisfied with their previous auditor, but nonetheless demonstrate that companies can secure competitive outcomes through tenders.

⁶⁷ See paragraphs 26 to 33 below, in particular showing (Figure 1) that there is no relationship between auditor tenure and profitability, and (Figure 2) that companies which do not tender have to negotiate on fees annually to address significant scope changes in their audits.

⁶⁸ Paragraphs 109 and 186 of the NSCP.

Section 2: Companies can effectively assess and judge quality and price without a formal tender

In this section, we explain:

- That the evidence shows that ACCs and FDs can and do effectively assess and judge both
 - Price: the services offered to each company are not so different that a meaningful comparison is impracticable, particularly as the purchasers are highly sophisticated and experienced users of audit services; and
 - Quality: large companies can judge quality from continuous interaction at many levels from annual reviews of performance and by carrying out a range of other reviews including formal benchmarking; informal comparison exercises; interactions with other companies and audit firms throughout the audit cycle; and from the targeting activities of rival firms.
- The fact that different ACCs and FDs conduct their tasks in different ways, with some having greater recourse to informal interactions with audit firms, is entirely consistent with a competitive market.

24 The CC questions how far ACCs and FDs can make judgements about the performance of audit firms absent a formal tender process. The evidence shows a formal tender is not often required:

- (a) It is accepted by the CC that these are “*experienced*” and “*sophisticated*” individuals with an understanding of the provision of audit services.⁶⁹ They have in many cases spent large parts of their careers working with, or even as, auditors: it is hard to think who could be better-placed to judge auditor performance.⁷⁰ The NSCP acknowledges the importance of this experience in the context of tenders where it states that in assessing tenders: “*The information provided by submissions will also be supplemented by the knowledge and experience those involved in the appointment process have gained working with or for the firms participating in the tender*”.⁷¹ Given the recognition of the value of this experience in assessing a tender, it is not clear why it is not considered to be

⁶⁹ As the CC data shows around 60% of ACCs and 66% of FDs have previously worked for one of the four largest audit firms, and therefore are highly likely to have worked with various audit firms in their professional careers (see paragraph 24 of the Survey WP). Moreover, as acknowledged, many hold concurrent appointments for other companies which will allow them to compare the performance of their current auditor with that of other possible providers at any particular time. We provided evidence in this respect as Annex 8 of our Initial Submission.

⁷⁰ The CC acknowledges at paragraph 74 that “*the majority of FDs/CFOs and ACCs for FTSE 350 clients have worked for one of the Big 4 firms, and that ACCs tend to be former audit partners and/or current or former finance directors and to hold more than one AC position*.” It has been suggested by some that the background or alumni status of ACCs and FDs at large audit firms may somehow prejudice their selection of auditors. In fact, there is academic evidence to suggest that personal familiarity with an organisation will lead to more informed purchasing decisions and better outcomes - see reference to a Harvard Business School study in an article by Lucy Kellaway in the Financial Times, 10 October 2012, responding to the publication of the CC’s working papers.

⁷¹ Paragraph 82 of the NSCP.

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of value in assessing audit firm performance absent a tender. This is particularly reflected in the context of the frequent wide ranging reviews of audit quality and service that the CC's evidence confirms are conducted, and the frequent interaction of ACs and FDs with a variety of audit firms.

(b) Audit appointments receive far greater scrutiny than other professional services appointments. An unusual feature of this market is the annual appointment process which forces consideration of the quality and performance of the audit firm in a way that does not happen with any other professional service. This means that:

- companies know that they will need to buy a statutory audit each year and can arrange its effective procurement well in advance;
- companies and individuals become more experienced buyers with every annual appointment; and
- in recognition of the importance of the audit to many stakeholders, the corporate governance requirements make the audit one of the most scrutinised purchases made by a company. FRC guidance mandates that companies, and in particular audit committees, engage with the audit process in some detail⁷² - this level of regulatory oversight of other professional services appointments is virtually non-existent.

This is why: *"...most companies regularly carry out reviews (internal or with their auditors) of audit quality and service, and the CC Survey results indicate that most re-negotiate the audit fee every year and nearly all at least every five years. These results are consistent with the findings of the case studies. We were told that review [sic] generally covered a range of aspects of the auditor's performance"*.⁷³

(c) The CC notes in paragraph 99 that the survey shows ACCs and FDs are in regular contact formally and informally with rival audit firms. This accords with our experience, which is that audit firms put considerable effort into marketing their services, e.g. developing relationships and a track record of good service through thought leadership activities, and also sometimes through more direct approaches to companies explaining their proposed audit approach and fees. Indeed, the existence of such direct approaches is acknowledged by the CC in paragraph 155, and supported by the evidence from the CC's Survey that 78% of FTSE 350 companies are approached by rival audit firms every year and 88% every two to three years.⁷⁴

25 The evidence shows companies are capable of judging their existing auditor's performance as regards price and quality without recourse to tenders. Taking each of these in turn:

⁷² Prior to recommending the audit firm's appointment at the AGM, the AC is required under the UK Corporate Governance Code (2010) to undertake a review of auditor effectiveness (paragraph C.3.2 of the Code). This is explained in more detail, together with actual examples of audit effectiveness reviews, in our response to MFQ 84.

⁷³ NSCP paragraph 66. See paragraph 36(c) below where we set out some of the detail reported by the companies in the case studies on the aspects covered in their auditor effectiveness reviews.

⁷⁴ See slide 46 of the CC's Survey.

Price

- 26 While the price and scope of any particular audit reflects the circumstances of the relevant company, this does not mean that the services offered to each company are so different that a meaningful comparison is impracticable, particularly given that the purchasers are highly “sophisticated” and “experienced” users of audit services. What is clear from the evidence is that those who deal directly with auditors in relation to the audit fee:
- (a) are able to scrutinise fees to a significant level of detail and over a number of years (given audits are repeat purchases);⁷⁵
 - (b) can require auditors to go to whatever level of detail they need in order to scrutinise their fees,⁷⁶ and examine fees with a clear understanding (based on their previous experience as auditors) of the metrics used and the economics of audit firms;
 - (c) can compare the audit price with that at other similar companies due to publication requirements, or by reference to hourly rates or proposal prices they have seen in other contexts;
 - (d) use their experience of working for other companies and with other audit firms to make allowance for similarities and differences between companies and thus to identify the level of resource required to carry out an audit at an appropriate fee;⁷⁷ and
 - (e) have resort to third party consultants where they consider this appropriate (3i Group in its hearing with the CC reported use of an external procurement consultancy, the external Buying Team consultancy firm, in this respect).⁷⁸
- 27 That this is an effective basis for a comparison is demonstrated in the outcomes: FTSE 350 companies have been successful in driving down audit fees per hour over the last five years with the CC’s data showing that while audit hours have remained broadly static, nominal audit

⁷⁵ This is demonstrated extensively by the case studies: the ACC of Company A said that “[t]he fee was negotiated annually and was benchmarked against other companies in the sector” (paragraph 70); the FD of Company D stated the company “periodically benchmarked audit fees against other companies” and the ACC described an informal retender which they required the company’s existing auditor to undertake (paragraphs 37 and 91); the ACC of Company E explained that he “used benchmarking to assess whether the fee was fair” (paragraph 60); the GFC of Company G observed that he is “able to benchmark the fees of the company paid against other banks’ audit fees” and that he cross checks these against “other global FTSE 100 companies” (paragraph 30); the FD of Company H explained that “the company did some benchmarking against other companies in extractive industries and companies with overseas requirements” (paragraph 39); the fund accounting manager of Company J stated that “the fee was reviewed against the audit fees of other similar investment trusts to ensure that it was competitive” (paragraph 16).

⁷⁶ This is seen in the case studies (for example the ACC of Company C stated that “the fee in the tender had been broken down so that the Audit Committee understood the hourly rate for each class of auditor involved from partner to junior accountant” (paragraph 71) and the FD of Company I explained that he “wanted to understand where the audit hours were being spent and to make sure that the number of hours was appropriate” (paragraph 27)). See our MFQ Response to Q87 which provided a detailed explanation of fee negotiations in relation to a range of audit clients (and mentioned in paragraph 33 of this response).

⁷⁷ See, for example, the Company E case study, where the ACC said that although the company was a unique business “this did not hinder the effectiveness of benchmarking as there were similar companies in terms of size and complexity to which to compare the audit fee” and given “the ACC’s vast sector experience he also had contacts at other companies he could talk to about fees” (paragraph 60).

⁷⁸ See paragraph 12 of the 3i Group hearing summary. We have also referred to [3<] (see paragraph 5.40 of our Initial Submission).

fees have declined by 15% in the last five years (implying an even higher decline in real terms).⁷⁹

- 28 Moreover, the best available evidence on the profitability of our audit business shows this is not excessive and has been similarly squeezed in recent years,⁸⁰ while analysis that was included in our Initial Submission, and reproduced below, shows that there is no relationship between the profitability of our FTSE 350 audit engagements and the length or tenure of these engagements, demonstrating that companies that do not switch are just as able to negotiate competitively scoped and priced audits as those that do.⁸¹

Figure 1: [X]

- 29 This conclusion is also supported by the data showing that the overall audit fee / hour has declined significantly in recent years, given that only around 4% of FTSE 350 companies will have switched in any particular year.⁸²
- 30 The suggestion that some companies accept inflationary price increases does not indicate a lack of scrutiny of fees, but simply recognition by companies that they are receiving a competitive price and a desire to avoid undermining quality by recognising the inflationary cost increases faced by their suppliers.⁸³
- 31 Figure 2 shows a frequency distribution of the percentage annual change in audit fees that are paid by non-switching FTSE 350 audit clients during the period 2000-11.⁸⁴

⁷⁹ See Figure 10 of our Initial Submission showing our audit rate per hour has remained static in nominal terms for four years, therefore declining in real terms. This was confirmed in the CC's own analysis (see paragraph 35 of the CC's Descriptive Statistics WP and Figure 9 (with which we were provided by the CC in a putback dated 5 September 2012 - "*Engagement Data Descriptive Statistics - PwC*").

⁸⁰ See our submission on profitability - our average profitability (in terms of the economic margin measure used) over five years is 1%, although this has declined over that period.

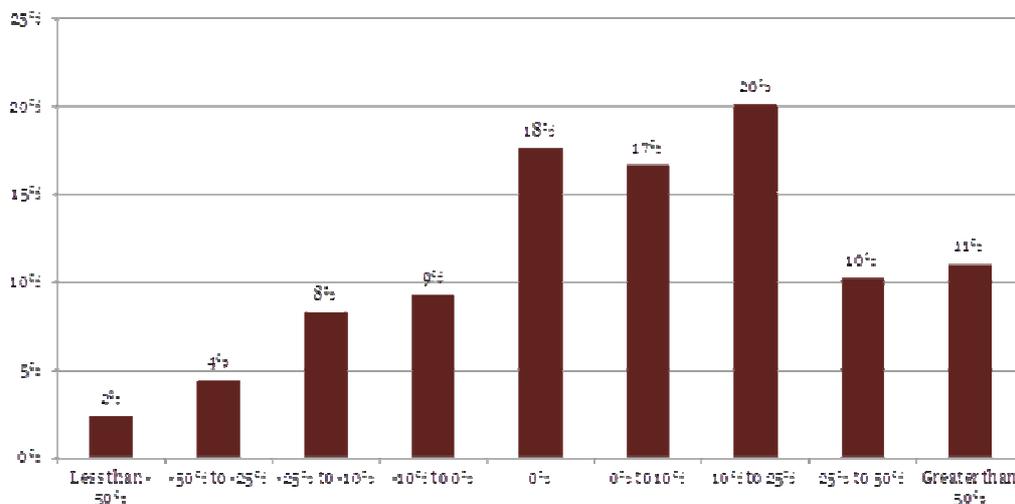
⁸¹ See our Initial Submission, figure 11, which plots our audit profitability (in terms of our internal CPy measure) against audit tenure - there is no indication that shorter tenure clients are more or less profitable than longer tenure clients (i.e. those who have not recently switched). This is discussed further in Annex 3.

⁸² See Chart 9 and paragraph 35 of the Descriptive Statistics WP.

⁸³ The assertion in paragraph 193 of the NSCP that companies allowing wage inflation and currency linked price changes amounts to them not being "active" in managing the audit relationship is odd given that without such increases audit firms would effectively be accepting ongoing price reductions for no reason.

⁸⁴ The key points to note from Figure 2 are: (a) Non-switching audit clients negotiate flat or reduced prices 42% of the time; (b) There were relatively few observations of modest price increases. Only 17% of nominal price changes were between 0% and 10%; and (c) Non-switching audit clients negotiate substantial (greater than 10%) fee increases 41% of the time. This is considered further in Annex 3.

Figure 2: Nominal audit fee prices changes for FTSE 350 non-switchers



Source: CC IDS

32 As can be seen, only a small proportion of these companies - all of which have chosen not to switch during the relevant period - have audit fee changes at a level that could be easily explained by inflationary increases (only around 17% have fee increases between 0% and 10%). In fact, this evidence shows active negotiations are inevitably revisited year on year in the case of non-switching companies, as significant audit scope changes (driven, for example, by business developments or regulatory changes) force these companies to consider how much more or less audit time is required to ensure a robust audit, and the rate they are prepared to pay for that service. It is inconceivable that such significant year on year variability in fees would be the result of passive interactions between companies and audit firms, or that in these discussions audit fees would be considered in isolation from audit quality and/or scope.

33 Indeed, the detailed evidence we submitted on annual price negotiations in Q87 of our MFQ Response showed that only one of ten companies accepted inflationary price increases - while also setting out how detailed these negotiations can be. The following extracts from this evidence (provided as exhibits to Q87 of our MFQ Response) illustrate the pressure exerted by companies over price increases:

- (a) [X]: *"There is an expectation from group management and the audit committee that the audit fee should not increase except where there are changes in scope leading to additional work....To achieve this, PwC UK has asked global teams to ensure that productivity savings are achieved each year to reduce the impact of any local inflationary increases."*
- (b) [X]: *Over the course of fee negotiations, "PwC was informed that the CEO had written to [X] asking them to make themselves independent in order to make a tender possible."*
- (c) [X]: *"In this year [2009], there was significant challenge on group audit fees before and after the February audit committee. The chairman of [X] stated that he was unwilling to accept the £[X] increase in fees arising from a deterioration in the £/€ exchange rate. As*

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a result, we commenced a two-year project to ascertain where additional efficiencies in the audit process may exist. This resulted in some fees for scope changes being reduced; some fees being delayed into the following year (for example, [X]); and agreement that our proposed £[X] inflationary increase would be waived.”

- (d) [X]: “As part of the 2011 process, management benchmarked the overall group fee as a proportion of revenue, profit and employee numbers against published 2010 data for their competitors, [X] and [X], in order to satisfy themselves that the PwC rates were competitive and that [X] continues to receive a fair fee. The results demonstrate that the proposed fee was significantly below the other groups.”

Quality

Companies are capable of assessing quality

- 34 It is wrong to characterise the audit as an “*experience good*”⁸⁵ to the extent this implies that purchasers cannot judge quality with a sufficient degree of likelihood in advance of purchase. The CC acknowledges that the purchasers are sophisticated and informed. Audits are repeat purchases with companies required by statute to purchase every year - and companies (and the individuals involved) inevitably learn from, and plan for, this experience.
- 35 There is sufficient transparency in the market for large companies to judge in advance of purchase whether the firm is capable or not. It is clear that firms know what qualities they want from their auditors and select on this basis.⁸⁶ This does not mean that occasional errors will not occur, as is inevitable with a complex professional service involving judgement, but the evidence shows companies to be generally satisfied with audit quality.⁸⁷

How companies judge auditor effectiveness

- 36 The evidence gathered by the CC demonstrates that the extent and depth of the reviews carried out regularly by companies to assess and judge the “*quality and service*” of their existing audit firm is far greater than is recognised in the NSCP:⁸⁸
- (a) **Focus on formal benchmarking and re-proposals:** Without any clear explanation or justification, the NSCP focuses on formal benchmarking and re-proposals as the only types of activity which give companies a significant insight into auditor effectiveness without going to full tender. No evidence is presented to demonstrate why such formal processes are more effective than comparisons based on informal activities.
- (b) **Extent of formal benchmarking:** Having decided that formal benchmarking and re-proposals offer the only effective method of gauging auditor capabilities and competitive

⁸⁵ As is suggested in paragraph 5 and more expressly asserted in paragraph 73 of the CC’s Reputation WP.

⁸⁶ There is a striking correspondence in the characteristics cited in the CC’s Survey between (i) what is most important in determining audit quality and in appointing auditors (experience, expertise, independence, challenge, ability to detect misstatements, efficiency) (see slides 33 and 38 of the CC’s Survey), and (ii) the reasons given for not selecting mid-tier firms (lack of size, coverage, expertise and experience) (see slide 85 of the CC’s Survey).

⁸⁷ See footnote 56 above.

⁸⁸ Paragraph 66 of the NSCP.

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options without going to full tender, the CC then focuses on what it sees as a sizeable minority of companies which it believes do not carry out such activities. However:

- (i) The CC's Survey in fact shows that 85% of FTSE 350 companies have benchmarked or conducted other formal comparisons.⁸⁹
 - (ii) It is clear that the CC in drafting its working papers had placed weight on its mistaken belief that 31% of FTSE 350 companies had never carried out formal benchmarking or required formal re-proposals. This error has been corrected - the actual figure being only 10%⁹⁰ - meaning that 90% of companies have either formally benchmarked or carried out formal re-proposals. The CC should now recognise that in addition to the compelling evidence that companies are able to gauge audit quality outside of tenders through informal processes, this evidence equally does not support the suggestion that there is insufficient formal benchmarking for companies to be able to judge audit quality.
 - (iii) The NSCP refers in several places to "*around one third*" of companies not "*regularly*" carrying out such formal review activities. As we have explained in correspondence to the CC, we believe this figure is incorrect and understates the regularity of such activities (and it remains for the CC to demonstrate otherwise).⁹¹
- (c) **Auditor effectiveness reviews:** In contrast to the apparent weight the CC places on formal benchmarking exercises, it largely dismisses the value of annual auditor effectiveness reviews in allowing companies to gauge the competitive performance of their auditors, despite the fact the CC's Survey showed these were carried out by almost all companies.⁹² The case studies show the extent and value of detailed reviews of auditor performance which are conducted against the backdrop of the standards expected and experienced by AC members and other senior management in their roles at other companies where they encounter other audit firms. Such reviews do not amount to "formal benchmarking" or requiring "formal re-proposals" but are very important in providing companies with the insight to evaluate and compare auditor performance:
- (i) Company A carries out an annual auditor appraisal against a long list of criteria, including robustness of process and professional scepticism; quality of delivery; and quality of people and service;⁹³
 - (ii) Company B carries out an informal annual review considering quality and fee;⁹⁴

⁸⁹ Slide 46 of the CC's Survey and paragraph 39 of the CC's Survey WP (revised).

⁹⁰ See paragraph 10(c) of the CC's Survey WP.

⁹¹ The NSCP refers to a third of companies never having carried out formal benchmarking or required re-proposals at paragraph 95 and to a third of companies not having carried out such activities "*regularly*" at paragraph 193(c). In both cases we believe the source for this information is the data presented in slide 46 of the CC's Survey presentation. If "*regularly*" is taken to mean every five years (which is a subjective view) we believe the correct figure is 19%, i.e., significantly less than a third. See further explanation in paragraph 3.10 of Annex 2 of this response. [3<]

⁹² See slide 46 of the CC's Survey. These reviews are explained in more detail, together with actual examples of audit effectiveness reviews, in our MFQ Response to Q84.

⁹³ Paragraph 60 of Company A Case Study.

⁹⁴ Paragraph 16 of the Company B Case Study.

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- (iii) Company C carries out the annual reappraisal through “a formal questionnaire completed by members of the Audit Committee, the Chief Auditor, General Counsel and regional senior management”;⁹⁵
 - (iv) Company D “most years...sent a survey to its subsidiaries to rate the quality of the audit...[covering] topics such as meeting deadlines, understanding the local businesses, the audit team continuity and performance, insights”;⁹⁶
 - (v) Company E reports “discussion at all levels of the business” on an annual basis on the auditor’s performance, involving management and the AC;⁹⁷
 - (vi) Company F describes an annual review process involving appraisal of quality, independence, timeliness, effectiveness of reporting, rigour and management relations;⁹⁸
 - (vii) Company G sends a “thorough questionnaire...each year to around 40 or 50 people around the company who had the main contact with the auditors”;⁹⁹
 - (viii) Company H produces a “full written report on the auditors every year” covering relationship, independence, competence, communication, objectivity, financial stability and risk profile, audit strategy, communication of unexpected or adverse findings, and audit finalisation;¹⁰⁰ and
 - (ix) Company I runs an annual auditor appraisal examining independence and objectivity, members of the audit team, technical skills, and service levels and fees.¹⁰¹
- (d) **Informal interaction throughout the audit cycle:** The evidence shows the deep and constant interaction between the audit firm and company during the audit process: it is through these interactions that the ACCs and FDs (as well as chairmen and CEOs) form a view of audit quality.¹⁰²
- (i) This view is further informed by reference to their extensive (and in many cases concurrent) experience of other audit firms working for other companies. The multiple appointments of AC members and management mean that typically FTSE 350 audits are continuously benchmarked against upwards of five other large

⁹⁵ Paragraph 25 of Company C Case Study.

⁹⁶ Paragraph 39 of Company D Case Study.

⁹⁷ Paragraphs 19, 50 of Company E Case Study.

⁹⁸ Paragraph 49 of Company F Case Study.

⁹⁹ Paragraphs 17-18 of Company G Case Study.

¹⁰⁰ Paragraph 30 of Company H Case Study.

¹⁰¹ Paragraph 17 of Company I Case Study.

¹⁰² See for example, in the case studies: Company A where there are “10 Audit Committee meetings per year”; Company C where the CFO had monthly meetings and “pretty good visibility of what the auditors were doing” and there was “continual dialogue between the Audit Committee, management and the auditor”; Company G where there was “extensive [interaction] throughout the year” with the ACC having “very regular contact with the external auditor...to discuss any issues that they might have”; Company H where the ACC described the “very full report from the auditors which described discussions between management and the auditors on significant accounting issues.”; Company I where the FD had “very frequent contact with the senior AEP during the year, approximately every two weeks” while the finance team were “responsible for the day-to-day running of the audit process”; and Company J where the Fund Accounting Manager had “clear visibility of the auditor’s work”.

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company audits, and in the case of very large companies there can be more than ten contemporary comparators.¹⁰³

- (ii) The frequent changes in AC members, directors and executives at the company will introduce new views on different audit providers, including exposure to their pricing structures and rate cards.
- (e) **The activities of rival firms:** Companies have regular exposure to rival audit firms in a number of different ways, each of which gives rise to the opportunity for the rival firm to impress the company and to present their credentials as a potential auditor:
- (i) The CC's Survey shows that the vast majority of FTSE 350 companies are regularly approached by rival auditors who will be seeking both to understand any concerns with the existing auditor's service, and to impress and to point out any advantages or innovations they can offer over the approach of the current auditor. In this respect.
- The CC's Survey shows that 78% of companies are approached by rival audit firms every year, and 88% every two to three years.¹⁰⁴
 - We have explained in detail the efforts we make to target rival firms' clients through initiatives such as *Tanks on lawns* and *Net 635*, and the success of such initiatives (although these initiatives and efforts receive only the most cursory attention in a single sentence in the NSCP).¹⁰⁵
 - The CC's Survey also notes that the experience and knowledge of the engagement partner is the most important single factor in auditor appointments¹⁰⁶ - and there is clear evidence that ACCs and FDs regularly meet partners from competing firms enabling them to draw direct comparisons with the current engagement partner.
 - Chairmen and CEOs will also evaluate the audit partners they meet with whom they discuss audit and wider business issues, enabling a comparison with their experiences of audit partners from other firms. It is straightforward for companies to judge between audit partners based on such meetings.

¹⁰³ Given that ACs have at least three members, the majority of whom have at least one other AC or executive role, and that Chairmen, CEOs and CFOs often have another AC or non executive role, this would on average suggest a minimum of six other AC or non-executive roles being held by individuals who have input into the audit oversight and appointment process. In addition to formal AC meetings in an audit each of these directors see the audit partner regularly throughout the year to discuss the scope and status of the audit and wider business aspects and will see other partners in similar circumstances at their other companies.

¹⁰⁴ See slide 46 of the CC's Survey.

¹⁰⁵ See paragraphs 4.29 to 4.39 of our Initial Submission which describes our various targeting initiatives, and in particular paragraph 4.38 which sets out that we won [x] net audits in FY11, including details of those within the FTSE 350. The only reference to such efforts in the NSCP is in paragraph 155: "*There is evidence that all the Big 4 firms actively target companies that are currently the clients of rival firms...*" It is notable that the CC does not explore why firms make such efforts, and that these efforts do not feature in its "*initial views*".

¹⁰⁶ CC's Survey, slides 33 and 38.

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- (ii) Other firms also often provide a range of non-audit services to large companies for which they are not the auditor, which gives them the chance to impress the company and at the same time gain an insight on any issues with the current auditor and how to undertake the audit if the opportunity arose. For example, in the case of [X], the audit was put out to tender because the company felt that [X] had “*taken their eye off the ball*” and we won the audit due to a track record of providing the company with excellent non-audit services.¹⁰⁷

37 It follows that the initial view in the NSCP that negotiations between audit firms and the highly “*experienced*” and “*sophisticated*” ACCs and FDs are largely limited to the audit fee¹⁰⁸ is wrong - the evidence above shows companies appraise the auditor annually in respect of quality and other factors in its annual negotiations, with substantial changes in scope requiring negotiation regularly and having a significant impact on both audit quality (in terms of the time allowed for auditors to carry out their work) and audit fee (in terms of how much this time will cost).

38 All of the touch-points described above provide ACCs and FDs with a wealth of information on the relative performance of auditors, allowing them to judge the quality and price they are receiving and make informed decisions on whether they need to go to tender, or conduct some further review short of a formal tender, in order to be better informed and exert more explicit pressure on their existing auditor to improve its offering.

Different approaches to auditor evaluation are entirely consistent with a competitive market

39 Corporate resources are limited and informed directors and executives choose not to devote resources that can be more productively used elsewhere to formal audit tender processes. They make this choice where they are satisfied as to the quality and price of their existing audit through other less costly but effective approaches to assessing auditor performance. This is no different from prioritisation decisions that they make in other areas, including other procurement exercises, in the pursuit of shareholder value. Shareholders of course have every interest in management making effective decisions on the best allocation of their limited resources.

40 Although the CC recognises that a majority of companies do carry out formal benchmarking/re-proposals, the NSCP focuses unduly on the small minority that do not.¹⁰⁹ In respect of this small minority, despite the wealth of less formal options available to “*sophisticated*” purchasers to help them assess auditor performance and their competitive options, the CC does not identify any “*other market testing activities [other than formal benchmarking or re-proposals] that would be substitutes*”.¹¹⁰

¹⁰⁷

[X]

¹⁰⁸

NSCP, paragraph 192.

¹⁰⁹

As discussed below in paragraph 3.10 of Annex 2, the size of this minority is uncertain, but the CC has acknowledged that its original suggestion that 31% of companies had never carried out formal benchmarking or required formal re-proposals should in fact have been a reference to 10% of companies (see paragraph 10(c) of the Survey WP).

¹¹⁰

See paragraph 141(c) of the NSCP. This contrasts with the responses noted in the Survey WP (paragraph 40), where “*44 per cent mentioned informal contact with their peer group; 30 per cent said that they drew on in-house experience and expertise; 22 per cent said that they carried out informal benchmarking and comparisons; and 7 per cent said that they reviewed the AIU reports.*”

41 However:

- (a) The CC has not provided any evidence that formal benchmarking or re-proposals are more effective than informal measures.¹¹¹ In fact, there is no reason to suggest that more formal measures are more valuable or necessary particularly given the costs associated with these processes, which may make companies less willing to use them where they already have reliable knowledge of the options available to them.
- (b) The NSCP ignores the fact that this is a reference market with a very limited number of players on both the supply and demand sides. The relatively small world of FTSE 350 ACCs and FDs facilitates access to up-to-date information and experiences from those involved in audit appointment decisions, who themselves have extensive experience working with a range of companies and audit firms, as well as concurrent appointments in many cases. Such informal assessment takes place both:
 - (i) as between audit firms and purchasers, as the audit firms seek to build relationships with potential audit clients by demonstrating their quality and efficiency; and
 - (ii) as between purchasers in exchanging information about good and bad experiences of audit firms.

42 Given the overwhelming evidence of detailed scrutiny on an annual basis by what the CC acknowledges are informed, sophisticated buyers with knowledge of the other audit firms from previous and concurrent appointments, there is no evidence that the small minority who have neither formally benchmarked nor requested formal proposals are in any way disadvantaged in terms of the service they receive. Indeed, given the wealth of other information available to companies, and the absence of any restriction preventing them being able to access such information if they wanted to from the existing auditor or other firms, we would not expect this to be the case.

43 It is also important to note that an audit firm may not even know whether or not a particular client has carried out a formal benchmarking exercise (unless the company makes the auditor aware of this to spur competitive pressure). Even if an audit firm felt a particular client were not monitoring its options, it would be very unwise to rely on this as a likely stable state of affairs and take advantage of the situation:

- (a) Auditors are well aware, as the CC's Survey shows, that companies can judge quality performance and will tender if they feel they are not receiving this.¹¹²
- (b) The frequent changes in AC members, FDs and their finance teams mean the auditor's approach is constantly exposed to new perspectives from informed purchasers.

¹¹¹ The CC's Survey (slide 46) shows that 88% of companies are approached informally by alternative audit providers every two to three years, and 78% every year.

¹¹² See slides 68 and 74 of the CC's Survey showing that 94% of ACCs and 86% of FDs would be likely or very likely to switch if the auditor showed signs of complacency.

- (c) Unsurprisingly, there is no evidence that firms seek to exploit customers who they may believe are not monitoring their options, even if they could be identified.¹¹³

Conclusion on companies' abilities to make meaningful comparisons

- 44 In summary, this is not a market in which complacency leads purchasers to stay with an existing supplier because they do not have the knowledge of alternatives or resources or incentives to consider the prospect of switching. Rather, a decision not to tender involves a positive assessment of all the circumstances in the round (performance of the current audit firm, consideration of alternatives, pros and cons of a tender) leading to the decision not to tender.
- 45 Given that companies are extremely well able to form a view of audit firm performance in the absence of frequent tendering, and that there are material costs associated with tendering, it is not surprising that companies do not want to engage in unnecessary tenders or rounds of tendering.
- 46 The CC's Survey shows that the vast majority of companies do not tender because they are satisfied with the service they receive without doing so, but that any indication of auditor complacency would trigger a tender.¹¹⁴ The "*experienced*" and "*sophisticated*" ACCs and FDs are well able to make this judgement, and then to decide to engage in a full tender process where they decide that the alternatives are worth considering in more detail.
- 47 While recognising that companies are aware of the potentially considerable costs of switching, the NSCP suggests that they are less able to judge the benefits.¹¹⁵ There is no evidence to support a conclusion that these well informed purchasers are aware of one aspect of the switching process but ill-informed as to the other aspect. Nor does the CC explain why such sophisticated purchasers, responsible for procuring a vital service on behalf of the largest, best resourced companies in the economy, would be satisfied with a position where they are unable to judge service quality and value for money, when it is open to them both to judge this accurately and ensure they achieve a competitive outcome, by tendering. Again, this is an example of concepts that may have validity in consumer markets being incorrectly applied to experienced large business purchasers.

¹¹³ A parallel can be drawn here with the evidence the CC has found of audit firms not pushing up prices in the years immediately after tender when companies might not be expected to re-tender. This is consistent with the reality that firms benefit from providing a high quality service on a continuous basis in order to maintain their client base, but also build their reputation which will assist in winning new clients.

¹¹⁴ See CC's Survey, slide 60: 70% of companies cited one of the following three reasons for not tendering: "*receive high quality service*"; "*receive good value for money*"; "*happy as things are*". As explained in footnote 56, companies provided more than one unprompted response, with the sum of positive responses (i.e. not tendering because satisfied with service received) being 133% (of the cumulative total of 172%), and only 29% cumulatively related to negative reasons (i.e. switching costs). However, slides 68 and 74 confirm that 94% of ACCs and 88% of FDs would be very likely or likely to tender were the company's auditor to act complacently, and only 13% of ACCs and 2% of FDs would be unlikely to tender if faced with a substantial price increase.

¹¹⁵ Paragraph 141(e) of the NSCP, see paragraphs 3.24-3.25 of Annex 2 of this response on this point.

Section 3: There are no concerns regarding the incentives companies have to tender

In this section, we explain that we:

- Agree with the CC's conclusion that tenders are highly competitive processes.
- Disagree with the residual concerns that the CC has identified regarding the operation of tenders, on the basis that:
 - switching costs do not unduly deter companies from tendering;
 - companies have sufficient choice; and
 - levels of innovation are high and greater than the tender results suggest.

48 We agree with the CC's initial views that tenders are structured and thorough competitive processes, providing significant detail for the purchaser on the capabilities of the audit firm and team that will carry out the audit, as well as on the fee.¹¹⁶

49 However, we note that the CC has certain residual concerns about aspects of the tender process. These are addressed below.

Switching costs do not unduly deter companies from tendering

50 The NSCP highlights "*perceived*" switching costs as a potential inhibitor of switching (discounting the obvious evidence of *real* switching costs),¹¹⁷ and states that "*a substantial proportion of companies would not consider switching in response to a problematic working relationship between the auditor and management*".¹¹⁸ In fact, this conclusion is directly contradicted by the CC's evidence, which shows that:

- (a) only 8% of ACCs and 11% of FDs said they were not likely to switch in such circumstances - figures which are clearly far from a "*substantial proportion*"; and
- (b) while 94% of ACCs and 88% of FDs said they would be likely or very likely to switch if the auditor showed signs of complacency.¹¹⁹

51 The CC highlights that, while over half of companies said they had not tendered in the last five years because they received good quality and/or competitive fees, "*over one third had mentioned disruption and the costs involved in tendering audits and changing auditors and the benefits of continuity*".¹²⁰ With respect to the second statement it is misleading to group these

¹¹⁶ Paragraphs 82 and 83 of the NSCP.

¹¹⁷ Paragraph 141 (e) of the NSCP.

¹¹⁸ Paragraph 141 (f) of the NSCP.

¹¹⁹ See slides 66 and 74 of the CC's Survey.

¹²⁰ Paragraph 190 of the NSCP.

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characteristics together. A switching cost is a cost that must be incurred for a company to receive benefits that might arise from a switch – the costs of a tender fall into this category. The benefits of continuity are a positive attribute of the existing auditor as a consequence of investment it has made in understanding the companies' business and accounting issues. This benefit is not a switching cost but rather a valuable positive attribute that would be lost if the company switched in the same way that an auditor's experience or competitive pricing might be lost through switching.

52 Of more concern, the CC misreads these statistics in a way which distorts the picture they demonstrate (one of several examples of arithmetical errors which have been used to support the CC's position)¹²¹. The correct interpretation of slide 60 of the CC's Survey, which sets out unprompted responses of companies as to why they had not tendered in the last five years, is as follows:

- (a) companies were able to give more than one response, with the total number of responses counted cumulatively across the slide amounting to 172%;
- (b) only 29% of this 172% total related to switching costs and disruptions - i.e., less than a fifth of responses;
- (c) 10% of the 172% total were neutral (i.e. the time was not right to tender); and
- (d) significantly 133% of the 172% total (or more than three quarters of responses) related to positive reasons for retaining the incumbent auditor.
- (e) Indeed, as noted in footnote 56 above, these responses were unprompted and companies evidently offered more than one response in several cases, it is likely that "negative" responses were accompanied by "positive" responses in many cases.

53 What emerges is far from the picture portrayed in paragraph 190 of the NSCP, but rather strong evidence that companies are broadly satisfied with the service they receive and that switching costs are not a major inhibition to the decision to tender. This broad level of satisfaction has been reported in other contexts - for example, the YouGovStone survey in 2011 which reported that of CFOs and ACCs of 120 of the largest businesses in Europe, 92% were pleased with the quality of their external audits.¹²² We are concerned that the CC should seek to draw negative conclusions about the existence of switching costs from the evidence in slide 60 which overwhelmingly portrays a market in which customers are satisfied with the service they receive.¹²³

¹²¹ See also paragraph 36(b)(ii) of this response and paragraph 3.10 of Annex 2 to this response.

¹²² See paragraph 6.61 of our Initial Submission, and the YouGovStone European Audit Committee Chair and CFO Poll (June 2011) provided to the CC on 11 November 2011 as document B11(1) in response to the Off the Shelf information request.

¹²³ We particularly do not understand how the CC has concluded that *"over half of [companies that had not tendered in the last five years] said that the quality of service had been good and/or the audit fee was competitive"*. In fact 51% said the former and 21% the latter, a total of 76%. And in any case, those were by no means the only positive reasons for not tendering mentioned in unprompted responses by the surveyed companies.

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54 As referred to in paragraph 43 above, what are most striking in relation to the potential inhibiting effect of switching costs on the willingness of companies to tender, are the results of the CC's Survey showing an extremely high likelihood of tender in the face of auditor complacency and the very low number of companies who were unlikely to tender if faced with substantial price increases. It is this approach which ensures audit firms operate with the constant concern that any slip in performance could jeopardise their position.

Companies have sufficient choice

55 The CC highlights that around 40% of companies said they faced limited choice between the four largest firms, and takes the view that "*the number of potential bidders could adversely affect perceptions on the potential benefits to be had from going through a tender process*".¹²⁴

56 However, the CC's evidence also shows that:

- (a) the average FTSE 350 tender has 3.7 bidders. In contrast, the average number of bidders for non-FTSE 350 tenders was 3.4.¹²⁵ Given that smaller firms are more likely to have the capability to be a serious bidder in relation to the audits of non-FTSE 350 companies, but despite this companies outside the FTSE 350 choose to have a lower average number of bidders, this is strong evidence that there is no material limitation of choice within the FTSE 350;
- (b) if invited to tender, all of the four largest audit firms participated, unless conflicted, and tender lists typically included at least three firms.¹²⁶ We note that the NSCP refers to audit firms participating in tenders unless "*they*" choose not to due to conflicts with non-audit work.¹²⁷ This does not reflect the reality of such situations - companies will decide whether they are prepared to allow a non-audit provider not to participate in an audit tender and should they wish the firm to participate they have the obvious sanction of discontinuing the firm's non-audit engagements should the audit firm continue to resist; and
- (c) significantly, slide 60 of the CC's Survey shows that no companies had not tendered in the last five years due to a lack of choice.

57 As we have previously explained, we have numerous examples of clients where we have had to "cleanse" ourselves of potential independence issues in order to participate in a tender (which we may not even win) - [redacted] is an obvious example. We have also provided evidence showing that (a) none of the large audit firms suffer from material weakness in any sector, such that we would view them as being unable to field a credible bid; and (b) companies are prepared to

¹²⁴ Paragraph 141 (g) of the NSCP.

¹²⁵ See paragraph 46 of the CC's Survey WP. That there are an average of 3.7 bidders in FTSE 350 tenders is noted in paragraph 145 of the NSCP.

¹²⁶ Paragraph 165(b) of the NSCP.

¹²⁷ Paragraph 116 of the NSCP.

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have the same auditor as one of their leading competitors; showing this does not materially limit choice.¹²⁸

58 This evidence demonstrates that large companies do not suffer from any material lack of choice in practice when selecting their audit firm, and we therefore disagree that choice is a factor which could be considered to inhibit firms from tendering in situations where they would otherwise see benefits from doing so.

59 Indeed, as set out by Professor Steffen Huck in Annex 4, according to economic theory of industrial organisation, a market with the characteristics of audit are at their most efficient with four or fewer competitors.

Levels of innovation are high and greater than the CC analysis of tenders suggests

60 As we have explained in previous submissions, large companies demand innovation to improve quality and efficiency. We have provided evidence of how we constantly innovate in the following respects:

- (a) to help companies improve the relevance and reliability of their corporate reporting;¹²⁹
- (b) to enhance the quality and efficiency of our audit process, through the delivery of our Audit Transformation Programme;¹³⁰ and
- (c) to differentiate our audit service within the boundaries of the regulatory model, including by providing insights and adding value during the audit process so as to improve company performance to the benefit of shareholders.¹³¹

61 We have also described the continuing efforts we and others make to improve the information on the audit process provided to stakeholders and in promoting regulatory changes to allow increased audit reporting.¹³²

62 The evidence shows that innovation is a feature of audit competition. That innovation is seldom noted as a feature in audit tender proposals and decisions¹³³ is not surprising as companies make their decisions based on a range of factors, of which the outcomes of innovation is only one. While in a consumer market it may be necessary to “spell out” the innovation process so that purchasers can understand its significance, in a sophisticated business market purchasers are more focussed on the improved methods, systems and outcomes that result from innovation - such as provision of insights, improved controls or efficiencies that result in lower fees.

¹²⁸ See paragraphs 4.49 - 4.70 of our Initial Submission.

¹²⁹ See paragraph 3.10 of our Response to Third Parties.

¹³⁰ See paragraphs 3.36 to 3.39 of our Initial Submission.

¹³¹ At our hearing we gave the example of how work undertaken for ITV using new technology developed to help identify fraud in accounts is now being used to enhance the audit process. Our MFQ Response, Q103 set out in detail examples of specific innovations we have made to enhance the audits of particular customers. We propose to provide more detailed explanations of such innovations in a separate submission.

¹³² See paragraphs 2.17 to 2.19 of our Response to Third Parties.

¹³³ Paragraphs 39 and 84 of the NSCP.

Conclusion

- 63 In the light of the points made above and the evidence described, the CC is wrong to suggest that competition is not functioning, particularly when the evidence on competitive outcomes suggests the opposite.
- (a) The evidence on pricing is clear – companies are able to negotiate and drive price down regardless of whether there is a tender demonstrating that buyer power outside of tenders is not weak.¹³⁴
 - (b) On profitability, our detailed and rigorous analysis of our own audit profitability - endorsed by Professor Ian Cooper of the London Business School - shows a level of profitability consistent with the other evidence of a highly competitive market.¹³⁵
 - (c) There is no evidence that those who tender are less able to achieve competitive pricing outcomes over time (as reflected in the profitability of their audits to audit firms).¹³⁶
 - (d) The CC accepts that audit firms do not take advantage by pushing prices up immediately after tender in the period when companies might be reluctant to go out to tender again.¹³⁷
 - (e) As an example of buyer power, we have been unable to agree limited liability agreements with any of our FTSE 350 audit clients, regardless of when they last tendered the audit (although such clauses are permitted by legislated).¹³⁸
 - (f) There is abundant evidence that those closest to the audit process, the ACCs and FDs, are able to judge audit quality - to understand what “good looks like”¹³⁹ - and can and do ensure they receive it.
 - (g) There is no evidence of poor quality and there is plenty of evidence of innovation to improve quality.¹⁴⁰
- 64 The evidence clearly demonstrates that audit purchasers are informed as to the alternatives available to them. We broadly agree with the CC’s view that “*where companies are well informed as to the alternatives available to them... low switching rates may be consistent with*

¹³⁴ As demonstrated by the CC’s analysis, from 2006 to 2011, the average auditor fee per hour has fallen around 15% in nominal terms (and therefore by a higher amount in real terms). See paragraph 35 of the CC’s Descriptive Statistics WP and Figure 9 (with which we were provided by the CC in a putback dated 5 September 2012 - “*Engagement Data Descriptive Statistics - PwC*”).

¹³⁵ We accept that evidence of our own audit profitability cannot be viewed as definitive in relation to the profitability of the wider market, but a 1% five year average economic profit margin is, at a minimum, a very strong indicator that the profitability of large audit services is at competitive levels.

¹³⁶ See, for example, figure 11 from our Initial Submission which shows that there is no relationship between the profitability of our FTSE 350 audit engagements and the tenure of these engagements.

¹³⁷ Paragraph 196 of the NSCP.

¹³⁸ See Q41 of our MFQ Response.

¹³⁹ See paragraph 21 of the Company E case study: “*The FD and his Head of Group Reporting Accounting were both former auditors, and the Head of Tax was ex-profession, therefore they ‘know what good looks like’. If the auditors were not up to scratch then they would be replaced.*”

¹⁴⁰ The CC’s Survey shows the vast majority of companies have not tendered in the last five years due to factors related to receiving competitive price and quality from their auditors (slide 60), but that they would be likely or very likely to tender if there was any sign of auditor complacency or any slip in the level of quality (slide 74).

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*firms facing strong competitive pressure to retain clients.*¹⁴¹ Where we differ is that we believe the existence of strong competitive pressure and informed buyers does not result in “low” switching rates, but switching rates that are appropriate to the market in question.

- 65 Where we take particular issue is with the characterisation of audit purchasers as “*experienced*” and “*sophisticated*” on the one hand, but yet uninformed “*as to the alternatives available to them*” on the other; and able to achieve competitive outcomes through tenders, but content to suffer uncompetitive outcomes by not tendering. There is an inherent contradiction in the NSCP in suggesting that these highly sophisticated purchasers are not able to make rational decisions on when they might require more information from prospective suppliers or when a tender is desirable. The CC must address this contradiction and take proper account of both its own evidence and the large body of evidence we have provided of the views of companies from our customer feedback exercises¹⁴² - these views were gathered outside the context of this investigation and reflect the reality of competition.
- 66 The evidence shows clearly a competitive market with sophisticated purchasers able to secure the quality and price outcomes they need with or without tenders. This evidence is consistent with the views of a number of key stakeholders expressed to the House of Lords before the CC investigation started:
- (a) Professor Vivien Beattie: “*all parties felt that it was quite a competitive market, in the sense of if [the audit firms] did not satisfy the other party then there was always a threat and sanction that there would be some change*”,¹⁴³
 - (b) ACCA: “*Even with a pool of only four big audit firms to choose from, companies can and do change their auditors if they are dissatisfied with the quality of service they are receiving*”,¹⁴⁴
 - (c) ICAEW: “*[the large firms] compete fiercely with each other on price as well as other differentiators. Competitive tendering or the threat of it across this sector ensures the firms are kept on their toes*”,¹⁴⁵
 - (d) Hundred Group of Finance Directors: “*there exists sufficient competition in the market to drive continuous improvement and breadth of choice to our shareholders*”.¹⁴⁶
- 67 What is particularly striking in the evidence is that those who purchase audit services - the ACCs and FDs - failed to mention any concern about market power, receiving low quality of service, or being unable to gauge their options when interviewed in the CC’s Survey and case

¹⁴¹ Paragraph 195 of the NSCP.

¹⁴² See paragraph 13 of this response in addition to Annex 3 of our Initial Submission (*Table of current PwC clients and feedback received*).

¹⁴³ Professor Vivien Beattie oral evidence to the House of Lords Economic Affairs Committee. See page 13, Volume 2 of the House of Lords Report.

¹⁴⁴ ACCA written evidence to the House of Lords Economic Affairs Committee. See page 33, Volume 2 of the House of Lords Report.

¹⁴⁵ ICAEW written evidence to the House of Lords Economic Affairs Committee. See page 45, Volume 2 of the House of Lords Report.

¹⁴⁶ Hundred Group of Finance Directors written evidence to the House of Lords Economic Affairs Committee. See page 251, Volume 2 of the House of Lords Report.

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studies. Yet the NSCP suggests that these individuals lack the information they require to make effective judgements and do not choose to take the action needed to rectify this.

- 68 As we have shown in this response, the concerns as to the effectiveness of competition outside of tenders that emerge in the NSCP are highly theoretical, internally inconsistent, and bear no relation to either the views of the market or the available evidence, including that gathered by the CC in its survey and case studies. We would expect the CC to address the serious flaws in its reasoning in the Provisional Findings.

PricewaterhouseCoopers LLP

29 October 2012

ANNEX 1

SUMMARY OF RESPONSES TO INITIAL VIEWS

	CC's initial views as expressed in the NSCP ¹⁴⁷	PwC's views ¹⁴⁸
1	Scope for firms to compete by differentiating themselves through innovation in the product and service offered (paragraphs 33 - 39 of the NSCP)	
	<p>The CC recognises that additional testing and reporting beyond minimum ISA requirements allows audit firms to tailor and differentiate their service¹⁴⁹, but suggests (on the basis of tender proposals) that firms do not compete on innovation in tenders.¹⁵⁰</p>	<p>We agree with the CC's initial view that there is scope for firms to compete by differentiating themselves through innovation in undertaking audits in various respects - this is shown in the evidence (see paragraph 60-61 of this response).</p> <p>However, we disagree with the CC's initial view that innovation has a limited role in tenders. Innovation informs the material that firms present in tenders - while it may not be labelled as such, in a sophisticated business market purchasers are focussed on outputs of innovation such as improved methods, efficiencies, insights, systems and outcomes. (Paragraph 62)</p>
2	The main variables across which audit firms compete for FTSE 350 engagements (paragraphs 67-68)	
	<p>The CC states that firms compete in respect of: (i) the experience and knowledge of the engagement partner and engagement team; (ii) the audit team's working relationships with senior management and the ACC; (iii) reputation of the audit firm with investors, corporate brokers, analysts and external advisers; (iv) strength of international network; and (v) audit fee.</p> <p>The CC adds that competition in winning clients is focussed on experience and quality, while annual negotiations focus on fee and audit scope.</p>	<p>We agree that audit firms compete in relation to the characteristics highlighted by the CC, and that experience and knowledge are pre-requisites for companies, with fees negotiable only after these criteria are satisfied.</p> <p>This does not mean that fees are considered unimportant but rather that there is no point in negotiating fees if the necessary quality is not available. Although fee and scope are covered in annual negotiations, the evidence shows that companies also review quality issues closely on an annual basis, and audit firms invest considerably in monitoring client satisfaction. Indeed negotiation of scope changes are associated with ensuring audit quality given the need for auditor hours to be sufficient to allow robust auditing of the financial statements. (Paragraphs 13-14, 28, and 36(c))</p>
3	Bargaining position of FTSE 350 companies in the context of tenders (paragraphs 83-84)	
	<p>The CC recognises that tenders are structured and thorough processes managed by knowledgeable and</p>	<p>We agree with the CC's initial view as regards the structure and thorough nature of tender competitions, and</p>

¹⁴⁷ Please note this is a summary of the initial views expressed by the CC in the NSCP.

¹⁴⁸ References to paragraph numbers of this response where the issue in question is addressed are provided in parenthesis after each PwC view.

¹⁴⁹ Paragraph 34 of the NSCP.

¹⁵⁰ Paragraph 39 of the NSCP.

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	<p>experienced individuals (the FD and the ACC).</p> <p>The CC then states that “a company’s bargaining position depends on the number of competent alternative audit firms... Companies that decide to put their engagement out to tender are more likely to be those that expect there be gains to be had from doing so: those that do not may not think that they have good alternatives (and so have limited bargaining power)”.</p>	<p>importantly, its recognition of the knowledge, experience and sophistication of audit purchasers. (Paragraphs 7,9, 24(a) and 48)</p> <p>We disagree with the CC that a company’s bargaining position is affected by the number of credible alternatives, as there is no evidence that companies that want to tender face any materially restricted choice. (Paragraphs 55-59)</p> <p>While we agree that companies that tender are those which see potential gains in doing so, the evidence shows that the vast majority of companies are satisfied with their existing audit suppliers and would tender if this were not the case. Therefore we strongly disagree with the suggestion that sophisticated, experienced buyers do not tender because they either mistakenly perceive a lack of benefits from doing so, or because of a material lack of choice. (Paragraphs 50-54)</p>
4	The bargaining position of companies with existing auditors (paragraph 141)	
	(a) Outside of tenders, companies’ bargaining position is weakened by the limited effectiveness of benchmarking, and switching costs.	We disagree that companies have a weak bargaining position outside of tenders. The evidence demonstrates that ACCs/FDs are experienced, sophisticated purchasers with access to information from numerous sources to compare rival audit firms, and that they can achieve competitive outcomes without switching. The evidence also shows switching costs are not so high as to dissuade companies from tendering where they want to. (Paragraphs 15, 23, 50-53 and 65)
	(b) Benchmarking exercises are the only source of comparison information outside tenders and “these exercises are often limited in scope to the comparison of fees and general considerations regarding the expertise of the audit firm and teams.”	We disagree. The evidence shows almost all companies engage in detailed annual reviews of various aspects of audit quality as well as price. The CC appears to ignore the value and extent of information available both informally and from direct/indirect contact with, and experience of using, other firms. The CC also discounts the efforts audit firms make to target companies to build relationships and better understand companies’ needs (see paragraph 24(c) of this response). The CC does not address the contradiction of experienced purchasers not tendering more often if tendering is the only way for them to get reliable information and achieve a competitive service - and does not follow the logic of the evidence on competitive outcomes which shows these can be achieved without tendering. (Paragraph 39)
	(c) Comparisons are not straightforward due to the wide range of factors that affect audit fees including sector experience; complexity; scope; and	We disagree. The case studies and other evidence show companies can and do perform such comparisons unhindered by the bespoke nature of an audit.

	geography.	(Paragraph 26)
(d)	As audits are bespoke and comparisons are complex, only by tendering can companies effectively able to judge the competitiveness of the service they receive.	We disagree. ACCs/FDs are knowledgeable and use experience of working for other companies and with other audit firms to inform their decisions. They allow for similarities and differences between companies, and have raised no concerns of inability to judge quality outside tenders, while outcomes illustrate they can. (Paragraph 36)
(e)	Switching rates may reflect the perceived cost of switching and the difficulty in assessing potential gains from doing so.	We disagree on a number of levels. First, there is no evidence of switching rates being anything other than optimal, as there is no evidence that companies that switch achieve better long-time outcomes than those that do not. Second, although there are some costs to switching, the evidence shows they do not stop companies from tendering. Most companies do not tender because they receive a good service. (Paragraph 53)
(f)	A substantial minority (around 40 per cent) of companies feel their choice of auditor is restricted and this could adversely affect their perceptions of the potential benefits of tendering.	We disagree. The evidence shows no companies have not tendered in the last five years due to a concern of lack of choice. Companies' buyer power means they can require audit firms to cleanse themselves of conflicts to participate in tenders should they require it. The required number of participant companies in tenders is higher in the FTSE 350 than outside it (3.7 against 3.4). The CC's assertion that companies' perceptions of the potential benefits of tendering are limited by choice is not supported by any evidence. (Paragraphs 55-56)
(g)	"ACCs and FDs have a limited incentive to tender to achieve fee reductions unless these are expected to be substantial."	We disagree. As discussed above, the focus on tendering as necessary to drive competitive outcomes is not supported by the evidence. The evidence also shows very few companies would be unlikely to tender if faced with significant fee increases, and that annual fee negotiations are often extremely detailed. More significantly, the market data shows that companies have been successful in driving down audit fees, and forcing audit firms to innovate to produce efficiencies, in most recent years, in most cases without needing to go to tender. (Paragraphs 26-27)
5	The strength of competition in winning new engagements (paragraphs 165-167)	
(a)	Competition in tenders for FTSE 350 engagements is strong.	We agree - this is shown clearly in the evidence. (Paragraph 18)

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(b)	Audit firms have the incentive to compete intensely during tender processes given that the demand for statutory audits is fixed, and so to expand their FTSE 350 client base, firms must displace competitors through tenders.	We agree that audit firms have an incentive to compete aggressively in tenders to maintain and increase their market share. However, the evidence shows audit firms make great efforts outside of tenders to ensure client satisfaction and to target rival firm's clients. (Paragraphs 23(d) and 31(e))
(c)	If invited to tender, Big 4 firms participate unless they are conflicted from doing so by non-audit work which they wish to retain.	We disagree. Audit firms will tender unless they are not conflicted by non-audit work the company wishes them to continue providing - the choice is with the company. The company will not allow a firm to decline to tender and remain secure as a provider of non-audit services unless that is its preference. (Paragraphs 56(b) and 57)
(d)	The tender selection process is led by experienced individuals many of whom have trained with or worked for one of the Big 4 firms. Most ACCs hold more than one AC position.	We agree that ACCs/FDs are experienced and that ACCs often hold more than one position. However, the CC downplays the fact that other AC members also hold multiple positions and senior executives also typically hold non-executive positions in other companies giving them considerable knowledge of audit processes, quality and suppliers which is relevant to assessing the competitiveness of the service received inside and outside tenders. There is no evidence that the fact that many of those selecting the auditor working in the past for one of the four largest audit firms affects the choices made, except to make them effective purchasers. (Paragraph 36(d))
(e)	If a company decides to tender, management and the AC take the process seriously.	We agree that given the importance of the audit service to a company, and the opportunity cost in terms of management time, companies take the process seriously.
(f)	For audit firms, participating in a tender is time-consuming and costly and potentially damaging to their reputation if they do not perform well. For this reason, firms take the process seriously.	We agree that audit firms compete seriously in tenders given the costs involved and the risk to reputation if they perform poorly. The harm to reputation of performing badly and the knowledge that on most occasions where there is a tender the current audit firm loses (because most often tenders result from company dissatisfaction) also prompts their efforts to retain clients by providing a constantly competitive service outside of tenders. (Paragraphs 13, 23(c) and (d))

Non-confidential version

	(g) Around 40 per cent of surveyed FTSE 350 companies said that they faced some limitation of choice between the Big Four firms.	We disagree that there is any material limitation of choice between large audit firms: although a minority of survey respondents said they faced some limitation of choice, none indicated that this had prevented them holding a tender, and the average number of tendering firms in the FTSE 350 is 3.7, higher than outside the FTSE 350 (where it was 3.4, despite a larger number of firms having the attributes to compete effectively for smaller company audits). (Paragraphs 55-56)
6	The competitive pressure faced by firms in the retention of FTSE 350 clients (paragraphs 192-196)	
	(a) Experienced ACCs and FDs can use the threat of switching to obtain better terms, but negotiations appear largely limited to the audit fee. There are factors that weaken the bargaining position of the companies.	We disagree that negotiations are limited to consideration of the audit fee. Almost all companies engage in detailed annual reviews of audit scope and quality as well as value, and will raise any concerns. Audit firms also proactively monitor company satisfaction and make adjustments accordingly. (Paragraphs 13-14 and 31(c))
	(b) Some FTSE 350 companies are less active in managing their audit relationship.	We disagree. In paragraph 193 of the NSCP, the CC highlights three factors (companies that allow inflationary fee increases, do not formally benchmark, and tender infrequently), but there is no evidence of these factors occurring in combination or of worse outcomes were they to do so. There is clear evidence that almost all companies would be likely to tender if the auditor was complacent, and the evidence of information available to companies does not support a suggestion they could be oblivious to poor auditor performance. (Paragraph 46)
	(c) As the time since an audit engagement was last tendered increases, companies may not have the information to assess effectively the competitiveness of the audit product and service provided by their existing audit.	We disagree that companies potentially have limited information about rival audit providers, or that this becomes more of an issue the less recently a company tendered. There is no evidence to support this suggestion, and plenty to counter it. Information from tenders becomes outdated quickly, particularly given that large changes in company requirements necessitating big scope and fee changes are common. Except immediately after tenders, ACCs and FDs rely on the information which is available to them from other sources, including their roles for other companies, which gives them a clear picture of the alternatives available and ability to demand more information if they require it. (Paragraphs 36(d)-(e))

Non-confidential version

	<p>(d) Infrequent tendering encourages stronger competition for when tenders occur. Firms face substantial costs in losing clients, beyond lost profits on the relevant engagement. Nevertheless, firms face greater competitive pressure the better informed the client, and the more credible the risk of tender. Where companies are well informed as to their alternatives, switching costs are low (relative to the potential gains), and companies have a choice of audit firms, then low switching rates may be consistent with firms facing strong competitive pressure to retain clients.</p>	<p>We agree that competition in tenders is fierce, but there is no evidence that tendering is less frequent than is optimal for this market. We agree that firms face costs if they lose clients, including damage to reputation, and that this incentivises them to provide a competitive service (not only to compete in tenders). We agree pressure increases with informed clients and a real risk of tender - the evidence shows large companies are sophisticated, experienced buyers, and that they use the threat of switching to achieve competitive outcomes. Switching costs are not low, but they are not so high as to dissuade companies from switching where they want to. As above, there is no evidence of material restrictions on auditor choice. (Paragraphs 23 and 51)</p>
	<p>(e) It seems unlikely that a company would want to change its auditor within 3 years of switching. Knowing this, firms could in theory raise prices after the first year. But fees are often fixed for 3+ years, limiting the ability of firms to do this, and fees decline after the first years of engagement, which could suggest that firms do not take advantage of companies in this way.</p>	<p>We agree that companies are not likely to want to switch auditor every three years or less because of the costs and disruption involved. The evidence shows fees are often fixed for three years in tender proposals and that fees decline after the first years of engagement. This provides strong evidence that audit firms have a long term perspective and awareness of the impact on their reputation of seeking to exploit companies in the short term. (Paragraph 63 (d))</p>

ANNEX 2

DETAILED COMMENTS ON NSCP

We set out below our views on key points raised in the NSCP, with cross references to where we have addressed particular issues in previous submissions or evidence. We do not attempt to respond exhaustively to every comment made in the NSCP, particularly in the light of certain aspects being more fully considered in other working papers. Rather, we provide comments on particular points in the NSCP under the various headings used in that paper. Where we have already covered these points in our response above, we cross refer.

1 Description of an audit

Fee

- 1.1 **Paragraph 16:** The NSCP suggests “*it may be difficult for FTSE 350 companies to compare the audit fees they pay with those paid by others.*” This is the first mention of this view, which appears to be an important aspect of the CC’s analysis, and with which we disagree for the reasons explained in paragraph 26 of our response above.

Audit quality

- 1.2 **Paragraphs 17-18:** We note the recognition in the NSCP that the technical quality of the audit encompasses the De Angelo definition of audit quality as well as the quality of internal reporting. We believe the CC’s Survey findings are highly instructive on what companies value in terms of audit quality, with efficiency, ability to detect misstatements, independence and challenge the most critical factors.¹⁵¹

Scope for innovation

- 1.3 **Paragraphs 33-38:** We agree with the CC’s initial view that there is scope for firms to compete by differentiating themselves through innovation in undertaking audits in various respects including, for example, through:
- (a) the development of industry-specific audit approaches;
 - (b) innovation in IT and systems; and
 - (c) the provision of greater insight into how a business is operating through detailed reports on financial controls.

See paragraph 62 above of our response.

¹⁵¹ See CC’s Survey, slides 26 and 28 in relation to aspects of audit quality valued by FDs and ACCs.

- 1.4 **Paragraph 39:** The finding that only 1% of tender losses are down to an innovative approach being offered does not contradict our view that innovation is an important aspect of competition in a tender context.
- 1.5 The purpose of innovation is to offer continual improvement in our service to clients - there is little point in innovating purely for its own sake. When it comes to presenting a tender proposal, we emphasise our ability to innovate but more importantly explain the benefits innovation delivers for the client. These may be in terms of, for example, lower cost, greater consistency of approach, or application of sector or other specialist knowledge, all of which lead to an improvement in quality, and/or the provision of additional value-added insight.¹⁵² It is the improved outcome created by the innovation that we would normally expect to be the key focus of the client's assessment, rather than the fact of the innovation itself.
- 1.6 For that reason, in most cases we would expect the reason given for the tender being awarded to the more innovative audit firm to be because of better efficiency or lower cost created by the firm's innovation, rather than for the sake of innovation alone, and we believe this is reflected in the low proportion of tender wins that are attributed entirely to innovation.
- 1.7 We disagree with the CC's conclusion in paragraph 39 that innovation normally only affects the cost and efficiency of an audit, rather than the nature of the audit service. As set out above, innovation is often relevant to cost/efficiency, but in addition we believe there are many examples where innovation has effects on the nature of the audit service - for example, one of the cases that the CC mentions is the introduction of industry-specific approaches to audits. These have a number of potential benefits, including bringing increased efficiency to audit processes, but more obviously are designed to improve the quality of the audit, and we believe that the client would experience a different audit service as a result.¹⁵³
- 1.8 We are conscious that at our hearing it appeared that the CC had found the descriptions of some innovations, and their value (particularly in the context of tender proposals), to be unclear. However, we have provided numerous examples of innovations made by PwC, both in terms of global methodologies,¹⁵⁴ offerings to specific clients,¹⁵⁵ and in relation to tenders.¹⁵⁶
- 1.9 On the basis of the substantial volume of evidence of innovation both during and outside tenders, the CC should revisit its initial view of the role of innovation in tenders as it is evident

¹⁵² For example, see paragraphs 103.19 to 103.26 of our MFQ Response, where we provide specific client examples illustrating the spectrum of our audit innovation in respect of:

- a) new global audit approaches;
- b) an enhanced controls approach;
- c) use of technology and data;
- d) an enhanced risk approach;
- e) the "Essential Elements" approach to providing insight; and
- f) informative reporting and audit benchmarking.

¹⁵³ For example, in the case of [redacted], we were able in our proposal to emphasise our industry expertise in the global energy sector and our ability to offer a range of industry-specific improvements, including: points of view on emerging industry trends; access to specialist individuals; industry-specific performance benchmarks, based on global best practices; methodologies and approaches in complex areas such as financial instruments and tax provisioning; and collaboration on accounting or technical issues unique to the energy industry, especially when interpretive guidance is needed [redacted]. See also our MFQ Response to Q103.

¹⁵⁴ Please see in particular Aura and GADM which are described in detail in "The Audit Transformation Programme" - Annex 6 to our Initial Submission.

¹⁵⁵ See our MFQ Response to Q103.

¹⁵⁶ See our MFQ Response to Q33.

that, while the regulatory framework imposes a degree of limitation on the scope for innovation, innovation is an important dimension of competition in tenders.

Visibility of elements of an audit

- 1.10 **Paragraph 41, Figure 1:** The CC sets out its initial views on the visibility of the various elements of the audit process in Figure 1 by way of a pyramid diagram which shows that the auditor has the most visibility of aspects of audit quality, followed by senior management, then the ACC (although their depth of scrutiny depends to some extent on the individual) and AC, and finally shareholders or other stakeholders who are largely limited to information that is publicly disclosed by the company.
- 1.11 We consider that the diagram is conceptually useful, but we query the suggestion that ACCs (and ACs) do not have visibility of the degree of challenge by the auditor or the commercial insights provided by the auditor. Awareness of the degree of auditor challenge is an essential aspect of the role of the AC, and management and auditors themselves will ensure that the AC members are made aware of any aspects of the financial statements that have been challenged.¹⁵⁷ Given their experience, including of similar issues in other companies, ACCs are well able to judge where issues are likely to arise in the audit of any particular company and therefore whether or not the auditor appears to have properly covered those aspects.
- 1.12 The diagram also suggests that the limited information available to shareholders is in some way less than optimal. This is not the case. The very reason for the existence of the AC is to scrutinise the audit on the shareholders' behalf since it is not appropriate for all shareholders to access detailed information about the audit process (e.g. for commercial confidentiality reasons).¹⁵⁸ The AC needs a certain level of information to achieve this aim - more than is available publicly - but will inevitably have less practical exposure to the approach of the auditor than the company management. The levels of information provided are therefore appropriate to the different roles of the participants and are sufficient for them to make the judgments that they need to make about the audit process.
- 1.13 We note that later in the NSCP (**paragraph 92**), the CC recognises that the evidence shows that ACs take their duties very seriously, and that ACCs and FDs are engaged with the audit process and act in accordance with their duties. We agree with these comments and believe the evidence to date, including the CC's Survey and case studies, shows that ACCs and FDs:
- (a) are aware of and act in accordance with their duties to the company and the shareholders;¹⁵⁹
 - (b) place value on the quality, objectivity and independence of the audit above other characteristics;¹⁶⁰

¹⁵⁷ Significant risks are formally reported to ACs at the outset of the financial year and conclusions reported to the AC at the end of the audit.

¹⁵⁸ See paragraph 2.8 of our Response to Third Parties.

¹⁵⁹ For example, in the Company D case study, the ACC acknowledged the importance of the AC and stated that the Audit Committee's role "was to address any issues that were raised as a result of the audit process and to act as a safeguard between the management and the shareholders to help the shareholders to have some confidence that the numbers are true and fair." (paragraph 57).

- (c) are engaged in the audit process and have visibility of the auditor's work;¹⁶¹
- (d) understand and are able to judge audit quality, with reviews of audit quality and the value of service provided carried out annually by almost all FTSE 350 companies;¹⁶² and
- (e) are able to judge when they are not receiving the level of service required, and in those circumstances are prepared to and able to switch.¹⁶³

1.14 **Paragraph 43:** There is some discussion of whether ACCs have sufficient time and resource to carry out their duties. In our view, the vast majority of ACs carry out their duties very effectively, and have the time and resource to do so.¹⁶⁴ Any suggestion that ACCs do not have sufficient time or resource available is contrary to the finding that they take their duties seriously: if companies do find their time or resource inadequate, for example because of changes in company circumstances, they will take steps to ensure that they have resources available.¹⁶⁵

1.15 We set out our views on the need for improved reporting to shareholders by companies in our Response to Third Parties.¹⁶⁶ While we recognise and spend considerable time with investor groups seeking to improve understanding of the audit process, we do not accept - that any concerns about market competitiveness should arise from the limited visibility of shareholders of the audit process, given that it is the role of the AC to act on behalf of shareholders in the context of the understandable limitations as to the amount of detail shareholders can have.

2 Variables on which firms compete

2.1 **Paragraphs 49-51:** We agree that in general the AC/ACC and FD/CFO are the most influential participants in choosing an auditor. However, it is clear that shareholders have the powers under the current system to scrutinise the audit appointment or auditor performance through the regular interaction with management, or the Chairman, or the Senior Independent Director, whose role under the FRC Corporate Code (A.4.1) explicitly requires them to be available to discuss unresolved shareholder concerns.

2.2 Shareholders also have the ultimate power to prevent an auditor appointment. The example of case study Company A is relevant here, where a majority shareholder required management to

¹⁶⁰ See slides 27 and 29 of the CC's Survey which show "*Independence of the audit firm*", "*Ability to detect misstatements*", "*Efficiency of the audit process*" and "*High degree of challenge*" as the most important factors for both ACCs and FD when assessing audit quality. Similarly, for example, in the Company G case study, the Group Financial Controller said that "*in terms of the qualities that he required from an auditor, he considered independence, and quality and expertise, to be prerequisites*" (paragraphs 17 to 20).

¹⁶¹ For example, in the Company J case study, the Fund Accounting Manager stated that he had clear visibility on the auditor's work (paragraph 9).

¹⁶² See slide 46 of the CC's Survey.

¹⁶³ See slide 74 of the CC's Survey: 94% of FTSE 350 ACCs said they would consider switching due to "*complacency of the audit firm*".

¹⁶⁴ Indeed, following the introduction of the new Combined Code and the accompanying Smith Guidance in 2003, the acknowledgement of the increased role for ACs has led to individuals spending greater time on AC duties and receiving increased fees to recognise their increased contributions. This is supported, for example, by the Company D case study where the ACC confirmed that the AC had the resources and expertise to scrutinise the current auditors and management (paragraph 56).

¹⁶⁵ In this respect, the case studies provide several examples of the depth of ACCs engagement with the audit process, e.g. paragraph 16 of the Company A Case Study, paragraph 50 of the Company C Case Study, paragraph 39 of the Company E Case Study, paragraphs 52 and 54 of the Company G Case Study, paragraphs 55 and 60 of the Company H Case Study, and paragraph 39 of the Company I Case Study.

¹⁶⁶ See paragraph 3.10 and Box 3 of our Response to Third Parties.

change auditor.¹⁶⁷ All shareholders have the ability to raise auditor performance if the issue is of sufficient concern to them – the “shareholder spring” votes against executive pay increases show how the body of shareholders can change company practice.

2.3 **Paragraphs 52 to 61:** We note the CC’s Survey findings and we agree with the views expressed – in particular, the recognition by companies that the experience of the audit partner is critical to delivering the efficiency, challenge, independence and ability to detect misstatements that they value. This experience of auditing large FTSE 350 companies is exactly what mid-tier firms are unable to offer, and we believe a critical reason why they are not selected when they participate in tenders. We note the NSCP does not refer to two of the most telling slides in this respect in the CC’s Survey:

- slide 54 which shows that mid-tier firms are involved in 30% of FTSE 350 tenders – this represents a significant opportunity for them to win FTSE 350 audits; and
- slide 62 which shows that when the mid-tier are involved in tenders against the four largest firms (whether inside or outside the FTSE 350), they almost invariably lose.

This shows that even when companies engage in very detailed scrutiny of mid-tier firms’ capabilities, they prefer to use the greater experience and attributes offered by the four largest audit firms. This is entirely consistent with the CC’s Survey findings as to what companies value in their auditors.

2.4 **Paragraph 62:** The NSCP refers briefly to our client satisfaction surveys. In fact, in addition to these we provided a significant body of other evidence¹⁶⁸ gathered as part of our ongoing process of monitoring client satisfaction and striving to improve service. The CC does not appear to have given sufficient weight to this evidence given it shows clearly the views of companies on both PwC but also other audit firms, and evidences the continuous competitive pressure we are under.

2.5 **Paragraph 66:** We object to the CC suggesting that only “*most companies regularly carry out reviews...of audit quality and service*” (emphasis added). According to the CC’s Survey, 91% of FTSE 350 companies carry out such reviews every year, and 97% every three years.¹⁶⁹ “[M]ost companies” significantly understates this reality. This understatement should not be used to downplay more generally the degree of scrutiny of auditor performance outside the context of tenders. The CC highlights that it is unusual for companies to discuss partners’ experience and qualifications in annual negotiations, but does not consider whether this is because they are satisfied.¹⁷⁰ As the [§<] example discussed at our hearing showed, companies will demand changes in audit quality and team if they are not satisfied, and go to tender if these issues are not resolved.

¹⁶⁷ See paragraph 58 of the Company A case study where this is made clear: “Following the previous auditor’s decision not to seek reappointment (the ACC’s understanding was that there was a falling out between certain of the majority shareholder’s directors and the auditors), the audit was given to [another] audit firm.”

¹⁶⁸ See paragraph 13 of this response.

¹⁶⁹ See slide 46 of the CC’s Survey.

¹⁷⁰ See slide 60 of the CC’s Survey: overwhelmingly companies report positive reasons for not tendering, including 70% of companies cited one of the following three reasons for not tendering: “receive high quality service”; “receive good value for money”; “happy as things are”. See also paragraph 52-53 of this response.

3 Behaviour and bargaining power of companies

In the context of tenders

- 3.1 **Paragraphs 74-75:** We agree with the CC's conclusion that ACCs and FDs are highly qualified and experienced individuals, who act as sophisticated purchasers of audit services.
- 3.2 **Paragraphs 76-82:** It is also our experience that tenders are thorough and detailed processes, in which there is often fairly intensive interaction between the company and the bidders to ensure the necessary information is available to prepare a comprehensive tender proposal. Despite this detail, until the audit is actually undertaken, there will always be uncertainty about the amount of time involved which can differ materially from that estimated at the time of tender.
- 3.3 **Paragraph 83:** We therefore agree with the initial view that *"tenders are structured and thorough processes...managed by the FD and ACC, ie individuals with the knowledge and experience required to critically assess the bids submitted."*¹⁷¹
- 3.4 **Paragraph 84:** For the reasons outlined above we disagree with the CC's finding that innovation is not important in tenders. We also disagree with the CC's suggestion that the number of competent alternatives has any material effect on the company's bargaining power in the vast majority of cases.
- 3.5 The question of limited choice raises the underlying question of how much choice is enough in the context of the market for supply of audit services to the finite population of the FTSE 350. We include as Annex 4 an academic perspective on this question from Professor Steffen Huck. This concludes that in the context of markets where quality and reputation are critical factors, four or three suppliers may well be the most efficient number, producing the best maximum social welfare.
- 3.6 Indeed, our experience is that, provided the company has two or more good alternatives to choose from, it can play them off against each other to achieve a competitive result.¹⁷² As the CC's own analysis shows, the average number of firms invited to participate in a tender process is between three and four (**paragraph 145**), and so we do not accept that in practice limited choice has any detrimental effect on companies' bargaining positions.¹⁷³ We are not aware of any companies that have not been able to conduct tenders because of lack of credible choice. We note in particular that no company indicated it had not tendered in the last five years due to lack of choice in response to the CC's Survey¹⁷⁴, and the CC's Survey found that companies outside the FTSE 350 invite fewer firms to tender than do FTSE 350 companies.¹⁷⁵

¹⁷¹ Paragraph 83.

¹⁷² For example, on fees, the notion that we could set our audit price at a level just below that required to avoid a switch does not match the reality of dealing with a large company who will review, negotiate and compare against alternative providers. For example, [X] benchmarked themselves and negotiated a fee discount for the last two years (having received an unsolicited offer from one of our competitors). Similarly, [Y] benchmarked our fee against peers and negotiated a reduction in 2011.

¹⁷³ Our views on this were explained further in Section 4F of our Initial Submission.

¹⁷⁴ Slide 60, CC's Survey.

¹⁷⁵ Paragraph 46 of the CC's Survey WP.

3.7 The fact no company feels limited in its ability to tender because of lack of choice is consistent with our view that the issue of potentially limited choice has been overstated [§<].¹⁷⁶ As we have stated in our submissions, companies are able to require audit firms to tender should they wish to,¹⁷⁷ with the audit firm being likely to jeopardise its wider relationship with the company by simply refusing to tender. It may occasionally be the case that a company agrees with a firm that it would prefer the audit firm to remain a provider of only non-audit services, and in this case the company (rather than the audit firm) limits the choice of auditor available. However, we have seen numerous examples of firms (including ourselves in relation to [§<]) foregoing significant non-audit engagements and changing other arrangements in order to be eligible for an audit tender because a company desired it. We therefore disagree with the statement that audit firms are likely to participate in tenders except where they wish to retain non-audit engagements - the choice is the company's.

In the context of relationship with existing auditor

3.8 **Paragraphs 93-99:** The CC highlights difficulties it believes it has identified in companies comparing rival audit firms. Other than going out to tender, the CC believes there is limited opportunity for companies to make this comparison, because formal benchmarking exercises are the only source of such information and these are often limited to comparisons of fees and general considerations of expertise.

3.9 We strongly disagree with this finding which is contradicted by statements elsewhere in the NSCP, and unsupported by the CC's Survey and other evidence, as discussed in detail above in our response.

3.10 In terms of the formal benchmarking process itself, we note the CC's comments about the difficulty of making comparisons between firms given the individual nature of a company's activities, and also the CC's concern that not all companies undertake a formal benchmarking process. However, we believe the CC is unduly pessimistic about how benchmarking is used:

- (a) We have found it difficult to understand the basis for the CC's comment in paragraph 95 that "*about one-third of FTSE 350 companies did not carry out such benchmarking or other formal comparisons or request a formal proposal or presentation from the auditor before re-appointment*".
- (b) To the extent the "*one third*" is a reference to the 31% of FTSE 350 companies which the CC suggests have never carried out benchmarking or required a formal re-proposal, the CC has now acknowledged this figure was incorrect and should be only 10%. (Please see paragraphs 36(b)(ii) above in addition to our comments on this issue in paragraph 8 of our response to the CC's Survey WP.)
- (c) To the extent this is a reference to companies carrying out such activities only every five years, our understanding, using the figures in paragraph 38 of the CC's Survey WP, is that:

¹⁷⁶

[§<]

¹⁷⁷

See our Initial Submission paragraphs 4.55 and 4.56.

- 67% of FTSE 350 companies carry out benchmarking every five years;
- 61% undertake formal proposals before reappointment; and
- 47% do both.

Combining these figures, the percentage of companies who do not undertake either process is 19%¹⁷⁸ - considerably less than the “one third” referred to.

- (d) We should be grateful if the CC could explain its reasoning more fully because we are concerned that this statistic – which appears incorrect – is being relied on to a significant degree to support the assertion that information outside tenders is inadequate for companies to be able to ensure they receive competitive services.
- (e) We believe the CC has understated the evidence available to show the sophistication of various processes undertaken by companies to compare and assess alternative audit firms. For example, the CC suggests in paragraph 97 that a comparison with a small number of companies in the same sector may not be useful if the comparator fees are not themselves competitive. However, many companies have clearly considered and addressed this issue - see, for example, the Company G case study, which specifically explains that the company carries out cross-sector benchmarking to avoid the possible problem of distorted results within a relatively small group.¹⁷⁹

- 3.11 Other methods are available to check the level of the audit fee is reasonable - for example, many companies have rate cards negotiated with other firms for a variety of services including accounting, or employ other firms for internal audit or carve-out work. Other companies, [§<], seek indicative estimates before deciding whether or not to proceed to a full tender.
- 3.12 The CC has misused comments made by the four largest firms regarding the transparency of fees in the context of tacit co-ordination (**paragraph 98**) to support the suggestion that purchasers lack reliable information. As noted in our response to the Tacit Co-ordination WP, there is a significant difference between the level of fee transparency required in order for tacit co-ordination to be effective and the information a client needs in order to play off rival firms against each other or to compare offerings effectively.¹⁸⁰
- 3.13 To summarise, the CC's assertion that companies have “limited information” about other audit options available to them is inconsistent with the evidence:

¹⁷⁸ Our reasoning is as follows:

- 67% in total do benchmarking; 47% do both; so 20% do only benchmarking;
- 61% in total do formal proposals; 47% do both; so 14% do only proposals.

So the percentage doing at least one of the two processes is 47% (both) + 20% (only benchmarking) + 14% (only proposals) = 81%. This indicates that 19% do neither.

¹⁷⁹ Paragraph 112 of the Company G case study.

¹⁸⁰ As the CC has found, the conditions for tacit co-ordination are absent regardless of the question of fee transparency - see the Tacit Co-ordination WP.

- (a) ACCs and FDs do not report a lack of information about competitive options in the market or difficulty in obtaining information on alternatives.¹⁸¹
 - (b) Benchmarking and formal comparisons are widespread and sophisticated, and offer real insight into rival offerings where companies feel they need them.
 - (c) The CC fails to give sufficient weight to the value of informal sources of information about rival audit services. These, as mentioned above, are extensive and varied and have real practical value to the extent that companies do not need to incur the additional cost of formal comparisons.
- 3.14 What the NSCP overlooks is that, unless a company decides to tender for governance reasons, a decision to tender often takes place when dissatisfaction has not been corrected. This does not mean tenders are the only opportunity for companies to measure their competitive options, but that companies use their awareness of their competitive options to decide the point at which it is in their interests to conduct a full tender. We explain this process, and especially how it works outside of tenders, in our comments above on competition to retain engagements (see, for example, paragraph 23).

Credibility of threats to switch

- 3.15 The significance of losing a FTSE 350 audit means that firms invest considerable efforts in ensuring they provide the requisite service and quality to their current audit clients in order to avoid a formal tender. We have provided extensive evidence of the efforts we make in this respect.¹⁸² Given the direct and indirect costs to the audit firm of losing an audit, sophisticated ACCs and FDs are well able to use implicit or explicit threats to tender to enhance their bargaining position.
- 3.16 **Paragraphs 100-103:** The CC suggests that while threats to switch appear to be effective as a strategy to lower fees, audit firms are aware of the “*infrequency*” with which FTSE 350 companies tender their engagements and switch auditor, and this means that in particular cases a threat to switch would be less credible.
- 3.17 We have seen no evidence to support this conclusion, which fails to take account of the commercial reality including the extensive expenditure firms incur to try and win audit tenders, as recognised by the CC and explained in more detail in paragraph 23 in our response above. Given firms invest up to the equivalent of a year’s audit fees in contesting a tender,¹⁸³ it is not credible to suggest that they would not be sensitive to any hint that their existing audits might be put out to tender. Indeed, we have provided extensive evidence of client satisfaction

¹⁸¹ For example, see the “Company E” case study, where the ACC said that although the company was a unique business “*this did not hinder the effectiveness of benchmarking as there were similar companies in terms of size and complexity to which to compare the audit fee*” and given “*the ACC’s vast sector experience he also had contacts at other companies he could talk to about fees*” (paragraph 60).

¹⁸² See Section 3 of our Initial Submission in addition to paragraph 2.67 which sets out the material we collect (as referred to in paragraph 13 above - Client Perspective Reports, Independent Senior Partner Reviews, Client Satisfaction Surveys, Post Decision Reviews, Audit Relationship Risk Diagnostic) as part of our usual business activities (and which predate this investigation) to help us understand the views of current and prospective audit clients to ensure that we continue to offer the highest quality services, satisfy clients’ requirements and compete effectively.

¹⁸³ Paragraph 117 of the Selection Process WP.

monitoring, referred to above, all of which would be redundant if we did not believe the threat of a tender was credible.¹⁸⁴

- 3.18 In practice, an auditor cannot ignore any hint of a threat to switch. The auditor will not be involved in the internal discussions of management referred to by the CC (**paragraph 103**) and so will not know how the perceived costs and benefits of switching are balanced in any particular case. Without this knowledge, the auditor cannot assume that the threat to switch is not credible and hence is incentivised to continue to deliver a quality service.
- 3.19 Against this background it would be a huge risk for an auditor to gamble that a threat to switch is empty. We are acutely aware that any (actual or perceived) failures in our performance increases the risk of tender, and so we always regard the possibility that a company will consider switching auditors to be realistic and serious. Our Audit Relationship Risk Diagnostic tool¹⁸⁵ has been developed specifically to monitor such threats and allow us to act quickly to mitigate concerns where they arise, and our client satisfaction process always focuses on this point.¹⁸⁶

Costs versus benefits of switching

- 3.20 **Paragraph 105:** We agree with the CC's finding that there are inevitable costs for companies associated with switching auditors. However, the CC should not overstate the impact of switching costs - the consistent evidence from case studies and the CC's Survey is that the "hassle" created by switching auditor does not prevent companies from tendering. For example, the Company G case study shows that companies are willing to incur switching costs if unhappy with the quality of the audit service: the ACC noted that "*switching auditor would be a huge exercise and had a huge risk associated with it*" and would be "*a major disruption to the company and would divert significant amounts of management time*", but that the company would tender if it thought that the quality of the team being allocated to its audit was not adequate and that over a period of time the audit firm had not responded to the company's needs and complaints.¹⁸⁷
- 3.21 **Paragraph 107:** This is confirmed by the evidence provided by EY, BDO and the CC's own analysis. The CC's Survey also shows that switching costs are not prohibitively high and that companies are prepared to switch where the auditor shows any signs of complacency or otherwise fails to perform.¹⁸⁸
- 3.22 Moreover, as explained in our response to the Survey WP, we have concerns about the basis for the statement that: "*nearly 40 per cent of surveyed FTSE 350 companies said that they had*

¹⁸⁴ See paragraph 13 above.

¹⁸⁵ The Audit Relationship Risk Diagnostic is a live document, which is updated with new responses for particular companies. [X<]

¹⁸⁶ See Figure 8 of our Initial Submission [X<]

¹⁸⁷ Similarly, mid-tier firms have stated that "*customer switching costs can be overstated*" (BDO Response to Issues Statement, paragraph 5.3.3) and that "*on an appropriate timescale, the cost of changing auditor is unlikely to be unpalatably restrictive to large companies and their investors*" (GT Response to Issues Statement, paragraph 9.7).

¹⁸⁸ See CC's Survey, showing 94% of ACCSs (slide 74) and 86% of FD/CFOs (slide 68) FTSE 350 companies would be likely or very likely to tender if faced with auditor complacency. Given this very high majority of FTSE 350 companies that would be likely to tender if the auditor was complacent, the CC cannot suggest auditors might become complacent because the threat to tender was not credible.

not tendered because of the costs involved in tendering and switching including the disruption and the loss of the benefits of continuity” (paragraph 111).

- (a) It appears that this may be based on paragraph 48 of the Survey WP (which states that, in responding to why they had not tendered in the last five years, 25% of FTSE 350 companies cited the disruption and costs involved in tendering audits and changing auditors and 12% mentioned the benefits of continuity).
- (b) However, this does not appear to accord with Slide 60 of the CC’s Survey, which shows that reasons for not tendering given by FTSE 350 companies included the following: disruption/getting new auditors up to speed - 16%; tendering too costly and time consuming - 13%; and continuity/familiarity - 6%.
- (c) The figures in Slide 60 do not add up to nearly 40% or match the figures in the NSCP. In any event, it is not appropriate to add such figures together, given that doing so for all the reasons cited in Slide 60 gives a total of 172%. Among the 40% of companies identified, it seems likely that a number referred to “positive” reasons for not tendering such as high quality service; good value for money; and the fact that these companies are happy with things as they are. If this is the case, the CC should acknowledge the breakdown. Further, to the extent that companies also included positive reasons for not tendering, this would be consistent with the finding that companies would almost universally tender at any sign of auditor complacency. Finally, in our view, if a company decides not to tender because it values continuity of the current auditor and its familiarity with the business, this is an indication that it sees positive value in its current arrangements, not because of difficulties in the tendering and switching process itself.

3.23 **Paragraph 110:** The CC acknowledges that the survey evidence supports this alternative explanation - the majority of companies who had not tendered recently indicated that this was because quality was good and/or fees competitive. Indeed, as explained in more detail in our response to the Survey WP, we believe that the way the results of the survey are presented on this point understates the positive reasons for companies to stay with their current auditor - according to the survey, 70% of companies who have not tendered in the last five years have taken this approach because they receive good quality and/or competitive fees and/or they are happy as things are. Further positive reasons offered for retaining a current auditor included that partner rotation keeps things fresh (15%), there are benefits in achieving continuity and benefiting from the current auditor’s familiarity with the company (6%), the existing auditor understand the company business (7%), and benchmarking indicated the company was getting good value (8%).¹⁸⁹

3.24 **Paragraph 111:** We disagree with the tentative conclusion the CC draws that companies may have decided not to switch auditor because they underestimated the benefits from doing so as a result of limited information on their options. This conclusion does not follow from the evidence

¹⁸⁹ Survey WP response, paragraph 3.5.

the CC has received. Low switching rates could have a number of causes, including that informed companies are in general happy with the service they are receiving.¹⁹⁰

- 3.25 However, the CC appears to be prepared to discount this evidence, obtained from individuals that it has described as highly qualified and experienced, on the basis that they were acting under a misapprehension about the options available to them in the market. To argue that such sophisticated buyers - who have concurrent experience of alternative auditors from other roles, plus long careers of dealing with auditors – are unable to gauge the options available to them is not credible on the evidence available. It is also not credible to suggest that if they felt uncomfortable with their ability to gauge whether their current audit service is effective they would fail to tender, when tenders are so effective.
- 3.26 We provide further evidence in Annex 3 showing that companies which tender are no more or less profitable for PwC, than other audit clients. The benefits of switching are strongest where the existing auditor is failing to perform, but it is also the case that an increasing number of companies are now deciding to tender for corporate governance reasons.

Choice available to FTSE 350 companies

- 3.27 **Paragraph 119:** The CC notes that the survey results show that a substantial proportion of companies would not consider switching outside the four largest audit firms for reasons including size and geographic coverage, sector knowledge and experience. We agree that these are likely to be relevant factors for companies in choosing an auditor, and that they are typically areas where the four largest audit firms are strong.
- 3.28 **Paragraph 120:** The CC also suggests that this preference for the four largest audit firms may reflect the backgrounds of the individuals concerned - especially that the majority of ACCs and FDs have previously worked for one of the four largest audit firms. We strongly disagree with this view:
- (a) There is little evidence to support individual preference being a relevant factor in auditor choice: the survey indicates that only 14% of companies who limited tenders to the four largest firms did so because of prior/personal experience.¹⁹¹ Even those 14% of cases are unlikely to all have been due to the employment background of the individuals concerned, but rather will include previous or current experience of working with various firms.
 - (b) The individuals concerned - ACCs and FDs - have left employment by the four largest firms, in some cases many years previously. Indeed, the evidence indicates that more than 71% left over ten years ago.¹⁹² The circumstances of such departures will obviously

¹⁹⁰ Paragraph 195 of the NSCP.

¹⁹¹ Slide 56 of the CC's Survey.

¹⁹² Our research shows (based on data as at 12 August 2012) that of the 59 current FTSE 100 FDs with a background of having worked at one of the four largest audit firms, more than 71% had left their alumni firms over ten years ago. Moreover, it is only in a very small proportion of cases that the appointed audit firm is the same audit firm for which the FD worked (and even where the firm is the same, in most if not all cases the auditor was in place prior to the FD's appointment).

vary but may not always have been positive or likely to incline such individuals to view their previous firms in a positive light.

- (c) Even if an individual did have a preference for a particular firm because of past employment, it is not clear why such an individual would also prefer one of the four largest firms of which they have no personal experience over a smaller firm.
- (d) The evidence indicates that the proportion of ACCs and FDs with employment history at any of the four largest audit firms is broadly similar in the AIM and TopTrack to the FTSE 350.¹⁹³ However, in the AIM and TopTrack markets there is much wider use of mid-tier firms, suggesting that there is no particular correlation between the background of ACCs and FDs and choice of audit firm.
- (e) Finally, the CC fails to take into account its own finding that these are highly qualified and experienced individuals, who take their duties and responsibilities seriously and are unlikely to allow personal preferences to affect the performance of their professional obligations.

3.29 **Paragraphs 122-123:** The CC notes that some companies may feel their choice is restricted by pressure from lenders or shareholders. We deal specifically with the issue of auditor clauses in loan agreements in our response to the Report on Auditor Clauses in Loan Agreements, and with the impact of reputation in our response to the Barriers to Entry: Reputation and Experience WP. In short:

- (a) We have very limited experience of external formal requests for a company to choose one of the four largest audit firms. From examination of the evidence gathered by the CC it appears that such requests are rarely limited specifically to only the four largest firms. To the extent that any such preference is expressed, this reflects a desire on the part of advisers, lenders or shareholders to ensure the company has a robust audit and that the markets be able to recognise this.
- (b) There is no compelling evidence of lenders or others of having an undue influence over auditor appointments.¹⁹⁴

3.30 The CC concludes that it believes there may be a large minority of FTSE 350 companies who consider their choice between the four largest audit firms to be limited for a variety of reasons, including conflict and independence issues. These points have been dealt with above in paragraphs 55-59. In short, we do not agree that any limitation is such that companies cannot hold a competitive tender.

¹⁹³ See paragraph 24 of the CC's Survey WP.

¹⁹⁴ Slide 56 of the CC's Survey shows that only 2% of FTSE 350 companies gave "investor perceptions and financial institutions expect a Big 4 auditor" as a reason for including only the largest four firms in tenders.

Incentives to switch

- 3.31 **Paragraph 133:** The CC finds that FDs have a limited incentive to initiate a tender process to achieve a reduction in fees alone, unless these are expected to be substantial, given the work involved in a tender process.
- 3.32 We disagree with this conclusion and believe it is not supported by the CC's own evidence:
- (a) The CC fails to appreciate the commercial reality regarding fees. While the reduction in fee that may be gained from a tender may be relatively small in the overall company context, no FD of a FTSE 350 company is prepared to pay inflated fees for audit services. Given that audit fees are published, to pay a high fee would set a bad precedent and raise concerns about the FD's ability to control costs more generally. Our experience is that FDs will, as experienced professionals, maintain constant pressure on fees, up to and including switching auditor if necessary.
 - (b) The NSCP acknowledges that companies can achieve fee reductions without needing to go to tender through using their bargaining power in negotiations – indeed the CC's data clearly shows they have succeeded in doing this and driving down audit fees in recent years,¹⁹⁵ in the vast majority of cases without resorting to full tenders.
 - (c) In addition, the CC's Survey data shows an approximately even split between reasons for switching auditor, with quality and avoiding complacency both receiving 30% of responses and price and sector expertise receiving 26%. This is inconsistent with a finding that fees are unlikely to be a relevant incentive for initiating a switching process.
 - (d) The CC's case studies illustrate that large companies are keen to ensure that their audit represents good value for money as well as the required level of quality and that they are prepared to tender if necessary. For example:
 - (i) Company D: “[t]he main driver of the decision to tender was the previous auditor seeking a substantial (60 to 70 per cent) increase in the audit fee” unrelated to changes in the company's business and this was a trigger for the company to test the market;¹⁹⁶
 - (ii) Company B: the FD indicated that he wanted to switch auditor for price reasons as “[h]e felt [the current auditor] was a bit expensive. He would like to reduce the audit fee by 10 to 15 per cent.”¹⁹⁷
 - (iii) Company G: The Global Financial Controller indicated that “a slip in independence, skills or value” (emphasis added) would trigger a tender.¹⁹⁸

¹⁹⁵ The CC's analysis shows that companies have been successful in driving down audit fees: average auditor hours per engagement have remained broadly static from 2006 to 2011, while average auditor fee per hour has fallen around 15% in nominal terms (and therefore by a higher amount in real terms). See paragraph 35 of the CC's Descriptive Statistics WP and Figure 9 (with which we were provided by the CC in a putback dated 5 September 2012 - “Engagement Data Descriptive Statistics - PwC”).

¹⁹⁶ Paragraph 16 of the Company D case study.

¹⁹⁷ Paragraph 17 of the Company B case study.

Costs of tenders to audit firms

- 3.33 **Paragraphs 138-140:** As explained in paragraph 3.15 above, we agree with the CC's findings on the high cost to the existing audit firm of a tender process, both in terms of the work involved in participating in a tender and the high risk of losing the audit as a result of the tender.¹⁹⁹
- 3.34 Indeed, switching costs exist for both the company and the current audit firm. Both parties make relationship-specific investments in the audit, and as a result they both have an incentive to make the relationship work if possible, with the costs of failing to do so likely to be more significant for the audit firm – in terms of immediate loss of revenues, the high costs of tendering in seeking alternative clients, and potential harm to reputation – than they will be for the company.

Bargaining position of companies with existing auditors

- 3.35 **Paragraph 141:** We fundamentally disagree with the CC's conclusion that companies have a weak bargaining position with respect to their existing auditor outside of a tender process. Furthermore, we note that the CC did not ask companies to provide views on this point in either the case studies or the CC's Survey. However:
- (a) the CC acknowledges that companies can achieve fee reductions if they negotiate;²⁰⁰
 - (b) fees are going down in real terms showing company buying power;²⁰¹
 - (c) companies are generally happy with audit quality as the CC's Survey indicates;²⁰²
 - (d) companies themselves have said clearly that they can maintain competitive levels of service from their auditors; and²⁰³
 - (e) the case studies we provided in Q87 of our MFQ Response, including client correspondence where available, clearly show companies negotiating hard and successfully.

4 Strength of competition during tenders

- 4.1 **Paragraph 145:** We agree with the CC's finding that typically firms invite at least three, and often four firms to tender.

¹⁹⁸ Paragraph 22 of the Company G case study.

¹⁹⁹ For example, proposal costs can be significant. Our analysis shows that, based on a small sample of seven proposals drawn from the period 2009-2011, proposal costs ranged from [\times]. See also paragraph 5.42 and 5.43 of our Initial Submission on the lengths firms go to in order to win audit appointments.

²⁰⁰ Paragraphs 64 to 66 and 175 of the NSCP.

²⁰¹ The CC's analysis shows that companies have been successful in driving down audit fees; average auditor hours per engagement have remained broadly static from 2006 to 2011, while average auditor fee per hour has fallen around 15% in nominal terms (and therefore by a higher amount in real terms). See paragraph 35 of the Descriptive Statistics WP and Figure 9 (with which we were provided by the CC in a putback dated 5 September 2012 - "Engagement Data Descriptive Statistics - PwC").

²⁰² Slide 60 of the CC's Survey

²⁰³ See for example the views of the Hundred Group set out in footnote 7 above and of Company G in the case study in which the ACC said "PwC knew only too well that the company could tender and so there was a dynamic, mutually respectful relationship." (paragraph 75).

- 4.2 **Paragraph 146:** We note that the CC believes that there are factors that limit choice between the four largest audit firms. As explained above in paragraphs 55-59, we consider that conflict and independence issues have a minimal effect on choice.
- 4.3 The CC also refers to lack of experience as a possible limiting factor in certain cases, but this seems to be a relevant consideration in only a very limited number of cases as there are few market sectors identified by the CC where there is even one of the four largest audit firms with a small presence. As the evidence shows, the four largest firms can pursue various approaches to address their apparent lack of experience for any given audit - for example, through lateral hires to bring in relevant experience or leveraging experience gained from non-FTSE 350 companies (including large private companies or those based overseas). An advantage of large global networks is the ability to bring in overseas talent to support audit tenders, as was the case for example with [redacted], where we brought a US partner across to lead the team.²⁰⁴ EY, which has been highlighted as the only large audit firm not to audit one of the four leading UK banks, has extensive banking experience outside the UK and a shadow team operating at [redacted] which it could use to make a credible pitch for any of the UK bank audits should the opportunity arise.²⁰⁵
- 4.4 Indeed the Market Definition WP noted that all of the four largest firms were capable of competing in each industry sector and had a record of doing so.²⁰⁶
- 4.5 **Paragraphs 162-164:** We agree with the CC's initial view that there are strong incentives for firms to compete aggressively when tender opportunities arise, particularly given that the demand for statutory audits by FTSE 350 companies is fixed, and firms must displace competitors to expand their market share. We note that the constant churn of FTSE 350 companies enhances this effect with effort required not just to retain and win audits within the FTSE 350 but also to compete for the business of new entrants.²⁰⁷
- 4.6 Fierce competition does not only arise during a tender process but more generally - audit firms have every incentive to be continuously alive to potential opportunities all the time, in the hope of prompting a tender (this is acknowledged in **paragraph 176** of the NSCP) but most importantly to be well placed if a company is dissatisfied with its current audit firm and decides to tender. We have provided extensive evidence of this and the investments that are made in targeting, innovation, marketing and thought leadership in order to enhance our ability to win tenders, as recognised by the CC in the Firms' Stated Competitive Strategies WP and demonstrated in the Annex.²⁰⁸

²⁰⁴ See paragraph 4.63(b) of our Initial Submission.

²⁰⁵ See paragraph 4.64(a) of our Initial Submission.

²⁰⁶ Paragraph 34 of the Market Definition WP.

²⁰⁷ See our Initial Submission, paragraphs 4.4 - 4.23, setting out use of market shares in isolation to indicate competitive activity must be treated with caution as an apparently static market shares disguise the significant "churn" of companies entering and exiting the FTSE 350 and the constant effort made by audit firms to retain market share by competing to win audits for companies that enter (or have potential to enter) the FTSE 350 as well as the audits of companies switching within the FTSE 350. This churn is shown in detail in the infographic available on the PwC website at <http://www.pwc.co.uk/who-we-are/the-uk-statutory-audit-market-infographic.html>.

²⁰⁸ See the Firms' Stated Competitive Strategies WP: e.g. "[a]ll the firms have adopted in some for the strategic objective of increasing their market share and revenue and to that end have instigated arrangements to win new clients" (paragraph 4); "[a]ll the firms seek to win work from new clients...and refer to the importance of building a relationship

- 4.7 **Paragraph 166:** There is no evidence to support the suggestion that the fact that not all four firms may participate in a particular tender is a disincentive to companies deciding to tender:
- (a) In fact, the number of firms which participate in what the NSCP recognises as the current effective tender process is often only three or even two.²⁰⁹
 - (b) No companies say that their decision not to tender was influenced by an absence of choice, and even where one or more firms may appear to face obstacles in acting as auditor, these can invariably be overcome should the company require it. Auditors cannot readily reject a request that they participate in a tender where a company desires it and hope to maintain a good relationship with the company.²¹⁰
 - (c) Academic opinion suggests that markets with the characteristics of audit are at their most efficient with four or fewer competitors, as explained by Professor Steffen Huck in Annex 4.
- 4.8 **Paragraph 167:** We note that the CC intends to consider further the extent of competition on innovation in proposals. As explained above in more detail (at paragraphs 1.4-1.9), we do not believe the CC's analysis currently appreciates fully the role of innovation in competition during tenders.

5 Strength of competition in the retention of engagements

- 5.1 **Paragraph 169:** The CC identifies this as an important section in its analysis, particularly given that in its view tenders are relatively "infrequent".²¹¹ Against this background, it is important to note that the CC identifies a number of factors that demonstrate strong competition among firms to retain audit engagements.
- 5.2 In particular:
- (a) **Paragraph 176:** Sometimes competing firms persuade companies to challenge the incumbent auditor, thus demonstrating competitive pressure being brought to bear by firms trying to win new clients.
 - (b) **Paragraph 177:** Firms invest significantly in seeking feedback from clients to understand their performance and clients' views. In PwC's case, these efforts are explained in detail in paragraph 13 of this response.

²⁰⁹
²¹⁰
²¹¹

with clients before a tender situation occurs" (paragraph 18); "[a]ll [firms] engage in marketing through programmes of thought leadership and sponsorship of events and awards." (paragraph 42).

See paragraph 145 of the NSCP.

[><]

We disagree with the suggestion that tenders are relatively infrequent. It is not clear what this is relative to, but we believe the market outcomes in terms of prices, profitability and quality show clearly that the level of tendering is sufficient to ensure effective competition. See paragraphs 26-33 of our response above.

- (c) **Paragraphs 178-182:** Firms have strong incentives to avoid clients going out to tender, because of the work involved and the risk of losing the engagement with the associated consequences. This point has been addressed above.²¹²
 - (d) **Paragraph 192:** As also explained above, FTSE 350 companies are experienced and knowledgeable buyers that have a degree of bargaining power when renegotiating engagements, and can use the threat of switching to obtain better terms.
 - (e) **Paragraph 196** While in theory the CC believes that audit firms could increase fees in the early years of an appointment (because clients do not want to switch auditor too frequently) in practice this does not appear to happen - fees are often fixed for three years in tender proposals and the CC's evidence indicates that fees in fact decline after the first years of engagement. This provides strong evidence that there is in fact ongoing competitive pressure on fees, which prevents audit firms from taking advantage of a possible opportunity to increase them. See Annex 3 for further evidence in this respect.
- 5.3 **Paragraph 193:** Despite the evidence, the CC appears to believe that some FTSE 350 companies are not active in the management of their audit relationship. Three reasons are cited in this respect:
- (a) they do not tender frequently;
 - (b) they appear to accept automatic adjustments to fees for inflation; and
 - (c) they do not carry out formal benchmarking.
- 5.4 There is simply no basis in the evidence for the CC's position:
- (a) We have not seen any evidence to suggest there are any large companies that in combination allow inflation fee increases, do not formally benchmark, and tender infrequently. There is no basis to link this set of characteristics.
 - (b) As explained above, the number of FTSE 350 companies who do not formally benchmark is relatively small, and much smaller than the CC erroneously believed when preparing the NSCP, with only 10% never having done so. Moreover, the significance of formal benchmarking is exaggerated as sophisticated ACCs and FDs can informally assess auditor performance and their options through various sources, and there is evidence of almost universal use of these sources every year.
 - (c) We explain in more detail in our response to the Selection Process WP the negotiations that typically surround inflationary fee increases. Acceptance of inflationary fee increases only indicates that the company believes it is paying an appropriate fee and that this should increase in real terms to reflect inflation as otherwise this will diminish the audit firm's ability to continue providing the level of service it is currently offering. Companies are well aware of the competition in the market for talented individuals and the need for

²¹² Paragraph 3.17 above.

audit firms to reward talent or risk losing it. Indeed, as shown in Annex 3, the data suggests that acceptance of inflationary fee increases is rare, with more significant year on year changes driven by negotiations around audit scope.

- (d) In contrast with the suggestion of allowing inflationary fee increases, there is indisputable evidence that audit fees have been driven down through companies negotiating aggressively in recent years, in most cases outside the context of tenders.²¹³ In **paragraphs 64-66**, the CC discusses factors considered in the renegotiation of audits, and we note the recognition that when companies ask for fee reductions, these are often secured – this clearly shows the buyer power that exists outside tenders.
- (e) It is clear that companies will tender where they feel a need to do so, with the CC's Survey showing that over 94% of ACCs and 86% of FDs of FTSE 350 companies would be likely to do so were their auditor to show any sign of complacency.²¹⁴
- 5.5 Companies will do what is right for them, having regard to their own circumstances and business priorities which may change from time to time. We therefore believe that it is wrong to characterise the behaviour of any subset of companies as not being “active” without specific evidence, particularly as it is counter to what would be expected of sophisticated buyers at the largest companies in the UK. Nor do we believe that the CC should conclude that there is a problem in the market as a whole even if there was evidence of some inactivity at a small minority of companies not representative of the whole. Indeed, even if an audit firm felt a particular client was not monitoring its options as effectively as it should at a particular time, it would be very unwise to rely on this as a likely stable state of affairs and take advantage of the situation. The company could easily and quickly change approach for a number of reasons - including the frequent changes that take place of ACCs and FDs. Unsurprisingly, there is no evidence that firms do seek to exploit any such customers, even if they could be identified.
- 5.6 **Paragraph 192:** Further, we disagree with the CC's initial view that re-negotiations are limited to the consideration of the audit fee. Almost all companies engage in annual reviews of audit quality as well as value,²¹⁵ and this is a factor in annual discussions ahead of reappointment. While it is not possible to agree a quantified increase in “*quality*”, it may be that the audit scope is increased if the company has concerns that insufficient scrutiny was given to particular aspects, or there may be challenge of particular members of the audit team, including the lead partner. Of course, if a company is not satisfied by the responses given by the audit firm, it will initiate a tender.
- 5.7 **Paragraph 194:** The CC repeats its concerns, identified earlier in the NSCP, about the possible effect of limited information on the ability of companies to assess the competitiveness

²¹³ “*Engagement Data Descriptive Statistics - PwC*” provided to PwC by the CC in a putback dated 5 September 2012. As mentioned above, the CC Engagement Data shows that companies have been successful in driving down audit fees: average auditor hours per engagement have remained broadly static from 2006 to 2011, while average auditor fee per hour has fallen around 15% in nominal terms (and therefore by a higher amount in real terms).

²¹⁴ See slides 68 and 74 of the CC's Survey.

²¹⁵ Slide 46 of the CC's Survey shows that 91% of FTSE 350 companies carry out annual review of the quality and value of the audit provided.

of their audit service. For the reasons explained in detail above, we believe the CC's view that companies potentially have limited information about rival audit providers is wrong.

- 5.8 **Paragraph 195:** Rather, we believe the CC more accurately describes the way the market operates when it says:

“Where companies are well informed as to the alternatives available to them, switching costs are low (relative to the potential gains), and they have a choice of audit firms, then low switching rates may be consistent with firms facing strong competitive pressure to retain clients.”

- 5.9 Where we disagree with this quotation is with the CC's characterisation of switching rates as “low” - this is a subjective view not based on the evidence. The evidence shows large companies are well informed as to their alternative options, and as such will tender and switch where necessary to secure good service and competitive pricing - thus switching levels are “appropriate” to purchaser demand. Equally, while switching costs can be material (for both the company and the audit firm) this only makes the threat to tender more potent. Audit firms do face strong competitive pressure to retain clients - the evidence of their efforts to ensure their own clients' satisfaction and target rivals' clients would otherwise make no sense. It is borne out by the evidence submitted to and gathered by the CC to date.

ANNEX 3

ECONOMIC EVIDENCE ON THE EFFECTS OF SWITCHING

There is no relationship between PwC client profitability and tenure

- 1 Figure 11 in our Initial Submission (reproduced below as Figure 1) shows the profitability of each of PwC's FTSE 350 audit clients plotted against the length of tenure of these engagements.
- 2 Figure 1 shows that there is no relationship between the profitability of our FTSE 350 audit engagements and the tenure of these engagements (i.e. that competitive pressure is effective outside tender situations).²¹⁶

Figure 1: [X]

Non-switchers frequently negotiate substantial changes in audit fee

- 3 Figure 2 shows a frequency distribution of the percentage annual change in audit fees that are paid by non-switching FTSE 350 audit clients during the period 2000-11.²¹⁷
- 4 The key points to note from Figure 2 are:
 - (a) Non-switching audit clients negotiate flat or reduced prices 42% of the time.
 - (b) There were relatively few observations of modest price increases. Only 17% of nominal price changes were between 0% and 10%.
 - (c) Non-switching audit clients negotiate substantial (greater than 10%) fee increases 41% of the time.
- 5 The above is clear evidence of active negotiations on the part of non-switching clients. It is inconceivable that such variability in fees would be the result of passive interactions between companies and audit firms, or that in these discussions fees would be considered in isolation from audit quality and/or scope.

²¹⁶

[X]

²¹⁷

The following should be noted in relation to Figures 2 and 3:

- (a) We define a non-switcher as a company that has been with its auditor for 4 years or more.
- (b) Our definition of non-switching clients includes those companies which have never switched during the period covered by the Industry Dataset (which covers 2000-11). It is therefore possible that a small number of some of these clients may have a tenure of less than 4 years for some periods e.g. if a client switched in 1999.
- (c) We define a FTSE 350 company as a company that was in the FTSE 350 index in the third quarter of the year in question. This is the same definition as that used by the CC.
- (d) The CC's Industry Dataset includes some 3,124 observations of year-on-year price changes experienced by FTSE 350 non-switchers. We define price as audit and audit related fees. All price changes presented are nominal year-on-year price changes.
- (e) Over the data period (2000-2011) the average annual rate of inflation (CPI) was 2.5%.

- 6 In the interests of completeness, in Figure 3 we show the same type of analysis but covering 2007-11, a period when price pressure has been particularly intense. The analysis covers a smaller number of data-points (1,361 compared to 3,124).
- 7 We see the same general pattern but:
 - (a) A higher proportion of clients (48% as compared with 42%) negotiated flat or reduced prices.
 - (b) A smaller proportion of clients (33% as compared with 41%) negotiated substantial fee increases.

Figure 2: Nominal audit fee prices changes for FTSE 350 non-switchers

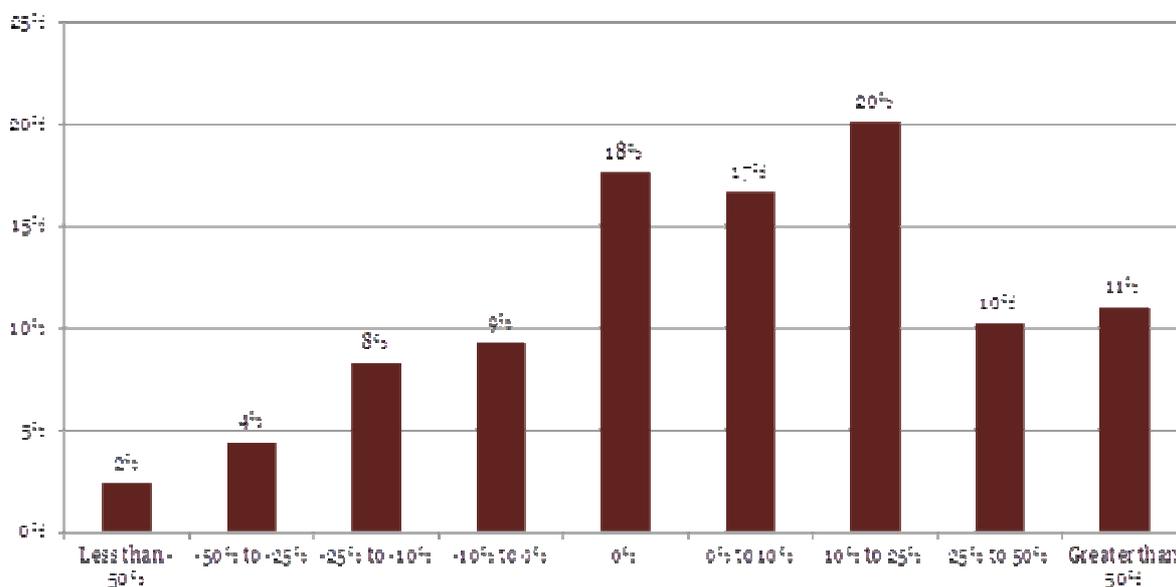
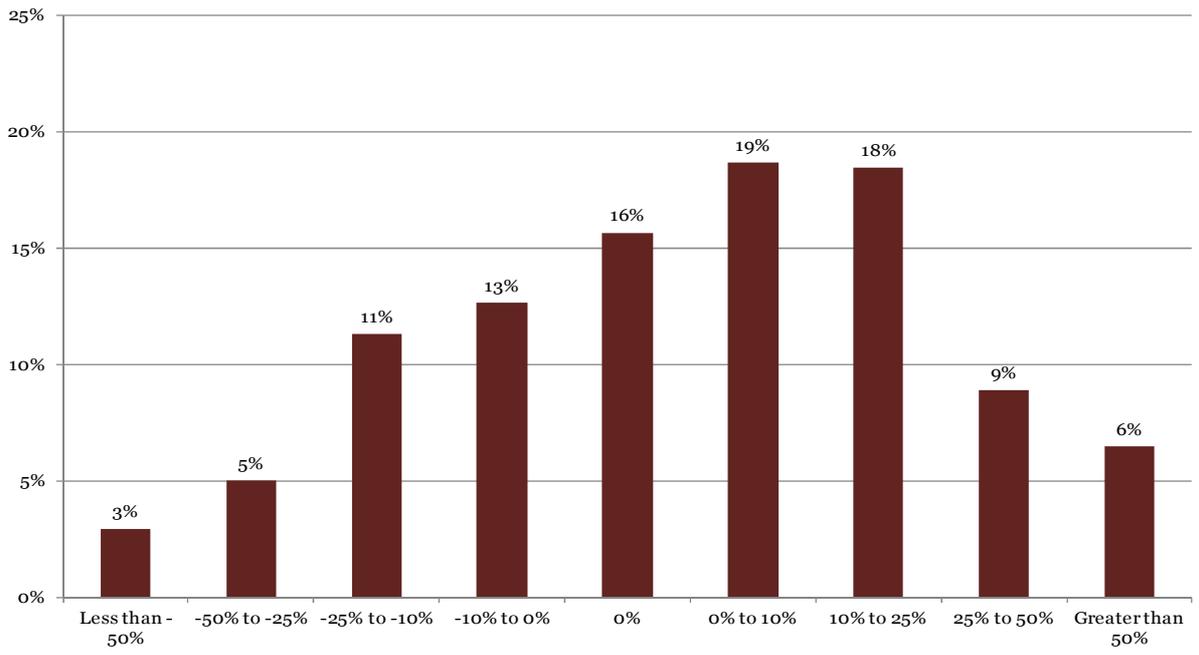


Figure 3: Nominal audit fee prices changes for FTSE 350 non-switchers from 2007 to 2011



ANNEX 4

OPINION OF PROFESSOR STEFFEN HUCK

Competition in the audit market: Is $n=4$ enough?

Introduction

- 1 I have been asked by Norton Rose LLP to consider the question of how many competitors (what n ?) would be required for competition to be effective in a market with the characteristics of the market for the supply of statutory audits to large companies.

Credentials

- 2 I have a Diploma (MSc) in Economics from Goethe University in Frankfurt, a PhD in Economics from Humboldt University in Berlin and a Habilitation in Economics also from Humboldt University. I am Professor of Economics at University College London (since 2003) where I served as Head of Department from 2008-2011 and I am Director of Economics of Change at the WZB in Berlin (since 2012).
- 3 I have published over 70 articles in peer-reviewed economics journals and according to Repec's h-index I am in the world's top 2% of most frequently cited economists. I am a member of the editorial boards of two of the "top 6" general interest journals in economics as well as the leading field journals in game theory and experimental economics. In 2004 I received a Philip Leverhulme Prize in Economics.
- 4 Over the last few years I have been advising UK regulators such as OFT and Ofcom on issues in behavioural economics and competition and I was a lead team member on the first ever behavioural economics study commissioned by the European Commission.

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- 1 The question of how well markets perform as a function of the number of competitors is as old as economics is as a discipline. The classic models (Cournot, Bertrand, Stackelberg) all suggest substantial welfare gains as one moves from a monopoly to some level of competition. However, marginal welfare gains tend to drop sharply as the number of competitors increases. For example, in Cournot markets with linear demand and costs (i.e., the workhorse model in the economics of industrial organisation), where n is the number of competitors, $n=4$ achieves 96% of maximum social welfare, while adding a fifth firm would only add an extra 1%.
- 2 The modern literature on industrial organisation (in particular, following the game theoretic revolution of the late 70s and 80s) has drawn attention to many relevant market characteristics that can have a profound effects on market performance and provides challenges to traditional ideas of “more competitors results in more effective competition”, starting with the analyses of adverse effects of free entry (see, for example, Weizsacker 1980).
- 3 In this brief note, I consider some of the key characteristics that I deem relevant for the market for statutory audits of large firms and discuss their consequences for the question of whether or not $n=4$ should be expected to deliver good market performance.

Audit as an experience good or the role of asymmetric information and reputation

- 4 I note that the CC is minded to think that the statutory audit is an experience good - i.e. that in purchasing an audit in any given year the purchasers cannot know in advance whether the auditor will provide a good service in terms of identifying inaccuracies in the financial statements, or otherwise. In making purchasing decisions, companies must instead rely on available indicators that the auditor will provide a good service - including previous direct and indirect experience of working with the audit firm, comparisons with direct and indirect experience of other audit firms, and the firm's wider reputation.
- 5 However, it has been well known since at least Satterthwaite (1979) that in markets for experience goods the presence of more competitors can spell bad news for buyers. This is because as information becomes more dispersed, search becomes less efficient and sellers can charge higher prices to their customers.
- 6 Recent experimental research has shown how in markets where quality of services cannot be fully ascertained before their provision, long-term relationships are formed endogenously and switching rates become small (Brown, Falk, and Fehr 2004). Huck, Lunser, and Tyran (2012) show, in addition, how in such markets, where trust is crucial, market structure becomes very swiftly highly concentrated (in this study, starting with four symmetric firms, concentration is such that, on average, the two biggest firms capture 80% of the market). Buyers for whom quality matters want to avoid risks and choose suppliers with the best reputations and in relation to whom direct and indirect experience shows performance levels are likely to be high. Very small differences in reputations (which are based on hard fact) can have a significant impact on long-term market shares. In fact, they show how even starting from only four (symmetric) suppliers, market shares often become concentrated among only a subset of these suppliers.

In a companion study they also show that price competition becomes extremely fierce despite this concentration (Huck, Lunser and Tyrann 2008).

- 7 If the CC continues to consider audits as an experience good, then it should note that the literature firmly shows that, relative to standard models of competition, a relatively smaller n will be desirable.

Investments into quality

- 8 If quality of services matters and suppliers can make investments into quality (that serve as credible signals to purchasers via direct and indirect experience of these investments, and hence the audit firm's reputation), it has been known at least since Sutton (1991) that competition can generate what are referred to as endogenous barriers to entry, and "natural oligopolies" may arise. While in the case of endogenous barriers created through advertising (a case Sutton emphasises) the creation of these barriers might be considered to be socially wasteful, this is not the case for investments into quality – such as recruitment of the best graduates, rigorous training of staff, development of methodologies and processes, and the development of international networks.
- 9 Indeed for markets where buyers' principal concern is quality (and where, as in the case of statutory audits for the largest firms, market size is more or less exogenously fixed) it can be shown that the optimal number of competitors can be as small as $n=2$ (Harmgart and Huck 2003). The intuition for this result is simple: with fixed total demand, investments into quality pay less and less.
- 10 Finally, as pointed out in a seminal paper by DeAngelo (1981), size itself is a driver of audit quality, simply because size serves as collateral for deviating from high-quality provision of services. Large audit firms stand to lose more from providing low quality services than do smaller firms.
- 11 Again, to summarise: compared to standard models, in markets where investments in quality are particularly important, we generally see that the optimal number of competitors be lower than is suggested by classic models of competition.

Network size and increasing returns to scale

- 12 Driven by the globalisation of companies and audit regulations, auditors that want to serve the largest multinational companies have found that they can only do this efficiently by creating extensive global networks. This is just one reason why increasing returns to scale have been empirically documented in audit markets (Banker, Chang, and Cunningham 2003). Views on precisely what scale economies are in audit, and how large they are, vary but they have been seen as one of the main forces of merger activity in the audit market.
- 13 Amir and Lambson (2000) and Amir (2002) provide rigorous analyses of (exogenous) variations in the number of competitors for oligopoly markets under different assumptions about returns to scale. Crucially, they demonstrate that, in Cournot models, the presence of even slight positive scale economies can generate "natural oligopolies" and welfare to be maximised at a finite n .

- 14 As above, the overall implication of increasing returns (or indeed the role of networks to serve global demand) is that the answer to “which n makes markets perform best” will be a relatively small number, and less than would otherwise be the case.

Sophistication of buyers and tenders

- 15 The market for statutory audits is characterised by having some of the most sophisticated buyers one can imagine (i.e. the largest and most successful corporations as well as representatives of their investors). It is telling to note that when they search for a new supplier of auditing services they only invite a fairly small number for tender (I understand from the CC's analysis on average 3.7 within the FTSE 350, and 3.4 in the CC's sample of large companies outside the FTSE 350). The question arises why do they not invite more potential suppliers to make competition more vigorous?

- 16 Given the sophistication of these buyers, the reason must be that inviting this number of bidders achieves better outcomes. But why would that be the case? There are at least three prominent economic reasons for this and they all contribute to concentration among suppliers.

- First, tendering is a costly drawn-out process and its costs rise linearly with the number of bidders.
- Second, prospective suppliers face stronger incentives to demonstrate all their capabilities in honest detail when the chances of being selected are higher. (This follows essentially the same logic as the argument above that explains why, when investments into quality matter, smaller n will often be preferable.)
- Finally, I note that the basic capabilities of large (big- n) firms can be assumed to be roughly homogenous which (i) ensures intense competition even with few bidders, and (ii) allows a focus on ideal fit with the actual individuals involved which is particularly important in situations which rely on trust, discussed above.

- 17 Buyer sophistication, of course, also means that what counts as reputation will be based on facts (i.e. the direct and indirect experience of using an audit firm of the sophisticated and knowledgeable individuals at FTSE 350 companies who make audit purchasing decisions), and not merely hearsay or “image”. This, in turn, accentuates the incentives for building reputation through the provision of high quality (rather than engaging in arguably wasteful “image campaigns”) - a further force, as we have seen above, that pushes efficient market outcomes towards high levels of concentration.

Concluding remarks

- 18 Traditional standard (mostly static) models of competition suggest that $n=4$ delivers outcomes which are close to full market efficiency. While there are some pronounced differences between these models (e.g. Bertrand competition suggests that two competitors can generate full efficiency, Stackelberg models point towards the benefits of asymmetric market shares), none would suggest substantial concerns in the case of $n=4$.

- 19 Indeed, the key characteristics of the audit market that I have listed above all point towards forces that, if anything, make a smaller number of competitors more attractive, with some even hinting that a duopoly structure would be advantageous.
- 20 However, to suggest that a duopoly would be optimal neglects the potential dangers of (tacit) collusion. Available empirical evidence - from both experiments (see, for example, Huck, Normann, and Oechssler 2004) and examinations of the European Commission's merger analyses (Davies, Olcakan and Coles 2011) suggests that collusion is mainly an issue for $n=2$, with very marginal concerns for $n=3$ and essentially none for $n=4$. I understand that in this case, the CC's initial view is that there is no evidence of tacit coordination. From that perspective, the main advantage of $n=4$ (over a smaller number of sellers which could indeed be optimal with purely non-cooperative equilibrium behaviour) is that it is two steps removed from the potentially dangerous duopoly situation. Given regulatory concerns (most notably what would happen if one of the largest firms were to fail), $n=4$ is quite likely to be, from the perspective of competition and market efficiency, the optimal practical number of suppliers in the market for statutory audits for the largest companies.

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