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# PwC Response to the Barriers to Entry Framework working paper

1 This submission sets out our initial views on the working paper on Restrictions on Entry or Expansion published by the Competition Commission (**CC**) on 17 August 2012 (the **Barriers to Entry Framework** or **BEF**).

2 In the body of this submission we have focussed on a limited number of high level matters that we believe the CC should take into account as it develops its thinking on the framework. In particular we set out a summary of our key views on barriers to entry in the main part of this submission. We provide a point-by-point high level response to some of the issues in the BEF in the **Annex**. We shall respond to any related points in any of the working papers issued more recently in more detail at a later date.

**Competition and entry under current market conditions**

3 The CC's published guidelines make clear that barriers to entry are to be considered where "*intra-market rivalry is not strong*".[1] As we have consistently set out and evidenced in our submissions to the CC, the current market for audit services to FTSE 350 companies is highly competitive. There are four large audit firms competing with each other to supply high quality, innovative and efficient services at competitive prices, under pressure from well-informed and effective purchasers. This process is dynamic and responds to customer demand and the actual and anticipated behaviour of competitors. In this context, the question of the existence of barriers to entry is therefore not relevant to the CC's assessment of the existence or not of an AEC.

4 Notwithstanding (or because of) the competitive nature of the market, smaller audit firms (the mid-tier firms) have self-evidently been unsuccessful to date in making significant inroads into the market for audit services to FTSE 350 companies.[2] In the context of the BEF this raises three related questions that are likely to be of interest to the CC:

(a) Why have the mid-tier firms not penetrated the FTSE 350 audit services market to date?

(b) Has the fact that they are not present in the reference market had adverse consequences for competition and market outcomes in the reference market?

(c) Do mid-tier firms have the ability to expand their position in the reference market?

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1 CC3 (*Market Investigation References: Guidelines*), paragraph 3.16.

2 See footnote 1 of the BEF. Whilst around ten FTSE 350 companies are audited by firms other than the four largest, the CC regards these as "*unrepresentative*".

**The reasons the mid-tier firms have not entered to date**

5 It is a matter of fact in the historical record that when a FTSE 350 company switches audit firm, or considers doing so, in the vast majority of cases it will choose one of the four large audit firms as an alternative to its existing audit firm.[3]

6 This is the case because the mid-tier firms do not have important attributes developed by the four largest audit firms which large companies regard as necessary for their audits to be effective – namely appropriately skilled people; specialist expertise; industry knowledge; appropriate geographical coverage (to the extent required by our customers); a consistent audit methodology; and the required compliance systems.[4] Consequently, when large companies compare the mid-tier firms with the largest audit firms they almost always conclude that one of the largest firms offers the best all-round combination of quality and price.[5]

7 Some of the mid-tier firms have told the CC that they already have the capability to audit many companies in the FTSE 350 other than the very largest and most complex.[6] We do not know whether this is true (as the mid-tier firms have no record of carrying out such audits), but even if it is, we do not think it is surprising that when choosing a supplier for a service as important as the audit, companies in the FTSE 350 prefer audit firms with very strong capabilities compared with those offering lesser, albeit possibly still adequate, capabilities.[7] We think this is not just the case for the largest companies but also smaller, less complex companies within the FTSE 350 who want the best experience available and have ambitions to grow, and want to appoint an audit firm with larger company experience.

8 It follows, therefore, that in order for the mid-tier to enter or expand in the FTSE 350 audit market they would need to develop the attributes of the largest audit firms. To date they have chosen not to do this.

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3 See for example Figure 3 on page 70 of our Submission of 12 January 2012 (our Submission) and slide 62 of the CC Survey Presentation by IFF Research published on 26 July 2012.

4 See paragraphs 3.12 to 3.41 of our Submission.

5 See for example feedback from audited companies at paragraph 3.57 of our Submission.

6 For example, *"We are confident that we are able to provide high quality audits to the majority of FTSE 250 companies and a number of FTSE 100 companies...Firms such as Grant Thornton have been honest in expressing the view that they have the attributes and resources to audit most of the FTSE 350 currently. We have also been honest that it would take time to build capability to audit the 50 or so largest UK companies"*, Grant Thornton response to PwC memorandum dated 6 July 2012, 1 August 2012, paragraphs 3.5 and 4.7; and *"We have made it abundantly clear that BDO is entirely capable of providing a high quality audit service across the FTSE 350, except to a small number of the largest companies which for particular reasons are currently beyond BDO's capabilities"*, BDO Response to Deloitte's marketing and financial questionnaire summary, 19 April 2012, point 1.

7 We note that the mid-tier firms' acknowledgement that they lack the attributes to perform the audits of the largest and most complex companies (see footnote [6]) is an admission that they do not have the attributes of the largest audit firms who do successfully perform such audits. However, the mid-tier firms do not appear to recognise that these attributes are valued by other firms in the FTSE 350 market as well. It is striking that according to the CC survey (slides 33 and 38 of the IFF presentation) the "*experience and knowledge of the engagement partner*" is the factor most valued by FTSE350 companies in appointing an auditor. This is an area in which the mid-tier cannot currently rival the larger firms.

9 Some of the mid-tier firms have told the CC that the reason they cannot enter the market is not because of their lack of the appropriate capabilities, but rather due to *"perception bias and prejudice"* against them[8], and a lack of opportunity due to low rates of tendering and switching.[9] We do not believe that experienced directors on the audit committees and boards of the country's largest and most sophisticated companies would systematically and continuously fail to appoint a particular group of suppliers offering a competitive service based on "*perception bias and prejudice"*. Rather, the evidence (including the CC's survey and case studies) demonstrates that they identify a difference in the attributes of those audit firms supplying most FTSE 350 audits and those that do not. This is the real reason for the choices made by the customers.

10 There are good reasons why there are not more formal tenders for FTSE 350 audits,[10] but there are a sufficient number of tenders to enable a mid-tier firm to enter the market.[11] In any case, the results of the CC's own survey shows that FTSE 350 companies continuously monitor their current audit and auditor[12] and if they identified an alternative supplier offering a better product they would initiate a formal tender. What is also clear from the results of the CC's survey is that, given the current capabilities of the mid-tier firms, more tenders would not help them to enter the market – they would simply incur more bidding costs and have a greater frequency of lost tenders,[13] because they do not have the right attributes to be appointed.

**The current market functions competitively and effectively with four firms**

11 We believe that the reason none of the mid-tier firms have acquired the necessary attributes to compete effectively with us and the other largest audit firms in the FTSE 350 audit market is that they do not see this as a good commercial opportunity for them.[14]

12 This is because the FTSE 350 audit market is already well-served by the four largest firms. Prices and margins are at competitive levels and quality is high, due to fierce competition between the existing suppliers reacting to effective competitive pressures exerted by large and

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8 For example, *"What the audit market needs – and the CC investigation can help with this – is a reduction in the perception bias and prejudice against mid-tier firms"*, BDO Response to Deloitte's marketing and financial questionnaire summary, 19 April 2012, point 1; and *"In our experience the reputational bias towards the Big-4 is particularly prevalent in unwritten form"*, Grant Thornton response to Issues Statement, 12 January 2012.

9 For example, *"Such low levels of switching make it difficult for Grant Thornton and other suppliers of audit services to destabilise the position of the four largest audit firms and grow market share, particularly when FTSE 350 audits are tendered infrequently"*, Grant Thornton response to Issues Statement, 12 January 2012.

10 There are costs associated with switching (both tender costs and costs of getting the new auditor up to speed) and risks associated with the quality of the audit immediately after the switch. These need to be considered against the potential cost and quality benefits of switching, in the context of large companies being able to exert competitive pressure on their existing auditor without needing a formal tender or switch.

11 The CC's survey highlights that mid-tier firms are invited to 30% of FTSE350 audit tenders (slide 54 IFF presentation).

12 See for example slide 46 of the CC Survey Presentation by IFF Research published on 26 July 2012 which shows that 93% of FTSE 350 companies surveyed negotiate their audit fee every year.

13 Ibid, slide 62 which shows that 97% of the FTSE 350 companies that have switched auditor in the past 5 years, switched to/within the Big 4.

14 Paragraph 3.22 of the CC's guidelines refer to barriers to entry being features of the market that prevent firms "*exploiting profitable opportunities in the market*." The mid-tier firms evidently do not believe such profitable opportunities currently exist given their reluctance to invest in the attributes required to be competitive.

sophisticated buyers[15]. The mid-tier firms understandably do not see a business case for acquiring the necessary attributes to compete when any pay-off would need to be secured in what is already a highly competitive market[16].

**The mid-tier firms can expand their market presence**

13 The larger mid-tier firms presently have a very limited presence in auditing FTSE 350 companies but, while it is the case that the companies they serve are less complex or less international than many others in the FTSE350, this presence does give them a base for further expansion. That there are no incentives currently for the mid-tier to further develop the attributes necessary to expand significantly in the FTSE 350 audit market does not mean that this will always be the case, or that there are substantial barriers faced by the mid-tier firms that would prevent them from increasing their market share if appropriate opportunities were to arise.[17]

14 As explained above, the current lack of incentives for the mid-tier firms to expand is due to the highly competitive nature of the market, which means that there are no supernormal profits or dissatisfied customers to target. If, hypothetically, at any time in the future there emerged an opportunity for an extra or different supplier to enter the market, then there would be incentives for the mid-tier firms to enter, in the form of dissatisfied customers to target.

15 In this hypothetical circumstance we believe that expansion by a mid-tier firm would be entirely feasible. The mid-tier firms have made the point that they are substantial businesses perfectly capable of making the necessary investments were the opportunities to arise. Although relatively small compared to the largest accountancy firms, the mid-tier firms are, by most standards, very large professional services businesses – even without merging which is clearly one option that is open to them. The total global revenues of the BDO and Grant Thornton networks are £3.6bn and £2.3bn respectively[18]. By comparison the largest law firm in the world by revenue is Baker & McKenzie which has global revenue of US$2.3bn (around £1.4bn). BDO has 48,800 staff in 1,118 offices across 135 countries and Grant Thornton has 30,000 people across 96 member firms[19].

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15 See Section 6 of our Submission.

16 The mid-tier firms have stated that they would like to enter the market, but it is clear that they would like to do so without acquiring the necessary attributes. This could only happen if companies were to decide that they did not value the attributes of the largest audit firms, or if there was a more widespread adoption of the shared audit model (with mid-tier firms engaged alongside a large audit firm to audit less important parts of FTSE 350 companies). There is limited market appetite for shared audits currently, and in any case the involvement of mid-tier firms in shared audits does not constitute full entry by them as they would still lack the necessary attributes to be chosen to sign an audit opinion for a FTSE 350 company.

17 We note that the CC's June 2012 draft guidelines in relation to assessing the impact of entry restrictions refer to examining "*the cost of gaining a significant share of the defined market (usually considered as 5 per cent)*." In the context of entering the FTSE 350 audit market, therefore, a "significant share" is around 18 audit appointments.

18 The suppliers of statutory audit services to large companies, Table 1, CC working paper, 29 August 2012.

19 Ibid, paragraphs 41 and 101.

16 The mid-tier firms have also told the CC that they would not find it difficult to raise capital[20]. We do not agree with the suggestion in the BEF that the mid-tier firms would not invest because accountancy firm partners have a shorter time horizon than external investors.[21] In fact the opposite is the case. External investors can have very short investment horizons and will switch capital in order to maximise return in the short term.[22] A partner can generally expect to have an interest in the business for more than 20 years from appointment as a partner and, unlike most external investors, will have an attachment and commitment to the business that goes beyond the purely financial. Indeed, our partners consider themselves to be custodians of the business for future generations and are actively encouraged to develop a "legacy" for after they retire.

17 While a "big bang" one-off expansion to enable the mid-tier firms to serve the largest FTSE 350 companies is unlikely to be feasible, a stepped, phased approach focussing on particular market and geographical segments and companies is perfectly realistic should a business opportunity arise. This would enable the new entrants to scale down their immediate investment requirement, with a view to increasing their experience and improving their reputation for quality and efficiency within the FTSE 350 audit market and using this as a platform for further investment and expansion. Much of the cost associated with providing large company audit services is associated with the audit team itself, and thus varies with the number and size of audits won. Centrally incurred costs, such as methodologies, systems and technical expertise, can also be scaled to a degree depending on the number and size of audits, building on what the mid-tier firms have already.[23]

18 In the current, effectively competitive market, where customers are satisfied with the existing suppliers, there is no such incentive to invest. It would appear that the mid-tier firms have not been prepared to risk investment based on their assessment of their likely ability to win tenders, and the returns that would be available in the event that they were successful. But were the market to become less competitive, this situation would change. There would be companies willing to switch to a new entrant[24] and the investments costs in order to achieve this would be manageable relative to the likely returns.

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20 For example, "*Restrictions on investment, which are effectively imposed by the regulatory requirements on the control of audit firms, can also act as a barrier to entry and expansion as they limit the methods by which audit firms may raise capital and attract investment. However, BDO does not consider this factor to have restricted its expansion to date*", BDO response to Issues Statement, 13 January 2012.

21 BEF, paragraph 10.

22 The overarching conclusion of the Kay Review of UK equity markets and long-term decision making was *"Overall we conclude that short-termism is a problem in UK equity markets",* July 2012.

23 Of course, if the mid-tier firms are correct and they already possess the attributes needed to provide audit services to many of the FTSE 350 companies then they could enter to supply an adequate service (albeit one that is inferior to that currently provided by the four largest firms) immediately a market opportunity presented itself in the hypothetical situation that competition between the four largest firms failed to deliver effective market outcomes. The text is written on the assumption that FTSE 350 companies continue to prefer to purchase audit services of the quality supplied by firms with the attributes of the largest audit firms, and therefore to enter the market the mid-tier firms would need to acquire these attributes.

24 This would be aided by the large and sophisticated nature of the customer base. FTSE 350 companies have the resources and expertise to manage their suppliers, and if they felt that the market was not being well-served by the

19 The customers in the reference market are large and sophisticated and well able to manage their supplier base to ensure effective competition and a high quality product at the lowest possible price.[25] In an effectively operating market there is no necessity[26] or appetite to encourage entry, but in an unsatisfactory market this can change quickly and dramatically, automatically inducing entry and ensuring a competitive market outcome.

**PricewaterhouseCoopers LLP**

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existing audit firms they would be perfectly equipped to encourage, or even sponsor, expansion or new entry. Encouraging a merger between larger mid-tier firms for example would offer an efficient way to expand resource and network.

25 In this context we note that the CC survey shows that in testing auditor performance (eg, in terms of regularity of auditor performance reviews, fee negotiations, contacts with other audit firms, benchmarking etc - see slide 46 IFF presentation) FTSE 350 companies are more rigorous than the non-FTSE 350 companies in relation to whose audits mid-tier firms are more successful.

26 As the CC Guidelines acknowledge, barriers to entry are only relevant where "*intra-market rivalry is not strong*", *ibid.*

# Annex

## PwC response to some detailed points in the BEF

In this Annex we provide a point-by-point high level response to some of the issues in the BEF. We shall respond to the issues in more detail as and when the relevant working papers are published by the CC.

**Strategic barriers to entry**

1. The BEF describes three possible strategic barriers to entry,[27] in relation to two of which it states there is little or no evidence: bundling/tying and signalling an aggressive competitive response. The reason that no such evidence can be found is because these practices are not engaged in by us or, so far as we are aware, our major competitors.

2. The remaining possible strategic barrier suggested in the BEF is raising sunk costs of entry by spending on activities designed to increase the value of the firm's product to customers or decrease the marginal costs of producing each unit.[28] This is based on theories developed by Sutton, and interpreted by Shiman and in turn the CC, that suggest that firms will be incentivised to invest in attributes such as advertising, marketing and R&D in expanding markets to increase endogenous sunk costs in order to maintain market concentration.

3. We have four observations on this:

    a. Investments by the largest firms in things such as bespoke software and improvements in quality that give rise to "barriers to entry"[29] reflect the nature and strength of competition in the market. The considerable sums expended annually by ourselves[30] and (we assume, based on our market observations) by other large firms on these attributes demonstrates that such competition is not merely historic but is ongoing. It is an aspect of the competitive process that improves quality in response to customer demand and highlights the effectiveness of competition between the largest firms. Indeed the argument as set out in the BEF gives rise to a "catch 22": if the large firms did not compete strongly by investing in attributes that companies value, this would suggest that they were not effectively incentivised to do so (including by the threat of entry). However, as they do compete by investing in such attributes, they are said to be seeking to erect barriers to entry. The reality is that the firms are not seeking to erect barriers through making

[27] BEF, paragraph 27.
[28] BEF, paragraph 31.
[29] BEF, paragraph 31-33.
[30] "[I]n the UK we spent £[≫] million on staff development in 2010 and contributed £[≫] million in the course of the last three years to a global network investment of some US$400 million in bespoke audit support IT software.", PwC Initial Submissions, par. 1.30(a).

investments, but to offer a more attractive proposition to companies in a competitive market.

b. The consistent theme from regulators[31], companies and investors[32] in this market is that quality is of paramount importance. Competition in respect of quality is fundamental to meeting company expectations in statutory audit markets in a way that is perhaps less obvious in the manufacturing sectors in which Sutton's research originated. It is notable that when Dick sought to apply Sutton's theory to a service market (US retail banking),[33] she found that the number of "dominant" banks (that is the banks with the largest shares that control over half of deposits) in a market was constant across markets of different sizes and the level of service quality was higher for the "dominant" banks than for the smaller ("fringe") banks. She also found that the "dominant" banks competed with each other closely. She concluded that *"the introduction of quality in models of banking competition, which this work suggests is important, changes the interpretation of empirical correlations between the number of firms, concentration and competition."*[34] Dick's research is, in this regard, consistent with our understanding of the relevant market - the largest audit firms compete closely with each other to invest in attributes which raise quality to the benefit of companies.

c. In any event, Sutton's theory does not imply that incumbent firms have incentives to increase endogenous sunk costs to increase market concentration or raise entry barriers. On the contrary, Sutton suggests that expenditure on certain items (he considers advertising and R&D, whereas in our market we should consider a range of attributes which underpin and improve quality and which are valued by sophisticated buyers) is motivated by a desire to meet customer demands in the form of higher quality or lower priced products. In other words these expenditures represent optimal short-run decisions by firms rather than strategic decisions to incur losses in the short-run to raise barriers to entry in the long-run. Indeed, in Sutton's model, even in a highly concentrated market, the threat of entry drives economic profits down to zero.[35]

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31 See discussion of FRC's Audit Quality Framework in paragraphs 2.38 and 2.39 of our Submission.

32 Responses to CC survey indicate that the experience and knowledge of the engagement partner is the most important factor in deciding to reappoint an audit (slides 35 and 40 of CC Survey Presentation), while case studies with Blackrock and Legal & General, and third party submissions from USS, Hermes, also emphasise the importance of audit quality.

33 Dick, *Market Size, Service Quality, and Competition in Banking*, Journal of Money, Credit & Banking, vol 39, No 1 (February 2007).

34 Dick, page 79.

35 It is important to recognise the context of Sutton's theory. What he explained is how the process of competition naturally leads to some markets becoming highly concentrated. As his is an equilibrium model – he was seeking to identify the equilibrium market structure – there is no scope for anti-competitive actions by firms. Specifically, the toughness of price competition is assumed to be constant, and, in equilibrium, firms earn zero economic profits. So, in Sutton's model, firms do not benefit from markets becoming more concentrated and there is also no economic motive or ability to deter entry through strategic behaviour. What Sutton argues is that markets become more concentrated because consumers value the investments made by firms, or because these investments reduce marginal costs. Competition forces firms to make these investments – if they failed to invest, they would supply a lower quality product and/or have higher marginal costs which would result in these firms losing market share and earning lower profits. (Please see Sutton, *Sunk costs and market structure*, MIT Press, 1991).

d. It is wrong simply to describe large audit firms' expenditure on the attributes required to be competitive as being either specific to the FTSE 350 audit business or sunk. Much of this expenditure is not product specific. We are a professional services firm offering a range of services and much of our relationship-building and thought leadership activities are designed to reflect and reinforce values which are common across the business. Such expenditure is not audit specific, let alone FTSE350 specific, and is of value to sophisticated purchasers of all of our lines of service. Moreover, much of this expenditure is made on an ongoing basis. This is also true of the mid-tier firms who market themselves as professional services firms. For example, the home page of Grant Thornton's website is headed: "*We are Grant Thornton: One of the world's leading organisations of independent assurance, tax and advisory firms*". They spend considerable sums on activities which are not specifically targeted at the audit market. Similarly, the first three "press release" items on the home page of BDO's website on 7 September 2012 related to: (i) the outlook for manufacturing; (ii) the impact of the Olympics on the High Street; and (iii) August Labour Market statistics. These are items that will benefit all aspects of BDO's business, including audit, by bringing the attention of interested readers to the firm, its skills and the services that it offers. Additional expenditure on marketing and the like by these firms to increase their profile with FTSE350 companies would similarly be of benefit to all aspects of their business - not just the audit business.

**International network**

4. We agree with the evidence set out in the BEF, and the CC survey, that a credible international network is an important attribute for winning business[36] in this market. We also agree that the largest audit firms have stronger networks than the mid-tier firms and that it would be difficult for the mid-tier firms to replicate the networks of the large firms in the medium-term.

5. That said, the mid-tier firms have significant networks which could form the basis of a phased international expansion of their firms if such investment decisions were to be made. The mid-tier firms do of course also have the option to merge in order to fast track such development.

**Reputation**

6. The BEF suggests that where reputation is an accurate reflection of capacity, quality, expertise, and efficiency, it allows companies to distinguish between potential suppliers of audit services and select the most appropriate for their needs. It also suggests that if it is not an accurate reflection, then any inaccuracy may distort companies' decisions as to choice of auditor.[37] We have explained elsewhere that we consider purchasers of audit services to be well-informed and able to

[36] Response to CC survey (slide 57) suggests that FTSE 350 companies limited the firms that they invited to tender based on their quality and capability with the top three reasons being: (i) auditor has specialist knowledge; (ii) regional strength / geographic coverage; and (iii) size of the audit firm.

[37] BEF, paragraph 38

judge value and efficiency[38] and act rationally on that judgement. This means that it is not the case that the attributes of the largest firms are merely perceived as opposed to reflecting reality.

7. In fact reputation, representing as it does the reality of the attributes, track record and service levels of the largest firms, is a valuable signal to the market and gives rise to its own virtuous circle: reputation is built on the reality of sustained audit firm performance as observed by informed market participants, and informed market participant take comfort from the observations of others. However, this rapidly breaks down if the reality of performance does not match market reputation.[39] Similarly, if a new or expanding entrant was able to offer innovative new services, it would not be difficult to build on this reputation in order to win further business.

**Switching**

8. We have explained elsewhere that where companies choose not to tender or switch this is not an indicator of complacency (as might be suspected for such customer behaviour in consumer markets) but rather the consequence of a weighing up of the options by sophisticated business purchasers and a decision that the company is receiving a competitive proposition from its existing supplier,[40] and that the costs and potential benefits of tendering or switching are outweighed by the benefits of continuing with the existing supplier.

9. The evaluation of auditor effectiveness and negotiation of scope and fees are typically carried out by companies on an annual basis in a context where rival auditors are actively pursuing their audits. The willingness of companies to continue with an existing auditor (providing it supplies the high quality and value for money service required) presents an incentive for smaller audit firms to invest in the attributes required to win new business in the knowledge that, if they win that business and continue to offer a competitive service, they are likely to have a relatively long payback period for the investment.

10. Although customer switching costs in this market can be considerable,[41] they are not significant enough to prevent a company from tendering its audit (particularly where a company is dissatisfied with its current auditor[42] or wants to tender for "governance" reasons). On this basis, we consider that switching costs do not prevent the market from operating effectively.

**Regulation**

11. We take issue with a number of the suggested regulatory barriers described in the BEF:[43]

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38 See paragraph 5.12 of our Submission.

39 As demonstrated in the demise of Andersen's, but also in the case of a number of mid-tier firms which have also suffered irreparable reputational damage. One such example is Robson Rhodes who were taken over by Grant Thornton in 2007, largely as a consequence of misconduct in relation to its audit of IT business iSoft.

40 See paragraph 1.33 of our Submission.

41 See paragraph 5.35 of our Submission.

42 Responses to CC survey indicate that complacency of an auditor or an increase in the audit fee are among the most likely triggers for a tender (slides 70 and 76 of CC Survey Presentation).

43 BEF, paragraph 53.

a. There is no connection between the binary nature of the audit report and the reputation of the largest audit firms.[44] We have explained how audit committees and management are well placed to judge audit quality and exercise this function effectively.[45] Even if the audit report contained a greater narrative element, this would not enable the investors to judge audit quality as well as the AC can. Investors would be in no better position than now to know how far the narrative reflected the underlying quality of the audit process.

b. Partner rotation requirements[46] and client size rules[47] are necessary safeguards of auditor independence. Any audit firm unable to meet these requirements is unlikely to be able to offer a high quality and independent service to its customers. We note that the CC's preliminary analysis indicates that the latter is unlikely to restrict the ability of mid-tier firms to offer services to most FTSE 350 companies, but the former may be problematic without investment.

c. We do not understand why the rules on component auditors and joint or shared audits are described as a regulatory barrier to entry.[48] There is no regulatory restriction on a company instructing joint auditors, but joint audits are very uncommon for commercial and not regulatory reasons - they raise costs and increase risk.[49] Companies are free to, and occasionally do, have their audits carried out on a shared basis. However, shared audits where material components of the audit are carried out by the secondary auditor, share the same disadvantages as joint audits.

d. The independence rules raise the cost of switching in respect of a very limited number of the largest banking and financial institution companies,[50] but not to a level where such tenders are untenable (as our recent Aviva tender illustrates[51]).

e. We explain elsewhere[52] why it is not credible to suggest that ACs or management would appoint a less suitable large audit firm in preference to a better quality/value mid-tier firm.[53]

f. The temporary inability on rare occasions to act, due to independence restrictions or conflicts, does not materially affect competition. This is because, whilst there might be an independence issue in the short-term, where the prospective audit customer desires it

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44 BEF, paragraph 53(b).
45 See paragraph 5.12 of our Submission.
46 BEF, paragraph 53(c).
47 BEF, paragraph 53(g).
48 BEF, paragraph 55(f).
49 See paragraph 2.61(d) of our Submission.
50 BEF, paragraph 53(h).
51 See paragraphs 4.56(a) and 4.59 of our Submission.
52 PwC Response to certain Third Party Submissions, paragraph 4.2.
53 BEF, paragraph 53(i).

there are very few situations where any audit firm would not be able to "cleanse" itself relatively quickly in order to compete.[54]

12. We agree with the CC that the cost of insuring liability risk is likely to be proportionate to the total size of business undertaken by the audit firm.[55] It is a direct cost of doing business in this market and is unlikely to deter entry if other entry conditions are satisfied. In our experience insurers will not underwrite liability risks where the audit firm's portfolio contains a significant number of larger FTSE 350 companies. This is not because there is a greater likelihood of such companies making a claim (indeed improved risk management and regulation mean that the number of claims by FTSE 350 companies has declined significantly over the last ten years and we currently have no such claims) but rather because of the size of the portfolio and because such claims, if they were to arise, could be very high.

13. If insurers were to decline to underwrite liability risks for these reasons this would, in our experience, impact the insurance of the whole audit portfolio, not just the largest audits in the portfolio. This does not detract from the CC's conclusion that the costs of such risks are proportionate to the size of business undertaken. However, once an expanding audit firm had acquired a significant portfolio of large audit customers it would have to self-insure its entire audit business.

**Auditor clauses in loan agreements and other pressure from advisers**

14. To the extent that clauses are included in certain types of loan agreement that stipulate that the borrower should have one of the four largest auditors, our position is that any mandatory stipulation that only certain firms should be appointed in all situations is inappropriate.

15. However, we note the CC's understanding is that such clauses are only common in sub-investment grade or leveraged loan agreements, where the risks associated with lending are relatively high and therefore borrowers reasonably require assurance that the lender's financial statements are accurate. To the extent that a clause in the loan agreement requires the appointment of an audit firm of international standing such as one of the four largest firms, with the option of other firms acting as auditor subject to the lenders' reasonable consent, then this seems to be an understandable and reasonable requirement.

16. To the extent that a lender's professional advisers suggest that one of the largest audit firms should be appointed, this is a reflection of their knowledge of the independence and quality that will be delivered by the largest firms, based on their experience. It would not be in the advisers' interests to make such a suggestion unless it was well-founded.

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54 See paragraphs 4.58 to 4.60 of our Submission and MFQ 54.

55 BEF, paragraphs 53(d)

**Modelling the entry case**

17. The use of entry models suggested by the CC may be a helpful tool to examine how individual factors affect entry incentives. In using such a model it will be important to capture the endogeneity of the competitive dynamics which are being modelled, rather than analysing individual factors in isolation.

18. Interpretation of such a model requires care. In every market, whether competitive or not, it would be possible to identify firms that have not entered from adjacent markets. The fact that such firms do not enter reveals little about the competitive conditions in the relevant market. Furthermore, an entry model which examines only existing market conditions is unlikely to reveal more than can be currently observed. In particular, we would not expect an entry model to show a strong current investment case for mid-tier firms, because the mid-tier firms would be making such investments if there was such a case.

19. Such a model can be more helpful to show the conditions which would be required to provide suitable entry incentive. For example, were the large audit firms to provide a sub-standard quality audit at an elevated price, as would be the case if there was inadequate competition between them, then we would expect both the rate of tendering and the win rate for mid-tier audit firms to rise. Such an entry model could be helpful in identifying the point at which entry would become profitable for mid-tier firms, and in confirming that an increase in tendering will not strengthen the incentive for mid-tier firms to expand, but rather that the incentive to expand will only arise where the mid-tier win rate increases (for example, because companies start to favour their offering over that of largest firms).