



## **Competition Commission Audit Services Market Inquiry**

13 September 2012

### ***Deloitte response to the Competition Commission's working paper "The Framework for the CC's Assessment and Revised Theories of Harm"***

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### 1. Introduction

- 1.1 Deloitte is grateful for the opportunity to comment on the paper published by the Competition Commission (the **CC**) on "The framework for the CC's assessment and revised theories of harm" (the **Working Paper**).
- 1.2 We set out our views on the revised theories of harm and related considerations below. This response adopts the following structure:
- (a) Comments on the three key features of the market that have been identified by the CC including discussion of additional features which we believe should be taken into account by the CC;
  - (b) Comments on the CC's first theory of harm;
  - (c) Comments on the CC's second theory of harm; and
  - (d) Comments on adverse outcomes identified by the CC.
- 1.3 We note that the Working Paper sets out at length a theoretical exposition of possible market dynamics. For the reasons we set out below, we do not think that this theoretical exposition is supported by evidence of what is actually happening in the market. When the evidence of actual market dynamics is properly taken into account, the theories of harm set out in the Working Paper reveal no evidence of an adverse effect on competition.
- 1.4 We note that the CC has published and proposes to publish further working papers which have a critical bearing on many of the issues raised in the Working Paper. We reserve the right to provide further comments and/or develop our position in the light of further material published by the CC.
- 1.5 For completeness, we welcome the indications that the following issues do not form part of the revised theories of harm that the CC is most actively pursuing<sup>1</sup>:
- (a) tacit coordination<sup>2</sup>;
  - (b) unduly high audit quality<sup>3</sup>.

The CC is correct to consider that there is no evidence to support those theories<sup>4</sup>.

### 2. Key features of the market

- 2.1 The CC identifies three features of the market which it states are "fundamental characteristics of the supply of audit services to FTSE 350 companies"<sup>5</sup>. Before addressing these, we draw the

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<sup>1</sup> We note also that neither regulatory failure nor bundling are explicitly addressed in the Working Paper, but do feature in the CC's working paper on "Restrictions on entry and expansion" (the **Barriers to Entry Working Paper**). We therefore assume that they still form part of the CC's thinking and will address them as appropriate in this response and in our response to the Barriers to Entry Working Paper.

<sup>2</sup> See paragraph 46 *et seq* of the Issues Statement.

<sup>3</sup> See paragraph 17 of the Issues Statement.

<sup>4</sup> See paragraphs 2.7 *et seq* and 8.1 *et seq* of Deloitte's Response to the Issues Statement.

<sup>5</sup> See paragraph 50 of the Working Paper.

CC's attention to a number of features which are not so identified by the CC, but seem to us to be *more* central to a proper understanding of the market for FTSE 350 audit. These are:

- (a) the nature of audit quality;
- (b) audit risk;
- (c) the informed and expert nature of buyers; and
- (d) the mechanisms for aligning interests of shareholders, directors and auditors.

### ***The nature of audit quality***

2.2 The first key characteristic of the market which requires fuller consideration by the CC is the nature of audit quality.

2.3 We have explained to the CC that quality is central to the delivery of audit to FTSE 350 companies<sup>6</sup>. This is strongly supported by the **case studies**<sup>7</sup> and other evidence that has been gathered by the CC<sup>8</sup>.

### ***“Service” quality and “technical” quality***

2.4 In the Working Paper<sup>9</sup>, the CC appears to posit a dichotomy between:

- (a) “technical” quality; and
- (b) “service” quality<sup>10</sup>.

2.5 This is not the right way to think about audit quality. There is no trade off between “service” quality and “technical” quality, and “technical” quality cannot adequately be delivered without also delivering “service” quality.

2.6 This is because (*inter alia*):

- (a) good communication and timely liaison with management ensures that the auditor is given all the information it needs in order to conduct an audit of high quality;
- (b) good communication between the auditor and management is critical to ensuring that issues that arise in the course of the audit are properly understood on all sides and hence subject to meaningful challenge;
- (c) good communication ensures that nothing “falls through the gaps”;

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<sup>6</sup> See paragraph 2.1 *et seq* of Deloitte's response to the Issues Statement.

<sup>7</sup> See, for example, paragraph 38 of the **Company C case study**: “The CFO thought that quality was key to an audit and that it was the overwhelming requirement.”

<sup>8</sup> See, for example, the submission of the **Hundred Group of Finance Directors**, and paragraph 12 of the **ABI's response to the Issues Statement**.

<sup>9</sup> Paragraph 64 of the Working Paper. The CC suggests that the interest of investors (and certain other stakeholders) “would tend to be limited to the potential impact on technical quality”, although the CC concedes in footnote 12 that “shareholders have an interest in efficient audit service delivery, just as they have an interest in the efficient delivery of all aspects of the business”. In fact, for the reasons below, their interests in all aspects of audit quality, including “service” quality, goes beyond this general interest in the efficient delivery of a professional service.

<sup>10</sup> We note that the CC adds a further category of “additional commentary/insights” in its discussion at paragraph 88 of the Working Paper. The discussion in this section of this response applies equally to work falling within this category; we believe it should properly be understood as being part of the service quality that Deloitte offers.

- (d) delivery of audit is subject to deadlines set by regulation and statute, and the ability to deliver in a timely manner is critical to ensuring that output of high quality is ready on time; and
- (e) efficiency in delivery of the audit means that stakeholders within the company can properly assess, question and verify that all appropriate steps have been taken.

2.7 All aspects of quality deliver “value add” to the company which is in the interests of shareholders, since it creates value for the shareholders.

2.8 That “technical” quality and “service” quality are two sides of the same coin is well recognised in the evidence before the CC – it is clear that all stakeholders demonstrably value both:

- (a) the Working Paper is wrong to suggest that ACCs and CFOs do or may attach unduly high value to “service” elements of audit quality, at the expense of “technical” elements of audit quality. The **evidence from ACCs and CFOs** shows quite the contrary – that ACCs and CFOs understand that the two are mutually reinforcing and both are critical to the delivery of a high quality audit. We set out some of the evidence available to the CC below:
  - (i) first, the CC’s **survey evidence** shows that ACCs and CFOs attach a very high value to “technical” aspects of audit quality, while also valuing “service” quality:

(A) **Table 1** below sets out the responses of ACCs and CFOs when asked which features were most relevant to the assessment of audit quality. The CC will observe that there is no pattern suggesting that “service” features are rated more highly than “technical” features:

**Table 1: Top five responses to CC survey: which features are most important in assessing audit quality? (FTSE 350 respondents only)<sup>11</sup>**

CFOs	%	ACCs	%
Independence of the audit firm	95%	Ability to detect misstatements	98%
Ability to detect misstatements	92%	High degree of challenge	97%
Efficiency of the audit process	91%	Independence of the audit firm	96%
High degree of challenge	89%	Efficiency of the audit process	91%
Reliability and usefulness of audit report	71%	Reliability and usefulness of the report	77%

- (ii) second, the CC’s **case studies** similarly make very clear that ACCs and CFOs attach a very high value to technical quality and see both “technical” and “service quality” as equally central parts of the delivery of the audit:

<sup>11</sup> See pages 26 and 28 of the IFF Research presentation of the survey conducted for the CC (the **CC Survey**). The CC may note also that “value added services”, which might be considered to be more typically of interest to management than investors (although still value-creating for shareholders) is, by some distance, the lowest-rated of the attributes set out in response to this question (for both CFOs and ACCs).

- (A) **Company C:** the CFO sets out the key questions for the assessment of audit quality as follows:

*“(a) Could they [the auditors] provide a high quality service? (b) Could they do a good job? (c) Have they got the expertise on the ground? (d) Could he work with them? (e) Do they have the technical capability? (f) Are they in the right (geographical) places?”<sup>12</sup>*

- (B) **Company E:** the finance director states that:

*“He judged an auditor by how much they debated issues and how robust they were.”<sup>13</sup>*

The ACC explains that his list of key factors comprises:

*“The quality of planning and preparation, leadership of the audit team, quality of the team itself and communication.”<sup>14</sup>*

- (C) **Company F:** the ACC observes that:

*“The most important aspect of quality was technical competence. He wanted to know and be convinced that sufficient work had been done so the Audit Committee could recommend to the Board that it could sign off on internal controls and the accounts.”<sup>15</sup>*

- (D) **Company G:** the global financial controller comments that:

*“A quality audit service [has] two strands: (a) appropriate challenge and independence of thought; and (b) an efficient approach to the work.”<sup>16</sup>*

and further observes that:

*“The audit firm provided the technical foundations of the audit through: the firm’s auditing ability (technical approach and assessment of, and approach to auditing, the risks); its accounting ability (understanding of how to apply the standards); its industry expertise (other clients, retail banks, particular trading desk audits in investment banks, etc); and its geographical expertise (skills in different territories).”<sup>17</sup>*

- (E) **Company H:** the financial director observes that:

*“The focus was on technical expertise.”<sup>18</sup>*

- (F) **Company I:** the finance director notes his view of the key facets of audit quality (upon which the company’s auditor is appraised annually):

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<sup>12</sup> Paragraph 38 of the Company C case study. The Company also notes the criteria against which it assesses the quality of the auditor’s performance at paragraph 26 of the Case Study.

<sup>13</sup> Paragraph 32 of the Company E case study.

<sup>14</sup> Paragraph 62 of the Company E case study.

<sup>15</sup> Paragraph 59 of the Company F case study. The Company also notes the criteria against which it assesses the quality of the auditor’s performance at paragraph 49 of the Case Study.

<sup>16</sup> Paragraph 35 of the Company G case study.

<sup>17</sup> Paragraph 39 of the Company G case study. The Company also notes the criteria against which it assesses the quality of the auditor’s performance at paragraph 18 of the case study.

<sup>18</sup> Paragraph 41 of the Company H case study. The Company also notes the criteria against which it assesses the quality of the auditor’s performance at paragraph 30 of the Case Study.

*“(a) independence and objectivity; (b) the members of the audit team; (c) technical skills; and (d) service levels and fees.”<sup>19</sup>*

(G) **Company J**: the ACC reports that:

*“In considering audit quality...measures included service levels, the quality of reports produced, technical expertise, as well as reports from the AIU.”<sup>20</sup>*

(iii) third, other evidence from company stakeholders confirms the same understanding, including the **CC conference call with anonymous company**:

*“Audit quality was not just a question of getting the numbers right but ensuring appropriate disclosure and a robust control environment...The company saw audit quality as comprising three elements. First was technical robustness and making the right judgments...Second was process delivery, in terms of understanding the risks challenging appropriately, understanding the business and the applicable regulation. Good technical and interpersonal skills were important. Third was the ability to interact effectively with management teams across the world and the Audit Committee.”<sup>21</sup>*

(b) furthermore, **evidence from investors** demonstrates that they have the same understanding that both “technical” and “service” elements are critical to the overall delivery of a high quality audit. For example:

(i) **Oxera Investor Paper**: Oxera identifies that a “common” theme to investor responses on audit quality was that:

*“A good quality audit will uncover where things are not right. This will involve high quality interaction between auditor and the company.”<sup>22</sup>*

(c) the same is true of the **evidence from regulators**. The CC should note the following examples:

(i) the **FRC Audit Quality Framework**, which identifies the regulator’s view of the “drivers” of audit quality<sup>23</sup>. The CC will observe that these relate to both “technical” and “service” elements of audit:

- (A) the culture within the audit firm;
- (B) the skills and professional qualities of audit partners and staff;
- (C) the effectiveness of the audit process;
- (D) the reliability and usefulness of audit reporting; and
- (E) factors outside the control of auditors affecting audit quality;

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<sup>19</sup> Paragraphs 17 and 29 of the Company I case study. The Company also notes the criteria against which it assesses the quality of the auditor’s performance at paragraph 17 of the Case Study.

<sup>20</sup> Paragraph 55 of the Company J case study.

<sup>21</sup> Paragraphs 26 and 27 of the Summary of the conference call with anonymous company.

<sup>22</sup> Page 6 of the Oxera, *Investor views on market outcomes and potential remedies in the audit market*, 8 August 2012 (the **Oxera Investor Paper**).

<sup>23</sup> See <http://www.frc.org.uk/Our-Work/Codes-Standards/Audit-and-assurance/Promoting-audit-quality.aspx>. We note that **BDO** describes the Framework as the “best description and definition of audit quality” – see the summary of BDO’s hearing with the CC, paragraph 15.

- (ii) the CC will be aware that the assessments undertaken by the **Audit Inspection Unit (AIU)** of the FRC address both “service” and “technical” elements, recognising, for example, that effective communication between the auditor and audit committee is a critical part of the delivery of a high quality audit<sup>24</sup>; and
- (d) finally, we note that the empirical literature on audit quality confirms that company stakeholders share the multi-faceted view of audit quality. **Professor Vivien Beattie and Professor Stella Fearnley**<sup>25</sup> explain that company stakeholders consider that the five most important factors in audit quality are:
  - (i) integrity of the audit firm;
  - (ii) technical competence of the audit firm;
  - (iii) the quality of the working relationship with the audit partner;
  - (iv) the reputation of the firm; and
  - (v) the technical competence of the audit partner.

2.9 Indeed, the CC itself recognises in the Working Paper that technical quality is of value to management even absent any consideration of their own statutory and other duties<sup>26</sup>. Our experience is that company stakeholders understand clearly how the two interact.

2.10 Thus, the evidence shows that management and investors (and regulators) highly value a wide range of facets of audit quality – including both “technical” quality and “service” quality. There is no evidential basis for the suggestion in the Working Paper that there is a misalignment of incentives as between management and investors as to the delivery of audit quality. Furthermore, as the CC correctly explains, where interests are properly aligned, information asymmetries (to the extent that they may exist as between the company and its shareholders) cease to be of competitive concern<sup>27</sup>. As a consequence, the concern posited in the Working Paper as to information asymmetries and misaligned incentives as between the company and investors has no evidential basis.

### **Audit risk**

2.11 The second key characteristic of the market that requires fuller consideration by the CC is audit risk (i.e. risk of an audit failure).

2.12 Auditors are further incentivised to deliver high levels of quality in all of its dimensions by another central feature of the market that we have explained to the CC<sup>28</sup>: the potentially unlimited risk that auditors bear in circumstances of loss to shareholders occasioned by a failing of audit quality.

2.13 We have explained that auditors face potentially unlimited liability for audit quality failures which lead to loss to investors<sup>29</sup>. This risk is magnified in the reference market due to the size of the companies and the level of complexity of their operation<sup>30</sup>.

<sup>24</sup> See, for example, paragraph 2.3.14 of the AIU's Audit Quality Inspections Annual Report 2011/12.

<sup>25</sup> Beattie, V. and Fearnley, S. (1995), “The importance of audit firm characteristics and the drivers of auditor change in UK listed companies”, *Accounting and Business Research*, Volume 25, pp.227-239.

<sup>26</sup> See paragraph 18 of the Working Paper, where the CC (correctly) explains that an audit that demonstrates high technical quality is useful for management as a signal of their competence and integrity.

<sup>27</sup> See paragraph 67 of the Working Paper where the CC notes that where interests are aligned, there is less potential for any information asymmetries to distort competition. We address reporting to investors in the context of the CC's second theory of harm below (see section 5 below).

<sup>28</sup> See paragraph 2.9 of Deloitte's response to the Issues Statement and paragraph 3.5 of Deloitte's Summary of its response to the CC's Market Questionnaire.

- 2.14 This is reflected in the internal controls that we have in place, and the investments we make, to ensure high levels of audit quality (in all its dimensions).
- 2.15 The contribution that this makes to the alignment of the incentives of the auditor and its customers (both companies and their investors) can perhaps be seen in the reluctance of the market to accept limitations on auditors' liability. As the CC is aware, auditors are permitted to limit their liability by contract, but, in practice, this has never been achieved in the reference market<sup>31</sup>.
- 2.16 Furthermore, auditors are also very aware of the risk to their own reputation (which is founded on continued delivery of high quality)<sup>32</sup>. This is widely acknowledged:

(a) **OECD:**

*"Reputation is an important mechanism to punish low-quality auditing."*<sup>33</sup>

(b) **Grant Thornton:**

*"All firms would recognise that reputational risk is so great that, like an airline, we simply cannot afford any crashes. For this reason, whatever the field of competition, no firm can afford to be anything less than fully robust in terms of the objectivity of the advice provided."*<sup>34</sup>

(c) **BDO:**

*"If people lost confidence (based on a firm's reputation) in the audit, then the firm would not survive. BDO said that this was what happened with Andersen."*<sup>35</sup>

- 2.17 The lessons of Arthur Andersen show just how precarious reputation can be in this market, and what the consequences of clients' loss of confidence in a firm can be. This provides a further incentive to ensure that all of the audits we undertake are of a very high quality.
- 2.18 Further, if an auditor was to align themselves with management at the expense of investors, this would be an extremely risky strategy. The majority of audit failures have in their genesis some sort of management or corporate failing at the outset. It is essential that auditors have an independence of mind at the same time as delivering high quality.

### **Expert and informed buyers**

- 2.19 The third key characteristic of the market that requires fuller consideration by the CC is the expert and informed nature of buyers the FTSE 350.
- 2.20 FTSE 350 ACCs and CFOs are (a) highly expert and (b) highly informed buyers of audit services. As we have explained, they are well able to discern quality and value, and make informed

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<sup>29</sup> Ibid.

<sup>30</sup> This risk is not mitigated (as seems to have been suggested by certain parties – see paragraph 16 *et seq* of the summary of the CC's hearing with institutional investors) by the judgment in *Caparo v. Dickman*, which limits the class to whom an auditor may owe a duty of care, but does not limit the auditor's liability where there is a failure leading to loss.

<sup>31</sup> The **ACCA** also notes this view in its written evidence to the House of Lords Economic Affairs Committee: see page 36 of Volume 2 of the House of Lords Report.

<sup>32</sup> The literature suggests that this effect may be particularly significant for large firms. See **DeAngelo**, L.E. (1981), "Auditor size and audit quality", *Journal of Accounting and Economics*, 3(3), pp 93-199.

<sup>33</sup> Page 8 of OECD Policy Roundtable, *Competition and regulation in auditing and related professions*, 2009.

<sup>34</sup> Grant Thornton written evidence to the House of Lords Economic Affairs Committee. See page 124 of Volume 2 of the House of Lords Report.

<sup>35</sup> Paragraph 47 of the summary of BDO's hearing with the CC.

decisions about auditor appointment accordingly<sup>36</sup>. This is strongly supported by the evidence before the CC, which the CC ought to reflect fully in its conclusions on how the market operates in practice.

### *Expert buyers*

2.21 First, the evidence shows clearly that ACCs and CFOs have an expert background:

- (a) the CC's **case studies** show experience built up over many years, commonly across multiple companies<sup>37</sup>;
- (b) the **case studies** similarly indicate very high levels of relevant professional expertise. In every case, both the CFO/finance director<sup>38</sup> and the ACC is a qualified accountant, with several possessing specific and significant audit experience<sup>39</sup>. The point is specifically noted by the ACC of **Company G**, who explains that he:

*“considered that his background (at KPMG) meant he was well placed to understand accounting issues that related to judgment.”<sup>40</sup>*

- (c) other evidence makes it clear that the CC's case studies are representative. For example, the CC may note **ACCA's** evidence to the House of Lords Economic Affairs Committee:

*“The buyers of professional services are sophisticated and frequently have a professional background themselves. They are in a prime position to understand the needs of their organisations and to commission services which best support their strategies and objectives.”<sup>41</sup>*

2.22 The CC will be aware of the relevant provisions of the Corporate Governance Code (the **Code**), which require that at least one member of the audit committee should have recent and relevant financial experience<sup>42</sup>. The **FRC's Guidance on Audit Committees** goes on to explain that:

*“It is desirable that the committee member whom the board considers to have recent and relevant financial experience should have a professional qualification from one of the professional accountancy bodies. The need for a degree of financial literacy among the other members will vary according to the nature of the company, but experience of corporate financial matters will normally be required. The availability of appropriate financial expertise will be particularly important where the company's activities involve specialised financial activities.”<sup>43</sup>*

It also contains details of appropriate training for members of audit committees. In Deloitte's experience, FTSE 350 audit committee members and, especially, ACCs, are nowadays highly expert and highly qualified to perform their roles<sup>44</sup>.

<sup>36</sup> See paragraph 3.7 *et seq* of Deloitte's summary of its response to the CC's Market Questionnaire.

<sup>37</sup> See paragraphs 12 and 49 of the Company A case study; paragraphs 5, 35 and 58 of the Company B case study; paragraphs 5 and 45 of the Company C case study; paragraphs 5 and 47 of the Company D case study; paragraphs 3 and 37 of the Company E case study; paragraphs 4 and 35 of the Company F case study; paragraphs 5-6 and 49 of the Company G case study; paragraphs 5 and 51 of the Company H case study; paragraphs 4 and 36 of the Company I case study; and paragraphs 6 and 32 of the Company J case study.

<sup>38</sup> In the case of Company G, the relevant respondent was the Global Financial Controller, and, in the case of Company J, the Fund Accounting Manager, who similarly have an accountancy background. For references, see footnote 39 above.

<sup>39</sup> See, for example, the CFO and ACC of Company A, the ACC of Company C, the finance director of Company E, the ACC of Company F, the Global Financial Controller of Company G and the ACC of Company H.

<sup>40</sup> Paragraph 55 of the Company G case study.

<sup>41</sup> See page 33 of Volume 2 of the House of Lords Report.

<sup>42</sup> Paragraph C.3.1 of the Corporate Governance Code.

<sup>43</sup> FRC, *Guidance on Audit Committees*, paragraph 2.16.

<sup>44</sup> *Ibid*, paragraph 2.17 *et seq*.

## Informed buyers

2.23 Furthermore, the evidence overwhelmingly shows that ACCs and CFOs commit large amounts of time to understanding and monitoring the audit, and hence have very strong visibility over the quality and performance of the audit:

(a) first, the **case studies** show very high levels of involvement of the CFO and finance team in performance of audit. For example:

(i) **Company A:** the CFO explains that he meets with the Audit Engagement Partner (“AEP”) *“every three weeks all year round”* in addition to the *“ten Audit Committee meetings a year”*<sup>45</sup>;

(ii) **Company C:** the CFO indicates that he has *“monthly meetings”* with the audit engagement partner and hence:

*“pretty good visibility of what the auditors were doing, the geographies they were looking at and the matters that concerned them.”*<sup>46</sup>

(iii) **Company G:** the Global Financial Controller describes his interaction with the company’s auditors as:

*“...extensive throughout the year. The interaction was most intense around the half-year and year-end reporting when he spoke with the auditors daily and sometimes several times a day.”*<sup>47</sup>

(iv) **Company I:** the finance director observes that he has *“very frequent contact with the senior AEP during the year, approximately every two weeks”*<sup>48</sup>, with a yet closer relationship with the company’s finance team who are *“responsible for the day to day running of the audit process”*<sup>49</sup>;

(v) **Company J:** the Fund Accounting Manager indicates that he has:

*“clear visibility of the auditor’s work as he answered many of the questions the auditor had.”*<sup>50</sup>

(b) second, the **case studies** also show very high levels of engagement between the ACC and the auditor. For example:

(i) **Company A:** the ACC notes the *“10 Audit Committee meetings per year”*, in addition to other informal meetings with the audit engagement partner<sup>51</sup>. The company’s CFO particularly notes the level of the ACC’s engagement:

*“The CFO met the ACC before Audit Committee papers went out. The ACC came in for a day, sometimes two days, and sat with the people who had prepared the papers (auditors, legal, internal finance) to check that he was happy with them.”*<sup>52</sup>

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<sup>45</sup> Paragraph 13 of the Company A case study.

<sup>46</sup> Paragraphs 7 and 8 of the Company C case study.

<sup>47</sup> Paragraph 8 of the Company G case study.

<sup>48</sup> Paragraph 5 of the Company I case study.

<sup>49</sup> Paragraph 7 of the Company I case study.

<sup>50</sup> Paragraph 9 of the Company J case study.

<sup>51</sup> Paragraph 50 of the Company A case study.

<sup>52</sup> Paragraph 16 of the Company A case study.

- (ii) **Company C:** the ACC notes the “*continual dialogue between the Audit Committee, management and the auditor*”, meaning that issues are always well-ventilated<sup>53</sup>;
  - (iii) **Company E:** the ACC notes his “*regular contact with the AEP*”, involving the audit committee meetings, pre-meetings and informal discussions<sup>54</sup>;
  - (iv) **Company G:** the ACC explains that he has:
 

*“very regular contact with the external auditors (PwC). He would meet or talk with them monthly throughout the year to discuss any issues that they might have.”*<sup>55</sup>

The ACC also notes that he travels to overseas subsidiaries to meet with local audit teams<sup>56</sup>;
  - (v) **Company H:** the ACC notes both his interactions with the auditor (in particular the audit engagement partner)<sup>57</sup> and:
 

*“[the] very full report from the auditors which described discussions between management and the auditors on significant accounting issues”*<sup>58</sup>
  - (vi) **Company I:** the ACC indicates that he has “*quite a lot of detail of the auditors’ work*”, based (*inter alia*) on “*comprehensive reports of the extent and scope of their work*”<sup>59</sup>.
- (c) third, a similar picture emerges from the **CC interviews** with 3i Group and the anonymous company, both of which indicate extensive engagement:
- (i) **3i Group:** the company notes the “*peer-to-peer engagement*”<sup>60</sup> that characterises the audit, as well as the more formal interactions through the audit committee<sup>61</sup>;
  - (ii) **Anonymous company:** the summary of the discussion with the anonymous company notes the “*weekly meetings between the auditors and management*” leading to “*interactive discussion and multiple layers of contact between the company and the auditors as the audit was delivered*”<sup>62</sup>. They are clear that “*senior management ensured that it had a line of sight on all relevant issues*”<sup>63</sup>. They also note that the audit committee “*worked very hard and was an important source of challenge*”<sup>64</sup>;
- (d) fourth, this position is confirmed by the most recent and most comprehensive empirical study in the literature, undertaken by **Professor Vivien Beattie, Professor Stella Fearnley and**

<sup>53</sup> Paragraph 50 of the Company C case study.

<sup>54</sup> Paragraph 39 of the Company E case study.

<sup>55</sup> Paragraph 52 of the Company G case study.

<sup>56</sup> Paragraph 54 of the Company G case study.

<sup>57</sup> Paragraph 55 of the Company H case study.

<sup>58</sup> Paragraph 60 of the Company H case study.

<sup>59</sup> Paragraph 39 of the Company I case study.

<sup>60</sup> Paragraph 5 of the summary of the conference call with 3i Group.

<sup>61</sup> Paragraph 4 of the summary of the conference call with 3i Group.

<sup>62</sup> Paragraph 7 of the summary of the conference call with the anonymous company.

<sup>63</sup> Ibid.

<sup>64</sup> Paragraph 9 of the summary of the conference call with the anonymous company.

**Tony Hines**<sup>65</sup>. Their study finds, in particular, that “*audit committee chairs are fully engaged with the financial reporting process*”<sup>66</sup>;

(e) fifth, the CC’s **case studies** show detailed review of auditor’s performance, commonly involving large numbers of people who have interacted with the auditor. For example:

(i) **Company A:** the ACC states that the auditor is appraised annually against a long and detailed list of criteria, under the following top-level headings:

(A) robustness of the audit process (including professional scepticism);

(B) quality of delivery; and

(C) quality of people and service<sup>67</sup>;

(ii) **Company C:** the CFO explains:

*“[the] annual appraisal of the auditor’s effectiveness through a formal questionnaire completed by members of the Audit Committee, the Chief Auditor, General Counsel and regional senior management”*<sup>68</sup>.

He notes the areas reviewed:

(A) independence and objectivity;

(B) financial stability and risk profile of the firm;

(C) audit strategy;

(D) communication of adverse or unexpected findings;

(E) finalisation of the audit; and

(F) concluding matters<sup>69</sup>;

(iii) **Company D:** the finance director explains that:

*“most years, the company sent a survey to its subsidiaries to rate the quality of the audit...The survey covered topics such as meeting deadlines, understanding the local businesses, the audit team continuity and performance, insights provided by the audit team.”*<sup>70</sup>

(iv) **Company E:** the finance director notes that there is an annual “*discussion at all levels of the business*”<sup>71</sup> on the auditor’s performance, conducted by management and also involving the audit committee<sup>72</sup>;

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<sup>65</sup> Beattie, Fearnley and Hines, “Reaching key financial reporting decisions: how directors and auditors interact”, ICAEW, 2011.

<sup>66</sup> Ibid, page 8. See also the joint work of the **FRC, ICAS and the Institute of Chartered Accountants in Australia**, *Walking the line: discussions and insights with leading audit committee members*, 2012.

<sup>67</sup> Paragraph 60 of the Company A case study.

<sup>68</sup> Paragraph 25 of the Company C case study.

<sup>69</sup> Paragraph 26 of the Company C case study.

<sup>70</sup> Paragraph 39 of the Company D case study.

<sup>71</sup> Paragraph 19 of the Company E case study.

<sup>72</sup> Paragraph 50 of the Company E case study.

- (v) **Company F:** the ACC notes the “*annual review process*” based on the following criteria:
- (A) quality of work;
  - (B) independence;
  - (C) timeliness of work;
  - (D) effectiveness of reporting;
  - (E) rigour; and
  - (F) relationship with management<sup>73</sup>;
- (vi) **Company G:** the Global Financial Controller explains a detailed process for assessing the performance of the auditor, by means of a “*thorough questionnaire...sent each year to around 40 or 50 people around the company who had the main contact with the auditors*”<sup>74</sup>. The relevant criteria are noted as follows:
- (A) independence;
  - (B) knowledge of the business and risks;
  - (C) effective liaison with internal auditor;
  - (D) quality of delivery, including timely resolution of issues, communication and presentation and working relationship with management;
  - (E) quality of people and service;
  - (F) transition of lead audit engagement partners; and
  - (G) value<sup>75</sup>;
- (vii) **Company H:** the FD explains that the company “*produced a full written report on the auditor every year*”, based in part on best practice guidelines produced by ICAS. The comprehensive criteria include:
- (A) relationship;
  - (B) independence;
  - (C) competence;
  - (D) communication;
  - (E) objectivity;
  - (F) financial stability and risk profile;
  - (G) audit strategy;

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<sup>73</sup> Paragraph 49 of the Company F case study.

<sup>74</sup> Paragraph 17 of the Company G case study.

<sup>75</sup> Paragraph 18 of the Company G case study.

- (H) communication of adverse or unexpected findings; and
  - (I) finalisation of the audit<sup>76</sup>;
- (viii) **Company I:** the company runs an annual appraisal process, assessing the auditor against criteria including:
- (A) independence and objectivity;
  - (B) the members of the audit team;
  - (C) technical skills; and
  - (D) service level and fees<sup>77</sup>;
- (f) sixth, the CC's **market survey** shows that this level of appraisal of auditor's performance is common and widespread. The survey indicates that 91% of FTSE 350 companies undertake an annual post-audit review of the quality and value provided by the auditor<sup>78</sup>. This is supported by other surveys of audit committee behaviour<sup>79</sup>; and
- (g) finally, the CC will note that the picture set out in the evidence that has been submitted to it is consistent with (and generally exceeds) the standards nowadays set in the **Corporate Governance Code**<sup>80</sup>.
- 2.24 This visibility means that company stakeholders do not have to rely on mere "reputation": they can rely on actively solicited insights into the quality and value delivered. Reputation thus becomes the *result* of such insight, rather than a proxy for such insight.
- 2.25 This extensive evidence is inconsistent with BDO's suggestion that it would generally expect an auditor to have no contact with an ACC or audit committee apart from two meetings each year<sup>81</sup>: in our experience, this is not the level of engagement demanded by companies in the FTSE 350. Moreover, the evidence is inconsistent with suggestions from BDO and GT that ACCs and management are not well-informed about the audit process and the delivery of audit quality<sup>82</sup>.
- 2.26 By contrast, it is highly consistent with the explanations and evidence that Deloitte has given to the CC on the extent of its interaction with its FTSE 350 clients<sup>83</sup>. In the light of the above, we welcome and strongly concur with the CC's acknowledgement that its initial view is that ACCs and CFOs have a high degree of visibility on audit quality in all its dimensions<sup>84</sup>.

### ***The additional mechanisms for aligning interests of shareholders, directors and auditors***

- 2.27 The fourth key characteristic of the market that requires fuller consideration by the CC is the large number of additional mechanisms for aligning the interests of shareholders, directors and auditors.

<sup>76</sup> Paragraph 30 of the Company H case study.

<sup>77</sup> Paragraph 17 of the Company I case study.

<sup>78</sup> See page 46 of the CC Survey.

<sup>79</sup> See, for example, the **KPMG** survey of audit committee members at [http://www.audit-committee-institute.be/dbfetch/52616e646f6d4956837c649d722e3cc59976a839ccbbef6b/aci\\_survey\\_june2010\\_1\\_.pdf](http://www.audit-committee-institute.be/dbfetch/52616e646f6d4956837c649d722e3cc59976a839ccbbef6b/aci_survey_june2010_1_.pdf).

<sup>80</sup> See paragraph C.3.2 of the Code and the Guidance on Audit Committees. See further paragraph 2.30 *et seq* below.

<sup>81</sup> See page 3 of BDO's response to Deloitte's Summary of its response to the Market Questionnaire.

<sup>82</sup> See, for example, paragraphs 3.4 and 9.2 of Grant Thornton's response to the Issues Statement and paragraph 26 of the summary of BDO's hearing with the CC.

<sup>83</sup> See, in particular, Deloitte's response to questions 80 and 84 of the CC's Market Questionnaire.

<sup>84</sup> Paragraph 63 of the Working Paper.

- 2.28 We have explained above that the evidence shows that the interests of investors, directors (and management) and auditors are all well-aligned in relation to the delivery of high quality audit<sup>85</sup>.
- 2.29 The Working Paper sets out a conceptual concern about misalignments of interest between these groups, but fails to note the many mechanisms in place to ensure that these interests are better aligned in practice. It is essential that the CC fully takes into account how the market works in practice, rather than relying on theoretical expositions of free-rider and principal/agent problems.

#### *Investor scrutiny*

- 2.30 The origin of the free rider issue identified in the Working Paper<sup>86</sup> is well documented<sup>87</sup>, but the Working Paper appears not to recognise the measures put in place to address its consequences in practice. The CC must take account of these measures, which include the following:
- (a) there has been extensive policy encouragement for shareholders (especially large institutional shareholders) to take a much more active role in governance. For example:
    - (i) the **Cadbury Report** of 1992 recommended (consistent with the work of the Institutional Shareholders Committee<sup>88</sup>) that shareholders “*should make positive use of their voting rights*”<sup>89</sup>;
    - (ii) the **Myners Report** of 2001 encouraged institutional investors to adopt and disclose an explicit strategy on the circumstances in which they would intervene<sup>90</sup>;
    - (iii) the **Department for Business, Innovation and Skills (BIS)** consulted in early 2012 on extending the powers of shareholders to intervene in relation to executive pay<sup>91</sup>; and
    - (iv) the **Kay Report** of 2012 further supported active engagement by institutional shareholders in key corporate decisions, as it sought to “improve the quality of engagement by investors with companies, emphasising and broadening the existing concept of stewardship”<sup>92</sup>;
  - (b) shareholder engagement on good corporate governance practices is increasingly supported and scrutinised by bodies such as PIRC and the Association of British Insurers (**ABI**). Their activities include:
    - (i) policy support for good corporate governance practices<sup>93</sup>; and
    - (ii) giving indications to shareholders as to compliance with best practice by companies in which they invest;
  - (c) the last few years have seen a marked increase in shareholder activism – primarily focused on executive compensation, but also ranging more broadly. As the evidence in front of the

<sup>85</sup> See paragraph 2.2 *et seq* above.

<sup>86</sup> Paragraph 10(b) of the Working Paper.

<sup>87</sup> See, for example, paragraph 5.88 of the Final Report of the Myners Review of Institutional Investment (the **Myners Report**).

<sup>88</sup> Now the Institutional Investors Committee: see <http://www.iicomm.org>.

<sup>89</sup> See paragraph 6.11 of the Final Report of the Committee on Financial Aspects of Corporate Governance (the **Cadbury Report**).

<sup>90</sup> See principle 6 proposed in the Myners Report (at page 149 of the Myners Report).

<sup>91</sup> See BIS, *Shareholder Voting Rights Consultation*, March 2012.

<sup>92</sup> See page 9 of the Final Report of the Kay Review of UK Equity Markets and Long-Term Decision-Making (the **Kay Report**).

<sup>93</sup> See, for example, PIRC’s annual UK Shareholder Voting Guidelines.

CC makes clear, issues such as auditor provision of non-audit services have an increasingly high profile with investors<sup>94</sup>:

(i) **Company E:** the ACC notes that:

*“he received a specific request to meet two investors. The investors had a strong view that the same firm should not provide the internal and external audit, as they saw a clear conflict of interest. Those investors voted against the Audit Committee Report at the last AGM.”*<sup>95</sup>

(ii) **Hermes Equity Ownership Management:** in relation to TUI Travel, Hermes notes that:

*“there had been a problem with the accounts, and the company sought to change the auditor to be the same as that of the parent (TUI AG). Since it appeared that the parent might bid to acquire TUI Travel, this caused concern for many shareholders as they did not consider the auditor to be fully independent. In addition, they were unclear as to this auditor’s role in the accounting issue as it had previously audited parts of the business. Accordingly, several voted against the management recommendation.”*<sup>96</sup>

(iii) **Legal and General Investment Management:** Legal and General note a number of companies in relation to which they made their views known on auditor issues – including Alfred McAlpine<sup>97</sup> and an unnamed company<sup>98</sup>.

#### *The interests of directors and shareholders*

2.31 The origin of the conceptual principal/agent issue raised in the Working Paper<sup>99</sup> is well understood<sup>100</sup>, but the posited effects are not ones that we recognise in the market. The Working Paper again seems to focus on the theory to the exclusion of the evidence - evidence which indicates that the issues are well-addressed in practice. In our experience, directors (especially in the FTSE 350) are very conscious of their responsibilities to shareholders:

(a) the Working Paper does not note the fiduciary duties that directors owe to act in the best interests of the company and, as a result, in the best interests of the company’s owners. These fiduciary duties, as the CC will be aware, originate in common law and are now codified in the Companies Act 2006:

(i) Section 172: “A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole.”

(ii) Section 174: “A director of a company must exercise reasonable care, skill and diligence.”

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<sup>94</sup> We note that the Oxera Investor Paper sets out a number of non-audit services in relation to which “investors generally have concerns about the auditor performing” (page 14 of the Oxera Investor Paper). The Paper fails to note that, in fact, many of these services cannot be provided by the auditor to a listed entity as a result of FRC ethical standards. Of the items listed, book-keeping and preparation of financial records and statements, valuation services and recruitment services for key management positions cannot be provided by the auditor to a listed entity. Tax services are also restricted. The CC should treat the Oxera Investor Paper with appropriate caution.

<sup>95</sup> Paragraph 43 of the Company E case study.

<sup>96</sup> Paragraph 2 of the summary of the hearing with Hermes Equity Ownership Management.

<sup>97</sup> Paragraph 7 of the Legal and General case study.

<sup>98</sup> Paragraph 9(a) of the Legal and General case study. In this case, Legal and General made their feelings known by voting against the resolution on director remuneration.

<sup>99</sup> Paragraph 11 of the Working Paper.

<sup>100</sup> See, *inter alia*, page 11 of the Literature Review conducted for the CC by Professor Vivien Beattie.

- (iii) Section 175(1): A director of a company must avoid a situation in which he has, or can have, a direct or indirect interest that conflicts, or possibly may conflict, with the interests of the company.”
- (b) the CC appears to underplay the extensive corporate governance scheme in place in the UK, primarily under the auspices of the FRC, which attracts high level of compliance among the FTSE 350.

As the CC is aware, this scheme is embodied in the Code, overseen by the FRC. It has been developed and refined over many years since its genesis in response to the Cadbury Report in 1992. Those developments and refinements have resulted in part from organic development under the auspices of the FRC (see, for example, its current consultation<sup>101</sup>, which we address further below), and through major reviews of UK corporate governance, including:

- (i) the Greenbury Review (1995) in relation to director remuneration;
- (ii) the Hampel Review (1998), reviewing progress since the Cadbury Report;
- (iii) the Turnbull Review (1999) in relation to financial reporting;
- (iv) the Myners Review (2001) on institutional investors;
- (v) the Higgs Review (2003) on non-executive directors;
- (vi) the Smith Review (2003) on audit committees;
- (vii) the Walker Review (2009) in relation to the financial crisis.

We do not believe that the CC can properly consider the principal/agent issue which it raises without considering it in the context of the corporate governance regime in place in the UK and the detailed consideration and study that has led to the development over time of this regime;

Deloitte works closely with audit committees and their chairs and publishes extensive literature to assist them in their work. The full range may be found within the Deloitte Centre for Corporate Governance website at: <http://www.corpgov.deloitte.com/site/uk/audit-committee/>. For example, Deloitte publishes:

- (i) a detailed guide to the roles and responsibilities of audit committee members (particularly that of the ACC)<sup>102</sup>;
  - (ii) audit committee self-evaluation checklists<sup>103</sup>; and
  - (iii) advice and surveys on reporting by audit committees<sup>104</sup>;
- (c) the CC’s case studies note multiple statements from directors (particularly ACCs) that their understanding of their role is to pursue and protect shareholders’ interests:

<sup>101</sup> See <http://www.frc.org.uk/getattachment/4794e206-50a7-45d1-815c-7393046fef33/Consultation-Dicument-revisions-to-teh-UK-Corporat.aspx>. See also details of previous reviews at <http://www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Corporate-Governance-Code/Previous-reviews-and-consultations.aspx>.

<sup>102</sup> See [http://www.corpgov.deloitte.com/binary/com.epicentric.contentmanagement.servlet.ContentDeliveryServlet/UKEng/Documents/Landing%20Page/UK\\_Audit\\_Catch\\_the\\_2009\\_current.pdf](http://www.corpgov.deloitte.com/binary/com.epicentric.contentmanagement.servlet.ContentDeliveryServlet/UKEng/Documents/Landing%20Page/UK_Audit_Catch_the_2009_current.pdf).

<sup>103</sup> See <http://www.corpgov.deloitte.com/binary/com.epicentric.contentmanagement.servlet.ContentDeliveryServlet/UKEng/Documents/Landing%20Page/Audit%20Committee%20performance%20evaluation%20checklist%20Feb%202011.pdf>.

<sup>104</sup> See, for example, <http://www.corpgov.deloitte.com/binary/com.epicentric.contentmanagement.servlet.ContentDeliveryServlet/UKEng/Documents/Swimming%20in%20words%20-%20LR.pdf>.

- (i) **Company A:** the ACC explains that he sees his role
    - “as a non-executive to be protecting the smaller minority [ ] per cent shareholders.”<sup>105</sup>*
  - (ii) **Company C:** the ACC states that:
    - “his role was to see that the company was well run and controlled. He was there to represent shareholders and other stakeholders.”<sup>106</sup>*
  - (iii) **Company D:** the ACC states that she sees
    - “her role on behalf of the shareholders [as being] to make sure that management was managing the business and that the results were credible and reliable.”<sup>107</sup>*
  - (iv) **Company F:** the ACC notes that *“the Board was ultimately in place to protect shareholders.”<sup>108</sup>*
- (d) the CC’s **case studies** note multiple references by directors to the fact that their “reputation is on the line” if they make bad decisions in their fiduciary capacity:
- (i) **Company E:** the ACC observes that:
    - “his greatest incentive to complete the job diligently [in his role as ACC] was that he was ‘putting his reputation on the line’.”<sup>109</sup>*
  - (ii) **Company G:** the ACC notes that:
    - “the company’s reputation, as well as his own, was at stake if he did not do a thorough job.”<sup>110</sup>*
  - (iii) **Company I:** the ACC states that:
    - “the main factors that influenced [his] performance were personal integrity and professional reputation, and following appropriate corporate governance practices.”<sup>111</sup>*
- (e) the emphasis and recognition of these responsibilities have been exacerbated in the light of the increased shareholder activism that we note above<sup>112</sup>. We believe that directors are very (and increasingly) conscious of their fiduciary responsibilities towards shareholders and are highly diligent in seeking to meet them.

2.32 In summary, our experience is that directors (both executives and non-executives) are very conscious of their responsibilities to shareholders (including as regards financial reporting and audit. The Working Paper neglects the evidence to this effect, and we urge the CC to take this evidence on board much more fully in its subsequent work.

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<sup>105</sup> Paragraph 55 of the Company A case study.

<sup>106</sup> Paragraph 56 of the Company C case study.

<sup>107</sup> Paragraph 57 of the Company D case study.

<sup>108</sup> Paragraph 48 of the Company F case study.

<sup>109</sup> Paragraph 48 of the Company E case study.

<sup>110</sup> Paragraph 34 of the Company G case study.

<sup>111</sup> Paragraph 44 of the Company I case study.

<sup>112</sup> See paragraph 2.30 *et seq* above.

### **Conclusion on features of the market**

2.33 In the light of the above, it seems to us that there are several features of the market which appear to be central to obtaining a proper understanding of the operation of the market for statutory audit of large companies in the UK but which are under-explored in the Working Paper. A careful examination of the evidence before the CC makes it clear just how central these features are. We urge the CC to give these features its full consideration.

### **3. The three key features identified by the CC**

3.1 We comment below briefly on the three features of the market identified by the CC in the Working Paper:

- (a) the nature of the audit product;
- (b) misalignment of objective and information asymmetries; and
- (c) cost structure.

#### ***The nature of the audit product***

3.2 The first key feature of the market which the Working Paper discusses is the nature of the audit product.

#### ***A regulated product***

3.3 The Working Paper suggests that regulation may affect the scope for competition on some aspects of the audit service<sup>113</sup>. In fact, while regulation generally sets a *baseline*, this baseline does not match the expectations of companies in that market, meaning that there is still scope for strong competition on price and quality<sup>114</sup>.

3.4 Market commentators explain their agreement with the view that there is extensive scope for competition beyond the regulatory baseline:

(a) **ICAEW:**

- (i) *“The application of standards is taken to be a necessary but not a sufficient condition for achieving audit quality.”*<sup>115</sup>
- (ii) *“Auditing standards are no substitute for the exercise of audit judgement, which is where mistakes are made.”*<sup>116</sup>

(b) **Hermes:**

- (i) *“While there are detailed and specific standards...these are a minimum threshold.”*<sup>117</sup>
- (ii) *“Regulation should be seen as a minimum requirement.”*<sup>118</sup>

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<sup>113</sup> Paragraph 56 of the Working Paper.

<sup>114</sup> See further Deloitte’s response to the CC’s Law and Regulation Working Paper.

<sup>115</sup> ICAEW, “Audit quality: challenges for international consistency”, June 2010.

<sup>116</sup> ICAEW, “Audit quality: Fundamentals – principles-based auditing standards”, July 2006.

<sup>117</sup> Page 2 of Hermes’ Response to the Issues Statement, page 2.

<sup>118</sup> Paragraph 25 of the summary of Hermes’ meeting with the CC.

- 3.5 By contrast with the position with regard to the substantive delivery of the audit, regulation may have an impact on some aspects of engagement with investors and on reporting, and we address these in detail below<sup>119</sup>.
- 3.6 Our experience leads us to caution against too narrow a view of the regulatory background to the CC's work: the CC needs also to consider the international context. The Working Paper does not pick up (though it is noted briefly in the CC's recent working paper on the Development of Statutory Financial Audit (the **Development of Statutory Financial Audit Working Paper**)<sup>120</sup>) the international nature of much of this regulation:
- (a) many of the corporate governance provisions in UK company law (including as regards the statutory audit) have their genesis in the various European Company Law Directives (which underpin successive Companies Acts from 1980 onwards)<sup>121</sup>;
  - (b) accounting standards regulation is increasingly international, and the CC will be aware of the extensive debate on IFRS standards and their effect on audit conduct and reporting. This issue has been raised in the evidence that has been put to the CC<sup>122</sup> and is extensively discussed in the report of the Economic Affairs Committee of the House of Lords<sup>123</sup>;
  - (c) many standards for auditing are now set on an international basis via the International Federation of Accountants (**IFA**), which, through its subsidiary body, the International Auditing and Assurance Standards Board (**IAASB**), sets auditing and other standards. These standards set minimum thresholds<sup>124</sup> for multiple aspects of the conduct of any audit, including:
    - (i) ISA 230: audit documentation;
    - (ii) ISA 320: audit materiality;
    - (iii) ISA 500: audit evidence;
    - (iv) ISA 530: audit sampling;
    - (v) ISA 570: going concern;
    - (vi) ISA 600: audits of group financial statements (including the work of component auditors); and
    - (vii) ISA 706: emphasis of matter.
- 3.7 The CC may note the striking fact of the important role that UK auditors play internationally. In its reference decision, the **OFT** notes:

*"the UK's leading position in the global audit sector"*<sup>125</sup>.

<sup>119</sup> See paragraph 5.10 *et seq* below.

<sup>120</sup> See paragraphs 4 and 53 of the Development of Statutory Audit Working Paper.

<sup>121</sup> *Ibid.*

<sup>122</sup> See, for example, the submission of the Universities Superannuation Scheme (page 1).

<sup>123</sup> House of Lords Economic Affairs Committee, *Auditors – Market concentration and their role* (the **House of Lords Report**) (see, in particular, paragraph 111 *et seq*).

<sup>124</sup> Deloitte has explained to the CC that the audit regulation sets only a baseline for the delivery of a high quality audit. The fact that a firm meets all applicable regulatory standards does not mean that it is well-equipped to compete effectively in the market for the audit of FTSE 350 companies or respond to the requirements of these companies. Consequently, there is extensive quality competition between market participants, as they go beyond these regulatory baselines.

<sup>125</sup> See paragraph 1.14 of the OFT's market investigation reference decision.

We believe that this reflects the high standard of audit that prevails in the UK (although we are never complacent about the need to maintain this), as well as the increasingly international nature of major UK listed companies, which we discuss further below.

#### *A bespoke product*

3.8 We agree with the CC that audit is a bespoke product<sup>126</sup>. We believe this has a positive effect on competition: it increases the scope for competition on quality and innovation grounds, as firms seek more effectively to tailor the audit to a company's needs. A firm that considers that an audit of FTSE 350 company is a commodity service will not be successful in this market<sup>127</sup>.

3.9 This feature does not, as the Working Paper suggests, have a negative impact on the potential for price competition. The evidence to the contrary is extensive:

(a) the **survey evidence** shows that companies are very aware of value and price considerations when making auditor appointment and appraisal decisions:

- (i) "efficiency of the audit process" is amongst the most important features identified in assessing the quality of the audit – particularly for CFOs<sup>128</sup>;
- (ii) only 8% of CFOs of FTSE 350 companies say that price is "not important" in making auditor appointment decisions<sup>129</sup>;
- (iii) the overwhelming majority of FTSE 350 companies (93%) renegotiate the audit fee annually, and 100% of them do so at least every three years<sup>130</sup>; and
- (iv) value for money offered by the existing auditor is the second most important reason cited for not going out to tender<sup>131</sup>, and price is amongst the most important reasons for a company's decision that it should go out to tender<sup>132</sup>;

(b) moreover, the **survey evidence** shows that benchmarking is widespread and regular:

- (i) a quarter of FTSE 350 companies (a proportion much higher than outside the reference market) benchmark audit fees every single year;
- (ii) more than half benchmark at least every three years; and
- (iii) more than two thirds benchmark at least every five years<sup>133</sup>.

This strongly suggests that companies see benchmarking as a meaningful and effective tool to generate value for money. Our experience is that clients internally benchmark our audit work (for example across divisions of the same client) as well as externally;

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<sup>126</sup> Paragraph 57 *et seq* of the Working Paper.

<sup>127</sup> We are aware of the concerns of certain investors that statutory audit has become a commoditised service, but note that these concerns are not shared by those who are closest to the substantive delivery of the audit – company stakeholders such as the CFO and ACC. As we explain later in this response (see paragraph 5.11 below), it appears to us that many or most of investors' concerns relate to reporting rather than the substantive audit process; we address reporting issues below in section 5.

<sup>128</sup> See page 26 of the CC Survey.

<sup>129</sup> See page 34 of the CC Survey. The equivalent figure for ACCs in the FTSE 350 is 13%.

<sup>130</sup> See page 46 of the CC Survey.

<sup>131</sup> See page 60 of the CC Survey.

<sup>132</sup> See page 63 of the CC Survey.

<sup>133</sup> See page 46 of the CC Survey.

(c) this is supported by the bulk of the evidence gathered in the **CC case studies**. The expert buyers in FTSE 350 companies are well able to discern within the various parameters that mark out one FTSE 350 company from another what level of audit fee would be appropriate:

(i) **Company A:** the ACC states that:

*“The fee was negotiated annually and was benchmarked against other companies in the sector, for example [ ].”<sup>134</sup>*

(ii) **Company D:** the finance director notes that the company *“periodically benchmarked audit fees against other companies”<sup>135</sup>*; the finance director and ACC also describe the informal retender which the company’s existing auditor was required to undertake, which involved a benchmarking exercise<sup>136</sup>;

(iii) **Company E:** the ACC states that he *“used benchmarking to assess whether the audit fee was fair”<sup>137</sup>*. Although the unusual nature of the company is widely noted throughout this case study<sup>138</sup>, the ACC explains that even though 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”<sup>139</sup>*

(iv) **Company G:** the global financial controller observes that he is *“able to benchmark the fees the company paid against other banks’ audit fees”<sup>140</sup>*. He also explains that he cross checks against *“other global FTSE 100 companies such as BP and Aviva”<sup>141</sup>*;

(v) **Company H:** the ACC explains that the Audit Committee asked the finance function in the company to undertake a benchmarking exercise<sup>142</sup>. The finance director explains that *“the company did some benchmarking against other companies in extractive industries and companies with overseas requirements”<sup>143</sup>*;

(vi) **Company I:** the finance director explains that the company has an annual benchmarking process:

*“The company benchmarked against similar companies, mainly in the same sector, which formed part of the regular Audit Committee papers when reviewing the fee every year”<sup>144</sup>*.

The ACC gives further detail:

*“Benchmarking included a combination of experience, looking at the charge-out rates and the number of hours, and making comparisons against other*

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<sup>134</sup> Paragraph 70 of the Company A case study.

<sup>135</sup> Paragraph 37 of the Company D case study.

<sup>136</sup> See paragraph 91 of the Company D case study.

<sup>137</sup> Paragraph 60 of the Company E case study.

<sup>138</sup> See paragraph 38 of the Company E case study.

<sup>139</sup> Paragraph 60 of the Company E case study.

<sup>140</sup> Paragraph 30 of the Company G case study.

<sup>141</sup> Ibid.

<sup>142</sup> Paragraph 77 of the Company H case study.

<sup>143</sup> Paragraph 39 of the Company H case study.

<sup>144</sup> Paragraph 26 of the Company I case study.

*companies based on the publicly available information on audit fees, taking account of market capitalization and perceived complexity.*<sup>145</sup>

(vii) **Company J:** the fund accounting manager states that:

*“the [audit] fee was reviewed against the audit fees of other similar investment trusts to ensure that it was competitive.”*<sup>146</sup>

(d) the nature of audit fee negotiation is also such as to aid effective bargaining by companies. It will be clear to the CC from the case studies (and consistent with Deloitte’s experience) that it is almost invariably undertaken on a “bottom-up” basis – that is, by considering the hours that are necessary in each jurisdiction for each part of the audit (and reflecting efficiencies that can be made in each such component), not by simply estimating a single top line figure. This pattern is common across the **case studies**:

(i) **Company C:** the ACC explains 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.”*<sup>147</sup>

(ii) **Company D:** the finance director explains that he has:

*“a detailed discussion of fees every year, although occasionally the base fee might be agreed for a couple of years...In addition to this top-down review, there was bottom-up pressure on the fee from the company’s subsidiaries.”*<sup>148</sup>

(iii) **Company G:** the global financial controller explains that:

*“fee negotiations were undertaken on a bottom-up basis...colleagues in the finance function negotiated the fee on a business-by-business basis.”*<sup>149</sup>

The ACC also explains that they required PwC to find certain efficiency savings in the conduct of the audit, the benefit of which were passed on to the company<sup>150</sup>;

(iv) **Company H:** the ACC observes that, upon appointment, he had instituted:

*“a more regimented system of fee planning”, and the proposal from the auditor had to be “itemized over the different areas the audit covered which the Audit Committee could review and challenge.”*<sup>151</sup>

He specifically notes that the expectation is for “a bottom-up fee proposal”<sup>152</sup>; and

(v) **Company I:** the finance director explains that “audit fees were preliminarily discussed at subsidiary level”<sup>153</sup> and that he “wanted to understand where the audit hours were

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<sup>145</sup> Paragraph 55 of the Company I case study.

<sup>146</sup> Paragraph 16 of the Company J case study.

<sup>147</sup> Paragraph 70 of the Company C case study.

<sup>148</sup> Paragraphs 35 and 36 of the Company D case study.

<sup>149</sup> Paragraph 30 of the Company G case study.

<sup>150</sup> Paragraph 108 *et seq* of the Company G case study.

<sup>151</sup> Paragraph 76 of the Company H case study.

<sup>152</sup> Paragraph 78 of the Company H case study.

<sup>153</sup> Paragraph 26 of the Company I case study.

being spent and to make sure that the number of hours was appropriate<sup>154</sup>. The ACC concurs that:

*“the company had a bottom up approach to the audit fee. Individual fees were agreed at local subsidiaries before the Group finance team would take a view on the fees”<sup>155</sup>*

Moreover, internal or external procurement teams are increasingly used in the process<sup>156</sup> – a point noted by **3i Group** in its evidence to the CC:

*“The Company instructed their Buying Team to assist in negotiating fees at the last review and would typically engage someone outside the direct audit engagement. The Buying Team was an external procurement consultancy that would not be swayed by any relationship issues and which had experience across the largest four auditors to identify best practice, time estimates and differing rates.”<sup>157</sup>*

- 3.10 Overall we believe that the evidence clearly shows that companies are able to conduct informed and effective price negotiations.
- 3.11 The Working Paper also suggests that the bespoke nature of audits may increase the costs to firms of bidding for audit engagements<sup>158</sup>. Even if this were true, no firm has submitted to the CC that bidding costs are a material impediment to their ability to compete (and many have indicated to the contrary<sup>159</sup>).

#### **Information asymmetries and the misalignment of objectives in the supply of FTSE 350 audits**

- 3.12 The second key feature of the market which the Working Paper discusses is the possibility of information asymmetries and the consequent misalignment of objectives in the supply of audits to FTSE 350 companies.
- 3.13 The Working Paper here posits the distinction between “technical” quality and “service” quality that we discuss above<sup>160</sup>. For the reasons set out above<sup>161</sup>, the evidence shows that this distinction is not a valid one and there is no misalignment of objectives – either between the company and investors, or between the auditor and investors.
- 3.14 With regard to the extent to which investors have the information they require, we address reporting issues in detail below in the context of the second theory of harm set out in the Working Paper<sup>162</sup>.
- 3.15 With regard to the suggestion that CFOs and ACCs may be concerned that negotiating a lower audit fee could send out a signal to the market that audit quality will be lower<sup>163</sup>, there is no

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<sup>154</sup> Paragraph 27 of the Company I case study.

<sup>155</sup> Paragraph 54 of the Company I case study.

<sup>156</sup> This point is also noted in **Cerniawska and Smith**, *Buying Professional Services: How to get value for money from consultants and other professional services*, 2010 (see page 35 *et seq*, where Stuart Diack of Deloitte explains the challenges that are sometimes faced when dealing with internal or external procurement teams).

<sup>157</sup> Paragraph 12 of the summary of the conference call with 3i Group.

<sup>158</sup> Paragraph 60 of the Working Paper.

<sup>159</sup> See, for example, paragraph 15 of the summary of **Grant Thornton**'s hearing with the CC and paragraph 23 of the summary of **BDO**'s hearing with the CC.

<sup>160</sup> Paragraph 64 of the Working Paper. We address barriers to entry further below in the context of the CC's first theory of harm. We will also be addressing it in detail in our response to the CC's Barriers to Entry Working Paper.

<sup>161</sup> See paragraph 2.2 *et seq* above.

<sup>162</sup> Paragraph 65 of the Working Paper.

<sup>163</sup> Paragraph 66 of the Working Paper.

evidence to support this in any of the material the CC has gathered from ACCs, CFOs or investors, and the suggestion should carry no weight.

### **Cost structure**

- 3.16 The third key feature of the market which the Working Paper discusses is the cost structure of the market. The Working Paper indicates that the cost structure of the market could have implications for competition, particularly with reference to the creation of barriers to entry and expansion<sup>164</sup>.
- 3.17 We have explained to the CC that the alleged barriers to entry and expansion in the market for FTSE 350 are (with only minimal exceptions such as bank covenants) a direct function of what FTSE 350 companies demand from their auditor<sup>165</sup>. The CC should not confuse attributes necessary in order to service customers' needs and demands, and true barriers to entry.
- 3.18 Customers' needs and demands are, of course, many, but can be summarised as:
- (a) the need for technical expertise delivered in an efficient manner;
  - (b) international scope and depth; and
  - (c) industry expertise.
- 3.19 Deloitte has made the investments necessary to compete on these features, and it has gained new FTSE 350 audit clients as a result<sup>166</sup>.
- 3.20 It is open to mid tier firms to make these investments, albeit that there is an unavoidable element of risk in doing so. To date, it appears that mid tier firms have focused their investment on other areas, including:
- (a) public sector audit;
  - (b) investment trust audit;
  - (c) mid-market company audit; and
  - (d) non-audit work.
- 3.21 The mid tier firms have not suggested that the quantum of investment that is required is beyond them. Indeed, they have indicated that they do not believe that there is any inhibition on their ability to obtain the necessary financing for continued investment:
- (a) **BDO:**
    - (i) *"[BDO] does not consider this factor [restrictions on investment] to have restricted its expansion to date"*<sup>167</sup>;
    - (ii) *"From BDO's point of view investment is not holding us back...we don't see investment is the issue."*<sup>168</sup>

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<sup>164</sup> Paragraph 71 *et seq* of the Working Paper.

<sup>165</sup> See paragraph 4.4 *et seq* of Deloitte's response to the Issues Statement.

<sup>166</sup> See paragraph 2.1 *et seq* of Deloitte's summary of its response to the CC's Market Questionnaire.

<sup>167</sup> Paragraph 3.1.6 of BDO's response to the Issues Statement.

<sup>168</sup> Oral evidence of Simon Michaels, BDO, to the House of Lords Economic Affairs Committee. See page 133 of Volume 2 of the House of Lords Report.

(b) **Grant Thornton:**

*“Our firm and some others believe we have the cash reserves that we would be able to make the investment to serve the entirety of that market [the FTSE 250] straightaway. So if we’re talking about making a significant change in the FTSE 250 and then building a more stable platform to look at changing the structure in the FTSE 100, we don’t think it’s a question of lack of investment capacity.”<sup>169</sup>*

3.22 The **House of Lords Economic Affairs Committee** reached the same conclusion:

*“We see no immediate grounds to change the law to lift limits on shareholdings by non-auditors in audit firms, especially since such a change would carry the risk that auditors might become less independent.”<sup>170</sup>*

3.23 We also agree with BDO’s statement to the CC at its hearing that the investment of energy and time is just as important as the investment of money<sup>171</sup>, and it is quite open to the mid tier firms to make this investment.

3.24 We will discuss these issues further in our response to the CC’s Barriers to Entry Working Paper.

#### **4. Theory of harm 1: market structure and customer behaviour**

4.1 The first theory of harm<sup>172</sup> encompasses both:

(a) market structure; and

(b) customer behaviour.

4.2 We do not believe that either of these features gives rise to an adverse effect on competition. We address the key issues raised in the Working Paper below and will address the totality of the issues in greater detail in our responses to the Barriers to Entry Working Paper and subsequent working papers published by the CC. We address first the series of issues related to market structure, then the issues related to customer behaviour.

#### ***Market structure: competition between the top tier firms***

4.3 We have explained to the CC that the evidence shows that there is strong competition between the top tier firms for FTSE 350 audits<sup>173</sup>. In this context, we hope and assume that the many references in the Working Paper to “weak competition”<sup>174</sup> do not indicate that the CC has closed its mind on this critical issue. The CC cites no evidence for such a conclusion, and it is not consistent with the evidence that has been put to the CC. We request that the CC clarify this point in its forthcoming working paper on competition in the market.

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<sup>169</sup> Oral evidence of Steve Maslin, Grant Thornton, to the House of Lords Economic Affairs Committee. See page 133 of Volume 2 of the House of Lords Report.

<sup>170</sup> See paragraph 182 of the House of Lords Report. See also the Government Response to the House of Lords Report.

<sup>171</sup> See paragraph 19 of the summary of **BDO**’s hearing with the CC.

<sup>172</sup> See paragraph 75 *et seq* of the Working Paper.

<sup>173</sup> See page 1 of Deloitte’s initial submission to the CC.

<sup>174</sup> See, for example, paragraphs 86 and 89 of the Working Paper.

4.4 Deloitte's view is well-supported by customers, experts and industry observers:

(a) **Hundred Group of Finance Directors:**

*"We are of the opinion that the services rendered by the "Big 4" are of a high quality and that there exists sufficient competition in the market place to drive continuous improvement and breadth of choice to our shareholders."*<sup>175</sup>

(b) **IG Group:**

*"An effective market exists for sophisticated buyers."*<sup>176</sup>

(c) **ICAEW:**

*"While there are relatively few firms currently serving the listed company sector those that serve the market 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."*<sup>177</sup>

(d) **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."*<sup>178</sup>

(e) **ICAS:**

*"We do not believe that there is a lack of competition in the listed company audit market."*<sup>179</sup>

(f) **Professor Vivien Beattie, Professor Stella Fearnley and Tony Hines:**

*"We have no evidence of lack of competition...the market appears to function in a competitive manner."*<sup>180</sup>

(g) **Professor Vivien Beattie:**

*"From the case study evidence that we are getting, from talking to the finance directors, the audit committee chairs and the audit partners, reading that evidence it seemed quite clear to me that all parties felt that it was quite a competitive market, in the sense of if they did not satisfy the other party then there was always a threat and sanction that there would be some change."*<sup>181</sup>

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<sup>175</sup> Hundred Group written evidence to the House of Lords Economic Affairs Committee. See page 251 of Volume 2 of the House of Lords Report.

<sup>176</sup> Page 2 of the IG Group submission to the CC.

<sup>177</sup> ICAEW written evidence to the House of Lords Economic Affairs Committee. See page 45 of Volume 2 of the House of Lords Report.

<sup>178</sup> ACCA written evidence to the House of Lords Economic Affairs Committee. See page 33 of Volume 2 of the House of Lords Report.

<sup>179</sup> ICAS written evidence to the House of Lords Economic Affairs Committee. See page 49 of Volume 2 of the House of Lords Report.

<sup>180</sup> Professor Vivien Beattie, Professor Stella Fearnley and Tony Hines written evidence to the House of Lords Economic Affairs Committee. See pages 2 and 7 of Volume 2 of the House of Lords Report.

<sup>181</sup> Professor Vivien Beattie oral evidence to the House of Lords Economic Affairs Committee. See page 13 of Volume 2 of the House of Lords Report.

- (h) **Shamharir Abidin, Professor Vivien Beattie and Alan Goodacre:** there is “no evidence to indicate that recent structural changes have resulted in anticompetitive pricing” in the UK listed company audit market<sup>182</sup>.

4.5 These observations are not surprising. We consider that the market is delivering good outcomes (which we discuss further below<sup>183</sup>) for companies and their investors, and this is a direct result of the competition between the top tier firms.

#### **Market structure: the nature of “barriers to entry and expansion”**

4.6 The CC indicates that it proposes to explore “the nature and extent” of barriers to entry and expansion<sup>184</sup>. We have explained above that many market features which are suggested to be barriers to entry in this market in fact are direct functions of clients’ demands<sup>185</sup>: Deloitte has invested in order to meet these demands, and the evidence shows that mid tier firms are well-placed to do the same. We will address the nature of alleged barriers to entry in this market in greater detail in our response to the CC’s Barriers to Entry Working Paper. For present purposes, we make the following headline points.

#### *Entry and expansion strategy*

4.7 Much of the discussion to date on entry and expansion has focused on gaining new FTSE 350 audit clients through winning tenders<sup>186</sup>.

4.8 This misunderstands (a) the starting position of many of the mid tier firms who are the most credible actual and potential competitors for entry into the market for FTSE 350 audits, and (b) the nature of the FTSE 350, which is not a static block of companies. Mid tier firms have audit relationships with a wide range of companies outside the FTSE 350 – for example, Grant Thornton markets itself as the leader in the AIM market<sup>187</sup>, and BDO does the same with respect to “mid-market companies”<sup>188</sup>. Given the ever-changing nature of the FTSE 350<sup>189</sup>, it would seem self-evident that an attractive strategy for mid tier firms would be to retain their clients as they grow and enter the FTSE 350<sup>190</sup>.

4.9 This strategy would address the complaint of mid tier firms that companies are not sufficiently aware of their capabilities<sup>191</sup>: companies which are already audited by mid tier firms will be very aware of their capabilities. To the extent that these companies nonetheless choose to switch auditor<sup>192</sup>, this cannot be blamed on lack of awareness of mid tier firms’ capabilities.

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<sup>182</sup> *Audit market structure, fees and choice in a period of structural change: evidence from the UK - 1998-2003*, British Accounting Review, 42(3): 187-206.

<sup>183</sup> See section 6 below.

<sup>184</sup> Paragraph 78 of the Working Paper.

<sup>185</sup> See paragraph 3.16 *et seq* above.

<sup>186</sup> See, for example, Section 6 of Oxera, *Competition and choice in the UK audit market* (April 2006).

<sup>187</sup> See <http://www.grant-thornton.co.uk/Services/Audit--Assurance/>.

<sup>188</sup> See <http://www.bdcareers.co.uk/page.aspx/BDO-Story>.

<sup>189</sup> As at December 2010, 186 companies (53%) had been in the FTSE 350 for less than 10 years and 116 companies (33%) for less than five years.

<sup>190</sup> Deloitte has conducted an analysis of the “half life” of its FTSE 350 clients. This half-life analysis indicates that of Deloitte’s clients in the FTSE350 in any one year, only half would still be Deloitte clients in the FTSE 350 14 years later (or 7 years if movements out of the index are included as well as switches).

<sup>191</sup> See, for example, 3.1.7 of BDO’s response to the Issues Statement.

<sup>192</sup> The CC will note in this context mere movement into the FTSE 350 is not an important factor in causing companies to switch auditor – cited by only 4% of FTSE 350 ACCs and only 7% of non-FTSE 350 ACCs: see page 75 of the **CC Survey**.

### *Scale, scope and cost-related barriers*

- 4.10 The Working Paper queries whether economies of scale and scope may give rise to barriers to entry and expansion<sup>193</sup>. At the root of these issues is a concern that the largest firms might have a cost advantage over mid tier firms. For this to be a valid concern, it must also be the case that this is a cost advantage that is not replicable by the mid tier firms. In fact, there is no evidence of such a cost advantage, and no firm has alleged that it is unable to compete effectively for FTSE 350 audit business for cost reasons. Indeed, each of the mid tier firms suggests that their greater involvement in tender processes would help drive prices down, suggesting that they believe that they can undercut the largest firms<sup>194</sup>.
- 4.11 Moreover, FTSE 350 audits are not the only driver of scale for Deloitte's audit business, being less than 30% of its total audit business. To the extent that scale may be considered necessary, it can be achieved without a significant FTSE 350 audit client base.

### *Reputation*

- 4.12 The Working Paper again raises the issue of whether "reputation" is a barrier to entry and expansion<sup>195</sup>.
- 4.13 We have explained to the CC that reputation cannot be divorced from the delivery of quality to companies in the market. It is a reflection and a product of the ability of certain firms to deliver against the requirements set out in 2.16 above.
- 4.14 Furthermore, we do not believe that "reputation" *per se* is in fact a material barrier to entry, and this is well supported in the evidence in front of the CC:
- (a) the **market survey** evidence: while reputation is mentioned as a factor relevant to audit appointment decisions<sup>196</sup>, it is only one of many, most of which more directly reflect the delivery of quality and value:
    - (i) in decisions on auditor appointment, reputation is noted as a factor by both ACCs and CFOs/finance directors, but as only one of a number of factors which are highly important most of which relate to factors that are specific to the quality of the audit engagement partner and the engagement team:

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<sup>193</sup> Paragraph 78 of the Working Paper.

<sup>194</sup> See, for example, paragraph 4.1 of **Grant Thornton's** response to the Issues Statement.

<sup>195</sup> Paragraph 78 of the Working Paper.

<sup>196</sup> Moreover, given respondents' highly informed and expert nature, it can reasonably be assumed that references to "reputation" in the context of the market survey mean reputation informed by actual delivery.

**Table 2: CC survey evidence on most important factors in auditor appointment decisions (FTSE 350 companies)**

<b>Factor for CFOs/finance directors</b>	<b>Percentage citing</b>	<b>Factor for ACCs</b>	<b>Percentage citing</b>
Experience and knowledge of the engagement partner	92%	Experience and knowledge of the engagement partner	97%
Good working relationships with the audit team	83%	Good working relationships with the audit team	90%
Reputation of the audit firm	83%	Reputation of the audit firm	86%
Experience and knowledge of the engagement team	82%	Experience and knowledge of the engagement team	85%
Sector-specific expertise or experience	69%	Sector-specific expertise or experience	74%

- (ii) in decisions on which audit firms to include in a tender process, reputation again features, but is markedly less important than other quality and value-related factors:

**Table 3: CC survey evidence on most important factors in firm inclusion in tender processes (FTSE 350 companies)**

<b>Factor</b>	<b>Percentage citing</b>
Auditor has specialist knowledge	43%
Regional strength/geographic coverage	34%
Size of the audit firm	30%
Company has set shortlist/didn't want to waste time/enough to ensure competitive price	20%
Reputation	20%
Quality of service provided	18%
Wanted to use a Big 4 firm	11%

The CC may also note another “reputation effect” factor that was included here: “investor perceptions and financial institutions expect a Big Four auditor”. The CC will

note that only 2 per cent of FTSE 350 respondents said that this was a reason for limiting the scope of the firms invited to participate in the tender process<sup>197</sup>.

- (b) the **case study evidence**: the case studies give no clear picture on the extent to which reputation is or is not a factor. Some respondents suggest that reputation is relevant, or set out generalised concerns that other stakeholders might be concerned about the choice of a non-Big Four firm (which might be an entirely rational concern, not one driven by any unmerited reputation), but others are clear that reputation *per se* is not important – it is the possession of the right capabilities that matters:

(i) **Company E:**

*“The FD had not considered the reputation aspects of appointing a particular auditor and did not know whether his shareholders would have a preference for a Big 4 firm or not.”<sup>198</sup>*

(ii) **Company H:**

*“The ACC had not faced pressure from outside the company to continue using a Big 4 firm.”<sup>199</sup>*

(iii) **Company J:**

*“The FAM had experienced no external pressure to switch to a Big 4 auditor: the current auditor, though smaller, had a good presence in the investment trust sector.”<sup>200</sup>*

- (c) as noted in paragraphs 4.8 and 4.9 above, an efficient growth and expansion strategy for mid tier firms would be to retain their clients as they grow and enter the FTSE 350. To the extent that companies switch away from the mid tier firms as they grow, these decisions cannot be based on reputational bias against the mid tier firms' capabilities.

### **Customer behaviour: search costs**

4.15 The Working Paper indicates that the CC proposes to investigate whether search costs are high<sup>201</sup>. The evidence does not suggest that they are; indeed, it is likely that they are lower than in most other professional services<sup>202</sup>. There are several reasons for this:

- (a) the **FRC/AIU inspection regime** gives public information on quality on all major firms (including mid tier firms), individually and collectively. While we acknowledge that the AIU reports give only a partial picture (since they focus on certain particular aspects in each report and are intended primarily as a tool to raise standards), they nonetheless provide a tool which is not available in most professional service markets;
- (b) as noted above<sup>203</sup>, the market is characterised by highly expert buyers (commonly with expertise in the very service that auditors offer<sup>204</sup>). The existence of expert buyers is well-recognised as limiting the relevance of search costs in any particular market;

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<sup>197</sup> Page 56 of the CC Survey.

<sup>198</sup> Paragraph 24 of the Company E case study.

<sup>199</sup> Paragraph 75 of the Company H case study.

<sup>200</sup> Paragraph 30 of the Company J case study.

<sup>201</sup> Paragraph 76 of the Working Paper.

<sup>202</sup> See also **Cerniawska and Smith**, *Buying Professional Services: How to get value for money from consultants and other professional services*, 2010, which notes that: “audits are easier to buy than advice on corporate finance” (see page 28).

<sup>203</sup> See paragraph 2.20 *et seq* above.

- (c) audit firms (including, but not limited to, the top tier firms) are required to publish annual audit **Transparency Reports**<sup>205</sup>. These give details of each firm's systems for ensuring audit quality, ethical standards and key financial information;
- (d) regulators provide guidance to audit committees on how to purchase audit services. Examples include:
  - (i) **ICAS: Dimensions of audit quality**<sup>206</sup>;
  - (ii) **ICAS: Guide to the Assessment and Appointment of Auditors**<sup>207</sup>; and
  - (iii) **FRC: Audit quality framework**<sup>208</sup>.

### **Customer behaviour: tendering costs**

- 4.16 The CC indicates that it proposes to investigate whether tendering costs are high<sup>209</sup>. While we believe that there are certain costs to tendering (both for the company and for the auditor), we do not believe that given the current level of tenders these are a material barrier. Rather, companies can and do conduct tenders when they consider that they may not be receiving the optimal value/quality services – consistent with how a well-functioning market should operate. This is well-supported in the evidence before the CC:
- (a) the CC's **survey evidence** suggests that companies do not think that tendering costs are high – they do not feature as a significant reason among those companies which have not recently held a tender for not having tendered<sup>210</sup>; and
  - (b) other market participants believe concerns on tendering costs may be overstated:
    - (i) the **Group A firms** refer to high tendering costs for companies as “a carefully cultivated myth”<sup>211</sup> (although they do not explain who is cultivating it);
    - (ii) the **Universities Superannuation Scheme** state that tendering and switching costs are “exaggerated”<sup>212</sup>; and
  - (c) from the supply side, we note that the CC has received no complaints from smaller firms about costs of participating in tenders<sup>213</sup>.

<sup>204</sup> See footnote 41 above.

<sup>205</sup> Deloitte's 2011 Transparency Report can be found at <http://annualreport.deloitte.co.uk/audit-transparency-2011/AT-report-2011.pdf>.

<sup>206</sup> See <http://icas.org.uk/home/technical-and-research/research-centre/research-publications/summary-auditqual--dimensions-of-audit-quality>.

<sup>207</sup> See <http://icas.org.uk/home/technical-and-research/technical-information-and-guidance/auditing/appraising-your-auditors/>.

<sup>208</sup> See [http://www.frc.org.uk/getattachment/79a53c7d-1289-4a9f-bb84-5c9829fb964a/The-Audit-Quality-Framework-\(1\).aspx](http://www.frc.org.uk/getattachment/79a53c7d-1289-4a9f-bb84-5c9829fb964a/The-Audit-Quality-Framework-(1).aspx).

<sup>209</sup> Paragraph 76(b) of the Working Paper. See also paragraph 60 of the Working Paper.

<sup>210</sup> Page 60 of the CC Survey. Only 13% of respondents indicated that one of the reasons for not holding a tender was that it was “costly and time consuming”.

<sup>211</sup> Page 3 of the Group A firms' submission to the CC.

<sup>212</sup> Page 7 of the Universities Superannuation Scheme submission to the CC. We note that the USS suggests that the top tier auditors are responsible for this exaggeration. While we do not speak for other audit firms, this is not correct with respect to Deloitte.

<sup>213</sup> We do note the passage in the summary of the CC's hearing with PKF which appears to suggest that maintaining tender teams is more expensive for private sector clients than for public sector clients (see paragraph 9). This appears to be a function of the fact that there are more individual opportunities in the private sector (i.e. public sector tender opportunities are more concentrated via umbrella bodies).

4.17 The **case study** evidence shows that when companies believe that they may not be getting the desired quality/value from their current auditor, tendering costs are no impediment to conducting a tender. While some of the firms who participated in the CC's case studies indicate that there are some costs to tendering, they are clear that they would not hesitate to carry out tenders as and when they considered it appropriate:

(a) **Company A:** the CFO comments that:

*"Switching costs would not affect a decision to change auditors."*<sup>214</sup>

(b) **Company B:** the finance director states that:

*"The tender process itself was straightforward, but needed to be run efficiently."*<sup>215</sup>

Even though the ACC of Company B considers that tendering could be an expensive process, she nonetheless indicates that she would plan to hold a tender "every three to four years"<sup>216</sup>.

(c) **Company D:** the ACC states that:

*"The monetary cost of switching auditor would normally be very small as she would expect the new auditors to absorb the initial costs of getting to know the business."*<sup>217</sup>

(d) **Company E:** the ACC explains that:

*"There would be very little monetary cost to holding a tender and...the tender process would cause minimal disruption to the business"*<sup>218</sup>,

(e) **Company F:** the finance director states that "running a tender was a valid process"<sup>219</sup> and that switching was "hard work but fairly straightforward"<sup>220</sup>. The ACC confirms that he "would have the necessary time to conduct a tender alongside his full time role"<sup>221</sup>.

(f) **Company G:**

*"The GFC said that there were not plans to tender the audit but this was kept under review. The company wanted to ensure that it received an independent review using the best skills and expertise at the best cost...The trigger points would be a slip in independence, skills or value for money."*<sup>222</sup>

The ACC adds:

*"If there was a situation where he said that he felt it was necessary to go out to tender, then this would happen."*<sup>223</sup>

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<sup>214</sup> Paragraph 35 of the Company A case study.

<sup>215</sup> Paragraph 20 of the Company B case study.

<sup>216</sup> Paragraph 43 of the Company B case study.

<sup>217</sup> Paragraph 63 of the Company D case study.

<sup>218</sup> Paragraph 52 of the Company E case study.

<sup>219</sup> Paragraph 28 of the Company F case study.

<sup>220</sup> Paragraph 27 of the Company F case study.

<sup>221</sup> Paragraph 52 of the Company F case study.

<sup>222</sup> Paragraph 22 of the Company G case study.

<sup>223</sup> Paragraph 68 of the Company G case study.

(g) **Company H:** the ACC states that:

*“The company was keen to be progressive in matters of corporate governance” and “its policy on tendering [i.e. to tender every ten years] tied into this.”<sup>224</sup>*

(h) **Company I:** the ACC states that *“tendering would be looked at again in the near future”* and that *“a tender would have been held [already] if the auditor team led by the new partners had not stepped up to the plate”<sup>225</sup>.*

4.18 In the light of this evidence, it seems that the CC’s concerns about tendering costs are unfounded. Tendering costs are not unduly high for companies or for firms (at the current levels of tendering). In particular, the evidence shows that companies can and do hold tenders where they are not convinced they are getting optimal quality and/or value.

### **Customer behaviour: price and tendering**

4.19 The Working Paper indicates that the CC also proposes to consider whether there is a risk that price does not drive tendering behaviour, since:

- (a) the audit fee is a relatively small part of the total FTSE 350 costs; and
- (b) audit is a bespoke product<sup>226</sup>.

4.20 While we agree that the evidence shows (consistent with Deloitte’s experience) that quality is probably the central feature in auditor appointment decisions, the evidence shows that stakeholders have a strong appreciation of value and price in their decisions as well:

- (a) the **survey evidence** gives strong support to cost issues as key factors:
  - (i) “efficiency of the audit process” is amongst the most important features identified in assessing the quality of the audit – particularly for CFOs<sup>227</sup>;
  - (ii) only 8% of CFOs of FTSE 350 companies say that price is “not important” in making auditor appointment decisions<sup>228</sup>;
  - (iii) the overwhelming majority of FTSE 350 companies (93%) renegotiate the audit fee annually, and 100% of them do so at least every three years<sup>229</sup>; and
  - (iv) value for money offered by the existing auditor is the second most important reason cited for not going out to tender<sup>230</sup>, and price is amongst the most important reasons for a company’s decision that it should go out to tender<sup>231</sup>;

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<sup>224</sup> Paragraph 68 of the Company H case study.

<sup>225</sup> Paragraph 50 of the Company I case study.

<sup>226</sup> Paragraph 76(a) of the Working Paper.

<sup>227</sup> See page 26 of the CC Survey.

<sup>228</sup> See page 34 of the CC Survey. The equivalent figure for ACCs in the FTSE 350 is 13%.

<sup>229</sup> See page 46 of the CC Survey.

<sup>230</sup> See page 60 of the CC Survey.

<sup>231</sup> See page 63 of the CC Survey.

(b) the case studies also show that companies consider price and value very carefully:

(i) **Company A:** the CFO explains that:

*“Fees were negotiated by the CFO and signed off by the Audit Committee, led by the ACC. The ACC’s recent experience as an auditor was helpful as he knew what firms charged... The company did not want to over pay.”<sup>232</sup>*

(ii) **Company B:** the finance director indicates that he wants to switch auditor:

*“as he felt [the current auditor] was a bit expensive. He would like to reduce the audit fee by 10 to 15 per cent.”<sup>233</sup>*

(iii) **Company C:** the CFO explains that “audit time and fees” is one of six criteria against which bidding audit firms were appraised<sup>234</sup> and notes that “pressure on fees [is] increasing.”<sup>235</sup>

(iv) **Company D:** the finance director explains that price was the primary reason for its most recent tender process:

*“The main driver of the decision to tender was the previous auditor seeking a substantial (60 to 70 per cent) increase in the audit fee.”<sup>236</sup>*

(v) **Company F:** the finance director explains that fees were “reviewed as an underlying factor” in the company’s most recent tender process<sup>237</sup>; he also notes that “not receiving value for money” is one of two cited triggers for contemplating switching<sup>238</sup>;

(vi) **Company G:** the Global Financial Controller indicates that “a slip in... value” is one of three factors (the other two being quality-related) that would trigger a tender<sup>239</sup>; while the ACC acknowledges that quality is paramount, he notes that “there [is] more pressure on fees today than there was two years ago”<sup>240</sup>;

(vii) **Company H:** the ACC notes that, having been concerned that the “[audit] fee looked high” he asked the auditors to “rebase” it and provide a “bottom-up fee proposal”. He observes that “tendering exert[s] pressure on the auditor not to be seen as overcharging”<sup>241</sup>;

(viii) **Company I:** the finance director notes that fees are one of the items on which the auditor is appraised every year<sup>242</sup>.

4.21 Moreover, as explained above, there is no reason to believe that the bespoke nature of audit services causes any impediment to competition on price grounds: companies are nonetheless

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<sup>232</sup> Paragraphs 40 and 42 of the Company A case study.

<sup>233</sup> Paragraph 17 of the Company B case study.

<sup>234</sup> Paragraph 23(c) of the Company C case study.

<sup>235</sup> Paragraph 36 of the Company C case study.

<sup>236</sup> Paragraph 16 of the Company D case study.

<sup>237</sup> Paragraph 23 of the Company F case study.

<sup>238</sup> Paragraph 28 of the Company F case study.

<sup>239</sup> Paragraph 22 of the Company G case study.

<sup>240</sup> Paragraph 75 of the Company G case study.

<sup>241</sup> Paragraph 78 of the Company H case study.

<sup>242</sup> Paragraph 17 of the Company I case study.

able to benchmark audit fees effectively – not least because of the expert nature of those undertaking the process<sup>243</sup>.

### **Customer behaviour: switching costs**

4.22 It appears that companies' satisfaction with their current auditor is an important explanation of current levels of switching in the market. The CC may note that the most cited reasons in its **market study** among companies who have not held a tender in the past five year for not having done so were as follows:

- (a) currently receive high quality service: 51%;
- (b) currently receive good value for money: 25%; and
- (c) happy as things are: 21%.

4.23 However, it is clear that where companies are not getting the desired levels of quality/value, they are able and willing to conduct a tender and, if appropriate, to switch. The point is well made by the Global Financial Controller of **Company G** in the CC case studies:

*"The trigger points for a tender would be a slip in independence, skills or value for money. These factors had to be considered relative to the competition: if the company thought that another audit firm could provide a better service at a lower cost and with a greater degree of independence, then this would trigger a switch."*<sup>244</sup>

4.24 Furthermore, there are features of the market which help to reduce companies' switching costs:

- (a) first, auditors absorb learning costs<sup>245</sup>; and
- (b) second, sharing of files between the old auditor and the new auditor.

4.25 That costs are far from insurmountable is well-supported by the evidence in front of the CC<sup>246</sup>,

4.26 Moreover, it is clear that there is general support from investors that they are comfortable with companies bearing any costs of tendering and switching where these are considered appropriate, as was made clear at the **Hermes hearing**:

*"The costs of switching were incurred in management time spent to explain to a new auditor how the company functioned and to justify existing accounting decisions. However, from a shareholder perspective, this was money well spent, since it entailed more rigorous scrutiny."*<sup>247</sup>

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<sup>243</sup> See paragraph 3.8 *et seq* above.

<sup>244</sup> Paragraph 22 of the Company G case study.

<sup>245</sup> It is clear from the CC's case studies that this is expected by companies in the reference market: see, for example, paragraph 18 of the **Company J case study**. See also paragraph 27 of the **Company F case study**.

<sup>246</sup> Paragraph 9.7 of Grant Thornton's response to the Issues Statement. See also Paragraph 5.3.3 of BDO's response to the Issues Statement and Page 7 of the Universities Superannuation Scheme submission to the CC.

<sup>247</sup> Paragraph 9 of the Hermes hearing with the CC.

### **Customer behaviour: incentives to switch on quality grounds**

4.27 The Working Paper posits that lack of visibility on “certain aspects” of quality may mean that quality gains from switching are not observable, so dampening incentives to switch on quality grounds<sup>248</sup>. There is no evidence to support this assertion – indeed the evidence suggests exactly the contrary:

- (a) the **survey evidence** indicates that quality is (along with fees) a key driver of switching. The following table sets out the main drivers of switching among FTSE 350 companies:

**Table 4: top five drivers of switching among FTSE 350 firms – CC survey evidence<sup>249</sup>**

<b>Factor</b>	<b>Percentage citing as a “principal factor”</b>
Better quality of service	33%
Keeps things fresh/avoids complacency/policy to switch regularly	27%
Better sector experience	24%
Price	24%
More professional/better customer service	21%

- (b) the **survey evidence** similarly shows that many companies which have switched have experienced the increase in service quality that was an important reason for seeking to switch for many of them: 64% of switching FTSE 350 companies consider that audit quality has improved<sup>250</sup>;
- (c) the **case study** evidence indicates that quality factors are critical in switching decisions:
- (i) **Company A:** although the details are redacted, it is clear that a perceived quality failing was instrumental in the decision to conduct a tender and end the shared audit structure<sup>251</sup>;
- (ii) **Company E:** the finance director indicates that:
- “If the auditors were not up to scratch then they would be replaced.”<sup>252</sup>*
- (iii) **Company F:** the finance director explains that, since fee proposals were relatively similar, the company’s most recent tender process was decided on quality-related criteria<sup>253</sup>.

<sup>248</sup> Paragraph 76(d) of the Working Paper.

<sup>249</sup> See page 63 of the CC Survey.

<sup>250</sup> See page 65 of the CC Survey. We welcome this figure since it indicates that market participants are responding to companies’ needs: where they are not getting what they consider to be the optimal cost/value service in response to their individual requirements, companies are testing the market and switching to achieve the balance they seek.

<sup>251</sup> See paragraph 26 *et seq* of the Company A case study.

<sup>252</sup> Paragraph 21 of the Company E case study.

<sup>253</sup> Paragraphs 22 and 24 of the Company F case study.

- (iv) **Company G:** the Global Financial Controller notes that a “*slip in independence [or] skills*” would be two of the three major triggers for a tender, and states that if another firm “*could provide a better service at a lower cost with a greater degree of independence, then this would trigger a switch*”<sup>254</sup>. The ACC comments that:
 

*“The biggest trigger for a switch would be where the company thought that the quality of the team being allocated to its audit was not adequate.”*<sup>255</sup>
  - (v) **Company H:** the finance director explains that, since fee proposals were similar, the company’s most recent tender was decided on a range of quality issues including geographic coverage and depth, and technical understanding<sup>256</sup>; and
  - (vi) **Company J:** the ACC indicates that the decision to switch from the company’s previous auditor had been driven by “*technical errors, communication issues and generally poor levels of service*”<sup>257</sup>; and
- (d) finally, the evidence from the **case studies** set out in detail above indicates that:
- (i) ACCs and CFOs have excellent visibility on the quality being delivered by their existing auditor (a sentiment with which the CC indicates its initial agreement)<sup>258</sup>; and
  - (ii) they have good visibility of the marketplace, given their interaction with other firms<sup>259</sup>.

### **Conclusions on the first theory of harm**

4.28 Overall, the evidence does not support the concerns set out in the Working Paper. Indeed, to the evidence strongly supports Deloitte’s view that:

- (a) there is strong competition in the market for the audit of FTSE 350 companies, in terms of both value and quality;
- (b) potential cost-related barriers to entry and/or expansion are not such that they should or do inhibit expansion of mid tier firms;
- (c) search, tendering and switching costs are all at levels that do not inhibit companies from taking action to ensure that they receiving what they consider to be the optimal value/quality service from their auditor: the evidence shows that companies which do not switch are generally satisfied by the offering of their existing auditor, while those that are not satisfied can and do take steps to address this. This is a sign of a well-functioning market.

## **5. Theory of harm 2: principal/agent issues**

5.1 The second theory of harm<sup>260</sup> relies on the posited existence of disconnects between each of:

- (a) shareholders and the company (both management and the audit committee); and
- (b) shareholders and auditors.

<sup>254</sup> Paragraph 22 of the Company G case study.

<sup>255</sup> Paragraph 69 of the Company G case study.

<sup>256</sup> Paragraphs 26 and 27 of the Company H case study.

<sup>257</sup> Paragraph 43 of the Company J case study.

<sup>258</sup> See paragraph 2.23 above.

<sup>259</sup> See paragraph 2.21 above.

<sup>260</sup> See paragraph 80 *et seq* of the Working Paper.

- 5.2 This theory of harm appears to touch on both concerns as to substantive audit quality (based on an alleged dichotomy between “technical” quality and “service” quality) and concerns as to reporting. It is important to separate the two:
- (a) there is strong alignment between all parties with regard to substantive quality, and no concerns arise, for the reasons we have explained in detail above<sup>261</sup> and summarise again below; but
  - (b) we acknowledge investors’ concerns as to reporting, note that progress is being made and welcome engagement.

### ***Substantive quality - alignment between shareholders and management***

- 5.3 As explained above<sup>262</sup>, there is no trade off between “technical” quality and “service” quality: “service” quality supports “technical” quality. An auditor that attempts to deliver an audit without recognising the importance of good client service – for example, in developing good working relationships with management and good communication to company stakeholders – will run a significantly elevated risk of failing to deliver “technical quality” in the audit.
- 5.4 This is strongly supported by the **case study** and **market survey** evidence, which shows that company stakeholders attach a high value to both “technical” and “service” elements of audit quality<sup>263</sup> - i.e. quality in all its facets.
- 5.5 Moreover, company stakeholders are deeply conscious of their role as guardians of shareholder interests and the UK scheme of corporate governance – designed to ensure that investors’ interests are properly guarded – provides further protection<sup>264</sup>.

### ***Substantive quality – alignment between shareholders and auditors***

- 5.6 Auditors’ incentives are similarly aligned with those of management and investors for three reasons:
- (a) they need to be responsive to management’s requirements (whilst maintaining an independence of mind) in order to be reappointed. As the **survey evidence** and **case studies** show, they will not be able to do this without a very high level of quality in all its facets<sup>265</sup>;
  - (b) the risk to their own reputation (which is founded on continued delivery of high quality)<sup>266</sup>; and
  - (c) their own financial risk means that they are strongly incentivised to pursue high levels of quality<sup>267</sup>.
- 5.7 There is thus no misalignment between the interests of investors, management and auditors. All three are incentivised to ensure that high quality audits (across all dimensions of quality) are delivered.

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<sup>261</sup> See paragraph 2.4 *et seq* above.

<sup>262</sup> Ibid.

<sup>263</sup> See paragraph 2.8 *et seq* above.

<sup>264</sup> See paragraph 2.27 *et seq* above.

<sup>265</sup> See paragraph 2.8 *et seq* above.

<sup>266</sup> See paragraph 2.16 *et seq* above.

<sup>267</sup> See paragraph 2.11 *et seq* above.

### **Visibility of quality to audit committees**

- 5.8 The Working Paper indicates that the CC will investigate in the context of this theory of harm whether the nature of the audit service means that stakeholders, including the ACC and audit committee, “may not have visibility on certain aspects of the product”, leading to a position where appointment decisions are based on proxies rather than true quality<sup>268</sup>.
- 5.9 For the reasons set out above, this theory is not supported by the evidence<sup>269</sup>. Company stakeholders – principally the finance director/CFO, the finance team, the audit committee and the ACC – have a very high level of visibility over the quality that is being delivered. We welcome the CC’s initial conclusion that this is correct<sup>270</sup>.

### **Reporting to investors**

- 5.10 Deloitte has taken careful note of the concerns that have been expressed by investors to the CC.
- 5.11 It is apparent from these that the primary focus of their concerns is the value they see in audit reporting (both the audit committee report and the auditor’s report). We note in particular the following evidence that has been put to the CC:

**(a) hearing with institutional investors:**

- (i) *“The representatives considered that the more important thing to develop at this stage was the Audit Committee report rather than the audit report itself. This was on the basis that in the first instance information should be provided by company directors rather than the auditor.”<sup>271</sup>*
- (ii) *“More could be put into the auditor’s report. In particular, the report could identify issues that had been scrutinized in detail by the company during the audit process.”<sup>272</sup>*

**(b) Hermes Equity Ownership Management:**

- (i) *“[A]udit quality was currently invisible to the consumers of audit services, the shareholders. However, it thought that proposals from the Auditing Practices Board (APB) were helpful steps towards addressing this and making the audit more useful to investors and its quality more apparent. In particular, these proposals entailed not more work for auditors, but better disclosure of what the auditor had done in that particular audit and the particular issues that had been examined. The auditor should be able to make a greater range of statements of assurance than currently.”<sup>273</sup>*
- (ii) *“Audit quality is currently invisible to the consumers of audit services, the shareholders. Current audit reporting, the only end product visible to shareholders, does the profession a profound disservice by being more about what the auditor does not do (much of the report is expressly designed to limit the auditor’s liability) than about what the auditor has specifically done in this audit.”<sup>274</sup>*

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<sup>268</sup> Paragraph 83(c) of the Working Paper.

<sup>269</sup> See paragraph 2.23 *et seq* above.

<sup>270</sup> Paragraph 63 of the Working Paper.

<sup>271</sup> Paragraph 6 of the summary of the institutional investors hearing.

<sup>272</sup> Paragraph 7 of the summary of the institutional investors hearing.

<sup>273</sup> Paragraph 16 of the summary of the hearing with Hermes Equity Ownership Management.

<sup>274</sup> Page 2 of the Hermes Equity Ownership Management response to the Issues Statement.

(c) **Oxera Investor Paper:**

- (i) *“None of the investors surveyed feels able to judge fully the quality of an individual audit from the audit report, and almost all would prefer increased disclosure to investors.”<sup>275</sup>*
- (ii) *“The majority of investors do not feel they have a precise understanding of the relative capabilities of different audit firms.”<sup>276</sup>*

We are aware that the same issues have been raised in other recent forums, including in evidence to the **House of Lords Economic Affairs Committee**<sup>277</sup>.

5.12 Moreover, **BDO** has identified this reporting issue as the central issue in “the future of audit”:

*“The decline in the perceived value of audit is linked to mounting dissatisfaction with the financial reporting framework. The Treasury Select Committee were fundamentally questioning the value of the statutory audit, not whether it was carried out effectively or not. Large financial institutions, and a limited number of very large, complex businesses, might benefit from an assurance model that reported more widely on business risk... There could well be value in auditors reporting more formally on operating and financial reviews, corporate governance statements and other written material issued to shareholders of public companies. This needs to be assessed and the form of reporting considered so that there are options short of “qualifying” to deal with nuances of emphasis that may mislead.”<sup>278</sup>*

5.13 The commentary set out above has not come as a surprise to us. However, it is important to acknowledge that there are important regulatory constraints on one-to-one contact between shareholders and auditors. Thus, for good public policy reasons, auditors are constrained in their ability to have one-to-one conversations with investors or discussions with select groups of investors about specific companies. We note that there have been some complaints to the CC that auditors generally have been reluctant to have such discrete discussions, but most investors seem to recognise the constraints that we and they operate under in this respect<sup>279</sup>.

5.14 Within the boundaries of what is possible, we have been active in increasing engagement with investors. For example, we recently had a meeting with institutional investors under the auspices of ICAS, and Deloitte is holding its first “Stakeholders Forum” in October, which is designed to increase engagement between Deloitte (as auditor) and institutional investors. The meeting will be attended by a range of senior team members from Deloitte including David Cruickshank (Deloitte’s chairman), David Sproul (Deloitte’s Senior Partner and Chief Executive), David Barnes (Deloitte’s Managing Partner, Public Policy) and Panos Kakoullis (Deloitte’s Managing Partner, Audit). In this light, we are pleased to see that investors consider that levels of engagement have improved<sup>280</sup>.

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<sup>275</sup> Page 6 of the Oxera Investor Paper.

<sup>276</sup> Page 8 of the Oxera Investor Paper.

<sup>277</sup> See, *inter alia*, the ABI’s written evidence to the House of Lords Economic Affairs Committee (page 296 of Volume 2 of the House of Lords Report); and Aviva Investors’ oral evidence to the House of Lords Economic Affairs Committee (see page 297 of Volume 2 of the House of Lords Report).

<sup>278</sup> BDO, *The Future of Audit*. See <http://www.bdo.uk.com/about-us/bdo-takes-active-role-public-policy/future-audit>.

<sup>279</sup> See for example, the ACCA/Grant Thornton Investor Round Table report, which notes that “Investors are aware that auditors have to be careful about one-to-one discussions with them, due to insider information concerns.” See <http://www.accaglobal.com/content/dam/accaglobal/PDF-technical/audit-publications/pol-afb-irtap.pdf>.

<sup>280</sup> See paragraph 50 of the summary of the CC’s hearing with institutional investors.

5.15 We believe that there have been other steps to improve the usefulness of audit reporting specifically in the past several years:

- (a) **Deloitte's recent survey of narrative reporting**, *Gems and Jetsam*, investigated compliance with reporting best practice by listed companies<sup>281</sup>. It found that:
- (i) 98% of relevant companies described the work of the audit committee in their annual report;
  - (ii) 47% provided details of key matters considered by the audit committee, such as key accounting assumptions and judgements (rising to 56% in the FTSE 350);
  - (iii) 33% gave an explanation of their auditor appointment decisions (rising to 56% in the FTSE 350).

The report also sets out two examples of current reporting best practice – from Barclays plc and Pearson plc, which give significant additional detail to investors about the work of the audit committee and the auditor. Other major companies in the FTSE 350, such as BP (which sets out in detail the activities of the audit committee over the year<sup>282</sup>) and RBS Group (which explains the issues on which the audit committee has spent most time over the year, and explains in detail its policies with regard to the appointment of its auditor<sup>283</sup>) have also been in the vanguard of increasing the information provided for investors in the annual report;

- (b) the CC will also be aware of the **FRC proposals** currently under consultation which provide for significantly greater disclosure of audit matters, including both issues of process (i.e. auditor appointment issues and auditor effectiveness) and of substance, including, in particular, significant issues considered by the audit committee<sup>284</sup>. Deloitte has supported these proposals; and
- (c) similar proposals on enhanced reporting are also being consulted on by the **IAASB**<sup>285</sup>.

5.16 Thus, while there are important regulatory constraints on our direct discussions with investors, we welcome detailed engagement on how reporting could be made more useful for investors. We are already contributing to existing processes for reform and would welcome engagement with the CC.

### **Conclusion on the second theory of harm**

5.17 The evidence shows that there is no misalignment of incentives between investors, the company and its auditors with respect to the delivery of audit quality (covering all its facets). The quality delivered by the auditor is highly visible to the key decision-makers on auditor appointments – the financial director/CFO and the audit committee members (in particular, the ACC).

5.18 We recognise the specific concerns of investors as to the usefulness of audit reporting. We believe that there have been important improvements but welcome engagement on how this could be further progressed.

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<sup>281</sup> See [http://www.deloitte.com/view/en\\_GB/uk/services/audit/9531b48367b13310VgnVCM1000001a56f00aRCRD.htm](http://www.deloitte.com/view/en_GB/uk/services/audit/9531b48367b13310VgnVCM1000001a56f00aRCRD.htm).

<sup>282</sup> See [http://www.bp.com/assets/bp\\_internet/globalbp/globalbp\\_uk\\_english/set\\_branch/STAGING/common\\_assets/bpin2011/downloads/BP\\_Annual\\_Report\\_and\\_Form\\_20F\\_2011.pdf](http://www.bp.com/assets/bp_internet/globalbp/globalbp_uk_english/set_branch/STAGING/common_assets/bpin2011/downloads/BP_Annual_Report_and_Form_20F_2011.pdf).

<sup>283</sup> See [http://www.investors.rbs.com/download/report/Annual\\_Report\\_2011.pdf](http://www.investors.rbs.com/download/report/Annual_Report_2011.pdf).

<sup>284</sup> See <http://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/Consultation-Dicument-revisions-to-teh-UK-Corporat/Appendices-to-Consultation-Documents/Appendix-to-Consultation-Documents-Draft-Revised-Gu.aspx>.

<sup>285</sup> See <http://www.ifac.org/auditing-assurance/projects/auditor-reporting>.

## 6. Potential adverse outcomes

- 6.1 The Working Paper cites three main possible adverse outcomes<sup>286</sup>. We do not believe that the evidence is consistent with any of these outcomes arising in practice.

### *Higher prices*

- 6.2 The evidence shows that prices for audit of FTSE 350 companies are highly competitive. Deloitte has provided significant evidence on the competitiveness of pricing in this market to the CC – particularly in relation to:

- (a) the lack of any relationship between the market structure and audit fee levels, in its paper on audit pricing (published by the CC on 27 April 2012);
- (b) profitability, demonstrating that the profitability of Deloitte's audit business is no more than reasonable by reference to appropriate comparators such as major law firms, and lower than that of our non-audit businesses (which the CC agrees operate in a competitive market<sup>287,288</sup>);
- (c) detailed information on its engagement level profitability (based on the commonly used RRR measure), which shows that RRR has, on average, been on a downward trajectory since 2006<sup>289</sup>.

- 6.3 There is also extensive third party evidence supporting this conclusion:

- (a) **Grant Thornton:**

*"We are not aware of any evidence that audit fees are excessive in the markets in which we operate."*<sup>290</sup>

- (b) **ICAEW:**

*"We are not aware of any evidence to support a claim that audit clients are charged excessive fees."*<sup>291</sup>

- (c) **ICAS:**

*"There is no evidence to suggest that clients are charged excessive fees."*<sup>292</sup>

- (d) **PwC:** we have reviewed the paper on audit pricing submitted to the CC by PwC<sup>293</sup> and we note that PwC independently reached similar conclusions to those reached by Deloitte in its pricing analysis;

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<sup>286</sup> See paragraph 79 of the Working Paper. The CC elaborates on this at paragraph 86 *et seq* of the Working Paper.

<sup>287</sup> See paragraph 30 of the CC's Barriers to Entry Working Paper.

<sup>288</sup> See paragraph 7.1 *et seq* of Deloitte's summary of its response to the CC's Market Questionnaire.

<sup>289</sup> See Deloitte's response to the CC's data request.

<sup>290</sup> Grant Thornton written evidence to the House of Lords Economic Affairs Committee. See page 124 of Volume 2 of the House of Lords Report.

<sup>291</sup> ICAEW written evidence to the House of Lords Economic Affairs Committee. See page 45 of Volume 2 of the House of Lords Report.

<sup>292</sup> ICAS written evidence to the House of Lords Economic Affairs Committee. See page 51 of Volume 2 of the House of Lords Report.

<sup>293</sup> PwC, *Observations on the assessment of profitability*, published by the CC on 14 August 2012.

(e) **Shamharir Abidin, Professor Vivien Beattie and Alan Goodacre:** there is “no evidence to indicate that recent structural changes have resulted in anticompetitive pricing” in the UK listed company audit market<sup>294</sup>.

6.4 We will put further evidence to the CC in the context of our response to the CC’s proposed working papers on competition in the market, profitability and its own econometric analysis.

6.5 The CC will no doubt have noted the FRC’s recent comments on pricing pressure in the audit market and the warnings they have given about the potential for a risk to audit quality if that pressure is maintained. In its **2011/2012 Audit Inspection Unit Annual Report**, it stated that:

*“Audit efficiency is becoming progressively more important to firms as audited entities seek to reduce fees. Firms should establish central safeguards to ensure that total audit hours, the determination of materiality and the extent of work performed are maintained at an appropriate level to protect overall audit quality, particularly where significant fee reductions have been agreed.”*<sup>295</sup>

*“Firms face significant pressures in the current economic environment and the level of tendering activity has increased. Substantial reductions in audit fees have occurred in a number of recent audit tenders for large listed entities.”*<sup>296</sup>

*“While acknowledging that fee pressures are a commercial reality that cannot be ignored, we remain concerned that audit efficiency is becoming progressively more important to firms as audited entities seek to reduce fees. Firms should ensure that they maintain appropriate controls centrally to ensure audit efficiencies are not achieved at the expense of audit quality, particularly where the extent of audit procedures performed are dependent on judgments relating to materiality, scoping or sample sizes.”*<sup>297</sup>

6.6 The **FRC report on Deloitte** stated that:

*“While the firm’s strategy emphasises the importance of maintaining or improving audit quality, it also focuses on growth and audit efficiency initiatives, partly to address audit fee pressures. There is a risk that the quality of future audits may be impacted by these fee pressures and the resulting initiatives to improve efficiencies. The firm should ensure that it continues to focus on audit quality and give particular attention to its audit policies and guidance in areas where the extent of audit procedures performed are dependent on judgments relating to materiality, scoping or sample sizes.”*<sup>298</sup>

6.7 We are very aware of the risks raised by the FRC, and for all the reasons set out above remain absolutely committed to quality above all<sup>299</sup>. While we do not believe that there is any present risk to audit quality (and it is important to note that the FRC’s request was that we “continue to focus on audit quality” (emphasis added)), it seems to us that the FRC’s warnings are not consistent with the existence of a market in which firms are pricing at unduly high levels.

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<sup>294</sup> *Audit market structure, fees and choice in a period of structural change: evidence from the UK - 1998-2003*, British Accounting Review, 42(3): 187-206.

<sup>295</sup> Paragraph 1.3 of FRC, *Audit Quality Inspections Annual Report 2011-12*.

<sup>296</sup> Paragraph 2.3.2 of FRC, *Audit Quality Inspections Annual Report 2011-12*.

<sup>297</sup> Ibid.

<sup>298</sup> Page 11 of FRC, *Audit Inspection Unit Public Report on the 2011/12 inspection of Deloitte LLP*.

<sup>299</sup> Deloitte issued the following statement in response to the FRC report:

*“Deloitte remains committed to improving audit quality wherever possible, and the firm has implemented a number of actions to respond to AIU findings. We note the potential risk on pricing expressed in the AIU’s annual report into the audit industry’s performance, since it highlights the impact of competitive pressures on audit fees. The report serves as a reminder to audit firms, audit committees and all stakeholders in the audit profession that a reduction in costs cannot mean a reduction in audit quality.”*

6.8 The FRC's views that there is significant competitive pressure on audit fees is widely shared in the industry:

(a) **Mazars:**

*"We are very careful that the squeeze on fees which the profession is currently facing does not adversely affect the requirement for accurate and reliable financial information."*<sup>300</sup>

(b) **BDO:**

*"There is certainly fee pressure, but...the professionals doing this operate in regulated markets and therefore it does not follow that this will affect audit quality...Should [fee pressure of this magnitude] continue, the business model will have to be looked at."*<sup>301</sup>

*"One of the biggest challenges we face at present, particularly in the more developed economies, is what my US colleagues call 'fee compression' - what I would call 'extreme downward pressure on fees'. Many companies, understandably given the tough economic environment, are putting their audit firms under considerable pressure to reduce their fees and most firms appear to feel they have no option but to respond by reducing their fees because they know that if they won't do so then one of their competitors will happily take the work at the lower fee."*<sup>302</sup>

*"Many will say that this is evidence of a healthy, competitive market and is one of the advantages of a free market economy. That it is a reflection of surplus capacity and that competition will drive prices down and that capacity will reduce until we will reach what my economics tutor called 'equilibrium'. Prices will then stabilise because supply and demand are balanced."*<sup>303</sup>

(c) **Baker Tilly:**

*"The question is how long fee pressure will continue...Clearly firms are prepared to take on audits for a lower return than they were previously."*<sup>304</sup>

(d) **KPMG:**

*"The audit business was steady. We didn't lose audit accounts but competition put pressure on fees."*<sup>305</sup>

6.9 Again, these views seem inconsistent with the suggestion that the market is delivering unduly high prices.

*Lower quality*

6.10 Deloitte has provided extensive evidence on quality to the CC, demonstrating that all aspects of audit quality are high under current market conditions<sup>306</sup>. This is not to be complacent: we and our regulators are agreed that continuous improvement is necessary<sup>307</sup>.

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<sup>300</sup> Mazars Annual Report 2010/11.

<sup>301</sup> International Accounting Bulletin roundtable, published February 2010. See [http://www.c8consulting.co.uk/pdf/IAB\\_roundtable\\_excerpt.pdf](http://www.c8consulting.co.uk/pdf/IAB_roundtable_excerpt.pdf).

<sup>302</sup> BDO, "CEO Insights" at <http://blog.e-bdo.com/intranet/global/JNblog1.nsf/dx/A-bizarre-market>.

<sup>303</sup> Ibid.

<sup>304</sup> International Accounting Bulletin roundtable, published February 2010. See [http://www.c8consulting.co.uk/pdf/IAB\\_roundtable\\_excerpt.pdf](http://www.c8consulting.co.uk/pdf/IAB_roundtable_excerpt.pdf).

<sup>305</sup> John Griffith-Jones, KPMG, commenting on KPMG's 2012 annual results: see <http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/9000943/KPMG-partner-profits-fall-10pc-on-weak-MandA-and-Government-spending.html>.

- 6.11 However, we do not believe that any good evidence has been put to the CC that the circumstances set out in either of the CC's theories of harm lead to poorer *substantive* audit quality<sup>308</sup>.
- 6.12 This view seems to have wide support by market observers and participants, including some mid tier firms:
- (a) **BDO:** in its most recent submission to the CC, BDO explains that the claim that more competition would increase audit quality is *"not a claim that we (or others, to our knowledge) have made."*<sup>309</sup>
- (b) **Grant Thornton:**
- "We are not aware of any evidence that the presence of four large firms has led to excessive fees being charged or had an adverse effect on audit quality in the markets that we serve."*<sup>310</sup>
- (c) **Kingston Smith:**
- "We do not believe that there is any particular evidence of a lack of audit quality arising from concentration at the top end of the audit market...Larger firms invest a great deal of time and effort in their audit processes and procedures."*<sup>311</sup>
- (d) **ABI:**
- "We also question whether the monitoring work of the Financial Reporting Council shows there is a need to increase audit quality at the major firms which cannot at this stage be met through the use of existing regulatory measures."*<sup>312</sup>
- 6.13 Deloitte has also provided to the CC the evidence of its surveys of the satisfaction of its own clients<sup>313</sup>.
- 6.14 As noted above<sup>314</sup>, it appears that the CC sometimes seeks to draw a distinction between "technical" quality and "service" quality<sup>315</sup>. We believe this distinction has no competitive significance: companies and investors are incentivised to require, and auditors are incentivised to provide, quality across both elements. There is no trade off between the two.
- 6.15 We also note that the large majority of investor concerns appear to relate to quality of reporting rather than substantive audit quality. We acknowledge the concerns that have been put to the CC by investors, and we have addressed this issue in detail in the context of the second theory of harm above<sup>316</sup>. We also discuss it in the context of innovation immediately below.

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<sup>306</sup> See *inter alia* page 24 *et seq* of Deloitte's initial submission to the CC.

<sup>307</sup> See in particular footnote 300 above setting out Deloitte's response to the most recent AIU inspection reports.

<sup>308</sup> We address the issue of reporting (which the CC correctly considers to be a separate issue – see paragraph 86 of the Working Paper) separately below.

<sup>309</sup> See BDO's response to PwC's response to certain third party submissions, published by the CC on 14 August 2012.

<sup>310</sup> Grant Thornton written evidence to the House of Lords Economic Affairs Committee. See page 121 of Volume 2 of the House of Lords Report.

<sup>311</sup> Page 3 of Kingston Smith's response to the CC's Issues Statement.

<sup>312</sup> Paragraph 12 of the ABI's response to the CC's Issues Statement.

<sup>313</sup> See Deloitte's response to question 102 of the CC's Market Questionnaire.

<sup>314</sup> See paragraph 2.3 above.

<sup>315</sup> See paragraph 63 of the Working Paper.

<sup>316</sup> See section 5 above.

### *Lower levels of innovation*

- 6.16 It seems to us that much of the criticism of alleged lack of innovation relates to innovation in audit reporting<sup>317</sup>.
- 6.17 This ignores the enormous amount of innovation in the substantive product over the course of many years. Over the last decade the accounting, auditing, regulatory and business environment for statutory auditing has changed significantly requiring Deloitte to innovate its audit approach in order to stay ahead of these changes.
- 6.18 Our audits have had to respond through innovation to the following changes and developments:

#### *Developments in accounting standards*

- a) Increasing number of accounting standards. Since 2001, IASB issued 13 new IFRSs and 20 IFRICs in addition to the 41 IASs existing at the time and it continued to issue amendments to the existing IAS and IFRS standards since 2001 through improvement projects;
- b) Transition from UK GAAP to IFRS. Listed companies in the UK were required to adopt IFRS from 2005. IFRS introduced some fundamental changes into the basis of financial reporting as well as introducing a significant number of new disclosure requirements in financial statements; and
- c) Increasing complexity and length of accounting standards. Certain accounting standards are particularly complex and have evolved significantly over time in response to changes in the markets and companies (for example there are four standards dealing with financial instruments (namely IAS32, IAS39, IFRS7 and IFRS9) or three standards in relation to valuation of intangible assets (namely IAS36, IAS38, IFRS3).

#### *Developments in auditing standards and other legislation*

- a) In 2005, the UK has implemented International Standards on Auditing (ISAs) which led to a significant change in the audit methodology to embed a risk-based approach, with greater emphasis on fraud;
- b) In 2010, following a process to enhance the clarity of ISAs, the UK has implemented Clarified ISAs. Clarity ISAs led to significant revisions to some standards. For example, ISA 540 was revised as a direct response to the increase in complexity of accounting standards (for example, increased use of fair values) and new business models being adopted by many companies;
- c) ISA (UK & Ireland) 720 (revised) issued on 10 April 2006 in response to the change in Companies Act and required the auditor to give an opinion as to whether the information given in the directors' report is consistent with the financial statements, instead of the previous duty to report by exception when the directors' report is inconsistent;
- d) For FTSE 350 companies which are SEC registrants, the Public Company Accounting and Oversight Board ("PCAOB") has issued 15 additional audit standards that govern the work and responsibilities which reach beyond the current requirements of ISAs;
- e) PCAOB further influenced the audit approach for auditors of SEC registrants to require significant incremental compliance responsibilities regarding auditor independence, incremental partner-led quality reviews of audits performed in accordance with PCAOB

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<sup>317</sup> See, for example, paragraph 10 of the summary of the CC's **hearing with institutional investors**; and page 3 of the submission of the **Universities Superannuation Scheme**.

standards, and additional requirements for communicating the results of the audit to management and to those charged with governance;

- f) The Sarbanes-Oxley Act of 2002 ("SOX") mandated an annual audit to be conducted by the independent auditor to assess the design and operating effectiveness of the internal controls over financial reporting ("ICFR") for substantially all SEC registrants;
- g) Introduction of anti-money laundering and know your client legislation; and
- h) APB Ethical Standards issued in 2004 and updated in 2008 and 2010 has led to enhancement of Deloitte's policies and guidance and has increased requirements for reporting to those charged with governance.

#### *Increased regulatory scrutiny on the auditors*

- a) FRC's Audit Quality Review team (formerly AIU) was established in 2003 and publishes publicly annual reports to present overview of activities since 2005 in addition to individual reports on each of the audit firms since 2008. In light of the FRC's continual focus on raising the bar on audit quality, Deloitte in turn places considerable focus on, and is committed to, improving our processes and procedures; and
- b) Audits of FTSE 350 companies with dual listings of equity or debt in the US are also subject to inspection by the PCAOB.

#### *More complex reporting requirements for UK listed companies*

- a) According to the Deloitte's 2011 survey on annual reports (Gems and Jetsam); the average length of annual reports is 98 pages which is 123% longer than when the survey started in 1996. This increased length has been driven by a combination of the Companies Act 2006, the Listing Rules, the Disclosure and Transparency Rules ("DTR"), the UK Corporate Governance Code, as well as new accounting standards;
- b) Reporting deadlines have become shorter. According to the Deloitte's 2011 survey on annual reports (Gems and Jetsam); the average time for report approval was 60 days for top 350 companies by market capitalisation. According to the 2006 survey, percentage of top 350 companies by market capitalisation approving their annual reports within 75 days was 85% with remaining reporting over 75 days; and
- c) FRC's 2009 guidance on "Going Concern and Liquidity Risk: Guidance for Directors of UK Companies" focused on directors' obligation to make a rigorous assessment of going concern, document their assessment and make balanced, proportionate and clear disclosures about going concern.

#### *More complex corporate governance requirements*

- a) Through major reviews of UK corporate governance, the level of interaction and reporting between the auditor, audit committee and investors has increased significantly resulting in increased focus on auditors communication with those charged with governance; and
- b) In 2006 it became a criminal offence to issue a knowingly or recklessly sign a misleading audit report. This carries an unlimited fine.

*Changes in the corporate environment*

- a) Companies have become more international. The number of foreign issuers in the FTSE100 has increased (for example energy and resources companies) and generally FTSE350 presence in (and trade with) emerging markets has increased;
- b) Increased use of more complex information technology by companies (both financial IT systems and wider enterprise resource planning systems); and
- c) Increased use of financial instruments by companies requiring increased auditor judgement.

*Changes in the business environment*

- a) Increased business risk following the credit crunch, sub-prime contagion and sovereign debt crises;
- b) Increased volatility in commodities and currencies has added additional complexity to asset valuations (both in terms of physical assets and esoteric assets such as derivatives).

6.19 In order to respond to all of the changes and developments noted above Deloitte has innovated its audit approach. Examples of this include:

- a) Significant investment in our technical competencies. Currently our National Accounting and Audit (NAA) department has [x] professionals, nearly double the size it was 10 years ago. Our Global IFRS and Offerings Services department (GIOS) has [x] professionals. Ten years ago this department did not exist;
- b) Investment in Global IFRS centre of excellence responsible for developing Global Deloitte positions on the application and interpretation of IFRSs;
- c) Continued development and extension of our existing software systems, Audit System/2, including significant enhancements into documentation of the audit evidence and to demonstrate professional scepticism, and its current replacement with the recently developed Deloitte Audit;
- d) Development of our quality control teams and processes including the introduction of “super” independent review partners;
- e) Development of our quality and risk management systems (including hot review workflow, conflicts, independence and client-take on procedures and our audit client monitoring systems);
- f) Expansion of the dedicated quality and risk community in the firm from around [x] people in 2001 to approximately [x] today (excluding NAA and GIOS mentioned above). In addition to our central Practice Protection Group, we have dedicated, full time partners and staff with responsibility for quality and risk management in each of our service lines and other partners and staff with recognised quality and risk roles and responsibilities (in addition to their client serving roles and responsibilities);
- g) Enhancement of our own policies and processes given changes in ethical requirements (Deloitte Code, expansion of the Office of Ethics Partner);
- h) Investment in managing regulatory inspection of our core systems and processes;

- i) Use of data analytics, as an integral part of our audit techniques, to interrogate and report on large volume transaction data – providing both efficiency in audit process and greater insight for clients;
- j) We maintain our ISO 27001 certification, the international standard for information security management, to demonstrate our commitment to the secure and appropriate way we handle our clients' confidential information;
- k) Investment to recruit and train the best people through professional development and industry learning programmes provided over and above mandatory accounting, auditing, compliance, anti-money laundering and risk management learning programmes and regular technical briefings;
- l) Increased use of subject matter experts – partners from elsewhere in the firm who are expert in taxation, IT, financial instruments, valuations, forensic accounting, pensions and financial regulation; and
- m) Substantial development of the audit committee reporting templates. These include as standard a planning report, an interim review report, a final report and, where necessary, a follow-up report on any outstanding issues.

6.20 Overall, an audit undertaken in 2012 is very different to an audit undertaken ten years ago and has responded to the increased size and complexity of our clients, legislation and regulation. Notwithstanding this, the engagement data we have provided to the CC shows that on average the number of hours input to a FTSE350 audit has been declining over time and that prices have not increased in real terms. This indicates that it is our clients (both companies and investors) that have been the beneficiaries of all of this innovation and development whilst overall efficiency has been improved.

6.21 As regards innovation in *reporting*, we recognise investor concerns that reporting by auditors and audit committees may not yet be meeting their needs<sup>318</sup>, and we welcome engagement with them. However, it is worth noting the extent to which even this aspect has developed over the past several years, as we have explained above<sup>319</sup>.

## 7. Conclusion

7.1 The Working Paper sets out a considered theoretical framework for two theories of harm. In taking such a theoretical approach, though, the Working Paper appears to omit the assessment of a large amount of relevant evidence that has been put to the CC. This evidence shows that the conceptual issues raised in the Working Paper do not lead to an adverse effect on competition in practice.

7.2 In particular:

- (a) the evidence shows that there is strong competition in the market for FTSE 350 auditors, reflected across both price and quality:
  - (i) there are no concerns beyond the merely theoretical that audit prices are unduly high; the regulator's own views indicate that such a concern is implausible;
  - (ii) we have seen no considered evidence indicating unduly low levels of audit quality. Given the features of the market that incentivise audit quality, such evidence would have to be compelling to lead to a conclusion that the market was not producing high levels of audit quality;

<sup>318</sup> See paragraph 5.10 *et seq* above.

<sup>319</sup> See paragraph 5.14 above.

- (iii) Deloitte and its competitors (including non-top tier firms) have invested in innovation in substantive audit quality. This has been essential to keep pace with the developments in audited companies;
- (b) stakeholders within companies – the ACC and CFO in particular – are strikingly experienced and informed buyers. Their level of commitment to understanding and maintaining visibility on the audit process is very high. They are consequently very well-placed to assess the quality provided and offered to them;
- (c) reputation cannot be divorced from actual quality provided. Given the visibility that stakeholders within companies have on actual audit quality, reputation becomes a function of, not a proxy for, actual quality. A failing in audit quality can lead to an immediate and very damaging loss of reputation;
- (d) there is no misalignment of interests between the company, its auditor and its investors: all are incentivised to seek a very high level of audit quality across all its dimensions;
- (e) barriers to entry and expansion are not such as to inhibit the investments necessary for non-top tier firms to compete more effectively in this market;
- (f) search, tendering and switching costs are not unduly high, and do not inhibit companies from taking effective action to ensure that they are receiving the level of value/quality that they demand. The evidence shows that companies who do not seek to switch generally do so because they are satisfied with the value/quality levels of their existing auditor; those who are not can and do take action to address this; and
- (g) there has been substantial innovation in the audit process in response to the changing demands of clients and legal and regulatory environment.

7.3 In summary, the evidence shows that this is a market that, in general, is working well for its customers. There is no basis set out in the Working Paper, and no basis in the evidence that has been put to the CC for the CC to reach any conclusion other than that no adverse effect on competition arises in the market for FTSE 350 audit services.

7.4 We recognise, separately, though, that investors have legitimate concerns in relation to audit reporting and its usefulness to them. We and other are taking steps to address this issue and would welcome engagement to take this process forward.

## Annex 1

### Responses to points of detail

¶	Working Paper wording	Comment
39	<p>'If shareholders are not involved in the appointment of auditors and/or auditors do not have direct contact with shareholders, there may be no means by which auditors can understand the demand of shareholders.'</p>	<p>Shareholders' demands are delegated to and represented by audit committees. Auditors therefore fully understand the demands of the body of shareholders (although not necessarily those of individual shareholders) through the ACs, and we are not aware of any evidence suggesting that the ACs are not voicing these demands appropriately.</p> <p>In addition, we note the CC's concerns that in practice investors have little interaction with auditors.</p> <p>However, we would like to make the point that it is the shareholders that vote to (re)appoint an auditor. In addition, the AGM is a forum for direct contact between the auditor and the shareholders.</p> <p>Whilst, as noted extensively in the main text of our response, we welcome additional interaction<sup>320</sup>, it is also important to recognise the current position.</p>
41	<p>'Individual auditors or audit firms may, however, have an incentive to free ride on the efforts of others, for example by not investing sufficiently in training. In this respect the reputational benefits to the audit profession as a whole created by the professional standards and behaviour of auditors have characteristics of a public good.'</p>	<p>Stating that reputational benefits have the characteristics of a public good implies that reputation can be unearned. We strongly dispute this in the context of the audit profession.</p> <p>Each individual auditor is a member of their respective institute which requires confirmation of the appropriate training and behaviour on an annual basis.</p> <p>Separately, Deloitte requires each individual to confirm compliance with the 'Deloitte code' (an ethical code) on an annual basis.</p> <p>The potential negative consequences, both as an individual and as a firm, for 'free-riding' on the reputation of the profession are substantial. Evidence of low quality provided by individual auditors or audit firms is detectable and severely punished when detected (in extremis by expulsion from the audit profession at the individual (or firm) level, or by a collapse at the firm level).</p>
44	<p>'...the shareholder is poorly placed to determine how effectively [professional bodies and regulators] complete their mission'.</p>	<p>We unaware what evidence the CC is using to make this statement. The FRC reports publicly on their monitoring of the firms and of the Institutes (the Institutes are the bodies who issue the firms' 'auditing licences', and are hence subject to scrutiny by the regulator).</p>

<sup>320</sup> Deloitte is holding its first "Stakeholder Forum" in October for senior members of large investors and investor bodies, regulators and governments, which will discuss our annual review, our governance structure, the regulatory environment and audit quality.

¶	Working Paper wording	Comment
54	<p>'...companies must buy [an audit] and there can be no demand-side substitution to a different product in response to poor quality or high prices'.</p> <p>'...to gain market share [in the FTSE350] firms must win audit engagements from rivals.'</p>	<p>We agree that an audit cannot be substituted for a different product. However we disagree that a company's management or audit committee cannot take any action (on behalf of its shareholders) to respond to poor quality or high prices. There is significant evidence in the survey results and the case studies to show that companies do tender and/or switch if they consider they are not receiving value for money or if they find that their needs (those of management, ACCs and shareholders) are not served adequately by their existing auditor. This evidence is detailed extensively in our main response.</p> <p>We disagree with this statement, which characterises the FTSE350 as a static block. It is possible for an audit firm to maintain a relationship with a company outside of the FTSE350 which then enters the FTSE350 via an increase in market capitalisation. Auditors can thus gain market share in the FTSE 350 market simply by retaining their existing clients as they develop.</p>
71	<p>'...certain industry sectors may only be sufficiently large to support a small number of firms with appropriate expertise'.</p>	<p>As has been confirmed in previous submissions to the CC, there are a very limited number of industry sectors which are only sufficiently large to support a small number of firms with the appropriate expertise (for example, banking). We would also supplement this statement with the fact that, due to the limited number of companies in such sectors, the lower number of audit firms is not a particular restriction.</p>
76e	<p>'The Big 4 background of most ACCs and CFOs may limit the population of auditors they perceive to be able to deliver appropriate quality of audit and reputation of audit.'</p>	<p>ACCs and CFOs have significant duties (including personal liability). To imply that ACCs and CFOs do not consider all options in respect of auditor appointment implies they neglect their statutory and fiduciary duties to act in the best interests of the company and its shareholders.</p>
87, 32	<p>'We are...aware that there are other means [other than audit reports] by which financial markets are provided with the information they need including due diligence'.</p> <p>'Due diligence reports are prepared for a potential acquirer of a company or its assets'.</p> <p>'Reporting accountant reports [are prepared] in preparation for IPOs'.</p>	<p>For the avoidance of doubt, due diligence reports are private reports. The information in due diligence reports would therefore not be available to inform the financial markets.</p> <p>Due diligence reports are usually prepared prior to an acquisition (or disposal), but can also be prepared for other reasons, for example a refinancing.</p> <p>Reporting accountant's reports are prepared in preparation for IPO. They are also prepared for any prospectus required for a main market issue (for example, a rights issue, a placing, an open offer etc). They are also prepared for a Class 1 acquisition or a Class 1 disposal. In addition, they are also prepared in respect of some Takeover Code requirements.</p>

¶	Working Paper wording	Comment
	<p>'The information [in due diligence and reporting accountant's reports] may also not be widely available outside the company or its advisers'</p>	<p>As above, in respect of due diligence, the information will not (as opposed to 'may not') be available outside the company and its advisers.</p> <p>In contrast, a reporting accountant's report is a public report.</p>