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Competition Commission Audit Services Market Inquiry

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Deloitte response to the Competition Commission's working paper "Views of investors and other stakeholders"

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1. Introduction and summary

1.1 Deloitte is grateful for the opportunity to comment on the paper published by the Competition Commission (the ***CC***) on "Views of investors and other stakeholders" (the ***Working Paper***).

1.2 This response comments on the following areas:

(a) Nature of inventor concerns: there is a widespread view that audits are important, though there are some concerns on reporting issues. We recognise these concerns and are active in seeking to address them.

(b) No barriers to switching: investors have raised no concerns as to any barrier to switching or to expansion by audit firms

(c) Investors are not a homogeneous group; and

(d) The CC's specific question on unmet demand.

2. Nature of investor concerns

2.1 The Working Paper sets out the general view from investors that audited financial statements are important to investment decision-making[1].

2.2 We agree with the view expressed in paragraph 22 that the value of an audit is derived from the underlying audit process rather than the audit report itself. However, it is not always acknowledged that these are not mutually exclusive – we are unable to deliver audit reports without a rigorous underlying audit process.

2.3 The Working Paper describes the ongoing debate that the audit report could contain more information and explanation than is currently generally provided[2]. In the past there has been a clear recognition that one of the advantages of the existing audit report format is that it is unequivocal and cannot therefore be misinterpreted. However, in recent years there has been a suggestion that more is included in the audit report. We are active participants in discussions on this issue through, for example, our support of initiatives by the IAASB and FRC and our participation and funding of AuditFutures[3].

2.4 Similarly, there has been discussion around greater dialogue between auditors and investors. Insider dealing legislation prohibits investors and auditors discussing issues about specific companies in private meetings. Nevertheless, for many years we have held generic discussions with investors to understand their points of view and explain our approach to auditing. Earlier this year we held a Stakeholder Forum to improve the dialogue we have with external stakeholders, including investors and regulators[4].

2.5 It is important to note that the content of the audit report – and the desire of some investors for more detail – is unrelated to the number of competitors in the market for statutory audit, or the

[1] Paragraphs 17-26

[2] Paragraph 65

[3] This was also referenced in our responses to the follow-up questions you sent to us following our Hearing in October

[4] Although this is the first instance of a 'Stakeholder Forum' with a large number of parties together, we have held a number of smaller meetings with one or two investors over the course of the past 4 to 5 years.

dimensions of competition between market participants. The content and format of audit reports is determined by statute and regulators, not individual firms[5].

3. No barriers to switching

3.1 It is clear from the Working Paper that the views of investors do not present any barrier to switching nor to the expansion of any audit firm.

3.2 There is little or no evidence that investors would be concerned by a switch to a new auditor (including a switch to a non-top tier auditor) occasioned by a proper evaluation of quality and value in a tender process[6]. While they would rightly be concerned by a switch that was occasioned by "opinion-shopping" or seeking a less robust audit, it is clear that investors understand that a switch of auditor following a proper appraisal process is not of concern.

3.3 Furthermore, there is no evidence that investors put pressure on company decision-makers not to involve non-top tier auditors in tender processes, or not to select non-top tier auditors. The large majority of investors indicate that they would be content for directors to select from a wider group of competent firms.

3.4 Within that group of competent firms, it is clear that investors recognise that the audit committee is best placed to select the audit firm that is best placed to deliver the highest quality and value: they recognise that the audit committee and ACC have the skills, background and remit to take this decision (in the best interests of the company and its shareholders)[7]. They do indicate that they would be concerned at the appointment of an auditor who obviously lacked the skills or resources to undertake the audit; this is proper and cannot meaningfully be understood to represent a barrier to switching or to audit firm expansion.

3.5 This view is also in evidence in submissions that for the very largest companies, even the appointment of a mid tier audit firm might cause concern; this is entirely consistent with the mid tier firms' own submissions that they are not (currently) capable of auditing the largest listed companies[8].

3.6 These findings in the Working Paper are consistent with the findings of the CC Survey that only an immaterial percentage of companies (2% of FTSE 350 companies) who chose not to include non-top tier firms in their tender process did so because of the perceptions of investors or other stakeholders.

4. Investors are not a homogeneous group

4.1 We believe that, overall, the Working Paper is a fair representation of the views of investors. However, we recognise that investors do not always agree with each other[9].

4.2 The diversity of investor views is one reason why different stakeholders can point to investor views that are inconsistent or contradictory. In comparing the views of investors, we find it helpful to consider the value of the funds they manage. Although the views of investors with a relatively small level of funds under management can be just as valid as those of larger investors, the size of funds under management can be more useful in considering what constitutes a consensus

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[5] In the UK, the format and content of the auditor's report are established by auditing standards (in particular, ISA (UK & Ireland) 700) and applicable legislation (in particular, the Companies Act 2006)

[6] For example, see the views of Standard & Poors in paragraph 33 and L&G in paragraph 37

[7] See, for example, the findings of the Oxera report set out at paragraph 59 of the Working Paper, in which it is explained that investors *"do not want any radical change in investors' degree of involvement in auditor selection"*. Indeed, investors acknowledge that they are not well-placed to make decisions as to the relative quality offered or provided by audit firms (see paragraph 16 of the Working Paper).

[8] See, for example, paragraph 1.8 of Grant Thornton's response to the Issue Statement.

[9] See, for example, paragraph 30 vs paragraph 34-37 which set out differing views

than relying purely on the number of investors. We suggest this could be a helpful approach for the CC to adopt as it considers the views of investors going forward.

5. Response to the CC's specific question on unmet demand

5.1 The CC asked us the following question on 16 November 2012. "*In this regard, please consider (within the context of our second theory of harm) whether these investor views show that there is an unmet demand relevant to the audit product, and if so, whether any inability of or constraint on either firms or companies is producing such unmet demand, and so could amount to one or more features of the market leading to an adverse effect on competition*".

5.2 We agree with the CC's own conclusion in the Working Paper that "*there is desire from <u>some</u> investors for more additional information*"[10] (emphasis added). We also agree with the CC's conclusion that there are mixed views as how this should be provided and particular whether the additional information would feature in the audit report or the audit committee report.

5.3 Reporting requirements (whether in the audit report, audit committee report or elsewhere in the financial statements) are generally dictated by statute and regulations.

5.4 Regulation is a very important aspect of the market as it allows auditors to understand what is required of them and it provides investors with a framework for them to understand what the audit report is saying (and what it is not saying).

5.5 We recognise that there needs to be a debate on audit reporting between all interested parties including regulators, investors and audit firms. We are actively participating in this debate.

5.6 The CC should take note of the following in respect of this debate:

(a) Not all investors are calling for change and any changes need to take account of the fact that investors are not a homogeneous group;

(b) Moving away from a tightly prescribed form of audit report wording introduces the possibility that there is a loss of clarity and consistency of message between audit reports making it harder for investors to interpret audit reports;

(c) Variability in the levels of disclosure between companies could impact capital markets through impacting share prices differently; and

(d) Concerns around audit liability would most likely result in audit firms maintaining audit reporting around accepted norms.

5.7 Finally, and perhaps most importantly, it is important to note that this issue is neither caused by a lack of competition between audit firms, nor does it lead to a lack of competition between audit firms.

5.8 BDO has suggested in its response to the Issue Statement and in responses to working papers[11] that the current approach to audit reporting may be evidence of a lack of competition in the audit market. This is absolutely wrong, and there is no evidence to support it. As the CC found in its working paper on the 'Nature and strength of competition', firms compete strongly to win and retain audit engagements, and there are multiple dimensions over which such competition takes place (including price, quality and innovation in the audit approach)[12]. The current approach to audit reporting has no connection with the number of market participants nor the dimensions or strength of competition between them. This is well evidenced by the fact that audit reporting

[10] Paragraph 81 of The Working Paper

[11] See paragraph 4.1.1 *et seq* of BDO's response to the Issues Statement and paragraph 1.1 of its response to the working paper on the 'Nature and strength of competition'.

[12] See, for example, paragraph 165 of the working paper on the 'Nature and strength of competition'.

takes a very similar form among groups of companies outside the reference market. For example, in the AIM market (in which Grant Thornton has noted its leading position), audit reporting is no different from audit reporting with respect to FTSE 350 companies.

5.9 Thus while we welcome engagement with the CC on issues of audit reporting (as we welcome engagement with companies themselves, the FRC and other stakeholders), the CC should not be misled into thinking that this issue is connected with market structure, dynamics or competition.