



For the attention of M Bethell Esq  
Inquiry Director  
Competition Commission  
Victoria House  
Southampton Row  
London  
WC1B 4AD

24 October 2011

Dear Mr Bethell,

**Market investigation reference - Supply of audit services to large companies**

This letter is provided to the Competition Commission (CC) in response to the OFT's Decision of 21 October 2011 (the Decision) to make a market investigation reference in respect of the supply of statutory audit services to large companies in the UK.

**Context**

Various reviews of the audit sector have taken place or are currently underway, in the UK and overseas, and policies may be shaped as a result of them. Regrettably, none of these reviews have included a proper assessment of competition and they appear to be based on a misconception that competition in the provision of audit services is less than effective. They also tend to conflate issues relating to competition with other issues that are perceived to have arisen from the financial crisis.

Given the crucial role played by audits in the effective functioning of the capital markets, there is a very real risk that policies will be inappropriately shaped in a manner which could have a substantial adverse impact on the sector, the capital markets and hence the economy more generally. In particular, regulatory interventions could have the unintended consequence of damaging the high quality of audit services to this market. Our hope and expectation is that the CC's market investigation will help to address this risk. PwC therefore welcomes the opportunity that is presented by this investigation to have a properly informed analysis of how competition works in the audit sector.

The Decision suggests that there are significant benefits to be gained from interaction between the EC's likely legislative process and the CC process. We agree that there may be such benefits and we would welcome an early discussion with the CC as to how it is intended that any such interaction should be structured.

**Features of the audit market and competitive pressures – the need for in-depth analysis**

The OFT has taken the highly unusual step of referring the audit market to the CC without having carried out a full market study or, as far as we are aware, any substantial review and analysis of the sector.

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*PricewaterhouseCoopers LLP, 1 Embankment Place, London, WC2N 6RH  
T: +44 (0) 20 7583 5000, 44 (0) 20 7583 5000 F: +44 (0) 20 7822 46528, [www.pwc.co.uk](http://www.pwc.co.uk)*

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As a result, the OFT has:

- Made some high level observations about two specific features of the market for large firm audits, i.e. the relatively high market shares accounted for by firms such as PwC and other members of what is commonly referred to as the “Big Four”, and the relatively low rates of tendering of audits and switching by companies between audit firms;
- Made suppositions about what these observed features mean for how competition works in the provision of audit services to large companies; and
- Drawn inferences about what these features are likely to mean in terms of the key market outcomes.

The suppositions and inferences that the OFT has made are completely inconsistent with our own experience of operating and competing in the market, the evidence of how competition actually works, and the outcomes that are delivered as a result. The market for audit services to large companies is a sophisticated one, and requires in-depth analysis which goes beyond the simple observation of obvious features such as market shares and the extent of tendering and switching.

This letter is not a detailed commentary on all the issues that we anticipate the CC will consider in the course of this inquiry. This will be provided to the CC in our full Initial Submission in response to the CC’s Issues Statement, as well as in later documents, along with relevant evidence and analysis on the intensity of competition and its effect on quality, innovation and price.

### **Market shares are an outcome of the competitive dynamic**

The OFT has observed that the market for large company audits (where large companies are provisionally defined as companies that may, from time to time, be listed on the London FTSE 350) is concentrated, alighting in particular on the market shares that are accounted for by the Big Four, and has inferred that this is a feature of the market that is likely to prevent, restrict or distort competition.

It is clear that the Big Four account for a significant share of this market, although it is far from clear that these shares are unduly high given the nature of the provisionally defined market. We operate in an environment which is Business-Business (B-B) and not Business-Consumer (B-C). Within the context of the OFT’s provisional market definition, four main competitors cater for 350 large and sophisticated companies. Our sector is very different to some others where a similar number of main suppliers provide goods or services to millions of individual customers<sup>1</sup>.

However, we fundamentally disagree that these market shares are indicative of a problem with competition because:

- The audits of large companies require certain attributes which only the largest auditors are capable of providing. This is corroborated by the extensive feedback that we gather from our clients as part of our efforts to compete with our rivals, and was recognised almost ten years ago by the European Commission<sup>2</sup>:

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<sup>1</sup> Indeed, the OFT has explored the level of concentration in markets as potentially granular as individual sectors and drawn attention to some sectors such as banking where concentration appears to be particularly high. This, however, begs the question of precisely how many audit firms the OFT would consider to be ideal. There are, after all, only five banks in the FTSE350, supplied by three auditors.

<sup>2</sup> Case No COMP/M.2810 – Deloitte & Touche/Andersen UK, Merger Procedure Article 6(1)(b) Decision, Commission of the European Communities, 1 July 2002.

*“audit and accounting services to quoted and large companies form part of a separate product market: the necessity for such companies to have audit and accounting services provided by a firm with the necessary reputation in the financial markets (in the case of quoted companies), the geographic breadth to cover the companies’ needs worldwide (in the case of multinationals), the depth of expertise in the particular sector (large companies in general and, in particular, regulated sectors such as banking and insurance) and significant resources (all large companies)... All these features are only provided by one of the large global audit and accounting networks”.*

- In the Decision, the OFT itself states that:

*“Larger auditors possess certain attributes necessary for auditing large companies... An extensive, integrated international network... Greater experience of auditing large and complex businesses... Relevant sector experience... Enhanced familiarity with latest developments in complex regulatory standards... better placed than mid-tier firms to provide additional services related to the audit, including advice on best practice across industries and countries... Existing links with Finance Directors and audit committee chairmen... The ability for the Big Four to recruit calibre staff attracted by the audit firm’s reputation and their extensive training programmes”*

- These attributes have been developed by PwC as a result of having made, and continuing to make, investments in people, infrastructure, tools and methodologies. We have done this to underpin quality in order to compete vigorously for business from demanding and sophisticated customers who are experienced buyers of audit services.
- We face fierce competition from rivals who, like PwC, have strategies based on growth in audit services. Mid-tier firms could have made (and could still make) the investments necessary to compete effectively but they have chosen (and continue to choose) not to do so.
- The market shares that we see are therefore the outcome of the competitive dynamic, not a feature that weakens it. Large companies have become increasingly complex and international, which has made it vital for their auditors likewise to become larger and international in order to carry out their audits effectively and win business. The capital markets (i.e. shareholders, investors and analysts) and regulatory authorities also demand and require increasingly sophisticated and effective methods of corporate reporting. The mergers and investments required in order to meet the demands of capital markets, companies and regulators result in there being a degree of economies of scale and scope in our audit business.

The market-driven nature of concentration in the market for large company audits has been corroborated by:

- The Chairman of the Accounting Standards Board when he stated to the House of Lords:

*“I think that standards have become more complex as businesses have become more complex... Those complex standards .... require more skills from auditors. That probably tends to push up the optimum size of audit firms, because they do need these specialists.”<sup>3</sup>*

- The Hundred Group of Finance Directors when they stated to the House of Lords that:

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<sup>3</sup> Oral evidence given by Mr Roger Marshall, Interim Chairman of the Accounting Standards Board, to the House of Lords Select Committee on Economic Affairs in response to question 464 on 18 January 2011.

*“Our service providers, including our auditors, are expected to be able to rise to the challenge of auditing our complex, global business. The barriers to entry for a global audit firm are high and require a certain ‘critical mass’ to be effective. Current requirements under ISA600 ....require significant input from group auditors which is practically translated as a requirement for group auditors to audit the majority of the group’s global subsidiaries. Therefore our membership will almost exclusively seek an audit from one of the ‘Big 4’ auditors.”<sup>4</sup>*

### **Competitive pressures are intense**

The OFT has taken another feature of the market, that tender and switching rates are in its view low, and inferred that this also indicates that competition is likely to be prevented, restricted or distorted.

This is also inconsistent with our experience, which is that competitive pressures are vigorous and are exerted in a number of different ways that are not reliant only on there being a formal tender:

- The audit customers which are relevant to this inquiry are some of the largest companies in the UK (and, indeed, the world). They are highly sophisticated, commercially astute, and have the incentive and ability to drive hard bargains and obtain value for money. These companies themselves operate within competitive markets and this makes it imperative for them to obtain value from the audit, both in terms of price and the business advantage that a quality audit provides.
- The relationship between the audit firm and the company which is being audited is one in which the company has frequent, intense and ongoing opportunities to review and challenge the quality and price aspects of the audit, something which is accentuated by access to published audit fees for rival firms which facilitates benchmarking.
- There are also a number of specific milestones at which competitive pressures are naturally brought to bear including:
  - The annual appointment process. Audit appointments last for one year, at the end of which companies must revisit the appointment to decide whether to continue with the existing audit firm or to re-tender. There is no automatic rolling-over of the audit contract and the act of re-appointment requires the company to make a positive (and generally public) decision.
  - Audit partners are required to rotate every five years, which provides a natural and, in our experience, very significant point at which the audited company will re-evaluate whether the existing audit firm should remain in place.
  - The frequency with which executive and non-executive board members change role results in considerable potential for challenge from newly appointed members of the board and/or audit committee if they consider that the quality and price of the audit are inappropriate or out of line with other companies with which they are, or have been, involved.
- Members of the executive and non-executive boards of large companies invariably have extensive experience of working with various of the large audit firms (either in connection with the audit or other services) and frequently have a background in financial reporting themselves. In our experience, audit committees have become increasingly important and

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<sup>4</sup> See letter from Mr Peter Williams, the Hundred Group of Finance Directors to the House of Lords Select Committee on Economic Affairs, 27 September 2010.

effective and now play a critical role in the appointment of auditors and corporate governance more generally.

- Indeed, it is hard to imagine any other service procured by companies that is subject to such a multi-layered and transparent process as the audit. Auditors are appointed in a three stage process - from independent audit committee, through board recommendation to appointment by shareholders. The audit is not an appointment that is in the gift of executive management. Moreover, the fees paid for an audit are published.
- The investments that are made by both the company and audit firm in the relationship between company and auditor mean that switching costs are significant, although not so large to render the threat of tender and switching anything less than credible. Crucially, the threat of a tender ensures that the audit is effectively contested even if not directly competed. The competitive pressures that would flow from a tender are realised by the company without the costs that are involved in formal tendering. Indeed, one of the reasons why tendering and switching is relatively low is precisely because the provision of audit services is so contestable.
- One of the keystones of our firm's commercial strategy is the pursuit of growth. This is an aspect of strategy that we know (from publicly stated strategies) is also pursued by at least two of the other Big Four. The size of the market for large company audits as defined by the OFT is constrained which means that in order for us to succeed we have to do so by winning market share at the expense of our competitors. The impact on the reputation of our firm (and of individuals within it) of winning and losing audits in a market which is open to so much scrutiny is substantial, and accentuates the competitive pressures between us and our rivals.
- As an important part of ensuring that we compete effectively, we actively seek information on a systematic basis from existing and potential audit customers on all aspects of our audit proposition, including quality and price. We do this, and use the information that we obtain, in order to help us continually shape our offering to win in the market place. The evidence that we will provide to the CC during the course of this investigation which shows how detailed our internal scrutiny of the competitive process is includes:
  - Client Perspective Reports and Independent Senior Partner Reviews, which are interviews with management and audit committee members at existing and potential audit customers. These are carried out in order to understand what we do well, what we could do better, and how we compare with our main rivals.
  - Post Decision Reviews, which are interviews with management at companies for whose audits we have tendered. The purpose of these interviews is again to understand what we did well, what we could have done better, and how we compare with our rivals.
  - Our Audit Relationship Risk Diagnostic, which is a tool which we have developed and which analyses data provided by partners responsible for large firm audits. The database analyses which of our existing audit clients are most "at risk" of being lost to us based on a range of different metrics.

### **Lack of adverse outcomes or theory of harm**

In the OFT's view, just as ineffective competition is assumed to follow from the features of the market which it has identified as unsatisfactory, so the OFT has assumed that there must be detrimental outcomes for customers.

The OFT discusses consumer detriment at paragraphs 6.19-6.28 of the Decision and finds no evidence of actual detriment relating to the key customer outcomes of price, quality or innovation. It concludes that *“the main elements of customer detriment identified... is [sic] that there is very limited choice of auditor for many companies”*. In other words, the only detriment identified by the OFT is one of the main features on which its theory of ineffective competition leading to detriment is based. PwC fundamentally rejects the OFT’s assertion that there is limited choice in this market, in any case considers it wrong to assess detriment on the basis of the extent of choice alone, and considers that the OFT’s approach in this area is symptomatic of a generally superficial approach to a market of considerable importance to the UK economy.

**Next steps**

We hope that the CC finds this letter helpful. We look forward to engaging with the CC on the issues it decides to consider and to providing it with the evidence required.



Richard Sexton

Executive Board Member – Reputation and Policy

For and on behalf of PricewaterhouseCoopers LLP