# PwC Response to the Barriers to entry: Reputation and experience working paper

1 This is PwC's response to the Barriers to entry: Reputation and experience working paper (the **Reputation WP** or the **Paper**). We provide a section-by-section response to the Paper in the attached Annex.

**Introduction and overview**

2 We set out below some fundamental areas of disagreement with the Competition Commission's (**CC**) approach to this issue and its initial conclusions, particularly those set out in paragraphs 73-80 of the Paper. In particular, we explain the following:

(a) Reputation is important in this market and it plays a pro-competitive role. It is based on the reality of the experience and observations of informed purchasers and helps companies select the audit firm most appropriate to their needs. Reputation also provides an opportunity for any expanding firms which choose to develop their attributes to match those of the four largest firms, or to offer a distinctive service, to make the market aware of their capabilities quickly.

(b) The question posed in the Paper why large companies do not appoint mid-tier firms when the latter match the largest firms is based on a false premise. Presently, the mid-tier firms do not match the four largest audit firms with the necessary attributes for auditing large companies. Having the technical competence sufficient to audit some, but by their own admission not all, large companies means that mid-tier firms cannot offer the same breath and depth of experience, knowledge, international coverage and technical support as the four largest firms and so are very often not appointed by large companies on this basis.

(c) The conclusion in the Paper that the largest companies make their selection of auditor based on "proxies" for quality including experience and reputation is wholly misconceived because:

(i) experience is an important component of quality in its own right - and the primary attribute sought by companies in appointing an auditor[1] - it is not a proxy for something else;

(ii) the Paper contains no convincing explanation of why what the CC acknowledges are highly experienced audit committee chairs (**ACCs**) and finance directors (**FDs**) would choose to rely on "proxies" rather than their own actual experiences and observations; and

[1] See slide 38 of the IFF Survey Results Presentation of July 2012 (the **CC's Survey**).

(iii) mid-tier firms have multiple opportunities to make large companies aware of their skills, including through tenders and non-audit engagements. Nevertheless, when large companies have such experience of mid-tier firms, they generally do not choose to appoint them as auditor because the large firms are better able to meet companies' needs.

**The fundamental error**

3 We agree with the CC that to the extent that reputation is objectively justified, it allows companies to distinguish between potential suppliers of audit services and select the most appropriate firm for their needs.[2]

4 We believe that there are two basic facts that are largely undisputed:

(a) each of the four largest audit firms has established a good market reputation based upon their capacity, quality, expertise and efficiency; and

(b) it is generally acknowledged that mid-tier firms have a lesser market reputation in respect of the audit of large companies than the largest firms.[3]

5 The key question that this response seeks to address is whether the lesser reputation of the mid-tier firms in this reference market reflects the reality of objective quality and other differences between the four largest audit firms and the mid-tier:

- the question is <u>not</u> whether the reputation of the largest firms is undeserved,
- <u>but</u> whether the mid-tier firms objectively have the same level of capacity, quality, expertise and efficiency as the largest firms with the consequence that their lesser market reputation is an unfair reflection of their actual position.

6 The Paper concludes that when the mid-tier firms match the capability of the largest firms they are at a disadvantage because "*companies generally make selection decisions based on proxy measures for quality including experience and reputation*".[4] This is a fundamental error for two reasons (which we address in turn below):

(a) It assumes, without any evidence on the point (and indeed contrary to much of the evidence on the strength of the four largest audit firms' international networks, quality of people and investment in systems), that there are circumstances in which the mid-tier firms match the capabilities of the largest firms in auditing large companies.

(b) It assumes that companies do not make their decisions on actual information, but rely instead on "proxies" which are inappropriate to such circumstances.

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2 See paragraph 3 of the Paper.

3 Our comments in this response are focussed on the market for the audit of FTSE 350 companies. Nothing we say here is intended to cast doubt on the ability of mid-tier firms to serve other markets on which they are principally focussed and around which they have developed their business models.

4 See paragraph 79 of the Paper.

**The capabilities of the mid-tier firms as compared against the four largest firms**

7 The initial conclusions are based on the premise that there are circumstances in which the mid-tier firms "*match*" the capabilities of the four largest firms but are nevertheless not appointed as auditor.[5] If this was the case it indeed may suggest that the largest firms were being appointed for non-objective reasons. However, the Paper contains no evidence to demonstrate that the mid-tier firms do genuinely "*match"* the four largest firms with comparable attributes. Indeed, the evidence points to the opposite conclusion:[6]

(a) As the Paper correctly recognises,[7] there are a number of objective factors that large companies value highly in their chosen audit firm. As is evident from the CC's Survey, these objective factors include the experience and knowledge of engagement partners and the wider team; sector specific expertise and experience; and the strength of the international network.[8] These are all objectively verifiable features possessed by the largest firms.

(b) Mid-tier firms may have some, but not all, of these attributes. Indeed, there can be no doubt that the mid-tier firms do not possess the capabilities to audit the largest and most complex companies as this is accepted by the mid-tier firms themselves.[9] Thus, for at least a significant proportion of the FTSE 100, the hurdle faced by the mid-tier firms is not an underserved lack of reputation but the observable fact that they do not possess the attributes needed to conduct an audit of the relevant companies. It follows that there are objective indicators of the attributes that constitute a better audit and they demonstrate a proper differentiation between the largest and smaller audit firms.

(c) The Reputation WP fails to recognise that the attributes that dictate that the largest audit firms are the only ones that can audit the largest FTSE companies are also of value to smaller (but nevertheless still large) companies in the FTSE 350. Even in cases where a mid-tier firm may have the technical competency to conduct an audit of smaller FTSE 350 companies they may nevertheless not be able to offer a combination of technical and service standards that matches those of the four largest firms. This is because there is a

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5 See paragraph 79 of the Paper.

6 See also paragraph 2.2 of the Annex below where we summarise the extensive and contemporaneous evidence that shows that the mid tier firms do not match the four largest firms in terms of their attributes, including our own client feedback reports, the reports of the AIU and the FRRP, and our Brand Health Index.

7 See paragraphs 12-15 of the Paper.

8 See slides 33, 34, 38 and 39 of the CC's Survey where the following factors were considered important when deciding whether to appoint (or reappoint) an audit firm: 97% of ACCs and 92% of FDs/CFOs cited "*Experience and knowledge of engagement partner*"; 85% of ACCs and 82% of FDs/CFOs cited "*Experience and knowledge of engagement team*"; 74% of ACCs and 69% FDs/CFOs cited "*Sector-specific expertise or experience*"; and 67% of ACCs and 65% of FDs/CFOs cited "*Strength of International Network*". Similarly, see slide 85 of the CC's Survey where when asked why FTSE 350 companies would not formally consider the mid-tier, 69% of ACCs and 59% of FDs/CFOs cited the "*Size of audit firm and geographical coverage*" and 45% of ACCs and 27% of FDs/CFOs cited the "*Sector specific knowledge/experience*".

9 The mid-tier firms themselves recognise that they have lesser attributes and resources than the largest firms: see, for example, BDO Response to Issues Statement (paragraph 2.3). where BDO state that its "*network is large enough to audit almost all companies, including companies within the Reference Market, with the exception of the largest and most complex companies and financial institutions*" (emphasis added) and the Grant Thornton Response to Issues Statement (paragraph 1.5) where Grant Thornton state "*we have the attributes, capability and the resources (both in the UK and internationally) to audit the majority of the FTSE 350*" (emphasis added). See also the Summary of BDO Hearing (paragraph 7); Grant Thornton Response to Issues Statement (paragraph 1.8). Smith and Williamson Response to Issues Statement (paragraphs 4 and 5); Summary of Grant Thornton Hearing (paragraph 10).

difference between having the technical competency to conduct an audit of smaller FTSE 350 companies and being able to offer technical and other service standards that go beyond the merely competent. Competency is a baseline – large companies expect more than this:

(i) The experience and ability of the partners and staff, sophistication of the systems and the size and strength of the network are objective differentiators between audit firms in respect of all FTSE 350 companies.

(ii) If companies are offered audit services at a competitive price from firms that possess these attributes (and there is no suggestion that the mid-tier firms are more price competitive than the larger firms), they are likely to take the opportunity - particularly given that, as we have demonstrated elsewhere,[10] there is strong competition between the larger firms for such work.

(iii) Thus, even where the mid-tier firms may have the necessary baseline technical ability, the superior attributes of the largest firms objectively differentiate the largest firms when competing for work from FTSE 350 companies.

**Experience and reputation as a proxy for quality**

8 The Paper initially concludes that "experience" and "reputation" are proxies for quality. These factors need to be considered separately.

***Experience***

9 It is wholly misconceived to describe "experience" as a "proxy" for quality. Rather, it is an important component in providing a quality audit. Experience is a highly desirable attribute for the delivery of any professional service, particularly services such as audit which require significant elements of judgement. The Paper makes it clear that companies want their auditors to be experienced in carrying out large company audits.[11] This lack of experience is, in its own right, a valid and objective differentiator between the largest firms and smaller firms. Companies recognise that experience alone is not a guarantee of quality – no single attribute can provide such a guarantee – but it is an important objective differentiator.

10 The mid-tier firms are less experienced than larger firms in auditing large companies. This is not an insurmountable obstacle to mid-tier firms who may choose to build up and demonstrate experience by hiring experienced personnel from the larger firms and/or by leveraging off their experience of less complex Top Track and AIM company audits to focus on opportunities with smaller FTSE 350 companies, for example in particular sectors of the market. However, in doing this, the mid-tier firms would not be using their experience with smaller companies as a

[10] See Section 4 of our Submission and Response to the Issues Statement of 12 January 2012 (our **Initial Submission**) where we set out our Second Pillar ("*There is competition between the large audit firms*") and in particular: Section 4B on how we seek to differentiate ourselves from our competitors, Sections 4D and 4C on how our rivals target our clients and how we aim to win new business and Section 4A on the resulting significant "churn" within the FTSE 350 as shown by market data.

[11] See for example the CC's conclusion at paragraph 26(a) of the Paper.

proxy for their quality but rather seeking to demonstrate to smaller FTSE 350 companies that they have experience of similar audits and hence are capable of exercising the judgement and other skills necessary for an audit.

***Reputation***

11 As for "reputation" being a proxy for quality, the working paper does not provide any persuasive explanation as to why the highly experienced individuals at large companies who are principally responsible for selecting the audit firm (ACCs and FDs[12]) should be relying on a proxy for quality rather than their own observations and experiences and other reliable information. We describe in our response to the Nature and Strength of Competition WP in some detail how the evidence demonstrates that ACCs and FDs have numerous references points for information on auditor quality and performance without needing to rely on proxies. Indeed, the CC has recognised that these individuals are sophisticated and capable purchasers of audit services, well able to judge objectively the attributes that make particular audit firms well placed to carry out the audit for their companies.[13]

**Reasons why mid tier firms may not be selected by large companies**

12 The Paper suggests three reasons why the attributes of the mid-tier firms may not be recognised by large companies: the background of ACCs and FDs[14]; the lack of opportunity for the mid-tier to demonstrate their capabilities to large companies[15]; and concern about investor perception.[16] None of these factors stand up to scrutiny of the evidence for the reasons explained below.

***Background of ACCs and FDs***

13 The Paper suggests that because a number of ACCs and FDs are alumni of the four largest audit firms, these firms have an advantage in building their client base,[17] in part because these individuals are less aware of the attributes of the mid-tier firms than they should be.[18] This is reflected in the initial conclusion where it is implied that the background of ACCs and FDs is a

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12 This is acknowledged by the CC in the Nature and Strength of Competition Working Paper (**Nature and Strength of Competition WP**). See, for example, paragraph 74: "*It appears that FDs/CFOs and ACCs for FTSE 350 companies are highly qualified and experienced individuals*."

13 In the Nature and Strength of Competition WP (see paragraphs 74, 74 and 88), the CC states that the results of the CC's Survey and case studies suggest that the majority of ACCs and FDs have audit backgrounds, and that ACCs tend to be former audit partners and/or current or former finance directors and to hold more than one AC position, concluding that "*FDs, CFOs and ACCs are experienced and knowledgeable purchasers of the audit services*" and that "*[g]iven these backgrounds, we consider that FDs and ACCs can be expected to have the professional knowledge and experience they require to monitor effectively in general terms the performance of the auditor*." The CC makes reference to the ample case study evidence demonstrating this: for example, Company A, paragraph 49; Company E, paragraph 37; Company F, paragraph 35; Company H. Similarly, in the context of tenders, the CC states in the Nature and Strength of Competition WP (paragraph 83): "*The process is managed by the FD and the ACC, i.e. individuals with the knowledge and experience required to critically assess the bids submitted*."

14 As per the conclusion at paragraph 74, drawing on paragraphs 34 - 37.

15 As per the conclusion at paragraph 79.

16 Paragraphs 54 - 68 of the Paper.

17 Paragraphs 34 - 39 of the Paper.

18 Paragraphs 40 - 48 of the Paper.

reason why "*Companies respond to a lack of information about audit quality by selecting auditors based on proxy measures such as relationships, familiarity and market norms*."[19]

14 The Reputation WP does not explain how the fact that a number of ACCs and FDs have spent some time working at the largest audit firms may influence their decision-making in respect of choice of auditor. It could only be because either (i) alumni are considered to be biased in favour of the largest audit firms (which would be contrary to their duties to the company and we would expect the CC to provide specific examples of where this had happened if it is being alleged), or (ii) because they are considered to be incapable of making an objective judgement on the merits as between competing audit firms (which one would not expect given the conclusion in the Nature and Strength of Competition WP that these individuals are "*experienced and knowledgeable buyers*"[20]). In fact:

(a) The CC's Survey demonstrates that one third of FTSE 350 ACCs and FDs had <u>not</u> previously worked at one of the four largest audit firms. These individuals would presumably not be influenced by any alleged bias or lack of objectivity. However, there is no evidence that they are more willing to appoint mid-tier audit firms than are the alumni of the largest firms.

(b) ACCs and FDs in Top Track and AIM listed companies include alumni of the largest firms to a materially similar level as FTSE 350 companies.[21] Nevertheless they are more likely to appoint mid-tier audit firms than are the FTSE 350.[22] This demonstrates that the choice of audit firm has nothing to do with the background of the individuals making the appointment but the fact that the mid-tier firms are better suited to auditing what are generally less complex and international companies.

(c) Many of the ACCs and FDs concerned will have spent only a short part of their career at one of the largest audit firms. Our research shows that the majority left practice more than ten years ago.[23] The suggestion that this would have led them to discard best practice in procuring goods and services (activities with which they are likely to be closely involved with in their companies) lacks credibility.

(d) There is no attempt to explain why alumni of a particular firm would be likely to prefer one of the other largest firms over mid-tier firms when they have not actually worked at the other large firms.

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19 Paragraph 74 of the Paper.

20 Nature and Strength of Competition WP, paragraph 192.

21 See paragraphs 24(a) and 24(b) of the CC Survey Results working paper.

22 See slide 16 of the CC's Survey: "*AIM companies least likely to use Big Four (67%); 81% of Top Track 350 use Big Four*".

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

(e) There is academic evidence to suggest that personal familiarity with an organisation will lead to more informed purchasing decisions and better outcomes[24].

***Opportunity for the mid-tier to demonstrate their attributes***

15 Neither is it the case that the mid-tier firms' poor record of winning audit appointments is because they are denied the opportunity to demonstrate their attributes to large companies:

(a) The Paper recognises that an existing relationship with the company is an important factor in getting selected as an auditor.[25] The mid-tier firms have existing relationships with many of the FTSE 350 companies. For example, in the year ended December 2011, Grant Thornton provided non-audit services to 36 FTSE 100 and 66 FTSE 250 companies.[26] This is a significantly higher level of activity than in relation to audit services, and indicates that lack of awareness of the qualities of mid-tier firms, or lack of access by the mid-tier firms to potential audit clients, are not reasons that they are not appointed as auditors.

(b) The suggestion in the Paper that because mid-tier firms have a lesser reputation they are not invited to participate in tenders and this therefore denies them the opportunity to demonstrate their true attributes[27] is incorrect. The CC's Survey shows that mid-tier firms are invited to participate in 30% of tenders and therefore have the opportunity to demonstrate their capabilities to a significant proportion of large companies.[28] However, they win very few of these tenders.[29]

(c) The CC's Survey also shows that the four largest firms are considerably more active in targeting large companies than the mid-tier firms, which appear to choose to target Top Track and AIM listed companies rather than companies in the FTSE 350. This demonstrates clearly that the mid-tier firms rightly recognise that their attributes are better suited to these typically less complex and/or international companies, where they stand a better chance of success.[30]

***Investor perception***

16 As a result of mid-tier firms not having the attributes of larger firms, it is not surprising that investors are in some cases unhappy about the prospect of a mid-tier firm being appointed rather than a larger firm with stronger attributes. Neither is it surprising that investors are content to leave it to those who have close experience of auditor performance - ACCs and FDs - to make the decision about which firm to appoint.

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24 See reference to Harvard Business School study in Lucy Kellaway article in the Financial Times, 10 October 2012, responding to the publication of the CC's working papers.

25 Paragraphs 16 - 18 of the Paper.

26 Grant Thornton response to Issues Statement, 12 January 2012, paragraph 1.5(e).

27 Paragraph 79 of the Paper.

28 See slide 54 of the CC's Survey.

29 See slide 62 of the CC's Survey which shows that the largest four firms win significant proportions of audits from the mid-tier both within and outside the FTSE 350. Within the FTSE 350, the mid-tier won no audits from the largest four firms, and lost about 76% where they were the incumbent auditor in competition with the largest four firms.

30 See paragraph 1.14 of the Annex.

**Conclusion**

17 In this market (i) there is evidence that the mid-tier firms are unable to match the attributes of the largest firms in relation to the audits of the largest companies; (ii) experience is not a "proxy" for quality but an attribute in its own right; and (iii) reputation is built on objective differences between the largest firms and the mid-tier firms. It follows that we do not accept the suggestion that "*… notwithstanding that [a new entrant's] quality and capability may match or exceed that of incumbents … reputation may present a particular difficulty for a firm looking to expand into the FTSE 350 audit market*"[31] because this fails to recognise that at present the mid-tier firms' quality and capabilities do not match or exceed that of the four largest firms. The reputations of the audit firms in the market reflect the reality of their capabilities, and given the ability of sophisticated purchasers to recognise this, reputation *per se* does not act as a barrier to the expansion of mid-tier firms into the FTSE 350 audit market.

18 Indeed, if a mid-tier firm invested to acquire the attributes to match those of the largest audit firms and/or offer a competitively distinct product, the small size of the market and the limited number of experienced buyers would make it much easier for a new or growing business to access this market. This would be easier than in, say, a consumer market where purchasers are much less well informed and a firm would have to market its offering across a much wider potential client base. In fact the CC's Survey shows that there is very little evidence of the mid-tier seeking to penetrate the market in any substantial way[32] (e.g. through innovation or aggressive targeting), in large part because of the intensely competitive nature of the market. If the market were for some reason to cease functioning in this way, mid-tier firms would find it more rational to invest in the attributes that are required, they could expect to gain more experience and their reputation would be enhanced, provided of course they performed well.

19 In summary, we consider that the CC's initial views expressed in conclusion at the end of the Reputation working paper at paragraphs 73-80 (in particular that large companies are unable to judge quality and so select an audit firm based on "proxy" measures, including relationships, familiarity and market norms) are wrong. These initial views are not consistent with the clear, undisputed and compelling body of evidence that the CC has gathered throughout its investigation, including evidence summarised in other parts of the Reputation WP, that companies have regard to objective factors relating to the experience and capability of potential audit firms when making an appointment. This conclusion is supported by other sources, including the CC's Survey, the case studies and our own evidence (drawn from contemporaneous sources including our client feedback reports).

**PricewaterhouseCoopers LLP**

**22 October 2012**

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31 Paragraph 77 of the Paper.

32 See slide 82 of the CC's Survey which sets out that FTSE 350 companies are more likely to be approached by the largest audit firms: indeed, 80% of ACCs and 76% of FDs of FTSE 350 companies stated that they were approached only by the four largest firms.

# ANNEX

In this Annex, we respond to the body of the Reputation WP section by section. We do not deal again with the CC's initial views on reputation as a barrier to entry at paragraphs 73-80, which is covered by our comments above. Where we do not comment on a particular paragraph, this should not be taken to indicate we accept the points expressed but rather we have chosen to highlight the main issues with which we agree or disagree.

## 1 Reputation and experience

1.1 **Paragraphs 7-9:** We note that the CC has grouped the factors connecting reputation into three categories, which we comment on in summary as follows:

(a) Experience and capability: This covers those factors identified by the CC's Survey as the most important for large companies when selecting an audit firm, which are all generally capable of objective assessment.

(b) Attracting talent and influence of alumni network: Attracting talent is a particularly important issue for all professional service firms because the abilities of individuals (particularly the knowledge and experience of lead engagement partners) is identified as the most important factor in selecting a firm appointment. It follows that the competition to attract the best talent is a key battleground among audit firms. As for the influence of alumni networks, we reject any suggestion that such a network distorts competition or acts to the detriment of mid-tier firms.

(c) Awareness of audit firms: This factor relates to the efforts of audit firms to market their capabilities in an effort to win new audit appointments by displacing existing audit firms. This is an area where we are particularly active having over the years launched a number of initiatives targeting growth in the large company audit market.[33]

1.2 We respond to each of these categories in more detail below by reference to the Reputation WP headings.

**Experience and capability**

1.3 **Paragraphs 12 - 13:** It is entirely consistent with our own experience of the market that large companies want - and indeed require - their auditors to be experienced both within the industry in which they operate and within the FTSE 350 more broadly.[34] That this is the most important factor identified by the CC's Survey shows that firms are right to seek to highlight their relevant experience when tendering for new appointments.

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[33] For example, our Tanks on Lawn initiative which involves targeting the audits of a small number of high-profile companies with the aim of growing the audit practice through winning "brand-defining" audit clients (see paragraphs 4.31 to 4.34 of our Initial Submission for more detail). Similarly, our Net 635 initiative has the objective of achieving an increase in audit revenues from new clients by £40 million over two years to 30 June 2012 (and is estimated to equate to a net win of 635 new audits).

[34] This is also supported by our own extensive client feedback results - see paragraph 2.2 below.

1.4 **Paragraphs 17 and 18:** Likewise, we are not surprised that existing relationships with large companies are important. As with all other professional services, the audit service is essentially provided by an audit engagement partner and team of professionals who need to demonstrate to the key stakeholders within the company that they are capable of providing a high quality service and can work effectively with the company. For firms seeking to demonstrate they could audit a particular large company, providing non-audit services effectively is a key way of allowing that company to assess the overall service quality of the prospective auditor. Furthermore, seeking to establish a relationship with the key individuals within the company, for example by approaching the company to explain how the firm might carry out the audit, is an important way of building a relationship over time.

1.5 **Paragraphs 19 and the example in paragraph 25:** We also recognise and agree that the role of international networks is particularly important for a number of large companies and this is where the quality and scope of mid-tier firms' international networks may be a particular issue.

1.6 **Paragraph 22:** We note with interest that mid-tier firms appear in their tender documents to anticipate that they may be regarded as weak in a number of jurisdictions and therefore seek to emphasise their strength in those areas.

1.7 **Paragraphs 23-24:** As regards the demands for technical resource, the finding that large companies demand technical and sector based skills in order for a firm to be selected is entirely consistent with our own experience.

1.8 **Paragraph 26:** It follows that the summary of evidence that companies look for experience, in particular sector-specific experience, when choosing auditors; that pre-existing relationships are important (and firms can demonstrate this by providing non-audit services effectively); and that a strong international network is important for many firms is all entirely consistent with our experience of how the market operates in practice. All of these attributes go to the experience and capability of a firm and are capable of objective assessment. The individuals at large companies responsible for selecting the audit firm (e.g. ACCs and FDs) are all well capable of judging these attributes.

**Attracting talent and influence of audit network**

1.9 **Paragraph 28:** The fact that the majority of companies expressed the view in the case studies that the quality of staff in the four largest firms was higher than the mid-tier is consistent with our view that these four firms are capable of attracting higher quality graduates to join them than is generally the case for mid-tier firms.

1.10 While we recognise that mid-tier firms can attract high quality individuals and that they have a number of people capable of providing a high quality service to their client base, this does not mean that mid-tier firms have the same strength in depth across their international network or in particular sectors and disciplines to allow them to compete effectively across the board with the four largest firms. Rather, it indicates that mid-tier firms may have attributes and individuals capable of auditing some smaller companies within the FTSE 350 for which they offer an acceptable alternative to the four largest firms. However, this does not mean that mid-tier firms

would be preferred, given that the four largest firms have greater strength in depth, far greater relevant experience, and are therefore objectively better placed to audit such companies.

1.11 **Paragraphs 34-37:** As regards the alumni network, we note that approximately two-thirds of the ACCs and FDs of FTSE 350 respondents to the CC's Survey previously worked for one of the largest audit firms. (Of course, this also means that a third of such individuals do not have this background.) This proportion is not materially greater than the equivalent individuals at Top Track and AIM company respondents, where mid-tier firms have a materially greater market share than in the FTSE 350.[35] This shows that the background of the individuals principally responsible for selecting the audit firm is not a relevant determinant, but rather that firms are selected according to their ability to do the job.

1.12 As we have previously explained, the fact that a number of ACCs and FDs may previously have worked for one of the largest audit firms is no basis to conclude that they improperly prefer their previous employer or any other of the largest audit firms.[36] Such individuals may only have worked for one of the largest audit firms (or one of their legacy firms) for a relatively short period to obtain qualification, most of them will have left the firm many years ago on entering into a corporate role and they will have experienced dealings with a wide range of firms in that corporate role, most likely including direct experience of dealing with a mid-tier firm. We are not aware that the CC has identified any examples of such individuals being alleged to have shown an improper bias in favour of their former firm.

**Awareness of audit firms**

1.13 **Paragraph 41:** It is not surprising that large companies generally have better awareness of the capabilities of the largest audit firms than of mid-tier firms. The four largest firms all have attributes that allow them to audit the FTSE 350 and by contrast the mid-tier firms may not have all of the same attributes and by their own admission are not capable of auditing the largest companies.[37] It follows that large companies are more likely to encounter large audit firms than mid-tier firms as potential providers of their audit service.

1.14 **Paragraphs 42 and 44:** That some companies may have views founded on distant experience of mid-tier firms appears directly linked to the fact that the four largest firms are considerably more active in targeting large companies. Indeed, we note that the CC's Survey shows that 76% of the FTSE 350 companies have been approached in relation to the auditing of their company by only the four largest audit firms.[38] Mid-tier firms appear to choose to target Top Track companies or AIM companies more actively and this demonstrates clearly that they rightly recognise that their attributes are better suited to these typically less complex and/or international companies. It appears that they recognise that they stand a better prospect of

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35 See paragraphs 24(a) and 24(b) of the Working Paper on the CC Survey Results.

36 As we have previously stated, ACCs and FDs take their role seriously and have no incentive to be loyal to a firm that is not providing the requisite quality or a competitive service: for example, the CFO of [✂] states "*I'm too hard-nosed to let any sort of tender be awarded on the basis of personal relationships, let alone an audit tender*." [✂]. See also our Response to Certain Third Party Submissions dated 6 August 2012 (our **Response to Third Parties**), paragraph 4.9.

37 See footnote 9 above.

38 CC's Survey, slide 82.

demonstrating that they are the best audit firm for such companies than is the case for the more complex and international FTSE 350 large companies.

1.15 **Paragraphs 46 - 47:** Nor is it surprising that large companies give particular attention to firms' international networks, which may act to the detriment of mid-tier firms. We have invested considerably over a long period of time to strengthen our international network across the world and to roll out a consistent audit methodology (through investing in our new Aura software) to allow us to use the international network to its full capability.[39] This is a very significant investment that has been made in response to the demands of the largest and most complex companies as well as in response to similar investments by our main three competitors. That mid-tier firms have not built up as strong an international network, with the same consistent methodology applied across their network, is an important competitive distinction that is relevant and taken into account by large companies with international business across the FTSE 350.

## 2 Use of reputation as a proxy for quality; external pressures and subjective factors

2.1 **Paragraphs 49-52:** We do not accept that reputation is a "proxy" for quality. On the contrary, as we have explained in more detail in our Response to Third Parties,[40] our reputation has been built up over a number of years and is founded on the objective attributes set out in Pillar 1 of as set out in our Initial Submission.[41] Only by consistently providing a high quality service that demonstrates good value-for-money have we been able to build our reputation as one of the leading providers of audit services to large companies. Indeed, we note that in the Nature and Strength of Competition WP, the CC recognises that "*all the Big 4 firms invest heavily in attributes that underlie reputation and strategies aimed at building relationships with potential FTSE 350 audit clients*" [emphasis added][42]. That our reputation is based on the reality of our track record makes reputation an entirely appropriate factor for large companies to take into account when selecting their audit firm.

2.2 It follows that, to the extent that the lesser reputation of mid-tier firms counts against them when large companies are selecting auditors, it is entirely appropriate and commercially rational for such companies to take into account that the mid-tier lack the equivalent experience, expertise, sector strength, specialist resource and size of international network as the four largest firms. We have provided the CC with extensive and contemporaneous evidence to support this point, which in summary comprises the following:

(a) **Feedback from companies**[43]

For example, from our own clients:

39 See paragraphs 3.36 to 3.39 of our Initial Submission.
40 See in particular Section 4 "*Auditor reputation reflects customer experience*".
41 See Section 3 of our Initial Submission "*The first pillar: Large company audits require specific skills and attributes*".
42 See paragraph 155 of the Nature and Strength of Competition WP.
43 See also our Initial Submission paragraph 3.57.

(i) [✂]: "*Mid tier firms do not have the horsepower to provide the required level of service to a FTSE 100 company. Very few firms have the capability of auditing this type of organisation.*"[44]

(ii) [✂]: "*Crucial for the auditor to have a wealth of insurance specific knowledge and are able to talk comfortably with the company about industry best practice and solutions available to related accounting issues.*"[45]

(iii) [✂]: "*They wanted a firm with strength and depth across the whole business. For [✂] this included three important attributes – [✂] and Plc issues… In respect of strength in depth, PwC was best positioned. Other firms had strengths in particular areas and indeed, in parts, were very impressive, but were not able to match across the piece.*"[46]

(iv) [✂]: "*Commented on what he saw as a missing point in the current debate about Big 4 dominance that it is only the Big 4 that have the capability to offer consistent service around the world and that businesses such as theirs need that from their service providers.*"[47]

(v) [✂]: "*The firms below the Big Four were in her words "miles away" in terms of level of service.*"[48]

For example, from the CC's case studies:

(vi) Company A: the ACC observes that the mid tier firms "*do not have the breadth of knowledge*".[49]

(vii) Company C: the ACC states that "*he considered [that the mid tier firms] lacked depth in expertise and skills required for the company's audit*".[50]

(viii) Company E: the FD states that he "*had also made a comparison between Big 4 and Mid-Tier staff when interviewing potential candidates for roles at the company, particularly at manager level. Manager level was where the majority of work was done on an audit and was therefore a very important position. There was a marked difference in overall capability between candidates from each type of firm — when interviewing, you are more likely to find a better candidate from the bigger firms. The FD explained that by capability he meant both technical accounting skills as well as wider skills such as: the ability to interact with individuals, think out of the box, be challenging to others and themselves, think about the bigger picture of the business, commercial awareness and a mindset to not just tick a box. He thought*

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44 [✂]
45 [✂]
46 [✂]
47 [✂]
48 [✂]
49 Paragraph 64 of the Company A case study.
50 Paragraph 66 of the Company C case study.

*that there was more likely to be a higher calibre individual in one of the Big 4 firms than in other firms*."[51]

(ix) Company G: the Global Financial Controller states that he "*did not think that they had suitable experience and expertise to audit the company as they did not audit other global banks or global FTSE 100 companies*."[52]

(b) **The view of the Hundred Group**

(i) The Hundred Group states that "*In our opinion the Big Four bias exists because the quality, breadth and experience offered by the Big Four is unmatched by other providers*."[53]

(ii) They elaborate by saying that "*Larger auditing firms will, by their nature, have a broader base of experience to draw from when conducting their audits. Our membership represents companies that are fully listed, are acquisitive, raise debt, purchase intellectual property, have complex tax structures and run international treasury functions. These activities require advisors who have a broad background of experience to service us appropriately. In our experience the Big 4 are consistently and comfortably able to deliver the expertise we demand of our auditors and accordingly our members and their shareholders predominantly look to the Big 4 when considering new auditors*."

(c) **The view of the Audit Inspection Unit and the FRRP[54]**

(i) The AIU in their report on the 2009/10 inspections of smaller firms concludes as follows:

"*At present all firms registered to conduct audit work may accept any audit appointment which they believe they are competent to undertake. Our findings suggest that consideration should be given to establishing specific competency requirements for auditors of listed and major public interest entities in order to reduce the incidence of poor quality audit work*."[55]

This confirms that to carry out an audit for large companies to the required regulatory standards, audit firms require a certain level of resources and expertise and where this is lacking, the audit firm is less likely to provide an acceptable level of quality.

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51 Paragraph 25 of the Company E case study.
52 Paragraph 28 of the Company G case study.
53 See "The Hundred Group" of Finance Directors letter of 27 September 2011 to the House of Lords (page 2).
54 See paragraphs 3.45 to 3.54 of our Initial Submission.
55 See "*Public Report on the 2010/11 inspections of firms auditing ten or fewer entities within AIU scope*" dated 22 September 2010, paragraph 1.2.

(ii) The FRRP issues press releases where a company it has reviewed has agreed to revise its accounts or take other corrective action. The higher ratio of FRRP press releases for the smaller and mid-tier firms is notable.[56]

(d) **Brand Heath Index results[57]:** The Brand Health Index measured the view of audit committees and PwC was awarded the highest overall BHI score of the four largest audit firms. These categories were: "familiarity" (Slide 26), "overall consideration" (Slide 28), "first choice" (Slide 30), "usage"(Slide 32), "main provider of services" (Slide 34), "loyalty" (Slide 37), "provides leading edge advice" and "inspires confidence" (both Slide 51).

2.3 **Paragraphs 54-69:** We note the evidence obtained by the CC that certain large companies have explained that they have used one of the largest audit firms because this is the "accepted norm" in the FTSE 350 and so was perceived as lower risk. We maintain that the reason the use of one of the largest audit firms has become the accepted norm in the FTSE 350 is related entirely and properly to the fact that they have a proven track record of providing a consistent high quality service across their international networks. By contrast, other firms do not have such a proven track record, and have not made similar levels of effort and investment in strengthening their international networks across the world and ensuring consistent audit methodologies. As such the appointment of smaller firms to audit large and complex companies may rightly give rise to questions by investors as to whether such an appointment was appropriate given the mismatch between that smaller firm's capabilities and the demands necessary to audit a large company. This does not make the relative reputation of audit firms a proxy for quality but rather a reliable indicator.

[56] See paragraphs 3.52 to 3.54 of our Initial Submission.

[57] As referred to previously in our response to Q27 of the Market and Financial Questionnaire (dated 24 February 2012) and see also the results presentation provided as Exhibit 10 to our Response to Third Parties.