

## PwC response to the Survey Results working paper

- 1 This paper sets out PwC's response to the Survey Results working paper (the **Survey WP**). We have set out in the attached Annex our more detailed comments on the individual paragraphs of the Survey WP.
- 2 The Survey WP sets out what the Competition Commission (CC) considers to be the key results from the survey of Audit Committee Chairs (**ACCs**) and Finance Directors / Chief Financial Officers (**FDs**) which IFF Research carried out on the CC's behalf, as reported in the IFF Survey Results Presentation of July 2012 (the **CC's Survey**). Given that, as the CC recognises, ACCs and FDs are experienced and sophisticated purchasers who take their responsibilities to the company and to shareholders seriously<sup>1</sup>, we believe weight can be placed on the CC's Survey.
- 3 We found the CC's Survey to be an informative and useful document which provides robust evidence from companies that corroborates the four pillars set out in our Submission of 12 January 2012 (our **Initial Submission**):

### **(a) Pillar 1 - large companies require particular attributes from their auditors:**

- (i) Slides 26, 28, 33 and 38 set out the characteristics that ACCs and FDs consider important in terms of audit quality and those they look for in an auditor. These slides show that companies value efficiency, technical ability, independence, challenge and reputation, and that the experience and knowledge of the audit partner and team (as well as good working relationships) are critical to providing these.
- (ii) Slides 33, 34, 38 and 39 also emphasise the importance of sector expertise and international networks.
- (iii) Slides 62, 83 and 84 show that when appointing an auditor, or when looking at who they would like to have as their auditor if their current firm were not available, large companies show a marked preference for the largest four firms. The clear inference to be drawn is that they associate these firms most closely with the qualities they desire in an auditor. This is confirmed in slide 85 which shows that lack of size and geographical coverage, knowledge and experience are the main reasons why these companies would not consider mid-tier firms.

### **(b) Pillar 2 - there is fierce competition between the largest four firms:**

- (i) Slide 83 shows that the largest four firms are considered to be broadly as attractive as each other to large companies, and slide 54 shows that they are invited to tender in roughly even proportions (indicating they are close competitors), and differentiated from smaller rivals.

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<sup>1</sup> See, for example, the CC's working paper on the Nature and Strength of Competition (hereafter, **Nature and Strength of Competition WP**), paragraphs 74, 75 and 92.

- (ii) Slide 82 shows that the largest four firms make considerable efforts to target large companies, by contrast with the mid-tier firms who do not seem to target FTSE 350 companies much or at all.
- (iii) Slide 62 indicates that while the largest four firms are effective competitors to each other, the mid-tier firms are not, losing the vast majority of tenders where they are up against opposition from the largest four firms.

**(c) Pillar 3 - large companies are experienced and sophisticated purchasers:**

- (i) Slide 46 sets out how purchasers regularly test the market, with the vast majority negotiating annually on price, carrying out post-audit reviews of quality and value, and having informal contacts with rival audit firms to their current supplier. A substantial majority also carry out formal benchmarking and/or require formal re-proposals every five years.
- (ii) Slide 56 shows that companies are able to gauge how many and which firms they require to conduct a competitive tender.
- (iii) Many of the responses (see, for example, slides 26, 28 and 46) appear to show that FTSE 350 companies take audit quality more seriously than smaller companies, for example, with regard to the importance of independence, challenge and benchmarking.

**(d) Pillar 4 - outcomes are consistent with effective competition:**

- (i) Slide 60 shows that a majority of companies feel they receive a high quality service and/or good value for money and so have not needed to tender in the last five years. Indeed, in the unprompted responses to this question from FTSE 350 companies, positive reasons cited not to tender amounted to 133% cumulatively,<sup>2</sup> while the negative ones (disruption and cost) amounted to only 29% cumulatively. The CC's use of the material in this slide is discussed in more detail in the Annex below.
- (ii) Slides 68 and 74 show that the vast majority of companies would be likely to tender were their auditor to become complacent, and slides 64, 65 and 67 show that when they do tender, companies are generally able to achieve positive outcomes from the process (although we agree with the CC that this may be because those who tender are dissatisfied at the outset).

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<sup>2</sup> The positive reasons being: (i) high quality service; (ii) good value for money; (iii) happy as things are; (iv) partner rotation keeps things fresh; (v) for continuity / familiarity; (vi) incumbent understands business; and (vii) benchmarking suggests get good value. We have categorised one response - time not right - as neutral (i.e. neither positive nor negative). This response accounted for 10% of the cumulative 173% of responses given.

### Inappropriate weight on the tender process

- 4 In this context, we are concerned that the Survey WP does not appear to reflect what we feel to be a strong endorsement set out in the CC's Survey of our view of how the market operates. We also note that there are several relevant questions that could have been asked in the survey (which we had encouraged the CC to ask) but were not - for example: (i) whether ACCs/FDs believe that the current market for the supply of statutory audit services is competitive<sup>3</sup>; or (ii) whether ACCs/FDs believe that their auditor's awareness of their ability to tender gives them leverage in fee negotiations<sup>4</sup>.
- 5 Instead, the Survey WP appears in places to focus on certain inconsistent responses and the views of minority respondents. These responses do not reflect the broader and very clear views and experiences of companies that emerge from the CC's Survey.
- 6 This is especially the case with regard to the evidence from companies who have not recently tendered on the reasons why they have not done so. As mentioned above, the positive reasons given - those relating to satisfaction with the current level of service - significantly outweigh the negative ones.<sup>5</sup> However, in paragraph 48 the CC chooses to aggregate certain negative factors (in particular, disruption and costs, which the CC includes together at 25%) and in the Nature and Strength of Competition WP refers to an even higher percentage (nearly 40%).<sup>6</sup> It is not entirely clear to us how these aggregate figures have been calculated, but stronger emphasis should be placed on the variety of positive reasons given by companies for retaining their existing auditor.
- 7 A particular theme which appears repeatedly in the way that the CC has used the survey results is the downplaying of the ongoing competitive pressure that exists in the audit market outside of tenders. This is a topic about which the CC has raised concerns in the Nature and Strength of Competition WP, but there is in fact considerable material in the survey results to support the existence of such competitive pressure.
- 8 An example of the CC's approach in this regard is the treatment of the survey results on market testing. In paragraph 39(c) of the original Survey WP the CC had stated that 31% of FTSE 350 companies never carry out either formal benchmarking or formal proposals before reappointment. This figure was revised by the CC following a query we raised about its mathematical accuracy, and the revised figure is now only 10%. We raised a similar query about the CC's statement in the Nature and Strength of Competition WP, based on paragraph 38 of the Survey WP, that one-third of companies do not carry out benchmarking or other formal comparisons with auditors regularly (we presume, but it is not confirmed, that this means at least every five years), which we also believe is too high.<sup>7</sup> These figures appear to have been used as evidence to support the CC's view that companies have limited visibility on comparative

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<sup>3</sup> See page 4 (in section on "Alternatives to B1/B2") in letter from Norton Rose to the CC dated 7 March 2012 (**PwC Response to Draft Survey**).

<sup>4</sup> See page 5 (regarding B8) in PwC Response to Draft Survey.

<sup>5</sup> See slide 60 of the CC's Survey.

<sup>6</sup> Paragraph 111 of the Nature and Strength of Competition WP.

<sup>7</sup> See, for example, paragraphs 95, 141(c) and 193(c) of the Nature and Strength of Competition WP.

audit services outside of tenders. It is important that the CC reviews its analysis in light of these points (as we understand will happen) and we assume that the CC will revisit in particular its conclusions on the use of benchmarking and formal re-proposals once it has confirmed the correct statistics to reflect the fact that the vast majority of FTSE 350 companies have either carried out formal benchmarking or required formal re-proposals of their auditors, or both.

### **Other concerns with the presentation of the CC's Survey by the CC**

- 9 While we note that the Survey WP (paragraph 72) focuses on the 65% of ACCs and 60% of FDs of FTSE 350 companies who said there were no factors limiting choice between the largest four firms, a further statistic which we believe has been highlighted inappropriately in the Nature and Strength of Competition WP is the focus on the 40% of companies who claimed that their choice was limited between the large audit providers (we note this question did not ask about whether mid-tier firms are considered an option).<sup>8</sup> This response does not tell us anything about whether companies have sufficient choice to conduct a competitive tender or what would have to be done to “cleanse” the firms which the company believes cannot currently provide its audit (in our experience this can be done in all but the most extreme cases. [X]).<sup>9</sup>
- 10 In contrast, and very significantly, the responses set out in slide 60 of the CC's Survey show that no companies have decided not to tender due to a perceived lack of choice. This finding is not highlighted in the Survey WP or the CC's Survey,<sup>10</sup> but undermines any suggestion that limited choice has a bearing on decisions to tender, as set out in the CC's initial views in paragraph 141(g) of the Nature and Strength of Competition WP.
- 11 In addition to our concern that the statistics used be accurate, a more fundamental concern is the way in which the CC places too much emphasis on these “formal” activities and fails to give sufficient weight to the many ways that companies can and do informally compare audit providers. For example, no attention is drawn in the CC's “key results” to the fact that 78% of FTSE 350 companies have informal contact with other auditors every year.<sup>11</sup> Insufficient weight is also attached by the CC to the near universal annual reviews of quality and fees by FTSE 350 companies evidenced in the responses set out at slide 46 of the CC's Survey - reviews which are conducted by individuals who have direct, current and past experience of audits at other companies, and who are therefore fully able to “*know what good looks like*”.<sup>12</sup> The ACCs and FDs of FTSE 350 companies are sophisticated and experienced purchasers of audits who can continually compare the audit services of their current supplier against what might be provided by other firms without the need necessarily to undertake formal benchmarking exercises (although, as above, the evidence shows that only a very small minority never do this at all).

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<sup>8</sup> See also slide 86 of the CC's Survey.

<sup>9</sup> [X].

<sup>10</sup> Paragraph 48 of the Survey WP covers unprompted reasons for not tendering in the last five years (taken from Slide 60 of the CC's Survey), but makes no mention of the fact that no companies said they had not tendered because of a perceived lack of choice of audit firm.

<sup>11</sup> Slide 46 of the CC's Survey.

<sup>12</sup> Company E case study, paragraph 21. Also, 60%+ of the ACCs and FDs surveyed had previously worked for one of the four largest audit firms, and nearly all ACCs sit on or chair another Audit Committee, so most ACCs and FDs can draw upon this direct, current and past experience (paragraph 24 of the Survey WP). Furthermore, if a firm is appointed by its

- 12 The CC should recognise, as the CC's Survey does, the other sources of information continuously available to ACCs and FDs on the competitive alternatives in the market. Our own views on the ability of companies to assess the competitive alternatives available to them are explained in more detail in our Response to the Nature and Strength of Competition WP.
- 13 A further significant omission from the Survey WP is in relation to the compelling evidence provided by companies that the lack of success of mid-tier firms in relation to FTSE 350 audits is not due to a lack of opportunity in tenders. The CC's Survey highlights what actually happens when mid-tier firms are included in tender processes by FTSE 350 companies. Slide 54 of the CC's Survey reports that a significant proportion - 30% - of FTSE 350 tenders held in the last five years included at least one firm from outside the largest four audit firms. However, slide 62 shows that within the FTSE 350, the mid-tier won no audits from the largest four firms, and lost about 76% where they were the existing auditor in competition with the largest four firms, with a similar position outside the FTSE 350. This shows that when companies have an opportunity to consider the attributes of the largest four firms in detail alongside the mid-tier they tend to overwhelmingly prefer one of the largest four firms.

**PricewaterhouseCoopers LLP**

**22 October 2012**

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*alumni*, this is a very good indication that the firm provides a high quality and value for money service - there is no better way of being able to measure performance of an organisation than being on the inside.

## ANNEX

This Annex sets out our detailed comments on the Survey WP, in the order in which topics appear in that document (and the headings below are the same as in the Survey WP). We have highlighted only those points about which we feel most strongly; where we have not commented, this should not be interpreted as implying agreement with the conclusions drawn in the Survey WP.

### 1 Dimensions of the audit product

- 1.1 **Paragraphs 29 - 31:** The Survey WP reports the CC Survey's main findings about the factors companies use in assessing audit quality and the important factors in selecting an auditor. These findings demonstrate that independence, challenge, ability to detect misstatements, efficiency, experience/knowledge, reputation with investors and analysts etc, sector expertise and network strength are particularly valued by ACCs and FDs.<sup>13</sup> The survey therefore clearly shows that facets of audit quality drive selection decisions and companies are well able to assess what constitutes a quality audit. It is notable that these qualities mirror the qualities that ACCs and FDs say that the mid-tier firms lack in excluding them from tenders.<sup>14</sup>

### 2 Market testing

- 2.1 **Paragraphs 36 - 42:** As discussed in the introduction above, the CC has revised the original percentage at paragraph 39(c) of the Survey WP for FTSE 350 companies that have never carried out either formal benchmarking or formal proposals before reappointment to only 10% of FTSE 350 companies. This figure has been corrected downwards from the CC's original figure of 31%, but in any event we are concerned that these are not the correct statistics to emphasise in measuring the ability of companies to judge audit quality and price:

- (a) We are concerned that there are several references to a "third" of companies not "regularly" carrying out benchmarking or formal proposals or other formal comparisons in the Nature and Strength of Competition WP,<sup>15</sup> and believe these are based on the figures in paragraph 38 for the number of companies which carry out benchmarking or other formal comparisons at least every five years. We believe again there may be a mathematical error with this calculation, and that the correct figure is likely to be significantly lower than one-third.<sup>16</sup> Once the CC has confirmed the correct statistics, we understand it will revisit its analysis in this area. In particular, the CC should take into account that formal benchmarking, comparisons and proposals before reappointment are far more common than was initially thought, and re-consider its initial views on the usefulness of such techniques in light of this updated information.

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<sup>13</sup> Paragraphs 29, 30 and 35, including Tables 9 and 11.

<sup>14</sup> See slide 85 of the CC's Survey: size, coverage, knowledge and experience are the main reasons why the mid-tier are excluded from tenders.

<sup>15</sup> See in particular paragraphs 95, 141(c) and 193(c) of the Nature and Strength of Competition WP.

<sup>16</sup> Based on slide 46 of the CC's Survey and paragraph 38(d) of the Survey WP, we understand that: (i) 67% of FTSE 350 companies carry out benchmarking every five years; (ii) 61% undertake formal proposals before reappointment every five years; and (iii) 47% do both. This suggests that 20% do only benchmarking (67 - 47 = 20), and 14% do only formal proposals (61 - 47 = 14). Therefore, 81% do one or the other every five years (47 + 20 + 14 = 81), and so only 19% do neither.

- (b) We are also concerned at the particular weight the CC appears to be placing on formal benchmarking and re-proposals as a method for ACCs and FDs to determine whether they are receiving a quality or value for money service - a theme which is carried through to the Nature and Strength of Competition WP. As explained in more detail in our response to that working paper, there are many other sources available to ACCs and FDs to assess and judge the service they are receiving and to compare it to rival options, as indicated in the list of alternative market testing activities identified in paragraph 40 of the Survey WP and by the fact that 78% of FTSE 350 companies have informal contacts with other auditors every year<sup>17</sup>. These sources of information are as valuable and far more prevalent than formal benchmarking activities. The CC should investigate and assess these sources in more detail.

### 3 Tendering - frequency and tender lists

- 3.1 **Paragraphs 43 - 47:** The Survey WP highlights that there is a lower level of tendering within the FTSE 350 than outside, and that the largest four firms (and then Grant Thornton and BDO) are the firms most often invited to tender. The reasons given most often for excluding smaller firms are the need for expertise, international network and size - characteristics consistent with those identified earlier in the CC's Survey (and mentioned above) as most desired by ACCs and FDs in their auditors.<sup>18</sup>
- 3.2 **Paragraph 48:** The Survey WP highlights that good audit quality and competitive fees are the main reasons for not tendering, but also that 25% of FTSE 350 companies mentioned the disruption and cost involved.<sup>19</sup> It is not clear how the CC has produced this statistic from what is shown in slide 60 of the CC's Survey - without access to the raw data we cannot determine that this is accurate (and this percentage should therefore be marked with “^” since it cannot be calculated without the raw data).
- 3.3 More worrying is that in the Nature and Strength of Competition WP, this number has risen to “nearly 40%”.<sup>20</sup> The basis for this statistic needs to be clarified - we understand that it also includes responses that mentioned the loss of the benefits of continuity, but we are unclear whether any other responses are included as well - we suspect this is likely to have been the case given the unprompted nature of these responses. In any event, we do not think it is appropriate to categorise the loss of the benefits of continuity together with cost and disruption as “negative” reasons discouraging switching. Auditor continuity is, as the CC has rightly stated, a benefit to the company that arises from the audit firm developing relationships with the company. In this respect it is similar to the understanding that the auditor will develop over time of the company's business. These are positive reasons for retaining the existing auditor and competitive advantages that the existing auditor will be able to offer as against the competition. The potential loss of the good service that the current auditor offers - whether in terms of

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<sup>17</sup> Slide 46 of the CC's Survey.

<sup>18</sup> Paragraphs 43 - 47, including Tables 14 and 15.

<sup>19</sup> Paragraph 48(b).

<sup>20</sup> Paragraph 111 of the Nature and Strength of Competition WP.

quality, competitive fees or knowledge of the business - is not a cost of switching, but a positive reason for the company to decide to retain its existing auditor.

- 3.4 As well as the lack of clarity surrounding the basis for calculating these figures, we have a significant concern with the CC's approach of aggregating certain results but presenting others separately. We believe that extreme care needs to be taken with this approach in order to avoid artificially increasing the importance of certain results. For example, if all the positive reasons cited on slide 60 of the CC's Survey for companies not to tender are added together, they amount to 133% in total.<sup>21</sup> In contrast, the obviously negative reasons (disruption and cost) amount to only 29% cumulatively. However, this balance - strongly in favour of positive reasons for retaining an existing auditor - is not reflected in the way that results are currently presented in paragraph 48 (or, indeed, in paragraph 190 of the Nature and Strength of Competition WP).
- 3.5 The CC's Survey shows that 70% of companies who have not tendered in the last five years have taken this approach because they receive good quality and/or competitive fees and/or they are happy as things are.<sup>22</sup> Paragraph 48 of the Survey WP omits those who are "*happy as things are*", which we believe should be included as it reflects companies receiving a high quality service.<sup>23</sup>
- 3.6 In combination, these factors point to strong positive reasons for keeping the current auditor in place and not tendering - factors which the CC downplays in the Survey WP. Our view is that the high satisfaction figures reflect the significant efforts that we make in measuring the risk in our audit appointments and monitoring company satisfaction<sup>24</sup>, and are a direct consequence of the associated efforts we make to ensure that we provide our clients with the high quality and reasonably priced service that they require to stave off the regular approaches our clients receive from rival firms who are interested in replacing us.<sup>25</sup> The role of competition outside tenders is discussed in more detail in our response to the Nature and Strength of Competition WP.
- 3.7 There are three further points covered in the CC's Survey that we believe should be included in the CC's findings and analysis on this topic:
- (a) Slide 62 of the CC's Survey 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 77% where they were the existing auditor in competition with the largest four firms.<sup>26</sup> Given that the Nature and Strength of Competition WP recognises that tenders are detailed, competitive

<sup>21</sup> Those reasons being: (i) high quality service; (ii) good value for money; (iii) happy as things are; (iv) partner rotation keeps things fresh; (v) for continuity / familiarity; (vi) incumbent understands business; and (vii) benchmarking suggests get good value. For the reasons stated above we have included continuity and business understanding as positive reasons.

<sup>22</sup> Slide 60 of the CC's Survey.

<sup>23</sup> In particular, if 94% of ACCs would be likely to tender if the auditor was complacent (Table 16), it follows that where companies are "*happy as things are*" this implies that the auditor is not complacent and is providing a competitive service.

<sup>24</sup> As summarised in paragraphs 2.67 - 2.70 of our Initial Submission.

<sup>25</sup> See slides 81 and 82 of the CC's Survey.

processes<sup>27</sup>, this gives a very clear indication that when scrutinised closely, experienced purchasers recognise that the competitive offerings of mid-tier firms are not equivalent to those of the largest four firms.

- (b) Slide 54 of the CC's Survey reports that 30% of FTSE 350 tenders involve at least one firm from outside the largest four firms - and slide 55 shows that this rises considerably for the smaller companies which responded to the survey. This indicates that the suggestion in the Nature and Strength of Competition WP (paragraph 143) that tenders "frequently" only involve the largest four firms is something of an overstatement. The CC should consider this result and the implications of the lack of success the mid-tier firms have in the apparently significant number of FTSE 350 tenders in which they participate. Indeed, their general failure to win the tenders of even the smallest FTSE 350 companies (with less complex and extensive audit requirements than the largest FTSE 350 companies) despite being consistently invited to tender is particularly striking.<sup>28</sup>
- (c) Slide 56 of the CC's Survey shows that very few companies gave "investor perceptions and financial institutions expect a Big 4 auditor" as a reason for including only the largest four firms in tenders - only 2% of FTSE 350 companies. This indicates that external perception is of limited relevance to the choice of a large audit firm, and in particular that factors such as clauses in loan agreements are unlikely to be important.

## 4 Switching behaviour and effects

- 4.1 **Paragraphs 51 and 53:** Frequent reasons for switching that are highlighted in the Survey WP include getting better quality, price or sector experience.<sup>29</sup> The Survey WP also highlights that many firms which had experienced switching reported benefits in terms of lower fees and improved quality.<sup>30</sup> Given that the majority of tenders are triggered where a company is dissatisfied with its current auditor (in particular, in terms of fee, quality of service or the overall relationship) these reasons and triggers for switching are unsurprising - indeed the CC recognises that these results may suffer from a selection bias: given that dissatisfaction is usually the trigger for switching, one would expect companies to obtain lower fees and receive improved quality after they have switched.<sup>31</sup> The benefits of switching reported by those companies that have switched may well therefore be overstated in relation to the position of companies more generally.

<sup>26</sup> This picture is equally pronounced outside the FTSE 350, with the largest four firms losing around 12% of tenders to the mid-tier where the existing auditor was one of the largest four firms, while tenders with a mid-tier incumbent lead to one of the largest four firms being appointed 93% of the time (again, reported in slide 62).

<sup>27</sup> See paragraph 83 of the Nature and Strength of Competition WP: "Our initial view is that tenders are structured and thorough processes, ... managed by ... individuals with the knowledge and experience required to critically assess the bids submitted."

<sup>28</sup> As noted elsewhere, slide 62 of the CC's Survey, which is ignored in the Survey WP, shows that mid-tier firms have a very low success rate in tenders against larger firms both inside and outside the FTSE 350. Given that they are involved in the majority of the smaller tenders, and remain largely unsuccessful, this shows clearly how far they are from offering a service which is competitive with that offered by the larger firms.

<sup>29</sup> Paragraph 51.

<sup>30</sup> Paragraph 53.

<sup>31</sup> Paragraph 186 of the Nature and Strength of Competition WP.

## 5 Triggers for switching

- 5.1 **Paragraphs 55 and 56:** The Survey WP confirms that 94% of FTSE 350 ACCs (and 86% of FDs) would be likely or very likely to tender if they thought their auditor complacent.<sup>32</sup> This is a significant finding, given that the Survey WP also finds the audit committee to have the most influential role in audit appointments.<sup>33</sup> This reflects the reality that we experience - companies expect their auditor to be constantly pushing to improve, and are not afraid to tender should they need to use this (often implicit) threat to spur our continuous efforts to ensure we do not fall below their expectations.

## 6 Formal and informal contact

- 6.1 **Paragraphs 59 - 61:** The Survey WP highlights formal and particularly informal contact from audit firms in the last five years with FTSE 350 ACCs and FDs, with both reporting far higher levels of contact from all of the largest four audit firms than the mid-tier (at least 45% for each of the four largest firms compared to around or less than 10% for BDO and Grant Thornton). This indicates that mid-tier firms have not invested in building and maintaining relationships with appropriate contacts with client companies and potential clients. Mid-tier firms cannot expect to grow their FTSE 350 market share if they do not develop relationships with potential clients. The considerable efforts that we and other large firms expend in targeting clients (for example, in PwC's case through our *Net 635* and *Tanks on Lawns* initiatives<sup>34</sup>) are because we recognise that success in tenders is in part based on having established a relationship with a company beforehand.<sup>35</sup>
- 6.2 The Survey WP reports the high level of post-audit review and fee negotiation that takes place,<sup>36</sup> but does not consider as a "key result" the finding that 78% of FTSE 350 companies have informal contacts with other audit providers annually.<sup>37</sup> This finding is highly significant as it evidences the efforts that the audit firms make to target each other's clients, and the fact that the vast majority of large companies receive direct information annually on alternative audit suppliers. This failure to present this evidence is consistent with the CC's general approach of downplaying the level of competition which auditors experience outside of tenders and the ability of sophisticated purchasers to judge quality and exert pressure on their auditors to achieve the desired outcome without needing to tender.

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<sup>32</sup> Paragraphs 55 and 56 and Table 16.

<sup>33</sup> Table 10.

<sup>34</sup> See sections 4.29 - 4.39 of our Initial Submission for more detail about these initiatives.

<sup>35</sup> See the working paper on Firms' Stated Competitive Strategies, where paragraph 18 notes that the benefits for audit firms of developing relationships with companies are twofold: "*the first is making the firm, and potentially an audit team, known to the target company and the second is that the firm is able to develop its own knowledge of the client's operations and business risks and use this in a subsequent tender*". To the extent that the CC finds companies ignorant of the offering of mid-tier firms, we suspect this is primarily because these firms do not engage proactively with companies to explain these attributes.

<sup>36</sup> Table 12 and paragraph 38.

<sup>37</sup> Slide 46 of the CC's Survey.

## 7 Forced diversion

- 7.1 **Paragraphs 62 - 66:** The CC has calculated diversion ratios should companies be forced to switch auditor and found that for FTSE 350 companies 73% of clients of the largest four firms would only consider the largest four firms, and 60% of other clients (i.e. those currently using mid-tier firms) would only consider the largest four audit firms if they had to switch. In contrast, no companies would consider only mid-tier firms.<sup>38</sup> Set against the background of the individuals making these purchasing decisions being “*highly qualified and experienced*”<sup>39</sup>, and the attributes listed in paragraph 1.1 above that are valued by companies in choosing an auditor, we believe these findings demonstrate that large companies consider that the largest four firms have the necessary attributes to undertake their audits whereas the mid-tier (and smaller) audit firms do not.

## 8 Reasons for not considering non-Big-4 firms

- 8.1 **Paragraph 69 and Table 19:** The reasons given by ACCs and FDs for not considering mid-tier firms correlate with the qualities these individuals have indicated they value in their auditors: including size and geographic coverage, sector knowledge and experience. These results confirm that auditors must offer these key attributes to be competitive in providing audit services to FTSE 350 companies.
- 8.2 We note that ACCs (11%) and FDs (23%) also cite reputation as a reason not to select mid-tier firms. We believe auditor reputation is a legitimate concern for ACCs and FDs both insofar as it confirms their understanding of the qualities an audit firm possesses<sup>40</sup>, but also in terms of offering reassurance to the wider market that the company is taking its audit appointment seriously. Reputation is only one factor among other measures of audit capability mentioned above.
- 8.3 We also note that ACCs and FDs refer to quality of staff as a relevant factor in not considering mid-tier firms. We have previously explained the efforts we make to recruit and retain the highest quality individuals,<sup>41</sup> and this finding is entirely consistent with the findings in slides 33 and 38 of the CC’s Survey that experience and expertise are critical to auditor appointments - large, complex companies cannot afford to risk appointing audit teams who do not have the requisite expertise and experience of auditing other large, complex companies.

## 9 Factors limiting choice between the largest firms

- 9.1 **Paragraphs 71 - 73:** More than 60% of companies said they face no restrictions limiting their choice between the largest four audit firms.<sup>42</sup> This shows that most companies have a choice of at least four large suppliers when they go to tender - and the Survey WP notes that the average

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<sup>38</sup> Paragraphs 62 - 66 and, in particular, Table 18.

<sup>39</sup> Paragraph 74 of the Nature and Strength of Competition WP.

<sup>40</sup> And we note that the CC recognises in paragraph 155 of the Nature and Strength of Competition WP that “*all the Big 4 firms invest heavily in attributes that underlie reputation.*”

<sup>41</sup> For example, see paragraphs 3.15 - 3.19 of our Initial Submission.

<sup>42</sup> Paragraphs 71 - 73, including Table 20.

number of firms invited to each tender is 3.7 for FTSE 350 companies (and 3.4 for others).<sup>43</sup> This shows that companies do not feel they need a higher number of bidders in a tender as, for smaller company tenders where more audit firms are realistic potential providers, the average number of bidders is actually lower.

- 9.2 For those who said they were restricted, the most frequently mentioned factors were provision of non-audit services, conflicts/independence and a previous bad experience. It is not clear how significant this restriction is, but in most cases we would assume it reduces the choice from the company's perspective from four to three of the largest firms - this is still more than sufficient for a competitive tender.<sup>44</sup> Indeed, this is consistent with our view that no company has wanted to run a tender but been unable to obtain sufficient credible bidders.
- 9.3 In addition, any restrictions are in practice a matter of the company's choice (for example, a company may feel that some audit firms are stronger than others in a particular sector). Such restrictions can generally be overcome if necessary, and so restrictions are short-term at most. [X].<sup>45</sup> [X] companies plan their auditor procurement well in advance and know how to do this effectively and can overcome any restrictions; they make the choices and can require us to change what type of work we do for them; and they will typically factor time into a tender process to allow audit firms to cleanse themselves if necessary.

## 10 International networks

- 10.1 **Paragraphs 74 - 86:** There is a separate section on international networks in the Survey WP. This section highlights the importance of consistency of worldwide delivery, strength of the network, the degree of benchmarking of global and regional coverage, how network strength limits the firms invited to tender and, in particular, how it is cited as a reason for only using the four largest firms. Thus, the fact that the mid-tier firms have not developed their networks to the same extent means that they are rarely considered to be a credible audit provider by the largest companies.
- 10.2 We also note that even where companies do not have international coverage (such that their audit firm does not need to have an international network), mid-tier firms are still not competitive. For example, slide 23 of the CC's Survey shows that 22% of FTSE 350 companies do not have any activities audited outside the UK, whereas slide 62 of the CC's Survey shows that 97% of FTSE 350 firms which have switched auditor in the last five years moved to/within the four largest audit firms - demonstrating that even those large companies with exclusively UK operations tend to prefer the large audit firms.

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<sup>43</sup> Paragraph 46.

<sup>44</sup> We note that, in the context of a competitive tender process, Bertrand competition theory indicates that the participation of two suppliers is sufficient to lead to a competitive outcome.

<sup>45</sup> See also section 4F of our Initial Submission.

## **11 Annex - Methodology for testing statistical significance**

- 11.1 We have reviewed the Annex to the Survey WP describing the methodology used by the CC for calculating confidence intervals and carrying out statistical significance testing. Our overall assessment is that the methodologies used are appropriate and are those typically used for analysis of this sort. We do not have any major concerns to raise with what is set out in this Annex.