

PwC response to market definition working paper

- 1 This paper sets out PwC's response to the CC's market definition working paper (**MDWP**).
- 2 The MDWP appears to take a pragmatic, rather than a technical, approach to defining the market (consistent with the CC's draft *Market Investigation Guidelines*), and recognises that market definition is a tool which provides a framework for analysis, but does not limit the CC's analysis. The CC explicitly states it intends to look both at sectors within the defined FTSE 350 audit services market (paragraph 46), as well as at competition beyond the FTSE 350 (paragraph 47). We do not propose to comment on these aspects at this stage, but will engage with the CC on any analysis of competition either in segments of, or outside, the FTSE 350 once it is published.

Where we agree with the MDWP

- 3 We agree with the CC that the relevant market is that for the supply of statutory audit services to FTSE 350 companies. We recognise that the nature and scope of audit work varies considerably within the FTSE 350, and that some companies outside the FTSE 350 may have higher turnover or more complex audits than smaller companies within the FTSE 350, as noted by BDO and Grant Thornton (paragraph 24). However, the general premise that FTSE 350 audits are the largest and most complex UK company audits - and can be distinguished on that basis - is both supported by the CC's analysis and consistent with our experience.
- 4 The CC recognises the traits which distinguish FTSE 350 audits from smaller audits and the characteristics of the large audit firms which are required to provide such audit services. The evidence presented in this respect is in line with our own submissions, notably the First Pillar (i.e. "*Large company audits require specific skills and attributes*") presented in our 12 January 2012 Submission and Response to the Issues Statement (our **Initial Submission**).
- 5 We also agree that it is appropriate to focus on the provision of statutory audit services in the UK given the legislative framework governing provision of such services, although in competing in the UK market the existence of an effective and properly coordinated international network is an important competitive differentiator.

Points in the MDWP which should be reconsidered

- 6 Notwithstanding our general agreement with the approach of the MDWP, we have a number of specific concerns which we consider the CC should address before reaching any Provisional Decision. These are set out below by reference to the paragraph numbers in the MDWP.
 - (a) Paragraph 30:
 - (i) The CC suggests that "*company characteristics described above*", which we take to include the information on switching and tendering rates in paragraph 29, are "*factors in explaining the differences in the levels of audit concentration*" that exist between FTSE 350 companies and smaller listed or Top Track 100 companies.



- (ii) If the CC is suggesting that lower levels of tendering or switching by FTSE 350 companies are one of the reasons for higher audit concentration, we disagree. Higher audit concentration in relation to FTSE 350 audits in reality reflects (as per our previous submissions):
 - (A) the level of service large companies demand from their auditors;
 - (B) the specific attributes that we and other large audit firms have therefore developed; and
 - (C) the intensity of competition between the largest audit firms.
 - (iii) The mid-tier firms assert that they could audit most of the FTSE 350, but acknowledge there are 30-60 audits they could not provide within the FTSE 350 (paragraph 41). In contrast, the large firms not only assert that they could provide such services but have a track record of actually having done so in each of the most complex sectors of the FTSE 350 over a number of years (paragraph 36). Moreover, despite the CC survey suggesting the mid-tier have been invited to participate in 30% of FTSE 350 audit tenders in recent years (and so having had considerable exposure to FTSE 350 companies), the CC's survey and case study evidence showed a clear majority of finance directors (FDs) and audit committee chairs (ACCs) believe that only a large firm could provide their audit service (paragraph 42).
 - (iv) The MDWP notes that larger companies find the large audit firms to be best able to provide their audit services, due not only to their greater international scope (paragraph 27), but also the range of other characteristics including reputation, expertise and resource. These are the characteristics which the European Commission recognised in defining a separate market for audit services to quoted and large companies *which only the large firms were able to supply* (paragraph 12).
 - (v) Indeed, the CC's survey report (slide 62) suggests that when FTSE 350 companies tender, they do not switch from larger firms to mid-tier firms, but are likely to switch the other way, reflecting the reality that when the largest companies consider the services of the mid-tier firms at tender, the mid-tier firms are not successful. Concentration is therefore not a result of the mid-tier firms not having the opportunity to tender for FTSE 350 audits, but of companies choosing to appoint the large audit firms on the basis of the more attractive package of experience and expertise, quality service and price that they offer.
- (b) Paragraph 28:
- (i) Sub-paragraphs 28(a) and (b) highlight the CC's survey findings suggesting that the audit requirements of larger companies (i.e. the FTSE 350) focus on factors related to audit quality more than those of non-FTSE 350 companies. Important factors which influenced FTSE 350 companies decisions included: the high degree

of challenge by the auditor; ability to detect misstatements; independence of the audit firm; reliability and usefulness of the audit report; strength of the auditor's international network; and ability to ensure consistent worldwide delivery.

- (ii) Sub-paragraph 28(c) then suggests that fewer FTSE 350 FDs and ACCs consider price an important factor in choosing an auditor. However, the CC's survey actually found that 93% of FTSE 350 companies renegotiate on audit fee every year, as compared with 88% of non-FTSE 350 companies (slide 46 of the survey report). This supports the evidence we have already provided (notably Figure 10 in our Initial Submission) and the evidence from the CC's Engagement Data which shows clearly that large companies have been very successful in recent years in pushing down audit fees¹. While larger companies may have a keener focus on audit quality than smaller ones, this does not mean they are unable to demand competitive prices.
- (c) Paragraph 38:
- (i) The CC cites two of its case studies in banking and insurance where companies reported that one of the large firms was "*weaker*" than the other three. The CC suggests that, if true, this would mean the "*choice available to firms in these sectors is significantly different*" from those in other sectors. We believe this overstates the position - one competitor having a stronger offering than a second competitor does not mean that the second competitor ceases to exercise a competitive constraint or be an option for companies - and it must be expected that competitive rivalry will lead to particular firms having a competitive advantage in relation to any particular client (if only through the experience of the team and audit partner proposed in relation to that particular client).
 - (ii) More significant is the ability of audit firms to respond to company demand in each particular industry or other specialised sectors - here the CC notes (paragraph 36) that "*each of the Big 4 firms has had a presence in each of these sectors over a number of years*" and that (paragraph 44) the majority of companies face no restriction on choice between the four largest firms.
- (d) Paragraph 45:
- (i) We note that, despite the mid-tier firms acknowledging that there are several companies for whom they could not provide audit services (paragraph 41), the CC does not identify any particular segments of the FTSE 350 that can only be audited by the Big 4 (paragraph 45). While segmentation on this basis may not be necessary for market definition purposes, there is clear evidence from companies and the mid-tier themselves that the smaller firms are not capable of auditing the

¹ The CC's Engagement Data shows that while auditor hours per engagement have remained static from 2006 to 2011, auditor fees per hour have fallen by around 15% in nominal terms (and so more in real terms factoring in inflation). This clearly shows the success of companies in putting pressure on audit fees both within, and notably outside, the context of audit tenders - and thus that tenders are not necessary in order for companies to exercise buyer power.

larger and more complex companies without making investments to improve their capabilities.

Where the MDWP drafting should be clarified

7 We believe the drafting in the MDWP is misleading in the following instances:

- (a) Paragraph 9 states: *“The OFT said that large international companies would likely be keen to employ the same audit firm in the different countries in which they operated, whilst smaller listed companies were likely to engage only a national audit firm.”* The evidence provided to the CC actually shows that smaller listed companies are also likely to employ a single network of firms to the extent they have international operations which must be covered by the audit², while listed companies that are only active domestically are still (on the basis of the market data) more likely to employ one of the largest four firms than any other³. We therefore suggest the correct wording should be *“...smaller listed companies were relatively more likely to engage only a national audit firm.”*
- (b) Paragraph 50 states: *“However, although many companies prefer to have the same auditor for the parent and subsidiaries, evidence from the CC survey shows that FTSE 350 finance directors and audit committee chairs value the strength of an auditor’s network.”* We do not see any contradiction in these statements - companies’ desire for a single audit firm for parent and subsidiaries will lead to them placing value on the auditor’s network. The *“although”* at the start of the sentence is therefore misleading in suggesting there is a contradiction between the first clause of the sentence ending *“parents and subsidiaries”* and the subsequent clause.

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² For example, the CC’s Survey Presentation shows the importance of strength of a firm’s international network to companies (e.g., slide 34), the Hundred Group of Finance Directors has highlighted the regulatory requirements which *“practically translated as a requirement for group auditors to audit the majority of a group’s global subsidiaries”* (see letter to House of Lords of 27 September 2011). The CC’s case studies generally show companies prefer to engage one audit firm to provide audit services for their entire network, e.g., the CFO of Company C said that his concern with using mid-tier firms was that this would require using mid-tier ‘partner’ firms in different territories which *“was too hard and he did not need this added difficulty”* (paragraph 33 of Case Study C); similarly, the ACC and FD of Company D made clear their reluctance to engage a mid-tier firm on the basis that they are *“keen to ensure consistency across the world”* and *“the mid-tier would not be able to conduct the whole audit and it was an advantage to use only one firm”* (paragraphs 28 and 65 of Case Study D).

³ The notes to slide 23 of the CC’s Survey Presentation show that for FTSE 350 companies with less than 40% of turnover achieved outside the UK, 95% used a Big Four auditor, and 65% would only consider using the Big Four. The CC’s Engagement Data shows that the market share of the four largest firms is not substantially lower in relation to any subset of the FTSE 350, reflecting the needs of these companies for certain attributes from their audit provider. In this respect we note that the mid-tier firms are also significant international businesses. The global turnover of BDO for example at £3.6 billion is far higher than the global turnover of the largest global law firm (based on Legal Business Global 100 figures for 2011, Baker & McKenzie had a global turnover of \$2.1 billion - approximately £1.3 billion).