



## **Competition Commission Audit Services Market Inquiry**

20 March 2013

### ***Deloitte response to the Competition Commission's Provisional Findings***

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## Deloitte response to the Competition Commission's Provisional Findings

### 1. Introduction and summary

- 1.1 Deloitte welcomes the opportunity to comment on the Competition Commission's (the **CC**) Provisional Findings (the **PFs**).
- 1.2 We believe that this is the most complete study of the market for statutory audit services ever performed anywhere in the world. We anticipate that the review will be referenced by a number of regulators or other bodies around the world and are therefore keen to provide this response on the PFs so that the CC's final decision appropriately and fairly reflect the evidence before it.
- 1.3 In this response we summarise those areas of the PFs with which we concur as well as commenting on those findings which we do not believe are supported by the evidence assembled by the CC and are inconsistent with our own experience.
- 1.4 We set out later in this response where we believe that a further review of the evidence collected by the CC should allow it to modify its provisional conclusion that there are Adverse Effects on Competition (**AEC**) in this market and that those adverse effects result in detriment to customers.

### 2. Deloitte welcomes certain key provisional findings

- 2.1 We welcome and endorse a number of the key elements of the PFs. In particular:

#### *Audit quality*

- (a) that most companies and most auditors perform their functions diligently and effectively most of the time<sup>1</sup>;
- (b) that firms make internal efforts to maintain quality and are subject to external regulation by the FRC and professional bodies<sup>2</sup>;
- (c) that most companies conduct regular reviews of quality and service<sup>3</sup>;
- (d) that firms have an incentive to maintain high quality as any failure to do so would seriously damage their reputation<sup>4</sup>.

#### *Decision-makers*

- (e) that FTSE 350 FDs and ACCs are highly expert and experienced<sup>5</sup>;
- (f) that ACCs carefully consider regulatory reports on audit quality<sup>6</sup>;

#### *Competition*

- (g) that firms have strong incentives to compete<sup>7</sup>; and

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<sup>1</sup> Paragraph 13.9. All paragraph references in this response relate to paragraphs of the PFs unless otherwise stated.

<sup>2</sup> Summary, paragraph 27.

<sup>3</sup> Paragraph 9.91: CC survey shows that 91 per cent of FTSE 350 companies carry this out annually and 99 per cent at least every five years.

<sup>4</sup> Paragraphs 9.211 and 11.92.

<sup>5</sup> Paragraph 9.66.

<sup>6</sup> Paragraph 9.123.

(h) that competition in tenders is fierce<sup>8</sup>.

2.2 These are all features of the market which we recognise and features of the market which contribute to creating effective competition amongst audit firms and good outcomes for companies and their shareholders.

*Other theories of harm*

2.3 We also welcome that the CC has provisionally found that there is no evidence for certain theories of harm originally posited by the CC - in particular that:

(a) there is no evidence that there has been any tacit coordination between firms in the market<sup>9</sup>;

(b) there is no bundling or tying of services that restricts competition<sup>10</sup>;

(c) there is no evidence that firms “low ball” to exclude competitors<sup>11</sup>; and

(d) there is no excessive influence on regulators or other regulatory distortion that favours top tier firms<sup>12</sup>.

**3. Evidence in relation to the CC’s first theory of harm: Customer behaviour and market structure produce adverse outcomes<sup>13</sup>**

3.1 Deloitte’s experience is that the market works well in delivering good outcomes for companies and their shareholders, in terms of good value, high quality and independent judgement. Companies, on behalf of their shareholders, are well placed to achieve these outcomes, monitor auditor performance and, if dissatisfied, switch auditor. We were surprised that the CC believes that the evidence in the PFs supports any conclusion that a feature of the market results in an AEC.

3.2 We set out in turn a number of key building blocks in the PF’s analysis which are either unevenced or not supported by the evidence, and explain why this is the case.

3.3 First, the PFs set out a provisional view that long audit tenure and low frequency of switching and tendering may indicate an AEC<sup>14</sup>. This conclusion should not be made without considering the impact of the FRC amendments to the UK Corporate Governance Code effective from October 2012 which have introduced mandatory tendering (on a comply or explain basis) for FTSE350 companies. These reforms have already resulted in a significant and demonstrable increase in tendering activity, as the CC should have noted from public reports of tenders recently announced by HSBC, Schroders, RSA and BG as relevant examples.

3.4 It is incumbent on the CC to take account of this change of circumstance when making its findings, as it has properly done in other cases<sup>15</sup>.

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<sup>7</sup> Paragraphs 9.36 and 9.56.

<sup>8</sup> Paragraphs 9.241 and 9.56.

<sup>9</sup> Paragraph 12.3.

<sup>10</sup> Paragraph 12.6.

<sup>11</sup> Paragraph 12.9.

<sup>12</sup> Paragraph 12.13.

<sup>13</sup> The Framework for the CC’s assessment and revised theories of harm, paragraph 75 *et seq.*

<sup>14</sup> Paragraph 7.24.

<sup>15</sup> See, for example, Movies on Pay TV market investigation, *Final Report*; and Aggregates, cement and ready-made concrete market investigation, *Working Paper on the Lafarge/Tarmac joint venture and the acquisition by Mittal of Hope Construction Materials*.

- 3.5 Second, we agree with the PFs' provisional view that "*FTSE 350 companies (in particular their FDs and ACCs) have the expertise, resources and information to appraise their current auditor...*" but we cannot see why the CC chooses to qualify this conclusion by stating that it only relates to "*some aspects of the audit*" and "*to a certain extent*"<sup>16</sup>. In fact the evidence the CC has gathered fully supports the conclusion that FDs and ACCs are able to and do fully appraise their auditors:
- (a) the evidence shows and the PFs agree that FDs and ACCs for FTSE 350 companies are typically well-qualified and experienced individuals<sup>17</sup>;
  - (b) the evidence shows and the PFs agree that ACCs consider they have the resources necessary to carry out their responsibilities<sup>18</sup>;
  - (c) the evidence from the CC's surveys shows that ACCs are confident that they can carry out this appraisal<sup>19</sup>; and
  - (d) the evidence shows that companies regularly review fees and quality<sup>20</sup> and that these reviews are intensive and rigorous<sup>21</sup>.
- 3.6 Third, the PFs set out a provisional view that companies may encounter "*significant uncertainties*" in appraising potential auditors outside of a tender, in particular in relation to the quality and fee of the audit offering<sup>22</sup>. This is contrary to the evidence obtained by the CC. The evidence shows that companies do actively compare their auditors to alternative providers in terms of fee and quality:
- (a) the survey shows that two-thirds of companies carry out some form of benchmarking or other formal comparison with auditors at least every five years and 90 per cent make informal comparisons<sup>23</sup>;
  - (b) in the follow-up survey most ACCs felt they could assess quality outside of a tender one way or another, as the PFs correctly note<sup>24</sup>;
  - (c) the evidence shows and the PFs agree that ACCs make use of private and public AQRT reports<sup>25</sup>. The AQRT points out in its 2012 report "*that the UK audit inspection regime is among the most transparent in the world.*"<sup>26</sup>;
  - (d) the evidence shows and the PFs agree that, additionally, FDs and ACCs can draw on personal experience, firms' provision of non-audit services, regulatory reports and firms' marketing efforts as sources of information on the offer of alternative audit firms<sup>27</sup>;

Indeed, the CC's own conclusion in paragraph 9.127 states that "*with regard to quality, we consider that the various sources of information available would allow companies to make an assessment of whether a firm would have the capabilities that the company would require of*

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<sup>16</sup> Paragraph 9.99.

<sup>17</sup> Paragraph 9.66.

<sup>18</sup> Paragraph 9.86.

<sup>19</sup> Paragraph 9.89 *et seq.*

<sup>20</sup> Paragraph 9.91.

<sup>21</sup> Paragraphs 9.98 and 9.94.

<sup>22</sup> Paragraphs 9.147.

<sup>23</sup> Paragraph 9.103.

<sup>24</sup> Paragraph 9.112.

<sup>25</sup> Paragraph 9.123 *et seq.*

<sup>26</sup> Audit Quality Inspections Annual Report 2011-12 paragraph 1.5.

<sup>27</sup> Paragraph 9.127.

*its auditor*". We agree with this, and we therefore fail to understand how the PFs can draw the apparently opposite conclusion that companies encounter "*significant uncertainties in appraising auditors outside a tender*"; and

- (e) finally, overall, the level of public disclosure on fees charged and the regulators' review of quality is much greater than for any other professional service a company may purchase. This is strongly pro-competitive.

3.7 Fourth, the PFs set out a provisional view that there are significant barriers to and costs associated with switching and that this gives rise to an AEC<sup>28</sup>. This conclusion is inconsistent with the evidence that the CC has gathered and set out in its PFs:

- (a) as noted above<sup>29</sup>, companies are fully able to compare the offer of alternative auditors to their incumbent, and there is no concrete evidence of an information-based barrier to switching;
- (b) we agree that the costs of switching will vary by company, but there is no evidence that costs are high in general; and
- (c) the PFs note, but then appear to accord no weight to, the fact that virtually all market participants agree that barriers to switching are low<sup>30</sup>. This is absolutely consistent with the evidence from the case studies<sup>31</sup> and the CC's survey, which showed that the overwhelming reason why companies had not tendered was unrelated to switching costs, as we note further below.

3.8 Overall the PFs correctly conclude in paragraph 9.176 that "*We think companies will be minded to go to tender only if they have reasonable expectation that the benefits to be had from doing so in terms of quality and/or fee will outweigh the costs of searching and switching*". This is a rational economic trade-off that companies make and applies equally to the purchase of any professional service not just statutory auditing.

3.9 Fifth, the PFs set out a provisional view that there are features of the market which weaken a company's bargaining power outside the tender process<sup>32</sup>. This conclusion is contrary to the facts gathered by the CC:

- (a) the PFs set out good evidence that companies do exert pressure on auditors to reduce fees and achieve fee reductions<sup>33</sup>; and
- (b) the PFs rightly conclude that "*firms can accurately gauge the extent of company discontent, and adjust the dimensions of the audit (in terms of personnel and fee) accordingly and so mitigate the risks of a tender.*"<sup>34</sup>

3.10 In conclusion, taken together, it is clear from the evidence that companies are well-placed to use switching, tendering, the threat of both, as well as other mechanisms to ensure that they maximise quality and value in the market at present. The fact that some companies do not tender is typically because they are happy with the price and quality of service being provided by their auditors. The PFs are incorrect to conclude that there are features of the market which result in an AEC with respect to the first theory of harm.

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<sup>28</sup> Paragraph 9.260.

<sup>29</sup> See paragraph 3.6 above.

<sup>30</sup> Paragraph 9.154.

<sup>31</sup> See Deloitte's response to the *Framework for the CC's assessment and revised theories of harm*.

<sup>32</sup> Paragraph 9.262.

<sup>33</sup> Paragraphs 9.198 and 9.200.

<sup>34</sup> Paragraph 9.264.

#### 4. Evidence in relation to the CC's second theory of harm: Principal Agent Issues<sup>35</sup>

- 4.1 Deloitte's experience is that the incentives of auditors, company directors and shareholders are broadly aligned, and that the UK's well-regarded corporate governance structure operates to ensure that this continues to be the case. There are already a number of significant checks and balances within the UK Corporate Governance Code and Effective Company Stewardship Code and the FRC has sought to strengthen these even further with the reforms in 2012. The PFs do not appear to have taken those reforms into account in their assessment of the market.
- 4.2 The CC's analysis of its second theory of harm appears to be based to a large extent on theory rather than practice or evidence. This gives the unfair and unwarranted impression that market outcomes are in practice adversely affected by these concerns. In fact, several key building blocks in the PFs' analysis are either unevicenced or are not supported by the available evidence.
- 4.3 The PFs set out a provisional view that "*the influence in practice of executive management on external auditors is a feature of the market that may prevent, restrict or distort competition by providing incentives for firms to respond to the demands of executive management rather than the different demands of shareholders*"<sup>36</sup>. This conclusion only holds if the demands of executive management are misaligned with the demands of shareholders. The PFs do not provide any reliable evidence in practice that this is the case. They also fail to take account of (and, indeed, scarcely mention) directors' duties as set out in law and regulation, and the incentives for directors to act honestly and with appropriate regard to their shareholders' interests.
- 4.4 The PFs fail to consider professional standards and duties which require an auditor to behave with proper regard to the interests of shareholders rather than management<sup>37</sup>. The PFs seek to draw strong conclusions in relation to auditor independence on the basis of AQRT review evidence<sup>38</sup>, but then make only passing reference to the constraint from regulatory review in the context of this second theory of harm<sup>39</sup>. This is not consistent: as the CC is aware, auditor independence is a critical part of AQRT regulatory review and should be accorded much greater weight in considering the incentives on auditors in the context of this theory of harm.
- 4.5 Furthermore, the conclusion that auditors fail systematically to adopt sufficient professional scepticism is not supported by the evidence<sup>40</sup>. As regards Deloitte at least, no evidence of a lack of scepticism has been established by the CC<sup>41</sup>.
- 4.6 It is clear that, in practice, the evidence shows that the interests of auditors are aligned with those of shareholders, given the well-regarded corporate governance structure that is in place. In particular, ACCs are highly expert and committed, and so ensure that the work of auditors is properly directed.
- 4.7 In conclusion, the evidence does not support the concerns expressed in the PFs with respect to the second theory of harm. Furthermore, to the extent that the second theory of harm suggests that any unmet demand may arise, there is no suggestion that this arises due to a lack of competition (which has an important bearing on the extent to which it may be said to be relevant to the first theory of harm).

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<sup>35</sup> Framework for the CC's assessment and revised theories of harm, paragraph 80 et seq.

<sup>36</sup> Paragraph 11.103.

<sup>37</sup> See Deloitte's response to the Framework for the CC's assessment and revised theories of harm.

<sup>38</sup> See paragraph 5.11 below.

<sup>39</sup> Paragraph 11.89.

<sup>40</sup> Paragraph 11.94.

<sup>41</sup> See further paragraph 5.11(d) below.

## 5. Market outcomes identified in the PFs

- 5.1 Deloitte believes that the market delivers good outcomes for companies. The evidence set out in the PFs as to alleged detriment does not support any contrary conclusion.

### *Price and profitability*

- 5.2 The provisional finding that “*the market is not working well in delivering competitive prices*”<sup>42</sup> has no foundation in the evidence – indeed, the evidence in front of the CC suggests the contrary:

- (a) first, the PFs correctly find that firms’ assurance service lines have comparable profit margins to other service lines<sup>43</sup>. We have previously made the point that these service lines are unambiguously competitive as there are often multiple, non-accountancy firm competitors participating in the same markets. This provides compelling evidence that assurance profitability is not too high. We note that the PFs seek to limit the persuasive value of this fact by stating that they have not assessed the competitiveness of non-audit markets<sup>44</sup>. Given the significance of the evidence that has been put to the CC and has been considered by it, it is incumbent on the CC to make this assessment. A comparison with other product (or service) markets is a widely used approach, properly noted in the CC’s guidance<sup>45</sup>.
- (b) Furthermore, the PFs’ suggestion that audit work may be less risky than non-audit work (and so merit lower profitability) is implausible. We have explained to the CC the existential risk to which audit work gives rise, and also that non-audit work is no more commercially risky than audit work. The PFs state that “*We were not persuaded that the ‘all or nothing’ nature of audit work...was necessarily a driver of increased risk once the engagement was won*”<sup>46</sup>. The risk of operating in a market, however, arises equally not only from engagements won but also from engagements *not* won;
- (c) second, the PFs find that engagement profitability of non-FTSE 350 engagements (where no allegations of a lack of competition have been made) is on average greater than for FTSE 250 engagements<sup>47</sup> but does not draw the obvious conclusion from this that FTSE 350 audit market profits are similarly the outcome of strong competition;
- (d) third, the PFs fail to take into account the direct evidence from all market participants, the CC’s own engagement dataset and the FRC that there is substantial pricing pressure in this market:
- (i) We<sup>48</sup> and other firms<sup>49</sup> have pointed out that the engagement dataset shows a decline in fees in real terms over the last five years, The PFs agree that this is what the data shows<sup>50</sup>. This is entirely consistent with our experience in the market that companies are very effective at negotiating audit prices.
- (ii) The PFs cite the recent comments from the FRC in relation to this pricing pressure only to seek to show quality concerns<sup>51</sup> and fail to conclude the more obvious point that this

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<sup>42</sup> Paragraph 7.94.

<sup>43</sup> Appendix 14, paragraph 162.

<sup>44</sup> Appendix 14, paragraph 163.

<sup>45</sup> CC Guidelines for market investigations, Annex A, paragraph 14, Draft for Consultation, June 2012.

<sup>46</sup> Appendix 14, paragraph 164.

<sup>47</sup> Paragraph 7.82(c).

<sup>48</sup> See paragraph 6.20 of Deloitte’s response to the *Framework for the CC’s assessment and revised theories of harm*.

<sup>49</sup> Paragraph 7.30

<sup>50</sup> Paragraph 7.32. We address the issues raised in paragraph 7.32 at paragraph 5.4 below.

<sup>51</sup> Paragraph 7.111.

is additionally direct evidence of competitive pricing pressure in the market. Furthermore the PFs note the FRC's acknowledgement of the effect of fixed fee agreements and the potential difficulty in audit firms obtaining increases for audit plan variations<sup>52</sup>.

- (e) fourth, pricing behaviour in the first few years of a new audit engagement does not indicate that newly appointed auditors have pricing power, as the PFs wrongly suggest. If incumbency did give rise to pricing power, it would be expected that the incumbent auditor would continue to be able to raise prices and profitability over time. In fact the evidence, properly noted in the PFs, indicates that they are unable to do so<sup>53</sup>. There is an obvious and identified<sup>54</sup> pro-competitive reason for this profitability phenomenon – that firms bear the costs of getting up to speed with a new audit assignment, representing a cost which unwinds over time.

5.3 Additionally, the CC uses evidence to support its findings which cannot be considered robust. This evidence should not feature in the CC's final findings:

- (a) the PFs adopt an economically unsupported test on pricing and profitability – that returns to partners are “attractive”<sup>55</sup>. This is not an acceptable basis on which to conclude that returns to partners are supra-competitive – it has no basis in economics or the CC's guidance. (The CC should consider the inverse of its observation: to avoid the inference being drawn that profits are supra-competitive, market participants would have to show that participation in the market was “unattractive”, which cannot be appropriate); and
- (b) the finding that “there appear to be significant numbers of companies from which the firms enjoy persistently higher profitability”<sup>56</sup> is flawed and has not been previously disclosed in working papers for commentary by market participants<sup>57</sup>. It ignores the obvious corollary that there are companies from which firms achieve persistently lower profitability. In the case of Deloitte, our spread of FTSE350 profitability by client shows a broadly normal distribution and the CC's Working Papers concluded that a steady level of profitability at the aggregate level “*masks a much greater degree of variability in...the profitability of engagements over time*”<sup>58</sup>.

5.4 The PFs are selective in their use of data, leading to a failure to take account of relevant evidence. Specifically, the engagement dataset shows that the audit fee per hour for FTSE350 companies has fallen by 19 per cent in real terms over the last five years indicating the strong pricing power of Companies. The PFs acknowledge this<sup>59</sup>, but indicate that they do not place weight on this (otherwise highly relevant) evidence citing the risk of control issues relating to changes in grade mix of staff<sup>60</sup>.

5.5 However, as the PFs acknowledge at Appendix 6, the CC has the information that allows it undertake this control exercise<sup>61</sup>. In fact the very same dataset is used (controlled for changes in grade mix of staff) in the PFs' analysis of the impact on audit fee of switching auditor<sup>62</sup> to conclude

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<sup>52</sup> Paragraph 7.112.

<sup>53</sup> Paragraph 7.33(b).

<sup>54</sup> Paragraph 7.34.

<sup>55</sup> Paragraph 7.75.

<sup>56</sup> Paragraph 7.92(d).

<sup>57</sup> We note that no such allegation was made in the working papers on *Engagement level profitability, Profitability 1, Profitability 2, or The characteristics of long tenure audit companies*.

<sup>58</sup> Paragraph 25 of the Working Paper on Engagement Level Profitability.

<sup>59</sup> Paragraph 7.31.

<sup>60</sup> Paragraph 7.32. We note that no other control issue is cited in this paragraph.

<sup>61</sup> See paragraph 4 of Appendix 6.

<sup>62</sup> Appendix 5, Paragraphs 96 and 97.

that auditors have power over price.<sup>63</sup> This is an inconsistent approach. Given the importance to the PFs' conclusions, the evidence of a decline in audit fees should not be discarded on the basis that the CC has not made use of data to perform adequate controls, particularly where it has undertaken such controls elsewhere in its analysis. This renders the PFs' provisional view of the evidence on pricing and profitability<sup>64</sup> unbalanced.

- 5.6 Taken together, the evidence that the PFs set out cannot be relied upon to reach the provisional conclusions set out in relation to pricing given the weight of evidence to the contrary.

### Quality

- 5.7 The provisional finding that "*there are significant, persistent and widespread concerns regarding the quality of audits delivered to FTSE 350 companies as identified by the AQRT*<sup>65</sup>" is not supported by the evidence. The evidence shows that audit quality is high and that this sweeping generalisation cannot be supported:

- (a) first, the PFs acknowledge that the CC has not gathered direct survey evidence from companies as to audit quality<sup>66</sup>. The PFs seek to dismiss this on the basis that the CC might not have received objective answers. In fact, there is no reason to suppose that the CC would have received anything other than candid responses, and the PFs do not explain why it considers that the opposite is the case, given the nature of the respondents and the CC's penal regime for misleading evidence given to it during its investigations. The Competition Appeal Tribunal has made it clear that this is not an appropriate basis upon which to neglect to obtain evidence<sup>67</sup>;
- (b) second, the CC cites AQRT evidence that the number of audits requiring "significant improvement" remained "*too high*" in 2009/10. This does not support the PFs' conclusions:
- (i) in fact, Figure 7.1 of the PFs shows that 92.7% of FTSE350 audits reviewed by the AQRT were either "good with limited improvements required" or "acceptable overall with improvements required" over the last three years;
- (ii) of the 19 audits classified as "significant improvements required" over the last two years, only 4 related to audits of companies in the reference market<sup>68</sup>; and
- (iii) the AQRT could properly observe that even a single example in this category was "*too high*", but this would not permit the CC to draw general conclusions about the delivery of audit quality by the market as a whole.
- (c) third, the PFs do briefly acknowledge the context of the audit file reviews undertaken<sup>69</sup> - for example, that they are not intended to represent a balanced scorecard – but then fail entirely to apply that acknowledgement in its assessment. It is not acceptable for the PFs to dismiss this contextualisation. As we have explained:

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<sup>63</sup> Paragraphs 7.52 – 7.54.

<sup>64</sup> Paragraphs 7.91 – 7.94.

<sup>65</sup> Paragraph 7.121.

<sup>66</sup> Paragraph 7.97.

<sup>67</sup> See further the Competition Appeal Tribunal's judgment in *Stagecoach v. Competition Commission* [2010] CAT 14, paragraph 75.

<sup>68</sup> Audit Quality Inspections Annual Report 2011-12 paragraph 2.2.2.

<sup>69</sup> Paragraph 7.119.

- (i) the AQRT adopts a risk-based approach in selecting audits for review<sup>70</sup>. This skews the review selection towards more complex and risky audits which is not representative of the market as a whole; and
  - (ii) the review culture of one of continuous improvement. The highest rating publicly disclosed by the AQRT is “good with limited improvements required”. It is therefore not possible to receive a completely clean review with no recommendations; and
  - (iii) the AQRT in its introduction to its 2011/12 report clarifies that: “*It is important to emphasise, however, that our reviews are not designed to assess whether the information being audited was incorrectly reported and so a poor grading does not necessarily imply that the financial statements were materially inaccurate or incomplete, or that an inappropriate audit opinion was issued.*”<sup>71</sup>
- (d) fourth, the PFs acknowledge that the case study evidence – the only direct evidence from companies that the CC has – “*generally expressed a positive view of their auditor*”, subject only to “*minor concerns*” (most of which are only tangentially linked to quality)<sup>72</sup>.
- 5.8 The FRC concerns about delivery of audit quality at a time of price pressure are, in the main, forward looking – a warning to maintain vigilance on quality rather than a commentary on existing levels of quality<sup>73</sup>.
- 5.9 Most importantly, the PFs state that “*the AQRT often identified short-comings in audit reports*”<sup>74</sup>. We are not aware of a single instance of the AQRT finding an error in an audit report. We believe that the finding is false and should be struck out of the CC’s final report or otherwise referenced back to a source.
- 5.10 Overall, the evidence in this section of the PFs does not come close to supporting the PFs’ sweeping conclusion that AQRT concerns on audit quality are “*significant, persistent and widespread*”. It is incumbent on the CC to revise its conclusion to accord with the evidence before it.

### *Independence*

- 5.11 The provisional finding that “*losses of independence occur and...this would not be an outcome that we should observe if auditors were responding only to shareholders*” (para 7.149) is not consistent with Deloitte’s experience - Deloitte is absolutely committed to maintaining its independence in the conduct of its audits - or the evidence in front of the CC:
- (a) first, the PFs contain no direct evidence of a loss of independence, and there is no basis for the PFs’ dismissal of the CC’s failure to find such evidence<sup>75</sup> – if such a loss occurred to any material extent, this would have been apparent from the case studies in particular. Rather, the case studies show strong debate between auditors and companies on key issues, as the PFs acknowledge<sup>76</sup>;
  - (b) second, this part of the PFs cites<sup>77</sup> analysis elsewhere in the PFs<sup>78</sup> on the involvement of executive management, suggesting that these show that “*company executives can and do*

<sup>70</sup> <http://www.frc.org.uk/Our-Work/Conduct/Audit-Quality-Review.aspx>.

<sup>71</sup> Audit Quality Inspections Annual Report 2011 – 12, Paragraph 2.1.

<sup>72</sup> Paragraph 7.99.

<sup>73</sup> Paragraph 3.4 FRC report to the Secretary of State for Business 2012.

<sup>74</sup> Paragraph 7.119.

<sup>75</sup> Paragraphs 7.125 and 7.130.

<sup>76</sup> Paragraph 7.130 and 7.135.

<sup>77</sup> Paragraph 7.131.

*influence their incumbent auditor*". In fact, these paragraphs relate only to audit fee negotiation, and contain no evidence at all in relation to the auditor's conduct of the audit or the conclusions reached by the auditor;

- (c) third, the PFs briefly note<sup>79</sup>, but then fail to give any weight to, the role of the AC in protecting auditor independence. In fact, this is well-evidenced in the case studies, where ACCs are clear as to their role as guardians of shareholders' interest, as we have explained to the CC<sup>80</sup>. It is also clear from the PFs' own conclusion elsewhere in the document that ACs and ACCs are an "*important and, by and large, powerful force in directing audit firms towards satisfying the demands of shareholders*"<sup>81</sup>;
- (d) fourth, none of the evidence set out at paragraph 7.137 *et seq* or in Appendix 17 properly evidences a lack of auditor scepticism – at least insofar as Deloitte has been able to review that evidence. We note that all firms have disputed the CC findings that there was a lack of professional scepticism in the examples set out in Appendix 17<sup>82</sup>. Since these examples were put to Deloitte (and, we assume, other firms) only by way of "put back" and only over the course of the week immediately preceding publication of the PFs, we find it difficult to understand how the CC can properly have taken on board the submissions of these firms in assessing whether it can rely on these examples to draw *any* implication as to professional scepticism; and
- (e) finally, we note that the conclusion is no more than that "*losses of auditor independence do occur*". This is a very limited conclusion, and gives no indication of the scale of the problem that the CC considers might exist. In fact, the evidence above suggests that it is not significant. Deloitte and, we believe, other firms, continue properly to make efforts to raise the bar at all times.

## *Innovation*

5.12 The CC makes a provisional finding that "*innovation is not at levels that we would expect to see in a well-functioning market*"<sup>83</sup> without providing any support for what an appropriate level of innovation should be. Furthermore, the statement is made after detailing multiple areas of innovation that audit firms have identified to the CC. We do not believe that the evidence available allows the CC to draw this conclusion:

- (a) first, the PFs find (see Appendix 18) that there are areas in which innovation has been evident. These are important, and the PFs should not dismiss them on the basis that they are "*primarily determinants of cost and operational efficiency*"<sup>84</sup>. These are the mechanisms directly under the control of auditors, and so capable of operational delivery. Such innovation benefits companies and investors through quicker, more efficient audits at lower cost (allowing focus on the most important risks) and there is no reason to attribute a lower value to these innovations; and
- (b) second, the only area in which the PFs identify a lack of innovation is in relation to reporting<sup>85</sup>. No other area is raised in the PFs in which there is potential for innovation but in which the CC concludes that sufficient innovation has not occurred. Innovation in this area is not, though, entirely within auditors' gift: they are constrained by regulation in particular.

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<sup>78</sup> Paragraphs 9.200 and 9.201.

<sup>79</sup> Paragraph 7.134.

<sup>80</sup> See Deloitte's response to the *Framework for the CC's assessment and revised theories of harm*.

<sup>81</sup> Paragraph 11.98.

<sup>82</sup> Appendix 17, paragraph 56.

<sup>83</sup> Paragraph 7.179.

<sup>84</sup> Paragraph 7.162.

<sup>85</sup> Paragraph 7.164 *et seq*

Given the linkage that the PFs make between this alleged outcome and unmet demand, we note that this is also the only area in which unmet demand is identified.

#### *Unmet demand*

- 5.13 The only area of unmet demand identified in the PFs is some demand from “*some shareholders*” for further reporting information, and we are working to address this already.
- 5.14 The CC correctly identifies that there are regulatory based constraints with respect to audit reporting<sup>86</sup>. We believe that it is through legal and regulatory change that this demand can be met and that there is no evidence that it is a lack of competition which is preventing this demand being met (which has an important bearing on the extent to which this alleged unmet demand can fairly be said to be linked to the competition-based first theory of harm).

#### *Quantification*

- 5.15 Finally, we note that the PFs fail to identify the scale of the alleged detriments as to price, quality and innovation. All the evidence indicates that, to the extent that any detriment arises at all, it is minimal.

### **6. Conclusion**

- 6.1 Deloitte continues to believe that the market is producing good outcomes for FTSE 350 companies and their shareholders. We believe that the CC has not properly reflected all of the evidence available to it when concluding that there are features of the market which lead to an AEC and has therefore not come up with a balanced conclusion.
- 6.2 The CC explains that in this investigation it was difficult to form some of the judgements that it has reached: “*We note that, to a greater extent than in many market investigations, the nature of the evidence base we faced meant that clear-cut distinctions between competing explanations for a number of issues were hard to determine. In these situations, we applied our judgement to reach our provisional findings, having regard to all the evidence available*”.<sup>87</sup> This makes it all the more important that the CC has properly reflected the balance of the evidence in its assessment and ensured that it has obtained and properly used all the available evidence. Furthermore, where the balance of the evidence is uncertain, it is important that the CC does not systematically err on the side of finding a concern in circumstances in which it would be appropriate for the CC to give market participants the benefit of the doubt.
- 6.3 We recognise that some investors are calling for additional information in audit reporting and are already working with the FRC, the IAASB and the investors themselves to push this debate forward. We believe that improvements in this area will be achieved through modifications to legal and regulatory framework on audit and audit committee reporting to shareholders and therefore we are pleased that the CC acknowledges that it will need to work closely with the FRC when assessing the need for any competition-based remedies.
- 6.4 We would be pleased to work further with the CC to help it clarify the issues we raise in this response.

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<sup>86</sup> Paragraph 7.156.

<sup>87</sup> Paragraph 2.12.