



Competition Commission Audit Services Market Inquiry

18 March 2013

Deloitte response to the Notice of Possible Remedies

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1. Introduction and summary

- 1.1 Deloitte is grateful for the opportunity to comment on the Notice of Possible Remedies under Rule 11 of the 'Competition Commission Rules of Procedure' (the **Remedies Notice**).
- 1.2 Deloitte has concerns in relation to the CC's Provisional Findings (**PFs**). Nonetheless, Deloitte welcomes steps which support audit quality and which benefit FTSE350 companies and their shareholders in a way that is effective and proportionate;
- 1.3 The PFs do not set out any sufficient evidence for their provisional conclusions on the extent of alleged detriment in the provision of audit services to FTSE 350 companies, and do not attempt to quantify that alleged detriment. In that light, there is little or no evidence upon which the CC can properly base a robust assessment of proportionality;
- 1.4 That said, several of the remedies which the CC is minded to consider do not give rise to significant costs, and can be effective (albeit sometimes in amended form) in helping to contribute to improving audit quality and benefit FTSE350 companies and shareholders. It is on this basis that we comment on the proposed remedies in this document;
- 1.5 With regard to Remedy 1 (mandatory tendering), Deloitte accepts the remedy in principle; we also accept the 10 year tendering period which has been introduced by the FRC's recent reforms. We believe that these reforms should be allowed to take effect. Any shorter period, would be disproportionate;
- 1.6 Remedy 2 (mandatory rotation) would be less effective than remedy 1 in addressing aspects of the Adverse Effect on Competition (**AEC**) identified in the Remedies Notice;
- 1.7 A combination of Remedy 1 (as amended) and remedies 3, 4, 5 (as amended), 6 and 7 would be effective in addressing the purported AECs identified by the CC; and
- 1.8 None of the remedies that the CC indicates that it is not minded to consider would be either effective or proportionate.

2. Relationship with the Provisional Findings

2.1 In our response to the PFs, we explain our view that we do not consider that the CC's evidence base supports a finding, on the basis of either theory of harm, that an AEC arises. In summary:

- (a) the PFs' provisional views in relation to theory of harm 1 fail to assess properly the evidence that expert purchasers of audit services in the FTSE 350 are well able to use a range of mechanisms – both inside and outside formal tender situations – to procure good outcomes for these companies and their shareholders;
- (b) the PFs' provisional views in relation to theory of harm 2 are founded only on theory, with no good evidence that these issues arise in the market. The PFs ignore the evidence that the regulatory structure and sophisticated corporate governance framework works well to avoid any divergence of interest in practice, and appears to have failed properly to take into account the recent reforms to that structure introduced by the FRC.

2.2 We go on to explain that the PFs' analysis of customer outcomes and related detriment is seriously deficient. This is highly relevant to the CC's remedy analysis. First, the PFs' provisional views as to customer outcomes/detriment are not properly supported by the evidence:

(a) *Price and profitability*

- (i) the PFs wrongly suggest that rising prices and profitability in the first few years of a new audit relationship suggest that the auditor has pricing power. If this were the case, however, it would be expected that the auditor would be able to continue to exploit that power by increasing prices and profitability for the duration of the relationship. In fact, as the CC is aware, profitability levels out after 5 years¹. There is an obvious and identified pro-competitive reason for this: that firms bear the costs of getting up to speed, representing a cost that unwinds over the first few years of a new relationship;
- (ii) the PFs fail to take into account the direct evidence from all market participants and the FRC that the market is characterised by substantial pricing pressure;
- (iii) the PFs wrongly fail to attribute proper weight to the evidence that firms' assurance service lines have comparable margins to non-assurance service lines (which are demonstrably competitive) and that non-FTSE 350 audit business is more profitable for the firms than that in the reference market; and
- (iv) the PFs adopt an economically unsupported test on pricing and profitability – that returns to partners are "*attractive*"². This is not an acceptable basis on which to conclude that detriment arises in relation to audit fee levels – it has no basis in economics or the CC's guidance.

(b) *Quality*

- (i) the PFs acknowledge that the CC deliberately has not gathered direct survey evidence from companies as to audit quality³ on the basis that the CC might not have received objective responses. In fact, there is no reason to suppose that the CC would have received anything other than honest answers, 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 evidence provided to it during its

¹ Paragraph 7.33(b) of the PFs.

² Paragraph 7.75 of the PFs.

³ Paragraph 7.97 of the PFs.

investigations. The Competition Appeals Tribunal (**CAT**) has made it clear in the past that this is not an appropriate basis on which to neglect to take evidence⁴;

- (ii) 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)⁵;
- (iii) the CC cites AQRT evidence that the number of audits requiring “significant improvement” remained “*too high*” in 2009/10. In fact, the evidence does not support the PFs’ sweeping conclusion: 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. Furthermore, 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; and
- (iv) most importantly, the PFs state that “*the AQRT often identified short-comings in audit reports*”⁶. We are not aware of a *single* instance of the AQRT finding an error in an audit report.

(c) *Independence:*

- (i) 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 evidence⁷ – 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 acknowledge⁸;
- (ii) this part of the PFs cites⁹ analysis elsewhere in the PFs¹⁰ on the involvement of executive management, suggesting that these show that “*company executives can and do 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; and
- (iii) the PFs briefly note¹¹, but then fail to give any weight to, the role of the AC in protecting auditor independence.

(d) *Innovation:*

- (i) the PFs state that “*innovation is not at levels that we would expect to see in a well-functioning market*”¹² without providing any indication of what an appropriate level of innovation should be, or evidence to support any such conclusion;
- (ii) 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

⁴ See further the Competition Appeal Tribunal’s judgment in *Stagecoach v. Competition Commission* [2010] CAT 14, paragraph 75.

⁵ Paragraph 7.99 of the PFs.

⁶ Paragraph 7.119 of the PFs.

⁷ Paragraphs 7.125 and &.130 of the PFs.

⁸ Paragraph 7.130 of the PFs.

⁹ Paragraph 7.131 of the PFs.

¹⁰ Paragraphs 9.200 and 9.201 of the PFs.

¹¹ Paragraph 7.132 of the PFs.

¹² Paragraph 7.179 of the PFs.

that they are “*primarily determinants of cost and operational efficiency*”¹³. These are exactly the types of innovation most closely under the control of the auditor. There is no reason to attribute a lower value to these innovations; and

- (iii) the only area in which the PFs identify a lack of innovation is in relation to reporting (which is an area where innovation by the auditor is arguably constrained by regulation and other factors)¹⁴. 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.

(e) *Unmet demand:*

- (i) 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. The CC correctly identifies that there are regulatory based constraints with respect to audit reporting¹⁵. 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. It is incorrect to attribute this concern to any lack of competition.

Taken together, there are serious flaws in each element of the PFs’ identification of customer outcomes/detriment such that it is not open to the CC to conclude that any material detriment arises for FTSE 350 companies or their shareholders in relation to the provision of audit services.

- 2.3 Moreover, the alleged detriment is, in all cases, unquantified. In relation to none of the outcomes/detriments identified in the PFs – even those most closely grounded in price – do the PFs attempt to make any quantification of the scale of the alleged detriment. This has important implications for the CC’s consideration of remedies, in particular in relation to the requirement that they must be proportionate. As the CAT observes in *Tesco v. Competition Commission*:

*“It is necessary to know what a measure is expected to achieve in terms of any aim, before one can sensibly assess whether that aim is proportionate to any adverse effects of the measure.”*¹⁶

*“The more important a particular factor seems likely to be in the overall proportionality assessment, or the more intrusive, uncertain in its effect, or wide-reaching a proposed remedy is likely to prove, the more detailed or deeper the investigation of the factor in question may need to be.”*¹⁷

This is important in the context of the CC’s proposal for mandatory auditor rotation in particular – a remedy that would be highly intrusive, distortive and uncertain in its effect. There is no sufficient evidence base as to the scale of the detriment in this market which would permit such a remedy to be imposed.

Deloitte supports steps which bolster audit quality and good outcomes for companies and shareholders

- 2.4 Notwithstanding these serious concerns about the PFs, there are a number of remedies which, individually or in combination we do consider could be implemented at relatively little cost and would be effective measures in that regard.

- 2.5 Deloitte is supportive of measures which are effective and proportionate in enhancing audit quality and generating good outcomes for FTSE 350 companies and their shareholders.

¹³ Paragraph 7.162 of the PFs.

¹⁴ Paragraph 7.164 *et seq* of the PFs.

¹⁵ Paragraph 7.156 of the PFs.

¹⁶ *Tesco v. Competition Commission* [2009] CAT 6, paragraph 143.

¹⁷ *Tesco v. Competition Commission* [2009] CAT 6, paragraph 139.

PART A: REMEDIES WHICH THE CC IS MINDED TO CONSIDER

3. Remedy 1: mandatory tendering

Summary

- 3.1 Deloitte accepts the principle of mandatory tendering. An appropriately formulated mandatory tendering remedy would be wholly effective and proportionate in addressing several of the concerns raised in the PFs.
- 3.2 However, there is no basis at all for the CC's dismissal of the FRC's recently implemented ten year mandatory tendering period. In fact, the evidence shows that a remedy going beyond the new FRC regime would be disproportionate.

Effectiveness

- 3.3 We believe that an appropriately formulated mandatory tendering remedy should be wholly effective in addressing several of the concerns raised in the PFs.
- 3.4 The Remedies Notice states that this remedy would address the provisionally identified AEC in three respects:
- (a) first, it would overcome barriers to more frequent tendering and increase the possibility of switching, which would increase companies bargaining power and the incentives for auditors to compete¹⁸. Without prejudice to our views set out above as to the appropriateness of the evidence as to the existence of an AEC, we agree with this: an appropriately designed mandatory tendering remedy will be wholly effective in addressing this issue. The PFs provisionally conclude that it is in a formal tender situation that a company is able to maximise its bargaining power with its current and potential auditors¹⁹, and so incentivise those auditors to compete as strongly as possible (on price and quality) for its business²⁰. That being the case, increasing the frequency of switching will address this concern;
 - (b) second, it would increase the opportunities for non-top tier firms to tender and so reduce perceived barriers to entry and expansion. Again without prejudice to our views on the appropriateness of the evidence of such barriers, we agree with this, and note the evidence from mid-tier firms which supports this view. Throughout this process, the mid-tier firms have been clear in their evidence that what they lack is not capabilities, or funds to invest in capabilities, but tender opportunities (in the course of which they can fully demonstrate their capabilities). That being the case, this remedy should be wholly effective in addressing this concern; and
 - (c) third, it will reduce the incentives of auditors to satisfy management rather than shareholders by providing for a settled period of auditor appointment. We explain in our response to the PFs that we do not consider that the CC has properly identified any misalignment of auditors' incentives, but to the extent that the CC considers that such a misalignment exists, this remedy, combined with remedies 5 and 6 would be wholly effective in addressing it.

¹⁸ Paragraph 23(a) of the Remedies Notice.

¹⁹ Paragraph 9.256 of the PFs.

²⁰ Paragraphs 9.36 and 9.56 of the PFs.

Proportionality

The FRC reforms to tendering

- 3.5 In October 2012, reforms introduced by the Financial Reporting Council (FRC) to FTSE 350 tender processes became operational. These reforms provide that FTSE 350 companies must (on a “comply or explain” basis) tender their audit every ten years²¹.
- 3.6 In our experience, the FRC reforms have already had a significant effect in the market, with a marked increase in tendering activity already apparent. The CC will have noted the reports of the recent tender processes by HSBC, Schroders, RSA and BG as examples of this increased tender activity.
- 3.7 In December 2012 Deloitte wrote to the CC to indicate that it was concerned that the working papers did not appear adequately to address the reforms to audit tendering introduced by the FRC in October 2012. The CC assured us that it was fully considering them in the course of its analysis. We were therefore surprised to find little or no mention of the FRC reforms in the PFs. As far as is apparent from the PFs, the CC has given no consideration to the effect of the reforms or to the views of market participants on their likely future effect. It is incumbent on the CC to take account of this change of circumstance during the course of its inquiry, as it has properly done in other cases²², and the failure to do so means that its preliminary views on the appropriate period for tendering are incomplete.
- 3.8 We were also surprised to find in the Remedies Notice a one sentence dismissal of the FRC reforms – “*We consider that a greater frequency of tendering [than 10 years] may be required to address effectively the AEC we have found*”²³. There is no basis for this conclusion in any of the evidence that the CC has gathered or in the material set out in the PFs.
- 3.9 When it consulted on the introduction of comply or explain basis at least every ten years, the FRC gathered views from stakeholders across the industry, demonstrating widespread support for a 10 year period²⁴. A clear majority of investors – including Aviva, Blackrock, F&C Investments, Governance for Owners, Hermes, Legal & General Investment Management, Standard Life, the NAPF and the IMA – indicated their support for the FRC’s proposals²⁵. Only a much smaller number indicated their support for any other period. We are surprised that the CC clearly has not given adequate consideration to this detailed work and has provided no explanation for its rejection of the conclusions that the FRC consultation reached.
- 3.10 We note that a 10 year rotation period does not, of course, preclude companies from tendering their audit more frequently, which we would expect to happen, consistent with the evidence that the CC has gathered, in circumstances where the company did not consider that it was obtaining optimal value or quality from its auditor.

²¹ See a summary at <http://www.frc.org.uk/News-and-Events/FRC-Press/Press/2012/September/FRC-publishes-updates-to-UK-Corporate-Governance-C.aspx>, and the full proposals which are incorporated in the *Guidance on Audit Committees* at <http://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/Guidance-on-Audit-Committees-September-2012.aspx> (see in particular paragraph 4.23).

²² 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*.

²³ Paragraph 20 of the Remedies Notice.

²⁴ See <http://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/Feedback-statement-on-UK-Corporate-Governance-Code.aspx>.

²⁵ See individual stakeholder responses held at: <http://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/Consultation-Documents-revisions-to-the-UK-Corporate-Governance-Code/Responses-to-the-consultation.aspx>

Any shorter period would be disproportionate

3.11 Furthermore, it is clear that any shorter period will increase the costs of mandatory tendering to companies and to audit firms. The PFs conclude that there are material costs for both in a tendering context.

3.12 The PFs note the costs borne by companies – partly in terms of the monetary cost of tender, but more importantly in terms of management time²⁶. The PFs conclude that:

“It appears that running a tender process can be onerous for some companies: the cost, principally in terms of management time, appears related to the size, complexity and geographic spread of the company. We note that very senior management time is required.”²⁷

3.13 The PFs also properly note the costs borne by firms participating in a tender process²⁸. The PFs note the highly detailed tender process (which the CC agrees is effective²⁹), which allows firms to make a robust assessment of the needs of the tendering company, tailor their tender to the particular company, and present their capabilities effectively. This can be, as the PFs note, an expensive process: a tender for a major FTSE 100 company can cost many hundreds of thousands of pounds. The PFs conclude that:

“From our analysis of the tender and engagement data, we found that the average staff costs of tendering as a proportion of the proposed fee for the first year of the audit by firm range from 20 to 60 cent [sic] and that for some engagements the ratio of costs to fees was considerably higher than the average.”³⁰

3.14 The PFs also note the time that management has to spend in the early years of a new engagement getting the new auditor “up to speed”:

“Firms and companies alike said that there was a two- to three-year education process as the company invested in educating its auditor.”³¹

Increasing the frequency of tendering will increase all of these costs without any increase in the effectiveness of the remedy.

3.15 The Remedies Notice appears to seek to counter this concern by suggesting that these costs (for both companies and firms) might be reduced in a world where tendering was more frequent. It states that:

“Under a more frequent system of tendering, resources expended by firms in mounting bids and companies in assessing bids would be reduced in view of the greater frequency of tendering.”³²

There is no basis for this statement – either in the evidence gathered by the CC or in our own experience. Given the importance of obtaining a high quality audit, companies are committed to a proper assessment of potential auditors’ capabilities, and firms are committed in the tender process to giving an effective account of themselves in a tender process. This implies a thorough, but costly, tendering process. This is acknowledged in the PFs:

²⁶ See paragraph 9.164 *et seq* of the PFs.

²⁷ Paragraph 9.253 of the PFs.

²⁸ Paragraph 9.203 *et seq* of the PFs.

²⁹ Paragraph 9.56 of the PFs.

³⁰ Paragraph 9.249 of the PFs. See also Appendix 24 of the PFs.

³¹ Paragraph 9.179 of the PFs.

³² Paragraph 24 of the Remedies Notice.

“We consider that these costs are reflective of the effort made by FTSE 350 companies to ensure that tenders have been effective and competitive processes.”³³

We do not see why this would change.

- 3.16 Indeed, we would have concerns were the tender process to change in the way the CC appears to envisage. As we explain below in the context of customer benefits, it would risk reducing the effectiveness of what the PFs acknowledge is a robust and effective process, to the detriment of companies and their shareholders.

A non-“comply or explain” approach would be disproportionate and impracticable

- 3.17 As the CC is aware, the “comply or explain” principle is a central feature of the UK’s corporate governance landscape. It is regarded as highly effective in securing compliance while still retaining a proper measure of flexibility for companies and their shareholders to order their affairs in their best interests. The FRC has explained that:

“The “comply or explain” approach is the trademark of corporate governance in the UK. It has been in operation since the Code’s beginnings and is the foundation of the Code’s flexibility. It is strongly supported by both companies and shareholders and has been widely admired and imitated internationally.”³⁴

- 3.18 We were surprised to see a single sentence dismissal of “comply or explain” in the Remedies Notice. The CC should note that the “explain” alternative is something that is specifically required of companies under the Listing Rules³⁵ and the FSA’s disclosure rules³⁶. Substantive explanations are required and this is not something that a company can take lightly. Indeed, it is not clear that the CC reviewed the FRC’s report on what constitutes an explanation under comply or explain³⁷, which reported Grant Thornton’s findings that:

“...Overall the FTSE 350 comply with 96 per cent of the aggregate code provisions that apply to them. This is a strong result and it would be difficult to conclude that the compliance cost of more formal regulation could be justified to raise the figure by a mere 4 percentage points”³⁸

- 3.19 We believe that it is important that audit committees retain the flexibility to take the action that is in the interests of their shareholders – including, in exceptional circumstances, not tendering the company’s audit in a given year. Such a decision would not be taken lightly, given the pressure to comply with expectations on good practice, and would require a full explanation to be given to shareholders.

³³ Paragraph 9.254 of the PFs. Further evidence is set out from paragraph 2.50 *et seq.*

³⁴ FRC, Appendix to Consultation Document, Draft Revised UK Corporate Governance Code, April 2012.

³⁵ FSA Listing Rules LR 9.8.6

³⁶ FSA Disclosure Rules DTR7.2.3R

³⁷ FRC: What Constitutes An Explanation under Comply or Explain? Report of Discussion between Companies and Investors, February 2012.

³⁸ *Ibid*, page 1.

Customer benefits

- 3.20 The PFs correctly note the effectiveness of current tendering procedures in allowing companies to generate competition and select the provider that is best able to meet their needs³⁹. This is a function of two factors:
- (a) the willingness of multiple well-qualified audit firms to participate in the tender process⁴⁰; and
 - (b) the detailed, and therefore more costly, process that the firms and companies undertake to make a proper comparison of capabilities and value⁴¹.
- 3.21 This benefit also clearly accrues to shareholders, who benefit from a better quality audit at lower cost than would be the case were tenders to be more cursory and/or to have fewer participants. This is a clear example of a relevant customer benefit arising from the way the market currently operates.
- 3.22 This benefit would be endangered by the remedy formulation proposed in the Remedies Notice. As explained above, the CC envisages that a more frequent tendering period would lead to a reduction in the intensity (and hence cost) of the tender process. If this were to happen, we believe that it would not be in the interests of companies or their shareholders, who would run the risk of appointing a firm which was not in fact best placed to offer optimal levels of quality and value⁴².

Specific questions raised in the Remedies Notice

What would be an appropriate timeframe for mandatory tendering?

- 3.23 For the reasons set out above, we believe that a ten year period would be the appropriate time frame. Any shorter period would be disproportionate: it would add to cost without any commensurate benefit.

Should the measure be subject to “comply or explain” implementation?

- 3.24 For the reasons set out above, the measure should be implemented on a “comply or explain” basis, and any other approach would be disproportionate and less practicable.

How should a valid “tender” and its constituents be defined, and how should access to relevant information be best provided on an “open book” basis?

- 3.25 In managing a tender process that allows bidders to have access to relevant information from the incumbent auditor, there needs to be an appropriate balance between necessary disclosure and appropriate retention of strategic and/or commercial information.
- 3.26 In our view, companies’ Audit Committees should be free to determine the tender process and devise appropriate criteria to select the auditor.

³⁹ Paragraph 9.256 of the PFs.

⁴⁰ Paragraph 9.50 of the PFs.

⁴¹ See paragraph 9.254 of the PFs.

⁴² As explained above, if it were *not* to happen, tendering costs would not fall as envisaged by the CC and such costs would have to be taken into account in an assessment of proportionality.

What costs and benefits would arise as a result of this remedy?

- 3.27 We have explained above the costs and benefits that we would expect to arise. In particular, we note that a remedy on a 10 year basis would give rise to no incremental cost, since this reform has been implemented by the FRC and forms the basis for company action going forward.

What should be the requirements for phasing in this remedy? For example, those companies with the longest period since last tender may be required to tender first within a specified period.

- 3.28 FTSE350 companies are already implementing the new FRC rules on tendering. Therefore audit firms are already operating in the “phase in” period. Given the combined impact of recent auditor appointments and recent audit partner rotations, we do not believe that there will be any undue “bunching” of tenders from the adoption of the FRC rules.

Are there any other relevant considerations to be taken into account in evaluating and implementing this remedy?

- 3.29 The composition of the FTSE 350 is not static. In determining how best to implement any of the remedies that the CC proposes, the Competition Commission will need to consider how to treat timing of tenders for new entrants to the index, which could arise from promotions and new listings. It will also need to determine protocols for determining tender dates following mergers and acquisitions (would it, for example, require a newly merged group to tender on the earlier or later tender date of its constituents, or some date in between?).

4. Remedy 2: mandatory rotation

Summary

- 4.1 This remedy would be less effective than mandatory tendering at addressing the concerns set out in the PFs than Remedy 1 (as currently implemented by the FRC).

Effectiveness

- 4.2 The mandatory rotation remedy would be ineffective in remedying the concerns set out in the PFs. The Remedies Notice states that it would address the AEC in three ways. In fact, none of these holds good:

- (a) first, the Remedies Notice states that it would realign the interest of auditors to compete to satisfy shareholder demand rather than management demand⁴³. We do not believe this to be the case, and the CC does not explain why it would do so. In fact, it is not clear why providing that an incumbent auditor cannot be reappointed (whether after a single or multiple terms) aligns the auditor’s interests with *any* party – whether shareholders, management or otherwise;
- (b) second, the Remedies Notice states that it would reduce barriers to non-top tier audit firm selection by providing greater opportunities for non-top tier firms to tender for FTSE 350 audits and reduce barriers to entry and expansion⁴⁴;

It will be apparent from the very formulation of this justification that it relates entirely to tendering and there would be no additional benefit from switching. The requirement to switch does not increase the number of opportunities for other firms – they have the same number of opportunities based on the requirement to tender the audit relationship

⁴³ Paragraph 31(a) of the Remedies Notice.

⁴⁴ Paragraph 31(b) of the Remedies Notice.

periodically⁴⁵. Neither does the requirement to switch increase the chances of participant firms winning. The CC's evidence shows that the average number of participants in a tender is three⁴⁶. Rotation would not necessarily change this average; and

- (c) third, the Remedies Notice states that it would remove (by overriding) barriers to more frequent tendering and so increase companies' bargaining power⁴⁷.

Once again, it will be clear that this justification relates entirely to tendering and not to switching. There is no sense in which a requirement to switch auditor will add to an effective mandatory tendering remedy. It is the act of tendering which the CC finds increases companies' bargaining power, as the PFs explain⁴⁸.

Taking the three points above together, it is demonstrable that this remedy is less effective than proposed in remedy 1 – mandatory tendering.

Proportionality

4.3 Mandatory rotation risks creating distortions of the market –which appear to constitute exactly the sort of distortions which a competition authority would in the ordinary course strongly resist and/or seek to remedy. These include:

- (a) the penalising of effective providers who win tenders, and then deliver a high quality service (which has a necessary investment cost) who are then precluded from bidding in the next tender round; and
- (b) perhaps most importantly, the reduction in choice and competition for companies. This has two dimensions: (i) the firm prohibited from bidding or acting may be the first choice of the company and its shareholders (for entirely objective and proper reasons), and yet cannot participate in the tender or take the role; and (ii) the tender will be less effective because it has one fewer (likely highly credible) competitor.

4.4 It is in this context that the failure of the PFs properly to identify the extent of any customer detriment becomes particularly significant. For such a distortive remedy (to say nothing of the direct costs), it would be incumbent on the CC to show very substantial customer detriment, which the remedy would effectively address. Given that the remedy is highly distortive and highly uncertain in its impact. Where this is the case, it is incumbent on the CC to ensure that it has the strongest evidence supporting its assessment. This is not the case here:

- (a) the link between the posited remedy and the alleged features of the AEC is not properly explained or evidenced, as we explain above⁴⁹. There is no evidence that this remedy would address any of these issues effectively; and
- (b) the evidence in the PFs as to the customer detriments that this remedy purports to address does not meet the required standard⁵⁰.

⁴⁵ We note in this context that the CC's data show that only 20% of companies who conduct a tender retain their current auditor, indicating that participation in a tender necessarily brings with it a meaningful prospect of winning the tender.

⁴⁶ Working Paper "Selection Process" – Paragraph 98.

⁴⁷ Paragraph 31(c) of the Remedies Notice.

⁴⁸ Paragraph 9.256 of the PFs.

⁴⁹ See further *Tesco v. Competition Commission* [2009] CAT 6, paragraph 146.

⁵⁰ See paragraph 2.1 above.

Opposition to mandatory rotation

4.5 The concept of mandatory rotation is opposed by many investors, companies and other stakeholders in the audit market. For example:

(a) the investor survey conducted by Oxera for BDO and Grant Thornton concluded that

*“Most investors were against mandatory rotation of audit firms.”*⁵¹

Investors gave several reasons for this view:

“1. poor-quality audit in the first year of tenure, as the new auditor has not yet become familiar with the specific complexities of the company being audited;

2. poor-quality audit in the final year of tenure, as the audit firm cannot be re-appointed and is perhaps focusing on pitching for new clients;

3. insufficient/inadequate audit resources available at the pre-specified time of rotation (‘flooding of the market’—ie, a demand/supply imbalance);

4. inappropriate timing of pre-specified rotation (eg, in a crisis);

*5. removal of control from the audit committee to choose the most appropriate audit firm.”*⁵²

(b) the UK’s Institutional Investor Committee – made up of representatives of from the Association of British Insurers, the Investment Management Association and the National Association of Pension Funds, which together manage or own £4 trillion of assets – set out in a paper⁵³ in December 2012 clear opposition to mandatory rotation. The paper commented that:

*“A mandatory rotation requirement could mean that companies are forced to switch auditor at a time when the existing auditor’s familiarity with the business would benefit the audit such as when there is a major acquisition or merger. It could also conceal the fact that the auditor has stood down for a particular reason and prevent an auditor being reappointed when they are the preferred choice of management and investors. They consider that it should be for a company, possibly through its audit committee of non-executives, to decide the best time to change auditor, in conjunction with its shareholders/investors. A mandatory rotation requirement disenfranchises both.”*⁵⁴

(c) a study⁵⁵ by Goethe University study showed only 17% of a broad range of stakeholders internationally support rotation; and

(d) 94% of approximately 600 letters that the US Public Company Accounting Oversight Board (PCAOB) received on its concept release exploring ways to enhance auditor independence opposed mandatory firm rotation.

⁵¹ See http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/oxera_investor_survey_report.pdf, paragraph 3.2.3.

⁵² Ibid.

⁵³ IIC (December 2012): “EU Audit Proposals – the Views of UK Institutional Investors”

⁵⁴ Ibid, page 3.

⁵⁵ Bocking et al, Chair of Auditing and Corporate Governance, Goethe University, Frankfurt, (2011): “Audit policy – lesson from the crisis”

- (e) companies and their representative bodies, such as the CBI, have also consistently opposed mandatory rotation. The CBI has commented that:

“We have estimated that if implemented in the UK, mandatory rotation every five years would add at least £55m per annum of costs to UK companies, without any guarantee that the audit would be awarded outside of the 'Big 4' audit providers.”⁵⁶

Customer benefits

- 4.6 The PFs note that there are certain benefits of current market behaviours with regard to switching. The PFs properly note the investment that an auditor and company make in one another: the PFs observe that *“companies do not lightly walk away from such a relationship”*.⁵⁷ These benefits would necessarily be lost in any proposal for mandatory rotation. Companies should be able to make an informed assessment of those benefits, properly assessed against the competing offers of alternative auditors as clearly established in a robust tender process.

Specific questions raised in the Remedies Notice

What might be an appropriate time frame for mandatory rotation, and how might this relate to mandatory tendering periods if this were also pursued?

- 4.7 We consider that mandatory rotation should not be implemented as a remedy to address the relevant alleged features of the market as there are other proposed remedies which are more effective at providing the desired remedies. However, if it were implemented, the rotation cycle time should be a multiple of the mandatory tendering cycle (but greater than one, or there would be no point in also implementing the dual remedy).

Should any such measure be subject to a waiver from the regulator (FRC) if a company's choice of auditor was substantially constrained and how would such a waiver operate?

- 4.8 Should the CC consider introducing mandatory rotation, we believe that a “comply or explain” basis would be the most appropriate, for the same reasons as set out in section 2 above: any other approach would be disproportionate. For completeness, were the CC to reject this, a form of waiver would be absolutely necessary to deal with individual FTSE 350 company circumstances which may from time to time constrain them from complying with the regulatory requirements.

- 4.9 If auditor rotation was mandated (without any waiver provisions), the risk is that it would make it very costly, to the detriment of shareholders, for some companies to comply with such auditor rotation. We therefore consider that a form of waiver is necessary to ensure that companies be able to benefit from a sufficiently flexible environment to deal with unpredictable situations that are beyond their control.

How should a valid “tender” and its constituents be defined, as a prelude to rotation, including whether and how best to provide access to relevant information on an “open book” basis?

- 4.10 See our comments on the same question in Section 2 above.

⁵⁶ See http://www.cbi.org.uk/media/1299735/cbi_position_paper_-_reform_of_the_audit_market_january_2012.pdf.

⁵⁷ Paragraph 9.173 of the PFs. As noted above, the evidence shows, though, that companies will switch auditor where they will get better outcomes from an alternative auditor (and we note above that tendering firms have only a 20% retention rate for the incumbent auditor).

What costs and benefits would arise as a result of this remedy?

- 4.11 We have explained above the costs and benefits that we would expect to arise. This remedy would add nothing to remedies otherwise proposed in the Remedies Notice and would impose very significant direct costs and distortions.
- 4.12 Mandatory rotation could improve investor perceptions of independence as it would avoid long tenure of auditors. However investor perception can equally be improved through mandatory tendering.

What should be the requirements for phasing in this remedy? For example, those companies with the longest period since last tender may be required to tender first within a specified period.

- 4.13 See our comments on the same question in Section 2 above.

Are there any other relevant considerations to be taken into account in evaluating and implementing this remedy?

- 4.14 The comments in Section 2 above apply.

5. Remedy 3: Expanded remit and/or frequency of AQRT reporting

Summary

- 5.1 In our response to the PFs we explain that the provisional finding that there is a “*significant, persistent and widespread concern regarding the quality of audits as identified by the AQRT*”⁵⁸ was not supported by any good evidence⁵⁹. However, Deloitte is generally supportive of steps which improve audit quality and the perception of audit quality and to that extent considers that this remedy would be broadly effective and proportionate.

Effectiveness

- 5.2 The Remedies Notice states that this remedy would address the AEC in two ways:
- (a) it would reduce barriers to switching through increased transparency and providing better information to companies on the quality of providers’ offerings, so allowing for better comparisons and increased incentives to compete on quality. While Deloitte continues to be of the view that companies are currently well able to assess audit quality, it welcomes measures that add to transparency with respect to audit quality, and considers that this remedy would achieve that aim; and
 - (b) it would reduce the role of executive management in the audit process by providing shareholders with more information on audit quality, so increasing incentives to compete to satisfy shareholder demand. Again, Deloitte welcomes transparency – for shareholders as well as for company decision-makers.
- 5.3 The effectiveness of the remedy will also depend, though, on its detailed implementation, which we address in more detail below.

⁵⁸ Paragraph 7.121 of the PFs.

⁵⁹ See section 2 above.

Proportionality

- 5.4 The Remedies Notice implicitly recognises that this remedy would give rise to costs, by virtue of extending the remit and role of the AQRT. The FRC's Final Plan and Budget⁶⁰ for 2012-13 showed Audit Inspection costs of £2.8m on top of Core Operating costs of £12.2m. These costs are met by the individual Recognised Supervisory Bodies that the firms are registered with. In the case of the reference market, the principal RSB is the ICAEW, which then recovers those costs from their members including the larger audit firms. As is evident, these costs are significant, which necessitates the need for a compelling reason to increase the remit and role of the AQRT materially.
- 5.5 We remain very strongly of the view that the PFs fail to set out any good evidence supporting the sweeping conclusion as to any lack of audit quality. In that light, it is important that any implementation of this remedy is not unduly costly, since it would otherwise be disproportionate.

Specific questions raised in the Remedies Notice

How frequently should FTSE 350 company audits be reviewed (and whether this should differ between FTSE 100 and FTSE 250 companies)?

- 5.6 The AQRT's published scope and objectives⁶¹ are to monitor the quality of the audits of listed and other major public interest entities (not just the reference market). In undertaking its monitoring role, the AQRT applies a risk-based approach in selecting individual audits for review, utilising a risk model covering listed and AIM listed entities. The model takes account of priority sectors, which are determined annually. The rationale for this is that certain entities are inherently more complex than others, and the risks and audit challenges necessarily vary across different industries and sectors. We agree with this approach as opposed to, for example distinguishing between entities solely on the basis of their market capitalisation at a point in time. However, it does create issues in relation to comparability of results, and whether they are representative of the market or a firm's performance as a whole, which we comment on below.
- 5.7 The AQRT's risk-based approach could be overlaid with an additional requirement that all FTSE 350 audits are subject to AQRT review at least once in every five years, as part of a rolling programme to ensure that the whole population is adequately covered over a period of time. We do not see the need to distinguish between FTSE100 and FTSE250 in this respect.

Should the AQRT be required to publish FTSE 350 results separately from other Public Interest Entity results?

- 5.8 We generally welcome more granularity in the AQRT's reporting, but there is a risk, if it is too detailed, that individual companies whose audits that have been reviewed by the AQRT could be identified. This could have wider implications for the individual companies and, accordingly, would require any move to providing greater detail to be balanced with safeguards to avoid companies being singled out in this way.
- 5.9 This risk is potentially greatest where an audit firm has a relatively low proportion of FTSE 350 audit clients. Within the larger firms, certainly the top tier firms, it should be possible for the AQRT to report on its reviews of FTSE 350 audits separately, both firm-by-firm and overall. We would be cautious about extending this further as the smaller sample sizes of audits reviewed at other audit firms increases the risk of individual audited entities being identified; here, the separation may well need to be in some form of aggregated report.

⁶⁰ <http://www.frc.org.uk/Our-Work/Publications/FRC-Board/FRC-Plan-and-Budget-2012-13.aspx>

⁶¹ <http://www.frc.org.uk/Our-Work/Conduct/Audit-Quality-Review.aspx>

Should the AQRT be required to change the scope of its review and if so, how? For example, should the AQRT be required to revisit key audit judgements based on the information then available?

- 5.10 The AQRT should continue to focus on assessing the judgements made by the auditor based on the evidence available to the auditor at the time of the audit rather than revisiting key audit judgements with the benefit of hindsight.

How could AQRT reporting be expanded to allow better comparison of Big 4 and non-Big-4 firms?

- 5.11 The purpose of AQRT reports as currently formulated is to promote improvement in audit quality. They are not designed to enable comparison between firms or audits and we therefore caution that the CC should not seek to use the reports in this manner as they are currently prepared. The CC should be aware of the following points:

- (a) the reports focus on identified areas of weakness and do not focus on areas of strength. Consequently the AQRT itself cautions that the reports should not be seen as a balanced scorecard or rating tool⁶²;
- (b) there is differing frequency of review with non-Big 4 firms not being reviewed on an annual basis; and
- (c) the scoring does not take into account the complexity of the engagement. A complex multinational organisation is treated and scored in exactly the same way as a simple investment fund.

- 5.12 These points would have to be addressed if the reports were to be used in the manner envisaged by the CC. Comparability of AQRT reports could be improved if some of the issues above could be addressed namely, increased frequency of review, developing a methodology for weighting complexity and balancing the reporting with both positive and negative findings.

How should any expanded remit of the AQRT be funded?

- 5.13 It seems likely that the costs associated with any expanded frequency would be funded by either an additional levy on audit firms or through a levy on FTSE 350 audited entities or a combination of both.

What costs and benefits would arise as a result of this remedy?

- 5.14 Please see our response above.

6. Remedy 4: prohibition of contractual clauses in template documents limiting choice to the Big 4 firms

Summary

- 6.1 The PFs, consistently with our own experience, find that instances of clauses limiting choice of auditor in the reference market are very limited⁶³. For that reason, we consider that the effect of this measure is likely to be limited, but costs are similarly likely to be limited.

⁶² Audit Quality Inspection Annual Report 2011/12, Appendix A

⁶³ See Appendix 7 to the PFs.

Effectiveness

- 6.2 The Remedies Notice states that this remedy would address the AEC in two ways:
- (a) it would increase companies' willingness to switch auditor by increasing the pool of permitted choices. To the extent that any reference market companies are so constrained (of which there is limited evidence⁶⁴), we agree that this would be effective; and
 - (b) it would reduce barriers to entry. Again, to the extent that these clauses are used in the reference market, we agree that this would be effective.

Proportionality

- 6.3 In spite of the limited benefits that we believe are likely to flow from this remedy, the costs are equally likely to be limited: they should be confined to some limited administrative or procedural costs, principally in the context of the LMA. If the CC wishes to extend its effect beyond the LMA context, it might require primary legislation (i.e. an amendment to the Companies Act 2006), which has more significant procedural costs, and would likely lead to a slower implementation⁶⁵.

7. Remedy 5: strengthen accountability of the external auditor to the audit committee

Summary

- 7.1 We are supportive of measures that work to strengthen the role of the audit committee and the accountability of the external auditor to the audit committee. We therefore support the principle of this remedy. However, it gives rise to a number of practical difficulties as currently formulated, which could give rise to disproportionate costs for companies.

Effectiveness

- 7.2 The Remedies Notice states that this remedy would be address the AEC in two ways:
- (a) by increasing the influence of the audit committee on the audit process by aligning external audit resources with the audit committee's particular responsibility to shareholders. We have noted in our submissions to the CC that we believe that the evidence shows that audit committees (and ACCs in particular) are very aware of their responsibility to shareholders⁶⁶, and we are supportive of measures that enhance this. In principle, measures which strengthen accountability of the external auditor to the audit committee should be effective in meeting this aim; and
 - (b) increasing the independence of the external auditor from executive management and reducing the influence of management on the audit process. We do not believe that the PFs set out good evidence that the incentives of management are not well aligned with the interests of shareholders, such that we remain sceptical that measures to divorce auditors from management will have any material effect and run a strong risk of having a detrimental impact on audit quality. To that extent, we believe that this remedy's effectiveness is likely to rest on the first effect identified by the CC rather than the second.

⁶⁴ See, in particular, the Cardiff Business School Report on Auditor Clauses in Loan Agreements, paragraph 60 *et seq.*

⁶⁵ That said, there would likely be some element of "soft convergence" prior to legislative implementation, by virtue of any recommendation from the CC.

⁶⁶ See Deloitte's response to the *Framework for the CC's assessment and revised theories of harm*.

Proportionality

- 7.3 The remedy will give rise to some direct and indirect costs.
- 7.4 First, it would give rise to certain direct costs in terms of the additional time commitment required of audit committee members, and ACCs in particular, and the consequent likely need for additional remuneration. Of more significance is the possibility that the additional time commitment could reduce the pool of suitably qualified persons willing to take on the role – the CC should ensure that it obtains a sufficiently detailed insight from reference market companies on this point.
- 7.5 Second, it appears to us that some of the detail of the proposed remedy would be likely to give rise to costs for companies because of a lack of practicability in some parts of the proposals. Specifically:
- (a) making the AC and the ACC solely responsible for all engagement management related matters (such as setting negotiating fees, authorising non-audit services, replacing the AEP etc) is disproportionate and unwieldy. A similar outcome could be achieved by making the AC and the ACC formally responsible for approving all decisions made in relation to auditor engagement management⁶⁷. This would have the impact of improving independence and oversight of the auditor relationship but also enable a three way dialogue between the finance director, audit committee and auditor to be maintained; and
 - (b) making the ACC the first point of contact if a material audit issue arose has significant practical difficulty. In practice, the finance director will need to be heavily involved in the investigation of an audit issue including the preliminary determination of the arguments for and against a particular accounting treatment. Recognising this difficulty, an alternative approach could be building into the Corporate Governance Code the requirement to report all material audit issues to the audit committee including details of how they were resolved⁶⁸.

Specific questions raised in the Remedies Notice

How this remedy could be practically specified and implemented? For example, what change to ACC availability and remuneration would be necessary for ACCs to take on an enhanced role effectively? How should this measure be specified to avoid circumvention?

- 7.6 As noted above:
- (a) this remedy will result in an increased time commitment for audit committees, particularly when coupled with the new UK Corporate Governance Code provisions in relation to fuller audit committee reporting on significant issues; and
 - (b) it may also impact on the willingness of suitably qualified persons to undertake this role.

Whether this remedy could be implemented as an extension to the current guidance on the role of the AC? How this could be implemented without affecting the current collective legal obligations of the directors of a company?

⁶⁷ This measure would augment the current position whereby the audit committee makes recommendations to the board as to auditor appointment.

⁶⁸ This would augment the current position whereby the audit committee is required to review and report to the board on any significant accounting issues. This measure would ensure that the audit committee was fully aware of any such issues.

- 7.7 The role of the audit committee and the ACC is currently set out in the Corporate Governance Code and, in particular, in the FRC's Guidance for Audit Committees. This remedy could be implemented by recommending to the FRC that the Guidance for Audit Committees be amended. This Guidance is widely respected by FTSE 350 companies. Alternatively, it could be implemented by recommending to the FRC to amend the existing provisions of the Corporate Governance Code which deal with the external audit relationship. This would subject the requirement to the more powerful "comply or explain" regime. We do not consider that legislation would be required.

What costs and benefits would arise as a result of this remedy?

- 7.8 See our comments above.

8. Remedy 6: enhanced shareholder-auditor engagement

Summary

- 8.1 We are supportive of initiatives to increase shareholder-auditor engagement and communication. This would increase awareness of the audit process, and go some way towards meeting the unmet demand from shareholders that the CC has identified.
- 8.2 We welcome the CC's acknowledgement that it should liaise closely with the FRC, major FTSE 350 shareholders and shareholder representative groups in shaping such a remedy. Additionally we think that it is important that the CC should involve the accountancy profession in this debate.

Effectiveness

- 8.3 The Remedies notes set out three bases upon which this remedy would address the AEC:
- (a) it would provide shareholders with enhanced opportunities to influence auditor appointment decisions through voting at AGMs. Assuming that investors make good use of the opportunities that would be afforded by virtue of this remedy, we agree that – in general it would be effective in this respect (although we have comments on the specific proposals discussed in the Remedies Notice which we set out below);
 - (b) it would provide shareholders with more information so that they can better assess audit quality and so more effectively exercise their rights to vote on auditor appointment. Again, assuming investors engage appropriately, the remedy should generally be effective in this respect also (again subject to our comments on specific suggestions below); and
 - (c) it would decrease the influence of management on auditor appointment decisions. As we have explained above, we do not believe that management decision-making has any negative effect in practice, and so consider that this remedy relies on the first two bases for its effectiveness.
- 8.4 We have specific comments on the effectiveness of each of the individual proposals discussed in the Remedies Notice:
- (a) *option to vote for holding a tender*: we are supportive of this proposal. We believe that the suggested remedy of giving shareholders the power to vote for a tender could be useful where shareholders have sufficient information on which to make a rationale decision on how to vote. This would include information in relation to the quality and effectiveness of the audit which could be provided by the proposed enhanced AQRT reporting;

- (b) *enhanced voting requirement to reappoint the incumbent following a tender*: we are unpersuaded that this would be an effective remedy. The power of shareholders to appoint the auditor (or refuse appointment of the auditor) on a majority basis is just as effective in addressing each of the points noted above at paragraph 8.3 above. We comment on the proportionality of this suggestion below;
- (c) *requiring AEP to present directly to shareholders at AGMs*: direct interaction between the AEP and individual shareholders, whether at the AGM or otherwise, is potentially an area where investors can obtain greater insight into the audit firm's approach to the delivery of high quality audits. Investors could seek answers to questions around firm's approach to the identification of audit risks, the way in which materiality is set, and the quality delivery and review processes in place.

However, were the AEP to engage in such specific dialogue, there are a number of practical and liability-related considerations that would need to be resolved:

- i. there would need to be a defined boundary between the AEP providing information about the audit process and providing company information which is best provided by other persons.
- ii. moving auditor's reporting into a freeform discussion poses a clear threat to audit quality, as it removes a series of layers of quality assurance, challenge and review that is associated with the current written report.
- iii. such an approach raises questions of transparency, since it would appear to favour those present at the meeting, rather than all shareholder (or even stakeholder) recipients of a formal written report.
- iv. there are a number of liability related issues, including the liability of the auditor in relation to providing information outside of an audit report and well as the consideration of the responsibility of the auditors to individual shareholders compared to the shareholder body as a whole, Ambiguity around liability would risk tipping the process into one whereby the AEP simply reads aloud the auditor's report, which is likely to serve as little more than an archaic formality rather than adding any value.

For these reasons, we believe that this suggestion requires more thought and consideration to become effective in practice; and

- (d) *requiring the ACC to have a dedicated Q&A agenda item at AGMs*: subject to our observations above on what information could be communicated in an AGM setting, we believe that this would be broadly effective.

Proportionality

- 8.5 In general, we do not think that the costs of this remedy would be high. Most of the suggestions could be accomplished without material cost to companies or to audit firms. They would therefore be broadly proportionate.
- 8.6 The exception is the suggestion of an enhanced majority requirement for auditor reappointment. We do not see how this could be effective and could have the effect of distorting the process of auditor reappointment (by introducing an uniquely high hurdle for one competing candidate auditor). It would also likely require primary legislation, which would reduce the extent to which it could become effective in a timely way. We consider that this suggested remedy would be disproportionate.

9. Remedy 7: enhanced reporting requirements in the audit committee report or the auditor's report

Summary

9.1 We are supportive of enhance reporting to shareholders as this will serve to improve shareholders' appreciation and understanding of audit quality. It should be effective and proportionate. The CC will be aware of existing workstreams to achieve this outcome and the CC should ensure that its remedy proposals are aligned with those workstreams. To the extent that the CC wishes further measures to be put in place, it should ensure that its aims are clear, consistent and not duplicative of reform efforts elsewhere.

Effectiveness

9.2 The Remedies Notice sets out two bases on which this remedy would address the AEC:

- (a) it would give shareholders better information so they can better exercise their rights at AGM: we agree that it would be effective on this basis; and
- (b) it would increase the visibility of audit quality and so reduce barriers to switching: while we are sceptical that such barriers are significant, we are supportive of measures to increase the visibility of audit quality and consider that this remedy would be effective on this basis.

Proportionality

9.3 The remedy is unlikely to lead to material costs if undertaken through FRC processes and so is broadly proportionate.

Specific questions raised in the Remedies Notice

How the CC may best support the FRC in establishing enhanced reporting and whether there are other avenues, including direct measures by the CC, that should also be pursued?

9.4 It is positive that the CC has acknowledged the on-going work of both the FRC and the IAASB in this area. These proposals, taken together with the enhanced audit committee reporting required under the UK Corporate Governance Code, should help to achieve the step change that investors and others users would like to see in audit committee and auditor reporting:

- (a) The FRC proposals in relation to auditor reporting are designed to respond to criticism that auditors' reports are uninformative. The most recent Consultation Paper relates to revisions to ISA 700 and would require auditors' reports to (i) describe the risks of material misstatement identified by the auditor, (ii) explain how the concept of materiality was applied and (iii) summarise the audit scope, with particular focus on how items (i) and (ii) were addressed; and
- (b) The IAASB proposals are wider, and consider the audit quality framework as a whole, as well as the audit committee reporting and that of auditors. The core considerations are similar, however, with a recommendation that these reports provide investors with greater insight into the activities of the audit committee, and more granularity around the issues considered and addressed by the audit.

9.5 At this stage it would not seem necessary for the CC to impose changes via a different route (e.g. legislation), but perhaps consideration could be given to a "backstop" measure in the unlikely event that the IAASB and FRC proposals do not lead to significant changes in reporting practice.

What should be the scope and form of enhanced reporting proposals? For example: Whether further disclosure should be made via the audit committee's report or the auditor's report

- 9.6 The FRC has recently changed the requirements for audit committee reporting and is consulting on potential changes to auditor reporting. We believe that this combination of reporting will provide investors with an improved set of information:
- (a) investors will understand the issues the audit committee have considered, which will need to have adequately addressed those matters communicated to them by the auditor; and
 - (b) investors will understand how the auditors identified risks and responded to them from reading the audit report.

What should the content of the additional disclosure should be? For example, should this be some form of commentary as to how the company's interpretation of the accounting standards compares with the norm; or commentary on the main topics of debate between auditor and management; or something else

- 9.7 We believe it is appropriate for the audit committee report to include a clear discussion of the audit committee's activities for the year, particularly in relation to the significant issues considered during the year and how they were addressed.
- 9.8 In relation to the audit report, we support the proposals set out by the FRC and the IAASB although, in our responses, we have raised some points for consideration in relation to certain definitions and key terms. Overall we support the provision of additional commentary on scope, materiality and audit issues.

What guidance as to the form of the disclosure should be required?

- 9.9 In order to discourage boilerplate disclosures and to encourage company-specific discussion, we consider that any guidance is best restricted to high level requirements, with further material provided to indicate factors to be considered in drafting.

What costs and benefits would arise as a result of this remedy?

- 9.10 See our comments above.

PART B: REMEDIES WHICH THE CC IS NOT MINDED TO CONSIDER FURTHER

10. Constraining non-audit service provision by the auditor or Introducing a limitation on non-audit fee income that may be earned by the auditor as a percentage of the audit fee

Summary

10.1 We agree with the CC that this proposal would be neither effective nor proportionate. None of the aspects of the AEC identified in the PFs bear on the issue of non-audit services (NAS) provision by the auditor

Effectiveness and proportionality

10.2 There is no aspect of the AEC identified in the PFs which would be addressed by this remedy. As the Remedies Notice explains, there is no evidence that the provision of NAS distorts the incentives on the auditor to adopt an appropriately independent approach⁶⁹. The PFs also found no concerns in relation to bundling of NAS and audit services⁷⁰.

10.3 Given this lack of effectiveness, the remedy would necessarily be disproportionate. The following factors should also be borne in mind:

- (a) effective regulatory measures are already in place in relation to the provision of NAS by an auditor;
- (b) firms have effective rules in place to maintain audit independence in the context of NAS provision⁷¹;
- (c) companies nowadays strongly police NAS provision by their auditor⁷²; and
- (d) such a remedy would also give rise to multiple additional costs and distortions:
 - (i) it would run the risk of reducing the competitor set for audit and/or NAS;
 - (ii) it could prevent companies selecting the most appropriate provider of audit services or NAS, with appropriate independence protections carefully respected; and
 - (iii) it may deprive companies of enhanced insights gained from the audit which are of relevance in their wider business.

It was for these reasons that a consultation by the Audit Practice Board in 2010 concluded that companies continue to value the ability to select their auditor for the provision of appropriate NAS, subject to appropriate constraints⁷³.

⁶⁹ Paragraph 71 of the Remedies Notice.

⁷⁰ Paragraph 12.6 of the PFs.

⁷¹ See Deloitte 2012 Audit Transparency Report at http://www.deloitte.com/view/en_GB/uk/about/annual-reports/index.htm.

⁷² This is well-evidenced in the case studies set out at Annex 2 to the PFs – see, for example, Case Study A, paragraph 48; Case Study B, paragraph 32, Case Study D, paragraph 44; Case Study F, paragraph 33; Case Study G, paragraph 47; and Case Study H, paragraph 45. See also [http://www.frc.org.uk/Our-Work/Publications/POB/Report-to-the-Secretary-of-State-for-Business-\(3\).aspx](http://www.frc.org.uk/Our-Work/Publications/POB/Report-to-the-Secretary-of-State-for-Business-(3).aspx).

⁷³ APB consultation on 'The provision of non-audit services by auditors' (July 2010).

11. Joint or major component audits

Summary

- 11.1 We agree with the CC that this proposal would be neither effective nor proportionate. It would not address effectively any aspect of the AEC set out in the PFs. Furthermore, there is widespread opposition to joint and/or major component audits from customers – both companies and shareholders – who recognise that it increases costs without adding to audit quality.

Effectiveness

- 11.2 A requirement for joint or component audit would not be effective in addressing any aspect of the AEC identified by the PFs or any aspect of the detriment identified by the PFs. The Remedies Notice raises three possibilities:
- (a) that it could increase companies' visibility of audit firm offerings, such that bargaining power would be increased. However, the PFs explain that visibility is achieved through the tendering process, which the PFs conclude is effective in creating dynamic competition⁷⁴;
 - (b) that it could reduce barriers to entry. However, there is no evidence that companies' behaviour in relation to auditor selection would change as a result of this remedy: companies would continue to select the auditors that they considered best placed to perform each aspect of the audit. Given the importance of the audit, there is no evidence that companies would be willing to select for a joint or major component audit any firm that they would not currently select to perform their audit. To the extent that a firm was well-placed to compete for a sole audit relationship, it would be competitive also for a joint or shared relationship; if it was not competitive for a sole audit relationship, it is hard to see why a firm would select it for a joint or shared audit relationship; and
 - (c) that it could enhance auditor independence. There is no reason to consider that this remedy would have any effect on auditor independence. The incentives of the auditor would be entirely unaffected.

In each case, the CC's concerns are more effectively addressed by other remedies within its package.

Proportionality

- 11.3 The CC correctly concludes that this remedy would generate costs disproportionate to its effect. It would lead to:
- (a) additional audit fees as a result of having two auditors for all or part of the audit; and
 - (b) additional switching and tendering costs.
- 11.4 There are also well-founded concerns that this remedy gives rise to additional risks to audit quality – specifically:
- (a) it is difficult for either firm to be in possession of the whole picture of the company's position and issues;
 - (b) there is a heightened risk of application of inconsistent audit methodologies; and
 - (c) there is a risk that issues or high risk items 'fall through the cracks', particularly where these are emerging and required additional scoping decisions during the year.

⁷⁴ Paragraph 9.241 of the PFs.

11.5 It is in the light of these risks that the historical evidence of undetected fraud under joint or component audits is most significant. Examples include BCCI, Parmalat and Polly Peck.

Opposition to this remedy

11.6 The above reasons explain the widespread opposition among customers – both companies and investors – to joint or major component audit. Some of this evidence is in front of the CC already:

- (a) a number of companies within the Case Studies proactively mention their opposition to joint or major component audit:
 - (i) “*twice the coverage but half the value*”⁷⁵; and
 - (ii) “*an added complication rather than an added assurance*”⁷⁶.
- (b) The Oxera investor survey report (conducted for BDO and Grant Thornton)⁷⁷:
 - (i) “*Investors expressed some concerns about joint audits, including whether two audit firms would coordinate effectively, and whether two auditors would delay any investigations into auditor liability*”
 - (ii) “*There are some concerns in relation to shared audits, including whether potential gaps in the responsibilities of each audit firm would emerge, and whether they would have any effect on changing the perceived status of non-Big Four audit firms.*”
 - (iii) “*We believe that we are best placed to ensure value and quality where we have clear and sole responsibility for delivery of the audit opinion.*”

11.7 The CC correctly notes that companies are currently free to choose a joint or major component audit model, but only a tiny minority choose to do so.

11.8 Further evidence of opposition is also extensive. For example:

- (a) ICAEW research among FTSE 100 ACCs in 2011 found that:

“*There is real opposition from audit committee chairs to joint audits. They have serious concerns about whether issues will ‘fall between the cracks’, the additional costs involved (paying two firms and the committee’s increased workload) and the challenges of two audit firms working effectively together.*”⁷⁸;
- (b) the Hundred Group have explained their opposition to joint audit in its submissions to the European Commission. The survey of its members showed 100% opposition to the concept of mandatory joint audits⁷⁹; and
- (c) overwhelming opposition to joint audit was reflected in the responses from corporates and investors to the European Commission’s consultation on its Green Paper, with a rejection rate of 86%⁸⁰.

⁷⁵ Company C case study, paragraph 10.

⁷⁶ Company G case study, paragraph 15.

⁷⁷ See http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/oxera_investor_survey_report.pdf.

⁷⁸ See <http://www.icaew.com/~media/Files/About-ICAEW/Newsroom/Accountancy/Features/icaew-1211-news-07-final.pdf>.

⁷⁹ See <http://one-hundred-group.production.investis.com/~media/Files/O/One-Hundred-Group/Attachments/Documents/100%20Group%20comment%20on%20draft%20european%20audit%20regulations%20final.pdf>.

⁸⁰ DT-MFQ-78-Summary of responses to EC Green Paper.

12. Shareholder group responsibility for auditor reappointment

- 12.1 The CC correctly identifies concerns as to this remedy's effectiveness and proportionality⁸¹. We also note that the evidence in front of the CC shows that investors do not want such a role. The Oxera investor survey (for Grant Thornton and BDO) found that:

*"the interviewees do not want any radical change to investors' degree of involvement in auditor selection."*⁸²

13. FRC responsibility for auditor appointment

- 13.1 The CC correctly identifies concerns as to this remedy's effectiveness and proportionality. We agree that it would risk giving rise to outcomes that were not in the best interest of companies or their shareholders. It would be a major departure from the established scheme of corporate governance in the UK, the case for which has not been made out.

14. Independently resourced Risk and Audit Committee

- 14.1 We agree with the CC that this proposal would be neither effective nor proportionate. Other remedies (particularly remedy 5) are more effective and more proportionate. This remedy would be likely to increase cost and bureaucracy without a commensurate improvement in outcomes for customers.

15. Packages of remedies

- 15.1 We have explained above that several of the remedies give rise to relatively low costs and would be effective in addressing the concerns set out in the PFs. In particular, a combination of remedies 1 (on the basis of a 10 year comply or explain approach), 3, 4, 5 (subject to the proposals for amendment set out above), 6 and 7 would form a wholly effective package to address the CC's concerns. Specifically:

- (a) remedies 1 (subject to amendment), 3, 4 and 5 (subject to amendment) would wholly address the CC's first theory of harm; and
- (b) remedies 3, 4, 5 (subject to amendment), 6 and 7 would wholly address the CC's second theory of harm.

Any package going beyond this would not represent the least costly and/or distortive package which is wholly effective in addressing the purported AEC, and so would be disproportionate.

⁸¹ Paragraph 81 of the Remedies Notice.

⁸² See http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/oxera_investor_survey_report.pdf, page i.

16. Conclusion

- 16.1 In our response to the PFs we set out our view that the evidence available to the CC does not support a finding, based on either theory of harm, that an AEC exists.
- 16.2 However, we support a combination of proposals as outlined above from the CC which support audit quality and generate good outcomes for FTSE 350 companies and their shareholders in a way which is proportionate and effective. We consider that a package reflecting the above principles would be a positive step for the industry and for customers and we are keen to participate in moving the debate forwards.
- 16.3 We are opposed to mandatory tendering on a basis different from the FRC's reforms, and do not believe that mandatory rotation would provide any additional benefit in addition to mandatory tendering as has been implemented recently by the FRC and could not be justified on the basis of the evidence set out in the PFs or the considerations in the Remedies Notice.
- 16.4 We look forward to discussing these issues further with the CC.