KPMG response to the Competition Commission's Remedies Notice

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KPMG's response to the Competition Commission's Remedies Notice

Executive summary

1 For the reasons given in our formal response to the Competition Commission (CC) Provisional Findings in the supply of statutory audit services to large companies market inquiry (the "Provisional Findings"), we do not accept that the Provisional Findings are well founded nor, therefore, that any remedies are justified by an Adverse Effect on Competition (AEC) finding. Our comments on the Remedies Notice are subject to that general comment.

2 In formulating remedies the CC must act proportionately. That in turn will depend on its final view on the suggested AEC. The CC has proposed a number of remedies options. Some of these will be more costly and carry greater risk than others. We encourage the CC to approach remedies from the perspective of the least degree of intervention that will address any concerns it finally determines. The CC ought also, in our view, to take into account the wider context of regulatory change driven by the Financial Reporting Council ("FRC") (and also to have regard to reforms being debated within the European Union). In short, the market and its regulation are developing at a rapid pace and if (as we believe is the case) other developments will address or render unnecessary CC remedies, in our view the CC should prefer forbearance.

3 The CC noted in its Provisional Findings that some companies are already able to exercise their bargaining power. The CC was however concerned that this was not true for all companies. And yet the CC also noted that all of the largest four audit firms have the incentives to pursue all clients in the reference market. We would therefore expect the CC to consider in more detail in the next phase of its investigation the characteristics of the companies who exercise their position effectively without further regulatory intervention so that it can consider whether there are ways of ensuring "best practice" on the demand side short of the extensive intervention contemplated by some of the possible remedies in the Remedies Notice.

4 Turning to specific remedies we summarise our detailed response here.

Mandatory tendering

5 We believe the FRC's comply or explain approach to mandatory tendering represents best standards of corporate governance and will address the CC's concerns that hitherto many companies have not regularly tendered the audit. To the extent that mandatory tendering is aimed at the first of the CC's theories of harm, we cannot see how the CC's approach adds to the bargaining power of the company any more than the FRC's approach. Even in the absence of a mandatory tendering requirement, if the audit firm fails to deliver best quality at best price in a way that is acceptable to the company and its shareholders, there will be a tender. That secures the company's bargaining position. Similarly in relation to the second of the CC's theories of harm we observe that there is generally a high standard of compliance with the UK Corporate Governance Code ("UKCGC") and companies are increasingly concerned to provide clear explanations to shareholders if, exceptionally, they do not believe it appropriate to comply. This means that audit firms will have to ensure both the company and its shareholders can appreciate the quality and independence of its service if the decision not to tender is to be explained.

6 Consequently we do not accept that the CC's proposal will achieve anything more than the FRC's new approach. Indeed we think it would be detrimental to the achievement of the CC's objectives for the reasons outlined below.

7 First, we think the CC's approach to mandatory tendering would reduce general competitive pressures in the market. If the CC's proposals were introduced the probability (and we would say near certainty) is that the inevitability of a tender at fixed intervals with no possibility of delay or explanation for not tendering will mean audit tenures will become fixed rather than variable. Competition between audit firms outside of tenders will become more limited. Companies' incentives to seek alternatives between tenders will reduce. The incentives on incumbents in the middle years between tenders would be less sharp. We currently pursue every commercial opportunity with our rivals' clients; fixed tender periods will mean in all likelihood that companies won't be interested in our approaches outside of tenders and will therefore limit our ability to compete aggressively.

8 Second, any predetermined time period will not be able to balance the costs and benefits of tendering for every company in the FTSE350. These will depend on both the size and complexity of the organisation and on when they last effected a change of auditor: what is appropriate for the 350th ranked company in the FTSE350 may not be appropriate for the company ranked 1st. There may also be specific circumstances such as change in company leadership, market activity or a critical business situation which makes it inappropriate to divert Audit Committee and/or management time to an audit tender.

9 Third, the CC needs to consider the costs involved. The CC has given an indication of the costs of investment by audit firms. Given the relatively small reduction in audit fees the CC expects from an increase in tendering rates[1] (which in any case we dispute), the remedy option cannot be judged to be proportionate. If the CC's answer to this is to say that the costs of tenders will be reduced by the use of "open book techniques" this is by no means proven as it will potentially increase the volume of information to be gathered and disseminated by the company and assimilated by each of the tendering firms. In addition such an approach will increase transparency of commercially sensitive aspects of an audit which may reduce competition and contribute (together with the increased regularity and predictability of tendering) to the creation of conditions in which tacit coordination may arise.

10 Fourth we do have concerns as to the possible effect on audit and tender quality that may result from overly increasing the frequency of tenders given the increased demands that will place on, say, the top 10 per cent of individuals in the profession. If audit quality overall is to be maintained at its current high standard throughout the market it will necessarily result in a reduction in the quality of individual tenders. However, to the extent that the CC believes the market will sustain an increase in frequency of tenders that maintain the same level of effectiveness as they currently have, some reduction in the total amount of the highest quality expertise brought to bear on audits may ensue. This implies that, contrary to the CC's expressed intentions in recommending this remedy, mandatory tendering will either not be effective in enhancing tender competition, or may result in lower quality of service being provided than might otherwise be the case.

[1] Paragraph 7.45 of the Provisional Findings.

11 Finally we would note that the CC has not considered whether its assumptions of the benefits of mandatory tendering are themselves based on the (in our view inaccurate) assumption that once they are mandatory and for relatively short periods, the degree of investment made in them by both companies and audit firms will be as great as with the more occasional but higher prize tenders that occur now.

Mandatory Rotation

12 We believe that mandatory audit firm rotation would be a disproportionate remedy because the AECs alleged by the CC could be addressed by remedies short of this. We explain this in the subsequent sections. Moreover mandatory rotation would impose serious economic costs, including a reduction in audit quality with no discernible benefits.

13 First, mandatory rotation by definition requires the incumbent supplier to be excluded from ongoing supply. That reduces competition and choice. In a market where the CC professes to have concerns about the range of choice, it is perverse to reduce that choice and competition by one, especially when that firm is likely to be a very (or even the most) credible bidder. Given that for some companies at least even the mid-tier firms do not see themselves as credible competitors this is effectively requiring companies to seek tenders from only three firms[2]. In some sectors the CC has commented that there are doubts by companies about the credibility of one of the largest four audit firms (and the mid-tier firms). In those sectors mandatory rotation is therefore pointing to competition between two firms. KPMG may often be one of those two firms and so may be a beneficiary of such a reduction of competition but for present purposes we merely point out that as a competition remedy this may have unintended consequences. The fact that this may affect banks and financial institutions which are of central importance to the economy is an observation relevant here and particularly in relation to the next point.

14 Second, the CC appears to recognise that on a switch, there is an increased risk of a fall in quality and a loss of efficiency. Mandatory rotation (unlike tendering on a mandatory or "comply or explain" basis) would require companies to take on that risk to quality

[2] Or only two firms if for some reason a company tendered before the end of the full mandatory term, meaning that the current incumbent and the previous incumbent are both disqualified from tendering.

and those extra costs even where neither the Audit Committee nor indeed their shareholders wish to do so. The CC may object that there will be no extra costs to companies because the audit firm will absorb those as part of the competitive process. However (given that audit tenures will be defined and are likely on average to decline) tendering and learning costs will increase and likely tenure will decrease for the audit firms, who will need to recover those costs in higher fees, providing less subsidy to companies for costs they face in transitioning to a new audit firm. With competition reduced to only three or fewer of the largest four audit firms (plus such mid-tier firms as may be credible) the risk of higher fees must be real. So far as quality is concerned it is clear that learning effects are capable of being an ongoing process. The risk of poorer quality audits in the early years is therefore accompanied by the certainty that the learning process will be limited to the duration of the mandatory rotation period. Further, any reduction in audit quality is likely to lead to an increase in companies' cost of capital, which imposes substantial costs not only on companies but on the economy as a whole.

15 Third, the CC has not articulated its view of what impact mandatory rotation would have on a company's bargaining power in the final years of the relationship. It may be said that price will be fixed in advance, but the scope of audit may change and so price will need renegotiating. Since the incumbent has no prospect of repeat audit business at the expiry of the fixed period, its incentives must change in that period. If the CC believes that it would be self-defeating for an incumbent to behave exploitatively in that year because of its position supplying Non Audit Services ("NASs") or because of the visibility of that behaviour to non-executive directors, who may be potential clients at other companies, then we would agree that those factors apply now and therefore undermine the CC's view of the AEC ab initio. However, it is far from evident that incentives that work under indefinite tenure would remain if rotation was mandatory.

16 We therefore conclude that this remedy option should be discarded.

The CC's other remedies

17 With regard to the other remedies proposed by the CC, while we do not think they would be needed to address any alleged AEC, we see the potential for these to increase audit quality without distorting the market. We would therefore broadly welcome the

implementation of these remedies, although we note that certain practical considerations must be taken into account in the design of the precise form of the remedy so that they do not impose disproportionate costs and burdens. We look forward to engaging with the CC further on these points.

1 Introduction

1.1 For the reasons given in our formal response to the CC's Provisional Findings, we do not accept that the Provisional Findings are well founded nor, therefore, that any remedies are justified by an AEC finding. Our comments on the Remedies Notice are subject to that general comment.

1.2 As a result, the CC can have no basis for imposing any remedies in the market for supply of statutory audit services as a result of any AEC finding. In principle we support any cost effective measures that improve audit quality. However, in our view mandatory tendering and rotation at frequent fixed intervals (without a comply or explain provision) would have a negative impact on both quality and costs and therefore lead to worse outcomes for companies and the economy as a whole, and so we are strongly against these options on any basis.

1.3 This paper sets out our response to the CC's Remedies Notice. We provide our views and evidence on the seven remedies options that the CC proposes to consider. We also provide high level views on those remedies that the CC proposes not to consider.

1.4 In considering any potential remedies the CC is required to determine whether its remedies would be effective in achieving their aims and whether they would be proportionate. In considering proportionality the CC's draft revised market investigation guidelines[3] state that a proportionate remedy is one that:

- is effective in achieving its legitimate aim;
- is no more onerous than is needed to achieve its aim;
- is the least onerous if there is a choice between several effective measures; and
- does not produce disadvantages which are disproportionate to the aim.

1.5 In considering proportionality it is therefore incumbent on the CC to conduct a thorough assessment of the expected costs and benefits of each of the remedies options, and of any remedies package it considers.

[3] Paragraph 337 of the CC's draft revised market investigation guidelines.

1.6 We find that mandatory tendering and rotation in particular would be associated with substantial economic costs:

- We have illustratively quantified part of the economic cost associated with the CC's mandatory tendering for FTSE350 companies remedy option, compared to the FRC's changes to the UKCGC, as £[41 – 51] million per year or £[85 – 95] million per year if implemented on a seven or five year basis respectively[4]. This includes the costs to audit firms of participating in tenders, costs to companies' management of conducting tenders and reduction in competitive pressures outside of prescribed tender intervals. We note that these cost estimates do not include any costs associated with increased rates of switching. However, to the extent that the CC believes that this remedy option will lead to a greater rate of switching, some or all of the costs associated with mandatory rotation will also apply in relation to mandatory tendering.
- We have not quantified all of the economic costs that in our view would be associated with the CC's mandatory tendering remedy option (compared to the FRC's changes to the UKCGC). These unquantified costs include reduced quality of audit tenders and, to the extent that the CC believes that tender effectiveness will be sustained even with an increase in tender frequency, a reduction in audit quality. Furthermore, there are likely to be reduced incentives for audit firms to innovate and increased administrative costs associated with resolving NAS conflicts and independence issues. We expect these costs to be substantial. The CC will need to take these into account in its assessment of the proportionality of this remedy option.
- We have illustratively quantified part of the economic cost associated with mandatory rotation as £66 million, £54 million or £46 million per annum if the remedy was implemented on a seven, 10 or 14 year basis respectively[5], as well as a cost to the UK economy associated with increasing FTSE350 companies' cost of capital in the region of £1 billion. This includes costs associated with the investment on the part of audit firms and FTSE350 companies in the audit firm learning about a company's business at the beginning of an engagement, reduction in the competitive pressure on audit firms outside of mandatory rotation windows, and the impact of a reduction in audit quality. We note that this relates only to the incremental cost associated with mandatory rotation – if the CC were to implement a remedy package combining mandatory tendering (of a greater frequency than the mandated tenure) with mandatory rotation these costs would apply on top of those associated with mandatory tendering.

1.7 We note that these figures represent only those costs that we have been able to identify and estimate in the time we have had available. We reserve the right to respond further on the methodologies used to quantify these costs and the categories of costs themselves.

[4] See paragraph 3.2.1.3 below.
[5] See paragraph 4.2.1.1 below.

1.8 As a result of these costs our view is that even if the CC confirms its Provisional Findings and concludes that there is an AEC in the supply of statutory audit services (which we argue there is not), the CC cannot reasonably conclude that the remedies of mandatory tendering and / or rotation it proposes are proportionate[6].

1.9 In our view it is also important to note that the CC has not sought in these remedies to address directly some of the features it identifies. While remedies options three to seven seek to address a supposed misalignment of incentives between audit firms and shareholders, none of the CC's remedies seek to address directly the following features the CC provisionally identifies: it is difficult for companies to judge audit quality outside of a tender process in advance due to the nature of audit; companies and firms will not lightly lose the benefits of continuity stemming from the relationship; company management face significant opportunity costs in the management time involved in the selection and education of a new auditor. We disagree that these are features that give rise to an AEC, but we also note that the CC's remedies options do not in the main seek to address them. While the CC may consider that tendering leads to better information, it is by no means clear that any improvement is commensurate with the cost and the CC has not really considered whether there would be other ways of improving the ability for companies to compare the offering of firms, without the need for a full-scale tender process.

1.10 The CC's draft revised market investigation guidelines state that "Remedies can remedy, mitigate or prevent the AEC or its detrimental effects on customers. The clear preference of the CC is to deal comprehensively with the cause or causes of AECs wherever possible, and by this means significantly increase competitive pressures in a market within a reasonable period of time"[7]. As explained above, in considering mandatory tendering and mandatory rotation as remedies options the CC does not seek to deal comprehensively with the cause of the AEC it provisionally identifies.

1.11 Moreover, in considering mandatory tendering and rotation neither is the CC seeking to remedy a direct customer outcome. Rates of tendering and switching are not in

[6] For example, these costs substantially outweigh the CC's estimated fee savings from more frequent switching, as set out in paragraph 7.45 – 7.46 of the Provisional Findings (which in any case we dispute, as summarised in section 2 below).
[7] Paragraph 323 of the CC's draft revised market investigation guidelines.

themselves determinative of customer benefits, which are instead derived from quality and overall value for money.

1.12 In other words, the CC has not sought to explore whether there are ways of directly addressing any information asymmetries or switching costs it has provisionally identified, nor the customer outcomes it alleges flow from the AEC it has provisionally found. The CC has not therefore considered whether there are other, less onerous, remedies options than the mandatory tendering and rotation remedies that it is considering. Instead, the CC appears to be considering remedies options, specifically mandatory tendering and rotation, that have already been discussed in other contexts or by other institutions in relation to the supply of statutory audit services, and has made no attempt to link them coherently to their own theories of harm or alleged features. This will fundamentally undermine the CC's effectiveness and proportionality assessment.

1.13 The rest of this response is structured as follows:

- In section 2 we set out our view that the CC has not established that there is any customer detriment in the supply of statutory audit services.
- In section 3 we set out our views on the mandatory tendering remedy option that the CC is considering. We discuss our views on the effectiveness of the remedy option and the economic costs to which it will lead.
- In section 4 we set out our views on the mandatory rotation remedy option that the CC is considering. We discuss our views on the effectiveness of the remedy option and the economic costs to which it will lead.
- In sections 5 to 8 we then set out our views on the other remedies options that the CC is considering. Overall, as we set out in paragraph 1.2 above, although we do not believe that these remedies are necessary because we dispute the CC's provisional AEC finding, we nevertheless favour these remedies if they will lead to an improvement in audit quality in a cost effective manner. We therefore discuss our views on some important practical details in their implementation.

2 Insufficient evidence of any customer detriment

2.1 We discussed the CC's evidence on outcomes in the supply of statutory audit services in section 2 of our response to the CC's Provisional Findings. In relation to outcomes our key points were:

- The CC acknowledges that it can find no reliable evidence of excess profits[8] on the part of audit firms and that there are various benign explanations for the patterns of pricing it observes[9]. When the CC considers variable engagement profitability the CC admits it has not tested whether complexity and/ or risk may explain the differences across engagements. Therefore, there is insufficient quality in the evidence on these key points for the CC to conclude, to the requisite level, that there is an AEC.
- The CC notes that a choice among four firms may suffice for competition[10] and indeed notes that efficient tendering may require no more than three or four bids for competition to be strong[11]. These observations show that there is no reliable evidence of customer detriment arising from any lack of choice or from the current levels of concentration in the supply of statutory audit services.
- On quality, the CC concedes that the case study evidence was generally positive and refers to the AQRT's view that ex post quality control reviews are indicative of a generally high level of quality. The CC is incorrect in extrapolating from isolated instances in errors of judgement calls to more general and fundamental failures of quality. Therefore the evidence on quality is not of a sufficient standard to support an AEC.
- The CC attributes those isolated errors of judgement to a loss of audit firm scepticism although it is difficult to assess on what basis; as they note this is heavily disputed by the audit firms and any rationale they have for this has been almost entirely redacted. In addition and with no evidentiary basis at all they conflate loss of professional scepticism with losses of independence, and necessary cooperation with management as a relationship that is overly consensual. The CC therefore lacks robust evidence to show that there is any customer detriment as a result of a lack of audit firm independence.
- The CC has evidence of extensive process innovation in the supply of audit services. It incorrectly dismisses this evidence of innovation, failing to realise that it brings important benefits to customers (including shareholders) and that much of this innovation also impacts directly on the audit product. The CC's conclusion that the level of innovation in the supply of audit services is indicative of an AEC is therefore without reliable evidentiary support.
- Finally, the CC has incorrectly characterised the existence of unmet demand in relation to audit services as a function of competition. Furthermore, audit firms are

[8] Paragraph 7.70 of the Provisional Findings.
[9] Paragraphs 7.36, 7.44 and 7.53 of the Provisional Findings.
[10] Paragraphs 9.23, 9.56 of the Provisional Findings.
[11] Paragraph 9.56 of the Provisional Findings.

engaged with developing the statutory audit product, but this requires consensus and, likely, regulation.

2.2 As a result the CC has no reliable evidence of any customer and shareholder detriment arising from the AECs it alleges and no reliable quantification of it. The CC argues in the Provisional Findings that companies might be able to obtain fee savings of 11 per cent if they switched every three years. As we set out in our response to the Provisional Findings the CC's argument is fundamentally flawed as current discounts offered to companies would be unlikely to be maintained if switching rates increased as a result of mandatory rotation. Furthermore, we set out in sections 4.2.3 and 4.2.4 below that mandatory rotation will lead to reduced competitive pressure and reduced choice, further undermining the CC's argument in relation to the potential benefits from this remedy option.

2.3 Against this background, even very small costs associated with the CC's remedies would be sufficient to make them disproportionate. In fact, the costs of the mandatory tendering and / or rotation remedies options are substantial, as in our view these remedies would seriously undermine quality, as well as imposing significant costs on companies and the broader economy. This clearly undermines the case for these remedies when their effectiveness and proportionality are considered.

2.4 With regard to the other remedies proposed by the CC, while we do not think they would be needed to address any alleged AEC, we see the potential for these to increase audit quality without distorting the market. We would therefore broadly welcome the implementation of these remedies, although we note that certain practical considerations must be taken into account in the design of the precise form of the remedy so that they do not impose disproportionate costs. We look forward to engaging with the CC further on these points.

3 Mandatory tendering

3.1 Our views on the CC's rationale for and effectiveness of the remedy option

3.1.1 The CC proposes to consider mandatory tendering as a remedy to address the alleged AEC in order to "ensure that companies assess the quality, price and innovation of their

existing auditor, compared with other options, on a more frequent basis"[12]. However, as we set out in section 3 of our response to the Provisional Findings, companies are able to and do compare their alternatives and apply effective bargaining power on their incumbent audit providers and therefore no remedy is required.

3.1.2 Furthermore, it is important that the CC takes account of existing regulatory changes in considering the effectiveness of further regulatory interventions. The CC recognises that the FRC has recently revised the UKCGC, which means that FTSE350 companies should put their statutory audit out to tender at least every ten years, or explain why they have not done so[13]. However, the CC states that it is minded at this stage to go further than the FRC's recent changes. In particular:

- The CC considers that a shorter period between tenders may be required and suggests at this stage that it will consider periods of five or seven years[14].
- The CC states that it does not currently favour tendering on "a comply or explain" basis but rather considers that the increased frequency of tendering should have mandatory force[15].
- The CC considers that tenders should be conducted on an "open book" basis[16].

3.1.3 In our view, each of these additions to the FRC's recent changes are damaging, in particular the mandatory element which disenfranchises ACs – the body charged with protecting the shareholders' interests. We discuss the likely costs associated with these additions to the FRC measures in the next section. Mandatory tendering is also not effective at increasing competitive pressure on audit firms. Increasing the rate of tendering is actually likely to reduce the competitiveness of tenders.

3.1.4 Following the amendments to the UKCGC, discussions of companies' statutory audit provision within their annual reports have increased. In addition, since the introduction of the changes, we are aware of five completed audit tender processes by companies in the FTSE350 since September 2012; three of which have taken place within the FTSE100. These include Royal Sun Alliance Insurance Plc (won by KPMG from Deloitte), Schroders Plc (won by KPMG from PwC) and ITV Plc (retained by KPMG).

[12] Paragraph 18 of the Remedies Notice.
[13] Financial Reporting Council, 'The UK Corporate Governance Code' (September 2012), paragraph C.3.7.
[14] Paragraphs 19 – 20 of the Remedies Notice.
[15] Paragraph 21 of the Remedies Notice.
[16] Paragraph 22 of the Remedies Notice.

In addition, a number of companies have signalled their intention to initiate a tender process. HSBC Plc, Compass Group Plc, Domino Printing Sciences Plc, Foreign Colonial Investment Trust Plc and Ladbrokes Plc have all recently stated they will tender their audits within the next three years. We would expect the number of companies signalling their intentions to tender their audits, or providing detailed considerations of their decision to reinstate their incumbent audit firm in the short term to increase dramatically as the full population of companies' first annual reports subsequent to the publication of the UKCGC becomes available.

3.1.5 The CC's extensions to the FRC's recent changes to the UKCGC are therefore not required to increase the rate of tendering from its current levels or change the bargaining positions of clients. In our view it is crucial that the CC allows the impact of these changes time to develop and to take effect rather than moving at this stage to impose further requirements on FTSE350 companies.

3.1.6 In the next sections we set out all the costs associated with this remedy which the CC will need to take into account as part of its proportionality assessment.

3.2 Economic costs associated with the remedy option

3.2.1 Introduction and summary

3.2.1.1 There is no evidence to support the particular time periods suggested by the CC, over and above the ten year period already suggested by the FRC. In particular, companies' needs and their cost benefit assessment of when and whether to tender their audit will vary according to the size and complexity of the audit, and a large range of other circumstances. For that reason, mandatory tendering at any fixed interval, rather than a 'comply or explain' provision, will remove the ability to choose the appropriate timeframe from the hands of companies' ACs (who are best suited to make this choice taking into account their duty to shareholders), and has the potential to impose significant inefficiencies.

3.2.1.2 Any proposal for mandatory tendering must therefore take into account the varying needs of companies and the differences in the costs associated with tendering for different companies. Therefore the mandatory tendering timeframe chosen (if there is no comply or explain provision) must be long enough to meet the needs of all, or

substantially all, companies – we expect this to be a lot longer than five or seven years or even possibly the 10 years in the UKCGC. For some of the largest audit engagements there is substantial time required in order for the audit firm to appropriately understand the business and maximise efficiencies. A fixed interval of five or seven years, with no comply or explain provision, would not allow companies to obtain the most efficient relationships with their audit firms, especially in relation to particularly large and complex audits of which there are many in the FTSE350. Furthermore in certain circumstances, such as when a company is undertaking a major acquisition or an initial public offering, it is inappropriate and hugely inefficient to divert management time towards an audit tender[17]. These costs necessarily imply that any mandatory provision on tendering is bound to be disproportionate.

3.2.1.3 In the rest of this section we set out the following costs that are associated with the CC's mandatory tendering remedy option:

- based on the CC's estimate of the cost to an audit firm of participating in a tender[18], the costs to all audit firms of participating in additional tenders over and above the current requirements of the FRC UKCGC, amount to approximately £[26 – 36] million (under a seven year mandatory tendering remedy) and £[60 – 70] million (under a five year mandatory tendering remedy) per year[19];
- costs to FTSE350 companies of conducting additional tenders, which we estimate to amount to approximately £6.6 million (under a seven year mandatory tendering remedy) and £15.4 million (under a five year mandatory tendering remedy) in total per year[20];

[17] In this regard we note the FRC's views on 'comply or explain' as set out in the CGC:
"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."

[18] Ie, the CC found that the costs of tendering are on average 23 to 57 per cent of the first year audit fee (paragraph 5(d) of Appendix 24 of the Provisional Findings).

[19] We take the CC's estimates of the cost to audit firms of participating in a tender and multiply this by the CC's estimate of the average audit fee. We assume three audit firms tender in the process. This gives a lower bound estimate of £986,700 (corresponding to the lower bound of the CC's estimate of the costs to audit firms of participating in a tender), an upper bound estimate of £2,445,300 (corresponding to the upper bound of the CC's estimate of the costs to audit firms of participating in a tender) and an average of £1,716,000 per tender. We multiply £1,716,000 with an additional 15 tenders under a seven year mandatory tendering remedy and an additional 35 tenders under a five year mandatory tendering remedy, compared to the current FRS UKCGC.

[20] Using figures from the European Commission (2011), Impact assessment on a proposal for Regulation of the European Parliament and of the Council on specific requirements regarding statutory audit of public-interest entities, Annex 20, 21, and 22.

- a reduction in competitive pressure outside of prescribed tender windows, which we estimate might be associated with an economic cost of at least £8 million in total per year[21];
- a reduction in the quality of tender processes, the impact of which we expect to be very significant;
- to the extent that the CC thinks the effectiveness of tendering will be preserved at current levels, a reduction in the quality of audit services as the most highly skilled resources are diverted away from audit work, the impact of which we again could be significant even given the firms' quality controls and also has adverse consequences for innovation and investor confidence as we set out in the next bullets;
- additional risks associated with "open book" tendering, the impact of which we again expect to be substantial; and
- an increase in administrative costs associated with resolution of independence and conflicts issues in relation to NASs and personal independence, which we have not precisely quantified but which we have shown to be substantial.

3.2.1.4 Overall, therefore we have been able to quantify part of the costs of the CC's mandatory tendering remedy option as £[41 – 51] million or £[85 – 95] million per year depending on whether any such remedy is implemented on a seven or five year basis respectively. We would consider it likely that a significant proportion, if not all, of the costs incurred by audit firms will be passed on to customers and shareholders by audit firms, adding to the costs incurred directly by them and to the UK economy as a whole.

3.2.1.5 However, on top of this the remedy will lead to substantial costs associated with reductions in quality and loss of investor confidence which the CC must also take into account.

3.2.2 Costs to audit firms of participating in additional tenders

3.2.2.1 Audit firms incur substantial costs in order to participate in a tender. As recognised by the CC, direct costs include the time spent understanding the clients' audit requirements through preparatory meetings and calls[22], in addition to the time spent preparing the proposal, attending the client pitch and receiving feedback on the tender outcome[23]. The CC estimates that time devoted to the tender process is, on average, 943 hours[24], although it recognises that this varies substantially across the tenders it has analysed,

[21] See section 3.2.5 below.
[22] Paragraph 54 of Appendix 23 of the Provisional Findings.
[23] Paragraphs 4, 9 and 20 of Appendix 23 of the Provisional Findings.
[24] Paragraph 26 of Appendix 24 of the Provisional Findings.

from 70 hours to 4,851 hours[25]. Further, the CC's analysis of information on tendering provided by audit firms demonstrates that senior resource comprises a greater proportion of the team involved in preparing the tender than would be required to deliver the audit, with partner time accounting for 30 to 35 per cent of the hours spent by audit firms preparing a tender[26].

3.2.2.2 Overall, the CC finds that the staff cost of preparing a tender comprises, on average, 23 to 57 per cent of first year audit fees[27], although it recognises that the ratio of costs to audit fees may in fact be "*considerably higher*"[28] and that in some cases the tender dataset indicated that the costs may exceed the first year audit fees[29].

3.2.2.3 Importantly, the above costs are estimated *per audit firm*. The total time and costs to audit firms of participating in a tendering process are therefore significantly higher since the CC's analysis of the tender dataset suggests that, on average, three firms participated in each of the tenders analysed[30]. Accordingly, using the information in the CC's Provisional Findings, it is possible to arrive at an estimate of total staff costs to all audit firms of participating in tenders of, on average, 69 to 171 per cent of first year audit fees[31].

3.2.2.4 The CC concludes that the cost estimates derived from its analysis of the tender dataset outlined above may overstate the costs of participating in the tender process. Since the CC has estimated the costs of participating in a tender using audit firms' scale rates, it suggests that this might overstate the true opportunity costs of time spent by audit staff preparing tenders. This is because the CC considers that the total time devoted by audit staff to the tenders analysed may not have been dedicated to audit work, or could not have been billed in its entirety at full scale rates[32]. However, we note that given that tendering will be more frequent due to mandatory tendering it is even more likely that audit firms will have to divert resources from audit work or other client engagements in order to participate in tenders. Accordingly, it is not clear that the CC's estimates are

[25] Paragraph 26 of Appendix 24 of the Provisional Findings.
[26] Paragraph 33 of Appendix 24 of the Provisional Findings.
[27] Paragraph 36 of Appendix 24 of the Provisional Findings.
[28] Paragraph 36 of Appendix 24 of the Provisional Findings.
[29] Paragraph 39 of Appendix 24 of the Provisional Findings.
[30] Paragraph 18 of Appendix 24 of the Provisional Findings.
[31] This is arrived at by multiplying the per-firm costs of participating in a tender by the average number of bidders per tender.
[32] Paragraph 37 of Appendix 24 of the Provisional Findings.

likely to overstate the costs to audit firms of participating in the tender process under mandatory tendering.

3.2.2.5 We therefore derive a range of the total costs to an estimated three audit firms of participating in a single tender process of between approximately £990,000 and £2,400,000, with an average cost of £1,700,000 per tender[33]. These cost estimates assume the current level of effort and resource on the part of audit firms. To the extent that mandatory tendering reduces the effort and resource that audit firms devote to tendering, the CC will need to take into account the impact of that reduction on the quality of tender processes

3.2.2.6 The cost of the CC's mandatory tendering remedy associated with the costs to audit firms of participating in tenders will therefore be the cost to all audit firms of participating in a tender, multiplied by the increased number of tenders that the CC expects to arise as a result of the remedy. The tender dataset analysed by the CC included between 83 and 103 FTSE350 audit tenders over a four year period from 2007 to 2011[34], which the CC finds amounts to an average of ten tenders per year. However, given the measures recently imposed by the FRC it is reasonable to suppose that this rate of tendering will increase even in the absence of the CC's proposed remedy. If companies on average tender their audit every 10 years, under the new UK Corporate Governance Code, then this is likely to correspond to an average of at most 35 FTSE350 tenders per year (since under the FRC proposals companies can exceptionally 'explain' rather than 'comply'). If firms are required to tender every five or seven years, the number of tenders in any given year is likely to increase to an average of between 50 and 70 tenders per year for FTSE 350 companies. Therefore the CC's proposals are likely to lead to an increase in the annual number of at least 15 (for the CC's proposal of mandatory tendering every seven years) or 35 (for the CC's proposal of mandatory tendering every five years).

[33] We take the CC's estimates of the cost to audit firms of participating in a tender and multiply this by the CC's estimate of the average audit fee. We assume three audit firms tender in the process. This gives a lower bound estimate of £986,700 (corresponding to the lower bound of the CC's estimate of the costs to audit firms of participating in a tender), an upper bound estimate of £2,445,300 (corresponding to the upper bound of the CC's estimate of the costs to audit firms of participating in a tender) and an average of £1,716,000 per tender.
[34] Paragraph 7.21 of the Provisional Findings.

3.2.2.7 Therefore, we have estimated that the total costs to audit firms of participating in extra tenders as a result of the CC's mandatory tendering remedies option, compared to the changes already implemented in the FRC's revisions to the UKCGC, to be approximately £26 million or £60 million per year[35], if the remedy is implemented on a seven or five yearly basis respectively.

3.2.2.8 However, it is important that the CC also recognises that evidence from past tenders is unlikely to accurately reflect the full costs to audit firms of participating in tenders under a mandatory tendering regime. If auditors are to maintain the same level of quality on their existing audits, any increase in the amount of proposal and tendering work over and above current levels is likely to have a material impact on the staff requirements of audit firms. Following the introduction of mandatory tendering, it is therefore likely that audit firms would be required to hire additional professional staff to manage the increased tender workload. If it is unlikely that audit firms will be able to hire the necessary number of professional staff (in particular highly skilled senior resources) to manage this increased workload, this will have a detrimental impact on audit quality, as discussed in section 3.2.7 below. We have not included the costs of any additional professional staff in our calculations, nor the potential impact on professional staff salaries arising due to increased demand in the market, but the CC will need to take any additional professional staff that are required into account in its proportionality assessment of this remedy.

3.2.2.9 Aside from any additional professional staff that are required to deal with the increased tender workload, we would need to increase the resources of our bid team, whose work is dedicated to support tenders and proposals. This team would require more staff and resources in the event of an increased number of tenders (which are not included in the CC's estimates of the cost to an audit firm of participating in a tender).

[35] The estimated figures are £25,740,000 and £60,060,000. These are based on the average cost to all firms tendering per tender, calculated in paragraph 3.2.2.5, multiplied by 15 for the lower bound (attributable to the CC's proposal of mandatory tendering every seven years) and 35 for the upper bound (attributable to the CC's proposal of mandatory tendering every five years). We also derived estimates based on the CC's lower bound estimate of the cost of tendering: 23 per cent of first year audit fees; and its upper bound of the cost of tendering: 57 per cent of first year audit fees. Under mandatory tendering every seven years, we estimate the lower bound of total additional costs to audit firms from participating in extra tenders to be £14,800,500, and the upper bound to be £36,679,500. Under mandatory tendering every five years, we estimate the lower bound of total additional costs to audit firms to be £34,534,500 and the upper bound to be £85,585,500.

3.2.2.10 The dedicated bid team is currently composed of [✂] members of staff[36] with salary costs of approximately £[✂] million per year[37]. This team spends approximately [✂] per cent of its time exclusively on FTSE350 audit tenders. In response to the anticipated increased rate of tendering as a result of the changes to the UKCGC (see paragraph 3.2.2.6 above), we have already committed to employing a further [✂] members of staff[38] in the dedicated bid team, at an additional salary cost of £[✂] million per year, plus £[✂] million of further investment [✂].

3.2.2.11 In the event of a further increase in the rate of tendering, we would anticipate further bid team resources being required. We estimate the increase in costs associated with employing a larger bid team as a result of the CC's mandatory tendering remedy to be approximately £[✂] million or £[✂] million per year if the CC implements mandatory tendering on a seven and five year basis respectively[39]. We can assume that the other three largest audit firms at a minimum will have similar internal central support teams. This contributes £[✂] million and £[✂] million to the cost for all of the largest four audit firms participating in tenders under a seven and five year mandatory tendering requirements respectively. This is an underestimate as it fails to take into account the cost of the mid-tier audit firms of increasing their central support teams.

3.2.2.12 Therefore our estimate of the total costs to audit firms of participating in additional tenders as a result of the CC's mandatory tendering remedy option (compared to the recent FRC changes to the UKCGC) to be £[26 – 36] million per year (under a seven year mandatory tendering remedy) or £[60 – 70] million per year (under a five year mandatory tendering remedy). This includes costs of participation on the part of audit firms as well as increasing the staff and resources in central support teams.

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[36] [✂] partners, [✂] directors, [✂] senior managers, [✂] managers and [✂] assistant managers.

[37] Comprising approximately £[✂] million in London and £[✂] million in the regions. Please note that for staff, these costs are based on average salaries at each grade for staff in Central Services. For partner costs, as an approximation we have used the average remuneration per partner in the audit function for 2011 that we estimated in our ROCE analysis.

[38] [✂] senior managers, [✂] managers, [✂] assistant managers.

[39] The changes to the UK Corporate Governance code imply there will be an extra 24.7 tenders per year compared to the CC's estimate of 103 tenders between 2001 and 2011 (see paragraph 7.21 of the CC's Provisional Findings – using 103 rather than 83 as the number of tenders between 20012 and 2011 implies that our estimate is conservative). This therefore corresponds to an increase of bid team resources of £[✂] per extra tender (£[✂] divided by 24.7). The CC's remedy option would suggest there will be a further 15 or 35 tenders per year (for seven and five year mandatory tendering respectively) on top of the extra tenders associated with the changes to the UK Corporate Governance code. Multiplying these extra tenders by £[✂] gives the estimates we set out in this paragraph.

3.2.2.13 We note that the CC argues that a more frequent system of tendering would reduce the resources devoted to each individual tender by audit firms[40]. The basis for the CC's assertion is unclear. In fact, audits are bespoke and so there are very few, if any, economies of scale associated with the participation in audit tenders and so the cost per tender is likely to remain unchanged regardless of the number of tenders an audit firm participates in. The best evidence therefore available to the CC in relation to the expected costs of imposing mandatory tendering are presented above, based on evidence of current tendering costs and current bid team costs (set out in paragraphs 3.2.2.5 and 3.2.2.11 above). The CC must show that the benefits of this remedy outweigh these (and all of the other categories of) costs if it is to implement this remedy.

3.2.2.14 On the other hand, if the CC concludes that a more frequent system of tendering will reduce the resources devoted to each individual tender, then it must take into account the impact of this on the quality and competitiveness of tenders as well as the usefulness of tenders in comparing alternative audit firms, as we discuss in section 3.2.6 below.

3.2.3 Increased staff costs

3.2.3.1 To some extent audit firms might seek to recruit additional staff in order to reduce the opportunity costs set out above. However it is far from clear that audit firms would be able to find sufficient highly skilled resources. It is important that the CC recognises any recruitment and increased staff costs if it is to consider that this might be a way to mitigate the other categories of cost we have discussed above.

3.2.4 Costs to FTSE 350 Companies of conducting additional tenders

3.2.4.1 The CC provisionally concludes that there are substantial opportunity costs to companies associated with running a tender process[41], separate from the costs of ensuring that a new audit firm is 'up to speed' with the company which we discuss in section 4.2.2 below. We have argued in our response to the Provisional Findings that in our view these costs should not be overstated, and that in any case they do not give rise to an AEC, since they do not imply that companies' bargaining positions are weak.

[40] Paragraph 24 of the Remedies Notice.
[41] Paragraph 13.3 b) of the Provisional Findings.

3.2.4.2 However, if the CC concludes that the costs to companies of conducting a tender are substantial then it must also take these into account in assessing the cost of a mandatory tendering remedy option. The CC's analysis shows that past tenders by FTSE350 companies lasted between six weeks and three months[42]. During this time, there may be up to twenty meetings with potential bidders to outline the audit requirements[43], in addition to time spent reviewing proposals and presentations, and providing feedback on the outcome of the tender process to bidders. The CC notes from its evidence that the committee tasked with selecting the audit firm in a tender process generally includes the company FD, ACC, members of the AC and the chief executive, but may also include other relevant individuals such as the financial controller[44]. In our experience the whole process also includes many other key management personnel from across the business and is certainly not restricted to the finance function.

3.2.4.3 Whilst it is difficult to estimate these costs precisely, it is crucial for the CC nevertheless to take them into account.

3.2.4.4 We estimate that the opportunity cost to a FTSE350 company of running a tender process is on average approximately £440,000 per tender, and could even be as high as £980,000 per tender. This is calculated based on European Commission estimates of the number of working days required by management to conduct a tender and multiplied by fee rates of senior management professionals provided by Income Data Services (IDS)[45]. We estimate the total additional cost to companies' management from running additional tenders under the CC's mandatory tendering remedy option, compared to the FRC changes to the UKCGC already implemented, to be between £6.6 million and

[42] Paragraph 25 of Appendix 23 of the Provisional Findings.
[43] Paragraph 53 of Appendix 23 of the Provisional Findings.
[44] Paragraph 38 of Appendix 23 of the Provisional Findings.
[45] In its 2011 paper "Impact assessment on a proposal for the Regulation of the European Parliament and of the Council on specific requirements regarding statutory audit of public-interest entities", the European Commission estimated the cost of company management time required to conduct a tender process to range between 150 and 1000 days. This was based on three case studies present across Appendix 20 – Appendix 22 of that report. We assume a 7 hour working day and multiply hourly rates provided by IDS for FD or equivalent positions in the FTSE350 to generate our estimates. We derive a lower bound estimate of £146,946 (based on a medium-sized PIE) and an upper bound estimate of £979,642 (based on a very large PIE). We set out this salary information we received from IDS in our response to the CC's working paper "Profitability analysis parts 1 and 2".

£15.4 million per year (for seven year and five year mandatory tendering respectively)[46].

3.2.5 *Reduction in competitive pressure outside of prescribed tendering events*

3.2.5.1 The CC considers that mandatory tendering will ensure that companies assess the capability of their existing auditor more frequently, and in a structured way, on a number of important metrics including price, quality and innovation[47]. There is no evidence to suggest that this will be the case and in fact there is a significant risk that this will dampen competitive pressure outside of these tendering windows, as we set out in the rest of this section.

3.2.5.2 Under the current rate of tendering, companies put their audits out to tender for a variety of reasons, including governance policies[48] and audit firms are aware that this could happen at any time. Similarly, under the FRC's recent changes to the UKCGC, companies might explain why they have not tendered at the exact 10 year interval, but could then indicate that they are planning to put their audit out to tender for reasons of governance in subsequent years. As we set out in our response to the CC's Provisional Findings, this threat of tendering exerts strong competitive pressure on incumbent audit firms.

3.2.5.3 However, under a mandatory tendering remedy, with no comply or explain provision, any company which tenders for audit services outside of the prescribed window (of five or seven years in the version of the remedy the CC is currently considering) is more likely to be dissatisfied with its current audit provider, as they would be less likely to be tendering simply for good governance reasons, for example. This means that any tendering events outside of the pre-defined windows are more likely to send adverse signals to investors, imposing a cost to companies.

[46] The estimated figures are £440,839 times 15 and 35 respectively for a seven and five year mandatory tendering remedy.
[47] Paragraph 18 of the Remedies Notice.
[48] Indeed, our survey of our FTSE350 audit partners, set out in our main submission in response to the CC's Issues Statement (paragraph 246) suggested that governance was a relatively common reason for companies going to tender.

3.2.5.4 Companies will be aware of this risk and this will reduce their incentives to tender outside of the prescribed windows. As a result, the competitive pressure which may be exerted on audit firms outside of the prescribed tender window is likely to be reduced.

3.2.5.5 The impact of a reduction in competition outside of prescribed tender windows could have an impact on all of the parameters of competition on which audit firms compete, including quality, innovation and price. Even if the CC believes that increased tendering would lead to a reduction in fees (which we do not) the CC will have to consider the broader effect on fees. This would include considering off-tender competition as creating the "base" from which any discount, or fee reduction following a tender, would apply. It is difficult to quantify the full range of these effects, but as an indicative, and relatively conservative estimate (as it only takes into account price effects), we have assumed that audit fees in the FTSE350 might increase by one per cent as a result. This is purely an illustrative calculation, however it shows the potential magnitude of these effects which the CC will have to take into account.

3.2.5.6 As a result we estimate that the CC's mandatory tendering remedy would give rise to an economic cost of £8.2 million[49] arising from the loss in competitive pressure outside of tender events, compared to the FRC's recent changes to the UKCGC.

3.2.6 Reduction in the quality and competitiveness of tender processes

3.2.6.1 We expect a mandatory tendering remedy to reduce the quality of tender processes. Currently, tenders often occur after negotiations between incumbent audit firms and companies have not resulted in a satisfactory outcome. In these circumstances the incumbent has a lower chance of winning the tender than (at least some of) its rivals. Under mandatory tendering, this will no longer be the case. If FTSE350 companies are required to put statutory audit services out to tender after a given period of time, this increases the chances that satisfied customers might conduct a tender process with less intention of switching away from their incumbent audit firm, as we discussed in relation to the effectiveness of the CC's remedy option in paragraph 3.1.1 above. This may reduce the incentive for rival audit firms to participate in tenders if the incumbent audit firm is seen to have an advantage (as it will not have to incur the costs of 'getting up to

[49] We have multiplied the total audit fees for FTSE350 companies in 2010 (as 2011 was incomplete) by 0.01.

speed' and the company will not have to bear similar costs of transition), thereby reducing competition during tender processes. We note that this concern is less likely to arise with a 'comply or explain' provision, since that allows companies to retain their audit firm without tendering if have no intention to change because they believe the incumbent provides the best offering and explain that decision.

3.2.6.2 In addition, the CC finds that audit firms currently invest significant resources participating in tenders, because tenders occur relatively infrequently and, if successful in the tender process, the duration of assignments is long[50]. We discussed in paragraphs 3.2.2.13 and 3.2.2.14 above that the CC anticipates a reduction in resources devoted to the tender process under this remedy. Specifically, the CC expects that more frequent tendering, and an increase in the provision of available information, will increase the efficiency of the tender process and reduce the risks, thereby decreasing the resource requirements for each individual tender[51]. We noted that the CC has no evidence to justify this suggestion and in our view therefore current costs of tendering are the best evidence available to the CC to analyse the costs of this remedy.

3.2.6.3 However, if the CC is to conclude that tenders will require fewer resources, it will need in that case to take into account the likely impact on quality – both in terms of audit firms' proposals and on the incentives on company management to ensure a high quality outcome. As set out in paragraph 3.2.2.14 above, it is important in that case that the CC takes into account fully the impact this is likely to have on the quality and competitiveness of tenders.

3.2.6.4 If the number of tendering opportunities increased above current levels, audit firms might be less willing and able to devote the same level of resources to each individual tender opportunity or might be less willing to bid on all tender opportunities. Any reduction in the time and resources devoted to mounting a tender bid is likely to have a material impact on the quality of submitted proposals, and therefore their informative value for companies. Similarly, any reduction in the resources devoted to tendering by

[50] Paragraph 24 of the Remedies Notice.
[51] Paragraph 24 of the Remedies Notice.

companies is likely to undermine companies' incentives to ensure a high quality tender process, as suggested by the CC in its Provisional Findings[52].

3.2.6.5 Alternatively, audit firms might be less inclined to participate in all tender opportunities that arise (unlike the current situation where opportunities are more infrequent and uncertain, incentivising greater participation[53]), thereby reducing the competitiveness of these tender processes.

3.2.6.6 The CC proposes that tenders be conducted on an "open book basis". To the extent that open book tendering involves fuller information from the company, such as its structure, processes and controls, whilst this may help those audit firms tendering in preparing their respective tenders, we find no evidence that conducting tenders on this basis would substantially reduce the resources required from the audit firm to submit a high quality and informative bid. It will however undoubtedly increase the costs for companies in assembling and disseminating the information. To the extent that this refers to the incumbent audit firm's files, the expectation that all potential bidders will have conducted a thorough review of the additional information in preparing their proposals is likely to result in additional time commitments for the incumbent audit firm and other bidders. In addition we believe that unrestricted access to the incumbent audit firm's audit files would be detrimental to competition, for the reasons explained in 3.2.8 below.

3.2.6.7 We have not quantified explicitly these costs but we expect that that they are likely to be very substantial and the CC will need to take them into account in its assessment of the proportionality of its remedies options.

3.2.7 *Reduction in quality*

3.2.7.1 As we set out in the previous section, participating in tenders generally requires a large amount of time from an audit firm's most senior resources. For an increase in the rate of tenders not to result in each tender being much less effective, the same quality of resources would have to be involved. In our view, it is highly unlikely that the profession as a whole would be able to hire significantly more of the most highly

[52] Paragraph 9.250 of the Provisional Findings.
[53] Paragraph 9.47 of the Provisional Findings.

skilled, experienced and senior resources to meet these additional demands, particularly in the case of the most significant and complex FTSE 350 clients and those clients with specialist requirements that require particular expertise (i.e. certain clients in the financial services industry). Therefore, to the extent that tender quality is maintained at the current high standard, the necessary diversion of resources, in particular the most senior and skilled individuals, from audit work to conducting additional tenders would impact on the total amount of the highest quality expertise brought to bear on audits.

3.2.7.2 Similarly, as set out above, tender processes require a substantial investment of resources on the part of company management. Since the time spent conducting tenders will increase as a consequence of this remedy option (as set out in section 3.2.2 above), to the extent that the CC believes that the increased frequency of tenders will be associated with the same effectiveness of each tender, this will necessarily lead to a reduction in the extent to which company management can engage with the audit firm, thereby adversely impacting upon the third limb of audit quality, which is discussed by the CC in paragraph 6.12 of its Provisional Findings.

3.2.7.3 In our view, mandatory tendering will not enhance audit quality and the CC provides no convincing evidence to support the view that mandatory tendering would have any benefit in terms of improving audit quality beyond the status quo; indeed, to the extent that the CC thinks that tenders will remain of the same quality as they currently are, it will have the opposite effect.

3.2.7.4 KPMG's Global Audit Committee survey, conducted every year through KPMG's Audit Committee Institute, sought to understand ACs' views on the impact of mandatory tendering. A majority of respondents (in the UK or on a global basis) in the latest survey noted that they did not view mandatory tendering as a way to improve audit quality (Global Audit Committee Institute Survey, 2013). Any reduction, or risk of a reduction, in tender or audit quality as a result of any remedy option is a significant cost, and we discuss further aspects of the impact on this remedy on audit quality below (in relation to innovation and investor confidence). The CC must take this cost into account in forming a view on the effectiveness and proportionality of the remedies it considers.

3.2.7.5 *Additional risks associated with "open book" tendering*

3.2.7.6 The CC is considering "open book" mandatory tendering[54] which would involve the incumbent audit firm being required to share its audit methodology and approach with competing auditors participating in the tender. An "open book" requirement will necessarily imply that a number of aspects relating to the type and delivery method of audit services will be disclosed to all competitors in a tender. These may include the details of commercially sensitive aspects such as project management, time allocation or ancillary reporting to management, or any other innovative aspects of the offer, including on efficiency of delivery of services. It is to be expected that firms will anticipate the inability to maintain proprietary knowledge of the specific aspects of their offer and therefore be less incentivised to develop them in the first place. This would inevitably lead to lower differentiation between firms and a lower degree of product and process development for the market as a whole.

3.2.7.7 Although it is difficult to quantify the exact magnitude of these costs, we expect that any reduction in these incentives to compete would impose a very substantial cost on companies, shareholders and investors. The economics literature is clear that the impact of adverse effects on innovation is far more detrimental to consumer welfare than adverse effects on price. Therefore the impact on consumer welfare from a loss of innovation is likely to be at least as great as the part of the economic costs that we have quantified.

3.2.8 Increased administrative costs in relation to management of conflicts associated with NAS

3.2.8.1 It is likely that increased tendering will impose additional administrative costs on audit firms to resolve independence issues in relation to NASs and to some extent personal independence matters. In order to conduct a thorough assessment of the expected costs of mandatory tendering, the CC must take these administrative costs into account.

3.2.8.2 Any time an auditor participates in a tender, it has to identify the provision of NASs that could breach independence with the potential client, and all the participating firms will not offer new prohibited NASs until they know whether or not they have been

[54] Paragraph 22 of the Remedies notice.

successful in the audit tender. With the current level of tendering, the CC has found that these issues have not prevented audit firms from participating in tenders[55]. Similarly, with the current rate of tendering audit firms shoulder the costs of identifying these issues and do not pass them on to their customers.

3.2.8.3 However, with the increased rate of tendering that would be implied with a mandatory tendering remedy, audit firms are less likely to be able to resolve all such issues which might reduce the number of audit firms participating in a tender. In addition, audit firms are likely to be less able to shoulder all of these costs of resolving independence issues and instead may have to pass them on to FTSE350 companies as part of their audit fees. This is likely to further add to the fee increase we calculated in paragraph 3.2.5.6 above. Further, there will be more instances where audit firms cannot bid to provide NASs to a company for the period around its audit tender, imposing greater costs (e.g. from a loss of competition) in NASs markets.

3.2.8.4 In addition, the administrative burden of resolving these conflicts and independence issues would increase as a result of this remedy and the CC will need to take these into account[56]. We provide more detail below on the steps that audit firms are required to take to ensure independence, in order to illustrate to the CC the potential magnitude of these increase administrative costs. The [✂] audit proposal that we submitted to the CC[57] provides evidence of the actions that need to be carried out to guarantee independence in preparation of an audit tender[58].

3.2.8.5 Firstly, the audit firm has to identify the provided non-audit services (NAS) that could breach the independence with the potential client. This activity is carried out through appropriate internal systems, but it can be time consuming particularly in relation to large engagements. Once identified, the conflicting engagements have to be terminated or, if possible, restructured so that independence is not breached. Either solution is likely to be costly both for the auditor, who has to handover the project to another

[55] Paragraph 9.48 of the Provisional Findings.
[56] Some of these costs may be included in the estimates of the cost to a tender but it is unlikely that all of the costs to audit firms from resolving NAS conflicts and independence issues are accounted for in these costs. For example, much of the work resolving conflicts issues is conducted by staff outside of the bid team, or staff working on the NAS engagement and this would not be picked up in the figures on the cost per tender in the CC's tender database.
[57] Submitted as supporting evidence to in our submission to the CC of our tender data.
[58] KPMG's [✂] audit proposal ([✂]), pages [✂].

consultant and reorganise its work, and for the client, who has to start a new relationship with a new consultant, (which may itself require a tender process to be conducted with the associated cost) and potentially experience delays and / or reduction in the quality of the particular NAS during the transition phase. The requirement to do this more frequently might lead audit firms to bid for fewer long term NASs engagements for potential audit clients, or to negotiating break clauses which will impose substantial costs of uncertainty on audit firms and companies. Again, these costs in the supply of NASs will need to be taken into account.

3.2.8.6 On top of clearing conflicting projects, the firm will have to guarantee independence of all the employees involved in the audit. Personal independence is breached when certain members of staff own certain levels of shares in the client, or by certain banking relationships for example. Identifying and clearing personal conflicting situations can be complex and in some instances it might require some effort by the client, as indicated in the [✂] proposal[59].

3.2.8.7 A good example of the scale of this administrative burden is in relation to the HSBC audit that HSBC has indicated it will put out to tender.[60] Our expectation is that this tender process will be completed by [✂]. The new audit firm (if different from the incumbent) will then be required to achieve independence by [✂], in order to be independent with effect from the start of the year ending 31 December [✂]. This period of approximately [✂] months is required in order for the successful firm (if different to the incumbent) to resolve firm and personal independence issues, globally, as well as resolve a large number of conflicts associated with significant amounts NASs worth.

3.2.8.8 We have not been able to quantify these increased administrative costs, but as we have described above, these are extremely substantial, in particular for the largest FTSE350 companies. In order to conduct a thorough assessment of the expected costs of mandatory tendering, the CC must take into account the relevant administrative costs to audit firms associated with international coordination and the management of conflicts associated with NASs, as well as on companies in relation to the reduction in competition in the supply of NASs and potentially the cost of additional tenders for

[59] See, for example, KPMG's [✂] audit proposal ([✂]), page [✂].
[60] In their Annual Report issued on 4 March 2013, HSBC did state that *"it is our intention that a tender process for the external audit contract will be undertaken, with the successful audit firm being appointed by 2015"*.

NASs where necessary where a newly appointed audit firm has to resign from the provision of such services.

4 Mandatory rotation

4.1 Our views on the CC's basis for the remedy option and its likely effectiveness

4.1.1 The CC states that it is considering whether to impose mandatory rotation in conjunction with mandatory tendering, for example so that if after a number of tenders a company has not switched audit firm, it is compelled to do so[61].

4.1.2 In our view the CC would have no basis for imposing this remedy, even if one accepts the provisional conclusions that the CC has drawn in its Provisional Findings, which we do not. The CC has concluded that tenders are effective in generating strong competition. As a result, there is no basis in the CC's Provisional Findings for imposing any remedy that removes the power of a company to conduct a tender process and select the audit firm they (and indeed the shareholders) judge to be the most appropriate following that process, even if this happens to be the company's incumbent provider.

4.1.3 Mandatory rotation will reduce the number of audit firms between which companies can choose by one and we therefore fail to see how this can be seen to be effective in increasing competition in the supply of statutory audit services. On the contrary, as we discuss in section 4.2.3 below in relation to the economic costs of this remedy option, we expect that mandatory rotation will reduce competitive pressures on audit firms.

4.1.4 The CC suggests that mandatory rotation is desirable to ensure greater independence of the audit firm from management. However, there is no evidence in the Provisional Findings that length of tenure has an impact on independence, as we set out in our response to the Provisional Findings. Insisting on a change of audit firm does not imply that there will be a "fresh approach to the audit of the company"[62], that would not otherwise be achieved to a substantial extent by the rotation of the audit engagement partner. Further, in circumstances where management's interests are indeed different to those of shareholders as the CC alleges occurs, it is more likely that management may

[61] Paragraph 28 of the Remedies Notice.
[62] Paragraph 27 of the Remedies Notice.

seek to influence the selection of an audit firm which may be at least if not more accommodating in its views on accounting judgements than an incumbent.

4.1.5 In addition, the FRC, with its extensive knowledge of audit quality, does not support mandatory rotation on the basis that it would reduce audit quality[63]. Similarly, investor groups such as the IMA do not support mandatory rotation.

4.2 The economic costs associated with this remedy option

4.2.1 Introduction and summary

4.2.1.1 The CC has indicated that it is considering a form of mandatory rotation on top of the mandatory tendering remedy option it is also considering. As suggested in the previous section on international experience of mandatory rotation, this remedy option would be associated with substantial economic costs. In this section we set out in detail the incremental costs that would be associated with mandatory rotation, on top of the costs we have already set out in relation to mandatory tendering. Specifically:

- additional costs incurred by FTSE350 companies and audit firms in ensuring that a newly appointed audit firm has a sufficient understanding of the company's business, which we estimate to be in total on average £33 million, £21 million or £13 million per year if the remedy is implemented on a seven, 10 or 14 year basis;
- reduced competitive pressure on audit firms outside of prescribed rotation periods, which we estimate to involve economic costs of at least £33 million per year;
- increased risk of errors in statutory audits as audit firms more frequently need to invest time and effort in learning about the company, and the risk of failure is greater during this learning period;
- reduction in choice of audit firm, which will also impact on competition and audit quality;
- loss of confidence on the part of investors, arising from the reduction in choice, quality and increased risk of error, which, which we expect will also lead to a perception of reduced quality among investors is likely to adversely impact companies' costs of capital. We estimated that this might amount to an economic cost of approximately £1 billion in total per year;

[63] See the FRC's response to the European Commission Green Paper (https://www.frc.org.uk/Our-Work/Publications/FRC-Board/Choice-FRC-response-to-EC-Green-paper.aspx) and the FRC's press release in relation to their submission in response to the Provisional Findings and the Remedies Notice (http://www.frc.org.uk/News-and-Events/FRC-Press/Press/2013/March/FRC-responds-to-Competition-Commission's-prelimina.aspx).

- a risk of regulatory arbitrage where large multi-national companies choose not to incorporate and list in the UK in order to avoid mandatory rotation, which will adversely affect the whole UK economy;
- increased administrative burden and costs associated with resolving independence issues relating to NASs, which can also impact on competition in NASs markets, as well as associated with coordinating rotation internationally for multi-national companies.

4.2.1.2 Overall we have quantified part of the costs associated with mandatory rotation as £66 million, £54 million or £46 million respectively if the remedy was implemented on a seven, 10 or 14 year basis respectively, as well as a cost associated with increasing FTSE350 companies' cost of capital which might be in the region of £1 billion. The costs of increased risk of audit failure, reduced choice, a risk of regulatory arbitrage are all taken into account as part of the estimate of the increase in audit firms' cost of capital as a result of this remedy, which would have a substantial impact on the UK economy as a whole. The substantial costs of increased administrative burden associated with resolving NASs independence issues and international coordination would be additional to the costs we have quantified here.

4.2.2 Costs arising out of duplication of investments at the start of a new audit relationship

4.2.2.1 As discussed in section 3 of our response to the Provisional Findings, because of the investments necessary at the beginning of each audit engagement, frequent switching is an inefficient outcome in the supply of statutory audit services. Any increase in the rate of switching above current levels would give rise to a loss of efficiency and quality; this will impose significant additional costs on market participants which will substantially exceed any potential benefits.

4.2.2.2 The Provisional Findings recognise the investments made by audit firms at the start of a new audit engagement as the audit firm becomes familiar with its new client[64]. It is necessary for audit firms to commit a considerable amount of additional time during the initial period of a new engagement in order to gain a comprehensive understanding of the structure and complexities of a company[65]. The GAO (2003)[66] study report

[64] Paragraph 7.36 of the Provisional Findings.
[65] Paragraph 21 of the summary of the Provisional Findings.
[66] GAO Report "Public Accounting Firms – Required Study on the Potential Effects of Mandatory Audit Firm Rotation" (2003).

calculated that the additional support costs to a public company's management would range from 11 per cent to 39 per cent of the initial year audit fee[67].

4.2.2.3 We estimate that the costs to audit firms, in terms of duplication of investments in gaining an understanding of a business in the first year of an audit are between £300,000 and £558,000, and on average £429,000 for every change in audit firm[68]. In our experience this is likely to be a substantial underestimate for the largest and most complex FTSE350 companies.

4.2.2.4 The Provisional Findings also refer to the significant investment by FTSE350 companies to educate the new audit firm[69], a direct measure of the inefficiency associated with switching since this investment would be inefficiently duplicated. The GAO (2003) study suggested that audit firms will see an increase of over 20 per cent in their initial year audit costs in order to acquire the necessary knowledge of a public company's operations, systems and financial reporting practices. We estimate that that the cost of the additional support companies need to provide following a change in auditor range between £157,000 and £558,000, and on average £357,500 for every change in audit firm[70]. However, as noted above in our view this is likely to be a substantial underestimate for the largest companies.

4.2.2.5 The CC suggests that it will seek views on a remedy requiring mandatory rotation every seven, 10 or 14 years. Therefore mandatory rotation is likely to lead to an extra 42, 27, or 17 changes in audit firm each year if implemented on a seven, 10 and 14 year basis respectively. We therefore find that the increase in costs associated with the additional time on the part of auditors and companies in ensuring that the new audit firm

[67] We recognise that this study is US- (rather than UK-) based and that it dates back to 2003. However, we have not identified a more recent or UK-based study. We are not able to calculate the costs directly (using the CC's estimates of the increased hours associated with a switch in Appendix 12), since we do not have information available on all hours on a global engagement. This is therefore the best available evidence on the magnitude of this cost.

[68] This is based on the GAO Report "Public Accounting Firms – Required Study on the Potential Effects of Mandatory Audit Firm Rotation" (2003), which estimates the increase in costs as a percentage of first year audit fee to range between 21 and 39 per cent. Multiplying these rates by the CC's measure of average first year audit fees, we derive a cost to audit firms ranging from £300,300 to £557,700.

[69] Paragraph 19 of the summary of the Provisional Findings.

[70] This is based on the GAO Report "Public Accounting Firms – Required Study on the Potential Effects of Mandatory Audit Firm Rotation" (2003), which estimates the additional support costs to a company following a change in auditor range between 11 per cent and 39 per cent of first year audit fees. Multiplying these rates by the CC's measure of average first year audit fees yields a range of £157,300 - £557,700.

has a good understanding of the company is approximately £33 million, £21 million or £13 million per year if the remedy was implemented on a seven, 10 or 14 year basis respectively[71].

4.2.3 Reduction in competitive pressure outside of mandatory rotation window

4.2.3.1 There is a significant risk that mandatory rotation will dampen competitive pressure outside of the prescribed windows for rotation. The CC's evidence on investor views showed that "for a large number of investors a change in audit firm was not seen to be an issue *so long as the rationale for the change was explained by the company*"[72] (emphasis added). Under a mandatory rotation remedy, it is far less likely that a company would be able to explain a change in audit firm to the satisfaction of investors outside of the mandatory rotation window. In particular, it is far more likely that any switch of audit firm outside of the mandatory rotation window will be seen as being associated with a serious problem with the company or with the audit, and so creates a far greater risk of an adverse investor reaction.

4.2.3.2 As a result, in our view companies are less likely to switch audit firm outside of the prescribed mandatory rotation window. In turn, audit firms will be aware that the threat of companies switching audit firm is weaker and will therefore face lower competitive constraints outside of the mandatory rotation window. This effect is similar to that which we described in section 3.2.6 above in relation to mandatory tendering, but we expect that it is likely to be greater in the case of mandatory rotation.

4.2.3.3 Furthermore, an important part of the current competitive environment is the uncertainty on the part of audit firms about when the next tender opportunity will arise, which ensures that audit firms have substantial incentives to compete fiercely on every

[71] The exact figures are £33,012,000, £21,222,000 and £13,362,000. We combined the average cost to audit firms of getting up to speed with a new engagement (£429,000 per change in audit firm) combined with the average cost to companies of educating the new audit firm (£357,500 per change in audit firm). Since 2001 there have been on average 8 changes of audit firm per year, and so mandatory rotation remedy would lead to a further 42, 27 and 17 switches of audit firm every year if the remedy was implemented on a seven, 10 and 14 year basis respectively. We multiplied this increased average switching rate by the average total costs of 'getting up to speed', incurred by audit firms and management.

[72] Paragraph 46 of Appendix 19 of the Provisional Findings.

tender opportunity. The CC also recognises the importance of the infrequency of tenders to the incentives of audit firms to compete fiercely to retain clients[73].

4.2.3.4 However, under a mandatory rotation remedy, this uncertainty is lost – instead, audit firms will know exactly when the next opportunity to win a new client from one of their rivals is likely to arise. This is likely to reduce the incentives on audit firms to compete so fiercely to retain their existing clients, if they are confident of other opportunities to make up this loss in the near future.

4.2.3.5 There is support in the academic literature for the view that mandatory rotation will lead to a reduction in competition, in particular Arruñada and Paz-Ares (1997) found that:

> "Additionally, the rule also drastically alters the pattern of competition in the auditing industry. It directly creates a system of turns and, in short, an artificial division of the market, which can favour collusion among auditing firms. More importantly, it also reduces the incentive to invest and compete because firms that manage to excel under it find themselves obliged to relinquish their achievements periodically."[74]

4.2.3.6 If anything, the risks identified by Arruñada and Paz-Ares (1997) are likely to be more substantial in the current market where there are fewer audit firms that have made the investments necessary to audit the largest FTSE350 companies.

4.2.3.7 We expect the costs associated with a reduction in competitive pressure on audit firms to be substantial, and impact on all aspects of audit firms' competitive offerings, including price, quality and innovation. Arruñada and Paz-Ares (1997) found that mandatory firm rotation led to an increase in audit fees of between four and 15 per cent just because of increases in costs, and noted that these could be higher if there was also a reduction in competition[75]. Therefore, as an indicative and relatively low estimate of the magnitude of the economic costs associated with a reduction in competitive pressure (as it takes into account only price effects and not the impact on quality and innovation), we have again applied a four per cent increase to the total audit fees, amounting to £33 million per year, and so even as an estimate only of the price effects of reduced

[73] Paragraph 9.215 of the Provisional Findings.
[74] "Mandatory rotation of company auditors: a critical examination", Arruñada and Paz-Ares, 1997 Science Elsevier.
[75] "Mandatory rotation of company auditors: a critical examination", Arruñada and Paz-Ares, 1997 Science Elsevier.

competition, this is in our view conservative. We note that this would be in addition to the costs associated with mandatory tendering.

4.2.3.8 At the same time, the switches that do occur at the point of mandatory rotation will send less of a negative signal about an audit firm's performance. Indeed, it is likely that they will send no adverse signal at all. This could reduce the reputation effect associated with switching, reducing the incentives for audit firms to deliver innovative high quality audits at competitive prices in order to maintain reputation.

4.2.4 Reduced choice

4.2.4.1 The CC provisionally finds that currently companies are not significantly constrained in their choice of audit firm[76]. However, it cannot be assumed that this will continue to be the case under mandatory rotation.

4.2.4.2 Mandatory rotation will prevent companies from awarding statutory audit services to their incumbent audit firm after a defined period of time, reducing by one the number of audit firms from which companies can choose. Reducing the available choice of auditors imposes a cost on companies, which the CC should reflect in its assessment of the proportionality of this remedy.

4.2.4.3 Furthermore, the detrimental effect on choice outlined above may be compounded by the reduction in incentives for firms to participate in the tender process. Mid-tier firms might be less incentivised to participate in tenders under mandatory rotation, as the time horizon for the recoupment of investment in, for example "bench strength", will be reduced. Similarly, mandatory rotation might even lead to one of the largest four audit firms choosing to drop a certain sector (or geographic specialisation) from its skills range if there are few companies and it knows that it would have only a short horizon with which to develop knowledge and build "bench strength" in this area.

4.2.4.4 In addition, if companies have judged their incumbent audit firm to have the most suitable skills and experience to conduct its audit to the requisite standard, forcing the company to switch to an alternative auditor will automatically mean that it has to use an

[76] Paragraph 33 of the Remedies Notice.

audit firm which it considers to have a less suitable experience base. This reduces choice, but also contributes to an increase in the risk of audit errors (see section 4.2.5).

4.2.4.5 The GAO (2003) study surveyed a number of Tier 1 audit firms and found that 54 per cent believed that mandatory rotation would likely reduce the number of firms competing for audits of public listed companies. Furthermore their survey of Tier 2 firms found that 55 per cent of them were uncertain of whether they would still provide audit services to public listed companies if mandatory rotation was introduced. This survey suggests therefore that mid-tier audit firms might be less likely to invest in the capabilities to audit FTSE350 companies and to the extent that this occurs this is likely to further undermine choice in the supply of statutory audit services to these companies.

4.2.5 Increased risk of errors in statutory audits

4.2.5.1 The CC acknowledges that there is an increased risk of audit failure in the early period of a new engagement[77]. The Global Audit Committee Institute Survey 2013 found that the very large majority of ACs (in the UK and globally) thought that mandatory audit firm rotation would not increase audit quality.

4.2.5.2 This is also supported in the academic literature, for example, Arruñada and Paz-Ares note that

"the rotation rule is not justified by its effects on audit quality because it probably damages the two main determinants of quality. The auditor's *technical competence* - i.e., his ability to detect irregularities in the financial statements - is hampered by the greater number of initial audits and the lesser degree of specialization. Mandatory rotation might also harm the auditor's *independence* - his willingness to disclose in his report any irregularities he might have detected. Even if the rule reduces the cost to the auditor of reporting and thus of being independent, it also probably reduces the expected cost of not reporting and becoming dependent."[78]

4.2.5.3 This effect will be exacerbated by the reduction in choice of audit firm under mandatory rotation, which we discussed in section 4.2.4 above, as companies are no longer able to

[77] Paragraph 9.152 of the Provisional Findings.
[78] "Mandatory rotation of company auditors: a critical examination", Arruñada and Paz-Ares, 1997 Science Elsevier.

select the audit firm deemed most suitable in terms of skills, experience and audit quality, further increasing the risk of audit failure. Overall therefore, the increased rate of switching associated with a mandatory rotation remedy would increase the risk of audit failure.

4.2.5.4 Whilst we believe that audit firms and companies may increase the hours devoted to the audit in the initial period of a new engagement in an attempt to minimise this risk at a greater cost to audit firms and companies, it will not be possible to fully eradicate this risk. This risk contributes to loss of investor confidence, which imposes additional costs (as we discuss in section 4.2.6 below).

4.2.6 Loss of confidence in the audit from investors

4.2.6.1 It is well-established in the academic literature that companies' governance standards affect their cost of capital. Most recently, Chen, Chen and Wei (2009) show that good governance is associated with a lower equity cost of capital, and Bhorjraj and Sengupta (2003) show that there's a cost of debt effect.

4.2.6.2 In addition, accounting standard setters have long claimed that better accounting standards drive down cost of capital, although such arguments have lacked a robust theoretical structure until recently. A formal modelling of the relationship between accounting disclosure and the cost of capital in a CAPM context can be found in Lambert, Leuz and Verrecchia (2007). They note "based on our model, increasing the quality of mandated disclosures should generally reduce the cost of capital for each firm in the economy".

4.2.6.3 The implications of these governance and accounting disclosure findings for the audit market are direct and obvious. Any diminution of audit quality would impact upon both cost of equity and cost of debt.

4.2.6.4 Furthermore, given this quality issue emerges solely in the UK as a direct result of the CC's proposals, the effect is to disadvantage any firms that retain a UK incorporation and listing compared to their global competitors.

4.2.6.5 As we have argued in the previous sections, mandatory rotation is associated with a reduction in audit quality as there is a greater risk of audit failure in the first years of an

engagement. This is exacerbated by companies no longer being able to appoint the audit firm with the experience and skill-set most closely matched to its needs, if this audit firm is the incumbent at the point where mandatory rotation is required. Therefore, mandatory rotation will lead to an increase in FTSE350 companies' cost of capital which has substantial effects on the UK economy as a whole. The CC needs to show that the benefits of a mandatory rotation remedy would outweigh this, and the rest of the associated cost.

4.2.6.6 Even a small change in cost of capital would have an enormous economic impact. As at the end of February 2013, the market capitalisation of the FTSE 350 stood at £1,876.5 billion[79]. To show the magnitude of this potential cost, suppose that it led to even just a variation of 5 basis points (i.e. 0.05%) in the cost of equity. This would cost UK companies around £1 billion. This, of course, ignores any additional costs caused by a chance in the cost of debt.

4.2.7 Possibility of regulatory arbitrage

4.2.7.1 Large, multinational companies have a choice over which index (or indices) to list on. If listing in the UK is associated with being forced into mandatory rotation, then this could lead some companies that are opposed to mandatory rotation (because it gives rise to greater inefficiency, risk, reduces audit quality and increases the company's cost of capital) to choose not to list in the UK but in other jurisdictions. We note that apart from Italy no other European country has adopted mandatory rotation, and so there is a realistic prospect that companies will engage in this kind of regulatory arbitrage.

4.2.7.2 This would lead to substantial costs to the UK economy which we have not at this stage attempted to quantify but would need to be taken into account by the CC in considering this remedy.

[79] FTSE350 monthly performance report, end of February 2013.

4.2.8 Increased administrative costs in relation to management of conflicts associated with NAS and reduction in competitiveness of NASs markets

4.2.8.1 As noted above in relation to mandatory tendering (see paragraph 3.2.8.1), it is likely that any increase in switching rates will impose additional administrative costs on audit firms in order to resolve firm and personal independence issues.

4.2.8.2 In the case of mandatory rotation, there are further costs associated with the provision of NASs which should be taken into account. There is a greater risk that audit firms may have to interrupt the provision of NASs, which will also impose costs directly on companies, particularly if the AC chooses an audit firm that is also considered by company management to be the most suitable for certain NASs.

4.2.8.3 This may reduce the likelihood of companies buying NASs from firms that also provide audit services, and of audit firms in bidding for non-audit work. The ramifications of, and potential costs associated with, this remedy are not therefore limited to statutory audit services, but may be broader, affecting other markets such as those for NASs. The effects on markets for NASs will include reduced competition (if audit firms choose not to bid for some NASs); a reduction in quality (if companies are forced to choose suppliers of NASs that would not be their first choice, if the first choice supplier is conflicted on audit work); and costs of transition and opportunity costs (associated with increased switching of NASs and having to run more NASs tender processes).

4.2.9 Increased administrative costs in relation to international coordination

4.2.9.1 In addition, there are further administrative costs and burdens associated with the implementation of a mandatory rotation requirement in the UK, without this being coordinated internationally. Large multi-national companies are audited in several jurisdictions, and mandatory rotation in one will require international coordination, which is likely to be administratively burdensome and lead to substantial inefficiencies.

4.2.9.2 As an illustration, when we were appointed as the audit firm for [✂] in [✂] it took approximately four years for all of the approximately 150 subsidiaries to switch to KPMG, involving a substantial administrative and opportunity cost of time. The management of this process (and ones like it) involves a substantial amount of senior

partner time, which further impacts on the quality of an audit and the likelihood of audit failure (see section 4.2.5 above), and eats into any mandatory rotation period.

4.2.9.3 In the case of multi-national companies, the CC has not set out whether mandatory rotation might apply to all components within a group (ie including those based overseas) or only to the holding company and Group audit. It will need to consider this in order to understand the practical implications of this remedy option. In addition, the CC will need to consider all the practicalities associated with requiring companies to move the group audit of large multi-national companies, including how, in practice rotation would be enforced across all subsidiaries. In addition, the CC will need to consider the impact on consistency of the group audit if some subsidiaries change audit firm up to four years after others – indeed, this is likely to represent a further substantial cost associated with this remedy option.

5 Expanded remit and/ or frequency of AQRT reporting

5.1 The CC suggests that expanding the remit and/ or frequency of AQRT reporting would ensure that companies have better information on the quality of FTSE350 audits, facilitating comparisons across audit firms[80].

5.2 We think the current AQRT regime works well, as we set out in our response to the Provisional Findings. In addition, in our view any decision to expand the remit of the AQRT needs to be taken by the FRC as the public interest regulator for the audit profession, which is best-placed to determine whether it is required. As a result it is not clear whether any incremental gain the CC seeks to obtain will outweigh the potential costs of increasing the remit of the AQRT.

5.3 In our view, the more companies that are reviewed by the AQRT, the lower the benefit per company reviewed – in other words the benefits from AQRT reviews are diminishing with the number of reviews. There is an initial benefit from the existence of these reviews in the first place, and on the reports into the largest four audit firms conducted each year. Adding a number of additional companies into those reports will not give rise to the same scale of benefits.

[80] Paragraph 35 of the Remedies Notice.

5.4 Furthermore, there would be substantial costs involved in increasing the scope and/or frequency of these reviews. An expansion of AQRT reporting would impose additional costs on firms. Under expanded reporting requirements, it would be necessary for firms to finance a much bigger or more frequent AQRT process, in addition to the requirement to devote additional time of the most senior auditors in order to comply with a more frequent AQRT process. Although it is difficult to quantify the exact magnitude of these costs, these costs could be substantial and the CC will need to take these into account in its assessment of the assessment of this remedy. It will also reduce the time commitment that the most skilled resource has to devote to carrying out audits.

5.5 An expansion of AQRT reporting would also be likely to increase the costs to auditors participating in the AQRT review process. The costs of this remedy to audit firms also include the time spent by audit staff in dealing with AQRT reviews.

6 Prohibition of contractual clauses in template documents limiting choice to the Big 4 firms

6.1 The CC proposes the prohibition of contractual clauses in loan agreements in order to "remove a limitation to competition for non-Big 4 firms"[81]. We set out in section 4 of our response to Provisional Findings why any lack of ability on the part of mid-tier firms to compete for FTSE350 statutory audit services does not imply that there is an AEC.

6.2 We are not aware that these contractual clauses are a significant determinant in the choice of audit firm for large UK companies, and similarly the CC states that by itself this remedy may not have a substantial impact[82]. We do not seek to have these clauses included in loan agreements and we would support the removal of such clauses if they were deemed to adversely affect competition. At the same time we would note that institutions lending to companies have particular requirements and genuine commercial needs which should be recognised.

7 Strengthen Accountability of the External Auditor to the AC

7.1 In our view, as we set out in response to the Provisional Findings, there is very strong evidence that ACs are already effective in ensuring audit firms deliver a competitive

[81] Paragraph 42 of the Remedies Notice.
[82] Paragraph 42 of the Remedies Notice.

offer. More generally, however, we support measures to improve reporting by audit firms to ACs, as we set out in our response to proposed EU audit reforms[83]. We note that audit firms will already often report to ACs on some or all of the following items: key risk assessments, areas of focus for the audit and approach thereto, views on management's key judgments and estimates, assessment of the quality of financial reporting by the entity and the auditor's assessment of the entity as a going concern. We would welcome changes that ensured this became standard (rather than best) practice.

7.2 We note that the September revision to the Auditing Standards (as part of the FRC's Enhanced Company Stewardship initiative) is very supportive of increasing accountability to ACs, and we also welcome this development. However, the revisions do not constitute a comprehensive increase in reporting to ACs, and were rather designed to support the AC in meeting its reporting obligation to investors.

7.3 It is nonetheless important, in our view, that the CC considers all of the practical implications and costs of any remedies it decides upon in this area. In addition, there would be costs associated with increased resources for the AC (as the CC recognises) and the CC will need to take them into account. We note that this remedy option is not well-developed in the Remedies Notice and we will be happy to continue to engage with the CC on this issue as necessary.

7.4 However, we are concerned that one aspect of this remedy option as set out in the CC's Remedies Notice would in our view damage audit quality and would be impractical and inefficient if implemented. The CC suggests that under the potential remedy, the 'first point of contact' for an AEP on material audit issues would be the ACC. This does not recognise that the preparation of the financial statements is in the first instance the FD's responsibility. It is inevitable therefore that there will be a dialogue with the FD to establish the facts and assumptions involved since without such discussion it would not be known with any certainty as to whether there was or was not a "material audit issue" needing to be resolved. As such this suggestion is in our view impractical and has the potential to lead to substantial inefficiencies.

[83] "Reform to enhance audit and audit quality: The KPMG view", September 2012.

8 Enhanced shareholder-auditor engagement

8.1 The CC proposes "the introduction of measures that increase shareholder involvement in auditor accountability and reporting"[84] in order to "address the distortion in demand whereby audit firms compete largely for the demand of executive management because it would enhance the role of shareholders in relation to decisions on the choice of auditor"[85]. Although we dispute the CC's finding that we compete to satisfy the demands of management, in particular if these may differ from those of shareholders, we currently seek to liaise with shareholders and with the FRC to establish whether there is a cogent demand and how audit firms and companies may best meet it[86]. We are therefore open to engaging with the CC, as necessary, to explore how increased engagement might be facilitated.

8.2 It is important that any increased engagement is practical and preserves the key function of a statutory audit, to provide an independent assessment on whether a company's financial statements provide a true and fair view of the company's accounts. In particular, it is crucial that the audit firm's role is maintained as an objective one, and increased reporting does not require the audit firm to offer subjective opinions which would run the risk of substituting management's judgement with that of the audit firms in preparing financial statements. Furthermore, it is not the role of the audit firm to disclose commercial information about the company that a company's management does not want to be disclosed – disclosure of information is the prerogative of the company's board.

[84] Paragraph 53 of the Remedies Notice.
[85] Paragraph 52 of the Remedies Notice.
[86] Section 2.10.4 of our response to the Provisional Findings.

8.3 Finally, it is also important that audit firms report to the body of shareholders as a whole and not to any individual shareholders in particular, as this would violate rules relating to insider trading.

9 Extended reporting requirements

9.1 The CC notes that it is considering extending reporting requirements in order to "override the reluctance of management to disclose information about the audit process and ... thereby enhance transparency"[87].

9.2 We note that to the extent that there is unmet demand that would be met by this kind of additional reporting, this is not something that can be solved by one audit firm acting unilaterally as demonstrated by the relatively modest success which audit firms have met in attempting to encourage further disclosure. Rather, it requires consensus and backing with regulation. Indeed, the CC itself notes that "the FRC is best placed as the specialist sectoral regulator to progress these discussions and resolve shareholder concerns"[88].

9.3 We, and other audit firms, already engage actively with the FRC discussions in this area and are working with the FRC to develop workable solutions. We are therefore happy to engage with the CC to the extent that it wishes to explore how it can also facilitate and further discussions already taking place with the FRC.

9.4 However, it is important that the CC recognises that there are some costs associated with increased reporting. In particular, there is the potential for the AC-audit firm relationship to be undermined if the contents of detailed discussions are made public. We reserve our right to comment on these costs once the CC has provided more detail on the types and forms of extended reporting that it is considering.

10 Remedies that the CC is not proposing to consider

10.1 The CC notes that it currently considers that the following remedies would be ineffective or disproportionate:

- constraining non-audit services by the audit firm;

[87] Paragraph 58 of the Remedies Notice.
[88] Paragraph 60 of the Remedies Notice.

- joint or major-component audit;
- shareholder group responsibility for auditor reappointment;
- FRC responsibility for auditor reappointment; and
- Independently resourced risk and audit committees.

10.2 We agree that all of these remedies are likely to be ineffective and disproportionate. In particular in relation to joint or major-component audit we note that in other jurisdictions where this has been implemented, this has led to substantial costs[89] without discernible benefit.

[89] For example, see the experience of Canada, as discussed in this report http://www.cica.ca/enhancing-audit-quality-canadian-perspective/item68293.pdf