

Annex 1: Market outcomes

- 1 In this section we review the seven outcomes identified by the CC. One would normally expect to see clear evidence of adverse market outcomes in a market investigation that found an AEC. However, this is not what the evidence base shows. This is one reason why the CC should be extremely cautious about reaching conclusions that suggest the market is not working well and pursuing highly intrusive remedies (namely mandatory tendering every five or seven years and mandatory rotation).
- 2 In summary, our position in respect of the outcomes identified by the CC is as follows:
 - (a) **Structure, tenure, frequency of tendering and switching and choice:** These are not market outcomes but rather are characteristics of the market. They should not be relied on by the CC to suggest that the market is not functioning effectively.
 - (b) **Prices and profitability:** The CC has concluded that the evidence in respect of these outcomes is difficult to interpret, and that it is not possible to undertake detailed economic profitability calculations. Nevertheless, the CC relies on other indicators of profitability, together with pricing and profitability patterns immediately post switching to conclude that prices and profits are higher than they would be in a competitive market. This analysis is deeply flawed. It also ignores very clear evidence of pressure on prices over a number of years, with fee levels falling.
 - (c) **Quality and independence:** The CC places undue reliance on the historic reports of the AQRT to conclude that there are significant concerns regarding audit quality and the potential loss of independence. While we take the reports of the AQRT seriously and have responded to them by addressing the issues identified, they do not show that audit quality is below the standard expected of a well-functioning market. The CC also fails to take into account more recent AQRT reports and recent improvements in audit quality. Other indicators that suggest audit quality is high - including the reduction of litigation, the low number of adverse reports by the Financial Reporting Review Panel (FRRP) and the positive views of companies - have been dismissed by the CC. Moreover, the CC is wrong to conclude that any occasional lapses of scepticism demonstrate that the market is not producing competitive outcomes.
 - (d) **Innovation and unmet demand:** The CC has underestimated the evidence of very significant innovation in audit delivery and in the initiatives by audit firms and the FRC to address the demands of the investor community. Furthermore, the CC has missed the key point that the examples of innovation observed in the PFs provide shareholders with substantial benefits by identifying and reducing risks, offering insights on companies' costs to improve operational efficiency and improving the quality and lowering the cost of the audit. The CC has also placed insufficient emphasis on regulatory constraints on audit reporting.

Structure, tenure, frequency of tendering and switching

- 3 The PFs identify structure, tenure, and frequency of tendering and switching as market outcomes.¹ We consider these to be market characteristics rather than a reflection of the outcome of the competitive process.² As the CC acknowledges, such characteristics may be “consistent with effective competition between the Big 4 firms”³. Thus:
- (a) On market structure, the CC acknowledges that there has been considerable movement in and out of the FTSE 350 and makes reference to PwC’s infographic presentation.⁴ However, the CC disregards this evidence on the basis that “*this movement could cause a firm’s share of FTSE 350 engagements to change, but not necessarily to fall.*”⁵ This fails to recognise the scope and level of competition that takes place among audit firms simply to maintain existing market shares: we need to compete outside the reference market in order to win and retain new entrants to it. Our infographic also clearly shows how companies which are in the FTSE 350 switch auditors at the rate of about one per month.⁶
 - (b) On tenure, the CC relies on its first survey results to reach the provisional view that “*long length of audit firm tenure ... may indicate an AEC*”⁷, without acknowledging that the same survey shows that the vast majority of companies do not tender because they recognise they currently receive a quality and high value service.⁸
- 4 In order to determine whether these characteristics are indicative of an AEC, the CC should test them against what the CC normally regards as outcomes of the competitive process – i.e. prices and profits, quality and innovation⁹. Given the paucity of evidence of any adverse competitive conditions having an impact on true outcomes, as described below, we do not accept that the market structure is, of itself, evidence of an AEC.

Choice

- 5 Likewise, we do not accept that the number of suppliers in the FTSE 350 statutory audit is an adverse market outcome. The CC’s statement that “*concentration of supply in the market...may suggest that there is less choice of alternative suppliers in the FTSE 350 statutory audit market*

¹ Paragraph 7.3.

² See CC’s draft Market Investigation Guidelines (2012) (CC Guidelines), paragraph 104. This is how the test is applied in the Summary to the Provisional Findings although not in the body of the report.

³ Paragraph 7.25.

⁴ Paragraph 7.10.

⁵ Paragraph 7.11.

⁶ For example, only 55 of our 108 FTSE 350 clients in Q3 2011 (that is, around half) were in the index and audited by us in Q2 2011. 114 companies audited by us exited the FTSE 350 in the last ten years and 94 companies audited by us entered over the same period (not including firms that have made multiple entries and exits). In addition we lost the equivalent of 19% of our total Q2 2011 client base within the FTSE 350 as a result of switches to other firms over that ten year period while gaining the equivalent of 25% of our Q3 2011 client base through switches to us within the FTSE 350 over the same period. Other large audit firms have faced similar rates of “churn”, with Deloitte doubling its market share (from 45 to 89 FTSE 350 clients) within that period (significantly higher than may be attributed to its acquisition of Arthur Andersen). As we set out in our Initial Submission (12 January 2012) at paragraph 1.31, the constant “churn” in membership of the FTSE 350 also creates numerous entry opportunities for smaller firms if they can show growing companies which have been their clients that they have the necessary attributes to retain the audits as the companies grow.

⁷ Paragraph 7.24.

⁸ See section 2 of our response to the Provisional Findings and Remedies Notice (our Response), paragraph 2.35 (b)(i).

⁹ See CC Guidelines, paragraph 105.

than we would expect to see in a well-functioning market. In a market with greater choice of alternative suppliers, we may expect to see a greater differentiation in offerings between firms".¹⁰

- (a) is inconsistent with evidence from the CC's survey: 62% of FTSE 350 companies thought that they had a choice of at least four firms (including Big 4 and Mid Tier firms) and 72% of the tender lists included at least three of the Big 4 firms;¹¹ and
 - (b) does not appreciate that the level of differentiation in this market - for example, as regards the form of the auditor's report - is constrained by regulation.
- 6 There is no absolute number of competitors which are indicative of a competitive market. It depends on the particular market circumstances. In its Merger Guidelines, the CC says that counting firms is not a sufficient basis on which to decide the appropriate number of competitors in a given market so that, for example, "[i]n relation to the number of firms, previous OFT decisions in mergers involving retailers suggest that the OFT has not usually been concerned about mergers that reduce the number of firms in the market from five to four"¹². In the absence of broader evidence that a market with at least four competitors is failing to deliver competitive outcomes, the presence of four competitors cannot of itself be considered to be indicative of a competition concern¹³.
- 7 Of course, to the extent that the CC identifies lack of choice as a detrimental outcome, this is highly relevant to any consideration of mandatory rotation, which would force large companies to select their auditor from an even smaller pool of capable audit firms (which in many or even most cases would be a maximum of three). Moreover, mandatory rotation would prevent a company from exercising choice where it is obliged to switch from its preferred supplier.

Prices and profitability

- 8 As regards prices and profitability, the CC has reached a provisional finding of adverse outcomes despite the fact that the PFs state that it is difficult to reach clear results: For example:
- (a) On prices, while the CC had the data to carry out a price concentration analysis (PCA), *"we were not persuaded that the results would be reliable."*¹⁴
 - (b) On profitability, the CC says that there were *"significant uncertainties ... which precluded us from generating economic profitability measures on which we could rely"*¹⁵ and *"we are*

¹⁰ Paragraph 7.28.

¹¹ Paragraph 9.18.

¹² Paragraph 5.3.5 of (CC2) Merger Assessment Guidelines.

¹³ See the paper prepared by Professor Steffen Huck on the optimal number of competitors for a market with the characteristics of audit services, which we submitted to the CC as Annex 4 to our Response to the Nature and Strength Working Paper (WP) (dated 29 October 2012).

¹⁴ Paragraph 7.56.

¹⁵ Paragraph 7.70

*not able to conclude...that Big 4 firms are earning profits above competitive levels*¹⁶ and *“we have not found good evidence regarding the overall profitability of the Big 4 firms”*.¹⁷

- 9 Notwithstanding these limitations, the CC then proceeds to rely on certain limited evidence to reach the provisional conclusion that *“the market is not working well in delivering competitive prices”*¹⁸ while dismissing or ignoring other relevant evidence that indicate pro-competitive outcomes.

Prices

- 10 The CC dismisses a number of sources indicating strong pressure on audit prices over a number of years, including:
- (a) clear results from analysis of the industry dataset (which shows prices falling by 15% in nominal terms between 2006 and 2011 and therefore even more in real terms) and the engagement data set (which shows reductions in the level of audit fees of more than 19% in real terms when taking into account declines in both the average hourly rate and the number of man-hours per audit). The CC appears to dismiss these findings on the basis of certain *“issues affecting these statistics”*¹⁹;
 - (b) evidence that the vast majority of large companies negotiate audit fees annually with their audit firm (which negotiations the CC considers are deficient on the basis that the appraisal of the incumbent must be comparative, which can only be achieved on tender)²⁰; and
 - (c) findings from the AQRT that there is pressure on engagement fees²¹.
- 11 Instead, the CC identifies a pricing pattern which they have interpreted as demonstrating that companies that switch achieve lower prices than those that do not.²² We explain below why the CC is wrong to disregard evidence showing pressure on prices and to misinterpret and place undue weight on the price pattern observed for companies that switch.

Evidence showing pressure on prices that the CC has disregarded

- 12 The CC guidelines recognise the importance of price data in assessing the nature of competition and in particular *“static or continually rising prices may, in the absence of other explanatory factors, indicate a lack of competition”*²³. By contrast, significant falls in prices should be indicative of a competitive market.
- 13 The overwhelming balance of evidence available to the CC shows that prices have fallen substantially and that large companies are able to negotiate highly competitive prices from their

¹⁶ Paragraph 7.74

¹⁷ Paragraph 7.91

¹⁸ Paragraph 7.94

¹⁹ Paragraph 7.32.

²⁰ Paragraph 9.147

²¹ Paragraph 7.111

²² Paragraph 7.52.

²³ CC guidelines, paragraph 110(a).

- audit firm. However, the CC has reached the provisional conclusion that “companies are offered higher prices ... than would be the case in a market without the features”.²⁴
- 14 This provisional finding is reached in spite of the evidence of prices falling referred to in paragraph 10(a) above. The CC appears to place no weight on this analysis because “there are issues affecting these statistics (e.g. they do not control for factors other than fee rates that may impact on the cost per hour such as the grade mix of engagement teams)”²⁵. However, the evidence shows that competitive pressure is focussed on the overall fee levels that companies pay for their audit and that these fee levels are falling. In response to these competitive pressures, audit firms are required to seek out cost effective ways of delivering high quality audits, which will include changes to the size and structure of their audit teams, but this does not detract from the fact that the price companies pay for their audit is falling. It therefore is wrong to disregard this evidence on price reductions.
- 15 The CC ignores a number of other sources of evidence that show there is real pressure on prices, some of which are relied on by the CC to reach adverse findings in other respects. For example:
- (a) “93 per cent of companies negotiate their audit fee every year, and nearly all companies negotiate their fee at least every five years”,²⁶
 - (b) “[o]ur case studies suggest that companies also requested granular fee details to assess the competitiveness of the audit fee”,²⁷
 - (c) “the evidence indicates that this process of negotiating audit fees will give the FD, in particular, a detailed understanding of the components of the audit fee although based on the fee in the previous year”²⁸.
- 16 The CC also ignores the AQRT’s observations that certain concerns regarding audit quality stem from the effect of pressure on engagement fees²⁹ (while nevertheless placing undue weight on the AQRT’s views on audit quality)³⁰. This demonstrates the pressure felt by audit firms and the success of companies in driving down fees (extensive evidence of which was provided to the CC in the context of responding to Q87 of the MFQ and in our Submission of Additional Evidence of Competition Outside of Tenders)³¹.
- 17 We also note that the CC’s own econometric analysis of audit engagement costs (which it appears largely to disregard) shows that the cost of auditing has declined over time.³² When

²⁴ PFs Summary, paragraph 33.

²⁵ Paragraph 7.32.

²⁶ Paragraph 9.95.

²⁷ Paragraph 9.96.

²⁸ Paragraph 9.98.

²⁹ As noted by the CC in paragraph 7.111.

³⁰ See, for example, paragraph 7.119: “we consider that the [AQRT] reports provide a sufficiently sound evidential basis in the context of our market investigation from which to draw conclusions. The AQRT reports indicate that there are significant issues surrounding the quality of some audits provided to FTSE 350 companies, and that the AQRT often identified shortcomings in audit reports that were not identified by the companies (whether .FDs or ACs) themselves.”

³¹ See PwC’s Submission of Additional Evidence of Competition Outside of Tenders (23 November 2012), pages 12 to 20, for a list of examples of companies placing pressure on PwC to drive down fees.

³² Paragraphs 7.31 to 7.32; Appendix 5, paragraph 89.

taken together with the medium-term plateau in profitability that the CC has also identified³³, this clearly suggests that prices have also been falling over time.

Why the CC is wrong to place undue weight on the pricing pattern observed for companies that switch

- 18 The CC focuses on the pattern that typically is observed when there is an audit firm switch, where reduced first-year prices (and profitability) are followed by increases over the subsequent two to three years, before reaching a plateau. The CC infers from this pattern that it:
- (a) potentially indicates an AEC because it demonstrates the ability of a new audit firm to increase its prices rapidly³⁴; and
 - (b) suggests that companies could obtain significant price benefits from frequent tendering (specifically that companies could obtain a price reduction of 7% per annum if they were to tender every three years).
- 19 We broadly accept the pattern of prices and profitability identified by the CC (although not the precise details) but we fundamentally disagree with the inferences drawn by the CC. With regard to the former inference, the pricing pattern does not demonstrate that market power is being exercised:
- (a) Our econometric analysis shows that prices decline immediately on tender or switch and then “rise” in the following three years. However, these price rises are in relative (not absolute) terms and are not “rapid”. Our econometrics shows that, after the immediate price reduction, prices rise at the rate of about 3% per annum relative to the price that would have been obtained if the company had not tendered or switched (but the prices that have been obtained by companies that do not tender or switch have themselves been falling).
 - (b) There is no evidence that prices rise above competitive levels. For example, our econometrics shows that (over the long run and on average), companies which tender or switch (and which are therefore exposed to transparent competitive pressure) do not pay lower prices than companies which do not tender or switch. The CC appears to disregard this evidence because it was not perfect³⁵ (as we acknowledged in our submission), despite it being more robust than much of the evidence on which the CC relies and the best evidence that is before the CC on this question.
- 20 With regard to the latter inference (i.e. how the CC considers that our econometric analysis shows that companies could obtain a price reduction of 7% per annum if they were to tender every three years):
- (a) This is not what our analysis shows at all. Rather, it shows the average short-run price reduction through switching and tendering where companies switch/tender at their current

³³ Paragraph 7.205(a)

³⁴ Paragraph 7.52.

³⁵ Paragraph 7.53.

rates. There is not a single company in the industry data set which has actually tendered or switched every three years. It is also worth noting that:

- (i) the results of our econometrics are based on companies which have actually chosen to tender or switch and hence likely include those where greatest short-run price reductions were achievable (because, for example, their previous prices were relatively high);
 - (ii) as explained above, our econometrics actually shows that companies which tender or switch do not obtain lower prices over the longer term than companies that do tender or switch.
- (b) If companies were in fact to tender much more frequently, audit firms would not have the incentive to offer the same level of discounts. This is recognised by the CC in the PFs where it states that *“given the current low level of switching, firms may on average expect to retain engagements for relatively long periods, hence the prospect of lower returns in the initial years of an engagement is unlikely to affect their incentives to bid for work”*³⁶. Therefore, the CC’s own view of the market is one where the initial discounting and propensity to bid for an audit is in part determined by the expected length of tenure (which would, of course, be shorter if companies were to tender or switch every three years).
- (c) The CC disregards our position that the current level of price discounts are dependent on the current frequency of tendering and switching because audit only generates a normal return, by describing the latter as *“an assumption that has not been established”*³⁷. We discuss the CC’s flawed approach to the evidence on profitability below.

Profitability

- 21 As with its treatment of evidence regarding prices, the CC is prepared to draw certain conclusions with regard to profitability even though it considers that it was precluded from *“generating economic profitability measures on which we could rely”*.³⁸ It uses the evidence on profitability as part of evidence *“in the round”* to come to the conclusion that the market is not working well in delivering competitive prices.³⁹ We consider it wholly unacceptable that evidence regarding falling prices should be discarded in its entirety while other limited evidence concerning profitability, on which the CC considers it cannot rely, is taken into account.
- 22 The CC explains correctly that the key measurement in assessing profitability is *“economic profits of the business activity in question”*.⁴⁰ The CC translates this into assessing whether profits from FTSE 350 audit engagements for those audit firms *“have exceeded the appropriate costs of capital over a sustained period”*.⁴¹ However, the CC *“encountered significant*

³⁶ Paragraph 9.34.

³⁷ Paragraph 7.44.

³⁸ Paragraph 7.70.

³⁹ Paragraph 7.94.

⁴⁰ Paragraph 7.63.

⁴¹ Paragraph 7.68.

problems⁴² with this analysis and concluded that “[i]n summary, there were significant uncertainties ... which precluded us from generating economic measures on which we could rely”.⁴³

- 23 Notwithstanding these difficulties and uncertainties, the CC nevertheless felt able to conclude that “the risk reward balance offered to audit partners is attractive”⁴⁴; that “on balance, we think that audit is a relatively attractive service line whose risks are not unusually high, when compared with other service lines”,⁴⁵ and that “there appear to be significant numbers of companies from which the firms enjoy persistently higher profits than average”.⁴⁶ Each of these conclusions is based on supposition and the analysis of the available evidence is weak and one-sided. The overall conclusion is tantamount to a finding of excessive profitability when the CC has admitted that there is no safe basis in fact to reach such a finding.

Partner profitability

- 24 A central finding that appears to underpin the CC’s view that audit partner rewards are attractive and on average are considerably above benchmarked salary levels for equivalent roles in industry⁴⁷ is that the risks associated with auditing large companies are “not unusually high”⁴⁸. This is said to explain why the reward to partners is attractive. In reaching this view, the CC fails to consider the evidence on why firms are unable to obtain competitive levels of insurance on the commercial market.⁴⁹ This is linked to the observed fact that audit firms are unable to limit their liability (notwithstanding the legal ability to do so – which the CC does not recognise as a factor that suggests that companies rather than audit firms have the stronger bargaining position)⁵⁰ and the history of very substantial claims that preceded the period of relatively low claims⁵¹.
- 25 The CC also fails to take into account that the reason the number of claims made has declined over recent years is because of the marked improvement in audit quality made by all of the large firms to mitigate the risk of potentially huge (and unlimited) claims.⁵² The CC appears to have reached the view that because these efforts have been successful, the risks do not exist. This is obviously flawed reasoning. While audit firms are unable, from a commercial

⁴² Paragraph 7.69.

⁴³ Paragraph 7.70.

⁴⁴ Paragraph 7.76.

⁴⁵ Paragraph 7.92(b) and (c).

⁴⁶ Paragraph 7.92(d).

⁴⁷ Paragraphs 7.71 to 7.76.

⁴⁸ Paragraph 7.92 (b)(iii)

⁴⁹ See our response Combined Response to the CC’s Profitability WPs (15 November 2012), paragraph A6.

⁵⁰ See paragraph 7.75 where the CC says: “[w]e found that the risks were capable of mitigation: the incidence and amount of claims paid out by firms was low, and claims were rarely made against individual partners.” This does not follow from the evidence submitted to the CC by firms in response to MFQ41 where we (and it appears other firms) submitted that we have not been able to agree a cap on liability with any of our FTSE 350 clients and have now discontinued attempts to secure such caps. The CC acknowledged the power companies had in this respect, stating in its Liability, Insurance and Settlements WP that “[a]lthough theoretically possible, such provision for liability limitation agreements in the CA 2006 had not proved acceptable to companies in practice” (see paragraph 14).

⁵¹ As acknowledged by the CC, prior to 2002 there was a period of substantial claims (see, for example, paragraph 7.116).

⁵² The low current levels of claims “can be contrasted with the levels of exposure in the past that led commercial insurers to associate major audit firms with a sharply increased level of risk of claims. This resulted initially in higher premiums and, by the early 1990s, led to commercial insurers withdrawing from the large firm audit market completely. Notwithstanding the improved claims record in more recent years, we are not able to obtain third party commercial insurance cover on terms that are economically acceptable” which highlights the level of risk faced by audit firms (see paragraph and 5 of our response to the Liability, Insurance and Settlements WP (19 October 2012)).

perspective, to limit their liability, there will always be a very real risk of substantial litigation. [REDACTED]. Such claims serve to illustrate that however much effort is made to mitigate the risks inherent in conducting an audit, the nature of audit work is inherently high risk.

- 26 The CC's description of Big 4 partner rewards as "*attractive*" also:
- (a) Fails to take into account that we remunerate our partners on a "one firm" basis rather than by direct evidence of the performance of a particular partner's business unit or service line. An audit partner's reward is therefore not an effective indicator of the performance of the audit business; and
 - (b) Misconstrues the difference between this type of partner reward and a benchmarked salary, which the CC considers to be a return on invested capital. While the CC acknowledges that the size of this return is driven partly by how partners do not purchase capital at market value on their entry to the firm (because if they did then their "return on capital" would be much lower than it appears from the CC's analysis), if the CC were to apply its approach to the vast majority of partnerships (including law firms and family owned businesses), it would likely suggest relatively high return in many of these businesses. We also believe that the CC's treatment of retained earnings understates the amount of capital that partners actually have in the business.

Engagement level profitability

- 27 There are two key problems with the CC's approach to assessing engagement level profitability:
- (a) First, the data which the CC is using is likely to generate skewed results because of how it is likely to underestimate systematically the costs of more complex audits (e.g. those in the FTSE 100) because such audits require more senior partner time.
 - (b) Second, the CC fails to reflect the extent to which engagement level profitability in fact is highly variable. While the CC has interrogated the data and identified that there are a small number of companies which generate above average profitability over the relevant period (although even the profitability of these engagements can vary significantly from one year to the next and can be less than average in specific years), the vast majority of FTSE 350 companies that we audit have engagement profitability that is widely variable. This reflects factors such as the specific needs of the company, the point in the audit lifecycle, and the outcome of company specific negotiations. [REDACTED]:
 - (i) [REDACTED];
 - (ii) [REDACTED];
 - (iii) [REDACTED]
 - (iv) [REDACTED].

Quality

28 To justify its provisional conclusion that there are “*significant, persistent and widespread concerns regarding the quality of audits delivered to FTSE 350 companies*”⁵³ one would expect to see clear and unequivocal evidence of audit failure. The CC seeks to support this definitive conclusion solely on the basis of the AQRT grading system and fails to appreciate the nuances in the AQRT’s reporting, while discounting evidence that the CC accepts could equally suggest audit quality is high.

Evidence from the AQRT

29 The CC places very substantial weight on certain AQRT findings dating back to the reports of 2008/09 and 2009/10. The CC also relies on the FRC’s observation that the effect of pressure on engagement fees caused the FRC to have “*concerns about the sufficiency of work performed*”.⁵⁴

30 We take seriously the concerns about audit quality raised by the FRC. However:

- (a) the AQRT has never described an audit as being “*unacceptable*”⁵⁵ and we object strongly to the CC’s description of some audits in this way when there is no basis for drawing such a conclusion.
- (b) the CC fails to acknowledge that the AQRT (in its 2009/10 report from which the CC has relied on selectively), said that it “*considers that the senior management of the major firms have quality control procedures in place which are generally appropriate to the size of the firms and the nature of their client base. Although some improvements are required at all firms, the [AQRT] is satisfied with the planned actions to address them.*”⁵⁶ [emphasis added]
- (c) The AQRT notes in its 2010/2011 Annual Report that “*inspection results are as good as, or slightly better than, those of last year. In particular, the AIU has seen a reduction in the number of FTSE 350 audits assessed requiring significant improvement.*”⁵⁷
- (d) As the PFs acknowledge, we have been recognised by the AQRT as having responded to its concerns and improved our audit quality.⁵⁸ [∞]. We recommend that the CC engage with the FRC to understand the most recent audit quality inspection results. Moreover, we suggest that the CC should ensure, in reaching its final conclusions, that it has evaluated the most recent data and reflected on the balance of evidence of recent improvements in audit quality in the UK statutory audit market. In addition to the AQRT, we suggest also that the CC also obtain inspection results from the ICAEW (to obtain

⁵³ Paragraph 7.121.

⁵⁴ Paragraph 7.111.

⁵⁵ Paragraph 7.119.

⁵⁶ FRC, Audit Inspection Unit 2009/10 Annual Report, paragraph 3.3.

⁵⁷ Ibid, section 1.3.

⁵⁸ As set out by the CC, in its published 2012 report on its most recent inspection of PwC, the AQRT acknowledged a number of improvements we have made, including specifically in relation to demonstrating how professional scepticism was applied on our higher-profile audits in response to the AQRT’s comments in previous reports (see paragraph 44 of Appendix 17).

inspection results from its Quality Audit Department) whose results are also relevant to the CC's assessment of the relative capabilities of firms.

- 31 Crucially, the fact that a regulator whose function is to continuously improve audit quality identifies examples of how audit quality can be improved does not demonstrate that there is "*persistent and widespread*" "*audit failure*" across the market. Rather, it shows that there are aspects of the audit that could be improved, often based on developing experience of complex accounting or economic issues, something that the AQRT and we recognise will always be the case. Indeed, on audits that are graded as "good", the AQRT will nevertheless identify suggested recommendations for improvement.
- 32 It is therefore wrong for the CC to highlight that "*78 per cent of FTSE 350 audits over this period [being 2007 to 2011] were identified as requiring some level of improvement*"⁵⁹ given that the AQRT's mandate is to identify areas of improvements. Rather, the CC should note, as set out by the AQRT that: "*The [AQRT] seeks to identify areas where improvements are, in its view, needed in order to safeguard quality and/or comply with regulatory requirements and to agree action plans with the firms designed to achieve these improvements. Accordingly, the [AQRT]'s reports place greater emphasis on weaknesses identified requiring action by the firms than areas of strength and are not intended to be a balanced scorecard or rating tool.*"⁶⁰ [emphasis added]

Other indicators of quality

- 33 We explain below that in respect of other indicators of audit quality, being the volume of litigation activity; FRRP reports; and feedback from companies, the CC has either ignored this evidence or used it selectively to support its position of adverse outcomes:
- (a) Reduction of litigation activity: The CC's treatment of the fact that audit firms have been successful in reducing the number of claims faced in recent years is used selectively. It would be intuitive to interpret this evidence as a positive market outcome. It shows that audit firms made a concerted effort to improve their audit processes and standards in the face of very substantial litigation claims in the 1990s and that they have been successful in improving audit quality as a result. However, the CC instead uses this evidence to support its conclusions of adverse market outcomes:
- (i) In the context of profitability, this is used by the CC to justify its finding that audit partners do not face an unusually high degree of risk and that the "*risk/reward balance offered by the Big 4 firms to audit partners is attractive*"⁶¹, with the insinuation being that audit firms are making unreasonable profits (despite the CC having asserted that it is not possible to carry out a proper economic analysis).
- (ii) In the context of audit quality, where the fact that litigation against audit firms has materially reduced might be expected to translate into a finding that firms have

⁵⁹ Paragraph 7.119

⁶⁰ See "*Appendix A - Inspection process and basis of reporting*" of all AQRT Annual Reports.

⁶¹ Paragraph 7.76.

done much to improve audit quality, the CC dismisses this evidence on the basis that reduced claims “*may be a product of the liability regime ... by which firms are only liable to companies under specific conditions*” and “*the difficulty, in the UK, of pursuing class-action style litigation by which shareholders may pursue joint claims against audit firms*”⁶². The fact that these potential barriers to claims existed in the 1990s when a series of very substantial claims were brought against the Big 4 firms is not considered.

- (b) FRRP reports: The FRRP is recognised as an effective financial reporting enforcement body and both companies and audit firms have strong incentives to comply with its standards⁶³. However, its important role in providing an objective indicator of quality has not been sufficiently recognised in the PFs. There have only been a very small number of FRRP press releases in respect of an adverse finding on an auditor’s non-compliance with relevant reporting requirements in a company’s audit. Further, of those press releases issued by the FRRP, the CC does not recognise that most relate to non-Big 4 audit firms⁶⁴.
- (c) Feedback from companies: The CC does not appear to place any weight on evidence from its survey or case studies with regard to companies’ views on audit quality. The CC indicates that it deliberately did not ask companies in its survey or case studies if they thought that their current auditor was performing well (on the basis that they are only likely to respond with “yes” unless they are taking active steps to change their auditor)⁶⁵. However, the results of the survey in response to the question on the factors important for assessing quality of an audit (e.g. ability to detect misstatements) together with questions on what would trigger a tender show companies are satisfied with audit quality.

Independence

- 34 Despite stating that it encountered difficulties in gathering direct evidence, the CC felt able to reach the provisional conclusion that “*losses of auditor independence occur*” and that this is not an outcome consistent with auditors responding only to the demands of shareholders.⁶⁶ Notwithstanding the comments by the FRC on the importance of demonstrating professional scepticism in its annual report 2009/10, the balance of the evidence relied on by the CC is circumstantial, inconclusive and does not place sufficient weight on the fact that auditors have regulatory and legal duties to remain independent. The CC also seems to conflate the two separate concepts of professional scepticism and independence and it is misleading in that respect to state that an alleged lack of professional scepticism by auditors leads to a loss of independence.

⁶² Paragraph 7.120.

⁶³ Beattie (2011) at section 1.6.

⁶⁴ See our Submission and Response to Issues Statement (12 January 2012), paragraphs 3.52 to 3.54: There have been 17 relevant FRRP press releases since 2005. Of these, five related to audits carried out by the four large audit firms (of which two were in respect of PwC audit clients, although it should be noted that only one of these related to financial statements), three related to audit clients of Grant Thornton (one) or BDO (two), and nine related to audit clients of other smaller auditors.

⁶⁵ Paragraph 7.97.

⁶⁶ Paragraph 7.149.

- 35 As we have explained in paragraphs 2.21 to 2.24 of section 2 of our Response, applying the benchmark of a well-functioning market should not lead the CC to conclude that any lapses of scepticism (or other failing) demonstrate that the market is not producing competitive outcomes. In this case, the PFs provide just six examples of what is said to show audit firms lacking scepticism⁶⁷ as “*all suggestive of the potential for auditors to have demonstrated a higher degree of scepticism*”⁶⁸. To date, the CC has only disclosed details to us of two of these six examples which, as we explained to the CC in advance of publication of the PFs, do not show a lack of scepticism:
- (a) JP Morgan Securities Ltd (JPMSL): In one aspect of our reporting to the Financial Services Authority (FSA) on JPMSL's compliance with the FSA's client asset rules (a private regulatory reporting requirement entirely distinct from, and that had no bearing on, the statutory audit of the entity), we did not detect and therefore did not report a temporary breach in that client monies held by JPMSL at JP Morgan Chase Bank (JPMCB) were not segregated. Notwithstanding that we accept this breach was not detected owing to a flaw in the relevant test in the context of the client money audit (as opposed to any step in the statutory audit), the Accountancy and Actuarial Discipline Board did not conclude that there had been any lack of professional scepticism.
 - (b) [§<]: The AQRT reviewed our audit file for [§<] and identified a number of issues with respect to the audit team documenting appropriate evidence to support its judgements on the impairment of goodwill. We did not accept that having regard to practice at the time there was a lack of scepticism in audit procedures on impairments of goodwill. Rather, we accepted the AQRT's finding that audit evidence from the procedures should have been more comprehensively documented in our audit working papers.
- 36 The CC's observations that audit firms seek to manage AEP rotation effectively (by finding a suitable partner and by handling the transition efficiently) also do not demonstrate a lack of independence. Indeed, evidence to the contrary might have led the CC to conclude that audit firms did not face sufficient competition from rivals to need to manage such transitions carefully. The CC therefore is wrong to dismiss the effect of AEP rotation as a mechanism that safeguards independence because the mandatory rotation of audit firm partners and staff, and regular changes in the company's management and AC personnel, means that relationships between the audit firm and company are constantly being renewed.
- 37 In reaching its provisional view on the lack of independence, the CC places undue weight on the Company I case study and the examples of management requiring firms to change AEPs, rather than the balance of other case studies and the survey⁶⁹. The CC also fails to take into account:

⁶⁷ Appendix 17, paragraphs 56 to 87.

⁶⁸ Paragraph 7.139.

⁶⁹ See slides 26 and 28 of the CC's survey; see also Companies F, G and H in the case studies.

- (a) Evidence on auditor effectiveness reviews: these are undertaken by ACs who assess the independence of auditors. We provided examples for [§<] to the CC.⁷⁰
- (b) Hundred Group submission: *“The vast majority of companies, both in the UK and in the rest of the EU remained strong during the recent financial crisis, and indeed weathered the very difficult economic conditions admirably. Inevitably certain sectors fared less well than others: However to predicate a significant and wide ranging reform on these isolated examples is to ignore the fact that in the vast majority of cases, the role and effectiveness of independent auditors has not been, and should not be, called into question.”*⁷¹
- (c) Insurance Europe submission to the European Commission: *“There is no evidence that audits of insurers have been inadequate or that auditor independence has been violated during the last financial crisis.”*⁷²

Innovation and unmet demand

- 38 On innovation, the CC appears to discount competition that gives rise to innovation in respect of costs and operational efficiency and innovation in reporting to management and the AC⁷³. The provisional views of the CC on innovation contain a long list of examples of innovative behaviour⁷⁴. Nevertheless the CC reaches the conclusion that innovation is not at levels it would expect to see in a well-functioning market⁷⁵ because of the issue of “unmet demand”.
- 39 This provisional finding fails to recognise that the examples of innovation in the delivery of the audit all create shareholder value by identifying and reducing risks, offering insight on companies’ costs to improve operational efficiency, and improving the quality and lowering the cost of the audit. These are the tangible outputs of innovation in the delivery of the audit which have value for shareholders. They should be recognised by the CC.
- 40 While we acknowledge the scope for further information to be provided to shareholders, and welcome the opportunity to discuss with the CC how this might be achieved, the restrictions on doing this are principally the result of regulations limiting the scope and form of audit reporting. In failing to acknowledge the extent of innovation by audit firms where the firms do have the power to innovate the CC is giving undue weight to those areas where innovation is restricted by regulation and failing to give proper weight to other innovative measures generated by the actions of the audit firms themselves, which are indicative of a well-functioning market.

⁷⁰ Our Response to Certain Third Party Submissions (6 July 2012), paragraph 2.15 and footnote 32.

⁷¹ See the Hundred Group Submission to the CC (16 April 2012), page 1.

⁷² Insurance Europe submission to the European Commission (11 June 2012), page 1.
⁷³ Paragraphs 7.161 and 7.165.

⁷⁴ Paragraph 7.171 to 7.177.

⁷⁵ Paragraph 7.179.