

Annex 2: The features of the market

- 1 We have explained in section 2 and Annex 1 how the CC's approach to the evidence has converted equivocal evidence or supposition into hard conclusions that the market is not functioning effectively. An objective and balanced evaluation of the evidence shows that the market is producing competitive outcomes. In this section we respond in summary to the features identified to support the CC's two theories of harm.

The first theory of harm: companies' willingness to switch and barriers to expansion and selection

Feature (a): Barriers to switching

(i) companies face significant hurdles in comparing the offerings of an incumbent audit firm with those of alternative suppliers other than through a tender process

- 2 Although we accept the provisional finding that "*formal tenders provide the best opportunity for a company to obtain the information*"¹ [emphasis added], we do not accept that the evidence shows that large companies are unable to achieve competitive outcomes without frequent tendering.²
- 3 The balance of evidence does not justify a finding that companies face "*significant*" hurdles in comparing the offerings of an incumbent audit firm with those of other suppliers, other than through a tender process. The PFs acknowledge that the overwhelming majority of companies carry out reviews of quality and fees.³ These reviews can be assessed by companies with the benefit of ACCs and FDs relying on their personal experience of other audit firms from other companies; their experience of other firms capabilities via provision of NAS; regulatory reports into other audit firms; and the benefit of other firms' marketing efforts to draw on in making a comparison with the existing audit firm.
- 4 Moreover, it does not follow that because some companies may not conduct benchmarking exercises that this is because they have insufficient information to do so. Indeed, companies have the power to obtain the information required for effective benchmarking exercises if they so desire as no rational audit firm would refuse to provide this information if requested, given the incentives to develop relationships with target audit clients.

(ii) it is difficult for companies to judge the audit quality in advance due to the nature of audit

- 5 It is wrong to suggest that large companies are unable to assess the likely quality of the potential audit firms prospectively. In fact, given the relatively limited number of audit providers to large companies (compared, for example, to legal service advisers or management consultants); the information and data available from regulators and the firms themselves; and

¹ Paragraph 9.256.

² See Annex 1, paragraph 2(a).

³ For quality, 91% of companies do this annually and 99% do this every five years; for fees 93% of companies do this annually and 100% every five years (Appendix 3, Table 14).

the business experience of ACCs and FDs (as well as others at the company), it is easier to make this assessment in respect of audit firms than for many other professional services.

(iii) companies and audit firms invest in a relationship of mutual trust and confidence from which neither will lightly walk away as this means the loss of the benefits of continuity stemming from the relationship

- 6 We have explained in section 2 that this feature fails to reflect the benefits of continuity for large companies of retaining their existing auditor in circumstances where that firm is performing well: it is only while the existing auditor is performing well that companies would choose not to “walk away”.
- 7 The evidence is very clear that while there may be substantial benefits to both the company and the audit firm from the relationship, any signs of complacency or lapse in quality by the audit firm would trigger a tender.⁴ The CC has not produced any hard evidence of adverse outcomes that are linked to this feature.⁵
- 8 Most significantly, this feature does not take into account the impact of the FRC’s changes to the new tender regime implemented in the Code. These changes can be expected to result in over a three-fold increase in the number of tenders in a year. However, other than to set out the changes in three paragraphs of Appendix 23,⁶ the CC has not considered the effect that this new regime will have in the context of this feature. The new tendering regime should cause the CC to reassess whether this feature remains relevant.

Feature (b): Company management face significant opportunity costs in the management time involved in the selection and education of a new auditor

- 9 We broadly agree that company management face significant opportunity costs in the management time involved in the selection and education of a new auditor. However, the evidence available to the CC shows that this will not prevent companies from tendering if they are dissatisfied with the service they are receiving.
- 10 That there may be certain occasions when management time is at a premium⁷ does not mean that such periods last indefinitely. As the CC acknowledges, it would not be “*in the interests of firms to act in ways that are potentially damaging to their relationships with clients that they have invested heavily if gains are short-lived or could trigger a tender in the near future*”.⁸

⁴ For example, the Group Financial Controller of “Company G” in the case studies said: “*trigger points for a tender would be a slip in independence, skills or value for money. These factors had to be considered relative to the competition: if the company thought that another audit firm could provide a better service at a lower cost and with a greater degree of independence, then this would trigger a switch.*” (Appendix 2, Company G, paragraph 22); See also paragraph 9.182 and Appendix 3, Table 20.

⁵ See Annex 1, paragraphs 3 to 4.

⁶ Paragraphs 106 to 109 of Appendix 23 set out the following changes proposed by the FRC to the Code:

- FTSE 350 companies put the audit contract out to tender at least every ten years on a ‘comply or explain’ basis;
- Companies should provide an explanation of how the AC has assessed the effectiveness of the external audit process and the approach taken to the appointment or reappointment of the external auditor;
- Transitional arrangements may be needed to ensure that the introduction of tendering is phased over a suitable period.

⁷ For example, significant transactions, financial stress, recent M&A activity etc.

⁸ Paragraph 9.171.

Therefore firms are unlikely to exploit any short-term inability of a firm to tender and the CC has not provided any evidence demonstrating that this has occurred.

- 11 To the extent that the CC believes that there may be certain times when companies may be disadvantaged in their dealings with auditors, mandating that tenders must take place at specified times is ill-advised.

Feature (c): Mid tier firms face experience and reputational barriers to expansion and selection in the FTSE 350 audit market

- 12 The CC notes the view (which is shared by all of the Big 4 firms) that there is a real difference in the quality of the networks of the Big 4 firms and the mid-tier firms and that this is the reason for their lack of expansion⁹. Despite a thorough analysis of the respective strengths of the different firms' networks in Appendix 25, the CC states: "*We have not formed a view on this*".¹⁰
- 13 Despite failing to form a view on this critical point, the CC "*broadly accepts*"¹¹ the submissions of the mid-tier firms that "*it was not the lack of investment in capability or international network which meant they were not winning FTSE 350 engagements*"¹². However, there is no acknowledgement in the CC's conclusion that the quality of the network - the very point on which the CC was unable to form a view - may be a critical reason why the mid-tier firms are unable to gain the experience (and hence reputation) that would allow them to win more large company audit clients.
- 14 In finding that the mid-tier firms face barriers to expansion and selection, the CC also fails to place sufficient weight on the fact that:
- (a) Despite mid-tier firms being invited to 33% tenders and having a significant number of NAS engagements with large companies,¹³ the survey evidence indicates that mid-tier firms make less significant efforts to target larger companies than Big 4 firms and often fail to make large companies aware of their capabilities.¹⁴
 - (b) Although finding that "*most investors seemed to be comfortable with a larger Mid Tier audit firm auditing FTSE 250 companies*",¹⁵ the CC ignores the survey evidence that found that if their current auditor ceased trading, 73% of large companies would only consider Big 4 alternatives.¹⁶
- 15 To the extent that the mid-tier firms are being denied opportunities to gain experience (and thereby reputation) by the use of "Big 4 clauses" in some syndicated leveraged loan

⁹ Paragraph 10.15.

¹⁰ Paragraph 10.15. We note that the CC does express a view on the quality differences of the networks in its case studies where it confirms that mid-tier firms do "*not have the geographic spread and quality in those locations to be able to undertake some of the international audits*". (Appendix 25, paragraph 121).

¹¹ Paragraph 10.15.

¹² Paragraph 10.14.

¹³ Paragraphs 10.8 and 10.20.

¹⁴ 77% of the FTSE 350 companies that had been approached for their audit were by only Big 4 firms (paragraph 10.11)

¹⁵ Paragraph 10.24.

¹⁶ Working Paper on Survey Results, Table 18

agreements that mandate the use of a Big 4 auditor¹⁷, we have long supported having such clauses removed. However, we do not believe that the mid-tier audit firms face any other barriers to entry that should be regarded by the CC as leading to an AEC.

The second theory of harm: principal-agent issues

Feature (d): Auditors have misaligned incentives, as between shareholders and company management, and so compete to satisfy management rather than shareholder demand, where the demands of executive management differ

16 We have explained in section 2 in our Response that this feature is not justified by a proper evaluation of the evidence and we challenge it in the strongest terms. In particular, we take issue with the PFs in the following material respects:

- (a) First, the divergence of demands between shareholders and management is overstated. It is wrong to characterise management demand and shareholder demand as two distinct, easily separable and competing demands. Both management and shareholders have complementary demands in ensuring that the audit is performed efficiently and is of sufficient quality; that the company's financial information is a true and fair reflection; and that this is recognised by the wider capital markets.¹⁸
- (b) Second, the influence of the AC in the selection of the auditor is greater than the CC concludes. The CC survey shows that "AC/ACCs were most frequently identified as the most influential."¹⁹ This has been demonstrated recently by the influence of the ACC in the tender processes run by BG, Man and Schroders.
- (c) Third, the FD's ability to influence the auditor's approach to proposed accounting treatments is materially overstated. The CC fails to recognise:
 - (i) The overriding influence of the auditor's personal incentives not to compromise his/her duties: The risk of substantial loss of reputation and livelihood (as previously noted by the CC in the Revised Issues Statement)²⁰ means that no rational auditor would knowingly put at risk his or her career by compromising their legal duties of independence and scepticism.

¹⁷ Paragraph 10.26.

¹⁸ The survey shows that for FDs, CFOs and ACCs, the factors most frequently identified as very important or important were the independence of the audit firm, and the efficiency of the audit process. Contrary to the CC's views, this in fact is aligned with shareholders' interests to have "reliable financial information about the company, so that they can accurately appraise its performance" (paragraph 5.8).

¹⁹ Paragraph 11.8.

²⁰ See the CC's "The framework for the CC's assessment and revised theories of harm" (Revised Issues Statement) at paragraph 68: "With regard to the relationship between shareholders and auditor (both individuals and the firm), the literature recognizes a risk that the desire on the part of auditors to maintain good relationships with managers with whom they have regular contact, and whose views may be decisive in future decisions on the appointment of an audit firm or individuals allocated to a audit team, would affect their willingness to challenge management. We note that much of the regulation is concerned with ensuring the independence, professionalism and integrity of the audit firm, for the benefit of shareholders as a whole. In addition, as mentioned above, this risk may be mitigated by the potential damage to an audit firm's reputation, and individual auditors, of mistakes resulting from a failure to retain independence." [emphasis added].

- (ii) The effectiveness of the AC: The evidence demonstrates that ACs are considerably more effective than the CC concludes.²¹
- (iii) The role of the AQRT and FRRP in ensuring that the auditor displays sufficient scepticism and independence²²: For example, the CC has ignored evidence of improvements made by audit firms to demonstrating scepticism in response to the FRC's annual reports of 2008/09 and 2009/10²³.

Feature (e): Auditors face barriers to the provision of information that shareholders demand

- 17 The CC refers to, but does not seem to take into account, that there are a number of important regulatory constraints on the ability of auditors to provide greater information about a company²⁴ and on ACs to disclose information about the audit process.²⁵
- 18 The CC overlooks that we (and other firms) have been active in recent years in engaging with the investor community to understand their views on how the audit might evolve and influence companies' corporate reporting. Our findings are that while some investors wish to see greater disclosure of financial information as part of the company's financial reporting, others are broadly content with the current position.²⁶
- 19 As acknowledged by the CC, shareholder demand is "differentiated"²⁷ and as the FRC has reported "shareholders generally did not have an agreed view as to what they might like in the way of enhanced reporting"²⁸. Yet the CC appears to have relied on certain minority views to conclude that "shareholders are not able to get the full benefit from the audit services"²⁹.
- 20 The evidence shows that individual shareholders already have significant powers that they are able to exercise in respect of the audit³⁰. Therefore, to the extent that shareholders do not exercise these powers regularly, the CC should consider the possibility that this might in reality indicate that they are content with the audit as provided.

²¹ Paragraphs 11.49 to 11.52; see also the FRC's annual report of 2011/2012, page 11, where it notes that "[a]udit committees are a lynchpin of UK corporate governance, representing the best interests of investors in the heart of their companies".

²² See also Beattie (2011) at section 1.6: "Effectiveness of enforcement. The FRRP was considered to be an effective financial reporting enforcement body and all key parties have strong incentives to comply with standards. The procedures of the AIU (the enforcement body for auditing standards) were considered to be process-driven and based on box-ticking; however, it was still considered a formidable regulator in enforcing ISAs and AEPs were most anxious to avoid adverse reports".

²³ See Annex 1, paragraph 27.

²⁴ Paragraphs 11.109-11.116.

²⁵ Paragraphs 11.117-11.130.

²⁶ PwC Closing Submission, paragraph 37.

²⁷ Paragraph 11.123.

²⁸ Paragraph 11.124.

²⁹ Paragraph 11.141.

³⁰ See paragraph 5(b)(ii) of PwC's response to the CC's Views of Investors WP (and relevant footnotes): "investors have certain rights that are available to them under the Companies Act⁵ and investors are able to influence companies (through representations made to the Senior Independent Director (SID), the audit committee chair (ACC) or to management) in respect of the audit process.⁶"

- 21 To the extent there remains a demand for the audit to evolve, this demand is being satisfied by the initiatives of certain companies (where we have played a role in leading the market);³¹ changes to the Code to require the AC to disclose more;³² and the current FRC and IAASB consultation processes.³³

³¹ As noted by the CC (see paragraph 7.200), six of our FTSE 100 audit clients - Barclays, GKN, Man Group, Unilever, BG Group and BT - have increased the transparency of reporting on their ACs' activities.

³² See our Closing Submission (7 January 2013), paragraph 4(b)(vii).

³³ Paragraph 11.132.