



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

13 August 2013

### ***Deloitte response to the Competition Commission's Provisional Decision on Remedies***

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## **Deloitte response to the Competition Commission's Provisional Decision on Remedies**

### **1. Introduction**

1.1 Deloitte is pleased to have the opportunity to respond to the Provisional decision on remedies (the **Provisional Decision**) issued by the Competition Commission (the **CC**) on 22 July 2013 (and published in full on 24 July 2013).

1.2 We agree that there are a number of the provisional remedies which will be positive for the FTSE 350 audit market and in cases will help improve audit quality and improve the perceptions of audit quality, in particular:

- (a) increasing the frequency of AQR team reviews on FTSE 350 audits and Mid-Tier firms;
- (b) prohibition of restrictive clauses in loan agreements;
- (c) encouraging increased shareholder involvement through the introduction of an advisory vote on the sufficiency of the disclosures in the audit committee report; and
- (d) strengthening the accountability of the auditor to the audit committee.

1.3 We also agree with many of the conclusions set out in the Provisional Decision, in particular:

- (a) that mandatory rotation is unnecessary and disproportionate;
- (b) that the other remedies discarded by the CC are neither necessary nor proportionate; and
- (c) that audit committees and audit committee chairs (**ACCs**) are effective custodians of shareholders' interests.

1.4 However, the CC's decision to prefer a five year period for tendering suffers from several flaws:

- (a) it runs contrary to the overwhelming majority of submissions from market participants (including the specialist regulator, investors and companies);
- (b) the reasoning behind the CC's decision to prefer a five year period to a 10 year period is weak; and
- (c) the CC wrongly assesses the proportionality of the five year tendering period. In particular, it understates the incremental cost of this remedy.

1.5 Overall the costs associated with the remedies package are understated and the posited benefits from the remedies package are spurious and inappropriately quantified.

### **2. Elements of the Provisional Decision with which we agree**

2.1 We are supportive of most of the proposed remedies as we believe that they will contribute to improving audit quality and the perceptions of audit quality.

#### *Increase the frequency of AQR team reviews*

2.2 Contrary to the CC's Provisional Findings, we believe that audit quality for FTSE 350 companies is high and this is supported by the findings of the AQR reviews over the last few years. We have

previously indicated to you the evidence<sup>1</sup> for this in our prior responses and will not repeat that evidence in this response.

- 2.3 Notwithstanding this point, increasing the frequency of reviews will contribute to the development of audit quality.
- 2.4 The CC notes that it does not make a recommendation on the scope and content of these reviews.<sup>2</sup> If the disclosure of the results of these reviews is to be increased, the FRC will need to consider how this can be managed without increasing the risk that the results are misunderstood by the reader.

#### *Prohibition of restrictive clauses in loan agreements*

- 2.5 We support the prohibition of these clauses on the basis that a company should be free to choose its own auditor.

#### *Enhanced shareholder engagement*

- 2.6 We support the amendment of the corporate governance code to oblige companies to seek dialogue with investors on audit issues and introduce an advisory vote on the sufficiency of disclosure in the Audit Committee report.

#### *Strengthen the accountability of the auditor to the audit committee*

- 2.7 We generally welcome moves to strengthen the accountability of the auditor to the audit committee.
- 2.8 We do have some concern that this remedy is giving the audit committee executive responsibility when it should be a non-executive body. The remedy should be modified to preserve the oversight role of this non-executive body.

#### *Competition objective for the FRC*

- 2.9 We have previously responded to the CC that we believe that the FRC already takes account of competition in discharging its duties<sup>3</sup>. However, we have no objection to the formalisation of a secondary duty if the CC concludes that this is appropriate.
- 2.10 In addition to the proposed remedies set out above we welcome certain of the other conclusions in the Provisional Decision.

#### *Mandatory rotation would be unnecessary and disproportionate*

- 2.11 We agree with the CC that mandatory rotation is not necessary given the extent of the remedies package proposed by the CC in the Provisional Decision (and, in particular, the effectiveness of mandatory tendering in addressing the same aspects of the adverse effect on competition identified by the CC in the Provisional Findings<sup>4</sup>)<sup>5</sup>.
- 2.12 In particular, we agree that it would be highly distortive, especially in relation to the incentives of the incumbent auditor<sup>6</sup>, and that this would be to the detriment of companies and their

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<sup>1</sup> Deloitte Response to the Provisional Findings 20 March 2013 Paragraph 5.7 *et seq.*

<sup>2</sup> Paragraph 3.248 of the Provisional Decision.

<sup>3</sup> Deloitte's response to the CC's Notice of a further possible remedy, 19 June 2013

<sup>4</sup> Deloitte has explained in its response to the Provisional Findings that it considers that the CC's identification of an adverse effect on competition in the Provisional Findings is flawed.

<sup>5</sup> Paragraph 4.66 of the Provisional Decision.

<sup>6</sup> Paragraph 4.65 of the Provisional Decision.

shareholders. We agree also with the CC's conclusion that a mandatory rotation remedy would be disproportionate given the costs and (lack of) benefits of this proposed remedy<sup>7</sup>.

*Other remedies not proposed by the CC*

- 2.13 We broadly agree with the analysis in the Provisional Decision as to those other remedies which it has provisionally decided not to propose<sup>8</sup>.

*The role of the audit committee and audit committee chair*

- 2.14 We concur with the clear theme emerging from the Provisional Decision that audit committees and ACCs can be trusted appropriately and effectively represent the interests of shareholders. This is a point we have been making to the CC throughout the investigation.

- 2.15 We are pleased to see that the CC considers that:

*"tenders were thorough, fair, and transparent processes in which the AC had an influential role, ensuring that shareholder interests are given appropriate weight."*<sup>9</sup>

*"The AC is an important part of the corporate governance architecture, and we place weight on its role in ensuring that competition takes place to satisfy the demands of shareholders."*<sup>10</sup>

*"As the representative of the interests of the shareholders, we expect ACCs to regard scepticism and technical quality as important factors in the selection of an auditor."*<sup>11</sup>

*"the effectiveness of a remedy that promotes more frequent use of tender processes would be greater if implemented in combination with other remedies aimed at promoting the role of the AC, as representatives of the interests of shareholders"*<sup>12</sup>

*"the information gained from the participation of the ACC or other members of the AC or board in tenders for other FTSE 350 audit engagements may assist in the annual renegotiations with the incumbent auditor."*<sup>13</sup>

- 2.16 The effectiveness of the role of the audit committee and ACC is at the heart of the rationale for several of the remedies proposed by the CC and similarly at the heart of the rationale for discarding several of those remedies that the CC does not propose.
- 2.17 While we welcome this recognition of the effectiveness of audit committees and ACCs, we believe that this same theme is not fully recognised in the Provisional Findings. Rather, the Provisional Findings too often display an unfair (and inaccurate) scepticism as to the effectiveness of audit committees and ACCs in representing the interests of shareholders<sup>14</sup>. We believe the CC should reconsider these elements.

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<sup>7</sup> Paragraph 4.66 of the Provisional Decision.

<sup>8</sup> Paragraph 4.67 *et seq* of the Provisional Decision.

<sup>9</sup> Paragraph 6 of the Summary of the Provisional Decision.

<sup>10</sup> Paragraph 10 of the Summary of the Provisional Decision.

<sup>11</sup> Paragraph 3.15(b) of the Provisional Decision.

<sup>12</sup> Paragraph 3.19 of the Provisional Decision.

<sup>13</sup> Paragraph 3.126 of the Provisional Decision.

<sup>14</sup> Paragraph 11.55 of the Provisional Findings.

### 3. Mandatory tendering on a five year basis

- 3.1 As we explained in our response to the CC's Remedies Notice, Deloitte accepts the principle of mandatory tendering<sup>15</sup>. We explained in that response that mandatory tendering on a "comply or explain" basis, and with a time limit of ten years between tenders, would be effective in addressing the CC's concerns. We are surprised and disappointed that the CC has taken a different view in its Provisional Decision.
- 3.2 The primary reason why this proposed remedy is flawed is that the AECs the CC is trying to remedy for are not properly supported by the available evidence, as we explained in our response to the Provisional Findings. We do not repeat these comments in this response. In addition, the CC's choice of five year tendering over ten year tendering is also flawed for the further reasons set out below.

*The Provisional Decision's conclusion runs contrary to the submissions of the clear majority of respondents*

- 3.3 The Provisional Decision summarises the submissions made to the CC on the appropriate tender period. However, it fails properly to note that the overwhelming majority of respondents indicated that a period longer than five years would be appropriate, and the Provisional Decision fails to explain why the CC is well-placed to second guess the views of a group that contains the clear majority of investors and investor groups, all company respondents and all auditor respondents (including those outside the Big Four).
- 3.4 The table at **Annex 1** shows the weight of opinion<sup>16</sup>.
- 3.5 In particular:
- (a) only a small minority of investors (particularly taking into account relative size) and investor groups favour a five year period. Importantly, the two bodies representing the majority of institutional investors – the ABI and the NAPF – both proposed a period longer than five years. The Provisional Decision does not properly assess the fact that the clear weight of investor demand is for a period longer than five years, and seems to prefer the views of a small minority; and
  - (b) the Provisional Decision states that "with the exception of BDO, the Mid Tier firms supported mandatory tendering at least every ten years"<sup>17</sup>. While that is correct, the more important point is that no mid-tier firm supported tendering as often as five years, and several make clear their opposition to such a period.
- 3.6 Nowhere does the Provisional Decision explain why the CC should take such a radical step as to ignore the views of the overwhelming majority of market participants.

*The CC's reasoning for preferring a five year period is weak*

- 3.7 The Provisional Decision sets out a number of reasons why it has preferred a five year tendering period above a longer period<sup>18</sup>. None of these stands up to scrutiny. To take each posited reason in turn:
- (a) the Provisional Decision states that a five year tendering process would "increase the bargaining power of FTSE 350 companies both *during* tenders and *in between* tenders" [emphasis added]<sup>19</sup>. There is no basis for saying this.

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<sup>15</sup> Paragraph 3.1 of Deloitte's response to the Remedies Notice.

<sup>16</sup> We also include those case study companies who expressed a clear opinion.

<sup>17</sup> Paragraph 3.38 of the Provisional Decision.

<sup>18</sup> Paragraph 3.149 of the Provisional Decision.

It is not contentious that a purchaser has full bargaining power when undertaking a tender amongst suppliers<sup>20</sup>. However, it is not logical that increasing the frequency of tenders will improve a company's relative bargaining position *during* the tender process. Given the existing balance of power *during* a tender, no remedy is required in respect of this.

In respect of relative bargaining power *in between* tenders the Provisional Decision does not explain how bargaining power is enhanced by switching to a five year tender period. We have previously indicated to the CC that there is a weight of evidence that companies do already have bargaining power in between tenders. This evidence includes:

- (i) evidence that efficiencies achieved year on year are passed onto companies in the form of real-terms audit fee savings rather than being retained by auditors<sup>21</sup>; and
- (ii) evidence that companies keep auditor performance under close scrutiny and in many cases annually review auditor performance and benchmark audit fees<sup>22</sup>.

Overall, given the evidence available, there is no basis to impose the onerous obligation of five year tendering (over ten year tendering) on the basis that companies' bargaining power needs to be increased;

- (b) the Provisional Decision states that a five year tendering period "would focus competition on a tender process in which the AC has an influential role in the specification of the process and the auditor selection"<sup>23</sup>. In fact, the evidence shows that frequency of tendering does not alter the relationship between the company, auditor and audit committee. This is achieved through entirely separate remedies<sup>24</sup>.

We do not believe that tendering on a five year basis will make any difference to the modes of competition between firms for audit relationships. Audit committees will (rightly) continue to seek the views of company executives. Companies who do not have the audit relationship will (rightly) continue to seek to impress companies with the quality of their non-audit work, thought leadership and other capabilities. The incumbent will (rightly) seek to do the same through its audit work and through developing good relationships with all stakeholders.

In relation to the intensity of marketing activity, reducing the tendering period to five years will have the opposite effect to that stated by the CC<sup>25</sup>. Rather than decrease marketing activities, firms will increase their marketing activities given the increased frequency of tenders. This is for two reasons:

- (i) the first priority for an audit firm is to be invited to tender and then to be shortlisted to participate in the tender in the first instance. The CC has found that the average number of participants is three<sup>26</sup>. There is no reason why, from a company's point of view, they should wish this to change and it would be reckless of an audit firm to leave the initial shortlisting to chance; and

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<sup>19</sup> Paragraph 3.149(a) of the Provisional Decision.

<sup>20</sup> Paragraph 3.13(a) of the Provisional Decision, referring in turn to the Provisional Findings.

<sup>21</sup> Working Paper "Evidence in Trends in Audit Fees" Paragraphs 5 and 8b.

<sup>22</sup> Deloitte response to the CC Working Paper "The Framework for the CC's Assessment and Revised Theories of Harm" Paragraph 2.23(e). This intense review activity is inconsistent with the notion that Companies do not have bargaining power in between tenders.

<sup>23</sup> Paragraph 3.149(b) of the Provisional Decision.

<sup>24</sup> See section 2 above in relation to Deloitte's support for other proposed remedies which would have this effect.

<sup>25</sup> Paragraph 3.84 of the Provisional Decision.

<sup>26</sup> CC Working Paper "Evidence relating to the selection process: tendering, annual renegotiations and switching" Paragraph 98.

- (ii) additionally, it is Deloitte's commercial experience that the success rate in a tender where there has been little prior contact with a company is greatly diminished;
- (c) as regards the alleged enhancement of choice<sup>27</sup>, switching to a five year tender cycle rather than ten year tender cycle with the hope of encouraging greater participation of mid-tier firms is disproportionate when less onerous alternatives could be implemented. For example, requiring audit committees to state in the audit committee report how they have selected their audit firm shortlist from the population of all available auditors for the tender process would be a more direct remedy to the feature of the market the CC is trying to address.

Furthermore, the CC is wrong to consider that firms will continue to participate in tenders on the same basis: of necessity, the costs of participation will mean that they will have to be more selective in tender participation. This is already happening as a result of the FRC reforms, and will be redoubled if the CC's proposals are implemented. Thus, for some companies, the CC's proposals may mean less, not more, choice.

- (d) the Provisional Decision states that it "may reduce the perception of a familiarity threat and may lead to improvements in audit quality and innovation through deployment of new personnel and techniques"<sup>28</sup>. Only a small minority of respondents to the CC have indicated dissatisfaction with the current audit partner rotation rules which have the objective of eliminating the familiarity threat<sup>29</sup>. A tender in itself does not mitigate the familiarity threat. This is only achieved through audit partner or audit firm rotation. Any improvement in quality arising from more frequent tendering needs to be balanced with the risk associated with an increase in the number of first year audits in the reference market. The submission from the Investment Management Association notes that for many investors tendering every five or seven years is too frequent.<sup>30</sup>

Furthermore, we have explained to the CC that innovation is a constant requirement even within an ongoing audit relationship. The CC will recollect that "complacency" was the most cited reason in the CC's survey for prompting a firm "seriously to consider" switching auditor. We have also explained to the CC the enormous innovations that have taken place in auditing practice generally, and in individual audits, in the past several years<sup>31</sup>. No evidence is provided by the CC that a five year tendering period will enhance existing activities in this respect.

Paragraph 3.17<sup>32</sup> provides no support for the conclusion that these aims are advanced by a five year rather than a ten year tendering process: it sets out only the FRC's support for the principle of "regular tendering". The CC will be aware, of course, that the FRC has opposed five year tendering, and so clearly could not have been supporting such a proposal when it made this statement. The reference should not be used in support of the CC's contention. Paragraph 3.17 provides no further analysis or evidence in support of this contention, nor does the rest of the Provisional Decision.

- (e) the final reason set out in the Provisional Decision is that a five year tendering period "may also combine with the effects of other proposed remedies to address the AEC"<sup>33</sup>. This is, of course, not a sufficient free-standing rationale for the imposition of a five year tendering

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<sup>27</sup> Paragraph 3.149(c) of the Provisional Decision.

<sup>28</sup> Paragraph 3.149(d) of the Provisional Decision.

<sup>29</sup> Submission from UK Shareholders Association 20 March 2013

<sup>30</sup> Paragraph 5 in Annexe to submission from Investment Management Association 25 March 2013

<sup>31</sup> See Deloitte's response to the Provisional Findings.

<sup>32</sup> The Provisional Decision cites paragraph 3.16 in support of this statement. We assume this is a typo (since paragraph 3.16 deals with ACC involvement in the tender process), and it intends to refer to paragraph 3.17 (which does deal with the two issues raised at paragraph 3.149(d)).

<sup>33</sup> Paragraph 3.149(e) of the Provisional Decision.

period, and provides no explanation as to why it would be a more effective supplement to those other remedies than tendering on a ten year period.

- 3.8 In summary, none of the justifications for preferring a five year tendering period stands up to scrutiny. In the light of the other considerations set out in this response, we do not consider that the decision to prefer such a short period can stand.

*The CC has wrongly assessed the proportionality of a five year tendering period*

- 3.9 The assessment of proportionality of the proposed five year tendering period in the Provisional Decision is flawed. This is the case for a number of reasons.

- 3.10 First, as the CC explains in its guidance, the idea of proportionality requires the CC to select the least onerous remedy from amongst those that are considered to be effective<sup>34</sup>. The Provisional Decision nowhere properly assesses the effectiveness of a ten year tendering period, as proposed by the clear majority of respondents to the Remedies Notice. While the Provisional Decision does (as noted above) compare the benefits of a five year and ten year tendering period, this is by no means inconsistent with a finding that both are fundamentally effective<sup>35</sup> and it is incumbent on the CC to state why a ten year tendering period is not effective.

- 3.11 Indeed, the CC suggests that it is the *principle* of mandatory tendering that is central to effectiveness:

*“Our provisional view is that mandatory tendering is an effective remedy and consider it to be a matter of judgment as to the appropriate interval between tenders.”<sup>36</sup>*

- 3.12 The only outright critique of a ten year period is the following brief statement:

*“We think ten years to be too long a time for an audit engagement not to be subject to the high level of scrutiny and competition that takes place without a rigorous tender process.”<sup>37</sup>*

This is not a sufficiently robust explanation for the decision to override the clear majority view among respondents that a tendering period of five years is not necessary for effectiveness.

- 3.13 There is now overwhelming evidence that the 10 year tendering regime implemented by the FRC is having a very material impact in the market for FTSE350 audits with a substantial increase in the number of tenders being completed or announced by FTSE 350 Companies since October 2012. This includes Schroders, RSA, BG Group, Land Securities, HSBC, Hargreaves Lansdown, Standard Chartered, Marks & Spencer, Tate & Lyle, Unilever, Travis Perkins, British Land, Cairn Energy, Marston’s, Perform, E2V, Henderson, DS Smith and Ladbrokes. Our research and discussions with FTSE 350 companies strongly suggest that this trend will continue over the foreseeable future.

- 3.14 Second, the Provisional Decision’s assessment of the comparative costs of a five year and ten year tendering process is flawed, since it incorporates several assumptions that appear to have no basis in the evidence before it, and that are contrary to Deloitte’s commercial experience. Specifically:

- (a) the Provisional Decision assumes that there is scope for a significantly increased efficiencies on the part of firms in the tendering process. This assumption is wrong.

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<sup>34</sup> Paragraph 344(c) of the CC’s *Guidelines for Market Investigations*.

<sup>35</sup> Paragraph 3.149 of the Provisional Decision.

<sup>36</sup> Paragraph 3.154 of the Provisional Decision.

<sup>37</sup> Paragraph 3.154 of the Provisional Decision.



First, the Provisional Decision states that there would be “incentives” for firms to invest in greater efficiency<sup>38</sup>. Whilst we may have the desire to become more efficient, the majority of tender costs are incurred through the time of partners and senior staff. No firm would want to reduce this time spent at the risk of reducing its competitiveness in a tender situation.

Second, on a related point, tendering processes are (as Deloitte has explained) designed by companies to ensure that they select the correct candidate for a very important role. The cost of involvement in the tender process is only to a very limited extent within the control of participating firms. We do not believe that any individual company would be willing to compromise the rigour of its auditor selection process in order to save firms’ costs, and the remedies proposed in the Provisional Decision in relation to greater disclosure in reporting to investors is likely to reinforce this<sup>39</sup>. Furthermore, we set out in section 4 below examples from our recent experience which show that the requirements during a tender process are increasing rather than decreasing.

Third, we note that the Provisional Decision cites undisclosed material “recently submitted by the firms” in support of its conclusion<sup>40</sup>. The CC has not indicated the nature of this material, and it unfair and improper for the CC to rely on such information to such an extent without giving Deloitte and other firms details of the nature of the information. Such information appears to be, as we explain below, directly contrary to Deloitte’s expectation.

- (b) the Provisional Decision assumes that there will be a material diversion of costs – particularly as regards the opportunity cost of partner time – from marketing activities to participation in tenders<sup>41</sup>. This is entirely unevidenced, misunderstands the nature of partner business development activities and is not a realistic assessment of how competitive firms will respond to the increased frequency of tenders.

If partners’ business development activities were confined to meeting with or entertaining company representatives with a view to persuading them to tender, this might have some credibility. However, this is not the focus of partner business development activities. Much the larger part of partner business development time is spent on activities such as thought leadership and similar projects designed to develop the relationship between the firm and client in the broadest sense. This is entirely consistent with the CC’s findings that the “main objectives” of partner business development time are “identifying potential audit clients, raising prospective client awareness of the firms’ capabilities and developing relationships with potential client staff”<sup>42</sup>. This activity will necessarily continue under a tendering regime of any duration.

Indeed, the CC’s supposition is directly contradicted by the evidence submitted by Deloitte (which is not mentioned by the CC): Deloitte’s internal documents submitted in response to the CC’s June 2013 questions on tendering and related costs clearly evidenced an *increased* degree of engagement from partners (including audit partners) with companies in the context of expectations of significantly increased levels of tendering;

- (c) the CC assumes that companies will hold tenders in “quiet periods” (on the basis that this has “often” been the case in the past) so as to allow a new auditor to get up to speed<sup>43</sup>. There is no evidence for this. Clients have historically conducted tenders at a wide range of different times throughout the year (and sometimes across years). The CC’s view appears to rest on the assumption that there is a short period in which audit firms (and partners in particular) are very busy, and a longer period in which they are not; this is wrong. Audit firms

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<sup>38</sup> Paragraph 3.69 of the Provisional Decision.

<sup>39</sup> See paragraph 3.14(d) below.

<sup>40</sup> Paragraph 3.72 of the Provisional Decision.

<sup>41</sup> Paragraph 3.84 of the Provisional Decision.

<sup>42</sup> Paragraph 3.84 of the Provisional Decision.

<sup>43</sup> Paragraph 3.83(b) of the Provisional Decision.

are busy throughout the year notwithstanding the additional pressure experienced in the first few months of the year due to 31 December year ends. Any concentration of tenders in any particular part of the year would, if anything, redouble the strain and costs imposed by the number of tenders in a given year implied by a five year tender schedule;

- (d) the CC assumes that companies also have significant scope for creating a more efficient tender process. It states that more frequent tendering will (as for firms) create the “incentives” to invest in such efficiencies<sup>44</sup>.

The CC fails to note, though, the countervailing incentives to ensure that the audit tendering process continues to be as rigorous as before (if not more rigorous) – some of which are created by the CC’s own proposed disclosure remedy. Indeed, when assessing whether there is a risk that companies do undertake an unduly superficial process, the CC concludes that its remedies and other existing market mechanisms will incentivise them to ensure that this does not happen<sup>45</sup>.

- (e) the CC has underestimated the costs of the move from 10 year to five year tendering, discussed in more detail below.

3.15 Third, the additional cost of participating in tenders (prior to any assumed efficiencies) has been understated by the CC.

3.16 We provided some historical data to the CC in response to its information request of 5 June 2013. Our most recent experience of tenders initiated since the amendments to the UK corporate governance regulations to require tendering of audits on a 10 year basis is that they have become more involved and time consuming, such that the historical figures can no longer be relied upon. Specifically:

- (a) companies are undertaking tenders in response to regulatory requirements rather than due to dissatisfaction with their current auditor. This increases the burden on companies as they need to be able to demonstrate to shareholders that any change in auditor will (at least) deliver the same levels of performance (across all the attributes of price, quality and innovation) as their current auditor;
- (b) there has been an increase in requests for information (RFI) to form the basis of a pre-tender selection process. For example, [X] have recently asked for a response to 18 detailed questions as a preliminary RFI. This entailed considerable research and preparation;
- (c) there has been an increase in the level of information requested and meetings held during the tender process. For example, the [X] tender required more than 40 site visits. The [X] tender required a full-day tender presentation; and
- (d) companies have started providing advance notice of tenders. As a result firms are putting teams to work on tenders earlier and for longer than was previously the case.

3.17 In order to come up with a reasonable assessment of the opportunity cost associated with an increase in tendering frequency to a five year basis we have extrapolated our most recent experience.

3.18 Assuming three participants in each tender, our recent data suggests a total incremental cost per year to audit firms of £61m. This excludes any additional company costs incurred as a result of more frequent tendering. See **Annex 2** for more details.

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<sup>44</sup> Paragraph 3.69 of the Provisional Decision.

<sup>45</sup> Paragraph 3.132 of the Provisional Decision.

3.19 In conclusion, for all of the above reasons, the Provisional Decision's reasoning as to the selection of a five year tender period is inadequate and cannot stand. The CC should consider more carefully the overwhelming weight of market opinion, and should reconsider this provisional decision before burdening FTSE 350 companies with an overly onerous obligation.

#### **4. Detriment and posited benefits of the remedies package as a whole**

4.1 The Provisional Decision makes a number of statements on the detriment suffered as a result of the provisional AECs and in particular the alleged shortfall in audit quality.

*"individual shareholders have less reliable financial information on which to ensure effective oversight of corporate decisions, including capital allocation decisions. Company performance and shareholder returns are lower as a result".<sup>46</sup>*

*"We expect there to be a wider detriment to the economy due to an undermining of trust in the quality of financial reporting and hence a higher cost of capital than would otherwise be the case"<sup>47</sup>*

4.2 The Provisional Decision goes on to say that the remedies package will result in an improvement in audit quality and have *very large* financial benefits<sup>48</sup> [emphasis added] and that small downward movements in the cost of capital as a result of improvements in audit quality and confidence in financial reporting could have large financial benefits for the economy in the order of billions of pounds<sup>49</sup>.

4.3 There are a number of significant flaws in these statements:

- (a) First, the CC has not found, nor is there any evidence that, audited financial information is not reliable, or that any practice investigated or reported on by the CC leads to a situation where financial reporting is less reliable. This statement is baseless and should be removed from any decision by the CC on remedies;
- (b) Second, the single biggest drivers of a FTSE 350 company's cost of capital are its own financial performance, the nature of its operations, sectors of activity, tax regime and the liquidity in its debt and equity securities. Corporate governance is an enabler of this liquidity. Given that UK corporate governance is already widely held to be amongst the best in the world<sup>50</sup>, it is unlikely that improvements to audit quality (however welcome they may be) will result in an increase in the liquidity of companies' securities to extent of the CC's speculation – i.e. billions of pounds;
- (c) Third, the posited link between improvements in corporate governance and reductions in companies' cost of capital is not something that is possible to measure in any way. The calculation<sup>51</sup> used by the CC to allow it to conclude that the benefit could be in the order of billions of pounds is nothing more than a mathematical illustration without any link to any audit-related driver and is misleading of the CC to seek to use it as the basis of its justification for the benefits of the remedies package; and

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<sup>46</sup> Paragraph 1.22(a) of the Provisional Decision.

<sup>47</sup> Paragraph 1.22(b) of the Provisional Decision.

<sup>48</sup> Paragraph 1.41 of the Provisional Decision.

<sup>49</sup> Paragraph 5.69

<sup>50</sup> See, for example, the Foreword to the London Stock Exchange publication "Corporate Governance for the Main Market and AIM Companies". The document can be found at <http://www.londonstockexchange.com/companies-and-advisors/aim/publications/documents/corpgov.pdf>

<sup>51</sup> Paragraphs 1.41 and 5.91 of the Provisional Decision

(d) fourth, it seems reasonable to consider that any company who thought that poor audit quality was damaging its cost of capital would have resolved this through replacing its auditor.

4.4 For all of the above reasons, the CC's conclusions on the benefits to which its remedy package will give rise are entirely speculative. They cannot be relied upon to assess the proportionality of any of the remedies proposed by the CC.

## Annex 1

### The clear majority of respondents oppose mandatory tendering every five years

Respondent	Category	In favour of mandatory five year tendering?
Aggreko	Companies	No
Barclays	Companies	No
Berkley Group Holdings	Companies	No
BT Group	Companies	No
Confederation of British Industry	Companies	No
GC 100	Companies	No
Hundred Group of Finance Directors	Companies	No
RBS	Companies	No
Rexam	Companies	No
SABMiller	Companies	No
Segro	Companies	No
Smiths Group	Companies	No
Smith & Nephew	Companies	No
Tate & Lyle	Companies	No
Unnamed company	Companies	No
Case study company G	Companies	No
Case study company L	Companies	No
Case study company M	Companies	No
Case study company N	Companies	No
Case study company O	Companies	No
Case study company P	Companies	No
Case study company Q	Companies	No
Case study company S	Companies	No
Case study company T	Companies	No
Case study company U	Companies	No

Respondent	Category	In favour of mandatory five year tendering?
Case study company W	Companies	No
Association of British Insurers	Investors	No
AXA	Investors	No
Baillie Gifford	Investors	Yes
Coalition of six investors	Investors	Yes
Hermes	Investors	No
Investment Management Association	Investors	No
Legal & General	Investors	No
National Association of Pension Funds	Investors	No
Newton Investment Management	Investors	Yes
Royal London Asset Management	Investors	No
Unnamed investor	Investors	No
Unnamed investor	Investors	No
Financial Reporting Council	Regulatory body	No
Chartered Institute of Management Accountants	Industry body	No
ICAEW	Industry body	No
ICAS	Industry body	No
International Federation of Accountants	Industry body	No
BDO	Auditor	No
Crowe Clarke Whitehill	Auditor	No
Deloitte	Auditor	No
Ernst & Young	Auditor	No
Grant Thornton	Auditor	No
Group A firms	Auditor	No
KPMG	Auditor	No
PwC	Auditor	No
Canadian Public Accounting Board	Non-UK	No

Respondent	Category	In favour of mandatory five year tendering?
Confederation of Swedish Enterprise and Institute for the Accountancy Profession in Sweden	Non-UK	No
Hong Kong Institute of Certified Public Accountants	Non-UK	No
Institute of Chartered Accountants Australia	Non-UK	No
South African Institute of Chartered Accountants	Non-UK	No
Simon Laffin	Individual	No
Nestor Advisors	Corporate governance consultancy	No

## Annex 2

### Incremental costs associated with tendering every five years rather than every 10 years

[§<]

- The table above assumes, based on the CC's findings, that there are three tender participants for each tender. Approximate costs per tender are taken from the analysis below.
- Bid team costs represent the incremental costs that we believe each big 4 firm will incur in expanding their bid support capability. In FY13 in anticipation of a move to 10 year tendering the headcount of our bid team was increased resulting in an increase in the cost of team from [§<] to [§<]. In light of the proposed five year tendering regime the bid team has recently proposed that a further [§<] investment will be required. For the purposes of estimating incremental market costs we have assume each big 4 firm will make a similar investment.
- We would encourage the CC to reconsider this analysis based on the bid team cost information received from other firms.

[§<]