KPMG response to the Competition Commission's Provisional Decision on Remedies

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NON-CONFIDENTIAL VERSION

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1 Executive summary

The Provisional Findings cannot be confirmed and do not support the proposed remedies, in particular the mandatory tendering remedy

1.1 KPMG continues to believe that the Competition Commission's ("CC") Provisional Findings into the supply of statutory audit services to FTSE350 companies ("Provisional Findings") are incorrect and unsupported by the evidence, as we set out in our response to the Provisional Findings.

1.2 Since then, there has been substantial new evidence published by the CC which further undermines the case for the CC's provisional finding that there is an adverse effect on competition ("AEC") in the market for the supply of statutory audit services to large companies. As the CC recognises this has been a particularly difficult case to assess[1] and it often has had to make judgements by balancing various elements of the evidence. That balance has shifted significantly and on an unbiased evaluation of all the evidence we submit that the Provisional Findings cannot be confirmed.

1.3 The CC's flawed AEC and customer detriment analysis also fundamentally undermines any rationale for the imposition of remedies. In addition, the assessment presented by the CC in its Provisional Decision on Remedies means that even if an AEC were judged to exist in the way the CC provisionally identified, the imposition of mandatory tendering every five years is completely disproportionate to the harm that is perceived to exist in the reference market.

Some of the other remedies may nonetheless assist in improving audit quality and are supported on those grounds

1.4 We have always been in favour of any measures that may improve corporate governance and audit quality. In this context we are generally supportive of the CC's proposed Remedies 2-7, many of which have the potential to improve audit quality and/or corporate governance. To the extent that the CC does find there to be an AEC then the evidence indicates that these Remedies in combination with the recent comply

[1] Paragraph 8.23 of the Provisional Findings.

or explain tendering obligation imposed by the FRC on FTSE350 companies, would effectively address any detriment the CC alleges.

Compared to the FRC's tendering requirements, the proposed mandatory tendering remedy provides no benefits, will be costly and poses significant risks to audit quality and corporate governance

1.5 In contrast the CC's proposal for mandatory tendering provides no demonstrable benefits and is likely to generate considerable costs (both direct costs and those resulting from increased risks to audit quality and corporate governance as well as reduced competitive pressure) when compared to the prevailing market conditions resulting from the FRC's recent reforms and cannot be justified. In particular the time period in the CC's proposed Remedy One is too short and its mandatory nature undermines the basic principles of UK corporate governance – both points emphatically made by the FRC in its response to the Provisional Decision on Remedies[2].

1.6 It is important to recognise that the CC is looking at a market which is in a state of flux. It has just been subject to one of the most important regulatory changes in the history of the industry, in particular the introduction of tendering on a "comply or explain" basis every ten years. The effects of this change are still emerging, but there is very clear evidence that it is having an effect on the market to increase both tendering and switching, and that this can be expected to continue. To the extent that the CC considers that tendering and switching would improve competition in the market, it is clear that the FRC reforms have already made a significant difference in this respect. The CC must recognise this and assess any supposed benefits flowing from again changing companies' tendering requirements against the benefits which are being delivered, and will be delivered in the future, by the FRC's reforms.

1.7 The relevant test for the CC is therefore whether, after allowing for the emerging, growing effect of the FRC's 10 year tender or explain measures, its other proposed remedies (i.e. Remedies Two to Seven) are sufficient to remedy the AEC it alleges exists. If the CC believes that they are not then it must demonstrate that imposing mandatory five year tendering will deliver significant additional benefits compared to

[2] Pages 2 to 6 of the FRC's response to the Provisional Decision on Remedies. http://www.frc.org.uk/Our-Work/Publications/FRC-Board/FRC-reponse-to-the-Competition-Commission-s-Statut.aspx

the FRC 10 year tender or explain measures, and that these additional benefits are greater than all the additional economic costs (including the risks to audit quality and corporate governance) this remedy is likely to generate. We submit that the CC's analysis, as set out in its Provisional Decision on Remedies does not meet this test. In particular, no comparison is made of these two possible alternatives – the only evaluation is of the package as a whole.

The proposed mandatory tendering remedy does not increase companies' bargaining power

1.8 In relation to the benefits of mandatory tendering, the CC has presented no robust evidence (in its Provisional Findings or elsewhere) that a company needs to conduct a tender in order to exert competitive pressure and achieve competitive outcomes in respect of either audit quality or price.

1.9 Specifically, there is no evidence that prices or margins fall following a tender or that companies' bargaining position otherwise improves leading to better outcomes - not surprising, given, as we have submitted throughout the inquiry[3], companies can and do exert competitive pressure on their audit firms on both quality and price through annual renegotiations without a tender. The evidence in the working paper "Evidence of trends in audit fees", published after the Provisional Findings, shows that audit firms' costs have reduced and these cost reductions have been passed on to customers (whether or not they have tendered the audit). This is strong evidence that the market is already working competitively, and companies have strong bargaining power outside of tenders. This evidence also demonstrates that whilst ensuring that audit quality remains high, audit firms are not overcharging. Indeed the CC has failed to demonstrate that any of the audit firms are making excess profits from statutory audit services.

1.10 In respect of audit quality the CC's other proposed remedies will significantly increase companies', ACs' and investors' visibility of audit quality (both of their own and of other audit firms) as independently assessed more regularly by the FRC, as well as allow investors to observe the AC's and company's reactions to those reports. In these

[3] For example, see Question 91 of KPMG's Response to the Market and Financial Questionnaire, Section 7.2 of KPMG's Main Submission in response to the CC's Issues Statement, Annex 2 of our response to the CC's working paper "Nature and strength of competition", Section 3.5.3 of KPMG's response to the Provisional Findings.

circumstances any additional bargaining power companies have in relation to audit quality the CC believes a company gains through tendering will be further reduced considerably. It is also difficult to see what greater comfort will be derived by investors on this aspect by additionally imposing mandatory tendering as frequently as proposed by the CC. In general, markets operate such that there is some trade-off between price and quality, as we discussed in our response to the CC's working paper "Review of evidence on the price effects of switching".

1.11 Therefore, the CC has no solid evidence to support its provisional decision that mandatory tendering every five years will increase the bargaining position of companies with regard to quality and/ or price.

The proposed mandatory tendering remedy may in fact reduce competition

1.12 In fact, the CC's proposals to increase the rate of tendering to every five years, and to make this mandatory, is likely, in our view, to actually reduce competitive pressure across the market. In particular, the largest and most complex companies will not find it efficient to change audit firm every five years – a position which the CC itself recognises in noting that it believes companies face substantial barriers to switching audit firm[4]. These companies' ACs therefore have no incentive to incur the substantial costs of setting up a proper, thorough tender process similar to tender processes currently being conducted under the FRC's regime. The additional tenders over and above those that would be conducted under the FRC's regime therefore risk becoming box-ticking exercises. There is also a real risk that this will set a precedent for all tenders and that competitive pressure will be reduced overall.

1.13 In this context, it is also likely that audit firms' incentives either to participate, or at a minimum to incur significant costs, in tenders will be far lower. Further, with more tenders each year, audit firms will face real constraints about which tenders to invest time and effort in competing for. We have already seen evidence of this under the new comply or explain tendering regime where we are aware of at least one major tender

[4] Paragraph 31 of the Provisional Findings.

opportunity in which one of the largest four audit firms declined to participate on these grounds[5].

1.14 For these reasons the CC cannot simply assume, as it does in its Provisional Decision on Remedies, that future tenders will deliver even the same level of benefits that it has provisionally concluded flow from current ones (which reflect a real possibility of changing audit firm).

The proposed mandatory tendering remedy will generate significantly more direct costs than the CC anticipates

1.15 The CC has also substantially underestimated the direct costs of tendering to both companies and audit firms, and over-estimated the potential for these costs to be reduced.

1.16 As regards actual costs, we set out in Appendix 2 examples of some recent tenders which support the view we submitted in our response to the Remedies Notice, that additional costs just for the audit firms of participating in the additional tenders for a five year mandatory tendering remedy will be of the order of £ [60-70] million per annum. These costs would be passed on to customers. These examples show that there are certain companies for which the costs of tendering are substantially greater than average, highlighting that tendering every five to seven years for the larger more complex companies imposes a particular burden.

1.17 Whilst some limited efficiencies may emerge as a result of more frequent tendering, it is clear from the Notes on Best Practice for Audit Tenders recently released by the FRC ('Best Practice Notes')[6] that in order for Audit Committees to gain any significant incremental insight into audit quality from the tender process, the process needs to be intensive and cover multiple aspects; a costly and time consuming process[7].

[5] EY declined to participate in the HSBC tender, citing that it wished to focus instead on the Standard Chartered Bank tender.

[6] http://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/Audit-Tenders-Notes-on-best-practice.pdf

[7] For example, paragraph 37 of the Best Practice Notes refer to companies stressing the importance of earlier stages of the tender process; paragraph 8 refers to some companies announcing a tender more than a year in advance, suggesting that it is a complex and time consuming process; the box above paragraph 19 emphasises the need for key company senior staff to be included in the tender process.

The proposed mandatory tendering remedy will not improve audit quality or corporate governance and risks of reducing both and/or investors' perceptions of both

1.18 The CC also argues mandatory tendering every five years will enhance the role of the AC and corporate governance more broadly and might thereby improve audit quality and shareholder perceptions and engagement. In discussing the benefits of its remedies package as a whole, the CC notes that the most important benefit is a refocusing of competition towards meeting shareholder demand leading to an improvement in audit quality, with substantial benefits across the UK economy. The CC does not, however, have any evidence that, and has not demonstrated how, the mandatory tendering remedy will actually contribute to audit quality or corporate governance in a way that the FRC regime does not, or whether tendering more frequently than the FRC requires will in general improve shareholders' perception of audit quality and corporate governance. This is not surprising since the FRC's measures were put in place after a detailed consideration of, and public consultation on, the appropriate time period for tendering and the impact on audit quality and corporate governance by a regulator charged specifically with promoting these aspects.

1.19 We note that in this regard the CC itself concedes that it only *"may"*[8] improve quality and shareholder perceptions – in our view this reflects the fact that the CC has an insufficient evidentiary basis for imposing a remedy which will impose such significant costs. The CC's statement that it is a *"matter of judgement"*[9] as to the appropriate length of time between tenders is not an appropriate basis upon which to decide to implement such an intrusive remedy and cite such substantial benefits from doing so.

1.19.1 Further, as noted above, whilst they are not justified by an AEC finding, the CC's other remedies within its overall remedies package do have the potential to improve audit quality and corporate governance. Adding mandatory tendering every five years on the contrary goes against this direction of travel by disenfranchising the AC (and thereby investors). In addition, we note that the cycle of mandatory tendering also undermines the effectiveness of the CC's proposals on increasing the frequency of AQRT reports as the time horizon for a tender following a switch may well be in advance of receiving any report on the incumbent firm.

[8] Paragraph 3.149d) of the Provisional Decision on Remedies.
[9] Paragraph 3.154 of the Provisional Decision on Remedies.

1.20 Neither is there any significant investor support for the view that frequent tendering will improve the perception of audit quality or corporate governance. Indeed in our view mandatory tendering every five years risks reducing audit quality and corporate governance and perceptions thereof. This is partly because of the danger that tenders become box-ticking exercises but also because of the inevitable distraction of senior professionals' time away from audits themselves towards tendering activity. In this context in our view the CC has misinterpreted our previous submissions as it is not a question of the audit firms deploying a *"strategy"*[10] of *"divert[ing] people away from audit engagements"*[11]. Rather it is the simple fact that the most senior audit partners handling the most complex engagements who will inevitably have to be involved in (probably multiple) audit tenders in their fourth or fifth year of an audit engagement in order to have an audit client to rotate onto. On top of this, the significant increase in the overall time spent by all audit firms in tendering might make this diversion of resources more apparent to investors thereby potentially further giving a perception of reduced audit focus in circumstances where senior audit partners spend more time tendering and less time doing statutory audit work.. We note that the FRC has raised similar concerns as to the possible impact on audit quality, or perception thereof, in its response to the Provisional Decision on Remedies[12].

1.21 In this context, the CC has also, in our view, grossly underestimated the resource challenge this involves. First, whilst there is clearly a busy season as regards the more junior personnel involved on audits, this is much less the case for senior personnel who contribute proportionately more time in relation to quarterly and half year reporting, as well as any ad hoc corporate transactions. Second, the CC is wrong to suppose that this tendering activity is really a substitute for the current marketing activity undertaken by audit partners. The latter is voluntary and not to a rigid timescale which means it can be flexed around other work; the former, on the contrary, is mandated by the company tendering. Companies expect to see a significant amount of their proposed senior team (and audit engagement partner ("AEP") specifically) in any serious evaluation of the tender proposal and will dictate the timetable having no regard to other commitments. Third, we do not agree that resources are unlimited when one is considering the most highly talented audit partners – like any profession, the most high quality resources,

[10] Paragraph 3.117 of the Provisional Decision on Remedies.
[11] Paragraph 3.117 of the Provisional Decision on Remedies.
[12] For example, see page 3 of the FRC's response to the Provisional Decision on Remedies.

particularly at a senior level are scarce in the audit profession and there is nothing to suggest this will change as a result of the CC's remedies package.

1.22 As the CC has argued, even small changes in the perception of the quality of corporate governance or audit quality can have substantial consequences for the UK economy. We agree and note that based on our comments above the CC's proposals on mandatory tendering risk substantial costs to the UK economy as the FRC makes clear[13].

The CC cannot proceed with the proposed mandatory tendering remedy and should consider other, less intrusive remedies

1.23 To conclude, the CC cannot, in our view, confirm its provisional finding that a remedies package which includes mandatory tendering on a five year basis is effective or proportionate. In terms of its effectiveness, the CC has no good evidence to support its provisional view that more tenders will improve outcomes for customers. The CC is therefore not only unable to conclude that the proposed remedy is effective, but it is even less able to identify the benefit that it supposes would flow to companies over and above the FRC reforms and its other proposed remedies. Further, the CC must consider the risk that its proposed remedy will actually reduce the quality of outcomes for companies and competition in the reference market and also risks incurring considerable direct and indirect costs. In terms of proportionality, the FRC's recent reforms, combined with the CC's proposed Remedies Two to Seven, are clearly a far less costly means of addressing the alleged AEC than mandatory tendering every five years. The CC is obliged to choose the least onerous remedies package.

1.24 For these reasons, and given the recent introduction of the FRC's measures, we recommend that the CC drops or at the very least considers postponing the implementation of Remedy One until the full effects of the FRC's recent amendments can be assessed[14]. In the meantime if the CC wishes to further improve shareholder perceptions and engagement it might consider requiring companies to include specific information on audit tendering (frequency etc) within the audit committee report. This would allow shareholders to indicate their view of such policies through the proposed advisory vote as part of the CC's proposed Remedy Four.

[13] Page 2, FRC response to the Provisional Decision on Remedies.
[14] As also suggested by the FRC on page 6 of its response to the Provisional Decision on Remedies.

Mandatory rotation would not be effective in addressing the CC's alleged AEC

1.25 In relation to mandatory rotation, we agree with the CC's conclusion that this remedy option should not be imposed, for all of the reasons that we set out in our response to the CC's Remedies Notice[15]. However, in its justification for its provisional conclusion the CC has failed to recognise that this remedy would not only be disproportionate but also ineffective, resulting in significant harm to competition in the reference market. The CC recognises that this remedy gives rise to substantial economic costs because it systematically excludes the incumbent and thereby weakens competition[16]. However, the CC fails to recognise that for that very reason mandatory rotation is not effective in addressing the CC's alleged AEC and realising any benefits.

1.26 Specifically, the CC's statement that its proposed remedies package addresses the AEC *"more effectively while delivering similar benefits"*[17] is confusing. The CC appears to concede that there are benefits in mandatory rotation and that such a remedy would be at least partly effective in remedying the AEC it has identified. The CC has provided no robust evidence to support either of these views, and we think it is important that the CC clarifies that any measure that clearly reduces competition (as the CC acknowledges) cannot possibly remedy an AEC and deliver benefits that might be associated with increased competition. In the absence of such a clarification the CC's conclusions will clearly be vitiated by a profound logical inconsistency.

1.27 The CC suggests that mandatory rotation would address concerns expressed by investors where a company has had the same audit firm for many years. We note that these concerns were expressed only by some investors from which the CC received views and so in that regard, the CC's statement here is misleading. There is no evidence to support the view that mandatory rotation would satisfactorily address any investor concerns[18], as there is no majority of investors in favour of this remedy[19]. Further, the CC has failed to recognise that this remedy risks reducing audit quality and therefore gives rise to substantial costs. Specifically, the CC appears to suggest that changes of

[15] Section 4 of our response to the Remedies Notice.
[16] Paragraph 4.59 of the Provisional Decision on Remedies.
[17] Paragraph 4.66 of the Provisional Decision on Remedies.
[18] Paragraph 4.66 of the Provisional Decision on Remedies.
[19] AXA Investment Managers, Association of Financial Markets in Europe, Blackrock, Kames Capital, and an unnamed investor did not favour mandatory rotation. In addition Newton Investment Management favoured mandatory rotation only on a comply or explain basis.

audit firm that are not in the best interests of shareholders will still give rise to benefits[20], albeit lower benefits than are associated with its current remedies package. The CC can have no basis for such a view. Instead, switching audit firm when this is not in the interests of shareholders gives rise to substantial costs, including as a result of the greater risk of audit failure in the first years of an audit (as we set out in our response to the Remedies Notice[21]) and, compared to the existing FRC regime, does not realise any benefits for shareholders.

Structure of our response

1.28 The rest of our response is structured as follows. First, we set out our strong view, with our reasons and evidence, that the CC cannot confirm its provisional AEC finding, particularly in the light of the evidence published since the Provisional Findings. Second, we discuss the CC's mandatory tendering remedy and why, in our view and based on the evidence received, it will not give rise to any benefits. Third, we set out our views on the proportionality of the CC's remedies package assessed by reference to the correct counterfactual, which is Remedies Two to Seven combined with the FRC's recently introduced tendering regime and the benefits which it could be expected to deliver. In relation to the CC's other proposed remedies in its package, we think that they generally have the potential to enhance corporate governance and audit quality, and on that basis we are broadly in favour of them as we do not think that they will distort the market substantially. However, in the final section of our response we set out some practical considerations that we believe the CC must take into account in the implementation of some of these remedies as well as our belief that the FRC would be in a better position to give effect to them than the CC trying to compose an Order which may interact with existing regulations in unforeseen ways.

2 The CC cannot confirm its AEC finding

2.1 Introduction

2.1.1 In its Provisional Decision on Remedies, the CC sets out its view as to the AEC it considers exists in the reference market and the resulting customer detriment[22]. We set

[20] Paragraph 4.66 of the Provisional Decision on Remedies, last sentence.
[21] Section 4.2.5 of our response to the Remedies Notice.
[22] Paragraphs 1.10-1.14 and 1.15 to 1.42 respectively of the Provisional Decision on Remedies.

out in our response to the Provisional Findings the reasons why we considered that these Provisional Findings should not be confirmed in the CC's Final Report. Recent evidence published by and/ or available to the CC[23] further strengthens the case against the confirmation of the Provisional Findings, which we outline in this section.

2.2 Recent evidence and the CC's analysis

2.2.1 Evidence published since the release of the Provisional Findings confirms that the CC's assessment, on which the AEC finding is based, is flawed. This new evidence concerns the following key 'outcomes' referred to in the CC's Provisional Findings:

- audit quality in the reference market[24]; and
- pricing and profitability of FTSE350 statutory audit services and audit businesses[25].

2.2.2 Under the Enterprise Act 2002 ("Enterprise Act"), a *"detrimental effect on customers"* is relevantly defined as one taking the form of:

- higher prices, lower quality, or less choice of goods or services in any market in the UK; or
- less innovation in relation to such goods and services.[26]

2.2.3 The new evidence, which we outline in detail below, is consistent with the existing body of evidence which suggests that audit quality in the reference market is high (accordingly, the level of trust and confidence in the audit services supplied must also be high) and that pricing and profitability are at competitive levels according to the CC's own benchmark. As we outlined in our response to the Provisional Findings, the level of innovation and the degree of choice in the reference market is also high.

2.2.4 Accordingly, the CC has failed to substantiate the existence of an AEC and resulting detrimental effects in the reference market. In such circumstances, the Provisional Findings cannot be confirmed and the justification for the imposition of the CC's remedies package is necessarily flawed. We deal in turn with the issues of audit quality, confidence and trust, pricing/profitability, bargaining power and misaligned incentives

[23] CC working paper "Review of evidence on the price effects of switching"; CC Case Studies G, K-W; Audit Quality Inspections, Annual Report 2012/13.
[24] Paragraphs 7.95-7.121 of the Provisional Findings.
[25] Paragraphs 7.29-7.94 of the Provisional Findings.
[26] Section 134(5) of the Enterprise Act.

below. Before doing so, however, we would note that ACs and investors have consistently said that their primary concern is audit quality. In general, there is some trade-off between price and quality, as we discussed in our response to the CC's working paper "Review of evidence on the price effects of switching". We deal first with audit quality and then with pricing, although, as we observe in the latter section, even as demands for audit quality are ever increasing, audit efficiencies continue to be identified and the benefits of these efficiencies are being passed on to customers demonstrating the competitive nature of the market.

a) Audit quality in the reference market is high

2.2.5 As a preliminary point, we note that the CC appears to have modified the view it expressed in its Provisional Findings that there are *"significant, persistent and widespread"* concerns regarding audit quality[27]. In the Provisional Decision on Remedies, the CC instead suggests that there is merely *"evidence of shortfalls in quality"* and that *"while there is some evidence of improvement over time, professional scepticism continues to be a concern"*[28]. The CC then goes on to state that *"the relative frequency of these shortfalls is difficult to determine precisely…but… even relatively infrequent notable instances are likely to have a significant detrimental effect on confidence"*[29].

2.2.6 The CC suggests that as a result of these alleged shortfalls in audit quality:

- shareholders have less reliable financial information on which to ensure effective oversight of corporate decisions, including capital allocation decisions, and that company performance and shareholder returns are lower as a result[30] ;and
- there is 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[31].

2.2.7 These conclusions lack adequate substantiation. The CC's findings also appear to be at odds with the evidence we have previously submitted in relation to the high level of audit quality in the reference market[32], and the most recently available evidence on audit

[27] Paragraph 7.121 of the Provisional Findings.
[28] Paragraph 1.31 of the Provisional Decision on Remedies.
[29] Paragraph 1.31 of the Provisional Decision on Remedies.
[30] Paragraph 1.22(a) of the Provisional Decision on Remedies.
[31] Paragraph 1.22(b) of the Provisional Decision on Remedies.
[32] Section 2.6 of the KPMG Response to the Provisional Findings.

quality which similarly suggests that standards are very high. In its most recent round of annual reviews, the AQRT made the following comments:

- *"Over the years we have seen continuous improvement in overall audit quality as indicated by the results of our inspection of individual audits. This improvement was more pronounced in the sample of audits inspected in 2012/13. The improvement is, however, not uniformly spread across all the firms and types of audited entities subject to our inspections, and there has been an increase in the proportion of audits of entities outside the FTSE 350 assessed in the current year as requiring significant improvements"*[33]; and
- *"The UK audit inspection regime is one of the most transparent in the world and we believe that this contributes to a continuous and sustained improvement in overall audit quality"*[34].

2.2.8 The AQRT's key findings on audit quality may be summarised as follows:

- a significant increase in audits assessed as good with limited improvements required (59 per cent compared with 46 per cent in 2011/12);
- an offsetting reduction in audits assessed as acceptable overall with improvements required (26 per cent compared with 44 per cent in 2011/12); and

2.2.9 Whilst there has been an increase in the number of audits assessed as requiring significant improvements (15 per cent compared with 10 per cent in 2011/12), this increase is attributable to the audit of entities outside the FTSE 350[35]. It is therefore not relevant to the reference market.

2.2.10 The CC's selective use of only some of the above cited evidence is not representative of the overall views expressed by the AQRT, which are that audit quality in the reference market has improved over recent years and is currently high, particularly when one compares this to audit quality outside of the reference market[36].

2.2.11 The CC also states that the *"quality demanded"* by shareholders is likely to be different in a *"well-functioning market"* compared to that observed currently[37]. The CC states that there would be a greater emphasis on professional scepticism and thoroughness. However, the CC's first survey shows that ACs had the main influence over the selection of an audit firm and that independence of the audit firm, ability to detect

[33] Page 5 of the Audit Quality Inspections, Annual Report 2012/13.
[34] Page 5 of the Audit Quality Inspections, Annual Report 2012/13.
[35] Page 7 of the Audit Quality Inspections, Annual Report 2012/13.
[36] Page 7 of the Audit Quality Inspections, Annual Report 2012/13.
[37] Paragraph 1.37 of the Provisional Decision on Remedies.

misstatements, high degree of challenge and efficiency were all seen as important by around 90 per cent (or higher) of ACCs and FDs.

2.2.12 We also note that the CC accepts that the UK governance framework scores well on international comparisons[38]. Hence, it appears unusual that the CC could retain such concerns regarding audit quality in the reference market, particularly in the light of the evidence outlined above from the AQRT's most recent annual review.

2.2.13 Not only does the above evidence suggest that the CC is incorrect to conclude that there is a shortfall in audit quality, but it also suggests that there is no lack of bargaining power on the part of companies, which are able to find reliable information on the quality of audit services in the reference market, both overall and concerning individual audit firms from the reports currently produced by the AQRT. If companies lacked bargaining power in the reference market one would expect to see lower audit quality and (potentially) higher prices and profit margins. The new AQRT evidence, however, suggests that quality is high and the evidence outlined in section 2.2 c) below indicates that pricing and profitability are at competitive levels in the reference market.

2.2.14 Further, even if the concerns regarding audit quality identified by the CC were correct, this detriment, or if there is thought to be a lack of independence or scepticism (which we have previously submitted there is not[39]), will likely be addressed by Remedies Two, Four, Five and Six. Mandatory tendering on the other hand will do nothing to enhance actual audit quality or the perception of audit quality and may in fact result in a decline for the reasons outlined below in sections 3.4 and 3.5.

b) No evidence of a lack of trust and confidence

2.2.15 The evidence outlined above regarding the high level of audit quality in the reference market also has the effect of undermining the CC's view[40] that there is a lack of trust and confidence in financial reporting.

2.2.16 First, we note that the CC's views regarding trust and confidence are supported by very little evidence. The CC notes that in the Oxera Investor Survey investors expressed

[38] Paragraph 1.40 of the Provisional Decision on Remedies.
[39] Section 2.7 of KPMG response to the Provisional Findings.
[40] Paragraph 1.22(b) of the Provisional Decision on Remedies.

divergent views on *"whether the audit market was delivering well"*[41] but that only *"one investor said it did not have sufficient information to judge the issue"*[42]. This is a poor evidence base from which to conclude that there is a lack of trust and confidence in the reference market more broadly, particularly in circumstances where, as noted in paragraph 2.2.12 above, the CC also recognises that the UK governance framework scores well on international comparisons[43].

2.2.17 In its Provisional Decision on Remedies, the CC also makes the following comments which suggest that the level of trust in auditors declined as a result of the Global Financial Crisis:

> *"Following the financial crisis the Big 4 auditor firms were criticized for a failure to identify mounting risks. For this reason, we consider that the benefits to be had from a remedy that would contribute to restoring trust in audit reports and promoting effective corporate governance would be highly valued in this sector"*[44].

2.2.18 As noted in our response to the Provisional Findings[45], the CC's comments in this regard are reached without sufficient evidence linking the corporate failures to a shortfall in audit quality or a lack of audit firm independence or scepticism. In our view, the reasons for these corporate failures are inextricably linked to the causes of the global financial crisis itself and cannot easily be ascribed to one particular factor. Although all parties (governments, regulators, corporates, auditors and investors) accept that improvements can be made so that collectively the chances of identifying systemic risks are improved, there is no basis for expecting auditors to be more prescient than other parties; nor will the CC's proposed remedies alter that. The fact therefore that all these parties failed to identify the financial crisis in advance is not evidence that auditors lacked professional scepticism or that audits were of poor quality. There continues to be a debate, illuminated by the Parliamentary Committee on Banking Standards Report[46], on whether the role of the audit should be enhanced, on how investors can have greater insight into the AC/audit firm dialogue and on improved collaboration between the prudential regulator and audit firm. But the actual quality of auditing of the systemically

[41] Footnote 22 of the Provisional Decision on Remedies.
[42] Paragraph 1.26 of the Provisional Decision on Remedies.
[43] Paragraph 1.40 of the Provisional Decision on Remedies.
[44] Paragraph 3.158(c) of the Provisional Decision on Remedies.
[45] Paragraph 2.6.3.11 of KPMG's Response to the Provisional Findings.
[46] July 2013

important financial institutions (as defined by auditing standards) has not been found significantly wanting by the independent regulator during or since the financial crisis.

2.2.19 Evidence given during the House of Lords Select Committee Inquiry attested to high levels of quality in the provision of audit services, arising from competition between audit firms:

- The Chairman of the Hundred Group stated that this group is *"content in general terms with the service provided and the competition that we observe in the market today"*.[47] This witness added that *"audit firms know that we have a choice and that very often it is all you need to keep their pricing and the quality of their service honest"*[48].
- Commenting on the delivery of the audit opinion, the Chief Finance Officer of Pearson and member of the Hundred Group stated: *"Could we get it cheaper? Possibly, but there's also an issue about quality. We want to make absolutely certain that we are getting the best advice"*[49].
- Commenting on value-added services, provided to an auditor using insights picked up during the course of conducting work for the audit opinion, the Chairman of the Hundred Group noted that these services add *"a lot of value to the audit committee and provides a lot of perspective, context, even assurance for the non-executive directors, which you wouldn't get from an insurance policy but you can get from your auditors"*[50].

2.2.20 It appears that the CC has not fully considered this evidence.

2.2.21 The CC also comments that *"instances where auditors have been found to lack scepticism are likely to be damaging in this respect"*[51]. The CC fails to provide any evidence that there is a general lack of scepticism among auditors or that such a lack of scepticism is resulting in a shortfall in trust and confidence in the audit services supplied in the reference market. As discussed in our response to the Provisional Findings[52], a number of the issues raised by the AQRT in its audit review process and in its final reports often indicate a difference of judgement on the extent of auditor evidence required to support individual assertions underlying a set of accounts. The CC should recognise that an audit is a complex process (particularly for FTSE350

[47] The group of Finance Directors of FTSE 100 companies.
[48] Page 11 of the House of Lords Select Committee on Economic Affairs, "Auditors: Market concentration and their role".
[49] Page 262 of the House of Lords Select Committee on Economic Affairs, "Auditors: Market concentration and their role".
[50] Page 262 of the House of Lords Select Committee on Economic Affairs, "Auditors: Market concentration and their role".
[51] Paragraph 1.27 of the Provisional Decision on Remedies.
[52] Paragraph 2.6.2.3 of KPMG's Response to the Provisional Findings.

companies), involves the exercise of professional judgement and is manually intensive. In such circumstances, disagreements over the fine judgements that need to be made are inevitable, even with the most extensive quality control measures in place. This is not indicative of a lack of scepticism.

2.2.22 Relevantly, the AQRT's most recent annual report made the following comments in relation to professional scepticism:

> *"Initiatives to reinforce the importance of exercising sufficient professional scepticism appear to be working although progress is not uniform"*[53].

2.2.23 It would therefore appear that the CC's concerns regarding the level of trust and confidence in the audit services supplied in the reference market are overstated. Further, we note that while the CC refers to the views of investors a number of times in its Provisional Decision on Remedies, we have been denied access to the responses, even in summary form, and also response rates to the CC's investor questionnaire. The views of investors are obviously important when assessing the level of trust and confidence in those audit services supplied in the reference market. We retain the view that this evidence should be made available to parties in full and we reserve our right to comment on this evidence if it is made available in the future. We discuss the CC's investor questionnaire further in paragraph 3.4.10 below.

2.2.24 The fact that the AQRT is focused, in each and every review it conducts, on finding areas of improvement is a sign that the standard is set very high and that there will never be a 'perfect' audit. This is particularly the case in circumstances where, as noted above, audits are complex and open to differences in judgement. We submit that this is in fact the sign of a healthy and competitive market, in which regulatory oversight on quality is effective and is designed to drive continuous improvements in practices and outcomes for customers.

2.2.25 In our view, which we have previously expressed in our response to the Provisional Findings, it is not a shortfall in quality or a lack of information about audit quality but rather a lack of engagement on the part of investors that requires consideration[54]. As discussed during our hearing with the CC on 29 April 2013 (the "Response Hearing"), KPMG has asked ACs and ACCs whether investors have ever requested information

[53] Page 9 of the Audit Quality Inspections, Annual Report 2012/13.
[54] Section 2.10 of KPMG's Response to the Provisional Findings.

from them regarding the statutory audit. None of those with whom KPMG spoke had ever received a request from an investor for information regarding the audit[55]. In the event that the CC considers that this aspect of the market gives rise to an AEC (with which we disagree), then we believe remedies that may have the effect of encouraging greater shareholder engagement, such as Remedies Four, Five and Six, would be more appropriate, subject to our comments outlined in section 5.

c) Pricing and profitability is competitive

2.2.26 In its Provisional Findings, the CC found that *"the market is not working well in delivering competitive prices"*[56]. This finding was not supported by the existing evidence, which is outlined in our response to the Provisional Findings, and is further contradicted by the CC's most recent working paper "Evidence on trends in audit fees" which provides compelling evidence to support the view, as expressed in our response to the Provisional Findings, that pricing and profitability are at competitive levels in the reference market[57]. This is also consistent with the CC's acknowledgement that it found no reliable evidence of excess profits[58]. The evidence in the most recent working paper indicates that while audit firms have reduced costs these 'efficiencies' have been passed onto customers in the form of lower hourly fees. Relevantly:

- average costs and fees per hour have fallen in real terms between 2006 and 2011 (the time period for which the CC has full information available)[59];
- gross margins between 2006 and 2011 have remained stable; and
- engagement hours have fallen over the same period[60].

2.2.27 The above data is consistent across the market and suppliers and shows that we, and other audit firms, have, whilst preserving and in fact improving audit quality (which was noted by ACs and investors generally to be their primary concern), been successful in reducing our costs. More importantly we have passed these reductions onto our

[55] Paragraphs 61 and 66 of KPMG's Hearing Summary dated 29 April 2013.
[56] Paragraph 7.94 of the Provisional Findings.
[57] CC working paper "Review of evidence on the price effects of switching".
[58] Paragraph 7.70 of the Provisional Findings.
[59] The CC states in its working paper "Review of evidence on the price effects of switching" that in real terms audit fees increased between 2001 and 2010, but this increase is based on the public dataset, where fees also include audit-related services and global audit fees. When the CC analyses total fees using the engagement dataset, for the period 2006 to 2011 (the same data and time period that is used to analyse hourly costs, fees and total engagement hours) it is apparent that total fees have also declined in real terms since 2006.
[60] CC working paper "Review of evidence on the price effects of switching".

clients and have not retained them for ourselves; a clear sign of a well functioning and competitive market. Our detailed analysis of the CC's working paper is set out in our response[61] in which we emphasised that pricing and profitability are at levels which one would expect in a competitive market. This is so according to the CC's own test of the pricing features a competitive market would exhibit:

> *"…in a competitive market we expect reductions in marginal costs to be passed on to customers…We therefore want to consider whether any reduction in fees was associated with a constant or falling gross margin".*[62]

2.2.28 The working paper therefore provides further clear evidence that competition is working in the reference market and this directly contradicts the CC's provisional finding that *"the market is not working well in delivering competitive prices"*[63]. Further, the CC's view that companies lack bargaining power and that audit firms have misaligned incentives,[64] is not borne out by the evidence either on audit quality or on pricing and profitability which suggests that ACs and companies have the power to demand high quality while placing the appropriate pressure on the fees charged by audit firms (by forcing audit firms to pass on any reductions in costs that they are able to make as a result of efficiencies). We fail to see how, on a balanced assessment of the evidence, the CC's Provisional Findings not only on pricing and profitability, but on the AEC as a whole, can stand in the light of the evidence contained in the CC's own working paper.

2.2.29 The CC also comments that *"companies on average tolerate higher prices and lower quality because they regard the costs of going out to tender and switching auditor to be significant"*[65]. However:

- as noted above, recent evidence suggests that audit quality in the reference market is high;
- the new evidence demonstrates that pricing and profitability in the reference market is at competitive levels;
- the CC provides no examples of companies that have tolerated higher prices and lower quality, or a willingness to do so, rather than switching auditor. We are not aware of any such examples.

[61] KPMG response to the CC working paper "Evidence on trends in audit fees".
[62] Paragraph 4 of the CC working paper "Review of evidence on the price effects of switching".
[63] Paragraph 7.94 of the Provisional Findings.
[64] Paragraphs 1.13-1.14 of the Provisional Decision on Remedies.
[65] Paragraph 1.34 of the Provisional Decision on Remedies.

2.2.30 In conclusion, it would appear that the CC's views on pricing and profitability in the reference market as expressed in its Provisional Findings are not substantiated by the available evidence. This also has the effect of undermining the CC's assessment of the AEC in the reference market, as discussed in section 2.3 below.

d) The level of choice and innovation is strong

2.2.31 As outlined in our response to the Provisional Findings, choice and innovation are strong in the reference market.

2.2.32 In relation to choice:

- the CC's provisional view is that if a FTSE 350 company decides to go to tender it will have a choice of at least three of the largest four audit firms and that there is *"strong competition"* for the tender[66]. The fact that three audit firms give rise to strong and effective competition undermines the view that companies do not have enough choice of alternative suppliers among the largest four audit firms;
- the CC provisionally found that mid-tier audit firms consider that they have the capability to audit nearly all of the sectors within the FTSE 350[67], which shows that companies can choose a supplier of audit services from a potential pool of not only the largest four audit firms but also the mid-tier firms; and
- the CC's survey evidence shows that companies are informed about their outside options and, rather than desiring there to be more firms to invite to tender, in fact many companies have said that they restrict the number of firms invited to tender[68]. This highlights the lack of evidence that there is any demand for greater choice on the part of customers in the reference market.

2.2.33 In relation to innovation:

- the CC finds evidence of extended reporting and extended audit arrangements[69];
- the CC finds innovation by some of the largest four audit firms with respect to their delivery model through using service centres[70];
- the CC finds that there has been innovation by the largest four and mid-tier audit firms in IT and systems[71];
- the CC finds that there is scope for innovation in methodologies that allows the development of industry-specific audit approaches[72]. Indeed, firms have identified that innovation has taken place through the use of industry-specialised modules[73];

[66] Paragraph 9.56 of the Provisional Findings.
[67] Paragraph 7.26 of the Provisional Findings.
[68] Paragraph 9.19 of the Provisional Findings.
[69] Paragraph 7.178 of the Provisional Findings.
[70] Paragraph 7.177 of the Provisional Findings.
[71] Paragraph 7.176 of the Provisional Findings.

- the CC has identified that whilst there are limits on the extent of innovation due to regulation, audit firms can and do provide additional testing and reporting (examples of this include our 'extended audit' product)[74]; and
- while the CC suggests that the audit report has changed little and is constrained by regulation, nevertheless, innovation has taken place in reporting[75] and the fact that audit reports are relatively unchanged meets shareholders' demand for consistency[76].

2.2.34 As a result of the new evidence outlined above in relation to audit quality, pricing and profitability, and the existing points outlined in our PFs response regarding choice and innovation, it would appear that the CC has failed to substantiate the existence of any detrimental effects in the reference market according to the test set out in section 134(5) of the Enterprise Act. Accordingly, the CC's provisional AEC findings cannot be confirmed. We outline in parts e) to g) below the effect of this new evidence on the CC's AEC analysis as contained in its Provisional Findings and Provisional Decision on Remedies.

e) *Bargaining power*

2.2.35 The CC's findings on the bargaining power of companies in its Provisional Decision on Remedies are also undermined by the new evidence on pricing and profitability. The CC suggests that the remedies package will "*improve the bargaining position of companies vis a vis the external audit*"[77]. As outlined in our response to the Provisional Findings, there is no evidence to suggest that companies lack the bargaining power (either during or outside of a tender event)[78] to demand a high quality audit at a competitive price and the available evidence indicates that ACs and ACCs are qualified and experienced and have the necessary expertise to assess quality and the competitive offering of audit firms. Further, the new evidence outlined in sections 2.2 a), b) and c) above not only demonstrates that audit quality is high in the reference market but also that pricing and profitability are at competitive levels. If companies in fact lacked bargaining power we would not expect such a high level of audit quality in combination with such competitive pricing.

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[72] Paragraph 7.175 of the Provisional Findings.
[73] Paragraph 7.161 and Appendix 8 of the Provisional Findings.
[74] Paragraph 7.173 of the Provisional Findings.
[75] Paragraph 7.164 of the Provisional Findings.
[76] Paragraph 7.174 of the Provisional Findings.
[77] Paragraph 5.5 of the Provisional Decision on Remedies.
[78] Section 3 of KPMG's response to the Provisional Findings.

f) Misaligned incentives

2.2.36 In its Provisional Findings and its Provisional Decision on Remedies, the CC finds that audit firms operating in the reference market compete to satisfy the demands of management rather than those of shareholders[79]. As set out in section 5 of our response to the Provisional Findings we do not consider that this conclusion is supported by the available evidence.

2.2.37 The CC's findings on this aspect of its second theory of harm in its Provisional Decision on Remedies are also undermined by the new evidence outlined in section 2.2 above. The CC states[80]:

> *"…if competition were directed more fully towards the demands of the shareholder, we consider that the audit product, and the competitive process itself, would be different in certain respects. We consider that the quality demanded is likely to be different: shareholders are likely to place greater emphasis on professional scepticism and thoroughness, and ensuring sufficiency of work performed"*

2.2.38 This comment does not appear to accurately reflect the evidence in the case studies, which we have previously referred to in our response to the Provisional Findings, that ACs and ACCs (acting as representatives of the shareholders) value a high quality and thorough audit – much more so than cost considerations[81]. Indeed, as we have previously submitted, ACs and ACCs in particular are jealous of their personal reputations and to subordinate audit quality to cost would clearly violate their duty to investors with damaging consequences to overall investor confidence and their reputations; they have no incentive to do this. This view also seems to be reflected in the CC's recently commissioned case studies[82]. Further, the fact that the most recent AQRT report suggests that quality is high (and scepticism is improving each year with significant progress having been made) undermines the finding that auditors have misaligned incentives or compete on the wrong parameters. If this were the case the AQRT's reports would contain substantially different findings.

[79] Paragraph 1.12(d) of the Provisional Decision on Remedies.
[80] Paragraph 1.37 of the Provisional Decision on Remedies.
[81] Paragraph 25(a) of Appendix 11 of the Provisional Findings.
[82] Paragraphs 17 and 18 of Appendix 1.1 to the Provisional Decision on Remedies.

2.2.39 We also note that the CC recognises that there are existing measures in place for shareholders to express their views[83]. The fact that they are not so doing suggests that the statutory audit may not be a key issue for shareholders. Hence, the problem would appear to be one of engagement rather than a failure of competition. It is, therefore, likely that Remedy Four (in combination with Remedies Two and Six) will address the CC's concerns in this regard. As outlined below in section 4, given the FRC's tendering requirements, it is likely that Remedies Two to Seven will be a more effective and proportionate means of addressing the AEC perceived to exist by the CC than a package of remedies that includes Remedy One.

g) Barriers in the provision of information

2.2.40 In its Provisional Findings and its Provisional Decision on Remedies the CC also states that audit firms face barriers in the provision of information that shareholders demand (in particular from the reluctance of company management to permit further disclosure)[84]. As set out in section 6 of our response to the Provisional Findings we do not consider this conclusion is supported by the available evidence.

2.2.41 In the Provisional Decision on Remedies, the CC restates a similar view that *"shareholders currently perceive audit quality only indirectly and the lack of visibility that currently exists means that these perceptions may at times depart from reality"*[85]. The CC has, however, produced no evidence to the effect that the perceptions do in fact depart from reality and we submit that they do not. The CC's view is inconsistent with the new evidence outlined above, and that contained in our response to the Provisional Findings, which indicates that:

- information on audit quality in the reference market is available and this information suggests that audit quality in the reference market is high and continues to improve;
- companies are able to make comparisons between the competitive offerings of audit firms and have the necessary information to do so[86]; and
- the AC/ACC and company management play an effective role in managing the relationship with the audit firm and providing shareholders with relevant information[87].

[83] Paragraph 3.354 of the Provisional Decision on Remedies.
[84] Paragraph 1.12(e) of the Provisional Decision on Remedies.
[85] Paragraph 5.63 of the Provisional Decision on Remedies.
[86] Section 3.4.1 of KPMG's Response to the Provisional Findings.

2.2.42 We believe the current review and reporting work undertaken by the AQRT is of a high standard and that the industry can, and does, use the AQRT's work in order to assess the competitive offering of other firms and of the incumbent auditor. Hence, as we note above, the issue may not be a lack of available information but rather a lack of engagement on the part of shareholders and investors. As we outline in section 3.4 Remedy One will do nothing to encourage greater shareholder engagement. In our view, it is likely that Remedy Four (potentially in combination with Remedies Two and Six) will address any residual concerns the CC may have in this regard in an effective and proportionate manner.

2.3 What this means for the CC's Provisional Findings and Provisional Decision on Remedies

2.3.1 The new evidence on audit quality[88] and pricing/profitability[89] suggests that the CC's assessment of the detrimental effects on customers resulting from the AEC is unsupported. The available evidence on choice and innovation, outlined briefly above in section 2.2 d), suggests that both are at competitive levels. Accordingly, the CC has not been able to make out any of the statutory elements set out in section 134(5) of the Enterprise Act that constitute 'detrimental effects on customers'.

2.3.2 For the reasons outlined above and in the light of the additional evidence regarding pricing/profitability and audit quality outlined in section 2.2, the CC's analysis of the AEC is also undermined. Accordingly, the findings of the CC in its Provisional Findings regarding the AEC cannot be confirmed as they currently stand. As such, there is no basis under section 134 of the Enterprise Act for the imposition of the CC's remedies package as outlined in its Provisional Decision on Remedies.

2.3.3 Even if the CC finds that an AEC does arise (which the balance of evidence does not support) its assessment of the effectiveness and proportionality of its remedies must necessarily be flawed, at the very least because this assessment did not take into account the new evidence outlined above in section 2.2. We also submit that the CC, in assessing the effectiveness and proportionality of its remedies, has failed to give the

[87] Section 6 of KPMG's Response to the Provisional Findings.
[88] In particular the AQRT's latest reports as set out in section 2.2 a) above.
[89] In particular the CC's working paper "Evidence on trends in audit fees", as set out in section 2.2c) above.

evidence outlined in our Provisional Findings response, referred to briefly in section 2.2 above, sufficient weight.

2.3.4 The CC's current AEC and detrimental effects analysis also fails to take into account the likely impact of recent FRC amendments. The potential effect of these reforms in addressing any harm that is alleged to exist in the reference market should necessarily influence the formulation of the remedies package.

3 The proposed mandatory tendering remedy will not give rise to demonstrable benefits

3.1 Introduction

3.1.1 We set out in the previous section that the AEC finding cannot be confirmed, in particular in the light of new evidence published by and/ or available to the CC, and therefore the CC has no basis for imposing any remedies under section 134 of the Enterprise Act. Even if, however, the CC confirmed the finding of an AEC, the CC's remedies package cannot be considered proportionate, particularly in light of this new evidence. That evidence undermines the CC's case that there is any substantial customer detriment associated with the AEC the CC identifies, therefore implying that any benefits of the CC's remedies package must necessarily be limited.

3.1.2 In this section we set out our view that, even if an AEC were considered to exist (and we believe it does not), the CC's proposal to impose mandatory tendering every five years[90] in particular will not give rise to any benefits and indeed may be detrimental to the perception of audit quality. It is our strong view that with remedies two to seven in place (in combination with the FRC's existing requirement for tendering every 10 years on a comply or explain basis) mandatory tendering every five years is not necessary to address the CC's competition concerns and nor does it deliver significant additional benefits.

3.1.3 In its Provisional Decision on Remedies, the CC suggests that mandatory tendering every five years will enhance companies' bargaining positions and increase choice (both

[90] Taking into account the CC's provision that companies can choose to explain for up to two years in exceptional circumstances. We note that the any additional benefits from the CC's remedy, compared to the FRC's approach must diminish as a company goes to seven years between tenders.

within and outside the largest four audit firms)[91]. There is no evidence that conducting a tender currently enhances companies' bargaining position on either audit quality or price and allows them to achieve better terms from their audit firm compared to other, less formal negotiations. This in itself implies that the CC has no evidence to show that imposing mandatory tendering on a more frequent basis than the ACs themselves judge to be appropriate will deliver benefits in the form of strengthening companies' bargaining positions.

3.1.4 Furthermore, while the frequency of tenders will likely increase under the CC's remedy, the quality of those additional tenders (that the CC mandates on a more frequent basis than the FRC's regime) and competition more broadly, will, in all likelihood only decline. Such additional tenders may well be reduced to box-ticking exercises as ACs will have little incentive to incur the costs required to conduct a proper, thorough tender when they have little real intention of switching audit firm. This in addition risks reducing competition overall, across the market, setting a dangerous precedent for all tenders. It makes the threat to tender less obviously a threat to switch and thereby reduces the ability of companies to use the threat to tender and switch to obtain competitive outcomes. In addition, the CC's suggestion that audit firms' resources will be diverted away from other marketing activities towards tenders will necessarily reduce the competitive pressure on audit firms outside of tender events by reducing the pressure from non-incumbent audit firms.

3.1.5 The CC cites further benefits from mandatory tendering every five years as enhancing the role of the AC (and reducing the influence of executive management) and the possibility of reducing a perception of a familiarity threat, of improvements in audit quality and of encouraging shareholder engagement[92]. However, the CC has not shown that mandatory tendering every five years will per se deliver any of these benefits and provides no good evidence to substantiate these assumptions.

3.1.6 In fact, mandatory tendering every five years risks worsening UK audit quality and corporate governance and the perception thereof. The CC's proposals depart from the measures the FRC put in place under its mandate to promote corporate governance in the UK, and lack any body of consistent shareholder support. In particular none of the

[91] Paragraph 3.149 of the Provisional Decision on Remedies.
[92] Paragraph 3.149 b), d) and e) of the Provisional Decision on Remedies.

views of investors cited in the Appendix to the Provisional Decision on Remedies agree that increased frequency of tendering will enhance their perception of audit quality and a number of them state concerns that it will achieve the opposite effect.

3.1.7 In addition, if the CC considers that there will be no diminution of tender quality then it must recognise the impact of this assumption on audit quality and perceptions of audit quality. The CC's argument that audit firms can recruit new, specialist resources to participate in the extra tenders as well as maintaining audit quality at its current high levels is not realistic: it is not a question of more resource but the existing senior audit engagement partners being of necessity involved in a far greater level of tendering activity whilst simultaneously maintaining the same level of involvement in their current audit work. Furthermore we note that the CC has not in any case taken into account any of the costs that would be required to recruit this extra, senior, specialist resource which would be passed on to companies[93].

3.1.8 In the rest of this section we begin by discussing the impact of mandatory tendering every five years on companies' bargaining power and choice (sections 3.2 to 3.3) and then discuss the impact on audit quality and corporate governance (sections 3.4 to 3.5).

3.2 There is no evidence that conducting a tender enhances a company's bargaining position

3.2.1 The CC has no good evidence to show that conducting a tender, in itself, improves outcomes for companies in respect of either increased audit quality or reduced price. We would also note that it is audit quality rather than price that is of paramount concern to investors and, as their agents, ACs. We therefore deal with quality first.

3.2.2 A number of the CC's remedies, in particular increased monitoring by the AQRT and publication of the individual company audit results together with the responses made by the firms and ACs, will increase the visibility of audit quality to investors. It will also improve information available to ACs in respect of the audit quality of other audit firms and indeed other audit engagement partners. If despite these remedies the CC continues

[93] As shown by the CC's working paper "Evidence on trends in audit fees", audit firms have passed on cost reductions to customers in the form of lower fees, showing that the market is competitive. In a competitive market, cost increases would also be passed on to customers.

to believe that ACs lack bargaining power, then more frequent mandatory tendering would do nothing to address this.

3.2.3 The CC's working paper "Review of evidence on the price effects of switching" considers patterns in total audit fees following a change in audit firm, and following a tender with no change in audit firm. Whilst we disagree that this analysis is informative of the value for money companies achieve[94], even setting aside those concerns, the working paper provides no evidence that tenders lead to any improvement in the price a company is charged by its audit firm. Specifically, the working paper found that tenders where there is no change in audit firm resulted in a two per cent increase in the median firm's audit fee[95] compared to the pre-tender audit fee. As we set out in our response to that working paper, this of course provides no evidence that bargaining power is driven by tender events and eroded outside of them[96]. The CC has similarly failed to provide any other evidence that shows that across the market, tender events themselves allow companies to achieve better pricing terms from their audit firm than negotiations outside of tender events.

3.2.4 This is unsurprising given that, as we have evidenced throughout this inquiry and as we set out in paragraph 2.3.2-5 above[97], companies' bargaining power in respect of both audit quality and price is as strong outside of a tender process as it is during tenders. Companies do not need to go through a formal tender process to obtain competitive terms from their audit firm because the threat to conduct a formal, thorough tender process and the threat of changing of audit firm are sufficient to generate competitive outcomes[98]. This is consistent with the evidence showing continuing rises in audit quality, fee decreases outside of tender events, the evidence on the pervasiveness of

[94] Sections 2.3.2 – 2.3.5 of KPMG's Response to CC working paper "Review of evidence on the price effects of switching".
[95] Out of all companies that tendered but did not switch.
[96] Paragraphs 1.6 and 2.3.5.3 of our response to the CC's working paper "Review of evidence on the price effects of switching".
[97] See Question 91 of KPMG's Response to the Market and Financial Questionnaire, Section 7.2 of KPMG's Main Submission in response to the Issues Statement, Section 3.5.3 of KPMG's response to the Provisional Findings.

[98] See for example the evidence we provided in Annex 2 of our response to the CC's working paper, "Nature and Strength of competition", which, as we noted in our response to the CC's Provisional Findings the CC does not appear to have been taken fully into account by the CC.

thorough yearly reviews of audit firms by companies.[99] Finally, it is also consistent with the evidence presented in the CC's working paper "Evidence of trends in audit fees", which, as set out in section 2.2 c) above, shows that the market is competitive.

3.2.5 With no evidence therefore that tenders are necessary to drive competitive outcomes, the CC has no evidence that mandating an increase in the rate of tendering will improve companies' bargaining positions.

3.3 Increasing the rate of tendering will most probably reduce and will not increase competition

3.3.1 The mandated, extra tenders under the CC's proposed mandatory tendering remedy will be substantially less competitive than current tenders, and hence even less likely to be a driver of companies' bargaining strength. In addition, in our view there is a real risk that mandating these extra tenders will lead to a reduction in competition across the whole market, both inside and outside of tender events.

3.3.2 As we discuss in section 4, tenders are costly for FTSE350 companies to set up and to run and costly for audit firms to participate in. Nor do we believe there are any significant opportunities to realise efficiencies in running such tenders for the reasons also explained in section 4. These costs will affect both companies' and audit firms' incentives if a remedy of mandatory tendering every five years is imposed. We begin by discussing companies' incentives under more frequent, mandatory tendering, and then discuss the incentives of audit firms.

Companies' incentives to run a tender process

3.3.3 Companies, especially the larger or more complex ones, are unlikely to switch audit firm every five years – a point implicitly recognised by the CC itself in noting that it believes that switching costs are significant and may well be substantial for such entities[100]. In our view, this will be the case for a large number of FTSE350 companies. Unless there were clear benefits to be obtained in audit quality and price compared with

[99] For example, the evidence we provided in Annex 2 of our response to the CC's working paper "Nature and Strength of competition".
[100] Paragraph 4.64 of the Provisional Decision on Remedies.

the service delivered by the incumbent auditor, it would be inefficient for them to change audit firm, as we have set out in other responses[101].

3.3.4 We discussed in our response to the CC's Remedies Notice the difficulties associated with changing audit firms for the largest companies, for example because of the requirement to resolve independence issues and manage non-audit services ("NAS") conflicts[102], as well as the difficulty of coordinating a change in audit firm across a global company[103]. We referred to the examples of HSBC[104] and [✂][105] as illustrations of the time that is required to change audit firm for the largest and most complex organisations. Importantly, we also highlighted the increased risk of audit failure following a change in audit firm, as the new audit firm gets up to speed with a company's audit, a risk we expect to be greater for larger more complex organisations. The CC recognises this risk at paragraph 3.130 of its Provisional Decision on Remedies yet does not appear to give these costs sufficient weight in its assessment of the proportionality and effectiveness of Remedy One.

3.3.5 In this context, those large, complex companies that have changed audit firm only five years previously will not conduct the next mandatory tender with any realistic prospect of a further switch, unless there was a clear problem with the incumbent auditor that could not be resolved which past practice suggests occurs less frequently than every five years. Unless this was the case, the company is therefore unlikely to have an incentive to incur the substantial costs necessary to run a proper, thorough tender process along the lines that tenders are currently conducted under the FRC's recently implemented comply or explain regime which leaves the ultimate decision on whether to go to tender to the judgement of ACs.

3.3.6 It is important to recognise that the costs that companies face in tendering, and the efficiencies they may forego by switching, do not currently prevent companies from effectively threatening to switch, thereby driving better terms (both in respect of audit quality and price) from the incumbent auditor. This is because audit firms realise these options are always credibly available to their clients if they do not deliver a high quality

[101] For example, see Paragraph 20 and Section 7 of KPMG's Main Submission in response to the CC's Issues Statement.
[102] Paragraph 4.2.8 of our response to the Remedies Notice.
[103] Paragraph 4.2.9 of our response to the Remedies Notice.
[104] Paragraph 3.2.8.7 of our response to the Remedies Notice.
[105] Paragraph 4.2.9.2 of our response to the Remedies Notice.

audit at a competitive price. However, in contrast, the introduction of a more frequent, mandated, tender process will make it less likely that companies will choose to tender outside the very narrow five year cycle. Because of this, and since a large proportion of these additional tenders will be recognised as driven purely by regulation and not by genuine dissatisfaction with the incumbent, it will be difficult for companies to signal, and audit firms to understand, which tenders will genuinely represent commercial opportunities.

3.3.7 We set out in our response to the Remedies Notice and discuss further in section 4 below the substantial costs to companies of participating in tenders. However, even supposing (as the CC does), incorrectly, that the estimates we provided on the costs to companies of running a tender were overstated and that there is scope for companies to realise significant efficiency savings, the evidence set out in paragraphs 3.75 to 3.102 of the Provisional Decision on Remedies still clearly shows that tender costs to companies are nevertheless substantial[106]. Companies are unlikely to have an incentive to incur these costs and set up a proper tender process, when they have little realistic intention of switching audit firm following that tender. The CC must therefore either accept that companies will not incur these costs and therefore will not specify a proper, thorough tender process, or else consider the substantial costs associated with its remedy in its proportionality assessment, which it currently does not do.

3.3.8 The CC argues that there will be other factors militating against companies choosing not to incur the costs required to set up a proper, thorough tender process. Specifically, the CC argues that:

- ACs are required to report on the approach taken to the appointment and reappointment of the auditor, a requirement which is strengthened by its Remedy Five proposal, and that the tender process will need to be specified robustly enough for those purposes;
- as tendering becomes more frequent, best practice will become established and so it will become obvious if a company departs from expected norms; and
- the willingness of rival audit firms to participate in a tender will be a further constraint since rival audit firms will be less likely to participate in a tender that is not properly set up.

[106] And, as we note in Appendix 1, should not be considered in 2005 prices, but rather the most recent prices that the CC has available.

3.3.9 The CC fails to recognise that these factors in themselves will reduce the power of the signal of a tender as a threat to switch. This will reduce the competitive pressure across the reference market.

3.3.10 In addition, even taking into account all of these factors, there will still be substantial leeway for ACs to specify less thorough and effective tender processes. The fact is that none of these factors is a substitute for the incentive that an AC has to guarantee a thorough tender process when it knows it has a genuine chance of using that tender process to choose a new audit firm. When there is little realistic chance of switching, then that incentive is simply not present and the factors noted by the CC do not compensate for it. As for the CC's third point above, the incentives of audit firms actually reinforce the incentives of companies not to specify thorough, robust tender processes, which we discuss in the next section. In addition, we note that an AC has little to lose from having fewer audit firms tender in a situation where that AC was not minded to change audit firm anyway during that tender.

3.3.11 The CC has therefore wrongly dismissed the substantial risk that under its mandatory tendering remedies will have an incentive to turn those extra tenders they will be mandated to conduct into less informative, box-ticking exercises, thereby damaging the quality of competition in the reference market.

Audit firms' incentives to participate in tenders

3.3.12 Similarly, audit firms will have less incentive to participate in all of the tenders that will be introduced under mandatory tendering every five years. This may also have the effect of reducing the quality of competition in the reference market. Audit firms will be aware that they will have no serious chance of winning a new audit engagement in a large proportion of these extra tenders; instead in these cases the incumbent will have a very substantial advantage. The FRC's measures, by contrast, do not require companies to tender even when they have very little intention of changing audit firm and therefore do not reduce audit firms' incentives to participate in tenders and also avoid the substantial extra unnecessary costs.

3.3.13 The CC dismisses the possibility that audit firms will have less incentive to participate in all tenders under a five year mandatory tendering regime, suggesting that the potential gains from winning a new audit relationship ensure audit firms have a strong

incentive to participate in the tender process[107]. However, that argument just doesn't hold if an audit firm judges that a company is very unlikely to change audit firm following the tender. In that case the chance of substantial gains following the tender is so remote that the case for an audit firm to invest in a tender process will fall away. Further, it would be economically inefficient for audit firms to participate in tenders where there is no realistic chance of companies changing audit firm – the costs of rival audit firms' participation would simply represent deadweight loss to the UK economy.

3.3.14 Furthermore, if the additional tenders are conducted with very little possibility of a change in audit firm it is difficult to see how this is likely to increase the opportunities to audit firms (including the mid-tier audit firms) to win new engagements, and thereby increase choice. Further, the CC's survey evidence shows that companies are informed about their outside options and, rather than desiring there to be more firms to invite to tender, in fact many companies have said that they restrict the number of firms invited to tender[108] - this is only likely to increase with a greater number of tenders.

3.3.15 The change in the incentives of audit firms and companies under the CC's mandatory tendering remedy reinforce each other. If companies don't invest in specifying a full, thorough tender process, because they do not have a realistic intention of changing audit firm, then this further increases the advantage of the incumbent audit firm and rival firms are less likely to participate in the tender[109]. Similarly, if audit firms are less likely to participate because they expect that a company will not change audit firm following the tender, then that will further reduce the incentives of the company to invest in a proper, thorough tender process, if it does not expect rival audit firms to participate (and in that case audit firms are even less likely to participate, and so on). The CC does not appear to have taken sufficient account of these risks.

3.3.16 The CC suggests that not participating in a tender might be a very risky strategy for an audit firm, since it will not be in a strong position to know which companies are likely to change audit firm and which are not, and so might risk missing out on some substantial opportunities[110]. However, under frequent mandatory tendering, the signalling power of a tender is reduced – in other words it is far less likely that a tender

[107] Paragraph 3.110 of the Provisional Decision on Remedies.
[108] Paragraph 9.19 of the Provisional Findings.
[109] As the CC recognises in paragraph 3.132c) of the Provisional Decision on Remedies.
[110] Paragraph 3.111 of the Provisional Decision on Remedies.

(particularly one following a recent switch) will be associated with a genuine possibility of a switch, given that the additional tenders are mandated. This means that the risk for audit firms from not participating in a tender are reduced. In addition, the costs to audit firms of participating in tenders for the largest, most complex audits are far greater than for smaller or less complex audits and are far more likely to outweigh the risk the CC identifies.

3.3.17 We set out in section 4 below the substantial costs audit firms face in order to participate in a tender, and why in our view the CC is wrong to dismiss these substantial costs on the basis that companies can realise efficiency savings. In addition to the costs of participating in a tender, there will be real constraints in practice on audit firms' ability to participate in the larger number of tenders that the CC's mandatory tendering remedy will imply, if audit firms are to also maintain audit quality at its current levels. The CC's proposals involve a very substantial increase in the number of tenders per year compared to the FRC proposals (from around 35 per year under the FRC measures to around 70 per year under the CC proposals) which will have a very significant impact on audit firms' ability to participate in all tenders. The CC suggests that in fact these constraints will not materialise since audit partners can spend less time on other marketing activities and that tenders will be conducted in the audit 'off-season'. Neither of these suggestions is realistic. Whilst it is true that for more junior staff there is a "busy season", for the more senior personnel and in particular engagement partners there simply is not nowadays such a thing as an audit 'off-season'. Such senior personnel make up a far greater proportion of the time expended on quarterly and half yearly reporting and ad hoc corporate transactions and are also precisely the people that prospective audit clients want and expect to see during tenders. In any case, tenders for the largest most complex companies can take several months (or almost a year in the case of the Compass tender, as discussed in Appendix 2).

3.3.18 In relation to marketing activity, we consider the CC's statements show a lack of understanding of the fundamental drivers of competition in the audit market. Although audit partners do build relationships with companies to encourage a tender process, there is a wider objective. The time audit partners spend with a company provides them with an understanding of its business and of the sector in general. Audit partners will therefore still need to put time and effort into learning about a business and a sector prior to a tender. This is in order to have a reasonable chance of displacing an

incumbent and in order to be able to provide as high a quality an audit as possible were a company to switch its audit to that partner's firm - removing this understanding from the competitive framework will therefore reduce the credibility of rival firms as alternatives, reduce tender quality, and, importantly, increase any advantage held by the firms' incumbent auditor. This will necessarily reduce the competitive pressure outside tender events from non-incumbent audit firms, and the CC must recognise this substantial cost of its mandatory tendering remedy proposal if it does envisage resources being diverted in this way.

3.3.19 The CC argues that recruitment will not be a constraining factor on audit firms' ability to participate in more tenders. However, this is purely an assumption and the CC has no evidence to show that, particularly at the most senior level, the requisite resources, required both for the increased number of tenders and to lead audit engagements can be recruited and are not scarce. Like any profession, the most senior and talented professionals are rare and scarce. Indeed, any organisation in the private or public sector that has dealt with substantial increases in their workload will have experienced difficulties in recruiting quality resources at a senior level. It is not clear why the CC thinks the audit profession is any different from others and is able to simply recruit more of these people to meet the extra burden of mandatory tendering. In this context, if tender quality is to be maintained at current levels for the new, mandated tenders, then the CC must also recognise the implications for audit quality, which we discuss further in section 3.5.

3.3.20 Finally, the CC dismisses our argument that the provision of non-audit services (NAS) and the requirement to resolve certain conflicts will limit the practical ability of audit firms to participate in all of the mandated extra tenders. Again, the CC has no evidence for its assertion that *"such matters would typically not need to be addressed in advance of a tender process"*[111]. In fact, as the FRC notes[112], we understand that proposals currently being considered by the EU (which will effectively determine the independence rules for the audit profession in the UK) will require 'clean periods' of at least one year either side of an audit engagement. Audit companies, even if they do not need to resign all NAS to participate in a tender, will not bid for further NAS work, reducing the level of competition in NAS markets – a cost which the CC has not taken

[111] Paragraph 3.115 of the Provisional Decision on Remedies.
[112] Page 4 of the FRC's response to the Provisional Decision on Remedies.

into account in its assessment of Remedy One. Further, with more frequent tenders, in particular where companies have no genuine intention of changing audit firm, then companies may not want all audit firms to resign NAS and resolve conflicts in order to participate in an audit tender. Therefore, the provision of NAS and independence requirements is further likely to reduce the ability and incentive of audit firms to participate in the extra tenders the CC mandates.

3.3.21 The same is true for other relationships particularly, in the context of major financial institutions, either the firm's or individuals' banking/insurance arrangements many of which are prohibited under the SEC rules to which they are subject. As already noted that is why HSBC has required such an extensive handover period to the new audit firm. In this context it is worth noting that under the CC's proposals HSBC would effectively be required to retender the audit during 2018-20, by which time the new firm would only have been conducting the audit for three to five years.

3.3.22 Therefore, with more frequent tendering, on a mandatory basis under the CC's remedy, audit firms are unlikely to incur the substantial costs required to participate in all the tenders that occur, particularly for the largest and most complex companies that have switched in the recent past and will have little real intention of doing so again. Our ability to do so will be constrained if the same level of audit quality is to be maintained. The FRC's best practice guidelines[113] set out suggested criteria for companies to use during tender processes, all of which imply a thorough and time consuming process.

3.3.23 By contrast, under the FRC's regime audit firms will have no similar incentive not to participate in tenders. Tenders are far more likely to be conducted with a genuine possibility of a switch (see paragraphs 3.3.3 to 3.3.11 above) given less frequent tendering and the option for companies to 'explain' rather than 'comply'. Further, the smaller number of tenders per year under the FRC's measures, given the 10 rather than five year period between tenders, eases the practical constraints on audit firms participating in all the tenders that occur[114].

[113] http://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/Audit-Tenders-Notes-on-best-practice.pdf

[114] The CC is incorrect to state that we *"did not support proposals for tendering every ten years on a comply or explain basis"* (paragraph 3.46 of the Provisional Decision on Remedies). Rather in our response to the FRC's consultation we set out what we considered to be some risks from the proposals and our view that a proper comply or explain provision was important to mitigate them. We also noted

3.4 The proposed mandatory tendering remedy will not enhance corporate governance or improve the perception of, or actual, audit quality

3.4.1 In its assessment of the proportionality of its remedies package, the CC states that *"the most important effect of our proposed remedy package will be to increase confidence in the quality of the audit product"*[115] and argues that this will give rise to economic benefits in terms of improved corporate governance and a lower cost of capital[116].

3.4.2 The CC notes that its proposed mandatory tendering remedy will in its view enhance the role of the AC, may reduce a perception of a familiarity threat, may lead to improvements in audit quality and may encourage shareholder engagement[117]. It is difficult to see how a remedy that only *"may"* increase audit quality and *"may"* encourage shareholder engagement can be seen to contribute to increasing confidence in the quality of audit and therefore the substantial benefits in terms of improving corporate governance that the CC cites.

3.4.3 In fact, mandatory tendering every five years will not improve perceptions of audit quality and will not improve UK corporate governance standards.

3.4.4 The FRC arrived at its measure of tendering every 10 years on a "comply or explain" basis after a detailed consultation which focussed on promoting UK corporate governance and audit quality. Indeed, the FRC is the regulator charged specifically with promoting high quality corporate governance in the UK and has extensive experience and skills in this area[118]. The CC has, however, proposed a tendering remedy that goes far beyond the FRC's measures, requiring more frequent, mandatory tendering. If the CC is seeking to cite improvements to UK corporate governance as a benefit of its mandatory tendering proposals, it must therefore explain why it considers itself better placed to judge and promote UK corporate governance than the regulator that is specifically charged with doing just that – it is not clear to us from the Provisional

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that for the largest companies, 10 year mandatory tendering might not be practical, but our view now the proposals have been implemented is that is also mitigated by the comply or explain provision.

[115] Paragraph 5.63 of the Provisional Decision on Remedies.

[116] Paragraph 5.63 of the Provisional Decision on Remedies.

[117] Paragraph 3.149 b), d) and e) of the Provisional Decision on Remedies.

[118] The CC recognises this in paragraph 5.10 of its Provisional Decision on Remedies where it states that the FRC is *"increasingly well equipped to provide high-quality independent regulation to the audit market"* and that its AQR team was *"well regarded, considered carefully by audit firms and companies, and … had an important role to play in promoting competition between audit firms whilst safeguarding audit quality"*.

Decision on Remedies in what way the CC considers the FRC's analysis to be incorrect. The CC notes that the FRC's review was not conducted in the context of a competition investigation. However this ignores the fact that the reforms were specifically designed to address perceived issues with independence and scepticism, which are at the heart of the CC's second alleged AEC. It is not clear why a shorter period would therefore better address these perception issues and the CC has not explained why.

3.4.5 The CC's statement that it is a *"matter of judgement"*[119] as to the appropriate interval between tenders is not an appropriate basis upon which to decide to implement such an intrusive remedy and from which to cite such significant but unsubstantiated benefits from doing so. In fact, the only evidence or argument the CC adduces to support tendering every five years (compared to any other period) is that this aligns with AEP rotation. However, in the case where a company needs to 'explain' for up to two years (as would be possible under the CC's remedy) then the tender cycle and the AEP rotation cycle would not be aligned, which would bring significant practical difficulties for companies.

3.4.6 The CC is unable to cite a large body of support from the various stakeholders as evidence in favour of its mandatory tendering proposals. In fact, serious concerns over the CC's proposals were raised by FTSE350 companies, ACs and Finance Directors, the FRC, UK industry bodies, international regulators and industry bodies and the majority of the investor groups the CC spoke with, as well as the largest four audit firms[120].

3.4.7 In particular, there is no significant body of shareholder or investor support for the CC's mandatory tender remedy – i.e. five years on a mandatory basis – or evidence that this would improve their perception, or experience, of audit quality in any way.

3.4.8 Furthermore, in our opinion the summary of investor views given in paragraph 3.24 of the Provisional Decision on Remedies, which describes them as *"mixed"*, is very misleading. Indeed, a summary of this kind could not be described in any way as "true and fair" – such a misleading summary in the context of an audit firm's work would

[119] Paragraph 3.154 of the Provisional Decision on Remedies.
[120] For examples, see: Paragraphs 3.24, 3.25 – 3.27, 3.30, 3.31 – 3.36, 3.42 of the CC's Provisional Decision on Remedies, Pages 2 – 3 of the Canadian Public Accountability Board's response to the CC's Remedies Notice, Page 2 of the Hong Kong Institute of Certified Public Accountants response to the Provisional Findings and Remedies Notice, Page 4 of the South African Institute of Chartered Accountants' response to the Remedies Notice, and Page 2 of Mr Simon Laffin's response to the Remedies Notice.

undoubtedly attract serious negative comment. As the CC notes, several investors support the FRC's measures[121], while another[122] supports a mandatory tendering period of more than 10 years. Of the remaining investor views which the CC summarised in Appendix 3(1) to the Provisional Decision on Remedies, we would note in particular the following[123]:

- Baillie Gifford supported five yearly tendering but on a "comply or explain" basis, which clearly recognises that it would not be appropriate for all companies[124].
- The Investment Management Association (who are not cited in the PDR itself despite representing a considerable body of investors), whilst noting that a significant minority of investors favour five to seven year tendering also stated that many believe it too frequent. However, support was expressed for either requirement to be on a "comply or explain" basis noting that *"Mandating that the audit is tendered after a set period disenfranchises both audit committees and shareholders"*[125].
- The National Association of Pension Funds supports tendering every seven years but also recognises that companies vary in complexity and size and therefore there should be sufficient flexibility with any governance system to allow for this accommodated. They note that *"The priority should be to ensure auditor independence is protected and we strongly believe that it should be with the audit committee that accountability for this is placed"*[126]. Whilst not completely clear this would seem also to indicate support for a "comply or explain" regime with a starting point of seven years not a mandatory backstop of this frequency.
- Royal London Asset Management supports tendering every five to seven years on a "comply or explain" basis with a mandatory requirement being set only at 10 years[127].
- An unnamed investor said that it was not clear why mandatory tendering more frequently than every ten years would create a notable benefit for investors[128].
- Another unnamed investor said that there were pros and cons to more frequent tendering than every ten years and it was not obvious that five or seven years were the best period[129].

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[121] AXA Investment Managers, Hermes (who favours 10 year tendering, also on a "comply or explain" basis but at a frequency of 10 years would be content for tendering to be mandatory), Royal London Asset Management and three unnamed investors.
[122] Legal and General Investment Management.
[123] Based on our analysis of Appendix to the PDR and the published original sources for those views where available.
[124] Paragraph 66 of Appendix 3(1) of the Provisional Decision on Remedies.
[125] Page 4 of the Investment Management Association's response to the Provisional Findings and Remedies.
[126] The National Association of Pension Funds' response to the Provisional Findings and Remedies Notice.
[127] Paragraph 72 of Appendix 3(1) of the Provisional Decision on Remedies.
[128] Paragraph 73 of Appendix 3(1) of the Provisional Decision on Remedies.
[129] Paragraph 74 of the Provisional Decision on Remedies.

- Another unnamed investor said that tendering more frequently than every ten years would not benefit shareholders. The costs could be expected to exceed the benefits[130].
- Newton Investment Management favoured tendering every five to seven years but again on a "comply or explain" basis[131].
- The Association of British Insurers, which is categorised by the CC as a UK industry body rather than an investor group although it does represent a considerable number of significant institutional investors, supported the FRC's provisions and did not accept that comply or explain undermined effective compliance[132].

3.4.9 In fact, there is only one investor group whose view is summarised in the Provisional Decision on Remedies that could be said to have expressed support for the CC's mandatory tendering remedy – the coalition of six investors and a body representing 56 local authority pension funds (who incidentally we estimate to own only approximately two per cent of the UK FTSE350). This is not made clear by the CC in paragraph 3.24 of the Provisional Decision on Remedies. Furthermore, from this group's response to the Remedies Notice, it is clear that even this investment group supported mandatory tendering only in conjunction with mandatory rotation – and so cannot be said to offer support to the CC's proposed remedies package. It is not clear why, in relation to this remedy, the CC is therefore willing to disregard the views of investors and implement a remedy which investors do not support, in particular when it notes elsewhere in its Provisional Decision on Remedies that it *"places considerable weight on the views of investors"*[133]. It has clearly not done so on this occasion and must explain why.

3.4.10 The lack of comment on mandatory tendering in response to the CC's 'investor questionnaire' is also telling (we discussed the investor questionnaire in paragraph 2.2.23 above). Our understanding[134] is that only two investor groups in addition to those the CC had already spoken with expressed a view in relation to mandatory tendering – in total the CC summarises views of 17 investor groups in relation to mandatory

[130] Paragraph 76 of the Provisional Decision on Remedies.
[131] Paragraph 77 of the Provisional Decision on Remedies.
[132] Paragraph 79 of the Provisional Decision on Remedies.
[133] Paragraph 4.111 of the Provisional Decision on Remedies.
[134] From the Provisional Decision on Remedies and the email received from the CC on 9 August 2013, we understand that all responses to the investor questionnaire are summarised in the appendix to the Provisional Decision on Remedies, unless those responses simply reiterated comments those investors had made previously to the CC.

tendering in the Appendix to the Provisional Findings[135]. This is compared to the 43 investor groups to which the CC sent its investor questionnaire[136] and therefore had an opportunity to comment on this (and other) remedy options. This lack of interest and lack of response in our view strongly undermines the CC's argument that mandatory tendering every five years will increase shareholder perceptions of audit quality or of corporate governance.

3.4.11 In our view, certain of the other remedies, as outlined in paragraph 5.1.1 below, in the CC's package address its concerns over misaligned incentives between audit firms, companies and shareholders as well as any barriers to audit firms providing information which shareholders demand – and do so without the substantial costs that are associated with mandatory tendering every five years. The CC has no evidence that mandatory tendering on a more frequent basis than the FRC's measures adds to those remedies in addressing those parts of its provisional AEC finding.

3.4.12 In fact, mandatory tendering every five years in our view diminishes the force of the other remedies, in particular the measures that the CC has proposed to enhance the role of the AC. Mandatory tendering every five years greatly reduces the AC's ability to determine the timing of a tender in the best interests of its shareholders bearing in mind its paramount concerns for audit quality and to use this as a way of seeking improvements from the incumbent audit firm.

3.4.13 The CC refers to one AC that indicated it may choose to explain rather than 'comply'[137]. The CC appears to be using this as evidence to support going further than the FRC measures. However, if an AC takes a decision to explain rather than comply, it must consider that to be in the best interests of the company's shareholders. We cannot see a basis in the CC's AEC's finding for concluding that ACs should not be given power over the timing of tender opportunities, particularly given the enhanced role of the AC under Remedy Five and the CC's own conclusion that the AC will act in the shareholder's best interest in determining whether or not to switch audit firm[138].

[135] On the assumption that the unnamed investor referred to in paragraph 74 are the same, and the six investors and the body of representing 56 local authority pension funds are each counted as a separate investor group.
[136] Email from the CC 22 March 2013.
[137] Paragraph 3.60 of the Provisional Decision on Remedies.
[138] Paragraph 4.42 of the Provisional Decision on Remedies.

3.4.14 Overall, therefore, the CC has no evidence that mandatory tendering every five years will improve the perception of audit quality or corporate governance standards, compared to the FRC's measures of tendering every 10 years on a comply or explain basis. This is particularly true if the CC's other six remedies are also put in place, which in our view will go a substantial way towards addressing the CC's alleged AEC. The lack of shareholder support for mandatory tendering is very significant.

3.4.15 In the next section we set out why, in our view, there is actually a risk that the CC's mandatory tendering remedy will worsen the standard and perception of UK corporate governance and audit quality, and therefore risks substantial adverse effects. These have not been taken into account by the CC in assessing the effectiveness and proportionality of its proposed Remedy One.

3.5 The risk that audit quality and corporate governance standards and perceptions will be reduced

3.5.1 The CC argues that any changes in audit quality and corporate governance standards lead to substantial effects in the UK economy[139]. We agree that this might well be the case and as such, the CC needs to be particularly careful in imposing any remedy which can impact audit quality or corporate governance or perceptions thereof, since if that remedy in fact worsens, rather than strengthens, them it would lead to very significant adverse effects. In our view this risk is particularly strong in relation to frequent mandatory tendering, since this remedy is not supported by a substantial number of stakeholders (particularly investors whose perceptions are important in this context), and since it unnecessarily extends the scope of measures recently put in place by a regulator specifically charged with promoting UK audit quality and corporate governance.

3.5.2 We highlighted in section 3.3 above, that more frequent, mandatory tendering will be likely to reduce the additional mandated tenders to box-ticking formalities rather than the thorough tenders that occur now under the FRC's alternative measures. Further, we highlighted the risk that this could set a precedent that undermines the quality of tenders overall. This will in our view damage the credibility of ACs and undermine confidence

[139] Paragraphs 1.41 and 5.90 of the Provisional Decision on Remedies.

in corporate governance, in particular for larger and more complex companies which are likely to represent a very significant proportion of the FTSE350 market capitalisation.

3.5.3 Neither is there any significant investor support for the view that frequent tendering will improve the perception of audit quality. Indeed, even those investors who might be categorised as supporters of the CC's mandatory tendering remedy raise potentially serious concerns, for example the consortium of six investors and the Local Authority Pension Funds notes *"Moreover, the risk that such a tender – without any certainty over an incumbent firm's departure date – could exacerbate the perverse incentives facing incumbents to support company executives should not be underplayed"*[140]. Although we do not agree that this would necessarily be the case, it could clearly be a commonly held perception and it is that which matters. Similarly an unnamed investor notes that *"the audit might be cheaper, but there would perhaps be a tendency to cut corners"*[141]. Such comments clearly indicate that investors' perceptions of frequent tendering do not inspire confidence – rather the reverse. On top of this, the significant increase in time spent in tendering might make this diversion of resources more apparent to investors thereby potentially further reducing perceptions of audit quality.

3.5.4 We also believe that mandatory tendering every five years risks reducing audit quality in particular because of the inevitable distraction of senior time on tendering activity. In this context we think that the CC has misinterpreted our previous submissions as it is not a question of audit firms deploying a *"strategy"* of *"diverting people away from audit engagements"*[142]. Rather it is the simple fact that the most senior audit partners who handle the most complex audits will inevitably be involved in (probably multiple) audit tenders in their fourth or fifth year on a client. Under the CC's proposals it is any client onto which they might rotate will by definition be one that is subject to an audit tender (whether the audit firm are the current incumbent or not) and so an audit engagement partner will necessarily be involved in tender activity towards the end of any five year rotation period. The alternative is that a partner spends some time 'on the bench' which will do nothing to enhance their professional experience and may well put them out of the market in clients' eyes in the future. Not only would this increase the

[140] USS Investment Management, RPMI Railpen, National Employment Savings Trust (NEST), Local Authority Pension Fund Forum, London Pension Fund Authority, Governance for Owners and Environmental Agency Active Pension Fund response to the Provisional Findings and Remedies.
[141] Paragraph 74 of Appendix 3(1) of the Provisional Decision on Remedies.
[142] Paragraph 3.117 of the Provisional Decision on Remedies.

costs to the audit firm[143], but more importantly the damaging impact of taking such a time out to their personal career is unlikely to be acceptable to the individuals concerned. In addition since the outcome of any tender will not be guaranteed (or should not if the proposed remedy is to be successful) it also follows that they may well have to be involved in multiple tenders, risking individual partners being overcommitted. Given the emphasis on the senior partners in any selection process (as illustrated by the Best Practice Notes) and the fact that any timetable will be dictated by the tendering company it may inevitably cause distractions from their current audit assignment.

3.5.5 The CC has also in our view grossly underestimated the resource challenge this involves. Firstly, whilst we agree that there is clearly a busy season for more junior audit personnel this is much less the case for senior personnel and in particular partners, who contribute a much higher proportion of the overall time spent in relation to quarterly or half year reporting as well as any ad hoc corporate transactions. As an aside, the CC's proposal to increase the frequency of AQRT reviews will also inevitably place an increasing and not inconsiderable demand on senior members of the audit teams of FTSE350 companies, although in our view in isolation this does not fundamentally undermine this proposed remedy.

3.5.6 Secondly, the CC is wrong to suppose that the increased time spent on tendering can be simply substituted by reducing the current marketing activity undertaken by audit partners. Neither the volume nor timescale are compatible. Current marketing activity is "voluntary" and not to a rigid timetable which means it can easily be flexed around existing commitments which can always easily take priority. Tendering, however, is determined to a timetable set by the tendering company (which as noted above may be as long as six months) having no regard to other commitments. It is also clear that it is precisely the senior members of the proposed audit team and crucially the audit engagement partner who the tendering company wish to assess and who will be expected to put in most 'face-time' with the prospective client.

3.5.7 In addition, we discussed above the scarcity of specialist resources, particularly at the most senior level. The CC's argument that audit firms can simply recruit more of these

[143] As the CC's working paper on "Evidence on trends in audit fees" shows, any such increase in cost would have to be passed on to companies.

resources is not supported by any evidence and is simply an assertion, as we set out in paragraph 3.3.19.

3.5.8 If the CC considers that audit firms continue to participate fully in the extra tenders it mandates then it must recognise the impact that will have on audit quality given the fact that it is precisely the same scarce resources as those that are needed to lead an audit. Either way, with either lower quality tenders or with a distraction from actual audit work, the remedy has the strong potential to reduce the overall quality of the audit firms' offerings, and shareholder perceptions thereof.

3.6 Other comments on the proposed mandatory tendering remedy

3.6.1 The CC's proposals for giving companies the power to request that audit firms disclose parts of their audit files to the AC during a tender process need careful implementation if they are not to have the effect of damaging audit quality and reducing the likelihood of innovation by audit firms and the standardisation of their tender responses. If not implemented properly, these proposals also risk reducing the level of competition by disclosing commercially sensitive information. We are pleased that the CC has recognised this risk, but the CC also needs to properly understand the type of information that is commercially sensitive. For example, the CC suggests that an audit firm's staffing model or a breakdown of hours by grade of staff might be disclosed. However, this is commercially sensitive information, as we discussed at our Response Hearing with the CC[144], and therefore disclosing this information involves a substantial risk of reducing competition. In our view, this part of the remedy needs to be implemented in such a way as to still allow audit firms to determine what information is commercially sensitive. In our view, the CC's proposals in the Provisional Decision on Remedies on disclosure of information during tender processes also lack sufficient clarity, for example whether the incumbent audit firm can refuse a request or negotiate on the scope of the information disclosed, and who makes the final decision. The CC must consider this in more detail in its Final Report.

4 The proportionality of the remedies package

4.1 Introduction

[144] Line 7, Page 64 to Line 23, Page 67 of the transcript of KPMG's Response Hearing.

4.1.1 As the CC notes, it is required to determine whether the package of remedies it proposes is a proportionate response to the AEC it has identified, by considering the following four questions: i) is the remedy package effective in achieving its aim? ii) is the remedy package no more onerous than is necessary to achieve its aim? iii) is the remedy package the least onerous if there is a choice? and iv) does the remedy package produce adverse effects which are disproportionate to the aim? [145]

4.1.2 A remedies package which includes mandatory tendering every five years cannot, in our view, be considered by the CC to be proportionate compared to a package composed of the other six of the CC's remedies combined with the FRC measures of tendering every 10 years on a comply or explain basis.

4.1.3 As set out in sections 3.2, 3.3 and 3.4 above, there is no evidence that mandatory tendering every five years will deliver any greater benefits compared to the rest of the CC's remedies package and the FRC's current regime. As a result, even small adverse effects and costs associated with mandatory tendering every five years would be sufficient to make a remedies package which includes that measure disproportionate. In fact, as noted in sections 3.3 and 3.5 mandatory tendering every five years gives rise to a number of substantial adverse effects. As explained below it also incurs significant costs compared to the FRC proposals.

4.1.4 As noted in paragraph 3.3.2, tenders are costly to companies and to audit firms. If the CC considers that the additional tenders that are mandated under its remedy proposal will be of a similar quality to the tenders that occur currently and will continue to occur under the FRC's measures, then it must recognise the substantial costs to companies of setting up a tender and to audit firms of participating in one. We discuss the costs to companies and to audit firms in turn.

4.2 Costs to companies of conducting a tender

4.2.1 The CC fails to appreciate the substantial costs in particular to large, complex companies, of running a tender, arguing that costs might be overstated and that there is scope for companies to realise efficiencies and thereby reduce cost[146]. The CC argues

[145] Tesco PLC v Competition Commission [2009] CAT 6.
[146] Paragraph 3.156 of the Provisional Decision on Remedies.

that the estimates we submitted in response to the Remedies Notice[147], overstate the costs to companies of conducting a tender and that ACs, FDs and other senior staff involved in a tender can manage the time required to conduct a tender within their existing profile of duties. The CC has no evidence that ACs, FDs and other senior staff are not already at their limits and still less evidence that they can absorb the additional time required to conduct tenders on a five yearly-basis. The cost of these senior executives' and non-executive directors' extra time must therefore be taken into account by the CC, and simply dismissing our method for quantifying this time, while not providing any other analysis, is insufficient.

4.2.2 We have seen no evidence to show where in the tender process companies could realise any significant efficiencies – for example, only one ACC in the CC's case studies believed that more frequent tendering *"might"* lead to a more efficient process[148]. The CC also refers to one example of a company using a procurement company to manage the tender process. We note that this would also involve substantial cost - specifically, the CC's summary of its case study with this company, notes that the fee was *"less than £500,000"*[149]. This represents a substantial amount particularly when compared to the lack of evidence that there are any benefits from tenders. We also note that even with a procurement company a substantial amount of time on behalf of senior staff and in particular the AC will be required to judge the quality of the audit company and ensure the quality of the tender process. It is also clear from the FRC's Best Practice Notes that running a proper tender process led and driven by the AC/ACC is demanding of both their time and the time of the companies' executive management.

4.2.3 The CC's reasoning for dismissing the costs to companies of conducting a tender is therefore not compelling, nor is it supported by sufficient evidence of its own.

4.2.4 The CC recognises that the costs of more frequent tendering will be greater for larger, more complex companies[150]. However, the CC appears to imply that it does not need to take into account those more substantial costs for these companies because of its view

[147] Which used salaries of FDs and equivalent positions to quantify the opportunity cost of management time.
[148] Paragraph 3.28 of the Provisional Decision on Remedies.
[149] http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/130514_summary_company_w.pdf, paragraph 6.
[150] Paragraph 3.158 of the Provisional Decision on Remedies.

that the benefits to these companies will also be greater than for smaller, less complex companies. However, the CC's reasoning in this regard is flawed:

- The CC argues that larger companies will achieve more substantial price reductions and efficiencies from their audit provider through a tender process than will smaller companies. However, as we have noted audit quality is the principle concern for investors and ACs. Moreover, the CC has no evidence that tender processes themselves drive more competitive outcomes, and so mandating tendering cannot be said to give rise to these benefits. Further, under the existing FRC measures, particularly when they are combined with Remedy Five, ACs can go to tender when they think the benefits (to audit quality, or to price as long as audit quality is maintained) will outweigh the costs. Mandating tendering therefore does not give large, complex companies any greater benefits than they can already obtain (while imposing on them substantial costs).
- The CC argues that the potential gains to shareholders will be greater for larger, more complex companies, given their greater market capitalisation. However, this again fails to appreciate that the extra tenders that the CC mandates will not deliver any benefits to shareholders, since ACs are already able to tender when they think the benefits to shareholders outweigh the costs. As a number of investors have stated, they are opposed to mandating time periods as it disenfranchises both ACs and themselves.
- The CC notes that banking audits are among the most complex and argues that its remedy will contribute to restoring trust in that sector. However, as we have noted several times before, and which the CC has failed to recognise, there is no link between the banking crisis and the quality of audits of banks. We therefore do not see that the CC has any evidence to show that this benefit will materialise.

4.3 Costs to audit firms of participating in a tender

4.3.1 The CC has failed to appreciate the very substantial costs that are required to participate in large audit tenders. The CC suggests that the average cost per additional tender process for each participating audit firm would be between £144,000 and £270,000[151], but for the larger and more complex companies, the costs to an audit firm of participating in a tender are significantly higher:

- In our tender database, we provided examples of a number of companies for which the hours we put into participating in the tender amounted to a cost of more than £400,000, quantified using our cost rates (i.e. the equivalent of staff salary costs)[152].
- The estimated cost of participating in the recent HSBC tender was, in total across all audit firms, for UK member firms of global audit networks £ 3-3.5 million and at

[151] In 2011 prices, since if the CC is considering the cost of implementing a remedy for 2013 onwards, it makes sense to use the most up-to-date prices available.
[152] [✂], [✂], [✂], [✂] and [✂].

least a further £2.25 million for other member firms. These costs are calculated using cost rates to value the time of audit personnel.

- The estimated cost of participating in the recent ENRC tender was, across all audit firms £2.24 million. These costs are again calculated using cost rates.
- The ongoing Compass Group tender is estimated to have cost approximately £1.26 million in total across all participating audit firms. This figure was again calculated using cost rates. We also note that this tender is only approximately half way through.
- The ongoing Standard Chartered Bank tender process is estimated to have cost, in total across all participating audit firms, more than £2.6 million (including UK and non-UK member firms). Again, this figure was calculated using cost rates.

4.3.2 These estimates are set out in more detail in Appendix 2. We note that these are substantial underestimates of the total cost as by using cost rates they do not take into account any of the opportunity costs associated with diverting resources away from other activities, as recognised by the CC[153].

4.3.3 The CC suggests that there might be scope for the cost of tenders to be reduced in the future, since audit firms will have an incentive to realise efficiencies in the tender process. The CC appears to base this suggestion on very limited evidence and what evidence the CC does have available is redacted so we cannot comment on it in full. Since we have not been provided with this evidence or the ability to comment on it effectively, for example in an anonymised form, the CC cannot rely on this evidence in reaching its findings or in the formulation of, or justification for, its remedies package. However, we note the CC itself states that *"these documents do not provide details on how such efficiencies might be achieved"*[154].

4.3.4 The CC has provided no other description of how and where costs to audit firms of participating in a tender might be reduced, and we challenge the CC to show how this might be achieved. In fact, the potential for audit firms to realise efficiencies and reduce the costs of participating in a tender is very limited since audits are bespoke and there are few or no economies of scale, as we noted in our Response Hearing with the CC[155]. The CC has not provided any substantive evidence to suggest that our view is incorrect. Indeed, if the tender process is appropriately thorough then it is evident from the FRC's

[153] Paragraph 3.80 of the Provisional Decision on Remedies.
[154] Paragraph 3.72 of the Provisional Decision on Remedies.
[155] Line 12, Page 57 to Line 6, Page 61 of the transcript of KPMG's Response Hearing.

Best Practice Notes that considerable time must be invested by audit firms and companies.

4.4 The CC's proportionality assessment

4.4.1 The expected increase of around 35 tenders per year under the CC's remedy, compared to the FRC's measures, would therefore lead to substantial costs for companies and audit firms which will be passed on to UK shareholders and customers. Where these additional tenders are mandated, rather than judged by the AC to be in the interests of shareholders (for example if the AC is dissatisfied with its current audit firm), then these costs represent pure deadweight loss for the UK economy. The CC has wrongly dismissed these costs, and argued that they may be reduced in future through efficiency savings without any solid evidence to support such a hypothesis.

4.4.2 In addition to the direct costs associated with the increased number of tenders, which are particularly substantial for large, complex companies, the CC's remedy risks generating further, substantial adverse effects across the reference market and the UK economy more broadly, as we set out in sections 3.3 and 3.5 above. These substantial adverse effects include a loss of audit quality and corporate governance and the perceptions thereof and the risk of reducing competitive pressure across the reference market.

4.4.3 Overall therefore, the CC cannot conclude that a package of remedies involving mandatory tendering every five years is proportionate. The costs are great and the CC has not demonstrated that it will deliver benefits compared to the current FRC regime. We note that the CC compares the costs of its remedies package with the total market capitalisation of the FTSE350[156]. This is an inappropriate benchmark against which to judge the costs of the CC's remedies. As previously stated by the Competition Appeal Tribunal ("CAT"), the proportionality assessment under the Enterprise Act requires a balancing of the costs associated with a proposed remedy against the benefits that are considered likely to accrue[157]. The ability of those companies within the reference market to pay for implementation is not the relevant comparison for analysis.

[156] Paragraph 3.152 of the Provisional Decision on Remedies.
[157] Tesco PLC v Competition Commission [2009] CAT 6 at [131].

4.4.4 Further, in comparing the costs and benefits of mandatory tendering, the CC does not produce an appropriately quantified estimate of either. In circumstances where its proposed Remedy One is likely to have profound cost effects on companies and audit firms alike in the reference market, and potentially have the effect of harming the quality of competition for the reasons set out above, it is incumbent on the CC to undertake a thorough analysis of all the relevant costs[158]. In our view, the CC has not taken into account the full costs to be borne by companies and audit firms if Remedy One were to be implemented. Nor has the CC conducted its cost/benefit analysis by reference to the appropriate counterfactual which, as previously noted, is the FRC's recently introduced tendering requirements on a 10 year comply or explain basis.

4.4.5 Under the Enterprise Act, the CC is required to *"have regard to the need to achieve as comprehensive a solution as is reasonable and practicable to the adverse effect on competition and any detrimental effects on customers…"*[159]. In our view the CC is not able to meet this statutory test in circumstances where it has not conducted a thorough and rigorous analysis of the relevant costs and benefits associated with its proposed remedies. The CC's cost/benefit assessment in relation to Remedy One is in many cases based on unsubstantiated assumptions rather than a thorough analysis or comprehensive projections.

4.4.6 For example, in relation to Remedy One, the CC suggests that firms will be able to make 'efficiencies' in order to participate in more frequent tenders but does not adequately identify what these efficiencies might include[160] or how they might be achieved. The CC suggests that these 'efficiencies' will result in the annual cost overall declining from around £30 million to £10 million, without substantiating its reasoning for this[161]. Further, in relation to the projected costs to companies of implementing Remedy One, the CC rejects the cost assessment we provided without suggesting a reasonable alternative. If the CC considers another method of assessment to be more appropriate, it should explain what this is and set out its methodology. As the CAT noted in Tesco PLC v Competition Commission [2009] CAT 6 at [163]:

[158] Barclays v CC [2009] CAT 27 at [128].
[159] Section 134(6) of the Enterprise Act.
[160] Paragraph 3.83 of the Provisional Decision on Remedies.
[161] Paragraph 3.152 of the Provisional Decision on Remedies.

"Whilst the precise methodology adopted for assessing these matters, and the weight to be attributed to the results of such assessments are (subject to rationality or questions of law) likely to fall within the margin of appreciation of the Commission, the assessments and the weighting must take place."

4.4.7 The CC is obliged to choose the least onerous remedies package. By including mandatory tendering the CC has not done that. A remedies package composed of Remedies Two to Seven, along with the existing FRC tendering measures would in our view lead to more benefit than the CC's proposed remedies package (as it has the backing of investors and would not therefore run the risk of undermining confidence in audit quality and corporate governance) and involve substantially less cost (and therefore would be less onerous).

4.4.8 There is no immediate urgency to implement the mandatory tendering remedy so any 'costs' of lost competition during this time will not be significant. Indeed, the CC envisages a five year transition period for its Remedy One in any event. Issuing an Order in these circumstances is therefore completely disproportionate, particularly where the CC concedes that it cannot quantify the benefits of its mandatory tendering remedy, appealing only to a vague and unsupported assertion that it will result in increased confidence and hence positive effects on market capitalisation but with very real prospects that confidence will in fact be damaged. This is analysis is simply inadequate in the circumstances.

4.4.9 If therefore the CC wanted to go further than its package of Remedies Two to Seven combined with the FRC's current regime, then we submit that the CC could take a 'watching brief' for a number of years while the effects of the FRC's reforms fully emerge. This is a less onerous solution than the CC's proposed remedies package, and one which can still deliver substantially the same benefits in the event that the FRC's recently introduced measures are deemed insufficient to fully address the CC's concerns. In order to reinforce shareholder engagement the CC could also consider requiring information on the company's policies as regards audit tenders (frequency etc) to be included in the AC report and hence subject to the proposed advisory vote. This would ensure that for a specific company its shareholders' views could be taken fully into account.

5 The other remedies in the CC's remedies package

5.1 Summary

5.1.1 As we noted above, in our view the other remedies (i.e. Remedies Two to Seven) in the CC's package do not risk imposing similar substantial costs on companies, audit firms and the economy as a whole compared to the CC's mandatory tendering remedy. In addition, we see that some of these measures have the real potential to increase audit quality and shareholder/investor engagement, which we are always in favour of. In particular, we see potential benefits arising from the CC's measures to: increase the level of reporting by the Audit Quality Review Team (AQRT) ("Remedy Two"); enhance shareholder engagement ("Remedy Four"); strengthen the accountability of the external auditor ("Remedy Five"); and extend reporting requirements ("Remedy Six"). However, we do have some comments on the implementation of some of these remedies which, in our view, will maximise the potential improvements to audit quality and minimise disruption and distortion. We set out these comments in the rest of this section.

5.1.2 For the remaining two remedies in the CC's proposed package (removing clauses in auditor loan agreements ("Remedy Three") and giving the FRC a duty to have 'due regard' to competition ("Remedy Seven")), we are less convinced that these are likely to give rise to improvements in audit quality, or increase competition in the reference market. However, we do not think these are likely to substantially distort the market or reduce competition and therefore we make no further comment on these remedies in our response.

5.2 Remedy Two: Audit Quality Review

5.2.1 In our view this remedy has the potential to deliver benefits in the context of UK audit quality and corporate governance more broadly. However, we note that this measure might be substantially less effective in other jurisdictions. Even in the UK, we think it is important to recognise the limitations of the AQRT reports. For example, all audit firms have shown that they can produce high quality audits but all have also shown that there have in the past been certain issues. We think the AQRT reports will therefore be more effective in highlighting issues on particular engagements rather than highlighting the performance of an audit firm more generally.

5.2.2 It is however important in our view that this remedy does not unnecessarily undermine the confidence in a company's financial reporting. As such careful consideration should be given to the timing of the AQRT reports with respect to a company's annual report, and the CC should include recommendations on the timing in its recommendations to the FRC. Specifically, it is crucial that ACs are given time to consider the AQRT review and make any statements about remedial action that has been taken by the AC or audit firms in response to any findings or suggestions for improvement made by the AQRT. This will ensure that there is no unnecessary overreaction on the part of investors to AQRT comments, and ensure that investors have a full picture of the action ACs have taken to ensure assurance on the company's financial reporting.

5.2.3 Further, in our view it is important that the timing of the AQRT report in relation to a company's annual report is standardised across all companies – so all companies can expect to get their AQRT report at a certain time ahead of the publication of the result in the annual report. This will ensure that there aren't distortions whereby some companies have been able to also publish what actions they intend to take in response to AQRT findings (and thereby reassuring investors) whereas other companies, with similar findings, may not have had the time to do that.

5.2.4 Finally, we note that the cycle of tendering that the CC has suggested in its mandatory tendering remedy, in combination with the frequency of AQRT reports is unlikely to work. Under the frequency of AQRT reports suggested under this remedy, and the timing of mandatory tendering periods, not all companies would receive an AQRT report prior to their mandatory tendering window. In our view this further supports the 10 year time frame proposed by the FRC which would ensure all companies received at least one AQRT report on their current auditors before being required to tender, and would encourage tendering in advance of the FRC proposed period if the AC believed the AQRT indicated quality failings by the incumbent audit firm that could not be rectified otherwise. If the CC is seriously focused on encouraging greater shareholder/investor engagement and promoting audit quality it would consider this seriously.

5.3 Remedy Four: Enhanced Shareholder engagement

5.3.1 As we have previously noted we dispute the CC's finding that we compete to satisfy the demands of management, in particular if these may differ from those of shareholders. Indeed we currently seek to liaise with investors and with the FRC to establish whether there is a cogent demand and how audit firms and companies may best meet it,[162] although we often struggle to achieve engagement with investors.

5.3.2 We are therefore supportive of this Remedy as a way of enhancing shareholder engagement. In addition as noted in paragraph 4.4.9 above we believe the CC might give consideration to requiring details of the company's policies on audit tenders to be included in the AC report which would then make it subject to the advisory vote.

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

5.4 Remedy Five: Strengthening the accountability of the external auditor

5.4.1 We note that the CC intends to make an Order regarding the various matters in this Proposed Remedy.

5.4.2 In this regard we would echo the independence concerns noted by the FRC[163] in their response in relation to the AC having the responsibility to *"negotiate and agree the audit fees and the scope of audit work"* and *"require the replacement of an AEP"*[164]. Whilst it should be the AC with whom the audit firm has a dialogue on scope, they can only agree increases over and above what the audit firm determines is required.

[162] Section 2.10.4 of KPMG's response to the Provisional Findings.
[163] Pages 9 to 10 of the FRC's response to the Provisional Decision on Remedies.
[164] Summary box of the CC's Remedy Five in the Provisional Decision on Remedies.

Similarly whilst it should be the AC (and not for example the CFO) who should raise any issues regarding the AEP they can have no authority to *"require"* replacement. We think it would be preferable for the CC to require the FRC to make changes to give effect to its proposals or at a minimum engage extensively with them on how the requirements are worded so as to avoid any unforeseen consequences or impacts on audit independence or quality.

5.4.3 Similarly we would suggest that it might be more appropriate for the FRC which has the necessary expertise in this matter to draft the detailed requirements in respect of NAS as they are not straightforward. For example, consideration needs to be given as to whether it should cover the Group both within and outside the UK; the latter would require incorporating definitions of network firms. Should it also include material affiliates or controlling corporate shareholders? Also we suggest that it should allow the concept of approval by policy rather than of every engagement individually which could unnecessarily take up ACs' valuable time. All of these aspects have for example been considered in the context of the SEC's independence rules and are also under active consideration by the EU.

5.4.4 In the event the CC confirms its provisional decision to issue an Order than it must take all such factors into account. We would be happy to provide input or comments on any specific proposals to ensure they are clear, operational and minimise conflicts with other jurisdictions.

KPMG

Appendix 1: Further detailed comments on the Provisional Decision on Remedies

This appendix sets out further detailed comments on the Provisional Decision on Remedies, supplementing our views included in the main text of our response.

Paragraph number(s)	***KPMG comments***
Summary	
6	We set out in section 3.3 in the main text of this response that the CC cannot expect the additional tenders it mandates under its mandatory tendering remedy to continue to be thorough, fair processes, such as those outlined in this paragraph.
8, 9	The CC misleadingly conflates the concepts of *"scrutiny"* and *"competition"* in concluding that 10 years is too long an interval between tenders. As regards scrutiny, the CC's other proposed remedies will require a review by the AQRT every five years – such scrutiny will be considerably more intensive than anything than would or could be undertaken during a tender exercise and hence will be addressed adequately by the implementation of Remedies Two to Seven. Remedy One does nothing to further enhance *"scrutiny"* of audit services in the reference market. As regards competition, as we set out in section 3.2 in the main text of this response, there is no evidence that tender events themselves enhance companies' bargaining power or increase their ability to obtain competitive terms. Instead, the evidence shows audit clients have bargaining power outside of tender events and subject the audit firms to scrutiny and challenge on an ongoing basis. As set out in section 3.3 in the main text of this response, the additional tenders imposed on top of those that will occur under the FRC's recent measures are likely to be reduced to box-ticking exercises which are even less likely to drive companies' bargaining positions. In fact, mandating tenders risks reducing competition across the market. As noted in sections 3.4 and 3.5 in the main text overly frequent tendering will also lead to adverse effects of the perceptions of, and potentially actual, audit quality and corporate governance which will lead to worse outcomes for the market as a whole.
12	We are in favour of measures that further increase the influence of ACs. However, we do not believe that the CC's mandatory tendering will increase the influence of ACs, compared to the FRC's regime. In fact, mandatory tendering removes ACs' powers to determine the timing of a tender and thereby removes power from ACs, cutting across the CC's other remedies.
13	As set out in our response to the CC's Remedies Notice, we would support the removal of clauses in loan agreements limiting choice to the largest four audit firms if they are deemed to adversely affect competition. However, we do not agree that the CC's mandatory tendering remedy will deliver any benefits in terms of increased choice, compared to the FRC's regime. The additional tenders, over and above those that would be held under the FRC's regime, will be conducted with little realistic chance of a change in audit firm, so we fail to see how these will increase the opportunities available to win

	engagements, as we set out in section 3.3 of the main text of our response.
14	We agree that the FRC has evolved into a body that is increasingly well equipped to provide high-quality independent regulation to the audit market. It is for precisely this reason that we believe the CC should respect their conclusion that it is not appropriate to mandate fixed time periods for tendering and that 10 years is an appropriate period generally for audit tenders. The CC has no evidence that its remedy delivers any demonstrable benefits in relation to audit quality and corporate governance, compared to the FRC's regime.
20	The combined FTSE350 market capitalisation is not the relevant benchmark against which to consider the proportionality of the costs of a remedy. The costs of the remedy must be weighed against the projected benefits that are considered likely to accrue as a result of implementation. Please see our comments on paragraph 1.24 below.
Introduction	
1.2	We do not believe the CC has *"considered carefully all the evidence [it has] received"*. In addition to our response to the CC working paper "Evidence of trends in audit fees" which by definition the CC cannot have taken into account in its Provisional Decision on Remedies[165], examples where the CC has not taken properly into account relevant evidence, or has assessed evidence incorrectly, include (but are not limited to): ■ the consequences of the CC's failure to control for audit scope in the CC's analysis of audit fees after a change in audit firm, after a tender and in other analysis (as discussed in our response to the CC's working paper "Review of evidence on the price effects of a switch" and our response to the Provisional Findings, section 2.3); ■ the CC's analysis in its Provisional Findings is based on gross margins, and therefore fails to take into account indirect costs. As a result of this flawed analysis, the CC is unable to conclude that any engagements enjoy 'high' profitability. Recent evidence in the CC's working paper titled "Evidence of trends in audit fees" further supports this view. Further, in comparing engagement margins across different groups of engagements the CC has failed to control for other factors, in particular complexity and risk, which makes the CC's observations in its Provisional Findings unreliable (discussed in detail in section 2.4 of our response to the Provisional Findings); ■ our assumptions in our profitability analysis submitted to the CC and the logical conclusion from that analysis that we do not make excess profits (which we discussed in section 2.5 of our response to the Provisional Findings); ■ the CC's flawed assessment of the nature and level of choice in the reference market (as discussed in section 2.8 of our response to the Provisional Findings); ■ the substantial evidence of process and other innovation (as discussed in section 2.9 of our response to the Provisional Findings); ■ the uncertainty on the part of audit firms in bargaining with companies and the implications of this for bargained outcomes (as we discussed in section 3.10 of our response to the Provisional Findings);

[165] Because we submitted that response after the CC published its Provisional Decision on Remedies.

	■ the extensive evidence of companies exerting competitive pressure outside of tender processes (as we set out in our response to the CC's working paper "Nature and Strength of competition"); ■ the evidence which suggests audit quality in the reference market is high (as set out in section 2.6 of our response to the Provisional Findings) and also as discussed in the AQRT's most recent 2012/13 Annual Report which also confirms this view; and ■ the evidence which suggests companies' bargaining power vis a vis audit firms in the reference market is high (as discussed in section 3 of our response to the Provisional Findings) and that this means those companies are able to achieve competitive outcomes (i.e. pricing and profitability are at competitive levels as outlined in our response to the CC's working paper "Evidence of trends in audit fees" and that audit quality is high in the reference market as suggested by the AQRT in its 2012/13 Annual Report).
1.11	We note that this Provisional Decision on Remedies is based on the Provisional Findings which by definition cannot have taken into account the subsequent evidence we discussed in section 2 of the main text of this response and in particular the working paper on "Evidence on trends in audit fees" and the responses to it. Also, as set out in section 2 of the main text of this response, once such evidence has been taken into account, the CC's Provisional Findings cannot be confirmed.
1.17	In this paragraph the CC discusses a market where prices are *"above competitive levels"* and where audit fees are *"excessive"*. As our analysis of profitability showed, the CC has no evidence to support this view. Likewise, its recent working paper "Evidence on trends in audit fees" shows that where audit firms have realised efficiencies, these have been passed onto customers in the form of lower prices; which the CC itself describes as a *"powerful indicator of a competitive market"*[166]. The CC is correct in describing the market as a whole as having inelastic demand, insofar as audit for listed companies is a required service. However, this does not imply that the elasticity of demand for an individual audit firm is inelastic[167], clients seek out value from their auditors and, as the CC's survey evidence has found, companies are willing to initiate tender processes and to switch auditor when required. The CC's recent working paper "Evidence on trends in audit fees" shows that pricing and profitability in the reference market are at competitive levels.
1.22, 1.26, 1.27, 1.31, 1.39, 5.91	The CC has no evidence that even if the AECs it alleges existed (which we dispute) they have in fact led to a decrease in audit quality. Indeed as we note in section 2 of the main text of this response there is substantial evidence from the audit regulator that audit quality is high and increasing. We set out in section 2.2 a) and b) of the main text of this response our view that the CC's evidence base does not support a view that there is any shortfall in audit quality in the reference market nor that there is a lack of trust or confidence, such that the remedies the CC proposes will lead to the substantial benefits it quotes[168]. Furthermore, we note in section 3.5 of the main text of this response our concern that the CC's mandatory tendering remedy risks reducing standards and perceptions of audit

[166] Paragraph 5 of the CC's working paper "Evidence on trends in audit fees".
[167] As we set out before in paragraphs 4 and 69 of our response to the CC-commissioned academic literature review.
[168] Section 2.2 a) and b) of KPMG's response to the CC's Provisional Decision on Remedies.

	quality and corporate governance.
1.24, 3.418, 4.39	As set out in section 3.5 in the main text of this response, far from creating the benefits it quotes here, the CC risks creating substantial costs of similar magnitudes as a result of its mandatory tendering remedy.
1.29	As set out in section 2.2 a) of the main text of this response, the CC has been selective in its use of the most recent AQRT reports. The evidence clearly shows that audit quality is high (and increasing, in particular for FTSE350 audits) in the reference market.
1.32	We agree that investor views are very important given that they are the 'customer' for statutory audit services. It is for this reason that we are supportive of the CC's Remedies Two to Seven, many of which have the potential to improve the outcome for investors including improvements of their perception and understanding of the statutory audit service (including any deficiencies identified by the AQRT). However for the reasons outlined in sections 3.4 and 3.5 of the main text of this response we do not believe this will be the effect of introducing mandatory tendering – rather it will exacerbate any concerns.
1.33	It is not clear whether Mr Nick Land's comments are in relation to the quality of audit or its scope and visibility to investors. Our impression is that this comment is more likely to be related to the scope and visibility of audit, which we agree can be expanded to include additional reporting and which the CC's Remedy Six goes some way to addressing.
1.34	As we set out in section 2 of the main text of this response, the CC has no evidence that companies on average tolerate higher prices or lower quality. Similarly, the CC has no evidence that tenders drive competitive outcomes as set out in section 3.2 in the main text of this response. This is unsurprising since companies exert competitive pressure on audit firms, in relation to price and quality, throughout the engagement.
1.35	We would point the CC to our previous comments on this working paper[169]. We would also note that until it addresses these concerns, the CC is unable to place any weight on this analysis in support of an AEC finding.
1.36	The CC has been selective in its use of the case study evidence in this paragraph. There were a number of other companies that the CC has failed to mention that state they are, and remain, happy with the quality of their audit[170]. In addition, companies seeking to resolve issues (regarding either quality or price) with their current audit firm, and exerting bargaining pressure on them to do that, is completely consistent with a competitive market, as we set out in previous submissions to the CC[171].
1.37	The CC states that the *"quality demanded"* by shareholders is likely to be different in a *"well-functioning market"* compared to that observed currently. The CC states that there would be a greater emphasis on professional scepticism and thoroughness. However, the

[169] KPMG Response to CC's Working Paper "Review of evidence on the price effects of switching"
[170] Case study D (paragraph 59); Case study E paragraph 58; Case study H paragraph 22; Case study J paragraphs 17 and 23; Case study V paragraph 2.
[171] For example, see paragraph 2.2.14 of our response to the CC's working paper "Nature and strength of competition".

	CC's first survey shows that ACs had the main influence over the selection of an audit firm and that independence of the audit firm, ability to detect misstatements, high degree of challenge and efficiency were all seen as important by around 90 per cent (or higher) of ACCs and FDs. Whilst Remedies Two to Seven may be expected to reinforce this influence, and which we support for this reason, there is no evidence to suggest mandatory tendering will have any effect – indeed it will disenfranchise ACs who can no longer make a decision as to whether or not to tender on the basis of what is in the best interests of shareholders.
1.37, 3.13(a), 3.18, 3.84, 3.117(a), 3.150(c), 5.78	These paragraphs refer to the CC's expectation that following the introduction of mandatory tendering the CC expects the time senior audit staff spend developing relationships with prospective clients to decline, and that this time will be spent, instead, on tender processes. We consider this statement shows the CC's lack of understanding of the fundamental drivers of competition in the audit market. Although audit partners do build relationships with companies to encourage a tender process, there is a wider objective. The time that audit partners spend with a company provides them with an understanding of its business and of the sector in general. Removing this understanding from the competitive framework will reduce tender quality, and, importantly, increase any advantage held by the firms' incumbent auditor. The CC also needs to recognise that this will necessarily reduce the strength of competition outside of tender processes.
1.38	It is not clear what the CC means by the *"right demand"* in this paragraph. The CC also states that if competition is functioning effectively, the market will specify the quality and price of the competitive product. The CC is yet to provide any evidence to suggest that quality and price are not already at competitive levels. It has been unable to show that audit firms make excess profits, and the analysis we provided shows that we do not. This paragraph therefore demonstrates that the CC has no evidence that prices and quality will be improved following the introduction of its remedies options, and by how much. This is not a sufficient basis on which to form an assessment of proportionality.
1.41	The CC has not provided evidence to link regular tendering with reductions in companies' cost of capital. As we set out in section 3.5 of the main text of this response, there is a substantial risk that mandatory tendering will instead lead to reductions the perceptions of and potentially actual audit quality and corporate governance standards, and therefore substantial adverse effects in relation to companies' cost of capital.
3. Remedy options that we are proposing to take forward	
3.4, 3.13(b), 3.149(a), 5.6, 5.46	We set out in section 3.2 of the main text of our response that the CC has no good evidence to show that tender events themselves drive companies' bargaining strength or competitive outcomes. In addition, the extra tenders introduced under the CC's mandatory tendering remedy a very likely to be less thorough and less effective than tenders are currently. Therefore, we fail to see how the CC can consider that it has any evidence that mandatory tendering will increase companies' bargaining power.

3.9	The CC states that *"companies appeared reluctant to go out to tender unless seriously contemplating switching auditors"*. This sounds to us like a good description of a competitive market, where companies tender and switch audit firm if they are dissatisfied with their current provider. The evidence in the CC's company survey is that ACs have the most significant influence on the decision to tender (and such influence would increase under the CC's proposals for Remedies Two to Seven) and overwhelming incentives to act in the best interests of shareholders (as the CC effectively acknowledges in its discussion of mandatory rotation). As such we believe that not only is the market competitive but that it also acts in the investors' interests. We set out the relevant economic framework and bargaining process in section 3.10 of our response to the CC's Provisional Findings
3.13	We set out in section 3.3 of the main text of this response that companies will not have an incentive to switch every five to seven years and nor therefore to incur the substantial costs required to conduct a proper tender. In these circumstances we do not think that it would damage an audit firm's reputation not to participate in the tender.
3.13(c)	The CC believes that companies will be able to streamline *"their processes and tender requirements"* thanks to the information gained from going out to tender every five to seven years. The CC has not substantiated what it expects can be streamlined from the process, as we set out in section 4 of the main text of our response.
3.14	As we previously noted, having certainty over the timing of the tender process is likely to reduce general competitive pressures in the market (see paragraph 7 of the KPMG response to the Remedies Notice). As we have stated in previous responses[172] it is not a lack of tender opportunities which means that the mid-tier audit firms have less market share in the FTSE350. It is instead their lack of the capabilities that are required to audit the largest companies and their apparent unwillingness to invest to the same degree as the largest four audit firms. In addition, as we set out in section 3.3 of the main text of this response, a large number of the extra tenders mandated under this remedy will be conducted without any genuine possibility of switching. As a result we fail to see how this remedy will significantly increase the opportunities available to mid-tier firms to win new engagements. Indeed it may cause them to decline to participate in an increasing number of tenders which will do nothing to enhance their reputation.
3.15	In our response to the CC's Provisional Findings, we noted that the CC had no evidence that in practice management's incentives are misaligned with those of shareholders[173]. In addition, to the extent that executive management still have influence on the decision on whether or not to tender the company's audit, this is addressed by Remedy Five which firmly puts this authority in the hands of the AC – it does not need to be mandated which as noted above actually prevents the AC from making the decision on when to go out to tender in the best interests of shareholders. The CC's mandatory tendering remedy cuts across the CC's other remedies, as well as its

[172] See section 4.4 of KPMG's response to the Competition Commission Provisional Findings.
[173] See Section 5.2 of KPMG's response to Competition Commission Provisional Findings in the supply of statutory audit services market inquiry

	dismissal of mandatory rotation by denying a well qualified and knowledgeable AC, the ability to judge when it is suitable to put its statutory audit out to tender. We believe that by making tendering mandatory, the *"detailed and transparent process"* that tenders currently follow is at risk as we set out in section 3.3 of the main text of this response. See also our comments to paragraph 1.37 above.
3.21	This paragraph highlights that the CC is premature in requiring more frequent mandatory tendering, and instead should at least wait and observe the effect of the recent FRC changes. We also do not believe that its operation is as *"uncertain"* as the CC implies. Whilst we agree that practice is still emerging, the direction of travel is clear and is complementary to and would be supported by the CCs other remedies (i.e. Remedies Two to Seven). As a consequence we expect there to be very high levels of compliance, as the CC recognises in paragraph 3.66, where it CC states that *"it appears to us that there is a general expectation that the level of compliance with the new FRC provisions will be high"*. To the extent that it is not complied with this will be very transparent to the shareholders of the company concerned who will be able to voice any concerns and take the appropriate action if required.
3.24, 4.111	When discussing joint audit, the CC notes that it *"placed considerable weight on the views of investors"*. Whilst the views of investors are mixed in relation to the appropriate time frame for mandatory tendering, it is clear that no investor supports the CC's proposed remedy as those that favour shorter time periods generally do so on a comply or explain basis recognising that the scale and complexity of companies varies. As we note in section 3.4 even the coalition of six investor groups and the body representing 56 local authority pension funds (who are described in paragraph 78 Appendix 3.1 as supporting mandatory tendering as proposed by the CC) make it clear that this is in the context of also requiring mandatory rotation. Indeed they note considerable concerns about mandatory tendering on its own which would be exacerbated with increased frequency. As a result, the CC lacks any significant investor support for its proposals.
3.25	We note that the CC did not receive a single response from companies in favour of the proposed mandatory tendering remedy. Furthermore, we note that there was widespread support from companies in the case studies for the newly implemented 10 year comply or explain regime. It is highly unusual for a competition authority to impose such an intrusive remedy on an industry in the absence of any customer concerns.
3.28	We echo the comments made by ACCs, a role which the CC describes as ensuring the tender process is *"thorough and fair"*[174], that there are not substantial efficiencies in the tender process to be gained from more frequent tendering. The CC cannot conclude that there are substantial efficiencies to be achieved based on the view of *"one ACC"* who believed more tenders *"might"* lead to a more efficient process but *"could not be sure"*[175]. In addition, we set out in section 3.3 of the main text of our response that under the CC's proposals the additional tenders are likely to become box-ticking exercises.

[174] Paragraph 3.16 of the Provisional Decision on Remedies.
[175] Paragraph 55 of Appendix 3 of the Provisional Decision on Remedies.

3.30	We agree with the FRC's concerns. Further, as noted in section 3.4 above, the FRC has considered the appropriate tendering on a 10 year comply or explain basis best promoted audit quality and corporate governance. It concluded that 10 years comply or explain tendering best promoted UK audit quality and corporate governance. It is not clear on what basis the CC feels that it is justified in going further. To do so risks reducing the perceptions of, and potentially actual, audit quality and corporate governance and imposing substantial economic costs with minimal additional benefits.
3.38	Mid-tier firms told the CC that mandatory tendering was *"said to be widely supported by other investors and stakeholders"*. This does not appear to be the case given the views of investors that the CC has gathered as set out in our comment in response to paragraph 3.24 above. The CC cannot put weight on assertions by mid-tier firms on the views of investors, which contradict the body of evidence the CC has received directly from investors.
3.40	The mid-tier firms' views that efficiencies can be realised in the tender process are not substantiated with any evidence or examples which is not surprising given their lack of experience in participating in tenders for the larger or more complex FTSE350 entities. As noted in section 4 of the main text of this response, we challenge the CC to show which parts of a tender process might be removed and efficiencies realised, while maintaining the quality of tenders. GT states that audit firms would be *"forced to focus their efforts in the tender process solely on quality and not the other matters that were often part of the tender process at present"*. We're not sure what *"other aspects"* of the tender process GT has in mind or what it does at present. In our experience, all substantial aspects of the tender process for major listed companies are aimed at allowing ACs to assess whether an audit firm has the expertise and skills necessary, (around the world for global audit clients) to conduct a high quality and value for money audit. Again, GT's statement that elements of the tender process can be reduced is unsupported by any evidence or examples. We agree however, with GT's statement that audit firms will have to be more selective about accepting an invitation to tender, for the reasons we set out in section 3.3 of the main text of this response and which the CC incorrectly dismisses in its Provisional Decision on Remedies.
3.41	We are pleased that some of the smaller firms recognise that there are problems with open book processes, namely that there is a risk these may stifle innovation.
3.42	We note that every industry body (including the ABI which is of course also a considerable investor representative group) responding to the CC supported the recent FRC provisions, showing that they have a degree of stakeholder support lacked by the CC's proposals for mandatory tendering on a more frequent basis.
3.46	The CC is incorrect to state that audit firms *"did not support proposals for tendering every ten years on a 'comply or explain' basis"*. In our response to the FRC's consultation we set out what we considered to be some risks from the proposals and our view that a proper comply or explain provision was important to mitigate them. We also noted that for the largest companies, 10 year mandatory tendering might not be practical, but our view now the

	proposals have been implemented is that is also mitigated by the comply or explain provision. The CC has provided no evidence to support its *"on balance"* view that it expects *"companies and firms to be able to respond to a requirement to tender every five years in ways that would be in the interest of shareholders"*. The CC has been presented with wholly unsupportive statements by investors, companies, industry bodies, the FRC and audit firms of its remedy proposals which contradicts that expectation.
3.49, 3.130	We are pleased the CC recognises the costs of the mandatory tendering remedy will differ across companies. The CC describes those companies that will find it disruptive as those *"with extensive international presence, multiple business lines, or companies in certain sectors where audits are technically more difficult"*. We note that this can be applied to a significant number of companies in the reference market, representing a very substantial proportion of the market capitalisation in the FTSE350.
3.53	The CC notes that some firms may want to *"take advantage"* of the possibility to comply rather than explain. We are pleased the CC recognises that there is an advantage to not tendering if the AC does not view it as the correct time. However we do not consider the two year leeway granted by the CC to be adequate as this still amounts to mandatory tendering within a very short timeframe.
3.60	We note the views of one ACC, openly stating that its company may wish to *"explain for a while into the future"*. We don't see the basis in the CC's theory of harm that suggests ACCs should be forced to tender their company's audit more frequently than they think is appropriate. Indeed as we have noted elsewhere if the CC believes that ACs will act in the best interests of shareholders in exercising their choice of audit firm then they should also be entrusted with when to exercise that choice through a tender process.
3.64	KPMG has not, to our knowledge, told the CC that we believe circumstances in which it would be acceptable to 'explain' are necessarily likely to be limited and short lived, contrary to the CC's suggestion in this paragraph. This is acknowledged by the CC in paragraph 3.66. However, we do expect widespread compliance, and the use of 'explain' only to be used for good reason and in relatively few instances.
3.66	The CC states that we *"expressed a view that some companies might seek to 'explain' more often and for longer"*. This is not an accurate summary of our views. We stated that a time period shorter than ten years was likely to be inappropriate for a number of companies, and might encourage greater explanation than compliance. We did not mention time periods. Further, we noted that in corporate governance generally, 'comply-or-explain' typically results in most companies *"complying in most instances rather than explaining over a protracted period … no reason why this would not apply in relation to tendering"*[176].
3.72, 3.73	The redacted evidence in this paragraph is, as far as we can tell, the only possible piece of evidence the CC has for concluding that audit firms will be able to realise any substantial efficiency savings. We are unable to comment on this given that it is redacted and it is not clear what level of efficiency savings might be envisaged. However, we do not think that there is scope for any significant efficiency savings, as we set out in section 4 of the main text

[176] Paragraph 43 of the summary of KPMG's Response Hearing.

	of our response.
3.74	We agree that documents such as those inviting expressions of interest and invitations to tender could be standardised, but since this is an extremely small part of the tender process, we would expect this to lead to only very small cost savings. However, this is the only real part of the process where this is the case, calling into question where other cost savings could be identified.
3.81, 3.82	Analysing costs based on 2005 prices understates the CC's cost estimates (which we already consider to be a substantial underestimate) by 20 per cent. Since the CC is considering the costs of implementing the remedies for 2014 onwards, it makes no sense to use 2005 prices rather than the most up to date prices available to evaluate the costs of the remedy.
3.86, 3.87	The CC notes that it is not persuaded that audit firms offer companies short term discounts to encourage switching. The CC is not in a position to make that conclusion without having taken into account our response to the CC's working paper "Review of the evidence of the price effects of switching". We agree with the CC's conclusion that a regulatory intervention that raises the cost for all firms may be expected to result in higher fees. This will be to the detriment of shareholders and UK consumers. However, we disagree with the CC's claim in paragraph 3.87 that audit firms may not be able to pass these costs on to customers. In a market where prices and margins are already at competitive levels, costs increases would need to be passed on to customers, just as the CC's working paper "Evidence on trends in audit fees" shows that we have passed on real cost reductions. The CC has not established that prices and margins are not at competitive levels. Its refusal to engage with our profitability analysis (or perform its own analysis) implies that it is not in a position to conclude that prices, profits and margins are at anything other than competitive levels.
3.88	We note that although the typical tender process lasts about six weeks to three months, this is not the case for all companies. Many of the larger FTSE companies will follow more extensive processes as we describe in Appendix 2 to this response.
3.95, 3.96	We note that four companies[177] noted the time pressures stemming from tender processes.
3.98	It is not clear to us how in practice the CC can be sure that two years is sufficient to deal with any of the circumstances it describes in this paragraph. In some instances, these circumstances might last for more than two years.
3.99, 3.150	We note that the CC dismisses FD or equivalent salaries as a way to measure the opportunity cost of time, but does not provide an alternative measure. This is not sufficient for a proper proportionality assessment. As it stands, and under the FRC's proposals, it is the AC's choice to decide when it goes out to tender for its audit. This allows an AC and FD to manage their portfolio of responsibilities and the CC has no evidence to show that ACs' and FDs' time are not already fully stretched. Not to take into account the costs of additional tenders is to

[177] Case studies G, M, N and S.

	suggest the marginal cost of an AC's or FD's time, is, effectively, zero. Furthermore, if this activity distracts the AC or FD from other important matters, the CC needs to consider the risk of other detriments arising from this distraction. Finally, insofar as this adds to the responsibilities and time commitment required for these roles (particularly part time non-executive directors) companies will have to increase remuneration. This is another cost the CC has not properly included in its assessment.
3.101	We maintain our view that a requirement to go out to tender every five years would be counterproductive. We also note that a number of companies agree with that assessment.
3.108, 3.149(c)	We are pleased the CC has recognised that the number of firms participating in tender processes is likely to decrease given the opportunity cost of resources required to bid. This undermines the CC's suggestion that its mandatory tendering remedy increases companies' bargaining power and choice.
3.109, 3.118, 3.149(c), 3.150(c)	We are pleased the CC recognises the payoff for participating in an audit tender under mandatory tendering is lower due to the decreased likelihood of switching, and, therefore, fewer firms may be invited to tender/ may accept invitations to tender than do currently. This undermines the CC's suggestion that its mandatory tendering remedy increases companies' bargaining power and choice.
3.110	The CC's argument is circular. It appears to be saying there is an incumbency advantage, but because of that advantage other firms will compete to try to win the new engagement (in order to obtain that advantage the next time around). We are not aware of any sound economic theory for this argument. Rather, economic theory clearly shows that incumbency advantages, all else being equal, reduce participation in tenders (auctions).
3.111	We disagree with the CC's argument in this paragraph as we set out in paragraph 3.3.16 of the main text of this response.
3.112, 3.113	These statements were made in relation to the current frequency of tenders, under the FRC's proposals. Moving to tendering every five years is likely to change this as issues of independence and conflicts will become far more difficult to manage with more frequent tenders. We disagree that a *"refusal to participate"* can be considered a high risk strategy when companies are unlikely to be genuinely considering changing audit firm, as we set out in paragraph 3.3.16 of the main text of this response.
3.115	There is a considerable amount of conjecture in this paragraph on the CC's part. It has no evidence to suggest that independence and NAS conflicts will not need to be addressed before a tender process, as we discussed in paragraphs 3.3.20 and 3.3.21 of the main text of this response. For example, our proposal for [✂], submitted to the CC as an attachment to the tender database refers to having to restructure certain NAS engagements to make them compliant with independence rules or resigning engagements in some instances. Further, this evidence corroborates the our view reported by the CC in paragraph 3.114 that "no firm participating in a bid would offer new prohibited NAS until it knew whether or not it had been successful in the tender audit process". Furthermore, the CC's expectation that NAS contracts may not be awarded to a preferred

	bidder when it may later restrict the choice of auditor is likely to create unnecessary detriment in NAS markets through reduced competition.
3.117(b), 5.24	We do not understand the basis for the CC's dismissal of the widely held view that high quality audit partners are in short supply, just as any high quality senior staff are a scarce resource in any other profession.
3.123, 3.124	As we stated in our response to the Provisional Findings[178], we and other audit firms have accepted significant risks in investing heavily to improve our offer. Mid-tier firms are invited to around a third of competitive tenders for FTSE350 companies, and the mid-tier firms that choose to invest outside of tender processes are more likely to be invited to subsequent tenders. As such, we believe the mid-tier firms already have enough incentives to invest, and we have provided a number of examples of UK-centric companies that would provide a useful starting point for these investments.
3.129, 5.25	This is not a fair representation of the case studies. Six companies stated that the costs were manageable. However, we note that four companies thought the process was very costly. Further, the evidence in Appendix 2 shows the substantial costs that are required for the largest and most complex companies to conduct a tender. As a result, the CC is incorrect to draw its conclusions in paragraph 5.25.
3.138, 5.25	Our comments quoted in paragraph 3.138 of the Provisional Decision on Remedies relate to the current situation of companies not being mandated to tender at any set interval. That does not imply that the current incentives on companies will continue to apply in a situation where companies are forced to tender their audit every five years. In such a situation, a tender outside of the set intervals is a much clearer signal of dissatisfaction with the current audit firm, than is a tender under a proper comply or explain regime. For this reason, companies may be less willing to tender outside of set windows. At the same time, those tenders that do occur at the mandated intervals are a far less clear signal of a company's intentions, in particular to its incumbent audit firm, and therefore a less credible threat to change audit firm.
3.142	The CC considers that its remedy provides *"a mechanism for the dissemination of information that reduces the amount of time that management spend in educating rival audit firms"*. The CC should clarify what information it is considering, and how that will reduce the time required for companies to educate a rival audit firm.
3.143, 3.144, 3.145 (a) (b) and (c), 3.149(d), 3.163	We welcome the principle of this element of the remedy, but there are considerable practical difficulties that the CC needs to consider fully. The CC recognises the risk to audit firms that disclosure of the audit file gives access to commercially sensitive information, and this is likely to reduce incentives to innovate. However, the elements of disclosure it presents in paragraph 3.145b) and c) in particular we would regard as commercially sensitive and should not be disclosed to rival audit firms. The CC's proposals are not clearly set out – for example, whether the incumbent audit firm can refuse a request or negotiate on the scope of the information disclosed and who makes the final decision as to what will/will not be disclosed. In addition we note that the mechanism used is to require disclosure to the AC for dissemination to other audit firms. In this context the CC needs to understand that the detailed audit papers are never normally disclosed to the audit client as that would threaten the

[178] Section 4.3 of KPMG's response to the Provisional Findings.

	integrity of the audit process which relies to some extent on conducting audit tests in a way that the client does not anticipate. This concern is clearly articulated in A12 of ISA 260 in relation to forthcoming audits the intentions for which may clearly be inferred from past practice.
3.149	By selecting mandatory tendering every five years, the CC dismisses concerns raised by investors, FTSE350 companies, ACCs and FDs, the audit regulator, UK industry bodies, international regulators, international industry bodies, individual respondents and the largest four audit firms. These are dismissed in favour of the views of a small number of mid-tier audit firms and a limited number of other investor groups, even the latter of which are not wholly supportive of the CC's proposals as we have noted in paragraphs 3.4.7 to 3.4.10 of the main text of our response. The CC has not explained here why the benefits it presents in (a) through (e) would not arise under the FRC's measures, nor why they would be greater under its five year mandatory tendering approach. The CC has therefore provided no evidence for the five year timeframe. We discuss this in more detail in sections 3 and 4 of the main text of this response.
3.149(d)	The CC has not provided adequate evidence to suggest that mandatory tendering every five years will further reduce the perception of a familiarity threat, on top of the existing measures for AEP rotation. We note that the FRC consulted heavily on this matter, concluding that five year AEP rotation was the optimal period to address this particular issue.
3.151	The CC notes that *"in our judgement we consider that these (perceived benefits) will significantly exceed the incremental costs of tendering every five years"*. As noted in section 4 of the main text of this response, the CC's cost/benefit assessment is in many cases inadequate and based on unsubstantiated assumptions rather than a thorough analysis and comprehensive projections. This is an inappropriate basis upon which to conclude that the remedies proposed are effective and proportionate in addressing the alleged AEC and detrimental effects. Further, the CC has not provided any evidence which supports its hypothesis that the increased frequency of tendering that will occur with the implementation of Remedy One and Remedies Two to Seven delivers any benefits beyond those that will accrue with the implementation of Remedies Two to Seven and the current FRC regime.
3.152	In our view the CC's £30m is an underestimate (for the reasons outlined elsewhere and in section 3 and 4 of the main text of this response). The CC has not shown there are any benefits that compensate these costs, as we set out in section 3 of the main text of this response. The CC also fails to provide evidence to substantiate its view that these costs will decline from an initial £30m to £10m overall. We note that the total annual audit fees of £800 million that the CC refers to in fact include audit-related fees.
3.154	The FRC concluded that tendering every 10 years on a "comply or explain" basis best promoted UK audit quality and corporate governance. The CC has not properly articulated why it feels justified to go further than these measures, as we set out in section 3.4 of the main text of this response.
3.156	There is no evidence to suggest audit firms have overstated the costs associated with tenders

	or that with familiarity these costs will reduce.
3.158	We agree with the CC that the costs to these firms will be much higher. However, we do not agree that the benefits will also be much higher as we set out in section 4 of the main text of this response.
3.167	We see no grounds for the CC as a competition authority to introduce a measure on the basis that it represents *"good corporate governance"* when the regulator specifically charged with this responsibility (the FRC) has concluded otherwise.
3.191	As already pointed in our response to the Provisional Findings[179], reputation is not the reason why mid-tier firms lack substantial market share in the FTSE350. Rather, it is their lack of expertise which has arisen from a failure to invest to the same degree as the largest four audit firms. The CC has not addressed our comments in relation to the capabilities of mid-tier firms.
3.228	In assessing the cost of increasing the frequency of audit file reviews, the CC has not recognised the additional cost required from audit firms to assist the AQRT with queries and the need for firms to engage with the AQRT over other issues. This 'cost' is both in terms of the monetary cost involved and more importantly in the inevitable distraction of senior personnel (including in particular audit engagement partners) from performing current audit work. We do not regard these costs to be substantial but they should not be ignored, particularly in view of the potential cumulative impact of the CCs proposed remedies. In addition, we note that the cycle of tendering that the CC has suggested in its mandatory tendering remedy, in combination with the frequency of AQRT reports is unlikely to work. Under the frequency of AQRT reports suggested under this remedy, and the timing of mandatory tendering periods, not all companies would receive an AQRT report prior to their mandatory tendering window. In our view this further supports the 10 year time frame proposed by the FRC which would ensure all companies received at least one AQRT report on their current auditors before being required to tender, and would encourage tendering in advance of the FRC proposed period if the AC believed the AQRT indicated quality failings by the incumbent audit firm that could not be rectified otherwise.
3.248	We welcome the CC's decision not to make any recommendation in relation to the scope and the content of the AQRT reviews, which we think in general work well.
3.326, 3.327, 3.338	We welcome the CC's view that the voting remedies would not be effective and its decision not to pursue them. As noted in section 5.3 of the main text of our response the CC could give consideration to requiring the company's policy on audit tenders to be disclosed in the AC report which would have the effect of bringing it within the scope of the proposed advisory vote.
3.377	We agree with the CC's view that the proposed remedy (i.e., strengthening the accountability of the External Auditor) does not address its provisional AEC finding.

[179] See section 4.4 of KPMG's response to the Competition Commission Provisional Findings.

3.387	The CC incorrectly describes The Chartered Financial Analyst Society of the UK (CFAS) as an investor group. It is, as the CC correctly denotes in Appendix 3.6, a group of analysts[180].
3.406	The arguments presented in this paragraph imply that the CC agrees with higher fees being associated with higher quality, a point that we have previously made in our submissions in particular in response to the CC's working paper on "Review of evidence on the price effects of switching"[181]. It must therefore accept the arguments we made in relation to that issue in that response. We note that the CC implies that the FD would accept a lower quality audit to obtain a lower price but has no good evidence that this occurs in practice.
3.418	The CC assumes an incremental cost of £30,000 per company provides an indicative size of the cost of the remedy. However, the CC does not provide any indication regarding how it derives this figure. In addition, the CC compares the total cost of £10.5 million per year to the profit, turnover and market capitalisation of the companies concerned when considering the cost of the remedy. As already discussed in our comments on paragraph 1.24 above, this is not a relevant benchmark. The relevant benchmark is the benefit that the remedy delivers.
3.427	As discussed in our response to the Provisional Findings[182], we do not agree with this conclusion.
3.473	As with other remedies in its Provisional Decision on Remedies the CC is unclear and it does not attempt to provide at least an upper bound estimation of the possible cost of the remedy.
3.523	The CC argues, in relation to remedy Seven that it does *"not envisage that this remedy would cause the FRC to incur significant additional cost"*. However, as pointed out by the CC in paragraph 3.503, the FRC *"had concerns about the cost implication"*.
4. Remedies we are not minded to pursue	
4.1, 4.58	We welcome the CC's recognition that mandatory rotation, by excluding the incumbent from participating in the tender, has an adverse effect on competition. We support the CC's provisional view not to pursue such a remedy.
4.11	The CC proposes that mandatory rotation might be introduced as a complement to mandatory tendering *"if there was an expectation that mandatory tendering would be ineffective or not fully effective"*. In the CC's view, one possible application of mandatory rotation might comprise of requiring companies who haven't changed auditor for more than a certain number of mandatory tender periods (two, for instance). This proposal contradicts one of the CC's arguments that mandatory tendering, as opposed to mandatory rotation, allows the AC to decide to retain the incumbent auditor if it believes that it is in the best interests of shareholders.[183]
4.22	The CC acknowledges that FTSE350 companies believe that the AC should decide whether or not to tender their company's audit, a view which is inconsistent with Remedy One. We

[180] Paragraph 2, Appendix 3.6 to the CC's Provisional Decision on Remedies.
[181] See section 2.3.3 of KPMG's response to the CC's working paper "Review of evidence on the price effects of switching".
[182] See section 2.6 of KPMG's response to the Competition Commission Provisional Findings.
[183] Paragraph 3.50 of the Provisional Decision on Remedies.

	note this is precisely the objective of the 'comply or explain' provision in the FRC regime.
4.19, 4.56	The CC finds that mandatory switching would undermine the role of the AC, as it would not allow them to decide for themselves what is in the best interest of shareholders. The same applies to mandatory tendering, since ACs will have to hold costly tender events even when they conclude that it would not be in the best interests of shareholders to do so – or else will not incur the full costs and reduce the tender to a 'box-ticking exercise'. There is no logical basis for allowing ACs to exercise their decision on choice in the best interest of shareholders whilst at the same time denying them the ability to determine when to exercise that choice through a tendering exercise.
4.41	According to the CC, one of the benefits of mandatory switching is that *"the investors could place more trust in the assurance provided by the audit report to the extent that any mistrust is based on the long tenure engagement"*. It is not clear on which grounds the CC makes this statement. First, many investors have expressed concerns over mandatory rotation and so it is not clear that such a remedy would increase investors' trust in statutory audit. Second, the CC has failed to provide any evidence on the link between audit outcomes and the longevity of engagements. Finally, in this statement the CC ignores the substantial risk to audit quality that is associated with mandatory rotation (and which would therefore also reduce perceptions of audit quality). Such a risk to audit quality risks giving rise to substantial costs across the UK economy, as we set out in our response to the CC's Remedies Notice[184].
4.65	We welcome the CC's recognition that mandatory rotation, by excluding the incumbent from participating in the tender, weakens the strong incentives that the incumbent auditor normally has to retain the audit.
4.66	The CC's statement that its proposed remedies package addresses the AEC *"more effectively while delivering similar benefits"*[185] is confusing. The CC appears to concede that there are benefits in mandatory rotation and that such a remedy would be at least partly effective in remedying the AEC it has believes it has identified. The CC has provided no robust evidence to support either of these views, and we think it is important that the CC clarifies that any measure that clearly reduces competition (as the CC acknowledges) cannot possibly remedy an AEC and deliver benefits that might be associated with increased competition. In the absence of such a clarification the CC's conclusions will clearly be vitiated by a profound logical inconsistency. As set out in response to paragraph 4.41, the CC has no evidence to suggest that mandatory rotation would improve investors' trust in or perceptions of UK audit quality and corporate governance. The CC also appears to suggest that changes of audit firm that are not in the best interests of shareholders will still give rise to benefits[186], albeit lower benefits than are associated with its current remedies package. The CC can have no basis for such a view. Instead, switching audit firm when this is not in the interests of shareholders gives rise to substantial costs, including

[184] Section 4.2.6 of our response to the Remedies Notice.
[185] Paragraph 4.66 of the Provisional Decision on Remedies.
[186] Paragraph 4.66 of the Provisional Decision on Remedies, last sentence.

	as a result of the greater risk of audit failure in the first years of an audit (as we set out in our response to the Remedies Notice[187]) and, compared to the existing FRC regime, does not realise any benefits for shareholders.
4.84	We do not agree that executive management determining a company's NAS distorts demand.
4.87	In this paragraph the CC refers to the view of one AC that *"further restrictions on the provision of NAS by the auditor would enable firms other than the auditor to establish relationships with companies and to give the other firms the opportunities to develop the right skills for working with the sector concerned"*. In our response to the Provisional Findings[188], we discussed that there is nothing that prevents this from happening already and it is a widespread practice in the market – the CC has provided no evidence to contradict our view.
4.93	We welcome the CC's recognition that current regulations do not prohibit joint audits and that their use is limited because they are not preferred.
5. The proposed package of remedies: effectiveness and proportionality	
5.4	We have set out above and in the main text of this response that we do not consider that mandatory tendering will increase a company's bargaining power, reduce any barriers to entry or expansion or lead to improvements in audit quality or shareholder engagement or perceptions.
5.12	See comment to 3.13(b)
5.24	In this paragraph the CC argues that the number of tenders in the short to medium term after the introduction of the remedies will be *"relatively small [...] in comparison with the number that we expect to be held under the current FRC guidance"*. However, in paragraph 3.173 the CC stated that it estimates *"around 15 to 17 firms per year tendering over the transitional period of five years as compared with a situation of compliance with the FRC's guidance"*. This increase cannot be considered small and will involve substantial cost. The CC also argues that the transitional phase would give firms and companies sufficient time to hire appropriate resources. As discussed in paragraphs 3.3.19 in the main text of this response, we disagree with this statement because the resources needed to carry out tenders require specific skills and considerable experience. People with such a combination of experience and skills are a scarce resource in the market. As we also point out in paragraphs 3.3.19 and 3.5.4 of the main text of this response it is not just a question of substitutable/additional resource but the ability of the same key resources to do multiple tasks at the same time. In addition to the points above, the CC concludes that the benefits of the remedy could be substantial. We have set out in section 3 of the main text of this response that we do not consider there to be any demonstrable benefits from the mandatory tendering remedy.
5.31	As noted in section 3.2 of the main text of this response, the CC has not provided any

[187] See section 4.2.5 of KPMG's response to the CC's Remedies Notice.
[188] Paragraph 4.3.3 of KPMG's response to the Provisional Findings.

	evidence that tender events themselves drive competitive outcomes.
5.38	We fail to see how the CC has arrived at the conclusion, even disregarding our serious concerns on the CC's analysis of the benefits of the remedies package, that it will have a substantial impact in two to three years' time if there are few additional tenders in the first one to five years[189] and the increased role of ACs is not fully delivered for three to five years[190].
5.47	We agree with the CC's view that the introduction of the remedy package would increase audit fees. However, we believe the primary driver of this increase will stem from the unnecessary cost burden mandatory tendering places on companies and audit firms.
5.50	We do not believe that the CC has carried out the proportionality assessment properly as we discuss in section 4 of the main text of this response.
5.55	It is misleading to suggest that the CC's mandatory tendering remedy maintains the "comply or explain" principle. It allows companies to explain for only two years in addition to what is already an unreasonably short timeframe, and is not in keeping with the general comply or explain principle in UK corporate governance.
5.56	As set out in section 4 of the main text of this response we do not agree that the CC's remedies package is no more onerous (or intrusive) than is required to address the CC's alleged AEC.
5.63	In this paragraph the CC argues that *"the most important effect of our proposed remedy package will be to increase confidence in the quality of the audit product"*. However, we set out in section 2 in the main text of this response that there is no evidence that quality is lower or perceptions of quality are lower than what would be expected in a well functioning market. Nor is there any evidence for the CC's contention that, incorporating their proposals on mandatory tendering, the package will have this effect. Indeed given a number of the concerns expressed by investors it might well achieve precisely the opposite.
5.67	As we noted in section 3.3 in the main text of this response we do not think that the CC's mandatory tendering remedy will increase companies' bargaining power or increase competition. It is likely to have the effect of reducing the quality of competition in the reference market.
5.68	It is not clear on what basis the CC considers the possible benefits resulting from the remedies package *"considerable"*, when it has not sufficiently quantified or indeed even evidenced them. We do not think that there will be any benefits from mandatory tendering, as we set out in section 3 of the main text of this response.
5.69	As noted in section 3.4 of the main text of this response, there is no evidence that the tendering requirements over and above the FRC will have any positive effect on corporate governance. Indeed, the FRC, the body with a specific corporate governance mandate, was not of the view that tendering every five years would have a positive effect on corporate

[189] Paragraph 5.24 of the Provisional Decision on Remedies.
[190] Paragraph 5.33 of the Provisional Decision on Remedies.

	governance and in its most recent response to the CC expressed serious concerns with the CC's proposed mandatory tendering remedy[191].
5.74	As already discussed in section 3.2 of our response to the CC's Remedies Notice, we highlight that the costs that certain companies would have to incur as a consequence of mandatory tendering are extremely high. The CC does not address this point and at the same time does not provide any evidence to support there being possible efficiency savings from the tender process.
5.76	It is not clear why the CC based its cost estimates only on PwC and Deloitte data. Similarly, as discussed in relation to paragraphs 3.81 and 3.82 above, it is not clear why the CC presented its figures in 2005 prices, when it would be more appropriate to present them in terms of the most recent prices available.
5.78	In this paragraph the CC assumes that companies will be less receptive to marketing from non-incumbent audit firms outside the prescribed tender window. We see no basis for this assumption.
5.86	Given the adverse reaction to the CC's proposals from companies, in particular to the mandatory tendering remedy, an additional adverse effect that the CC fails to take into account is the reduction of the attractiveness of the UK as a place to list.
5.91	We set out our concerns with this analysis in sections 3.4 to 3.5 and 4 of the main text of this response.
Appendix 1.1 - General Comment	There are 15 companies in the CC's case studies. A number of these, specifically those that the CC chooses to focus on, had chosen to tender. We would expect these companies to have lower costs of tendering and the expected benefits of tendering exceed the expected costs. As such, there is selection bias in the data. The CC should not infer that the views of these companies around the cost of tendering can necessarily be applied to all companies in the FTSE350.

[191] Pages 2 to 6 of the FRC's response to the CC's Provisional Decision on Remedies.

KPMG

Appendix 2: Additional information on recent tenders

1 Introduction and summary

1.1 We have gathered further information on the costs of recent tenders, which were conducted after we submitted the information that was requested by the CC for its tender database (and therefore not included in that database). We have obtained information on the cost and process involved for the tenders we have participated in (and in some cases continue to participate in) for HSBC, Compass Group, ENRC and Standard Chartered Bank.

1.2 We note that our estimates of costs of tenders in this annex refer only to the costs of audit firms, and not to the costs of companies, which will in our experience be similarly substantial.

2 Tender costs in current and recent tenders

2.1 HSBC

[✂]

2.2 Compass Group Plc

2.2.1 Compass Group Plc ("Compass") operates in 50 countries, of which 49 require local statutory audit, and has a group turnover of approximately £17 billion. Given its global reach, with a significant proportion of its business overseas, Compass has a regional structure. As such, Compass requires audit partners in each region, who liaise with staff to coordinate regional finances ahead of reporting to the Group.

2.2.2 In its 2012 Annual Report, Compass stated that[192]:

"During the year, preliminary consideration was given to the potential impact of the proposed requirement by the UK Financial Reporting Council ('the FRC') and the European Union/Commission ('the Commission') to mandatorily retender auditors and to the provision of non-audit services by the Auditor.

Whilst continuing to monitor the proposed changes by the Commission in respect of auditor services and retendering, the Committee has recognised the changes made by the FRC from 1 October 2012 (including their proposed transitional guidelines issued

[192] Compass Group Plc, Annual Report, page 49.

just before the end of the financial year in September 2012) and currently intends to retender the audit during the financial year ending 30 September 2014."

[✂]

2.3 Standard Chartered Bank

[✂].

2.4 ENRC

[✂]