



21 March 2013

Our ref: ICAEW Rep 46/13

Inquiry Manager, Audit Market Investigation  
Competition Commission  
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Southampton Row  
London  
WC1B 4AD

By email@ [auditors@cc.gsi.gov.uk](mailto:auditors@cc.gsi.gov.uk)

Dear Sirs

**Competition Commission Statutory Audit Services Market Investigation**

ICAEW is pleased to respond to your request for comments on the *Notices of provisional findings and possible remedies* in respect of the above investigation.

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours faithfully

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## ICAEW REPRESENTATION

### COMPETITION COMMISSION STATUTORY AUDIT SERVICES MARKET INVESTIGATION

Memorandum of comment submitted in March 2013 by ICAEW, in response to the Competition Commission Notices of Provisional Findings and Possible Remedies in respect of its investigation into Statutory Audit Services, published in February 2013.

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## INTRODUCTION

1. ICAEW welcomes the opportunity to comment on the *Notices of Provisional Findings and Possible Remedies* published by the Competition Commission in February 2013 (and subsequent related reports), copies of which are available from this [link](#).

## WHO WE ARE

2. ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter, working in the public interest. ICAEW's regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 140,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained. Our members include auditors, investment managers, audit committee chairs, finance directors and others involved in the corporate reporting chain. We are well placed therefore, to comment on these proposals.
3. ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.
4. As part of our technical policy work, ICAEW has been running a campaign to reassert the value of audit and assurance. This has focused on explaining what audit is there to do, as well as how the audit profession is changing to meet new stakeholder expectations. There are four strands to this campaign:

**Educate people about the role and value of audit:** This strand is about addressing expectation gap issues and is being run through a website we have created and populated called [trueandfair.org.uk](http://trueandfair.org.uk).

**Demonstrate the distinct insight auditors can provide on the economy:** This strand takes the form of a series of quarterly 'sector reports' the first of which, on the retail sector, was launched in January. These reports draw on the expertise of auditors working in particular sectors to identify key trends and challenges in those sectors.

**Assert the value and importance of assurance:** We have launched an assurance source book supported by case studies to explain the role assurance can play in helping assess company performance across a range of areas.

**Explore how the audit profession needs to evolve:** This strand of the campaign is being led through our *AuditFutures* project which brings together a broad range of stakeholders to develop ideas about how audit needs to evolve to better serve society.

We are also heavily engaged with the European debate on audit as well as providing input to the Parliamentary Commission on Banking Standards which has been taking a keen interest in audit.

## KEY COMMENTS

5. In responding to your provisional findings in respect of the large company statutory audit market, we have sought to gather views from across our membership on the substance of those findings as well as the remedies proposed.
6. In the short period we have been given to respond it has not been possible to make a detailed assessment of the evidence base you present. Where we comment on proposed

remedies it should not, therefore, be inferred that we agree that the evidence base supports the adoption of these remedies (see appendix).

7. The accountancy sector is critically important to the UK economy. There are some 300,000 professional accountants in the UK. It makes a significant contribution to the UK balance of payments and it has been one of the key factors in helping the financial and professional services sector become a world-leading industry – responsible today for around 13% of UK GDP.
8. Audit is an important component of the work this sector undertakes, helping build trust in the quality of corporate reporting and confidence in the way in which companies present themselves to market.
9. Ensuring more choice across the listed audit market is an important objective and one we support.
10. We believe however that market choice can only be broadened if boards and their audit committees take into account the quality and talent to be found outside the major accounting firms. While the removal of Big 4 only clauses will go some way to addressing this issue, audit committees need to be open-minded about the high quality auditing that is being performed beyond the largest firms.
11. More broadly, we are concerned that these interim findings will do little to underpin confidence in the current UK Corporate Governance Code. At a point where the UK Government, Financial Reporting Council (FRC), ICAEW and others have been actively making representation in Brussels in support of our corporate governance framework, which includes a comply or explain approach, these interim findings do little to instil confidence in a regime which is widely regarded as market leading. As the FRC makes clear on its website *'high quality corporate governance helps to underpin company performance (and) the UK has some of the highest standards of corporate governance in the world.'*
12. That is not to say we should not be open to developing this framework to ensure it remains market leading. Work is already in hand through the FRC on a number of the areas addressed in your interim findings and where this is the case we believe the FRC, supported by professional bodies like ICAEW, should be given the time and free rein necessary to assess the impact of this activity. For example, the FRC introduced changes to the Corporate Governance Code last year to enhance audit committee transparency and the frequency of tendering and we have yet to see what effect this has on market concentration and choice.
13. We welcome the fact that the interim report found no evidence of anti-competitive behaviour in the audit market. We also agree that it is in the public interest to ensure that audit creates transparency and that auditors act in the best interests of shareholders, who need to heed this report and become more engaged in the audit process.
14. Specifically we would support, among other things:
  - Increased authority for audit committees to help in their role as custodians of the audit relationship on behalf of the shareholders. This would cover: the selection, retention or removal of auditors (including the tender process); negotiating audit fees; and the management of the audit process.
  - Better general information about the quality of competing audit firms, based on the AQR process.
  - A more streamlined tender process on a 'comply or explain' basis that does not place undue cost on smaller firms trying to break into the listed company market.
  - Greater dialogue between audit committees and auditors.
  - Increased opportunities for auditors, audit committee chairs and investors to discuss issues in appropriate forums (recognising the challenges of achieving that, of course).

A number of these points are already in the Corporate Governance Code and we believe that robust application of the Code should support the Commission's intent.

15. We believe that the points above should lead to more tenders based on the FRC's comply or explain regime.

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## APPENDIX

### POSSIBLE REMEDIES

**A1.** ICAEW members operate in a wide range of fields and different sizes of organisation, both as users and providers of audit services. Our observations in this appendix, on the possible remedies, are based on considerations of whether they will impact upon audit quality or whether they are likely to achieve any enhancement in competition. It should not be inferred from this commentary that we agree with the evidence base for the introduction of these remedies.

#### 1. MANDATORY TENDERING

**Comment 1 - Views are invited on the specification, effectiveness and proportionality of this remedy and, in particular, on the following:**

- (a) What an appropriate time frame for requiring mandatory tendering might be, given the bounds suggested above?**
- (b) Whether and for what reason the measure may be subject to ‘comply or explain’ implementation?**
- (c) How a valid ‘tender’ and its constituents should be defined, including whether and how best to provide access to relevant information on an ‘open book’ basis?**
- (d) What costs and benefits would arise as a result of this remedy?**
- (e) What should be the requirements for phasing in this remedy? For example, those companies with the longest period since last tender may be required to tender first within a specified period.**
- (f) Whether there are any other relevant considerations to be taken into account in evaluating and implementing this remedy?**

- A2.** The notion of mandatory tendering has been raised by, among others, the European Commission (EC) and the FRC. ICAEW has supported a more frequent, within reason, tendering process, on a comply or explain basis. However, it is important to consider this alongside measures to improve the auditor selection process. The whole issue of whether shareholder/audit committee perception of different firms matches their actual suitability needs to be addressed. In isolation, an over-detailed requirement for mandatory tendering could well result in some audit firms being invited along solely to make up required numbers. This would merely result in significant extra costs, with no clear benefit in terms of opening up the market.
- A3.** The invitation to tender document that might be produced may include so many obligations and attributes within it that it might automatically exclude the firms that such a process was meant to get engaged. This is discussed further under Comment 4 below.
- A4.** We supported the FRC proposals to introduce tendering for the FTSE 350 every ten years on a comply or explain basis. Ten years fits in with the current requirements of the FRC’s auditor independence provisions for the engagement partner to rotate every five years. These proposals were introduced into the Corporate Governance Code in 2012. It is too early to assess whether the comply or explain provisions will have an effect and they should be given time to bed down. We do not support the Commission’s view that a comply or explain option would be inappropriate: in our view the Commission is underestimating the power of disclosure to shareholders and the value of having ‘explain’ as a genuine alternative to ‘comply.’ In addition a comply or explain approach at least partially recognises that any fixed period is by definition somewhat arbitrary and not suitable for all companies. This is because the cost/benefit relationship will vary from company to company and will be dependent on factors such as size, industry, and date of last change. The FRC’s approach may assist competition without imposing cost on companies and auditors for the sake of it.
- A5.** The proposals for open book access are an interesting idea to reduce potential cost to companies, but we would be concerned if such an approach led to a stifling of innovation or

an increased focus on cost rather than audit quality. The impact might also be limited if a reduction in pre-tender engagement reduces their ability to assess the potential auditors. Clearly there are potential issues of confidentiality (as required by the professional code of ethics), liability and commercially sensitive information and any requirements would need to bear these in mind.

- A6.** The Commission will be aware that EC audit proposals, currently under discussion in the European Parliament and EU Council of Ministers, include provisions on tendering. These provisions are complex and may not necessarily achieve the desired outcome – to encourage greater choice across the listed audit market. Proposals in this area must not fall into the trap of forcing smaller firms to tender simply to fill quotas rather than because they have any real prospect of success. In our submission on the EC’s Green Paper that preceded these proposals, we stressed that the process for the appointment of auditors should remain with the audit committee (AC), but envisaged some safeguards through enhanced transparency and the dissemination of sectoral information in highly specialised market segments such as banking and insurance.

## 2. MANDATORY ROTATION OF AUDIT FIRM

**Comment 2 - Views are invited on the specification, effectiveness and proportionality of this remedy and, in particular, on the following:**

- (a) What an appropriate time frame for requiring mandatory rotation might be, given the bounds suggested above and how this might relate to mandatory tendering periods if this were also to be pursued?
- (b) Should any such measure be subject to a waiver from the regulator (FRC) if a company’s choice of auditor was substantially constrained and how would such a waiver operate?
- (c) How a valid ‘tender’ and its constituents should be defined as a prelude to rotation, including whether and how best to provide access to relevant information on an ‘open book’ basis?
- (d) What costs and benefits would arise as a result of this remedy?
- (e) What should be the requirements for phasing in this remedy? For example; those companies with the longest period since last rotation may be required to rotate first within a specified period.
- (f) Whether there are any other relevant considerations to be taken into account in evaluating and implementing this remedy?

- A7.** ICAEW has considered the issue of mandatory rotation of audit firms on a number of occasions, as it has been raised frequently in the contexts of independence and competition. We do not, on balance, support mandatory audit firm rotation as in our view it will potentially limit choice for ACs by preventing them from choosing the firm they feel is best equipped to do the work, add to cost and cause practical difficulties without clear benefit. In addition, critically from our perspective, while academic evidence is not wholly conclusive, it tends to suggest a negative effect on quality in the early years of an appointment<sup>1</sup>.
- A8.** The draft EC legislation includes proposals on rotation and its own impact analysis suggests additional costs for public interest entities of between €10,000 and €67,000 each - but this excludes management time, which is a key consideration as the Commission notes.
- A9.** If mandatory rotation of audit firms is to be retained notwithstanding the apparent cost/benefit mismatch, at the very least a longer period would reduce the costs. As the Commission notes, there is an obvious issue with interaction with the FRC auditor independence partner rotation requirements of five years for the engagement partner and seven years for other key audit partners. Clearly if there were a compelling case for a particular period that does not dovetail with existing regulation, that would take precedence. However, in the absence of that, were there to be a mandatory rotation maximum period it would be useful to allow for

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<sup>1</sup> For example, *What do we know about mandatory firm rotation?* Ewalt-Knauer, Gold and Pott, ICAS, 2013, summarises the key academic findings to date.

such regulation. Most of the FTSE 350 will have international operations and the practical consequences of UK mandatory rotation would need to be fully considered, including international requirements on partner rotation; the *International Ethics Standards Board for Accountants Code of Ethics* includes a seven year rotation requirement for the engagement partner and other key audit partners.

- A10.** The Commission accepts that were a fixed period to be applied, there may be some circumstances where a change at a given time would be inappropriate and it is suggested that the FRC be able to grant relief. Arbitrary rules will result in unintended consequences – a reason of itself for not adopting them in such a black and white fashion. Where there is a rule it is right to allow for exceptional circumstances, but pre-clearance is not a process that the FRC or other regulators within the accountancy profession prefer to adopt. A better option would be to give guidance on the sort of circumstances that might be exceptional and allow temporary deferral, with full disclosure to shareholders, and an opportunity for them to disagree.
- A11.** Any requirement would need to consider transitional provisions in respect of companies that move in and out of the FTSE350.
- A12.** As regards application of an open book approach, we refer to our comments above under Comment 1.

### 3. EXPANDED REMIT AND/OR FREQUENCY OF AUDIT QUALITY REVIEW TEAM (AQRT) REVIEWS

**Comment 3 - Views are invited on the specification, effectiveness and proportionality of this remedy and, in particular, on the following:**

**(a) How the AQRT's remit should be designed in terms of enhanced scope and frequency.**

**For example;**

- (i) How frequently should FTSE 350 company audits be reviewed (and whether this should differ between FTSE 100 and FTSE 250 companies)?**
- (ii) Should the AQRT be required to published FTSE 350 results separately from other Public Interest Entity results?**
- (iii) Should the AQRT be required to change the scope of its review and if so, how? For example; should the AQRT be required to revisit key audit judgements based on the information then available?**
- (iv) How could AQRT reporting be expanded to allow better comparison of Big 4 and non-Big-4 firms?**

**(b) How should any expanded remit of the AQRT be funded?**

**(c) What costs and benefits would arise as a result of this remedy?**

**(d) Whether there are any other relevant considerations to be taken into account in evaluating and implementing this remedy?**

- A13.** As noted above, in our view the perception of shareholders and ACs is key to any actual change in concentration and we therefore agree with the intent behind this proposal, to provide more information to help break down misperceptions.
- A14.** However, it is not clear to us that the FRC's current quality review process of auditors of FTSE350 companies is deficient in its coverage: the FRC itself is best placed to make that determination.
- A15.** As regards the proposal to increase publication of review findings, as a general rule we support increased transparency, as a means of enhancing dialogue and reducing misperception. However, although there are clear benefits and public interest drivers to increasing transparency and improving information provided to potential or existing audited businesses, this potential remedy should be treated with caution to ensure that unintended consequences do not result. It is likely to add extra work/cost into the process for all firms.

The net effect may be that additional transparency would be counter-productive, discourage new entrants into the market at the margins and reinforce the status quo.

- A16.** Caution should be exercised in terms of increased granularity. The willingness of firms to accept identified shortcomings of a subjective nature is significantly changed where the outcome is to be published. While in the short term this could be considered a beneficial outcome, in practice reasonable recommendations that could enhance the audit might be argued with, delaying reports, rather than simply implemented, and quality improvements applied far more slowly as a consequence. A side effect could be that arguable judgement points could be interpreted as more objective shortcomings, damage the reputation of the profession and weaken public confidence in the outputs.
- A17.** There is an important balance to be struck between enhancing the transparency of relevant information provided to shareholders and ACs and building and maintaining confidence in audits and auditors.
- A18.** We suggest that it would be better to ensure and explain rigorous and effective regulation and oversight and refer by exception to firms that have fundamentally failed to deliver against essential standards and action plans or respond to fair warnings.

#### 4. PROHIBITION OF 'BIG 4 ONLY' CLAUSES IN LOAN DOCUMENTATION

**Comment 4 - Views are invited on the specification, effectiveness and proportionality of this remedy and, in particular, on the following:**

- (a) The range of documents to which this prohibition should be imposed and how the prohibition could be best implemented. For example: are there documents in addition to Loan Management Association lending agreements that this prohibition should cover?
- (b) What costs and benefits would arise as a result of this remedy?
- (c) Whether there are any other relevant considerations to be taken into account in evaluating and implementing this remedy?

- A19.** ICAEW supports the removal of such anti-competitive clauses without reservation. Where they exist, they could be in a wide range of individually drawn-up contracts, not just LMA lending agreements and so any requirement will need to bear this in mind.
- A20.** In particular, reference is made by the Commission to tender documents, which if drawn too tightly in their requirements are as effective as the Big 4 only clauses in limiting competition, merely by replacing names with attributes. The warranties and guarantees themselves that form part of an invitation to tender may well be beyond the risk capability of any of the smaller firms particularly when dealing with FTSE 350 companies that operate in a number of countries.
- A21.** Whether the abolition of such clauses will have any practical effect will depend on, as with other matters, a recognition that quality exists outside the major firms.

#### 5. STRENGTHENED ACCOUNTABILITY OF THE EXTERNAL AUDITOR TO THE AUDIT COMMITTEE (AC)

**Comment 5 - Views are invited on the specification, effectiveness and proportionality of this remedy and, in particular, on the following:**

- (a) How this remedy could be practically specified and implemented? For example, what change to ACC availability and remuneration would be necessary for ACCs to take on an enhanced role effectively? How should this measure be specified to avoid circumvention?
- (b) Whether this remedy could be implemented as an extension to the current guidance on the role of the AC? How this could be implemented without affecting the current collective legal obligations of the directors of a company?
- (c) What costs and benefits would arise as a result of this remedy?

**(d) Whether there are any other relevant considerations to be taken into account in evaluating and implementing this remedy?**

**A22.** Proper accountability of the auditor to shareholders is a fundamental component of the audit quality process. Given the practical difficulties involved with auditor/shareholder engagement in a listed company, the AC has a critical role to play in acting on behalf of the shareholders, as custodian of the audit relationship.

**A23.** Measures to enhance dialogue between the auditor and the AC are welcome. Auditors will need to have discussions with the FD and other executive management as a matter of practicality. This does not mean auditors are less interested in communicating with the ACC, but the variability of audited entities in terms of size, AC composition, and the likely issues suggest that a very precise rule that 'x, y and z shall only be agreed between the auditor and the AC chair' might prove not to be optimal or indeed workable in all circumstances. For example, audit issues will usually involve a difference of opinion and so parties other than the AC will usually need to be involved at some stage.

**A24.** The AC will have a role to play in asking key questions, but their role is to oversee the audit relationship: not to re-perform the audit or behave in a management capacity. Auditors also have a responsibility to bring key matters to the AC's attention if management has failed to do so.

**A25.** We support, in principle, more information being made available by ACs about their discussions with auditors, to provide:

- more reassurance to stakeholders about the way in which ACs handle their governance responsibilities; and
- greater clarity around the nature of the judgements the board has made in the accounts.

It is important though, that additional requirements do not just result in more boilerplate disclosures.

**A26.** The matters discussed within this proposal overlap with issues dealt with by the Corporate Governance Code. We recommend that the proposal be passed as a general aim to the FRC in its role as custodian of the Code, so that it can consider and consult on proposals that would combine these requirements with a recognition of varying circumstances, in the most appropriate manner.

## **6. ENHANCED SHAREHOLDER-AUDITOR ENGAGEMENT**

**Comment 6 - Views are invited on the specification, effectiveness and proportionality of this remedy and, in particular, on the following:**

**(a) What are considered to be the most effective means of enhancing shareholder engagement on audit and financial reporting issues?**

**(b) Suggestions as to how such means could be achieved.**

**(c) What costs and benefits would arise as a result of this remedy?**

**(d) Whether there are any other relevant considerations to be taken into account in evaluating and implementing this remedy?**

**A27.** We note that a number of investor groups indicated to the Commission that they have a clear interest in engaging with auditors. As a general principle we support dialogue and transparency. However, the report seems to extrapolate the indications received, to a presumption that shareholders in general want more engagement, and have the capacity to be involved with, auditors. This ignores the fact that 'shareholders' consist of varied groups with different interests and so the impact of enhanced shareholder-auditor engagement must be limited, especially as engagement other than via the formal means (the AGM) risks not treating shareholders equally.

- A28.** Remedies suggested here are intended to enhance the direct role that shareholders may play in governance matters. Some of these merit further research, including for example direct auditor presentation at AGMs. This will clearly interact with the suggested enhanced engagement between the ACC/AC and auditors, and the current important provisions in the Corporate Governance Code about the relationship between the ACC and shareholders. To ensure these remain connected, perhaps notions such as shareholder representation on the AC could be considered, though the process would need to be considered carefully: as commented previously, it is important that shareholders are treated the same.
- A29.** As with recommendation 5, we believe that the matter is inextricably linked with existing UK corporate governance arrangements and should best be referred, as a general aim, to the FRC as custodian of the Corporate Governance Code.
- A30.** We do not support requiring auditor re-appointment to be approved by an enhanced level of shareholder votes. Such requirements should be for fundamental issues of the corporate constitution. For the will of a simple majority not to be allowed to prevail in such a matter significantly undermines majority rights.

## 7. EXTENDED REPORTING REQUIREMENTS.

Comment 7 - Views are invited on the specification, effectiveness and proportionality of this remedy and, in particular, on the following:

- (a) How the CC may best support the FRC in establishing enhanced reporting and whether there are other avenues, including direct measures by the CC, that should also be pursued?
- (b) What should be the scope and form of enhanced reporting proposals? For example:
- (i) whether further disclosure should be made via the AC's report or the auditor's report;
  - (ii) what the content of the additional disclosure should be. For example, should this be some form of commentary as to how the company's interpretation of the accounting standards compares with the norm; or commentary on the main topics of debate between auditor and management; or something else; and
  - (iii) what guidance as to the form of the disclosure should be required.
- (c) What costs and benefits would arise as a result of this remedy?
- (d) Whether there are any other relevant considerations to be taken into account in evaluating and implementing this remedy?

- A31.** The content of and detail behind, audit reports, is a complicated matter subject to much debate over the years. It is inextricably linked with, amongst other things, the purpose of the audit, cost benefit considerations, and potential liability concerns.
- A32.** We are not entirely convinced that extended reporting is relevant to competition. However, it is relevant to an important issue in its own right: ensuring that audit continues to be aligned with the needs of shareholders. As the Commission notes, the International Auditing and Assurance Standards Board and the FRC are considering the issue and we agree that the matter should be dealt with by them.

## OTHER MATTERS

8 - The CC invites views on all these possible remedies which we are not minded to consider further and on any other possible remedies that we have not included in this Notice which interested respondents consider may be effective in addressing the AEC we have provisionally found. Where respondents are of the view that these remedies could be effective, they are asked to submit evidence to support their views and in particular provide views of the costs and benefits of the measures and any other relevant factors that they consider significant to the evaluation of the measures in addressing the AEC we have provisionally identified.

- A33.** As regards potential remedies not included in the *Notice of Possible Remedies*, as noted above, we consider the key to reducing concentration to be adjusting the perceptions of shareholders, ACs and others who are in a position to influence auditor choice. This is not new: we raised it in the 2005 Audit Quality Forum report *Shareholder involvement – competition and choice*<sup>2</sup>. Improving engagement between ACs and shareholders is critical to this. Firms looking to enter the large company audit market will need to be sure they can be judged on the merits of their case, so that they can invest the resources they judge necessary, to make an appropriate impact.
- A34.** We note that the Commission also does not advocate any measure in respect of liability limitation. Its published papers conclude that liability is not a major hurdle, and while we agree that medium and smaller audit firms are unlikely to take a decision not to tender based primarily on such concerns nonetheless anecdotal evidence from smaller firms indicates liability exposure remains an issue. Given that the Companies Act 2006 provisions on limiting auditor liability have proven to be ineffective, inevitably liability concerns will be part of the cumulative consideration that such firms will make. We believe unlimited liability also, at least partially, contributes to a view that larger audit firms are to be preferred as they are perceived to have ‘deep pockets’. It is important for the preservation of quality, that auditors be held accountable for the consequences of their own actions, but being held liable for other people’s actions will not enhance competition.

**9 - Views are invited as to whether any particular combinations of remedy options would be likely to be effective in addressing the AEC we have provisionally found. Views are also sought as to whether there are any particular combinations of remedies which are likely to interact adversely in reducing effectiveness or otherwise lead to undesirable outcomes.**

**10 - Views are invited on the nature, scale and likelihood of any relevant customer benefits within the meaning of the Act and on the impact of any possible remedies on any such benefits.**

**A35.** We have no comments on either of these points other than as noted in our observations above.

**A36.** We would be happy to discuss any of the points raised in more detail with the Commission.

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<sup>2</sup> <http://www.icaew.com/en/technical/audit-and-assurance/audit-quality-forum-aqf/shareholder-involvement>